The National Budget 2009

Advantage Dissecting the National Budget of 2009

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αdvantage asset managers

Investigating the impact – Advantage wraps it up

You've heard the budget, read the summaries and seen the economists' views. But what impact does this have on the markets and your investments? In dissecting the budget, we canvassed comments and opinions from numerous fund managers. Here are some of their views.

General Comments

Overall, there has been a very positive response to the budget, which was formulated in one of the most turbulent times, with the world economy facing the worst downturn since the Great Depression, and South Africa not spared the mayhem in the market. The budget, which was delivered by the Finance Minister, Trevor Manuel, on 11 February 2009, is considered to be more difficult than the previous 13 which the Minister, who has delivered more budgets than any currently sitting Finance Minister, has had to prepare during his term.

RMBAM

- "It is very heartening that the finance minister has stuck to a prudent fiscal policy, despite all the rumours that the government would adopt a "more populist" stance. This is a pragmatic budget that offers hope for better times ahead.
- The government has shown that they are prepared to deviate from their long term projections to adapt to changed circumstances.
- We are in an envious position. The good fiscal discipline over many years enables the government to adapt to the current trying times by running a high deficit to alleviate some of the stresses in the economy.
- The extent of borrowing by the government and state owned enterprises is significantly higher than in previous years. Despite this, overall government debt remains very low in comparison to global levels."

Orthogonal Investments

"Trevor Manuel is a very capable finance minister (in all likelihood, the best South Africa has ever had) and has once again delivered a wise budget, this time in the most difficult circumstances he has faced in this capacity. However, at Orthogonal Investments, we have regularly demonstrated the futility of macro-economics in managing active investment portfolios. We cannot recall many cases in 19 years in which the budget speech has had a meaningful impact on equity or bond markets."

Effect on Equity Markets

General Comments

Orthogonal Investments

"For equities, the effect on consumers from the deceleration in real GDP growth has been partially offset by mild stimulatory measures such as the perfectly predictable relief from fiscal drag (a feature of almost every budget speech) which leaves the consumer about neutral. The one year deferral of royalties payable by mining companies provides a smidgen of relief to those firms, but in the greater scheme, this has a negligible impact on valuation. So once again, the effect on equities is barely discernible."

Cadiz African Harvest Asset Management

"Today's Budget seems to favour the local equity market over bonds. A growth-friendly (more expansionary) budget in an extremely growth-unfriendly environment should offer some assurance on how deep the profit down-cycle is likely to go and how long the slump in earnings will last. At the same time, we do not believe that government's structural fiscal position has been seriously compromised or that our view for fairly aggressive monetary easing in 2009 has been derailed."

Infrastructure Spend – how will it affect the construction sector?

Investec Asset Management

"In short, the minister's budget speech was quite positive for the construction sector. The message from Minister Manuel was that SA needs to spend on infrastructure to build the platform for future growth. *Why is this significant for the construction sector?*

- The budget for infrastructure spend increased from R700bn to R787bn, being the total spend over three years.

- The increase in public sector spend bodes well for the construction sector as it is currently plagued by a slump in private sector activity. The additional spend targets areas where construction companies are most active in namely roads, rail and water infrastructure (amongst others).

- Further good news for construction companies, exposed to residential-type building, is the additional allocation of R45bn to government's Breaking New Ground housing delivery programme – which aims to build around 250,000 houses per annum.

- Government has also agreed to provide a loan guarantee for R176bn of Eskom's capex program, enabling the energy utility to source cheaper funding. The spin-off for the construction sector is that Eskom is now able to expand on its power generation programme at a faster pace. The larger construction companies should stand to benefit from the roads and civil engineering works required for large power station builds.

- This opens the way for Eskom to acquire USD5bn in World Bank funding, which will also provide key financing for the current account, with the cash probably spread over the next two years.

- Since the construction sector employs a significant number of SA's workforce, the spend goes a long to not only supporting the sector but also to alleviating SA's unemployment burden."

Foord

"… the infrastructure spend (which in 2007 amounted to below R400bn over the three year framework period) does not conclude with the 2010 world cup. This was reiterated with the announcement today, confirming that spending on infrastructure will total R787bn, of which R390bn will be by SOE. Again, it is unlikely that all this spending will be implemented, and delivery will lag the time frames indicated, but this is supportive of a longer GDFI cycle.

Today's announcement does not derail our view that construction companies will show good profit growth through the cycle. Order books remain full, and margins relatively high. But nonetheless, weaker companies across the market will struggle in an environment where growth will be lower, job losses may escalate and access to capital may become more expensive and harder to come by. Our focus remains on investing in quality companies with good balance sheets, and where their cash generation will enable them to survive, and grow their market share in this difficult time."

Mining royalty

Government will delay the implementation of the mining royalty tax until March 2010. This should go a long way to saving jobs in the Mining Industry.

