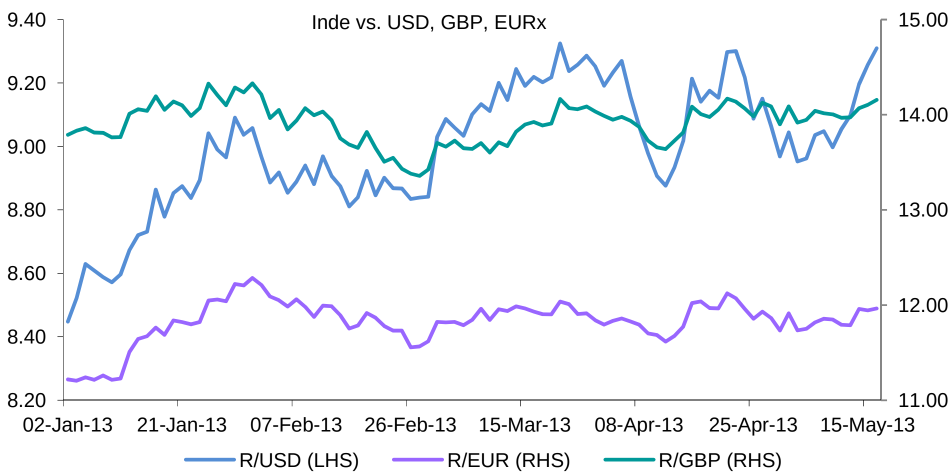
Rand quick note: strike action afflicts the rand as we move increasingly into the down case – the down case probability rises

17th May 2013

Figure 1: ZAR vs USD, GBP and EUR



Sources: SARB, Investec

The rand has weakened as foreigners sold off –R0.4bn in equities and –R0.7bn in bonds this week, driving the rand from R9.15/USD, R11.88/EUR and R14.00/GBP at the start of the week to R9.40/USD, R12.08/EUR and R14.30/GBP. International markets are very sensitive to any labour disruptions in the mining industry given the tragedy at the Marikana mine last year, where substantial violence and loss of life occurred. Police action on the 16th of August spoke to government repression with 34 dead, an image SA urgently had to correct in the aftermath, and one the authorities are currently being careful to avoid, not least with the negative impact it has on investor confidence. The problems in the labour market in SA's mining sector have increased operational costs, as has substantial government resistance to proposed retrenchments to rationalize the workforce in the face of rising costs, not least wages given the low degree of mechanization and high level of labour intensity compared to international models. The inability to price risk for SA corporates has risen and is not limited to the mines as labour rigidities, from difficulties to hire and fire, very low levels of flexibility in wage determination to low productivity levels compared to pay levels internationally, prevail. Indeed, the WEF ranked SA as the worst country in the world in terms of cooperation in labor-employer relations even before the Marikana tragedy occurred.

The rating agencies have raised concern over the labour unrest in SA's mining sector and on social unrest generally in SA, given the inflexible labour market which reduces the chance of employment for SA's unemployed. Unemployment is formally recorded by government at a rate of 25%, but informally the unemployment rate is close to 40%. SA's labour unions (the Congress of South African Trade Unions) have ruled South Africa since 1994 in a tri-partite alliance with the ANC and the South African Communist Party and it is no surprise that labour market rigidities have escalated. Both Moody's and Standard and Poor's have SA's long-term foreign currency rating on a negative outlook and as such, renewed tensions and loss of mining output, and so reduced exports and a widening of the trade and current accounts, are of concern to them , although

Figure 2: Forecasts – probability given for each scenario, scenario one is the expected case – actual rand for Q1.13 R8.94/USD

