momentum investments

Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

Tshiamo Masike
Economic Analyst

in the moment

Business pulse: Confidence improves but remains disappointing

Highlights

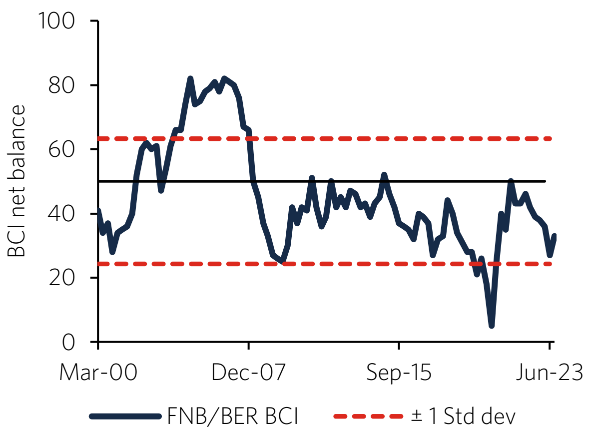
- Business confidence, measured by the First National Bank (FNB)/Bureau for Economic Research (BER) Business Confidence Index (BCI), picked up to 33 points in the third quarter of 2023 after plummeting to 27 points in the second quarter (the lowest level since the third quarter of 2020).
- The improvement in BCI was broad-based but retailers expressed the biggest increase of 12 points to 32 points. This largely reversed the 14-point drop recorded in the second quarter.
- According to the BER, non-durable goods retailers expressed more optimism in the third quarter, which can be explained by the moderation in food and transport inflation in recent months.
- Despite manufacturers' sentiment being the most downbeat of the industries surveyed, manufacturing production increased by 2.3% q/q in the second quarter. Mining production also grew by 1.5% q/q, which is a relatively good performance for these industries considering ongoing power outages. The second quarter has been the third worst quarter of loadshedding so far which contextualises the severity of loadshedding in the quarter and points to the resilience of these industries. Nevertheless, mining production in the first half of 2023 was 1% lower than last year and year-to-date (YTD) growth in manufacturing remains muted.
- In addition to electricity outages, falling commodity prices are negatively affecting the earnings of mining companies which will in turn lead to lower tax revenues.
- Stats SA's manufacturing survey conducted once every three years reveals that the industry's contribution to economic activity and employment has gradually decreased. Profits have also decreased despite an increase in total income and a larger number of firms are responsible for the bulk of income (less concentration).
- The decline in the manufacturing industry workforce and lower contribution to economic growth is in line with the long-term decline in capacity utilisation. Addressing constraints faced by manufacturers (insufficient demand, logistics constraints, electricity shortages, stringent labour laws as well as high interest rates and taxes) could reverse the deterioration in capacity utilisation and lead to more jobs and economic growth.
- The agriculture industry rebounded to 4.2% q/q in the second quarter of 2023 following two consecutive quarters of contraction. However, sentiment remained weak with the Agbiz/IDC Agribusiness Confidence Index unchanged at 44 points in the second quarter of 2023.
- Directionally, business sentiment has improved, but on balance businesses remain pessimistic about overall operating conditions in the local environment. We expect growth to improve from a revised 0.7% this year (thanks to a better-than-anticipated second-quarter figure and lower levels of loadshedding over winter relative to expectations) to above 1% next year, on the back of an assumed improvement in energy supply. However,

structural bottlenecks and weak demand, in a restrictive interest rate environment, will continue to dampen private investment (outside of renewable energy projects) and jobs growth.

Broad-based improvement in business sentiment off a weak base

The FNB/BER BCI increased to 33 points in the third quarter of 2023. This improvement comes after a consistent deterioration in business sentiment over the past five quarters which saw sentiment at the lowest level (27 points in the second quarter of 2023) since the third quarter of 2020. The uptick in the BCI is a positive outcome but the index is still well below the 50-point neutral mark (see chart 1) which indicates that respondents still perceive prevailing business conditions as being unsatisfactory.

