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MACROECONOMIC & MARKET OUTLOOK
Q4 / 2016

Seedwell Hove

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Macroeconomic and Market Outlook[1]

Fourth Quarter, 2016

Highlights

- The global economy is showing signs of picking up, after the tumultuous start to the year and Brexit shock in June, but remains subdued. Global growth is projected at 2.4 percent in 2016.
- The global economy is projected to pick to 2.8 percent in 2017, but downside risks continues to weigh on the outlook.
- The impact of the Brexit vote was less severe than initially envisaged, but the long term macroeconomic impact will be felt when UK finally exit the EU.
- The outlook for emerging market and developing economies is expected to strenghten slightly, with growth expected at 3.5 percent in 2016.
- Monetary conditions remains loose, with ample policy stimulus in the Euro area, Japan, UK and China, stabilising global financial markets somewhat.
- Global trade will be sluggish in 2016, while global inflation will remain low.
- The slowdown in China is continuing at a measured pace, with activity firming up in recent quarters due to policy support, but concerns remain.
- Economic activity in Sub-Saharan Africa will remain less robust in 2016 due to continued external and internal headwinds.
- Commodity prices have improved somewhat since the slump at the beginning of the year and the Brexit shock. Oil prices are projected to average about $43 per barrel in 2016 and improve to $52 per barrel in 2017. Other commodity prices are also expected to strengthen slightly
- The outlook is subject to downside risks emanating from the forth-coming US elections in November, the general risk of de-globalisation, a possible hike in the US interest rate in December, persistent low commodity prices, continued slowdown in China and uncertainties on the UK's exit from the EU, following the Brexit vote, geopolitical risks, political and security risks and droughts in various countries.

[1] Prepared by Seedwell Hove, with contributions from Jeremy Wakeford

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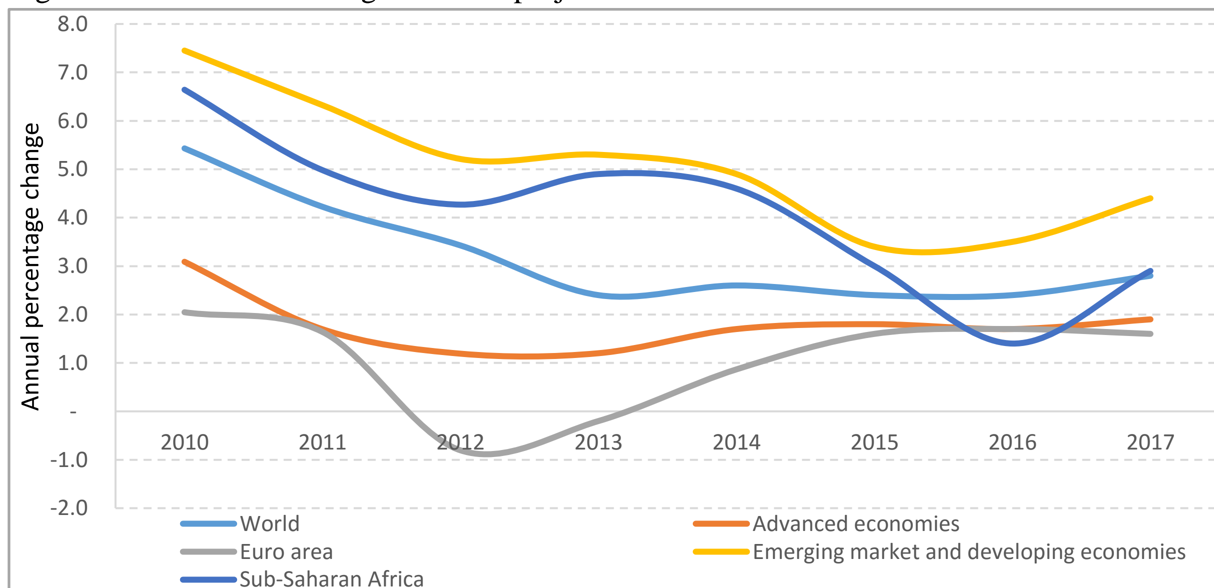
Global economic outlook

The global economy is projected to grow at a modest pace of 2.4 percent in 2016, despite some volatility experienced in the first half of the year. The first quarter was quite turbulent, with marked volatility in the financial markets, which calmed in the second half of the year, only to be perturbed by the Brexit vote in June. The initial reaction by financial markets to Brexit was sharp, as equities, commodities and currencies declined significantly, but they have gradually recovered as the fears of imminent spillovers of the Brexit to the global economy relented somewhat. The recovery was supported by accommodative policies around the world. Despite some signs of pick up in recent months, global economic activity remains generally subdued.

The impact of the Brexit vote has been less severe than initially envisaged, reflecting some resilience of the global economy. Recent data suggests that the fallout in the Euro area has been muted, while the U.S. economy has marginally picked up in the second quarter. The prospects for developing and emerging markets are slowly strengthening, as some of the growth drags last year, including lower oil prices and U.S. dollar appreciation, are gradually fading and helping stabilize conditions somewhat. Some major economies are showing tentative signs of stabilisation. For instance, China's economic activity firmed up in the second quarter, while the difficult economic conditions in Brazil and Russia seem to be gradually abating, with signs that they are moving closer to exiting recession. Monetary conditions remain loose and accommodative, with ample policy stimulus in the Euro area, China and Japan, while the pace of normalisation of US monetary policy is expected to remain gradual. Long-term bond yields in advanced economies have declined further, compressing term premiums, while stock markets have improved. The easier financial conditions have helped the growth in emerging market assets in recent months. Financial market sentiment towards emerging markets has improved, on the back of improved expectations of lower interest rates for a longer time, reduced worries about China's near term prospects and slowly firming of commodity prices. Markets expect central banks in advanced countries to remain dovish for longer than previously expected amid sluggish economic activity and muted inflationary pressures.

Figure 1: Global economic growth and projections



Source: IMF and World Bank

Growth of global trade is expected to remain sluggish in 2016 on the back of China's rebalancing process, cyclical headwinds in EMEs and Brexit. The World Trade Organisation has slashed global trade growth forecasts for 2016 by one third. Global current account balance which had improved modestly in 2015, is expected to fall in 2016. Global trade is expected to pick in the medium term, as economic activity and investment in emerging markets recovers gradually. Global inflation is expected to remain low as slackness in commodity prices and disinflationary conditions in advanced economies persist despite loose monetary policy. However, partial recovery of commodity prices is expected to lift up consumer prices modestly in the medium term.

Growth in advanced economies is projected at 1.7 percent in 2016 (Figure 1). Output gaps remain negative, reflecting weak global demand, while wage pressures have moderated and inflation remains low (with deflation in some cases). Advanced countries growth is projected to pick up to 1.9 percent in 2017, led by strengthening activity in the US, Canada and Japan.