		Q1.13	Q2.13	Q3.13	Q4.13	Q1.14	Q2.14	Q3.14	Q4.14
Scenario 1:	Expected case **45%**	8.94	8.90	9.00	8.90	8.85	8.60	8.85	8.70
	Improving growth domestically and globally, flux between risk-on and risk-off, risk-on increasingly prevalent								
Scenario 2:	Down case **40%**	9.20	10.30	9.70	9.30	10.60	11.00	11.20	11.15
	Domestic work stoppages (government fiscal slippage, rating downgrades) resulting in sharp economic slowdown								
Scenario 3:	Extreme down case 10**%**	9.50	11.50	12.50	13.00	13.50	14.00	14.50	15.00
	Recession. Global led on ongoing fiscal problems, or SA's rankings continuously drop, resulting in a failed state								
Scenario 4:	Up case **5%**	**7.00**	**6.50**	**6.20**	**6.00**	**5.95**	**6.80**	**6.65**	**7.00**
	The return to the boom period before the 2008/2009 global recession								

Source: Investec

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Web: http://www.investec.co.za/research-and-insights/economy/economic-research-v1.html

Figure 3: Exchange rates forecasts - averages

	Q2.13	Q3.13	Q4.13	Q1.14	Q2.14	Q3.14	Q4.14	Q1.15
USD/ZAR (Av)	8.90	8.80	9.00	8.90	8.85	8.60	8.85	8.70
GBP/ZAR (Av)	13.64	13.49	13.96	13.81	13.68	13.30	13.75	13.66
EUR/ZAR (Av)	11.50	11.37	11.66	11.39	11.15	10.71	10.93	10.66
ZAR/JPY (Av)	10.51	10.63	10.22	10.17	10.17	10.47	10.23	10.52
GBP/USD (Av)	1.52	1.53	1.55	1.55	1.55	1.55	1.55	1.57
EUR/USD (Av)	1.29	1.29	1.30	1.28	1.26	1.25	1.24	1.23
USD/JPY (Av)	94	94	92	91	90	90	91	92

Source: Investec

neither have indicated an increased likelihood to downgrade SA yet.. SA is two notches away from speculative grade, on the Fitch and Standard and Poor's BBB. A further downgrade would place it at triple B minus, only a notch away from BB+, the highest speculative grade ranking on offer. Foreign investors, who hold a third of SA's bonds and equities, sold off SA's government bonds on the strike news on fears it could increase the odds of a country rating downgrade for SA. This has also weakened the rand, as investors are very wary of SA dropping to the bottom of the investment grade ratings. Unfortunately not only are we likely to see more of the same in the months and years ahead, in terms of the dysfunctionality of the labour market, where strikers are rewarded with more pay without concomitant rises in productivity, but the Minister of Mineral Resources in SA has threatened mining companies with loss of their state controlled mining licenses in the face of proposed retrenchments previously. This high level of state control and loss of free market functioning means the labour market will get increasingly fractured. While SA is in the process of quite correctly addressing the apartheid legacy and the necessity for a decent wage, estimated at R6500 per month given the rand based living costs workers face, many of the mining sector strikers tend to earn substantially more than this, double if not even higher.

We have raised the probability of our down case (rating downgrade) scenario, to 40% from 30% (and lowered the likelihood of the expected case to 45%), due to the destructive nature strike action can potentially have on the economy. The down case scenario includes domestic work stoppages (fiscal slippage, rating downgrades) resulting in economic slowdown and so widening of the current account and trade deficit ratio with GDP. The drop in GDP growth would also result in widening of the fiscal deficit and fiscal debt ratios, reducing the perceived chance by the rating agencies of the SA government meeting their repayments slightly, i.e. reducing SA's Governments perceived credit worthiness. However, we have lowered the probability of our extreme down case (failed State) scenario to 10% from 15% as we believe government is well aware of these issues,