Chart 1: BCI edges up to 33 points

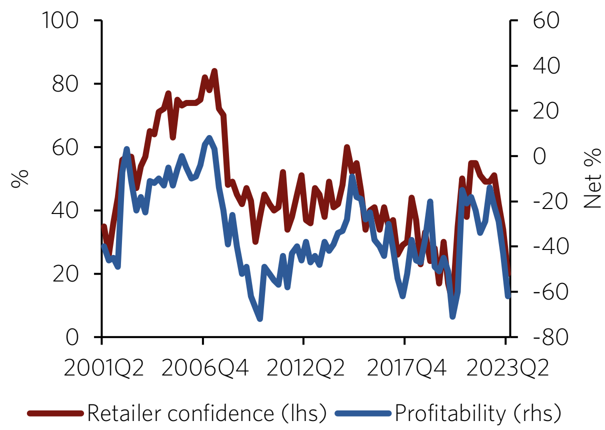


Source: BER, Global Insight, Momentum Investments

Less intense pessimism was registered across four of the five sub-indices in the third quarter. Retailers were the biggest driver of the increase in BCI with confidence improving markedly by 12 points to 32 points. Confidence of new vehicle dealers went up by seven points to 30 points and confidence of wholesale and manufacturers ticked up by six points each to 38 points and 23 points, respectively. The only deterioration in sentiment was registered by building contractors which corresponds with the lower fixed investment in residential and non-residential buildings during the second quarter (negative 2% q/q and -0.8% q/q, respectively). Due to the depressed sentiment built up over the past quarters, the improvement in the sub-indices still leaves the respective indices in contractionary territory. Moreover, manufacturers still have the lowest confidence levels among the surveyed industries. The BER notes that actual manufacturing data is, however, not as weak as sentiment because manufacturing production rose in the second quarter of 2023 and exports were higher.

The 12-point rebound to 32 points among retailers was to a large extent reversing the 14-point drop recorded in the second quarter. According to the BER, profitability was behind the decline and subsequent recovery in sentiment. In the second quarter, profitability was down to its lowest level since the second quarter of 2020 (see chart 2) due to higher costs associated with loadshedding, high food inflation and elevated interest rates. The increase in profitability in the third quarter was due to milder purchasing price increases.

Chart 2: Weak retailer confidence reflects pressure on consumers

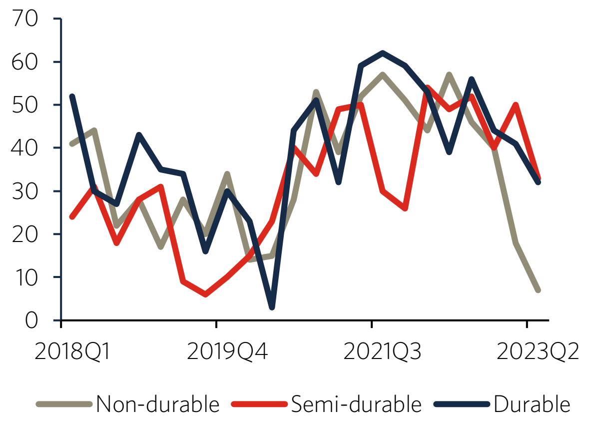


Source: BER, Momentum Investments
Data until second quarter of 2023

The third quarter sentiment levels among retailers also reversed downbeat sentiment that was previously expressed by non-durable goods retailers. As seen in chart 3, confidence of retailers trading in non-durable goods plummeted to seven points in the second quarter. According to the third-quarter BCI report, 'the confidence of non-durable and semi-durable goods retailers was at its best level this year' which suggests a substantial improvement in sentiment by non-durable goods retailers in the third quarter. Previously, the sub-segment was negatively affected by the surge in inflation and the recent deceleration in inflation may be behind the reported reprieve expressed by food retailers.

While sentiment has improved, factors weighing on confidence and economic activity remain. According to the BER, respondents cited loadshedding and the taxi strike in Cape Town as some of the factors affecting business activity in the third quarter.

Chart 3: High food inflation affected non-durable retailers' sentiment



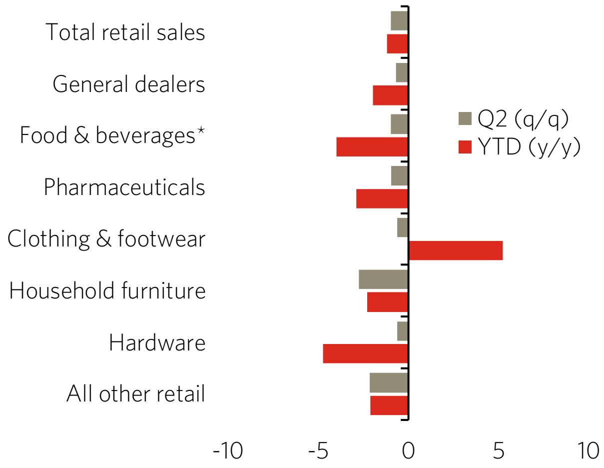
Source: BER, Momentum Investments

Difficult trading environment for retailers spills over to wholesalers in the second quarter

