

---

# The relationship between South Africa's macroeconomic policies and the performance of the various asset classes

C Harmse

## Introduction

The aim of this paper is to analyse the effects of the macroeconomic stabilisation policy of South Africa since 1994 on the performance of the various asset classes of investments that are available for the investor.

The South African economy, like the political change that has taken place in South Africa since the release of former president Mr Mandela, has undergone a noticeable fundamental and structural adjustment. This political and economic adjustment had a substantial effect on not only the everyday life of the citizens of the country, but also on the business and financial investment climate in South Africa. The challenge for the new South Africa was to create an economic and social-political environment where citizens would have access to quality work and enterprise opportunities, and access to the capacities and skills to make use of these opportunities. Enterprises of all types and sizes would have to become adaptive, innovative and internationally competitive. The challenge was to build on a platform of infrastructure and logistics, competitive input prices, skills, technology and innovation, partnerships, efficient regulation and effective government offerings. Consumers were to have access to safe, competitively priced quality goods and services in a non-exploitative system that encourage producers to respond to consumer needs, while providing effective recourse mechanisms where abuse occurred.

Various analyses about the adjustment process of the South African economy prove that it was in particular successful from the late 1990s. Prudent fiscal, trade and monetary policy stabilisation programmes had contributed towards not only the creation of a normal economic and investment environment, but also diminished the risk factor for foreign portfolio and direct investment. In an environment of low interest and inflation rates since 2000, South African companies could improve their competitiveness, and as a result share prices were suddenly low-priced in the analysis of foreign investors. Given exceptional low price-earnings ratios for most listed companies in South Africa, South African shares became popular amongst especially foreign portfolio investors. In such an environment, not only did the demand for South African shares on the JSE start to rise, but also the value traded on a daily basis, from around R2 billion in 2002 to the current R8 billion to R10 billion. As a result, the all-share index (Alsi) has increased more than fourfold, from around 5 000 in 2001 to the current 20 000 levels.

Against this economic and policy structural adjustment process, since 1994 investment opportunities in South Africa have also undergone structural change. The risk of investment increased considerably, not only due to some lifting of exchange controls on residents, and total abolition on non-residents over the last ten years that opened the opportunities for domestic and foreign investors to diversify their portfolios over various asset classes, but also due to the opening of the South African economy to globalisation. Therefore, it has now become necessary to analyse the effects of these macroeconomic stabilisation policies on the performance of the various domestic and global asset classes available for the South African investors, so that rational and risk-free adverse decisions can be taken by the portfolio manager and broker, as well as the investor.

## The South African economy: Structural adjustment after 1994

The South African economy, like the fundamental political change that has taken place in South Africa since the release of former President Mandela, has undergone a noticeable fundamental and structural adjustment. These political and economic adjustments had a substantial effect on not only the everyday life of the citizens of the country, but also on the business and financial investment climate in South Africa. The challenge for the new South Africa was to create an

economic and social-political environment where citizens would have access to quality work and enterprise opportunities, and access to the capacities and skills to make use of these opportunities. Enterprises of all types and sizes would have to become adaptive, innovative and internationally competitive. The challenge was to build on a platform of infrastructure and logistics, competitive input prices, skills, technology and innovation, partnerships, efficient regulation and effective government offerings. Consumers were to have access to safe, competitively priced quality goods and services in a non-exploitative system that encouraged producers to respond to consumer needs, while providing effective recourse mechanisms where abuse occurred.

This economy would have to be built on the full potential of all persons, communities and geographic areas. The government's objective is to substantially achieve these structural changes by 2014. This means that it has to accelerate the current trajectory of the economy if South Africa is to achieve this vision. There are constraints in the domestic economy, in our relationship to global production systems, and the changing basis of competitiveness that have to be removed.

### ***The period before 1994***

South Africa's economic and industrial performance during the late 1980s and early 1990s was constrained by both external pressures towards the political and economic isolation of South Africa, and continued internal structural inadequacies. In the sanctions era, manufacturing policies moved further towards import substitution and self-sufficiency in strategic products, leading, for example, to huge government investments in oil-from-coal and weapons industries. High levels of protection remained largely in place until the early 1990s. Weak competition laws, powerful industrial interests and various prohibitions on entrepreneurial activities, combined with a lack of interest from foreign investors led to rising levels of concentration in the ownership and structure of the manufacturing sector. This constituted a hostile environment for new entrants, black-owned enterprises and small businesses. In addition, public investment in infrastructure began to fall, leading to a backlog of new infrastructure development and maintenance of existing infrastructure. South Africa had become a country of two nations: One well-resourced with the potential to compete and the other marginalised, lacking the necessary infrastructure and with limited access to economic assets and opportunities, and in danger of even further marginalisation.

The results of these dangerous developments crystallised into the dismal economic performance in the economic growth rates achieved, as well as the ability to create jobs. This is demonstrated in Figures 1 to 4 and can be summarised as follows:

- Economic growth and employment recorded seven years of negative movements during the 1980s. This tendency continued until the beginning of 1994.
- Unemployment reached epidemic aggregates with an average rate of -3.6 per cent recorded between 1989 and 1993.
- Inflation aggregates reached alarming levels of more than 15 per cent by 1991.
- Balance of payments instability due to economic sanctions and a lack of foreign direct investment reached chaotic proportions, with the level of gross foreign reserves dwindling to less than \$2 billion.

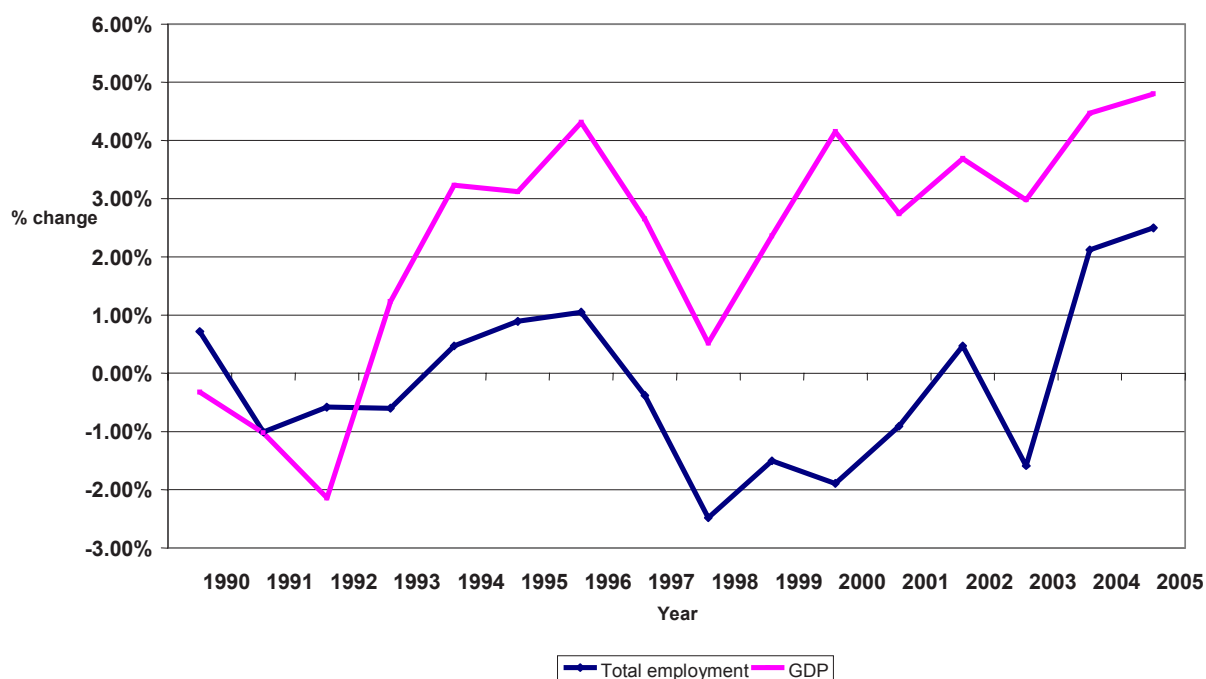
The previous government began to recognise these dangers and that the structure of the economy was fundamentally unsustainable. The economy was vulnerable to international competition and the threat of de-industrialisation. However, to continue remaining isolated from the global economy would only increase the level of vulnerability. The policy challenge was to manage the re-integration into the global economy. The sequencing of reforms had to be managed to avoid a dramatic collapse of South Africa's manufacturing sector.