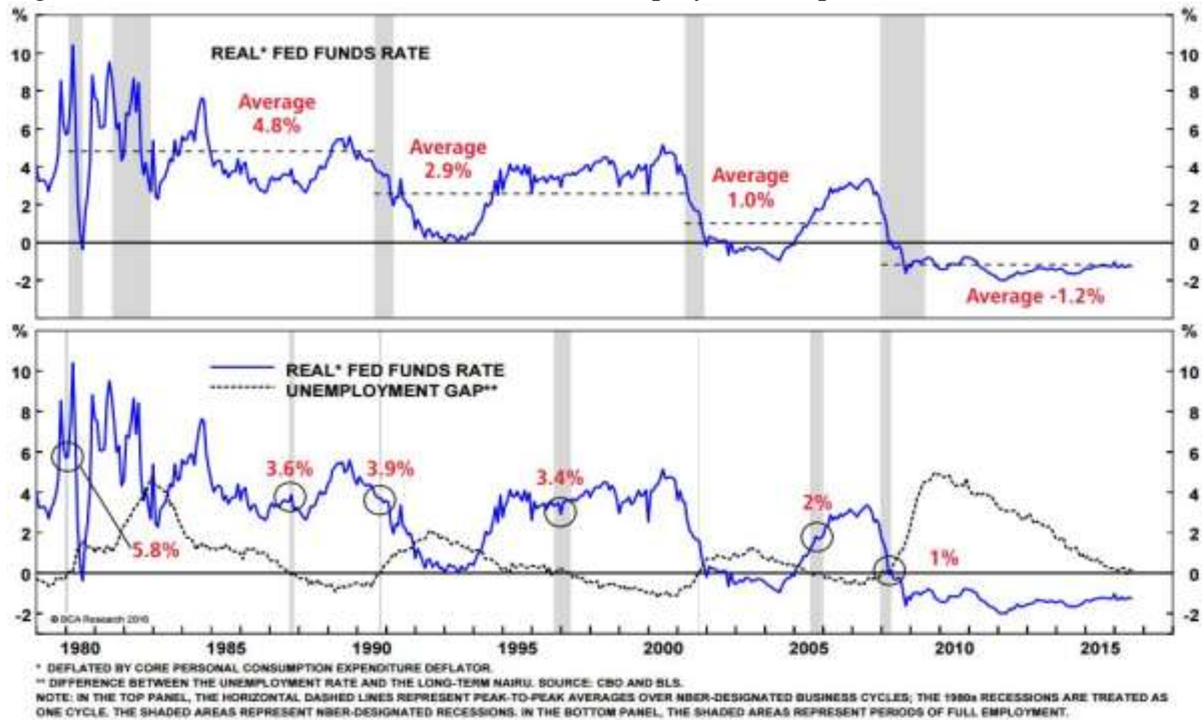
The **U.S.** economy marginally firmed up by 1.1 percent (but less than expected) in the second quarter, after the 0.8 percent growth in Q1, driven by strong private consumption and exports.[2] Data in July suggest that the U.S. labor market remains solid, but growth in retail sales and the manufacturing sector are sluggish. The economy is expected to expand at a moderate pace to average 1.8 percent in 2016, as consumer spending and the housing market provide a boost, while labour market conditions strengthen. US inflation remains low, inching up 1.1 percent in August, reflecting earlier declines in prices of energy and non-energy imports. Inflation is expected to rise to the 2 percent benchmark over the medium term as the transitory impulses from energy and import prices dissipate and the labor market strengthens further. The Fed kept its interest rate unchanged in September, despite improved conditions, preferring to wait for further evidence of continued progress. Thus if conditions continue to improve, we may see an interest rate hike in December, but the pace of increase is expected to remain gradual. However, there are questions as to why the Federal Reserve Bank is not raising interest rates in spite of improvement in conditions. Looking at the past, the relationship between the real Federal Funds Rate and unemployment gap seem to matter in interest rate decisions. Figure 2, shows the relationship between the real Federal Funds Rate and unemployment gap. The unemployment gap is nearing zero, suggesting that a rate hike could be coming soon, although it is expected to be gradual and steady.

The US economic outlook for 2017 looks positive, with growth expected to pick up to 2.2 percent as drags from previous appreciation of the dollar and lower energy prices wane. The outlook is largely subject to two domestic risk factors: elections in November and the possible interest rate hike in December. Recent opinion polls suggest that Clinton is ahead of Trump, but the race remains tight. A victory by Clinton could be favourable to markets as policy could largely continue in the same thrust as in the Obama Administration, but victory by Trump could reflect a marked shift in both domestic and foreign policies, thus generating considerable uncertainty[3].

[2] US Federal Reserve Bank Data, 2016

[3] For instance, Clinton could reappoint Yellen in 2018, while Trump could replace her as Fed governor.

Figure 2: U.S Real Federal Funds Rate and Unemployment Gap



Source: BCA Research

In the **Euro Area,** economic recovery is continuing, but with lower growth rates than initially envisaged (1.7 percent expected in 2016), largely supported by private consumption which has been bolstered by low oil prices and supportive monetary policy. As such, growth in the Euro Area remains susceptible to uncertainties surrounding the Brexit negotiations, especially with respect to the immigration and access to the single market. Uncertainty will take a toll on confidence, investment and trade, financial conditions and market sentiment and could negatively affect global economic growth. Euro Area growth slowed to 0.3 percent in the second quarter from 0.5 percent in the first quarter, as the favourable effects of some temporary factors (e.g domestic demand) faded. However, economic sentiment rose in August, with the PMI rising to seven-month highs, reflecting resilient consumer sentiment. A substantial downward revision to foreign demand, mostly related to much weaker import demand in the UK after Brexit, is projected to dampen Euro Area export growth. Euro Area growth is projected to inch down to 1.6 percent in 2017[4], but the outlook is shaped by the Brexit uncertainties, political hurdles in Italy (referendum) and elections in Spain in 2016 as well as elections in France and Germany in 2017.

The **UK** economy is stabilising after the Brexit vote in June, with growth in the second quarter moderating to 0.6 percent from 0.4 percent in the first quarter. GDP growth for 2016 has been revised downwards to 1.7 percent, slowing further to 1.3 percent in 2017. The Bank of England cut its Bank Rate and expanded its quantitative easing program in August, helping UK equities to recover their post-referendum losses. Meanwhile, the pound slided by 4 percent, a 31-year low following the announcement by Prime Minister May that Brexit negotiations will start in March 2017. Uncertainty on Brexit negotiations, especially on sticky issues of migration and access to the EU single market will continue

[4] ECB staff macroeconomic projections for the euro area, September 2016

to weigh down investor confidence, weaken domestic demand and dampen trade in 2016-2017. However, accommodative policy action taken by the Bank of England will soften the impact.

Japan's GDP growth decelerated to 0.7 percent in the second quarter (seasonally adjusted annualized rate), as the uncertain global economic outlook, strong yen and challenging demographics weigh on activity. The government has unveiled a JPY 28.1 trillion (USD 269 billion) fiscal stimulus, the largest stimulus package since 2009 to catalyze the economy, but the absence of decisive structural reforms will hamper economic growth impetus. 2016 growth is projected at 0.5 percent[5], but the strong yen and weak global growth will continue to weigh on growth prospects in 2017.

