



2009 Budget Commentary

Trevor Manuel is a very capable finance minister (in all likelihood, the best South Africa has ever had) and has once again delivered a wise budget, this time in the most difficult circumstances he has faced in this capacity. However, at Orthogonal Investments, we have regularly demonstrated the futility of macro-economics in managing active investment portfolios. We cannot recall many cases in 19 years in which the budget speech has had a meaningful impact on equity or bond markets. (As an aside, poorly thought-out pronouncements from cabinet ministers outside of the budget speech can certainly shock markets, as in the case of the deleterious, ill-conceived and un-researched proclamation on mining royalties a few years back).

The budget speech seldom delivers great surprises, simply because analysts are quite good at anticipating its prominent features. In recent years, this has been exacerbated by the MTBP, which provides clear guidelines to government's financial plans. As such, most pronouncements are well discounted and the effect on markets is minimal. Occasionally, some participants briefly mis-interpret some aspects. For example, yesterday's speech contained certain partial, explicit guarantees for Eskom's debt. For a very short while, this caused the spread on Eskom's bonds to narrow. Then when it dawned on those bond market participants that Eskom's debt always was *de facto*, if not *de jure*, government guaranteed, this aberration unwound fairly quickly.

The slowing economy means that the fiscal position will deteriorate, causing government borrowing to increase rapidly. The minister now expects a deficit of 3.8% of GDP. This, *ceteris paribus*, does not bode badly for bonds, as the correlation between issuance and yields is very low, in spite of widespread beliefs to the contrary – currently, extraordinarily low US Treasury yields in the face of an avalanche of impending new supply demonstrate this adequately. We expect further weakness in the local bond market as a result of heroic assumptions on inflation that have been priced into bonds, but this is not a budget issue; it is a valuation issue, all that ultimately counts.

For equities, the effect on consumers from the deceleration in real GDP growth has been partially offset by mild stimulatory measures such as the perfectly predictable relief from fiscal drag (a feature of almost every budget speech) which leaves the consumer about neutral. The one year deferral of royalties payable by mining companies provides a smidgen of relief to those firms, but in the greater scheme, this has a negligible impact on valuation. So once again, the effect on equities is barely discernible.

We suggest that as is the case with nearly all companies' managements, the minister's forecasts are probably a little optimistic. His GDP forecasts are certainly higher than the private sector's consensus, so unless SARS manages yet again to improve on revenue collection, the deficit may exceed Minister Manuel's expectation. Such an outcome would manifest itself slowly, and fail to surprise markets.

The budget speech is an increasingly fabulous spectacle, replete with fanfare and fashion, and is an opportunity for full-time economists to justify their salaries and jam printing presses for a few days. It makes for good television and produces a perennial comical groan when sin taxes are raised (are parliamentarians bigger drinkers and smokers than average South Africans?). But alas, the budget is quite an anti-climax for market analysts who must continue the difficult job of ascertaining fair value and for portfolio managers who must implement positions when prices deviate from estimates of fair value.