### ***Post 1994: Building the foundations for sustainable growth***

The new government was faced with a massive challenge. Not only did it have to address the domestic constraints that had been identified, but it also had to bring a vulnerable and isolated South African economy back into a volatile global economy at a time when the forces of

globalisation were accelerating. Changes in global capital markets had implications for a national strategy to increase investment. This opening up of trade was applied unequally across sectors of the economy, with areas such as agriculture remaining highly protected. Nevertheless, global trade was growing at a faster rate than global gross domestic product (GDP), varying from 11 per cent in 1994 to 8 per cent in 2000, with the only significant dip being during the crisis of 1998 (International Monetary Fund (IMF) and World Trade Organisation). This is compared to GDP growth rates that did not climb above 5 per cent in G7 countries during this period and which fluctuated widely within and amongst emerging economies (IMF).

**Figure 1: Economic growth and employment in the non-agricultural sector: 1990 – 2004**



Source: South African Reserve Bank, *Quarterly Bulletin* (various issues)

The new government committed to avoid de-industrialisation, and to accelerate the growth of the manufacturing sector in South Africa as a key driver for growth and employment. The first step was a macroeconomic stabilisation programme (Growth, Employment and Redistribution, or GEAR). The aim was to reduce central government deficit from 8.0 per cent in the early 1990s to less than 3.0 per cent. Second was to bring down the inflation rate considerably from levels of more than 10 per cent prior to 1994 (see Figure 2), especially by lifting price controls, scrapping the financial rand and replacing it with a floating exchange rate, and giving the Reserve Bank more independence. Third, the introduction of a set of initial microeconomic policy reforms was initiated, the so-called "integrated manufacturing strategy". This took place within a broader strategy to transform the economy to improve the life of all its citizens, including macroeconomic interventions to address the debt and balance. Fourth, government reprioritised expenditure. More money was to be allocated towards infrastructure and service delivery. Fifth, government engaged in an extensive trade liberalisation programme in order to open the economy and create opportunities for growth and improved competitiveness. At a multilateral level, South Africa played a significant role in alliance with other countries of the South in seeking to reform the World Trade Organisation. The negotiation of 12 trade agreements with the European Union and Southern African Development Community created the possibilities for improved market access. Various bi-national commissions were established, and the foundations laid for further trade agreements. In general, the tendency was towards a lowering and simplification of tariffs. This process took place from 1995 and was largely completed in 2002.

## Economic performance since 1994

### *The long-term growth recovering era*

After the abolishment of sanctions and disinvestment in 1994, together with the above macroeconomic stabilisation policy programme of the new government, the South African economy recovered quickly. Figure 1 shows that the growth in real GDP improved noticeably to a 3.4 per cent average between 1994 and 1997. This was due to the large inflow of portfolio capital between 1995 and 1997, together with increased exports, as the rand exchange rate depreciated somewhat. This robust economic growth was temporarily stopped in 1997 and 1998 when economic growth dwindled to only 0.5 per cent, as exports and foreign capital inflows decreased due to various international economic movements, for example a drop in the price of gold, the weakness in the United States, European and Japanese economies, the East Asian financial crisis and the delayed effects of the stronger rand in 1997. Economic activity had already been slowing down when the financial problems in Southeast Asia began to spread to South Africa in the first half of 1998. The potential threat to financial stability and concern about the long-term well-being of the economy convinced policy-makers that steps had to be taken to stabilise financial conditions with as little delay as possible. Interest rates accordingly rose over the full spectrum of maturities from April to August 1998. Business and consumer confidence wilted, and real output, which had been sluggish in the first half of 1998, fell in the third quarter of 1998 so that for the year as a whole, real gross domestic product rose by just 0.5 per cent (see Figure 1).

This temporary backward movement in economic growth until 1999 was criticised by the Congress of South African Trade Unions (amongst others) that the GEAR strategy had been a failure. Nevertheless, the continuous strict monetary and fiscal policy stance of the government started to bear fruit. The steady depreciation of the rand started to affect exports positively. Together with the downward movement in the inflation rate, this contributed to set the platform for an economic upswing, and economic growth quickly accelerated to 4.15 per cent in 2000.

The South African economy had been recovering quite robustly from the setbacks suffered at the time of the international financial crises of 1997 and 1998 when world economic conditions began to deteriorate towards the end of 2000. Real gross domestic product was growing at an average annualised rate of some 3½ per cent in the second half of 2000, but when weaker international demand conditions began to spill over into South Africa, economic growth fell back to an annualised rate of about 2½ per cent in the first half of 2001. The depreciation in the value of the rand during the past year and a half cushioned the full impact of the weakening in the world economy on the domestic economy (South African Reserve Bank, *Annual Financial Statements* (2000: 1-2).

In reaction to the tragedy that hit the US with the destruction of the Twin Towers on 11 September 2001, the world economy recorded a sluggish growth rate in 2001, but recovered hesitantly in 2002. World output growth had accelerated from 2.5 per cent in 2001 to 3 per cent in 2002. The outlook for the first half of 2003 was clouded by uncertainties related to the war in Iraq, which eventually broke out in late March 2003. This was aggravated by the outbreak of the Severe Acute Respiratory Syndrome (SARS) epidemic which was concentrated in the Asia Pacific region and parts of North America. The tourism and travel industries, in particular, were adversely affected due to fears of SARS.

While economic activity in most parts of the world remained lacklustre during 2002 and 2003, inflation was quite low, allowing central banks sufficient leeway to pursue accommodative monetary policies. Most developed countries pursued expansionary macro-economic policies: The combination of monetary and fiscal policy settings adopted in the United States. These developments and concerns about the growth prospects of major industrialised countries has not had a significant impact on South Africa's economic performance since 2002. Although weakness in the world economy caused a reduction in the demand for South African exports, it in turn contributed to a slowdown in real gross domestic product growth to just below 3.0 per cent in 2003. The slowdown was most severely felt in manufacturing and in the primary sectors, with real output stagnating or contracting in each of these sectors during the first half of 2003.