Despite headwinds at the beginning of the year, the picture in developing and emerging markets is improving somewhat, but risks remain. Growth is expected to average 3.5 percent, led by strong growth in East and South Asia. Despite challenging macroeconomic conditions, the outlook of some major emerging market economies such as China, Russia, Brazil and South Africa has strengthened somewhat. China's economic activity has strengthened, while confidence appears to have bottomed out in Brazil and Russia's GDP decline could be milder than initially envisaged, helped by the recent modest pick-up in commodity prices.

In **China** economic activity firmed up in the second quarter at 1.8 percent from 1.2 percent in the first quarter (quarter on quarter), supported by policy stimulus[6]. Money supply rose by 10.4 percent in August and credit growth accelerated, while fiscal policy turned expansionary in the second half of the year as infrastructure spending picked up, while credit growth has accelerated. Industrial production grew by 6.3 per cent annually in August, while retail sales growth accelerated to 10.6 percent in August. Investment in fixed assets grew steadily, while investment in infrastructure maintained fast growth, as efforts to cut overcapacity, reduce inventory, deleverage, lower costs and strengthening weak links seemed to yield fruits. Policy stimulus has also boosted the housing markets, with house prices in 70 large- and medium-sized cities rising by 1.5 percent in August[7], representing the strongest growth since January 2011. The recent strengthening could allay fears of a hard landing somewhat. In the context of economic restructuring, the growth of the real estate sector demand and prices will likely push back any broader economic slowdown to later in 2017. However, risks remain. China's growth trend remains on a gradual deceleration and thus presenting a risk factor, as the adjustment could be bumpier than expected, and further dampen global trade and commodity prices. High stock of corporate debt and local government debt remains a concern. Continued reliance on credit as a growth driver[8] and high shadow banking could heighten the risk of disorderly unwinding which could be disruptive and complicate the ongoing rebalancing of the economy. With these risks, Chinese hard landing fears are likely to reemerge as a global risk factor in 2017. Investors should monitor any increases in developer inventories, which could lead to a downturn in property prices as has happened in past two cycles.

Brazil's troubled economy remains in recession, but recent data suggest that activity is bottoming out as the effects of past shocks is gradually fading. GDP growth improved to -3.8 percent in the second quarter, from –5 percent in the first quarter, the smallest contraction in a year, as consumer and business confidence

[5] IMF, World Economic Outlook, October 2016
[6] National Bureau of Statistics of China
[7] ibid
[8] MRB Partners Report, 11 October, 2016

improves somewhat.[9] As such, recession could be less severe than initially envisaged in 2016, with growth expected at -3.3 percent. Recent data shows that retail sales contracted in July, by 0.3 percent over the previous month, while industrial production recovered, reflecting the beginning of stabilization. On the political front, tensions are easing after Dilma Rousseff was eventually impeached on 31 August with Michel Temer taking the remainder of Rousseff's term until 2018. The easing of political hurdles will allow the government to focus on economic reforms and reviving confidence in the economy. Looking ahead, economic growth is expected to pick up to the positive territory of 0.5 percent in 2017[10], as the effects of political discord, policy uncertainty and past shocks subside somewhat.

The **Russian** economy has been transcending through a painful adjustment process which has seen it in recession since 2014, amid dual shocks from oil prices and sanctions. The economy contracted by 0.6 percent in Q2, after the 1.2 percent contraction in Q1, marking the slowest decrease since late 2014[11]. Despite negative economic growth, recent data also show that the industrial sector accelerated by 0.3 percent in Q2, showing tentative signs of stabilization, although the service sector was less robust. Improving oil prices in the second quarter have provided some relief to economic activity such that the decline in GDP this year could be milder than initially expected. The central Bank has cut its repo rate to 10 percent from 10.5 percent in September, to support economic activity, as inflation expectations remain benign. The Bank expects GDP to leap out of recession, with positive growth in the third quarter, which could narrow the rate of contraction in 2016. The outlook remains subdued and clouded by downside risks emanating from the slow recovery in oil prices, Brexit uncertainties, further softening of demand from China and geopolitical disturbances in Syria.

The outlook for other emerging market and developing economies is uneven. In Sub-Saharan Africa, growth projections were substantially revised downwards reflecting difficult prospects for the three largest economies: Nigeria, South Africa and Angola. Oil price recovery in the second quarter provided some breath to oil exporters in the Middle East and North Africa (e.g. Iran, Saudi Arabia, Qatar and Algeria), but if oil markets remain oversupplied, and geopolitical tensions and civil conflicts in some countries intensify, the prospects may be dampened. In East and South Asia, growth is fairly robust, supported by strong economic activity in Indonesia, Hong Kong, India and Bangladesh. Indonesia's structural reforms are buoying its cyclical growth momentum, and helping to deepen credit and better financing of current account balances. India's robust growth is supported by surging private consumption, low oil prices and economic reforms, despite a weak external sector. Economic activity in other commodity exporting emerging market economies (e.g. Mexico, Venezuela, Argentina, Ecuardo, Tunisia) remain difficult amid persistently low commodity prices. Hungary will grow faster than potential, while momentum in Turkey is saddled by mounting political (attempted coup) and economic risks.

In our view the global economy is on a modest recovery path, but remains fragile as downside risks remain dominant. Global growth is projected to pick up to 2.8 percent[12] in 2017, lower than initially projected (3.1 percent). The IMF is more optimistic, projecting global GDP growth of

[9] Brazil Central Bank, Economic Indicators
[10] IMF, World Economic Outlook, October 2016
[11] The Central Bank of the Russian Federation, Monetary Policy Report No 3, September 2016
[12] World Bank, Global Economic Prospects, June 2016.

3.4 percent in 2017.[13] In our view, these growth projections will be difficult to achieve considering significant downside risks on the horizon affecting both developed and developing countries. The risks to the global outlook mainly relates to elections in the US in November and other countries amid political discords, the still softer commodity prices, the possible hike of the US interest rate in December, uncertainties surrounding the Brexit negotiations, the continued slowdown in China with significant spillover effects to other developing economies and geopolitical tensions.

Macroeconomic outlook for Africa

Economic activity in Sub-Saharan Africa (SSA) remains difficult in 2016. Projected growth for 2016 has been revised to 1.4 percent from 3 percent, reflecting a sharp decline from 3.4 percent in 2015, and well below the average of 5-7 per cent over the past decade (Table 1). This reflects the slowdown or recession in the region's largest economies, Nigeria, South Africa and Angola, as lower commodity prices interact with other difficult and complex economic and political forces. Other commodity exporting economies such as Democratic Republic of the Congo (DRC), Chad, Equatorial Guinea, Zambia and Zimbabwe are also facing headwinds from both external and internal forces. However, there are a few bright spots in the region: Cote d'Ivoire, Kenya, Senegal, Rwanda and Tanzania, which will continue to grow at robust paces, expected well above 6 percent in 2016. Growth in these countries is supported by infrastructure investments, agriculture and consumption, boosted by lower oil prices and dynamic private sectors.