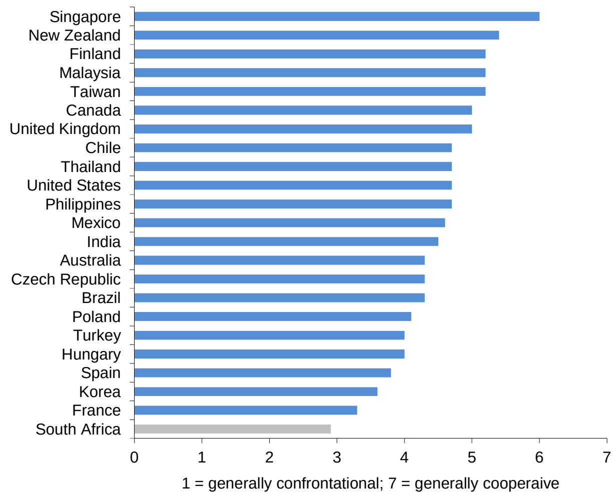
Figure 4: Credit ratings

S & P	Moody's	Fitch	R & I
AAA	Aaa	AAA	AAA
AA+	Aa1	AA+	AA+
AA	Aa2	AA	AA
AA-	Aa3	AA-	AA-
A+	A1	A+	A+
A	A2	A	A
A-	A3	A-	A-
BBB+	Baa1	BBB+	BBB+
BBB	Baa2	BBB	BBB
BBB-	Baa3	BBB-	BBB-
BB+	Ba1	BB+	BB+
BB	Ba2	BB	BB
BB-	Ba3	BB-	BB-
B+	B1	B+	B+
B	B2	B	B
B-	B3	B-	B-
CCC+	Caa1	CCC	CCC+
CCC	Caa2	CC	CCC
CCC-	Ca3	C	CCC-
CC	Ca	RD	CC
C	C	D	C
D	WR	WD	
NR		PIF	

Source: Bloomberg

**Dark green is investment grade, the light is not.*

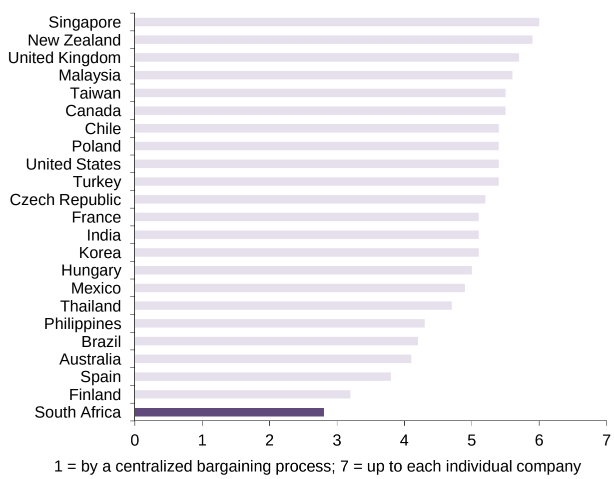
Figure 5: Cooperation in labour-employer relations



Source: The Global Competitiveness Report 2012

particularly of a rating downgrade, although more flexibility is needed in the labour market and government regulation (particularly relaxation of state control of the mining sector). The expected case scenario is one of economic growth of 3.0% this year rising to 5.0% by the end of the forecast period (see figure **11**), on the back of the improved global economy. We expect the global economy to reach trend growth in 2016, pulling SA economic growth stronger. Improved exports would reduce the current account deficit, aiding the currency. However, stronger economic growth will clearly depend on an improvement in labour-employee relations, strengthening global economic growth, increased labour productivity, better public service delivery and stronger incentives for investment. Specifically, Fitch says in its rationale for the ratings downgrade that South Africa's "(w)eak growth reflects (is a result of) structural rigidities, declining competitiveness, policy uncertainty and labour unrest." In our expected case scenario household spending will be constrained by high debt levels, which along with rising inflation should prevent further interest rate cuts (see Interest rate outlook Q2 2013, 13th May 2013, contact details below), although the SARB may choose to cut next week, potentially by 25bp, to boost sentiment. However, an interest rate cut