**Table 1: Fundamental economic indicators: 1990 – 2005 (real % growth)**

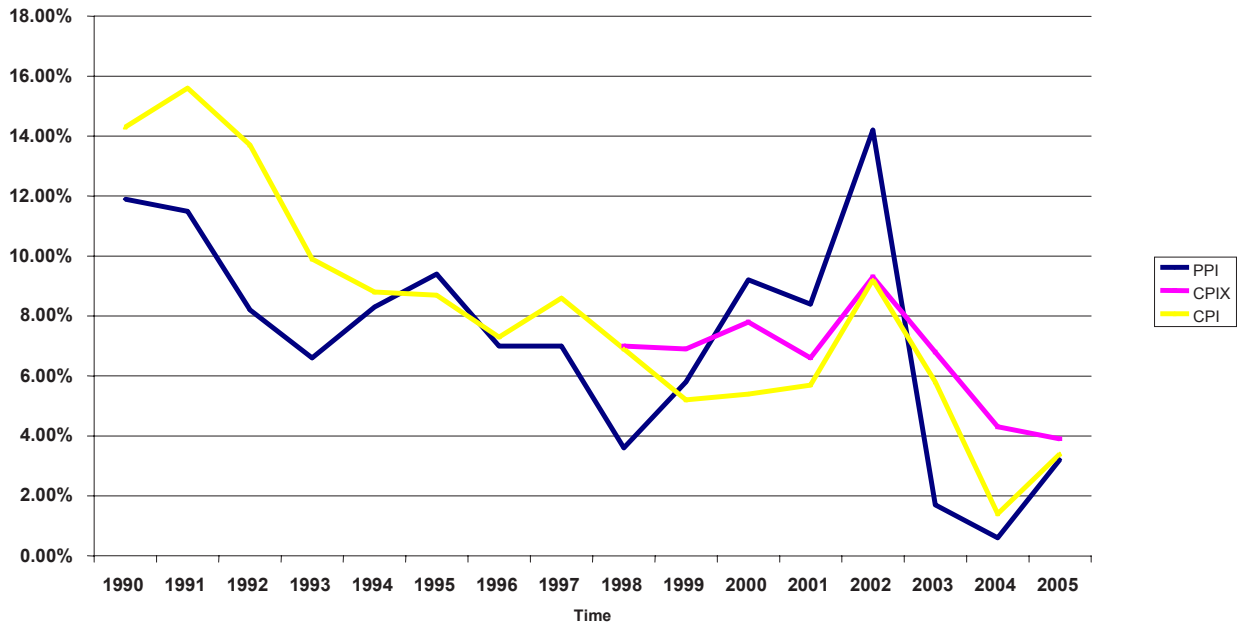
	GDP growth (value)	CPIX	CPI	PPI	Employment (value)
1990	-0.32		14.3	11.9	0.72
1991	-1.02		15.6	11.5	-1.01
1992	-2.14		13.7	8.2	-0.58
1993	1.23		9.9	6.6	-0.6
1994	3.23		8.8	8.3	0.47
1995	3.12		8.7	9.4	0.89
1996	4.31		7.3	7	1.05
1997	2.65		8.6	7	-0.38
1998	0.52	7	6.9	3.6	-2.48
1999	2.36	6.9	5.2	5.8	-1.5
2000	4.15	7.8	5.4	9.2	-1.89
2001	2.74	6.6	5.7	8.4	-0.91
2002	3.69	9.3	9.2	14.2	0.47
2003	2.98	6.8	5.8	1.7	-1.59
2004	4.47	4.3	1.4	0.6	2.12
2005	4.9	3.9	3.4	3.2	2.5
<b>Average</b>	3.0	6.6	7.1	8.1	-0.17

Notwithstanding slower growth in real production during 2003, the growth in aggregate gross domestic expenditure started to become buoyant, recording annualised half-yearly increases of 4.5 per cent in both the second half of 2002 and the first half of 2003. Of particular significance was the growth in real gross fixed capital formation that accelerated strongly during 2002 and reached an annualised rate of 9 per cent in 2003. Together with this structural supply-side improvement, the fruits of the strict monetary and fiscal policy began to create the environment of low inflation and a strong currency within which domestic expenditure could excel from 2004. Economic growth rates of 4.5 per cent for 2004 and an estimated 4.8 per cent in 2005 followed. Public corporations' investment spending remained buoyant, while that of general government accelerated somewhat from low levels.

### ***Inflation: The growth environment stabiliser***

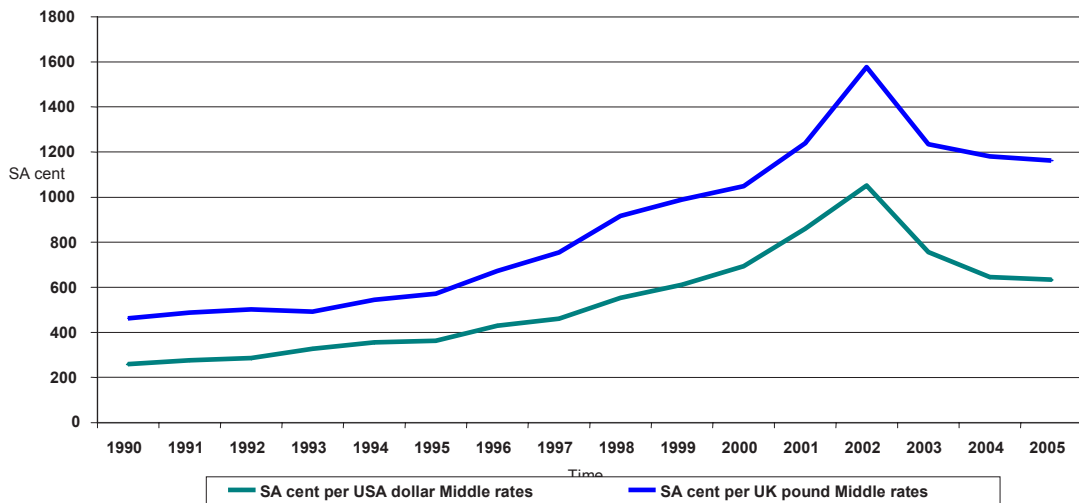
Table 1 and Figure 2 demonstrate the success story of a prudent strict monetary policy. All three the inflation indicators showed a consistent decrease over the past 15 years, with the only exception during 2002. This was a year of disquiet and frustration during which inflation worsened appreciably and moved beyond the 10 per cent mark following the strong depreciation of the exchange rate of the rand in 2001. The maintaining of discreet monetary policy in the sense that the repo rate was increased by more than 7.0 per cent, as well as prudent fiscal policies and the recovery in the exchange value of the rand have contributed to the remarkable reduction in inflation since then.