Lower oil and commodity prices, the slowdown in China, tightening global financing conditions and a possible slowdown in Europe after the Brexit vote in June will continue to dampen the region's outlook. Commodity prices are expected to remain below their 2014 levels in 2016, and may not rise to cyclical highs anytime soon. On the domestic front, policy uncertainty, droughts, and political and security concerns continue to weigh on economic activity in some countries.

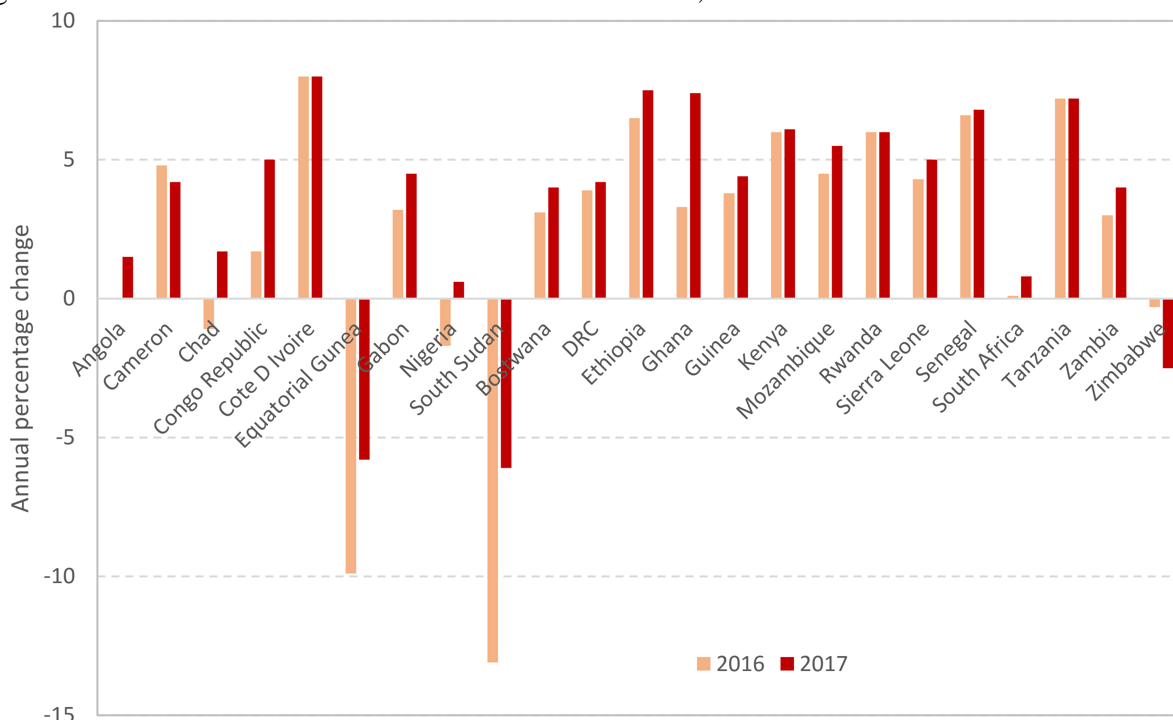
Table 1: Macroeconomic Indicators for Sub-Saharan Africa

	2010	2011	2012	2013	2014	2015	2016	2017
Real GDP Growth (percent)	6.9	5.1	4.1	4.1	4.6	3.4	1.4	2.9
Nominal GDP (USD Billion)	1275	1428	1526.3	1607	1670	1560	1478	1620
Inflation (percent, yoy ave.)	8.2	9.5	9.4	6.6	6.4	6.9	9.0	8.3
Oil production (mbpd)	5.4	5.4	5.6	5.2	5.3	5.1	5.0	5.4
Net FDI (percent of GDP)	2.7	2.1	2.0	1.3	1.3	2.1	2.2	2.4
Fiscal Balance	-37.4	-1.1	-1.8	-3.1	-3.5	-4.3	-4.6	-4.1
Total Public Debt (percent of GDP)	27.7	28.3	28	29	29.9	30.7	37.2	36.8
CA Balance	-0.9	-0.7	-1.9	-2.4	-4.1	-5.7	-6.2	-5.5
Reserves (Months of imports)	4.2	4.6	5.3	5.0	5.6	5.1	4.2	3.9

