

INVESTMENT NOTE

3 FEBRUARY 2025

TURNING A CORNER



IZAK ODENDAAL

OLD MUTUAL WEALTH
CHIEF INVESTMENT STRATEGIST

South Africa remains a country blighted by poverty and inequality. Sadly, the economic stagnation of the past decade halted progress in addressing these ills. It left the government with an unsustainable debt burden, while local and global investors became disillusioned by lacklustre returns. Is 2025 the year where it finally turns a corner? There are good reasons to believe it will be. If things go broadly according to plan, the economy will experience a cyclical and structural growth uplift.

What does this mean? Think of a car. The speed at which it can travel is determined mainly by the size of the engine. The driver's inputs will matter, but if the driver floors the accelerator too much for too long, it

will overheat and seize up. If the driver slams the brakes too hard, the car screeches to a halt. External conditions also matter, since foggy or rainy weather will slow things down, as will traffic congestion.

The economy's structural growth potential can be likened to the size of the engine. The only way to increase the speed on a sustained basis without overheating will be to upgrade the engine. The driver inputs are cyclical conditions, including the central bank which can speed things up or slow them down by changing interest rates. Finally, the external environment, in South Africa's case the global financial backdrop, is also very important since we are a commodity exporter and capital importer.

INVESTMENT TOO LOW

How do you raise an economy's structural growth potential? More capital investment, faster productivity growth and an expanding labour force. The latter is not a problem, since our workforce is still growing, but the former is. We have more than enough workers, but capital investment is too low. It is generally believed

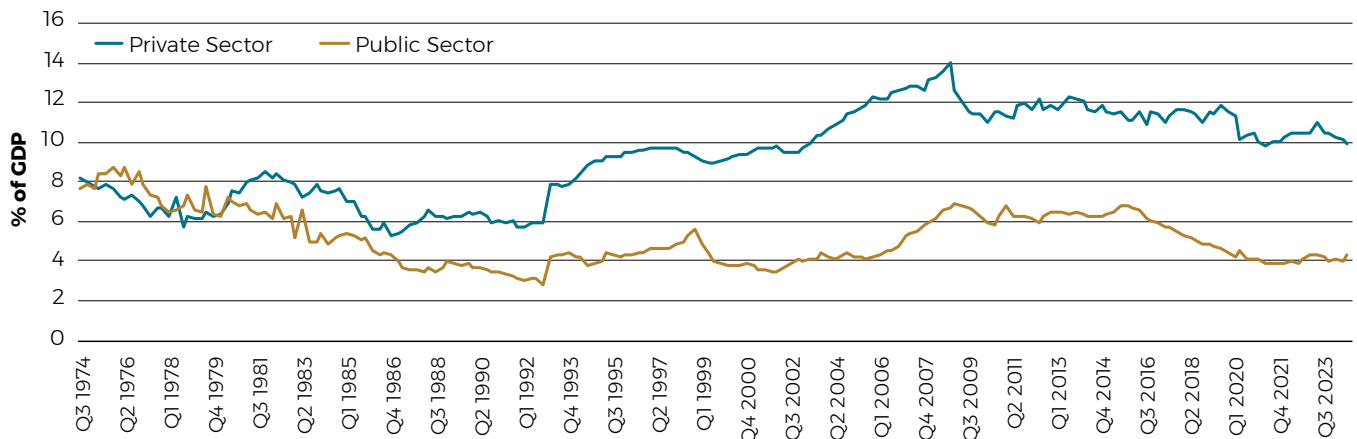
that countries should invest around 30% of national income (GDP) to sustain rapid economic growth. South African barely achieves half that number. Among other things, it means the country's infrastructure is inadequate. This in turn impedes productivity growth, which is largely the interplay of the various forms of capital -



physical capital (such as infrastructure), human capital (skills) and social capital (trust and cooperation). Human capital formation remains low, though there has been some progress, as is social capital, which is undermined by crime, corruption and inequality. For instance, South African businesses have

to spend inordinate amounts on security, money that could be invested more productively elsewhere. Crime can be deadly for small businesses – literally and figuratively – contributing to the fact that South Africa has lower rates of entrepreneurship compared to our peers.

CHART 1: SOUTH AFRICA FIXED INVESTMENT AS A SHARE OF GDP



Source: Statistics South Africa

These are not easy issues to fix, but you have to start somewhere. The government must play an important coordinating role. However, the South African government caused as many problems as it fixed for a long time.