**Figure 2: Inflation numbers, 1990 – 2005**



Source: South African Reserve Bank, *Quarterly Bulletin* (various issues)

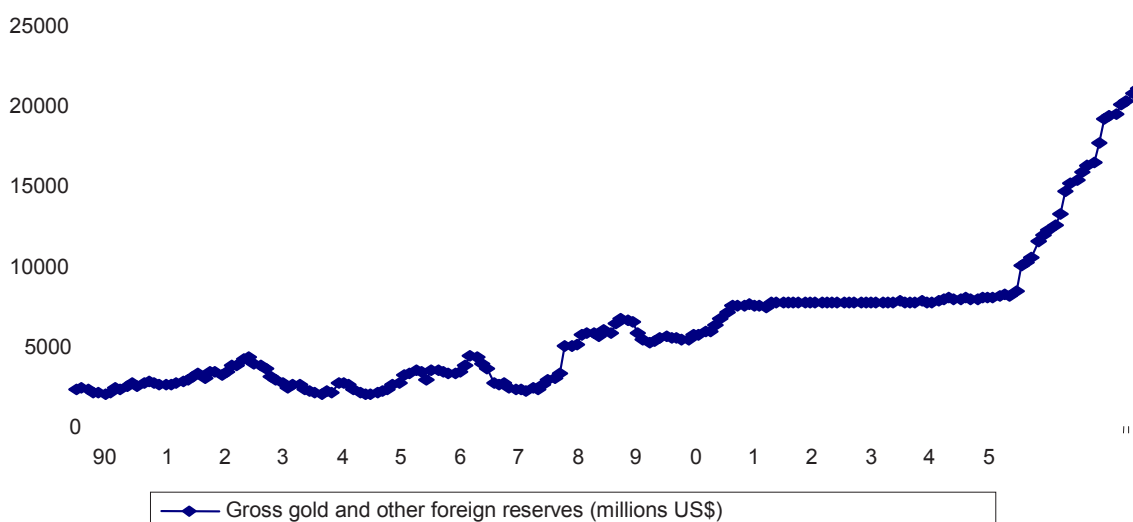
**Figure 3: Exchange rates, 1990-2005**



Source: South African Reserve Bank, *Quarterly Bulletin* (various issues)



**Figure 4: Gross gold and other foreign reserves, 1990 - 2005 (Millions US\$)**



Source: South African Reserve Bank, *Quarterly Bulletin* (various issues)

### ***Unemployment: The Achilles heel***

While poor employment prospects continue to hound the South African labour market, comprehensive figures obtained from the 1996 and 2001 population census indicate an increase in overall employment of 470 000 people between the two census dates. The less comprehensive enterprise-based data on formal employment in the main non-agricultural sectors indicate a welcome increase in employment in 2002, following a persistently declining trend since 1989. Whereas 2002 was a year of disquiet and frustration during which inflation worsened appreciably and moved beyond the 10 per cent mark following the strong depreciation of the exchange rate of the rand in 2001, the progress made in arresting inflation during 2003 was gratifying. Prudent monetary and fiscal policies, as well as the recovery in the exchange value of the rand have contributed to the remarkable reduction in inflation. Whereas the twelve-month rate of increase in the overall consumer price index for metropolitan and other urban areas excluding mortgage interest costs (CPIX) reached a peak of 11.5 per cent in late 2002, this rate had fallen back to 6.5 per cent by June 2003 – close to the psychologically important target range of 3 – 6 per cent.

There has been a sustained and steady rise in labour productivity since 1994, with labour productivity having increased by 26 per cent since 1994. Labour productivity has risen in almost all sectors, except for wood and wood products, footwear, and leather and leather products. Rising productivity is an indicator of the capacity of our manufacturing firms to compete in global markets.

However, these productivity increases have taken place in a context where the manufacturing sector has been consistently shedding labour. It is therefore important for us to develop an understanding of what is happening to multifactor productivity, including a more complex understanding of the interplay between the productivity of capital and labour and competitiveness. Job losses in manufacturing have tended to accelerate. There are only a few sectors that have experienced any increase in demand for labour, such as leather and leather products, plastic products, wood and related products, other chemicals, television, radio and communications equipment, printing publishing and recorded media and basic chemicals. A number of the most labour intensive sectors, such as clothing, wood and wood products, footwear and furniture have all seen a significant decline in employment intensity measured by the employment/output ratio.

## Investment opportunities: Asset-class performance

Against the backdrop of the above economic and policy structural adjustment processes, investment opportunities in South Africa also underwent structural change. Not only due to some lifting of exchange controls on residents, and total abolition on non-residents over the last ten years that opened the opportunities for domestic and foreign investors to diversify their portfolios over various asset classes, but also due to the opening of the South African economy to globalisation, the risk of investment increased considerably. Therefore, it now becomes necessary to analyse the performance of the various domestic and global asset classes available for the South African investors, so that rational and risk free adverse decisions can be taken by the portfolio manager, broker, as well as the investor.

For classification purposes this study will compare 9 different asset classes. In the domestic market (onshore), the five classes consist of SA cash, SA bonds, SA property, SA equities and SA alternative (hedge funds). The offshore asset classes are global bonds, UK property, USD cash and global equities.

Tables 1, 3a, 3b and Figure 5 analyse the various asset classes' nominal performances in rand terms between 1990 and 2005. The following deductions can be made:

- SA bonds registered the biggest returns, on average, over the past 16 years at an average rate of 21.96 per cent. Bonds were followed by SA property (19.63 per cent), UK property (18.07 per cent) and SA equities (17.25 per cent).
- All asset classes beat the average inflation rate of 7.1 per cent by almost double (100 per cent).

All other asset classes, of course with the exception of cash, outperformed the average short-term interest rate of 13.12 per cent over the period 1990 – 2005.

**Table 2: Rates of return: Various onshore and offshore asset classes, 1990 – 2005 (% in nominal terms and SA rand)**

Date	SA cash	Alternative	SA bonds	Global bonds	UK property	USD cash	SA property	SA equities	Global equities
1990	20.8	20.0	16.2	15.40	12.5	8.2	2.7	-0.5	-0.18
1991	18.7	18.6	14.4	24.7	3.1	12.8	19.0	31.0	24.3
1992	15.4	12.4	27.8	12.3	-10.2	14.9	6.8	-2.0	3.3
1993	12.0	28.2	32.0	28.1	26.7	14.3	11.9	54.8	34.0
1994	11.0	1.8	-0.9	4.0	27.1	8.6	9.4	22.7	7.6
1995	14.0	13.0	30.2	25.2	5.3	8.7	11.6	8.8	22.3
1996	17.0	43.6	66.0	41.2	55.3	34.7	-10.4	9.3	43.4
1997	17.3	13.8	29.2	4.6	15.8	9.3	20.4	-4.5	18.7
1998	17.9	29.3	5.0	42.6	34.3	27.1	3.4	-10.1	48.7
1999	13.8	6.0	29.9	-7.9	17.8	9.7	56.4	61.5	29.1
2000	9.5	34.8	20.2	26.5	25.9	30.7	27.6	-0.1	5.9
2001	9.0	69.9	18.3	58.5	65.44	62.9	7.9	29.1	29.8
2002	10.6	-19.8	17.8	-17.1	-12.7	-27.5	23.0	-8.2	-43.5
2003	10.60	-12.7	18.8	-10.9	-3.7	-21.7	41.0	16.1	1.8
2004	6.5	-12.9	15.4	-7.1	7.0	-14.6	42.8	25.4	-4.8
2005	5.9	19.3	11.1	5.2	19.6	16.1	40.6	47.3	21.1
<b>Average</b>	<b>13.12</b>	<b>16.58</b>	<b>32.96</b>	<b>15.33</b>	<b>18.07</b>	<b>12.14</b>	<b>19.63</b>	<b>17.25</b>	<b>13.96</b>