Sources: AFDB, IMF, World Bank, IEA

[13] IMF, World Economic Outlook, October 2016

Figure 3: Growth forecasts for selected African countries, 2016 and 2017

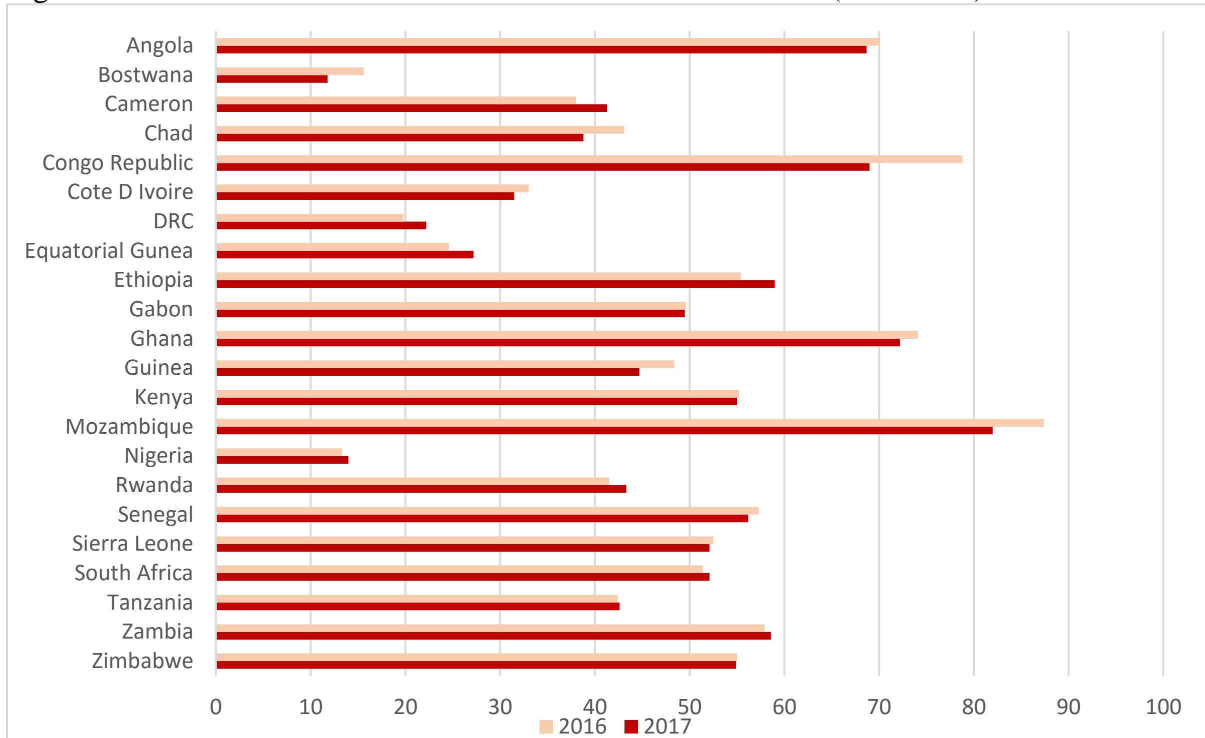


Source: IMF and World Bank

The fall in commodities-related revenues is adding pressure to fiscal and external balances in many countries, translating into declines in foreign reserves, currency depreciations and soaring debt in the low growth environment. A number of countries which borrowed from the international markets when commodity prices were high are struggling with high debt levels as debt service costs have soared in local currency terms, while foreign currency shortages persist. Government debt is significantly high in Mozambique, Congo Republic, Ghana and Angola) and well above SSA average of about 40 percent of GDP (Figure 4). Fiscal deficit for the region is projected to widen to 4.6 percent of GDP in 2016, and possibly narrow to 4.1 percent of GDP in 2017[14]. Fiscal deficits are widening most in oil exporting countries (Congo Republic, South Sudan, Cameroon and Equatorial Guinea). Fiscal consolidation efforts started in 2015 in some countries (e.g. Angola, Chad, Equatorial Guinea) are slowing down in 2016, even though oil revenues remained subdued. Yet for other countries such as Ghana, Botswana, Namibia and Niger, fiscal consolidation efforts are helping to reduce fiscal deficits. External imbalances remain a concern for a number of countries. Although oil exporters have been affected, the situation appears to be more acute in oil importing countries such as Liberia, Malawi, Mozambique and Zimbabwe, reflecting weak external positions and low buffers at the beginning of the shock in 2014 (Figure 5).

[14] IMF, World Economic Outlook, October 2016.

Figure 4: Government Debt for selected Sub-Saharan Countries (% of GDP)



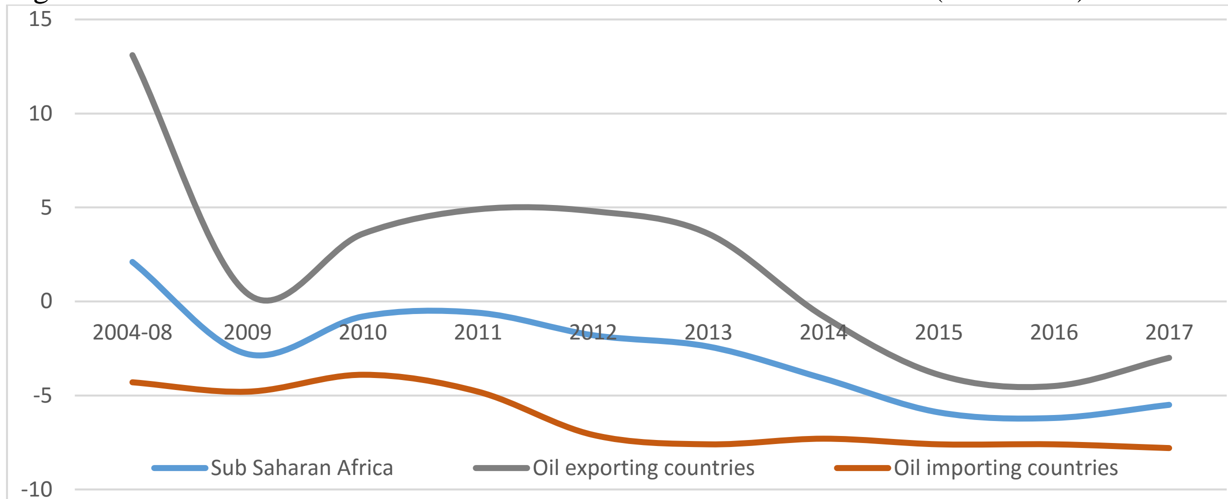
Source: IMF

Capital flows to the SSA region are slowing down, emblematic of challenging external financing. Capital flows in Nigeria declined by 55 percent in the first quarter, reflecting sharp declines in portfolio investments and FDI flows, while capital outflows doubled[15]. According to the National Bureau of Statistics in Nigeria, portfolio investment declined by 84 percent in the second quarter of the year compared with the same period in 2015[16], while foreign direct investment fell to $184m in the second quarter, compared with $211m in the second quarter of 2015. Mozambique also saw a slowdown in FDI, amid rising debt distress. Eurobond issuances also declined in 2016, with only Ghana and South Africa issuing bonds so far in 2016.

[15] Africa Pulse, October 2016, World Bank

[16] National Bureau of Statistics, Nigeria, GDP Report, Q2, 2016

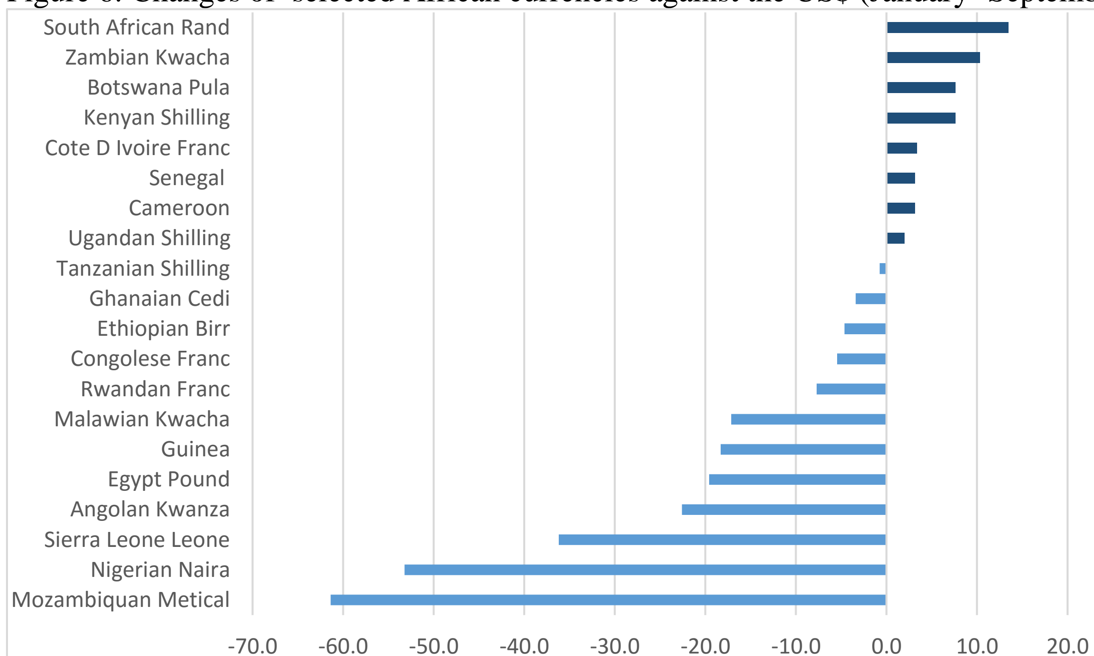
Figure 5: Current Account Balances for Sub-Saharan African Countries (% of GDP)