The formation of the government of national unity (GNU) last year raised optimism that things could improve. It hasn't been smooth sailing, and the past week or so saw frictions between the largest parties burst out into the open. There are deep disagreements between the coalition partners on

a handful of policy areas, particularly National Health Insurance, but broad agreement on the rest. The coalition is perhaps stronger than it appears from the outside, since the parties need each other, and find the alternative populist scenarios are unappealing, though for differing reasons. But they also need to maintain individual identities and keep their internal audiences onside. Politicians and voters alike must get used to coalition politics.

GLUED TO THE GNU

Nonetheless, the number one question most investors will be asking themselves is whether the GNU can last, at least until next year's municipal elections and the ANC's internal elections in 2027. The answer is yes. If nothing else, the fact that South Africa is the G20 host this year means we must avoid global embarrassment over petty political infighting.

However, betting on politics is risky. Anything can happen. Rather, we should focus on the reforms underway that will raise the economy's long-term growth potential and could survive the GNU if it does collapse. Many of these actually pre-date the formation of the GNU, such as the substantial restructuring of the electricity market. Though this weekend saw an unwelcome break in the 311-day loadshedding-free streak, such incidents will probably be sporadic. A return to the extremely disruptive loadshedding intensity of 2022 and 2023 is very unlikely.

The next big challenge is logistics. South Africa isn't blessed geographically. It is a large country, sparsely populated in many parts, and without any large navigable rivers. Our largest urban centre is hundreds of kilometres from the nearest port, as is the biggest export industry (mining). The country needs world-class rail infrastructure to overcome these setbacks, but instead it has deteriorated over the past decade. The good news is that change is underway. Just as Eskom has been unbundled into generation, transmission and distribution businesses, Transnet Rail has been split into a separate infrastructure manager and operator. It is opening up its network to private businesses to run their own trains.

Large scale private investment spending has been unlocked in the energy sector, and it will carry on until the end of the decade. The same is likely to happen in the logistics space,

as well as bulk water provision. This can crowd in local and global capital.

Even if the GNU doesn't survive in its current form, we are unlikely to revert to the world of vertically integrated state-owned monopolies. Those were 20th century business models that should not have persisted so deeply into the 21st.

There are many other areas that require attention that this week's State of the Nation Address is likely to elaborate on. This notably includes the second phase of Operation Vulindlela, the joint Presidency-Treasury initiative aimed at removing a defined set of key obstacles to ensure faster economic growth.

OF INTEREST

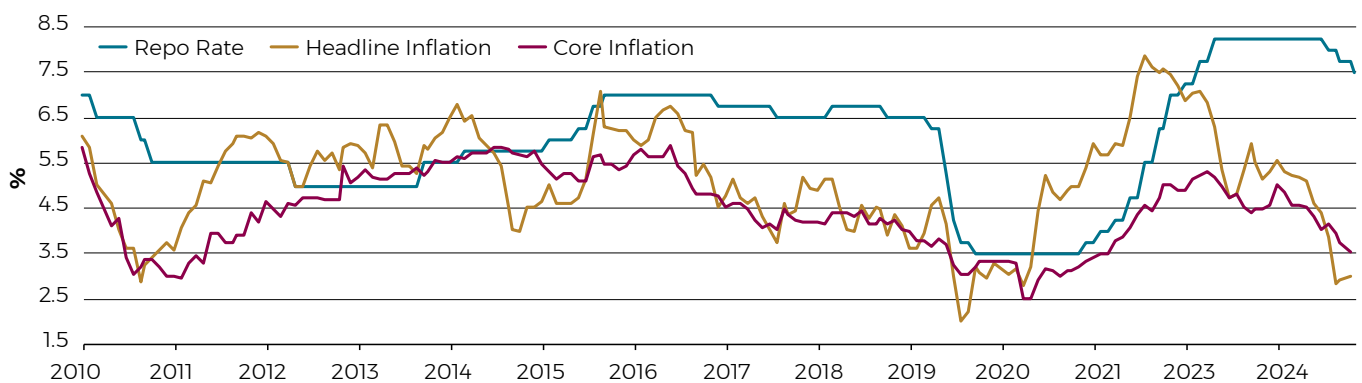
Apart from the supply-side (infrastructure) challenges, there is no doubt that high interest rates have been a contributing factor to economic malaise. Interest rates are elevated for both cyclical and structural reasons, i.e. both because of the size of the engine and the behaviour of the driver.