Second quarter retail trade data published by Stats SA correlated with the pessimism expressed by retailers in the second quarter BER retail survey. Retail sales in the second quarter were down by 1% q/q, sa. This follows an increase in sales in the two preceding quarters which contributed positively to economic growth. The drop in sales during the second quarter was across all seven retailer types and the largest quarter-on-quarter decline was recorded for household furniture, appliances, and equipment sales (negative 2.7% q/q, sa) as seen in chart 4. This ties in with the 10-point drop in consumer sentiment measuring the appropriate time to buy durable goods according to the second quarter consumer confidence survey results.

In the first half of 2023, retail trade sales were 1.2% lower than in the first half of 2022 and the decrease was evident across six of the seven retailers. Retailers in hardware, paint and glass experienced the biggest decrease of 4.7% y/y, followed by those who trade in specialised food and beverages (negative 4%) and pharmaceuticals (negative 2.9%). The only retailers with higher sales over this period were clothing and footwear stores (see chart 4).

Chart 4: Robust clothing and footwear sales



Source: Global Insight, Stats SA, Momentum Investments
Food, beverages and tobacco in specialised stores

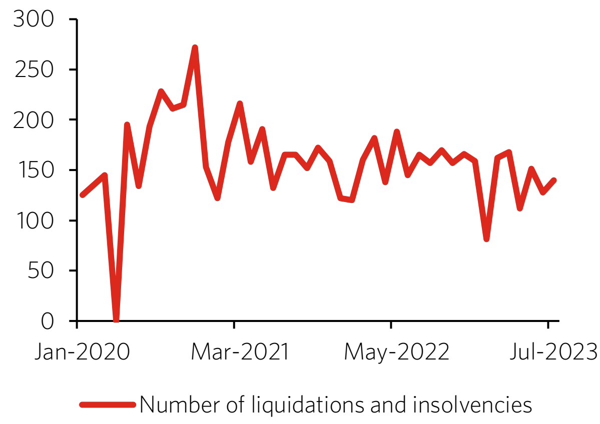
Pessimism expressed by retailers about expected sales and order volumes in the second quarter was reflected in wholesale trade sales. Seasonally-adjusted wholesale trade sales decreased by 0.9% q/q in the second quarter of 2023. The largest monthly decreases in wholesale trade sales were experienced in May (negative 4.5% m/m) and June (negative 3.3% m/m).

The lower retail and wholesale trade activity contributed to the 0.4% q/q contraction in trade, catering and accommodation during the second quarter which resulted in this industry detracting 0.1% from

GDP growth of 0.6% q/q published by Stats SA. The improvement in confidence expressed by retailers and wholesalers in the third quarter may be signalling an improvement in outcomes for the third quarter trade sales.

The number of business liquidations in July was 140 and the bulk (55) of this was cases from financing, insurance, real estate and business services industries. The trade and accommodation industry had the second most cases of liquidations (22) in July.

Chart 5: Liquidations on a downward trend



Source: Global Insight, Stats SA, Momentum Investments

Mining and manufacturing output suggests growing resilience against loadshedding

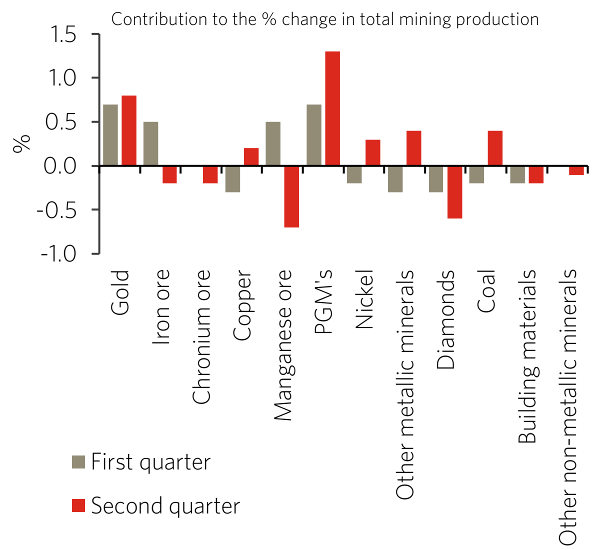
In contrast to retail and wholesale trade sales, mining and manufacturing production were positive in the second quarter.

