TURKEY AND TRADE WARS **DOMINATE GLOBAL HEADLINES**

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Last month we reported on a global economy that still experienced strong growth in the second quarter of this year and – despite somewhat more disparate growth between different countries and regions – would likely retain above trend growth rates into 2019. We also mentioned that the biggest risk for the global economy was the potential for a full-blown trade war. While trade is still a major issue, we have seen some progress on this front, with the US reaching a better understanding on trade issues with the European Union and Mexico. Despite further sabre rattling from the US president, talks with Canada and China are ongoing. Nevertheless, trade remains a big risk.

POLITICAL TURMOIL TURNS TO ECONOMIC WAR

In August, simmering political and economic problems in Turkey suddenly turned into a crisis, impacting emerging market currencies as market participants feared contagion.

KEY TAKEOUTS

- TRADE TENSIONS REMAIN A RISK, DESPITE SOME PROGRESS
- SIMMERING PROBLEMS IN TURKEY QUICKLY TURNED INTO A CRISIS
- EMERGING MARKET CURRENCIES SUFFER CONTAGION FEARS

The Turkish lira started plunging in May, on the back of increasingly weak economic fundamentals and significant political risk. While GDP growth was strong in 2017 (7.4%), it was fuelled by a sharp rise in credit growth and an expanding fiscal deficit. With a large current account deficit, high dependence on foreign borrowing, inflation above 15% (three times higher than the target) and a lack of central bank action due to political interference (the president announced that interest rates would not be raised), conditions rapidly deteriorated. Matters came to a head when a dispute with the US over the release of an American preacher arrested on terrorism charges led to sanctions and significant tariff increases. The Turkish president likened this to "economic war".

WHAT IS NEXT FOR TURKEY?

Policy credibility needs to be restored if there is any hope of stabilising the currency. Despite rising inflation – and further upward pressure from the sharply weaker currency – the central bank did not hike rates in July at their regular meeting, nor during the currency crisis in August. Regaining credibility requires the central bank to commit to bringing down inflation and the current account deficit, even if that means significant pain to the economy in respect of growth. The focus needs to be on achieving medium-term sustainable growth, contained inflation and financial stability. The sharply weaker currency should help in rebalancing the current account, but tighter monetary and fiscal policies will likely also be needed to depress demand. None of this is likely, though, without political support.

Contagion risk should be relatively small, despite its relative strategic importance as a member of NATO. Turkish GDP accounts for only 0.6% of European GDP and only 3% of European exports. Exposure to European banks varies, but is probably not as large as feared. In addition, Turkey constitutes just 0.6% of the global emerging markets (GEM) market cap and only 3.7% of GEM bond indices. The biggest risk is probably that markets may focus on other economies with similar fundamentals.

The combination of some emerging market contagion from the Turkey crisis, and the stronger US dollar during August (which strengthened from US$1.17 to the euro at the beginning of August to US$1.13/€ by mid-August), has caused some pain for other emerging economies, including South Africa. We still believe that somewhat more synchronised global growth going forward – including improving Euro-area growth combined with somewhat slower US growth – and the underlying US fundamentals (such as the large twin deficits) will lead to the US dollar moving back towards the US$1.20/€ range. This will help in stabilising emerging markets and also lead to more evenly spread global growth.

We remain of the opinion that despite recent blow-ups and continued risk around trade issues, the world economy should continue to perform relatively well. Growth is likely to moderate going forward, but is unlikely to turn into a full-blown downturn.

WHAT'S BEHIND SOUTH AFRICA'S RECESSION?

Many market participants, including ourselves, were surprised by the announcement in early September that the economy had contracted by 0.7%. This follows a negative first quarter annualised GDP number of -2.2% (which was further revised down to -2.6%).

These two consecutive quarters of negative GDP put us into technical recession. The main reason for the low growth is the lack of consumer, business and investor confidence, largely because of political and policy uncertainty. However, there were additional factors that dragged our growth numbers down. For instance, the agricultural sector was a significant contributor to the GDP contraction, down 29% quarter on quarter, annualised. We had a record agricultural year last year, thanks to the hugely improved maize crops. While maize production has been strong again and more than enough to satisfy our own needs and to export, it is down 28% compared with last year.

Second quarter GDP was also affected by weak consumer spending. Consumers faced rising prices following the VAT increase and petrol price hikes. In addition, public sector employees – who make up roughly a third of the total wage bill in SA – didn't get their annual increases during the second quarter this year. The new wage agreement was backdated to April, which means they got back pay at the end of July. This should support a recovery in consumer spending and retail sales, and even GDP numbers, in the third quarter.

The weak overall GDP number means 2018 growth will be even weaker than last year's 1.3%, whereas at the start of this year we expected stronger growth to come through. Even if there's a recovery in the third and fourth quarters, growth will, at best, be around 0.7%-0.8%.

The recession announcement, of course, has had a severe impact on currency, which had already been under pressure from concerns around emerging markets – driven by fears of contagion from Turkey and Argentina. Following the release of the GDP numbers, the rand fell further over concerns around much lower growth and Government's ability to reach their fiscal targets, putting our credit ratings at renewed risk.

A weaker currency is reflected immediately in the economy through petrol price increases and will eventually have an impact on other pricing, such as food. The South African Reserve Bank (SARB) has already said that it will only react to second-round inflationary impact. In other words, it will not act simply because the petrol price has gone up due to a weakening rand. In any case, the weaker rand and a higher petrol price are deflationary in that people have less to spend on other goods, so there are no demand-driven price increases. It has already been difficult to pass on price increases from a weaker currency, given the slow growth in the economy, and these conditions will persist. Therefore, the SARB will continue to talk hawkishly, but I don't think an interest rate hike is imminent, given the deflationary impact of recent price increases and the weak state of the economy.

Despite all of this, I still think we're probably sitting at the peak of pessimism regarding economic growth, confidence and the currency. Our investment theme for South Africa of "Winds of Change" is still intact, but will take time to unfold. With national elections coming up, we shouldn't expect significant policy changes before then. And if President Ramaphosa's investment target of US$100 billion over five years comes to fruition, it is not impossible that – in conjunction with other policy measures – we can reach 3%-3.5% GDP growth by the early 2020s. ■