Figure 6: Flexibility of wage determination



Source: The Global Competitiveness Report 2012

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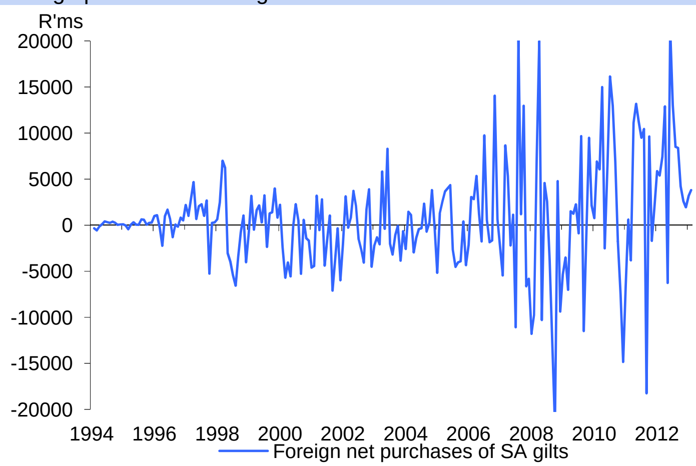
Figure 7: Foreign purchases of SA gilts

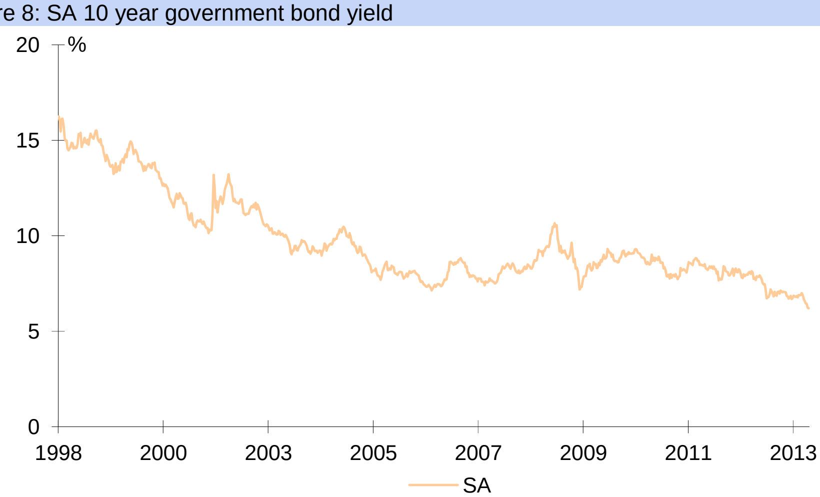


Source: I-net Bridge

(even of 50bp) will not stimulate economic growth in SA's highly state regulated economy (see "Infrastructure outlook: rising capital utilisation signifies increased private sector investment but the regulatory burden grows as state control rises", 13th May 2013, contact details below) and fractured labour market, while such a cut would erode the carry trade currently in operation which is boosting foreign purchases of SA's government bonds (see figures **7** and **8**). With foreigners holding a third of SA's bonds, government relies on this foreign (portfolio) investment to fund its expenditure needs, which are onerous given the huge number employed in the civil service, and the rapid, above inflation increase in wages. Erosion of the differential offered to foreigners in SA's carry trade by cutting interest rates will erode the ability of government to fund its deficit and make other investments, such as many high yielding African countries state debt more attractive.

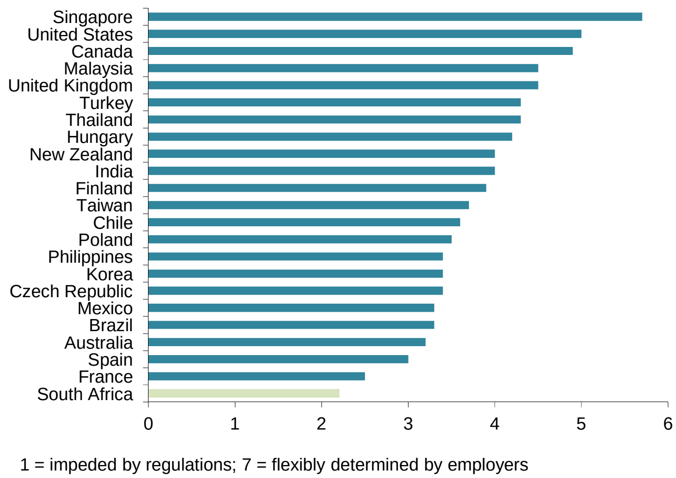
Fixed investment should strengthen (see "Infrastructure outlook: rising capital utilisation signifies increased private sector investment but the regulatory burden grows as state control rises", 13th May 2013), although continued high incidence of disruptive, violent strikes would scupper this. Capacity utilisation levels are rising steadily in South Africa, an upward trend since the recession of 2009, which typically would herald faster growth in private sector fixed investment (or GFCF, Gross Fixed Capital Formation) in 2013, and so boost economic growth and job creation. While the savings of non-financial corporates run into the hundred billions (of rand) in South Africa, substantially higher than those of households (and

