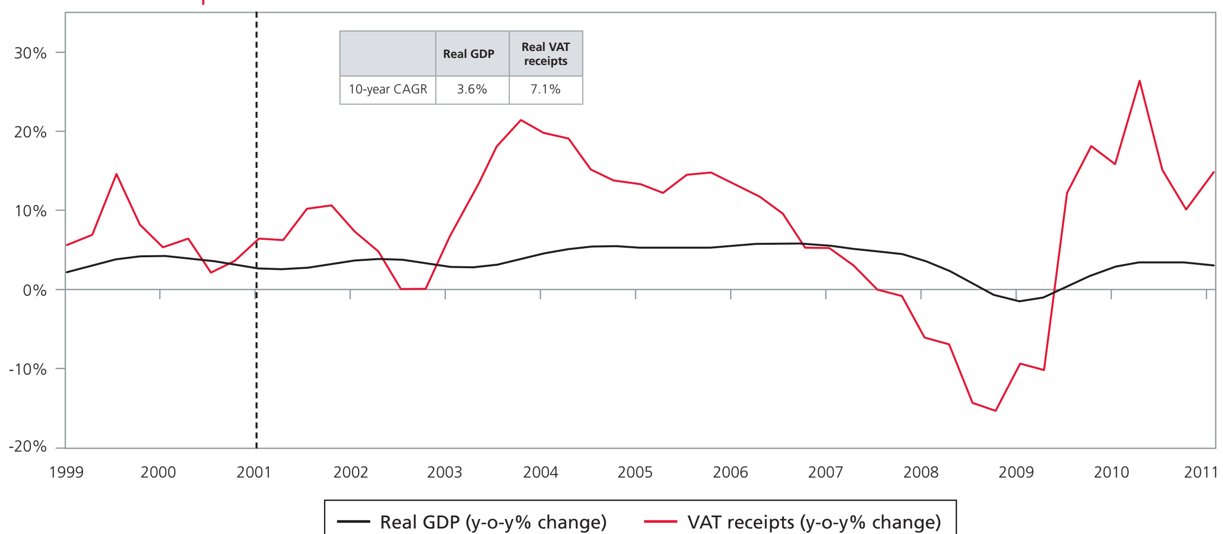
Ian Liddle

How healthy is the South African economy?

EXECUTIVE SUMMARY: **At a recent presentation to investors, Ian Liddle encouraged investors to ask themselves whether their current investment strategy implicitly relies on the belief that the South African economy is healthy. He demonstrated that the strong growth in South African consumer spending over the last decade has not been supported by growing production; rather, it has depended on rising commodity prices and investment by foreigners. There is a risk that either or both of these supportive factors may fall away, in which case South African consumer spending and the value of the rand may come under pressure. A selection of slides from Ian's presentation is discussed here. You can see the full presentation on www.allangray.co.za until 31 August 2012 (click on this article, which can be found in the 'Latest news' section).**

Note: the graphs that follow represent different time spans. In order to help the reader normalise for this, a black dotted verticle line is drawn on each chart at 31.12.2001, which in most cases, is 10 years before the end point.

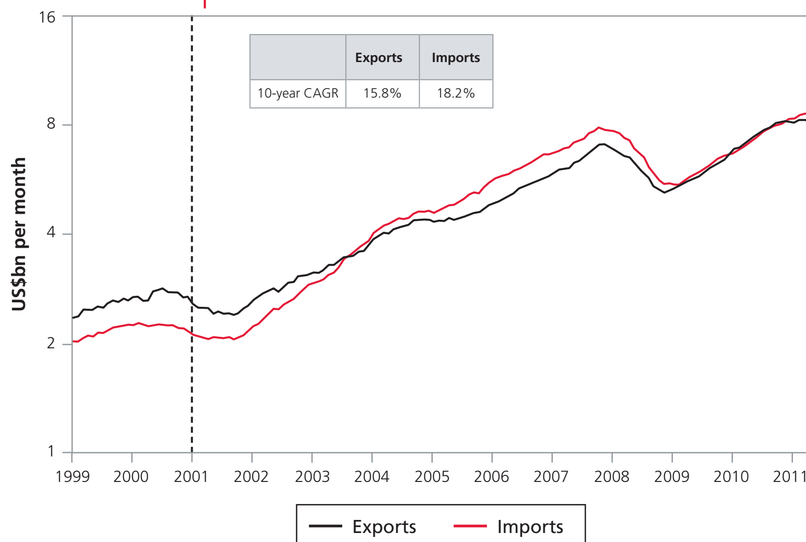
GRAPH 1 | Growth in real VAT receipts and real GDP