The driver – the Reserve Bank headed up by Governor Lesetja Kganyago – has eased up on the brakes by cutting the repo rate by a cumulative 75 basis points. After last week's rate reduction, homeowners will pay R1 000 a month less on a R2 million bond at the prime rate, money that can be spent elsewhere.

The interest rate relief is due to lower inflation and an improved outlook for future inflation. In December, annual

headline consumer inflation was only 3%, a bit less than expected. This is somewhat distorted by a temporary fall in fuel prices. But even excluding food and fuel, 'core' inflation was only 3.6%. The Reserve Bank expects inflation to average 3.9% this year and 4.6% next year, and even these forecasts might be a touch too high since energy regulator Nersa subsequently announced lower-than-expected electricity tariff increases. Eskom will be allowed to raise its tariff by 12.7% in the coming financial year. This is almost three times the inflation target, but much less than it asked for and less than generally assumed (the Reserve Bank's forecast was for 15%).

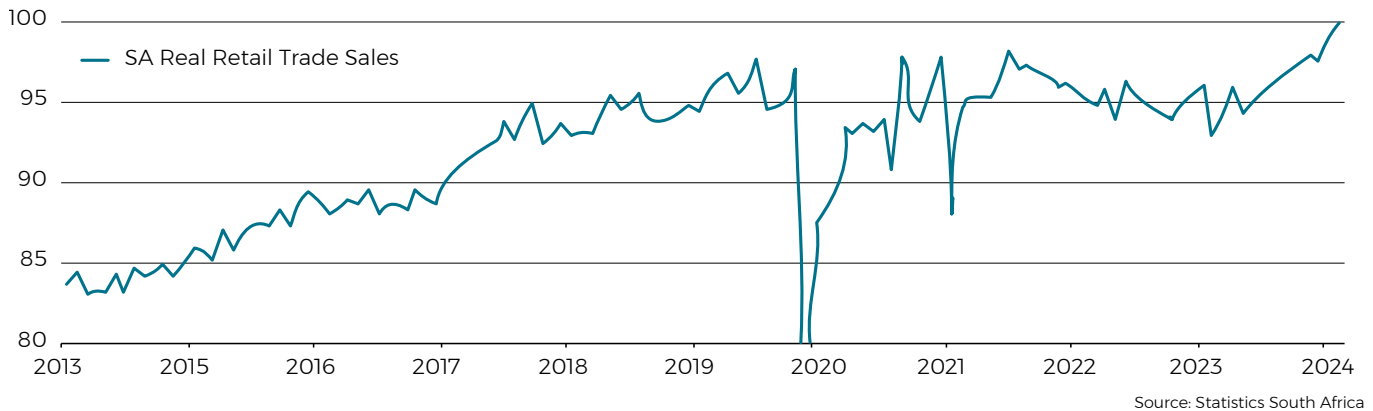
CHART 2: SOUTH AFRICAN INTEREST RATES AND INFLATION, %



Source: LSEG Datastream

Lower inflation doesn't just allow for lower interest rates, but also increases the real purchasing power of households. Income growth for employees now generally exceeds the inflation rate, and we can see it in the retail sales numbers. As inflation rose in 2022 and 2023, households would spend more but got less in return. Now they are getting more again. This is an important cyclical boost and contributes to a better

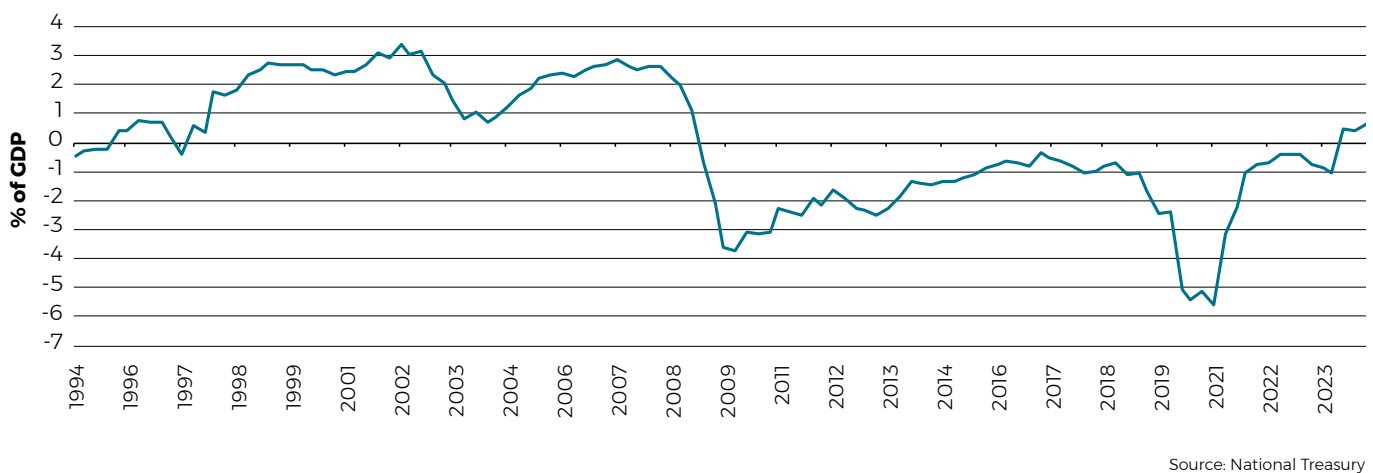
growth outlook over the medium term. The growth outlook has already improved. The Reserve Bank's expects the economy to expand by 1.8% this year and next, rising to 2% by 2027. This is slow compared to many other emerging markets, but a meaningful improvement to the 0.5% average growth rate over the past decade.