Mining production increased by 1.5% q/q, sa in the second quarter of 2023 and contributed 0.1% to the economy. The growth in production was mainly due to platinum group metals (PGMs) increasing by 5.8% q/q and contributing 1.3% as well as gold (5.2% q/q, contributing 0.8 %). The increase in PGMs and gold overshadowed the contraction from manganese ore (negative 9% q/q, contributing negative 0.7%) and diamonds (negative 17.4% q/q, contributing negative 0.6%), see chart 6. PGM production increased for the second consecutive quarter following four quarters of contraction and Investec attributes higher PGM production in the first half of 2023 to strong global auto sales.

Growth in mining production growth in the second quarter was at the same pace as in the first quarter (1.5% q/q) despite more intense loadshedding in the second quarter. To date, the first quarter of 2023 has been the worst quarter of loadshedding, followed by the fourth quarter of 2022 and then the second quarter of 2023 (see chart 7). While the second quarter is the third-worst quarter of loadshedding to date, stage 6 loadshedding was implemented more often during that quarter than any other quarter which means the frequency of load curtailment was also higher.

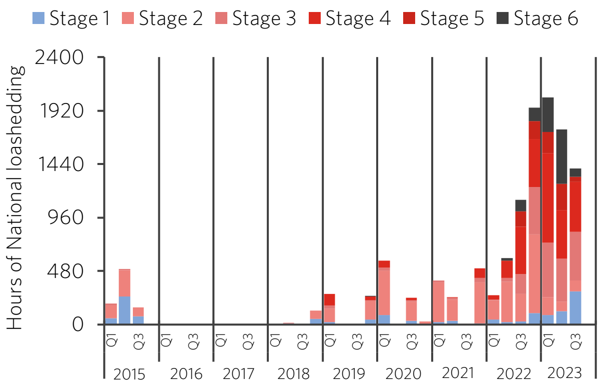
Consequently, operating conditions were relatively tougher in the second quarter, yet mining production increased on a quarter-on-quarter basis.

Chart 6: Contribution from PGMs held up mining production in the first half of 2023



Source: Global Insight, Stats SA, Momentum Investments

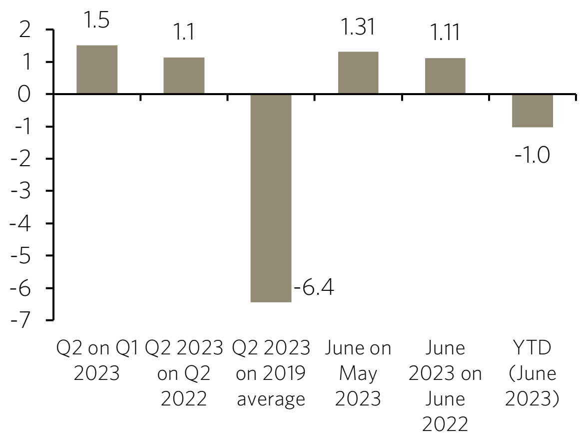
Chart 7: Stage 6 was more frequent in Q2 2023



Source: Global Insight, Stats SA, Momentum Investments

In Anglo American's interim results for the first six months of 2023, the company noted that power outages have had a limited impact on mining production because mining and processing companies experience load curtailment instead of loadshedding and careful planning helped reduce the impact of power outages. The company further noted that in instances where they need to shut down some processes to reduce power consumption, they typically decrease operations at the processing stage and not mining operations which explains the resilience underlying mining production.

Chart 8: Mining output performance over different periods, %

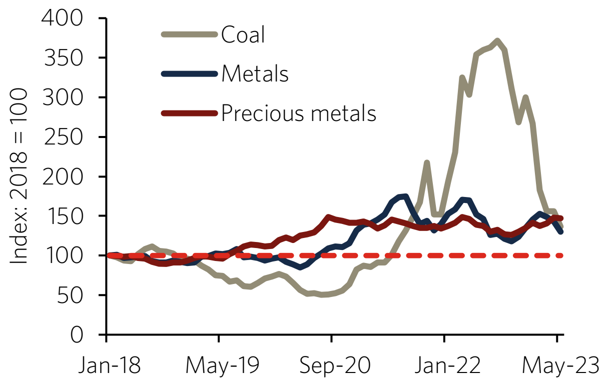


Source: Global Insight, Stats SA, Minerals Council of SA, Momentum Investments

The impact of loadshedding on mining production may be limited quarterly but the impact is not negligible. For instance, mining output was 1% lower in the first half of 2023 compared to the first half of 2022 (last column in chart 8) and second quarter production was 6.4% lower than pre-pandemic levels. Aside from power outages, logistics deficiencies and slowing global growth also have a role to play in these outcomes.