Source: I-Net Bridge, data to 31.12.2011, data is smoothed (four-quarter rolling average), 10-year CAGR is to 31.12.2011

Real growth in South African GDP over the last decade has amounted to 3.6% p.a., which is solid but not spectacular. South African consumer spending has grown much faster than the overall economy. A good measure of consumer spending is total VAT receipts, which have grown at almost double the rate of the overall economy over the last decade. The factors driving this growth in consumer spending are well known: wage increases consistently above the inflation rate, growing public sector employment and strong growth in social welfare payments. Growth in bank credit, and more recently in unsecured lending and government borrowing, has added fuel to the fire.

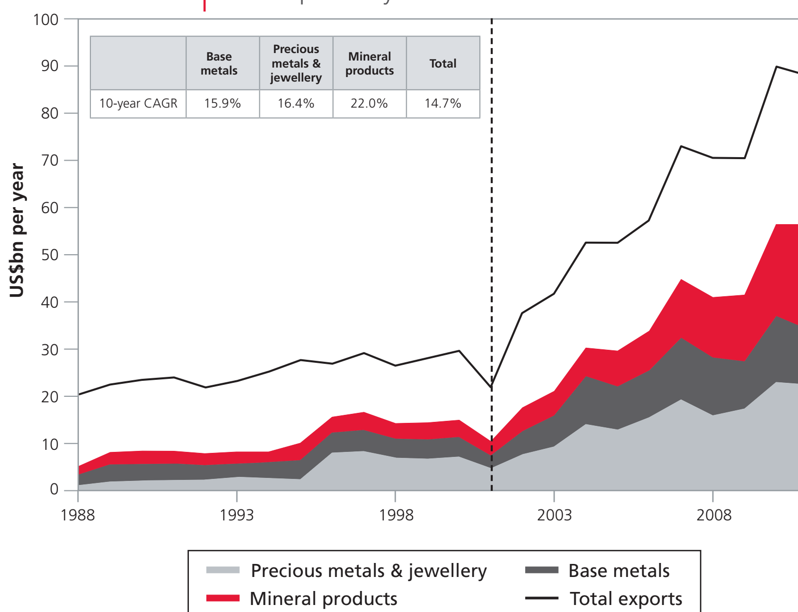
GRAPH 2 | RSA trade balance



Source: I-Net Bridge, data to 31.03.2012, data is smoothed (12-month rolling average), 10-year CAGR is to 31.12.2011

South Africans buy many things that we do not make for ourselves. The growth in consumer spending has translated into imports into South Africa increasing from approximately US$2 billion per month in 2001 into the current rate of approximately US$8 billion per month. This amounts to a compound annual growth rate of 18.2% p.a. in dollar terms. Fortunately, the value of South African exports has also grown strongly (by 15.8% p.a.) so that the value of imports and exports are roughly matched today.