CHART 3: SOUTH AFRICA'S REAL RETAIL SALES, R BILLION

But interest rates remain structurally elevated, weighing on economic activity and equity valuations. To lower the long-term trajectory around which rates will fluctuate requires a similarly lower inflation trend. This is why the Reserve Bank is keen on a lower inflation target, such as the 3% most of our peers aim for, to embed lower inflation expectations. The current goal is the midpoint of 3% to 6%, i.e. 4.5%.

The other source of structural upward pressure on interest rates is the government's perceived lack of creditworthiness. Its creditors – bond investors – demand a risk premium that ends up also applying to private sector borrowers, directly

or indirectly. This risk premium will only decline when economic growth has accelerated meaningfully and structurally, and the government's finances are in better shape. Growth will boost tax revenues, thereby lowering the government's borrowing requirement, but discipline on the spending side is also necessary. This is not easy, given the ever-growing spending demands, but the Budget Speech later this month will probably show Treasury sticking to the script of fiscal consolidation, maintaining a rising primary surplus (i.e. tax revenues exceeding non-interest spending). Success on this front should see eventual credit rating upgrades and lower borrowing costs.

CHART 4: SOUTH AFRICA'S PRIMARY BUDGET BALANCE

The Monetary Policy Committee (MPC) statement noted that a scenario where deeper structural reforms are implemented would allow growth to rise to 3% by 2027 while resulting in lower inflation and interest rates. Stronger growth usually puts upward pressure on inflation and interest rates as the economy eventually runs too hot. However, in South Africa's case, the supply side reforms that boost growth

will also lower costs. For instance, improved electricity supply means firms can produce more, but also don't have to pass on the cost of running diesel generators to consumers.

But the global environment – the driving conditions – will always matter. The current global backdrop is particularly uncertain, as witnessed by the volatility of the rand since the Trump election in November.

The US Federal Reserve has put its rate cutting cycle on pause, and the risks of a US-ignited trade war have risen with the imposition of tariffs on Mexico and Canada. This is potentially a recipe for rand weakness with negative consequences for inflation. No one knows exactly how things will play out, and the MPC therefore described the risks to

its inflation outlook as being tilted to the “upside”. Two of the six committee members favoured leaving rates unchanged given the uncertain global backdrop. It suggests that the bar for future rate cuts has risen, but not insurmountable. One or two 25 basis points cuts are likely, but not necessarily at each upcoming meeting.

DRIVE CAREFULLY

In summary then, both the cyclical and structural outlook for the local economy have improved. This does not imply that everything is hunky dory or that there won't be potholes or speedbumps along the way. Many challenges remain, and many South Africans live extremely difficult lives. From an investment point of view, however, it suggests that we

can expect further value to be unlocked from local bonds, equities and real estate, while the rand also has room to appreciate. Patience remains a virtue, whether driving or investing. It might take time before the global investment community recognises the progress.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	3 837.0	-0.52%	3.48%	3.48%	19.72%
United States	S&P 500	US\$	6 041.0	-0.98%	2.70%	2.70%	24.66%
Europe	MSCI Europe	US\$	2 140.0	0.61%	6.84%	6.84%	6.10%
Britain	FTSE 100	US\$	10 749.0	1.29%	5.09%	5.09%	11.03%
Germany	DAX	US\$	1 915.0	0.47%	8.87%	8.86%	20.59%
Japan	Nikkei 225	US\$	257.2	3.15%	1.36%	1.36%	4.18%
Emerging Markets	MSCI Emerging Markets	US\$	1 093.0	0.28%	1.67%	1.67%	11.99%
Brazil	MSCI Brazil	US\$	1 321.0	3.93%	12.23%	12.23%	-21.97%
China	MSCI China	US\$	64.9	1.09%	0.64%	0.64%	30.93%
India	MSCI India	US\$	986.9	1.03%	-3.63%	-3.63%	5.77%
South Africa	MSCI South Africa	US\$	453.0	1.12%	5.35%	5.35%	15.86%

