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ECONOMIC NEWSLETTER

Dragon Wealth

NAVIGATING MARKET VOLATILITY AMID POLITICAL AND ECONOMIC UNCERTAINTY

February 2025 saw market volatility, with resilience tested by earnings surprises, policy shifts, and economic uncertainty. Nvidia fell 7% after releasing its Q4 results, while the U.S. intensified its tariff rhetoric, targeting tariffs of 25% on EU, Mexico, and Canada and 10% on China (effective March 4).

Domestically, failure to adopt the 2025 Budget highlighted the fiscal strain weighing on consumers. Debt has climbed to 75.4% of GDP (R5.9 trillion), with spending pressures and declining per capita GDP weighing on investor sentiment.

SOUTH AFRICA: THE BUDGET THAT WASN'T

The 2025 Budget Policy Statement, set to take place on Wednesday 19 February, was subsequently postponed due to internal political disagreements over a proposed increase in the value-added tax (VAT) rate from 15% to 17%. This potential 2% hike has faced significant backlash, particularly given the already strained financial position of many households and the weak tax buoyancy observed in the economy. The additional VAT burden would not only increase consumer costs but could also contribute nearly a full percentage point to the Consumer Price Index (CPI) inflation rate, depending on how zero-rated items are treated.

The VAT increase was projected to generate approximately R58 billion in additional tax revenue, which would have helped address fiscal pressures over the medium term. With the plan now uncertain, the government must explore alternative ways to bridge the revenue gap:

1. **Adjusting other taxes** – This could involve increasing personal income tax, corporate tax, or fuel levies to compensate for the lost VAT revenue.
2. **Utilizing the Gold and Foreign Exchange Contingency Reserve Account (GFECRA)** – This would involve tapping into foreign exchange reserves to fund expenditure, as was done previously.
3. **Cutting government spending** – A politically sensitive approach that may involve reducing public sector wages, social grants, or infrastructure investment.
4. **Increasing debt issuance** – Borrowing more in the bond market, which could lead to higher yields and increased government debt costs.

The delay in the Budget announcement has introduced uncertainty in financial markets, with investors closely assessing the potential implications. Bond markets have reacted mildly so far, though concerns persist about how the government will fill the revenue gap. If the state chooses to rely more heavily on borrowing, it could weaken government bonds further.

From a credit rating perspective, the postponement is unlikely to have a significant impact in the short term. S&P Global Ratings, one of the three major agencies (alongside Fitch and Moody's), upgraded South Africa's credit outlook to positive in November 2024, signalling the potential for a future upgrade from its current BB- rating. This decision was based on an improved political environment following the stable and peaceful National Elections last year, as well as the formation of the Government of National Unity (GNU). Given this context, rating agencies are expected to take a wait-and-see approach rather than react immediately to the Budget delay.

On the economic front, South Africa's inflation rate rose to 3.2% in January, up from 3.0% in December, following a methodological overhaul by Statistics South Africa. This increase was primarily driven by rising costs in housing, utilities, insurance, and financial services, in line with economists' expectations.

SOUTH AFRICA: THE BUDGET THAT WASN'T CONTINUED

South African Reserve Bank (SARB) Governor Lesetja Kganyago has highlighted external risks, including rising global tariffs, which could disrupt the broader disinflation trend. Looking ahead, traders currently see a 24% probability of a 25 basis-point interest rate cut at the March Monetary Policy Committee (MPC) meeting. However, given ongoing inflation.

AMERICA'S DEBT ISSUE

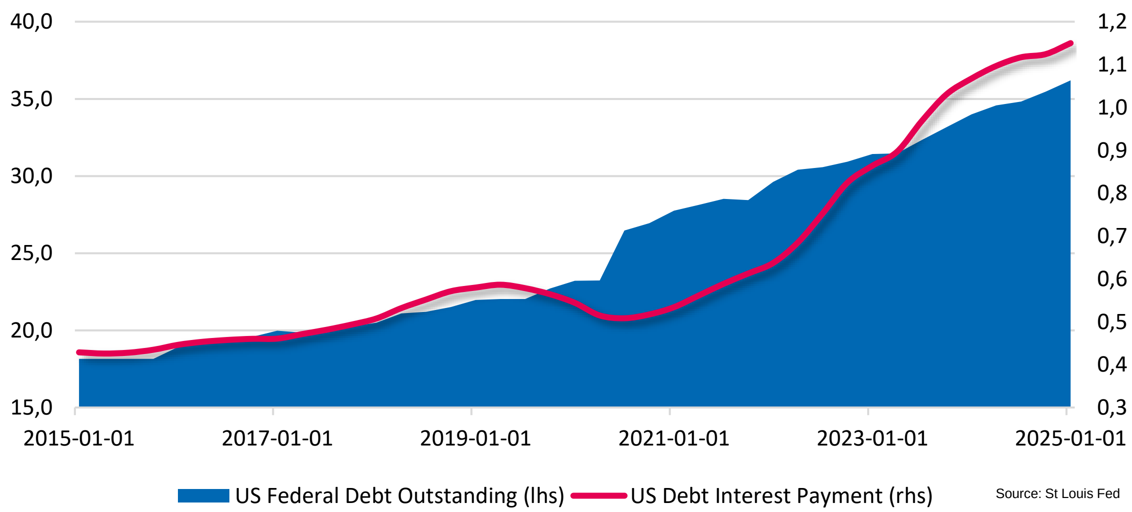
A newly formed advisory body, created by U.S. President Donald Trump and led by billionaire entrepreneur Elon Musk, has been tasked with cutting government spending and reducing the federal workforce. The initiative aims to streamline government operations, eliminating what Musk considers unnecessary expenditures and inefficiencies that burden taxpayers.

Despite its official-sounding name, the Department of Government Efficiency (Doge) is not a formal government agency. Unlike official federal departments that require congressional approval to be established, Doge was created through one of Trump's executive orders. It functions solely as an advisory body, with dedicated teams assigned to assess spending within each government agency. Reports indicate that at least four employees from Doge will be embedded within every major federal department to evaluate costs and identify areas for potential cutbacks.

A key component of Doge's mandate includes modernising government IT infrastructure and reducing the number of government employees. The advisory body must complete its work by July 2026, after which it will submit final recommendations on restructuring federal agencies, optimising budgets, and potentially eliminating redundant positions.

Musk has publicly stated that Doge's mission is to protect taxpayers' money and help reduce the U.S. national debt, which currently stands at a staggering $36 trillion. A major concern fuelling the urgency of spending cuts is the rising cost of servicing that debt. In the second half of 2024, interest payments on U.S. government debt surpassed $1 trillion, exceeding the annual budget allocated for national defence. If left unchecked, Musk and his team argue, this growing debt burden could pose significant economic risks to the country.

Fig 1. US National Debt & Interest Expense (U$tn)



Source: St Louis Fed