Cadiz African Harvest Asset Management

"Minister of Finance, Trevor Manuel announced in the annual budget speech that the imposition of SA mining royalties will be deferred until 1 Mar'10, representing a reprieve of 11months. He stated that this will boost the mining sector by ZAR1.8bn to minimise job loss. Manuel "hopes" that this relief will contribute to constructive dialogue between government, the mining houses and labour, resulting in practical initiatives to mitigate the impact of expected retrenchments in the sector. Gold, iron ore and export coal producers are the big beneficiaries."

"Unfortunately, there will be little (in absolute terms) reprieve for the diamond and platinum companies that are facing huge margin compression. In terms of the formulae, we expect that the savings for the marginal producers in these sectors will be little more than the minimum 0.5% royalty on turnover."

Consumer Spend

In this budget the tax relief is substantially raised to R13.6bn. However, manager opinions are conflicted as to the direct impact this will have on the consumer.

RMB Asset Management

"Over the past two years the Minister has scaled down the extent of direct personal income tax relief (from R12bn to R8.4bn to R7.2bn) but in this budget the tax relief is substantially raised to R13.6bn. While this does not do much more than compensate for the effects of inflation, it does provide tax relief mainly to lower and middle income earners, particularly as the tax-free income threshold was raised. But do not get too excited, as the increase in the petrol levy will raise R4.9bn, the electricity tax is also to bring in an additional R2.8bn, and an increase in excise duties on tobacco products and alcoholic beverages (and other small indirect tax increases) is expected to yield a further R2.3bn. The overall tax reduction therefore only comes to R4.6bn, or less than 1% of the total revenue raised in FY2008/09. "

Coronation Fund Managers

"… the substantial tax relief to consumers and social assistance expenditure reflects a combination of efforts to support domestic demand and shield the poor from the worst of the economic downturn. We think this is prudent in the context of a global economic recession and is testimony to the sound fiscal policies implemented under the Manuel regime."

Effect on Bond Markets

RMB Asset Management

"The budget speech unfortunately confirmed our worst fears as bond investors. The Ministry of Finance was faced with a balancing act of huge proportions as they attempted to engineer a soft landing for the local economy, while at the same time ensuring that financial metrics on the government's balance sheet remain healthy enough to ensure credit rating stability and access to bond markets at an acceptable cost of funding.

Our view is that they have pushed the envelope slightly too far, especially with the acceleration in monetary policy easing coming through, and that the bond market will choke on the financing required in order to fund the substantial budget deficit projected for the next three fiscal years.

The deficit moves substantially weaker to peak at 3.9% of GDP, with the funding thereof resulting in a more than doubling in size of the weekly government bond auction. This is accompanied by very sizable public sector borrowing requirements from all the parastatals that are part of the infrastructure drive.

Put this all together, and investors will be spoilt for choice and may be overwhelmed by availability of bonds in the medium-term. This is not something unique to South Africa as most of the world is facing huge capital shortages and the need to fund very large deficits. The net result is upward pressure on bond yields with steeper yield curves as most of the issuance will be longer dated. This means a fairly circumspect outlook for the potential returns that bond investors can expect going forward.

There is a distinct possibility that South Africa's sovereign credit rating may be revised downward as balance sheet deterioration is even more pronounced after the government explicitly guaranteed R175 billion of Eskom debt over the next five years."

Cadiz African Harvest Asset Management

"While the financing requirement has been larger than expectations, the price action of long-dated bonds over the past month has discounted a large portion of today's announcement. With a significant amount of new bond issuance over the next two years, institutional investors can become more selective about entry levels. The scarcity premium on bond yields is reversing into a discount. The yield curve is therefore expected to flatten in coming months as long dated bond yields remain under pressure. A similar pattern is experienced by industrial countries, were the slope of yield curve have become more positive as a result of the massive funding requirements of the stimulus packages ahead. The directional view on bonds is unexciting at present although the valuation on long-dated bonds is not as stretched as in December 2008 or January 2009."

Foreign Exposure Limits

No Change to policy

In summary:-

Equity Markets

- While Rowan from Orthogonal Investments feels that budgets tend to have very little effect on the equity markets, Cadiz African Harvest Asset Managers commented that, in their opinion the budget favoured equity markets. (relative to bonds)

- The budget speech was positive for the construction sector, while the mining sector may benefit from the delayed implementation of the mining royalty tax.

Bond Markets

- RMB is concerned with the implications the budget speech had for bond investors with Cadiz commenting that an unexciting directional view on bonds currently prevails.

While the budget, delivered in these trying times for South Africans was well received, we cannot escape the impact of the global slowdown. It will in all likelihood be a very tough year for South Africans.

Similarly for our portfolio managers. To quote Rowan Williams-Short from Orthogonal Investments, "… the budget is quite an anti-climax for market analysts who must continue the difficult job of ascertaining fair value and for portfolio managers who must implement positions when prices deviate from estimates of fair value."

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