Source: IMF

The large current account deficits have continued to put pressure on many currencies. The currencies of Mozambique, Nigeria, Sierra Leone and Angola have weakened significantly against the U.S. dollar since January (Figure 6). The Mozambiquan metical lost more than 61 percent since the beginning of the year as the external position worsened after the revelation of the undisclosed borrowing exceeding US$1 billion. The Nigerian naira depreciated by 53 percent since the floating of the currency in June, while the Leone in Sierra Leone lost 36 percent since the beginning of the year, due to a decline in exports to China. Meanwhile, the South African rand rebounded after the Brexit lows, strengthened by improving current account balances on solid export growth. The Zambian kwacha also strengthened after elections in August, while in Kenya, strong growth of exports is supporting the shilling.

Figure 6: Changes of selected African currencies against the US$ (January- September 2016)



Sources: Bloomberg and Xe.com

The tight financing conditions especially in the first and second quarter implied that increased external pressures were partly met with reserve drawdowns in order to support currencies. As such, reserves have declined significantly, with cumulative declines in international reserves in SSA exceeding 30 percent between end-June 2014 and March 2016[17]. Over this period, reserves decreased by about 24 percent in Angola, 26 percent in Nigeria, 35 percent in Mozambique and 19 percent in Uganda. Declining reserve positions will imply less room for monetary authorities to respond to foreign currency pressures going forward.

The SSA region's average inflation is trending upwards, driven by mounting inflationary pressures in some countries such as Ghana, Mozambique, Angola and Nigeria, with inflation above 15 percent. The main drivers of inflation include pass-through of deep exchange rate devaluations, energy, water and food shortages, which are driving up prices in some countries. The surge in inflation in these countries has forced central banks to tighten monetary policy aggressively. In Nigeria, the central bank raised the monetary policy rate by 200 basis points to 14 percent in June, while Angola's benchmark rate was hiked by 200 basis points to 16 percent in July. In some countries (e.g Angola and Nigeria) real interest rates have remained negative, suggesting that further monetary policy tightening may be necessary to anchor inflation expectations. In CFA franc zone countries in West and Central Africa, inflation remains relatively low because of the stable peg to the Euro. Overall, inflation is expected to pick up in the next few quarters as pressures continue to mount in countries with significant macroeconomic imbalances.

The outlook for SSA remains difficult for a number of countries. However, with some of the drags subsiding in 2017, growth in SSA could firm up to around 2.9 percent. Oil and commodity prices could improve somewhat, in the light of the agreement by OPEC to reduce production and as supply inventories unwind somewhat in 2017. Downside risks emanating from commodity price volatility, weak external demand and further slowdown in China and elections in some countries e.g. in Ghana in 2016, Kenya, Angola, DRC, Rwanda and Senegal in 2017.

The picture for individual countries is quite variegated. **Nigeria** is struggling to keep its head above water, as its GDP contracted in the second quarter by 2.1 percent,[18]following a 0.36 percent dip in the first quarter. The economy is expected to close the year in recession, with -1.7 percent growth in 2016, as it faces manifold headwinds. Attacks on oil production infrastructure by the militant group Niger Delta Avengers and other groups have led to a drastic fall in oil output from 2.11 mbpd in Q1 to 1.69 mbpd in Q2. The Nigerian naira has depreciated by 60 percent since its floating on 20 June, putting pressure on prices. While floating of the naira helped somewhat to reduce macroeconomic imbalances, foreign currency shortages and the concomitant import restrictions have persisted in the economy. The shortages of energy remain a constraint to economic activity, as tariffs continued to increase, feeding inflation. Inflation has soared to 17.6 percent in August, representing the highest rate in 11 years, and prompting the Central Bank to raise its policy interest rates to 14 percent in July. With increasing external pressure, foreign reserves dropped to below $25bn, less than five months' import cover, from above $40bn before the oil price crash.[19] Growth in 2017 is projected at 0.6 percent, if oil prices stabilise and foreign exchange market stabilise after devaluation. However, this is subject to a number of visible downside

[17] World Bank, Africa Pulse, October 2016

[18] Nigeria Bureau of Statistics, GDP Report, Q2, 2016

[19] Financial times, 20 September, 2016.

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risks: low oil prices, instability in the Niger Delta, foreign currency shortages, low investor confidence and power shortages. The banking sector is also weakening and a potential banking sector is looming amid recession. The government is pledging to stimulate the economy through heavy spending on infrastructure, but the revenue squeeze could hinder successful implementation.

Angola's prospects continue to deteriorate as oil prices remain depressed. The IMF projects no growth in Angola in 2016.[20] Lower revenues have prompted the government to revise the 2016 budget. The oil price assumption was cut from $45 to $41 a barrel, but crude oil production remains steady at 1.77 million barrels per day. The country's total debt remains elevated at 62 percent of GDP in 2015 and expected to rise to 70 percent in 2016. The Finance minister Armando Manuel was replaced with Archer Manueira in September. Lower oil earnings have translated into acute shortage of foreign currency, which is causing liquidity problems in the banking system and hampering economic activity. Inflation edged up to 38.2 percent in August, marking the highest level in 12 years, driven by sustained depreciation of the Kwanza and increases in food and energy prices, especially after the removal of subsidies on these products. The Central Bank hiked the benchmark interest rate by 200 basis points to 16 percent in June, for the third time in 2016 to fight inflation. The outlook for 2016 remains challenging, but 2017 growth is expected to improve to about 1.5 percent, if oil prices stabilise and shortages of foreign exchange are addressed.

The **South African** economy improved in the second quarter, recording a rather surprising 3.3 percent growth (quarter on quarter), and escaping recession. The pick-up was supported by the rebound in the manufacturing sector. However, the PMI remains negative in August, reflecting low business confidence and political uncertainty. The economy continues to face headwinds from both external and internal forces, which could keep growth below the projected 0.6 percent. Despite the sharp depreciation after the Brexit vote in June, the South African rand has recovered quickly and strengthened significantly in the past months (8.5 percent since June 23), reflecting improvement in some commodity prices (e.g. gold), global search for high-yielding assets in emerging markets after the Bank of England cut its policy rate, no interest rate hike in the US in September and favourable macro data. Inflation inched down to 5.9 percent in August, falling within the inflation target range of 3-6 percent, and the South African Reserve Bank (SARB) has kept its policy rate unchanged at 7 percent in September.