While mining production has remained relatively robust under the circumstances, there is a build-up of work-in-process inventory which affects sales volumes and overall earnings. Earnings are also negatively affected by lower commodity prices and higher costs associated with renewable energy investments.

Chart 9: Plunge in coal prices

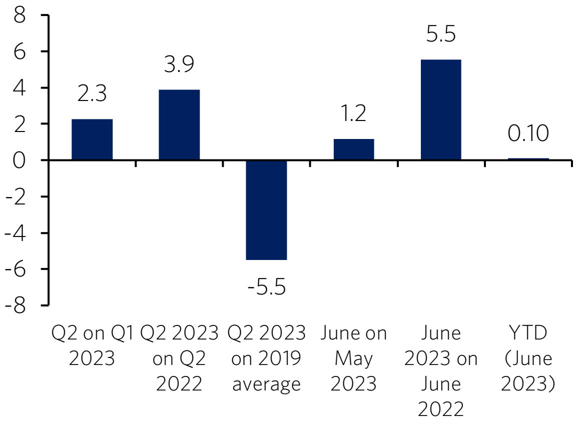


Source: Bloomberg, Momentum Investments
Metal = Aluminium, copper, iron ore, lead, nickel, tin, uranium, zinc
Precious metals = Gold, Palladium, Platinum, Silver

In May 2023, the International Monetary Fund (IMF) coal price index was down by 61.4% (negative 45.5% in April). The metals price index was 14.4% lower in May and the precious metal index was up by 5.7% y/y%. Lower business earnings due to falling commodity prices will negatively affect the industry's contribution to GDP and government revenues. According to the Mineral Council of SA, the mining industry contributed R73.6 billion in taxes in 2022 but this will possibly be lower in 2023.

Similar to mining production, manufacturing output increased despite more intense loadshedding in the second quarter and contributed positively to GDP (0.3% contribution). Seasonally adjusted manufacturing output grew by 2.3% q/q, higher than 1.4% q/q in the first quarter. All the categories, apart from food and beverages, reported positive growth. The biggest contribution was from petroleum, chemical products, rubber and plastic products (4.1% q/q, contributing 0.9%) and basic iron and steel, non-ferrous metal products, metal products and machinery (4.1% q/q, contributing 0.8%).

Chart 10: Manufacturing output performance over different periods, %



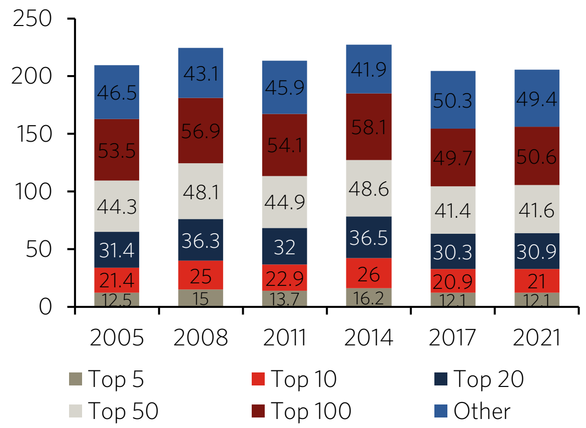
Source: Global Insight, Stats SA, Momentum Investments

Manufacturing production was broadly unchanged in the first half of 2023 compared to the first half of 2022 (last column in chart 10) and second quarter production was 5.5% lower than pre-pandemic levels.

The latest Stats SA manufacturing survey (conducted once every three years since 2005) indicates that income generated in the industry has increased by 6.7% between 2005 and 2021, however, profit margins have declined and the workforce has decreased by 308 845 jobs over this period. Moreover, the industry's contribution to economic growth has gradually decreased from 23.1% in 1993 to 13.2% by 2021.