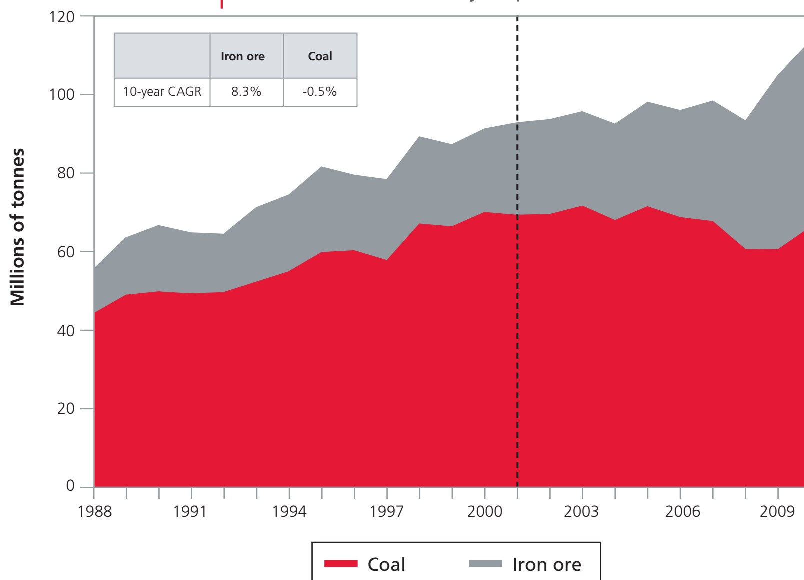
GRAPH 3 | RSA exports by value



Source: DMR, SARB, data to 31.12.2011, 10-year CAGR is to 31.12.2011

Precious metals, base metals and mineral products together contribute to approximately two-thirds of South African export revenues. Their share of export revenues has expanded over the last decade. Note the long period in which export revenues were stagnant before the boom of the last 10 years.

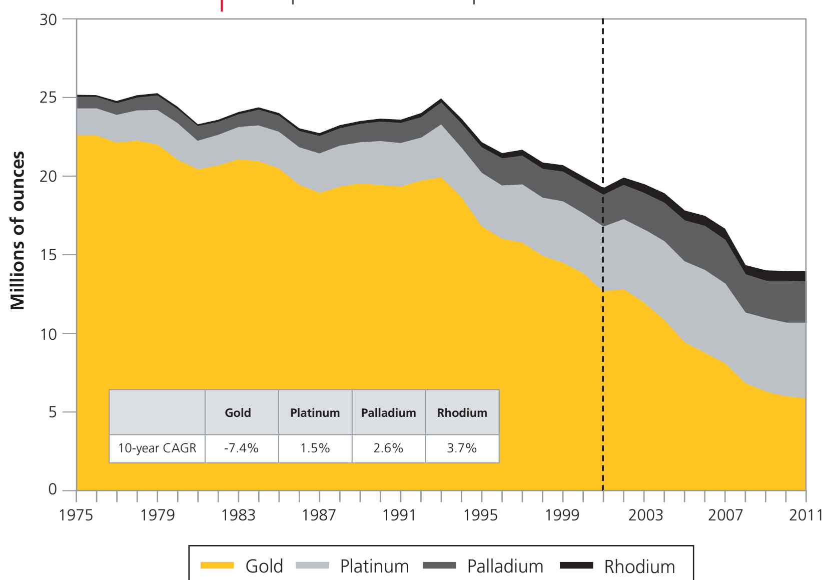
GRAPH 4 | RSA bulk commodity exports – volume



Source: DMR, data to 31.12.2010, 10-year CAGR is to 31.12.2010

Graph 3 showed an economist's view of the world – it looked at the monetary value of our exports. But what would we see if we looked at our exports as an engineer would, in tonnes and ounces? South Africa's two major bulk commodity exports are coal and iron ore. Coal export volumes have been flat over the last decade, as bottlenecks on the railway line to Richards Bay have constrained growth. We have had more success in increasing the capacity on the railway line to Saldanha Bay and iron ore exports have grown by 8.3% p.a.