Table 3a: Asset classes performance: Ranked per annum: 1990 – 1999

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
SA cash 20.8%	SA equities 31.0%	SA bonds 27.8%	SA equities 54.8%	UK property 27.1%	SA bonds 30.2%	UK property 55.3%	SA bonds 29.2%	Global equity 48.7%	SA equities 61.5%
Alternative strategy 20.0%	Global bonds 24.7%	SA cash 15.4%	Global equity 34.0%	SA equities 22.7%	Global bonds 25.2%	Alternative strategy 43.6%	SA property 20.4%	Global bonds 42.6%	SA property 56.4%
SA bonds 16.2%	Global equity 24.3%	USD cash 14.9%	SA bonds 32.0%	SA cash 11.0%	Global equity 22.3%	Global equity 43.4%	Global equity 18.7%	UK property 34.3%	SA bonds 29.9%
Global bonds 15.4%	SA property 19.0%	Alternative strategy 12.4%	Alternative strategy 28.2%	SA property 9.4%	SA cash 14.0%	Global bonds 41.2%	SA cash 17.3%	Alternative strategy 29.3%	Global equity 29.1%
UK property 12.5%	SA cash 18.7%	Global bonds 12.3%	Global bonds 28.1%	USD cash 8.6%	Alternative strategy 13.0%	USD cash 34.7%	UK property 15.8%	USD cash 27.1%	UK property 17.8%
USD cash 8.2%	Alternative strategy 18.6%	SA property 6.8%	UK property 26.7%	Global equity 7.6%	SA property 11.6%	SA cash 17.0%	Alternative strategy 13.8%	SA cash 17.9%	SA cash 13.8%
SA property 2.7%	SA bonds 14.4%	Global equity 3.3%	USD cash 14.3%	Global bonds 4.0%	SA equities 8.8%	SA equities 9.3%	USD cash 9.3%	SA bonds 5.0%	USD cash 9.7%
SA equities -5.1%	USD cash 12.8%	SA equities -2.0%	SA cash 12.0%	Alternative strategy 1.8%	USD cash 8.7%	SA bonds 6.6%	Global bonds 4.6%	SA property 3.4%	Alternative strategy 6.0%
Global equity -18.3%	UK property 3.1%	UK property -10.2%	SA property 11.9%	SA bonds -9.0%	UK property 5.3%	SA property -10.4%	SA equities -4.5%	SA equities -10.1%	Global bonds -7.9%

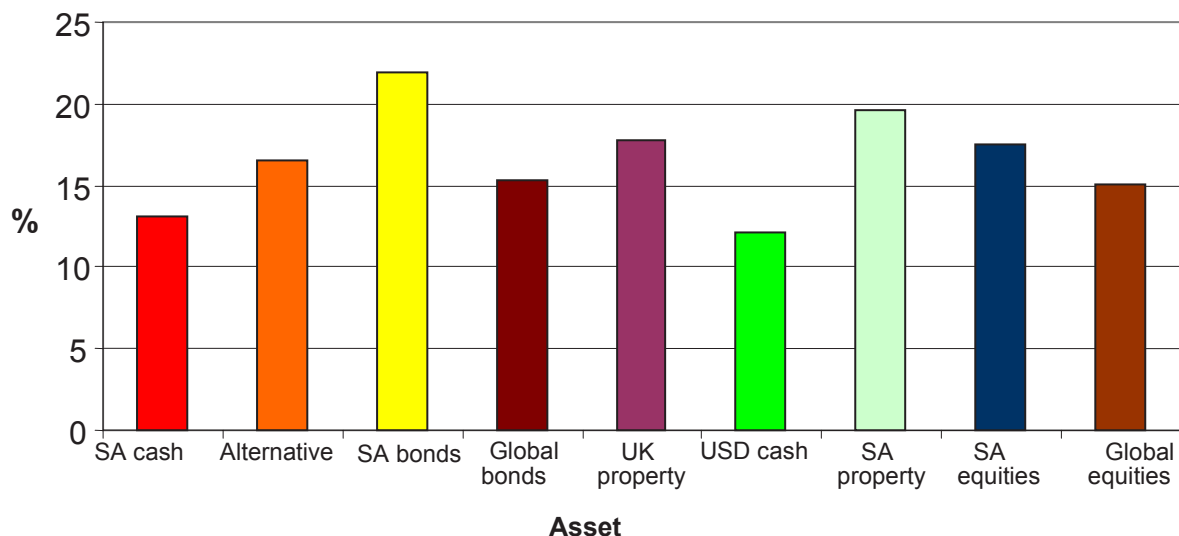
Source: Old Mutual Asset Managers (OMAM)

**Table 3b: Asset classes performance: Ranked per annum: 2000 – 2005**

2000	2001	2002	2003	2004	2005
Alternative strategy 34.8%	Alternative strategy 69.9%	SA property 23.0%	SA property 41.0%	SA property 42.8%	SA equities 47.3%
USD cash 30.7%	UK property 65.4%	SA bonds 17.8%	SA bonds 18.8%	SA equities 25.4%	SA property 40.6%
SA property 27.6%	USD cash 62.9%	SA cash 10.6%	SA equities 16.1%	SA bonds 15.4%	Global equity 21.1%
Global bonds 26.5%	Global bonds 58.5%	SA equities -8.2%	SA cash 10.6%	UK property 7.0%	UK property 19.6%
UK property 25.9%	Global equity 29.8%	UK property -12.7%	Global equity 1.8%	SA cash 6.5%	Alternative strategy 19.3%
SA bonds 20.2%	SA equities 29.1%	Global bonds -17.1%	UK property -3.7%	Global equity -4.8%	USD cash 16.1%
SA cash 9.5%	SA bonds 18.3%	Alternative strategy -19.8%	Global bonds -10.9%	Global bonds -7.1%	SA bonds 11.1%
Global equity 5.9%	SA cash 9.0%	USD cash -27.5%	Alternative strategy -12.7%	Alternative strategy -12.9%	SA cash 5.9%
SA equities -0.1%	SA property 7.9%	Global equity -43.5%	USD cash -21.7%	USD cash -14.6%	Global bonds 5.2%

Source: Old Mutual Asset Managers (OMAM)

**Figure 5: Average rate of return of various asset classes, 1990 – 2005  
(nominal growth in rands)**



### **SA bonds versus SA equities**

The performance of SA bonds as the highest average yield return could have been expected due to the following reasons:

Firstly, the bond market in South Africa remains more or less a captured market, given the history of prescribed assets (although abolished in 1989), as well as foreign exchange controls. Pension funds, life insurers, the government, as well as the banking sector kept a substantial part of their assets in bonds. Long-term insurers during the 1990s kept, on average, around 14 per cent of their assets in fixed-interest securities of the government, the Public Investment Commission kept 49 per cent, short-term insurers kept 15 per cent, the pension and provident funds kept around 40 per cent and the banks kept around 3 per cent.