In 2021, the bulk of total income in the manufacturing industry was generated from petroleum and chemicals (accounted for 26% in 2021 from 24% in 2005) followed by food and beverages (23% from 17% in 2005). The lowest income source was telecommunication, medical and optical equipment (1%) but this division had the highest profit margins. The least profitable manufacturing division in 2021 was furniture, other manufacturing and recycling.

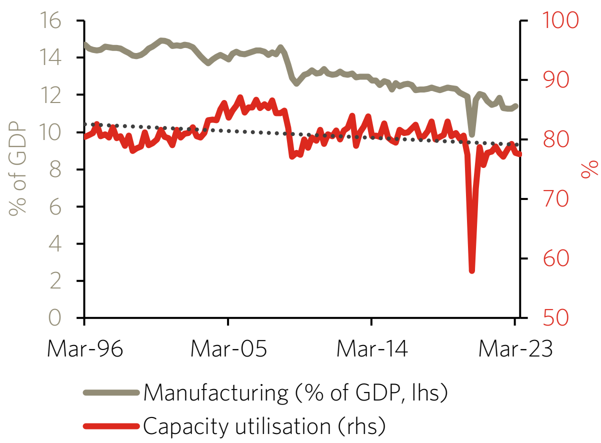
Chart 11: Highest income concentration ratio was in 2014, %



Source: Stats SA, Momentum Investments
Concentration ratio refers to the distribution of total income among enterprises i.e. concentration ratio is higher if a few large firms generate most of the income
The percentage from top 5 to top 100 is cumulative and 'other' is separate. Therefore top 100 + other = 100%

The concentration ratio for total income in the manufacturing industry in 2021 was slightly lower than in 2005 (see chart 11) which implies that income was generated among a larger number of enterprises and signals slightly more competition in 2021 compared to 2005. The highest concentration in the industry was in 2014 when the top five companies accounted for 16.2% of total income while the top 100 companies accounted for almost 60% of total income. As such, 2014 was the least competitive year.

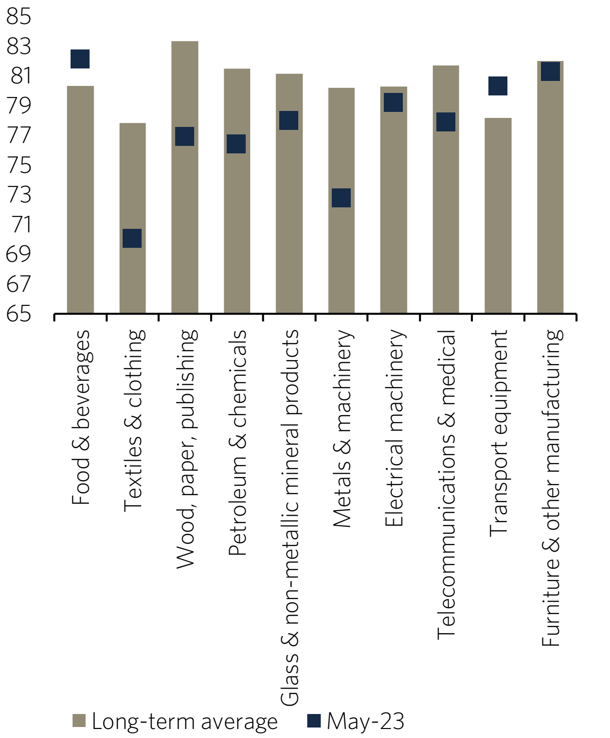
Chart 12: Long-term downward trend in capacity utilisation



Source: Stats SA, Momentum Investments

The decline in the manufacturing industry workforce and lower contribution to economic growth is in line with the long-term decline in capacity utilisation (see chart 12). According to Stats SA, capacity utilisation was 77.5% in May 2023, slightly higher than 77.1% a year ago but lower than 77.8% in February.

Chart 13: Broad-based capacity utilisation decline, %



Source: Stats SA, Momentum Investments

The only two manufacturing divisions that were operating above their respective long-term average capacity levels in May 2023 were transport equipment (80.3% compared to 78.2%) as well as food and beverages (82.1% compared to 80.3%). As seen in chart 13, all the other division's capacity utilisation levels were below the long-term average with the biggest decline recorded in textiles and clothing as well as metals and machinery. Enterprises in textile and clothing attributed the bulk of the drop to insufficient demand. This was also the biggest driver in the metals and machinery division coupled with a shortage of raw materials. None of these two divisions put much weight on the shortage of labour (skilled/semi and unskilled labour) as a constraint which in part correlates with the increasing unemployment rate. Therefore, improving capacity utilisation in this industry has the potential to create job opportunities and decrease the unemployment rate but this is dependent on addressing the mounting challenges facing the industry, namely, insufficient demand, logistics constraints, stringent labour laws, as well as high rates and taxes.