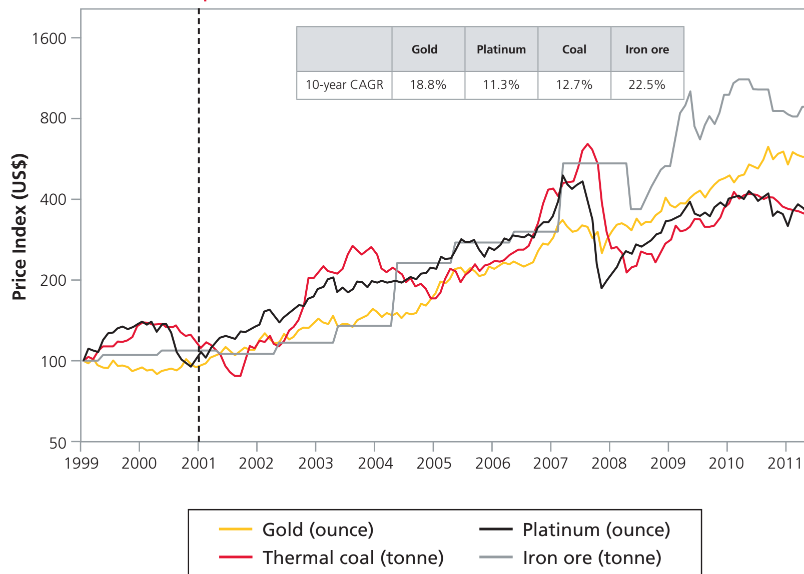
GRAPH 5 | RSA precious metal production – volume



Source: Johnson Matthey, data to 31.12.2011, 10-year CAGR is to 31.12.2011

Gold production has halved over the last decade. South Africa is now producing less gold than it did during the First World War. Production of platinum group metals has grown marginally over the last 10 years, but this data does not yet take into account the recent and impending closures of some platinum mines.

GRAPH 6 | Key commodity prices

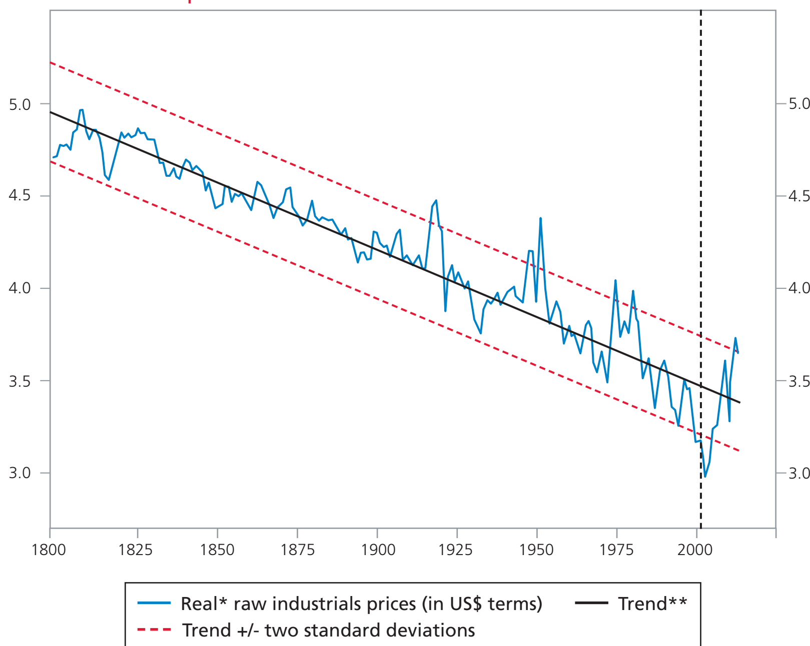


	Gold	Platinum	Coal	Iron ore
10-year CAGR	18.8%	11.3%	12.7%	22.5%

Source: I-Net Bridge, UBS, data to 31.03.2012, 10-year CAGR is to 31.12.2011

So, how does one reconcile the mixed and lacklustre growth in export volumes shown in Graphs 4 and 5 with the strong growth in export revenues shown in Graph 3? The answer, of course, is prices. The dollar prices South Africa receives for its key commodity exports have increased powerfully over the last decade. Platinum and coal prices, the laggards, have roughly tripled since the turn of the century. At their peak, iron ore prices were up eight times from the price at the end of 1999. Rising prices, not rising production volumes, have been the primary driver of our growing export revenues.