Between 2000 and 2005, however, given the gradual relaxing of exchange controls and the abolishment of prescribed holding of bonds, institutional demand for bonds started to dwindle. The Public Investment Commission's holding of bonds decreased to 44 per cent, those of pension funds to 36 per cent, life insurers almost halved their holding to 8 per cent, whereas the banks kept their holdings at a low 4 per cent, while short-term insurers also decreased their share to a mere 9 per cent.

Secondly, given the environment of high inflation (10.0 per cent), interest rates (13 per cent) and exchange controls between 1990 and 1999, the average 10-year bond rate was much higher at 15.3 per cent. In the years between 2000 and 2005, this environment changed dramatically as the average inflation rate dropped to 5.9 per cent, interest rates dropped to 9.0 per cent and exchange rates were gradually abolished. Not only did this contribute to higher economic growth rates since 2000, but company profits also increased substantially. This resulted in lower average price-earnings (PE) ratios than most international share markets, and especially foreign buying of shares started to increase. In this changed and stabilised economic environment, shares started to outperform bonds. The average yield of return for SA bonds shrunk from 18.2 per cent between 1990 and 1999 to 16.6 per cent between 2000 and 2005. The returns on shares, in return, have increased from 16.8 per cent to 21.3 per cent over the same period.

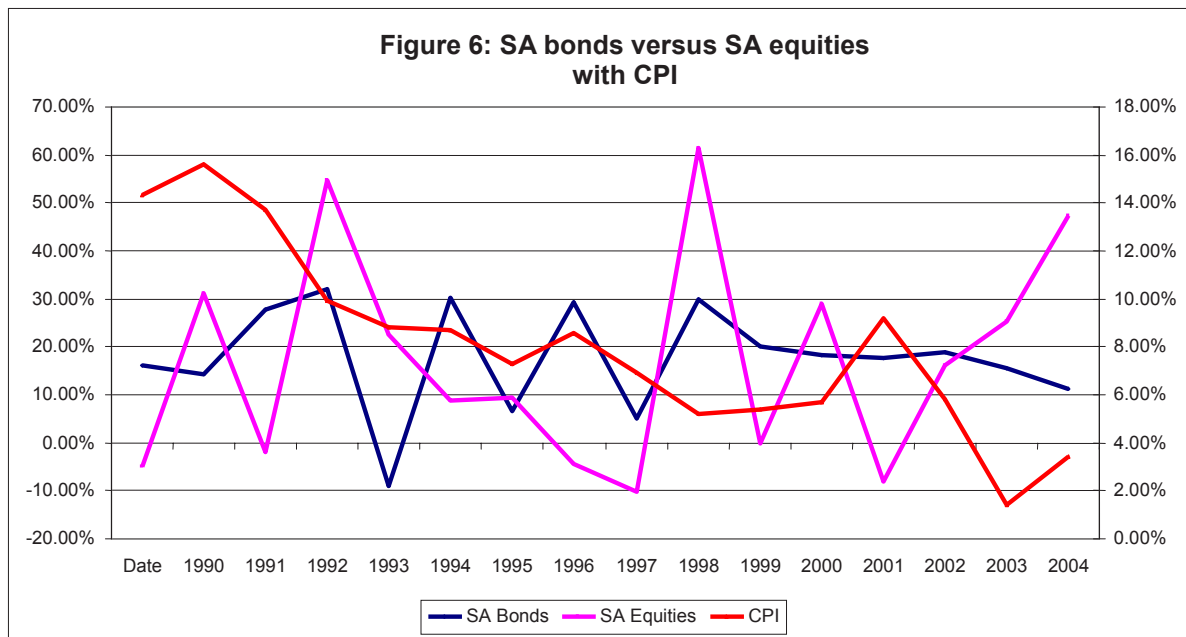


Figure 6 illustrates the relationship between the long-term movement of bonds, shares and the inflation rate, especially the imminent correlation between the movement in bonds and the inflation. Since the introduction of inflation targets in South Africa in 2001, the downward trend in the consumer price index (CPI) led to bond yield rates also decreasing steadily. Given the sincerity of the Monetary Policy Committee of the Reserve Bank to keep the inflation rate within the set of targets, one can deduce that bond rates will continue to stabilise at around their current levels of between 7 per cent and 8 per cent. In return, yields on bonds are also expected to move around 8 per cent to 10 per cent, as interest rates should stay more stable over the next five years (Table 1).

On the other hand, given the assumption that economic growth is bound to be sustained at levels between 3.5 per cent and 5 per cent for the next three years, together with a stable depreciation of the exchange rate by 5 per cent per annum and commodity prices at their current level, one can expect that the return on share prices are likely to vary between 6 per cent and 15 per cent for the next three years (see Table 4).

### **SA property versus equities**

Yields on SA property (commercial and retail) shares was the highest of all the asset classes since 2000, reaching an average of 30.8 per cent, against the 21.9 per cent of shares and 16.6 per cent of bonds.

The low environment of interest rates and inflation, together with the large demand for commercial property and more recently for office space, as well as deliberate construction investment by government, were mostly due to these high levels of return in the property sector (see Figure 7).

Figure 7 shows the movement of both property and share yields since 1990 against the inflation rate. Given the negative perceptions before the 1994 elections and the low levels of economic growth and high levels of inflation, yields on property stayed low, as firms' as well as government capital expenditure on commercial property were almost non-existent.

As a result, the average return on property between 1990 and 1996 was a mere 7.3 per cent in nominal terms against an average inflation rate of 11.2 per cent over the same period. This gave a yield of -3.9 per cent in real terms.

The successful monetary policy in South Africa, especially after 1996, contributed to the establishment of a low inflation environment, as the inflation rate dropped to an average of 5.8 per cent between 1996 and 2005. Together with the higher levels of economic growth, the

demand for property surged, especially since 2000. As an asset group it also provided a hedge against the large depreciation of the rand in 2001 and 2000, as yields on commercial property continued to rise.