Figure 8: SA 10 year government bond yield



Source: I-net bridge

Figure 9: Hiring and firing practices

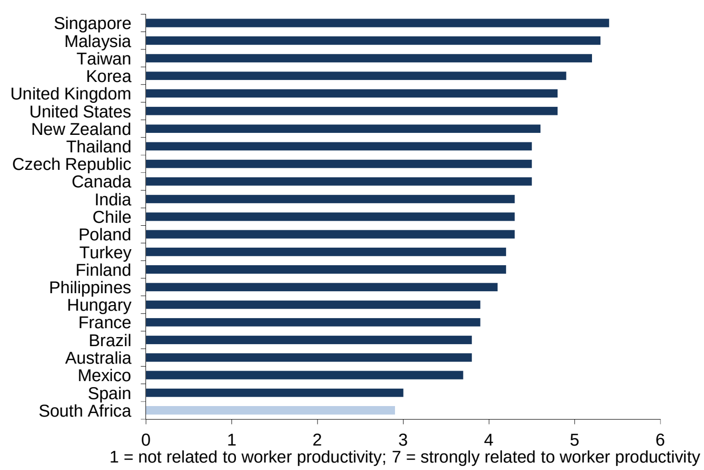


Source: The Global Competitiveness Report 2012

government runs a deficit, borrowing significantly instead to fund expenditure), it must be borne in mind that after the depreciation cost of infrastructure, i.e. replacement value is taken into account, non-financial corporate savings drop substantially to less than a hundred billion rand, but implies corporates are well positioned to reinvest.

The exceptional disparity between the remuneration of some top executives, which runs into multiple millions of rand, means workers are justifiably discontented with earnings in the low thousands, even if this amounts to a couple of hundred thousand rand a year. Living costs have risen in SA from many years of double digit electricity tariff increases, and other high government services costs, with administered price inflation running close to 10%. Additionally, the poor state of the education system in SA, ranked amongst the worst in the world, with the quality of maths and science second worst in the world, and Yemen the worst, means many parents who have aspirations for their children are attempting to offer better (private) schooling. Many emerging from the state education system find themselves unemployed, due to low skills levels with a pass rate of only 30% accepted, and there is union opposition to a youth wage subsidy to help these individuals gain access to employment.

Figure 10: Pay and productivity



Source: The Global Competitiveness Report 2012

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Figure 11: Summary	2011	2012	2013	2014	2015	2016	2017
GDP (real, %)	3.1	2.5	3.0	4.2	4.7	5.0	5.0
Total domestic demand (real, %)	5.1	4.0	4.2	4.9	5.2	5.4	5.2
HCE (real, %)	5.0	3.3	3.2	4.2	4.5	4.8	4.5
GCE (real, %).	4.5	4.0	4.0	4.1	4.2	4.2	4.3
GFCF (real, %)	4.4	5.9	6.5	7.9	8.2	8.2	7.9
Real Change in Inventories (R'bn)	4.8	7.1	12.0	12.5	13.1	13.8	4.8
GFCF as a % GDP	20.0	20.7	21.4	22.2	22.9	23.6	24.2
GDE (real, %)	4.3	4.3	4.3	4.9	5.2	5.4	5.2
Export (goods & non-factor services) - (real, %)	5.9	-0.2	2.2	6.3	5.8	6.4	4.5
Imports (goods & non-factor services) - (real, %)	9.7	6.6	7.2	8.0	7.0	7.1	5.4
Balance: Current Account (saa) - R'bn	-98.8	-179.8	-223,.4	-269.1	-324.1	-364.7	-381.3
Balance: Current Account (saa) - % GDP	-3.3	-5.6	-6.4	-7.0	-7.6	-7.8	-7.3