GRAPH 7 | Long-term commodity prices

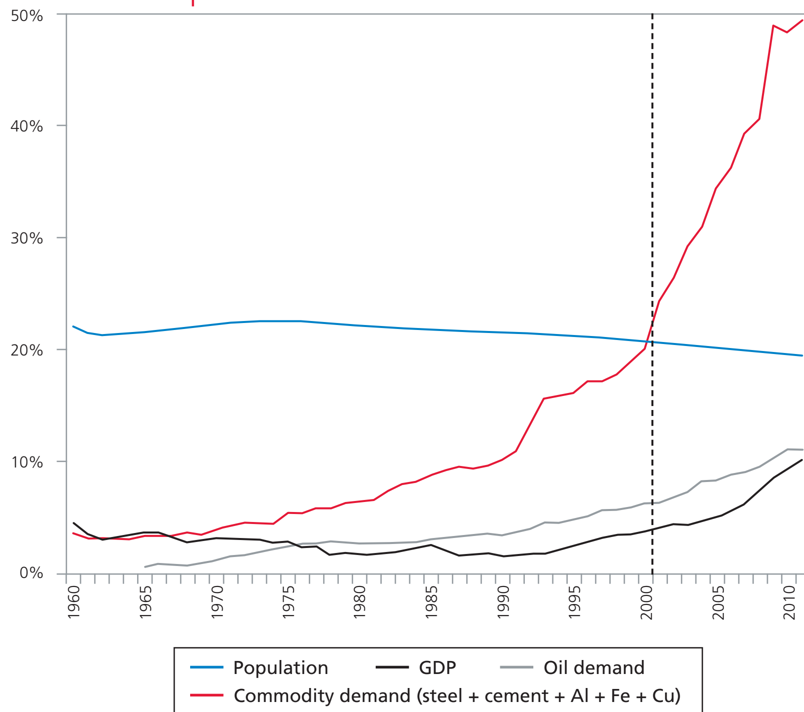


* Adjusted by US GDP Deflator; shown as a natural logarithm
** Time trend from 1800 to 2000

Source: BCA Research

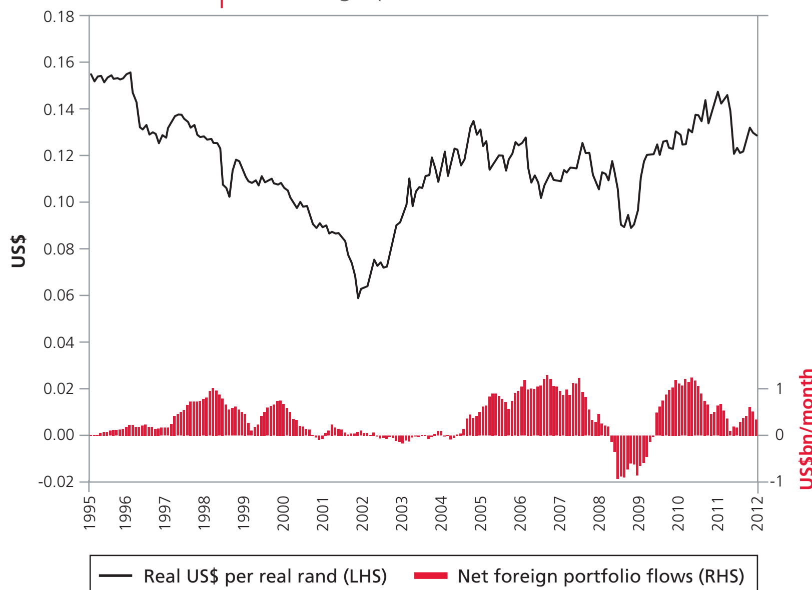
One should view the rise in commodity prices over the last decade in the context of a much longer period of history. The Bank Credit Analyst has compiled an index of commodity prices stretching back to 1800. The boom in commodity prices over the last 10 years has taken their commodity price index from more than two standard deviations below its long-term trend line to more than two standard deviations above its long-term trend-line. Importantly, the long-term trend line is down. This is a testament to human ingenuity. Over the last two centuries, we have constantly found new and more efficient ways to produce and use commodities, and this has driven prices down over time. The new technologies to access America's considerable shale gas reserves are the latest example of this. We believe it would be a mistake to simply extrapolate the strong rise in commodity prices over the last decade far into the future.