The ABSA purchasing managers index (PMI) averaged 48.9 in the second quarter of 2023, lower than the average of 50 in the first quarter. The drop was broad-based across eight of the nine subcategories of PMI. Inventories was the only sub-category that went up from contractionary territory (49.1) to expansionary territory (52.7). The business activity sub-index slid from 49.9 to 48.1 in the second quarter which was against the growth in production output recorded in the industry but ABSA notes that a divergence between these two indicators is not an unusual occurrence. The biggest drop was registered for expected business conditions (55.4 to 49) which signals that manufacturers are not optimistic about operating conditions in the next six months. This is not surprising considering sluggish economic growth, financially burdened consumers, rising political uncertainty and ongoing power cuts. The ABSA PMI index improved slightly from 47.3 in July to 49.7 but remained in contractionary territory. ABSA notes that respondents experienced longer delivery times from suppliers in August and the institution partly attributes this to the Cape Town taxi strike, which should reverse in the coming readings.

The S&P PMI for SA lifted into positive territory at 51 points in August from 48.2 in July. This is the first time the index recorded above the 50-point neutral mark in six months.

Agriculture sentiment remained downbeat in the second quarter

The agriculture industry rebounded to 4.2% q/q in the second quarter of 2023 following two consecutive quarters of contraction. However, sentiment remained weak with the Agbiz/IDC agribusiness confidence index unchanged at 44 points in the second quarter of 2023. This level is the lowest since the second quarter of 2020 and is the third consecutive quarter below the 50-point neutral mark which signals that agribusinesses are not optimistic about operating conditions. According to Agbiz, respondents attribute downbeat sentiment to a range of factors namely, "intensified geopolitical tensions, unfavourable draft water regulations, persistent episodes of loadshedding, rising interest rates, poor road conditions and ongoing weaknesses in municipal service delivery".

Unfavourable draft water regulations refer to the revisions of regulations on the "Procedural Requirement for Water Use Licence Applications" recently published by the Department of Water and Sanitation (DWS) in May 2023. The revised draft captured the reduction of the turnaround time for processing licence applications from 300 days to 90 days and introduced regulations to redress the skewed allocation of water licences toward historically advantaged individuals. The DWS proposed to redress the skewed allocation through race quotas in the form of a black shareholding requirement (25%, 50% or up to 75%) for water applications to be granted. According to Agri SA, the DWS clarified that the race quota would apply to new applications only and would not affect existing license holders. The impact of this regulation on agricultural business confidence illustrates the importance of policy and the role it can play in creating a conducive environment for businesses to operate in.

Growth should improve into 2024 but will remain historically weak given structural bottlenecks

The slight improvement in business confidence for the third quarter of 2023 is a positive outcome but the index remains in contractionary territory (below the 50-point neutral mark) which indicates that the current operating environment continues to be characterised as unfavourable.

A big determinant of activity in the retail and wholesale space is the state of consumer finances which remain under pressure due to the escalating impact of previous interest rate hikes and elevated inflation. As such, we may continue to see weak activity in retail sales in the third quarter but the festive season and Black Friday in November will likely improve sales growth in the fourth quarter.

Given the evidence of growing resilience in the mining and manufacturing industries, the risk of more intense loadshedding in the coming months will unlikely significantly impact production. Softening commodity prices does, however, pose a risk to activity in the mining sector.

Despite downbeat sentiment by agribusinesses, the agriculture industry is one of the more robust industries supporting economic growth and we do not expect any material change to this trend because of an expected good harvest and government measures implemented to mitigate the impact of loadshedding on the sector.

In spite of the increase in liquidations and insolvencies during July, we have observed a general downward in insolvencies since March 2023.

The slight improvement in the BCI and PMI supports our upward revised growth estimate of 0.7% for 2023 (thanks to a better-than-anticipated second-quarter figure and lower levels of loadshedding over winter relative to expectations). We expect growth to improve to above 1% next year, on the back of an assumed improvement in energy supply. However, structural bottlenecks and weak demand, in a restrictive interest rate environment, will continue to dampen private investment (outside of renewable energy projects) and jobs growth.