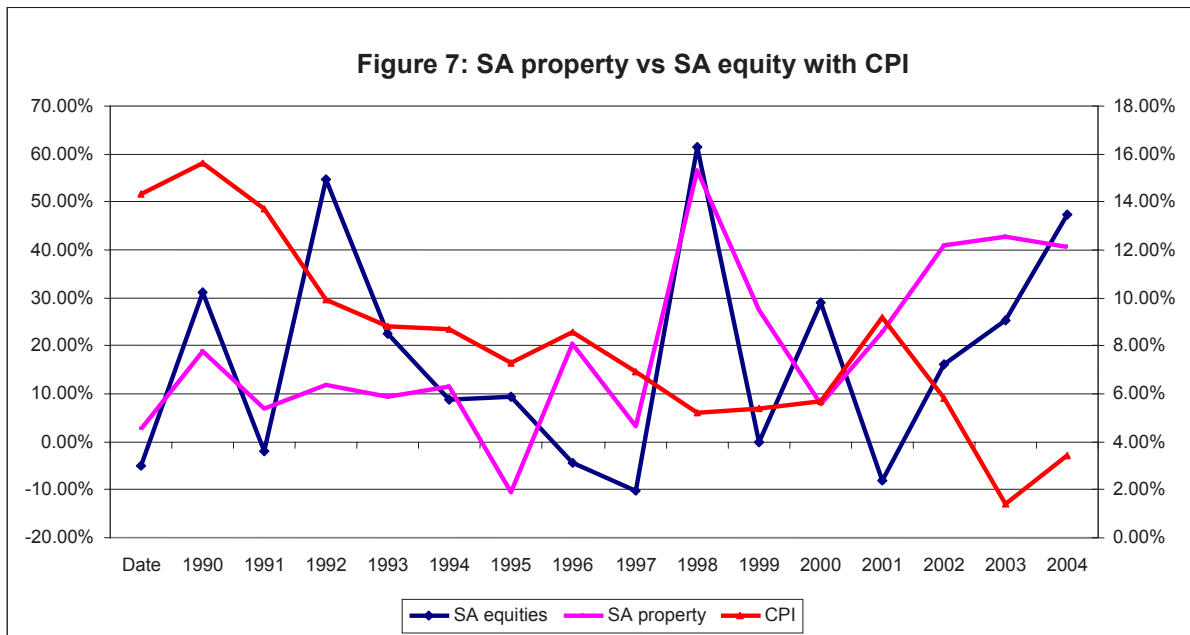
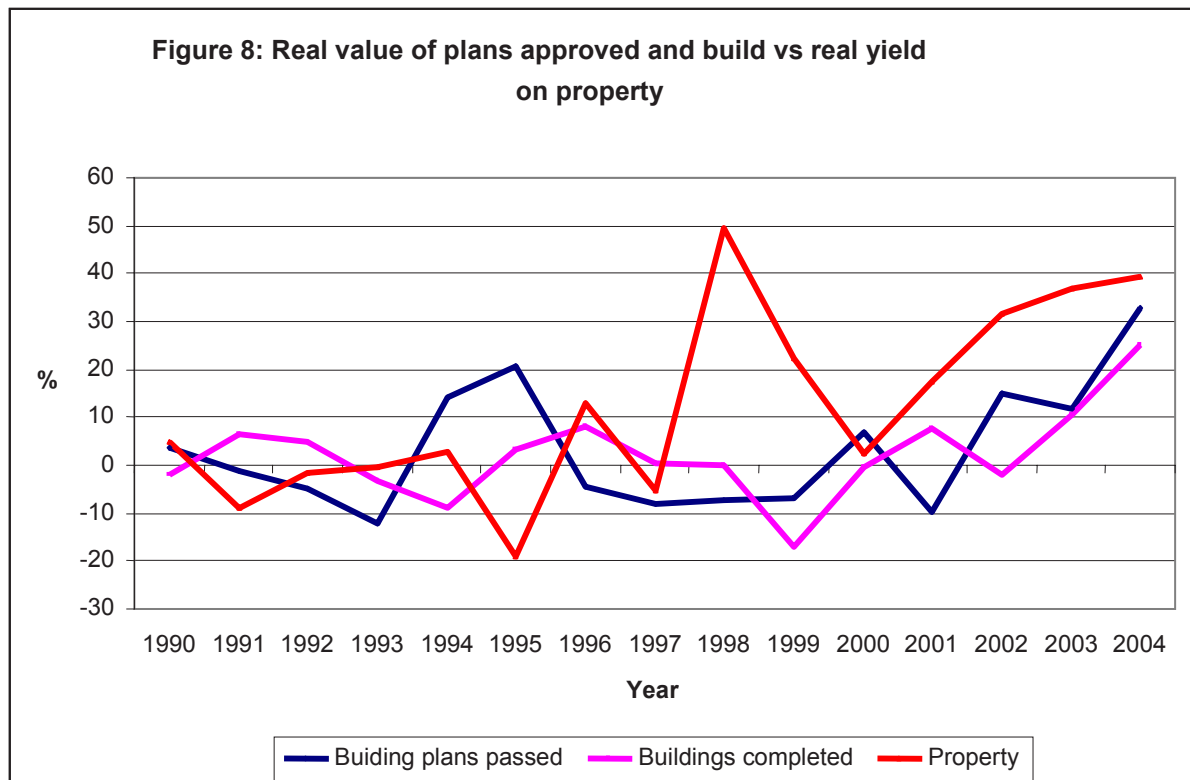
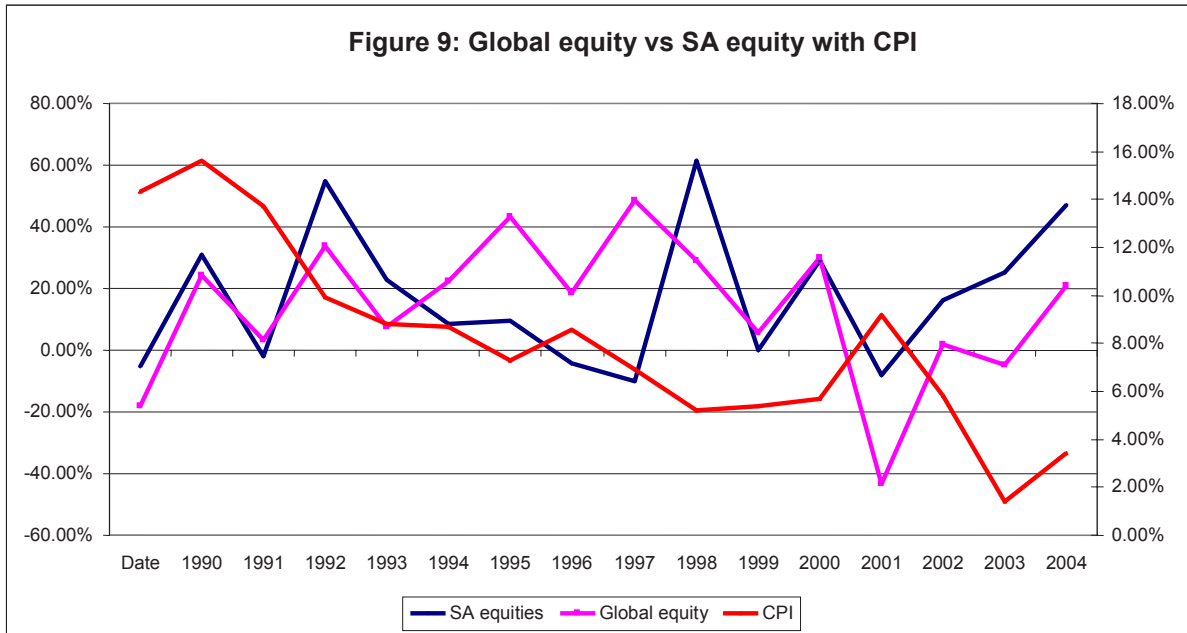


Figure 8 shows the high correlation between the real value of building plans passed and completed and the real yield on property since 1990. Between 1990 and 1999, the average real growth in the value of building plans approved was -0.66 per cent and for buildings completed -0.8 per cent, against the average real yield on property of 5.7 per cent. From 2000 the average growth in the real value of plans passed and buildings completed increased substantially to 11.4 per cent and 8.1 per cent, respectively, while the real yield on commercial and industrial property increased by 25.5 per cent.