Inflation could end the year close to 6 percent because of pressures coming from rising food prices, in the light of the poor harvest this year. Discontent over South Africa's poor economic performance has materialized at the local government elections in August, with the ruling African National Congress (ANC) party losing in several major cities to the opposition parties. Looking ahead, weak external demand, low commodity prices, political and institutional challenges and tense labour relations and protests will continue to limit growth beyond the projected 0.8 percent for 2017. South Africa is facing a possible credit rating downgrade at the end of this year, which could further dampen investor confidence and spark volatility in the markets.

Ghana presents mixed fortunes, with positive growth amidst risks. The economy recovered some ground in the first quarter, with 4.9 percent expansion after a deceleration in 2015. However, Ghana continues to battle high debt levels (over 74 per cent of GDP), high budget deficit (3.9

[20] IMF, World Economic Outlook, October 2016.

percent of GDP) and double digit inflation (16.9 percent in August, well above the central bank's target of 8 percent), affecting credibility if the central bank. The fiscal consolidation programme largely remains on track, but could be jeopardized by the passing of a bill by parliament which allowed funding of the fiscal deficit by the central bank (up to 5 percent of the previous year's total revenue). Ghana has started pumping crude oil from its second major oil development –the Tweneboa, Enyenra and Ntomme (TEN) offshore oil fields, expected to produce around 25,000 barrels per day. Ghana issued a $750 million Eurobond in September at a favourable yield of 9.25 percent, which was oversubscribed, reflecting investor confidence in the economy. The Ghana cedi, which lost almost a third of its value in 2014, has also been stable this year. Going forward, the policy challenge for the government is to keep the fiscal consolidation program on track in light of the forthcoming elections in December 2016.

Zambia is grappling with anemic economic growth (expected at 3 percent in 2016), rising inflation (20.2 percent as at July) and a fragile currency amid headwinds coming from lower copper prices, electricity shortages, high interest rates and drought. Zambia's credit rating was downgraded by Moody's to B3 in April on fiscal slippages and prospects of further deterioration of debt metrics.[21] In a tense and closely contested election, Edgar Lungu won the election with a small margin (50.35 against 47.67 percent) in August, but tensions have now subsided. Zambia is negotiating a USD1.2 billion loan from the IMF, which is widely expected to stabilise the budget and stimulate economic activity.

Some frontier economies (Kenya, Cote d'Ivoire and Senegal) are experiencing robust growth. Kenya's well-diversified economy will grow at 6 percent in 2016, sustained by strong growth in agriculture, infrastructure development and accommodative monetary policy. Inflation remains under control at 6.3 percent in August, while the shilling remains stable. The Central Bank of Kenya (CBK) kept its main policy rate at 10.5 percent in July, but the capping of commercial bank lending rates at 4 percent above the central bank base rate in September is likely to distort the credit markets and constrain lending to the private sector. Cote d'Ivoire is benefiting from strong reform momentum, a dynamic private sector and a stable macroeconomic environment, while fiscal discipline is helping to contain the fiscal deficit. The constitutional referendum in October is expected to bolster peace and stability in the country and improve the business environment. Senegal's robust growth of 6.6 percent in 2016 is buoyed by strong growth in agriculture and dynamism of the private sector.

Growth is holding up in some low-income countries (Rwanda, Tanzania and Ethiopia), with growth rates above 6 percent expected over 2016-2017, boosted by infrastructure development, mining expansion and dynamic consumer spending.[22] Rwanda's growth is expected to remain solid at 6.8 percent in 2016, buoyed by policy reforms, improving business regulatory environment and growth in fixed investment. Tanzania's robust growth is sustained by its dynamic infrastructure projects which includes the construction of a liquefied natural gas (LNG) terminal, an oil pipeline connecting with Uganda, a railway connecting neighbouring landlocked countries, a new port in Bagamoyo and rural household electrification. Ethiopia's growth is supported by reforms and strong infrastructure program. In July, the Ethiopian government launched the agro-investment project to boost crop production,

[21] Moody's Report, Inside Africa, September, 2016

[22] World Bank, Global Economic Prospects, June 2016

with the support of the European Union. The government will continue with its ambitious Growth and Transformation Plan II (GTP II) focusing on building key infrastructure, such as energy and transport facilities and improve healthcare and education which will drive economic expansion going forward. However, the slump in agriculture due to the El Niño driven drought is constraining further growth.

In Zambia, Malawi and Zimbabwe, economic activity is affected by a severe drought, which is holding back agricultural production. In Mozambique, prospects are saddled with negative effects of a financial scandal (undisclosed borrowing that exceeds US$1 billion) which has led to the suspension of international aid flows. The revelation has put the public finances under pressure, weakened international reserves and the currency, and prompted credit rating downgrades. GDP expanded at the slowest pace in eight years in Q2 (3.7 percent), while inflation soared to a multi-year high of 20.7 percent in July. Mozambique's growth outlook is clouded by disorderly debt distress, lower aid flows, weak investment and tighter fiscal and monetary policy. South Sudan is expected to remain in deep recession in 2016, amid political instability affecting economic activity, especially oil production.

Financial Markets

Following a tumultuous start to 2016, global financial markets have experienced a period of relative tranquility, especially between early March and early June as global economic conditions improve somewhat. Some turbulence returned after the Brexit vote in June, destabilizing financial markets especially equities, currencies and bonds. However, the effects were short-lived. The Bank of England cut its interest rates in August, while the earlier stimulus in China, ECB and Japan continue to lift the mood in the markets. In Africa, the Brexit shock on the financial markets was generally mild, reflecting the region's limited financial integration with the rest of the world and weaker trade links with the UK. However, there were some abrupt reactions in the first few days after Brexit vote in some countries with strong financial and trade ties to the UK, such as South Africa.