EQUITIES - SOUTH AFRICA (TOTAL RETURN UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	85 957.0	1.98%	2.21%	2.21%	15.29%
All Share	All Share (Total Return)	Rand	15 729.0	1.98%	2.32%	2.32%	19.58%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	38 593.9	1.89%	2.56%	2.56%	19.72%
TOP 40/Large Caps	Top 40	Rand	14 066.0	2.40%	3.26%	3.26%	18.37%
Mid Caps	Mid Cap	Rand	25 330.0	1.72%	0.74%	0.74%	19.62%
Small Companies	Small Cap	Rand	42 244.0	-0.99%	-4.60%	-4.60%	27.13%
Resources	Resource 20	Rand	5 317.8	2.59%	17.91%	17.91%	16.19%
Industrials	Industrial 25	Rand	26 309.0	2.90%	1.06%	1.06%	20.09%
Financials	Financial 15	Rand	15 277.0	0.88%	-2.71%	-2.71%	21.86%
Listed Property	SA Listed Property	Rand	2 347.2	1.06%	-2.32%	-2.32%	21.05%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
IBOXX Global Government S&P Overall (USD Unhedged)		US\$	74.1	0.07%	0.37%	0.37%	-3.53%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	1 107.5	-0.02%	0.44%	0.44%	16.86%
Government Bonds	BESA GOVI	Rand	1 090.6	-0.01%	0.44%	0.44%	16.75%
Inflation Linked Bonds	BESA CILI	Rand	375.4	0.35%	-0.32%	-0.32%	7.36%
Cash	STEFI Composite	Rand	598.6	0.15%	0.66%	0.66%	8.42%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	75.7	-3.61%	0.89%	0.89%	-6.58%
Gold	Gold Spot	US\$	2 797.0	0.97%	6.92%	6.92%	37.18%
Platinum	Platinum Spot	US\$	1 033.0	8.05%	12.90%	12.90%	10.84%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	18.67	-1.44%	0.90%	0.91%	0.11%
ZAR/Pound	ZAR/GBP	Rand	23.15	-0.78%	2.07%	2.07%	2.42%
ZAR/Euro	ZAR/EUR	Rand	19.34	-0.10%	1.09%	1.09%	4.50%
Dollar/Euro	USD/EUR	US\$	1.04	0.96%	-0.48%	-0.48%	3.85%
Dollar/Pound	USD/GBP	US\$	1.24	0.72%	0.87%	0.87%	2.49%
Dollar/Yen	USD/JPY	US\$	0.01	-1.38%	-2.14%	-2.14%	4.68%

Source: I-Net, figures as at 31 January 2025

The Old Mutual Wealth Investment Note is published on a weekly basis to keep our clients and financial planners informed of what is happening in financial markets and the economy and to share our insights. Markets are often very volatile in the short term and similarly, economic data releases or central bank actions may cause concerns for investors. This does not mean that investors should take action based on the most recent events. It is better to be disciplined and remain invested in well-diversified portfolios that are designed to achieve long-term objectives. Our Strategy Funds are actively managed, with asset allocation changes based on valuations and in anticipation of future real returns, and not in response to the most recent market noise. The future is always uncertain and that is why our Strategy Funds are diversified and managed with a long-term focus.



WEALTH

Old Mutual Wealth is brought to you through several authorised Financial Services Providers in the Old Mutual Group who make up the elite service offering. This document is for information purposes only and does not constitute financial advice in any way or form. It is important to consult a financial planner to receive financial advice before acting on any information contained herein. Old Mutual Wealth and its directors, officers and employees shall not be responsible and disclaims all liability for any loss, damage (whether direct, indirect, special or consequential) and/or expense of any nature whatsoever, which may be suffered as a result of or which may be attributable, directly or indirectly, to the use of, or reliance upon any information contained in this document.