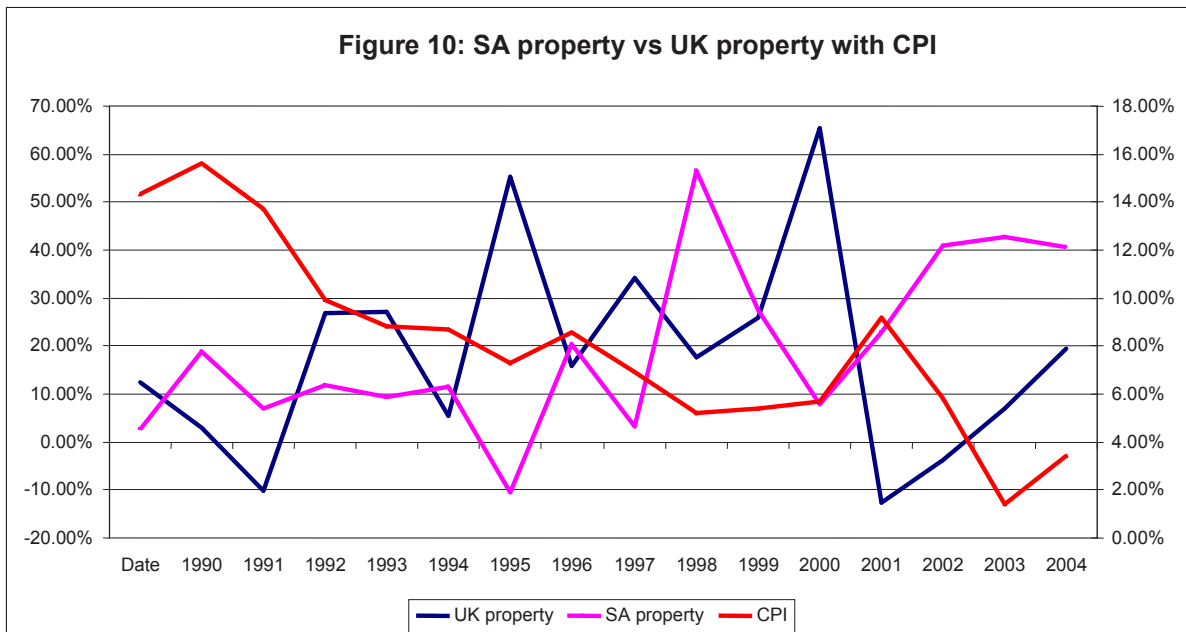


**Offshore versus domestic asset performance**

Figure 9 clearly shows how South African shares started to outperform global equity from 2000. Between 1990 and 1999, the average return on SA equity was 16.6 per cent against a 21.3 per cent return on global equity. Given the successful macroeconomic adjustment of the South African economy, as explained above, domestic shares became more popular amongst foreign investors. Therefore, portfolio share demands for South African shares have begun to increase considerably over the past five years.



Between 2000 and 2005 the yield on South African shares increased by an average of 21.9 per cent, given the slump in world share markets after September 11, as well as a slowdown in economic performance in Europe (integration teething), Japan (deflation) and the US (twin deficits). The danger of rising global interest rates and rising geopolitical concerns of escalation in the so-called “War on Terror” may be the double jeopardy that will take down the global markets in 2006/07.





The same tendency can be observed if one compares the domestic property market with that of global property. By using the UK property market as a proxy, Figure 9 shows that just as in the case of shares, returns on commercial and retail property in South Africa lacked more than that of the UK during the 1990s. The average return on UK property between 1990 and 1999 was 18.8 per cent in nominal rand terms, while in South Africa it was much lower at 13.1 per cent. Between 2000 and 2005, the annual average nominal return in the UK only increased marginally to 20.3 per cent, whereas in South Africa it has increased almost threefold to 36.6 per cent. In real terms the comparison is still more favourable towards South Africa.

## Conclusion

Various analyses about the adjustment process of the South African economy prove that it was in particular successful from the late 1990s. Prudent fiscal, trade and monetary policy stabilisation programmes had contributed towards not only the creation of a normal economic and investment environment, but also diminished the risk factor for foreign portfolio and direct investment. In an environment of low interest and inflation rates since 2000, South African companies could improve their competitiveness, and as a result share prices were suddenly low priced in the analysis of foreign investors. Given exceptional low PE ratios for most listed companies in South Africa, South African shares became popular amongst especially foreign portfolio investors. In such an environment, not only did the demand for South African shares on the JSE start to rise, but also the value traded on a daily basis, from around R2 billion in 2002 to the current R8 billion to R10 billion. As a result, the ALSI has increased by more than fourfold, from around 5 000 in 2001 to the current 20 000 levels.

Given the normalised South African economic and political environment, together with affirmative action and Black Economic Empowerment, a strong middle class is developing.

Not only did this middle class increase the demand for household goods, but Black people also started to buy residential property. Together with decreasing interest rates, especially since 2003, prices of property began to sky-rocket. Together with this ever-increasing demand for household goods and services, retail and commercial property space became a scarce commodity. Not only did investment in these properties increase substantially, but property prices also increased far beyond expectations. Yields from commercial and retail property have multiplied and is about to continue. Therefore, investment in property will stay profitable during the next five to six years.

Given the successful price stabilisation policies of the Reserve Bank, the rand became one of the strongest and most traded currencies in world markets. Therefore yields on offshore investments for South Africans in rand terms will not necessarily be a preferred option, even if exchange controls are abolished in total. In the same manner, South African shares and property have become popular amongst foreign investors.

## References

Republic of South Africa (Department of Finance). 1996. *Growth, Employment and Redistribution. A Macroeconomic Strategy*. Pretoria: Government Printer. (Growth Employment and Redistribution – ‘The Tale of Two Economies’. [www.numsa.org.za](http://www.numsa.org.za)).

Republic of South Africa (Department of Trade and Industry). 2002. *A Guide to the microeconomic reform strategy*. Pretoria: Government Printer.

Republic of South Africa (Department of Trade and Industry). 2005. *The medium term outlook 2006-2009*. The contribution of an integrated manufacturing strategy. Pretoria: Government Printer.

Republic of South Africa. Statistics South Africa (various issues).

South African Reserve Bank. *Quarterly Bulletin* (various issues).

Website accessed: [www.oldmutual.co.za](http://www.oldmutual.co.za)