

## South Africa at a political crossroad

The political events of the last 10 days, and the resulting ratings downgrade by S&P Global Ratings, have seriously eroded investor confidence in South Africa, both domestically and internationally. Further downgrades from the other rating agencies are probable. The immediate consequence has been a weaker rand. Currency depreciation creates an environment which promotes higher inflation and higher interest rates. It imposes a cost on all South Africans and has disproportionately negative consequences for the poor because it increases the cost of petrol and food. In the longer run the erosion of business confidence has a cost in the form of less investment and slower economic growth.

At the time of writing, it is too soon to predict the final outcome of President Jacob Zuma's actions and the consequent pushback by his political opponents. However, the outcome of this struggle will have profound consequences for all South Africans.

Since 1994 ANC governments have managed public finances with prudence and discipline. In contrast to some other government departments, the National Treasury has developed a well-deserved reputation for integrity and competence. It has insisted that South Africa lives within its means and that public spending be rationally allocated. It has also actively fought against corruption. Recently it has increasingly found itself in conflict with the President and a significant sector of the ANC, who see its role as being very different. They seek to use government procurement to the advantage of constituencies and clients whose interests they wish to promote. They regard the Treasury as an unacceptable impediment to this agenda. They dislike the Treasury's strict monitoring of spending by other departments and parastatals.

This sector of the ANC seems unconcerned about the need for fiscal discipline. The most notorious example of this is the President's obsession with nuclear power. Despite its technical merits, for South Africa, nuclear power is unaffordable and unnecessary given that there are cheaper alternatives. The President is promoting a project which would involve expenditures which would permanently cripple the country financially, especially as it will create unaffordable foreign debts. To date the attitude of the Treasury has been that the nuclear programme will be conditional on demonstrable affordability. There are widespread fears that new Finance Minister Malusi Gigaba will succumb to the enormous political pressures to proceed with nuclear regardless of affordability.

Over the past four years there has been a growing conflict between two factions within the ANC, one of which believes in the long-established policy of fiscal discipline and controls and the other led by the President, which seeks control of the Treasury to promote their own very different agendas. In firing former finance minister Pravin Gordhan, the President is seeking to resolve this matter in his favour once and for all. The S&P downgrade was based on deep concern about this situation.

### Politics and economics intertwined

In recent years South Africa has run significant current account deficits. Its domestic savings are inadequate. It is dependent on capital inflows from abroad to pay for imports and to fund capital spending needed to promote economic growth. Current levels of capital spending are too low to shift the country to the stronger growth path needed to reduce widespread poverty. However, boosting economic growth requires continuing foreign investment. As a consequence of a long history of South African financial prudence, foreigners currently own more than a third of government debt, which is clear evidence of the Treasury's success in creating investor confidence.

In the wake of the downgrade, it will be up to Minister Gigaba to show that he is committed to fiscal discipline and to prove that South Africa can still be an investment destination of choice. One cannot spend one's way to prosperity with money one does not have. History is full of examples of countries that have tried to do just this and failed with disastrous consequences. The latest example of such failure is unfolding in Venezuela, whose economy is rapidly imploding. Only within a structure of prudent financial discipline can South Africa's social and economic woes be solved.

Minister Gigaba will be under enormous pressure from the political lobby close to the President to boost spending and abandon fiscal prudence. If he succumbs to such pressures South Africa faces a bleak future indeed. The recent history of Zimbabwe and Venezuela is a frightening warning of the dangers of following such a path. A successful finance minister is seldom popular. Whether Minister Gigaba succeeds or fails will depend on his willingness to resist such pressures regardless of any ensuing unpopularity.

### Impact on your portfolios

Our investment philosophy is to build a diversified portfolio of undervalued investments from the bottom up, so as to maximise the probability of real returns while limiting the risk of permanent capital loss. This philosophy has protected our clients' wealth during periods of uncertainty such as the present. We continually reassess risks and potential returns as circumstances change, making appropriate portfolio changes over time.

In your Balanced and Stable portfolios we converted some of the foreign exposure back into rands at attractive levels in early 2016, but these portfolios remain at their maximum offshore allowance, allowing the portfolios to benefit from global returns uncorrelated with events in South Africa. Our top 10 equity holdings contain several well-diversified global businesses whose earnings are generated offshore and not in South Africa. We also have investments in many solid local businesses that have proven that they can withstand shocks such as what we are going through currently. We shall look to add to these if their share prices are impacted by a widespread sell-off of domestic assets. It is this diversity of assets which aims to protect our clients against loss.