Figure 12: Household Consumption Expenditure	2011	2012	2013	2014	2015	2016	2017
Total - (real, %)	5.0	3.3	3.2	4.2	4.5	4.8	4.5
Durable Goods (real, %)	15.7	10.0	4.4	5.4	5.8	6.1	5.7
Semi-Durable Goods (real, %)	7.0	5.3	3.6	4.2	4.6	4.9	4.6
Non-Durable Goods (real, %)	2.9	2.8	3.2	4.1	4.4	4.7	4.4
Services (real, %)	3.8	1.5	2.7	3.9	4.2	4.5	4.3
Real disposable income (real, %)	5.2	3.3	3.3	4.2	4.6	4.9	5.2
Population growth	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Labour force growth	1.5	1.7	1.0	1.1	1.1	1.1	1.1
Employment growth rate	1.6	1.2	1.1	1.9	1.8	1.8	1.8

Figure 13: Gross Fixed Capital Formation (Total)	2011	2012	2013	2014	2015	2016	2017
Total – (real, %)	4.4	5.9	6.5	7.9	8.2	8.2	8.2
– Private Sector & Public Corporations (real, %)	5.0	5.4	6.1	8.1	8.5	8.4	8.4
– General Government (real, %)	0.8	8.8	8.7	7.2	6.6	6.6	6.6
Construction (real, %)	0.6	4.4	7.0	8.6	8.9	8.8	8.8
– Private Sector & Public Corporations (real, %)	0.6	3.2	7.1	10.0	10.5	10.3	10.3
– General Government (real, %)	0.7	6.9	6.9	5.8	5.4	5.4	5.4
Non-Residential Buildings (real, %)	-2.0	2.2	7.4	9.1	9.4	9.2	9.2
– Private Sector & Public Corporations (real, %)	-2.9	-0.5	6.3	9.4	10.0	9.8	9.8
– General Government (real, %)	1.0	10.7	10.4	8.5	7.6	7.6	7.6
Residential Buildings (real, %)	-6.6	2.8	7.1	8.8	9.1	9.0	9.0
Transport Equipment (real, %)	6.6	11.1	6.5	7.2	7.5	7.5	7.5
Machinery (real, %)	11.7	6.7	6.8	8.7	8.9	8.8	8.8
– Private Sector & Public Corporations (real, %)	12.1	6.4	6.5	8.5	8.9	8.8	8.8
– General Government (real, %)	1.5	15.2	14.2	11.2	9.8	9.5	9.5

Figure 14: Inflation	2011	2012	2013	2014	2015	2016	2017
Consumer Inflation (Av: %)	5.0	5.7	5.8	5.4	4.8	4.5	4.5
(year-end: %)	*6.1*	*5.7*	*5.1*	*5.6*	*4.5*	*4.5*	*4.5*
Producer Inflation (Av: %)	8.4	6.2	5.6	5.9	5.0	4.6	4.6
(year-end: %)	*9.8*	*5.2*	*6.0*	*5.8*	*5.1*	*5.5*	*5.5*
Salary & wage increases (%)	5.7	5.8	8.3	7.4	7.8	8.0	8.0

Figure 15: Monetary Sector	2011	2012	2013	2014	2015	2016	2017
Private Credit Extension seasonally adj (Av: %)	5.4	7.7	9.7	9.6	10.4	10.6	10.6
Money Supply seasonally adj– M3 (Av: %)	7.6	1.9	6.9	7.5	5.3	6.5	6.5
Repo Rate (year-end: %)	5.5	5.0	5.0	5.5	6.0	6.5	6.5
Prime Overdraft Rate (year-end: %)	9.0	8.5	8.5	9.0	9.5	10.0	10.0
SA rand bond (Av: %)	8.5	7.9	7.8	8.8	8.9	9.0	9.1