GRAPH 8 | China's share of the world (1960-2011)



Source: Worldbank, BP, UBS, 2011 numbers are estimates

GRAPH 9 | Net foreign portfolio flows

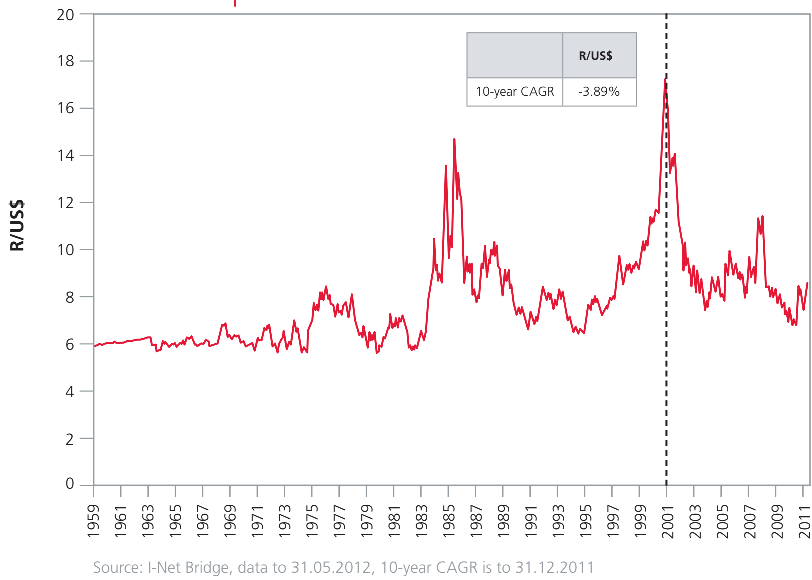


Source: I-Net Bridge, data to 31.05.2012, smoothed, monthly data (flows)

China has had a considerable impact on commodity prices over the last decade. Roughly one in five people on the planet are Chinese. This ratio has been declining slowly. Chinese GDP amounts to a smaller share of global GDP, although it has been growing strongly since the early 1990s. China's share of global oil consumption corroborates the GDP numbers. However, China consumes substantially more than its natural share of the global supply of steel, cement, aluminium, iron ore and copper – between 40 and 50%. China is using these commodities to build roads, railways, airports, dams, bridges, factories, cities, shopping malls, skyscrapers and apartment blocks. The portion of Chinese GDP spent on fixed capital formation is close to 50% – this is unsustainably high. It is hard to see how Chinese demand for these commodities can continue to grow from these levels, and there is some risk that it may even contract.

Graph 2 does not show a complete picture of South Africa's current account, which has generally been in deficit over the last decade. The deficit has been funded by foreign investors buying mainly South African shares and bonds – there has been limited foreign investment into new productive capacity. For most of South Africa's democratic history, foreigners have willingly funded our current account deficit. But they have wavered on two occasions: in the early 2000s the net inflows dried up, and around the time of the global financial crisis in the second half of 2008, the net inflows reversed and became net outflows. On both occasions, the value of the rand came under considerable pressure.

GRAPH 10 | Inflation-adjusted rand/US dollar



	R/US$
10-year CAGR	-3.89%

Source: I-Net Bridge, data to 31.05.2012, 10-year CAGR is to 31.12.2011

When looking at a long-term picture of the rand/US dollar exchange rate, one needs to adjust for the different CPI inflation rates in each currency to see a true picture. For example, an exchange rate of R8.50 to the dollar today is not as competitive as it was in 2001, because rand costs have increased at a much faster rate than dollar costs since then. We believe that there is limited potential for the rand to appreciate over the long term, and substantial potential for it to depreciate. If either dollar commodity prices were to fall or foreign inflows were to dry up (or both), the value of the rand and South African consumer spending could come under considerable pressure. Investors should be mindful of this vulnerability in the South African economy.

Ian is our chief investment officer, with overall responsibility for the investment team and portfolio management. He joined Allan Gray in 2001 after several years as a management consultant.