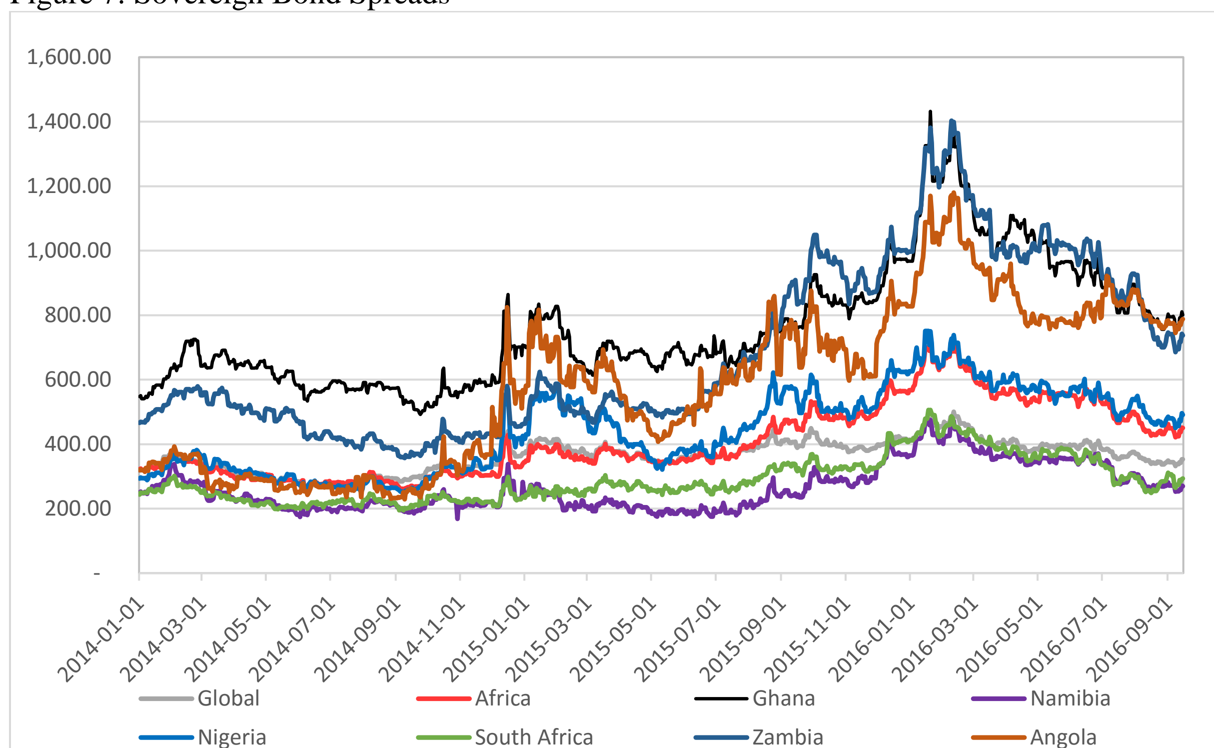
Risk assets continued to trade higher in recent months. Equities posted positive returns with emerging market and UK equities leading the way, recovering the Brexit losses, while Japanese, European and US equities also recovered reflecting some improvement in sentiment, pick up in commodity prices and lower borrowing costs. The FTSE 100 Index gained 8.9 percent between June 23 and September 30. The MSCI global index firmed by 2 percent while the MSCI emerging market index rose by 8 percent for the same period. Equities' recovery was largely driven by the continued low interest rates in the markets due to continued accommodative monetary policies especially in developed countries. The Nigerian stock market, however, slumped by about 9 percent, reflecting the devaluation of the naira in June, while the Johannesburg Stock Exchange has shed 2 percent between June 23 and September 30.

Capital flows to emerging market economies, which declined significantly in the second half of 2015 and slow start to 2016, are stabilizing because of continued expectations of lower interest rates in developed countries and improvements in commodity prices which are luring investors back to emerging market assets. However, the continued fragility in the global economy continues to limit sustained recovery in capital flows. This is especially the case for commodity exporting emerging and developing countries, where foreign direct investments into mining and exploration have slowed. Although oil prices are likely to remain range bound, they could recover somewhat especially in 2017, following OPEC's agreement to cut production as well as unwinding of

previously accumulated inventories. Thus lifting market sentiment towards commodity exporting emerging markets.

Although borrowing costs have remained low, thanks to ample stimulus by major central banks, financial market conditions remain susceptible to sudden bouts of volatility. In response to increasing stimulus from a number of large centrals banks and further rate cuts after the Brexit vote, bond yields have declined especially in developed countries. 10 year US and German Bonds declined by 25-30 basis points between March and August, while UK 10 year gilts declined by 90 basis points.[23] However, 10-year US Treasuries improved marginally in September. Bond spreads have also narrowed across the world since the beginning of the year, reflecting some improvement in sentiment. However, compared with other emerging markets and developing countries, African bond spreads have remained elevated and above world averages (Figure 7). This largely reflects still challenging economic conditions and low market confidence in some countries (e.g. Ghana, Zambia and Angola).

Figure 7: Sovereign Bond Spreads



Source: Bloomberg

A number of countries in Sub-Saharan Africa are struggling to keep investment grade credit ratings. In the first six months of 2016, Angola, Gabon, Lesotho, Mozambique, Republic of Congo and Zambia have seen their credit ratings downgraded by Moody's, S&P and Fitch, on concerns of rising debt ratios, slowing economic conditions, widening fiscal deficits and growing vulnerabilities. Credit rating downgrades are keeping the relative cost of borrowing high for these countries. Table 2 shows credit ratings of selected African countries.

[23] IMF World Economic Outlook, October, 2016

Table 2: Credit Ratings of Selected African Countries

	S & P		Moody's		Fitch	
Country	**Credit Rating**	**Outlook**	**Credit Rating**	**Outlook**	**Credit Rating**	**Outlook**
Angola	B	Negative	B1	Negative	B	Negative
CoteD' Ivoire	Not Rated	Not Rated	Ba3	Stable	B+	Stable
DRC	B-	Negative	B3	Stable	B+	Stable
Ethiopia	B	Stable	B1	Stable	B	Stable
Gabon	Not Rated	Not Rated	B1	Negative	B+	Negative
Ghana	B-	Stable	B3	Stable	B	Negative
Kenya	B+	Negative	B1	Stable	B+	Stable
Mozambique	CCC	Negative	Caa3	Negative	CC	Not Rated
Namibia	Not Rated	Not Rated	Baa3	Stable	BBB-	Negative
Nigeria	B	Stable	B1	Stable	B+	Stable
Rwanda	B	Stable	B2	Stable	B+	Stable
Senegal	B+	Stable	B1	Positive	Not Rated	Not Rated
South Africa	BBB-	Negative	Baa2	Negative	BBB-	Stable
Zambia	B	Negative	B3	Negative	B	Negative

Source: Bloomberg

Despite some divergence internationally, monetary policy conditions remain largely accommodative, especially in developed countries. The Bank of England reduced policy interest rates by 25 basis points and expanded its quantitative easing program in August to stimulate the economy following the Brexit. The US Fed kept its interest rates unchanged in September and October, but is widely expected to hike its interest rates at the December meeting. Australia, New Zealand, Russia and Indonesia have cut their policy interest rates in recent months to support economic activity, while Mexico raised its interest rates after the Peso came under pressure immediately after Brexit. In the face of weak growth and low inflation in Europe, the European Central Bank continues with its quantitative easing program (€1.74-trillion worth of bonds), keeping interest rates in the negative territory. We expect the ECB's Quantitative Easing program to be extended before the end of 2016. In Africa, Uganda and Kenya's central banks have cut their interest rates amid benign inflation outlooks, while Egypt, Mozambique and Nigeria raised their interest rates in recent months in response to rising inflationary pressures.

The outlook for financial markets remains fragile amid the still sluggish global economy and presence of some underlying vulnerabilities in emerging economies making economies making them to be susceptible to sudden shifts in investor confidence. The possible interest rate hike in the US remains an important risk to monitor. The US presidential election is another potential risk factor for financial markets, as a victory by Trump could bring policy uncertainty because of possible policy shifts.

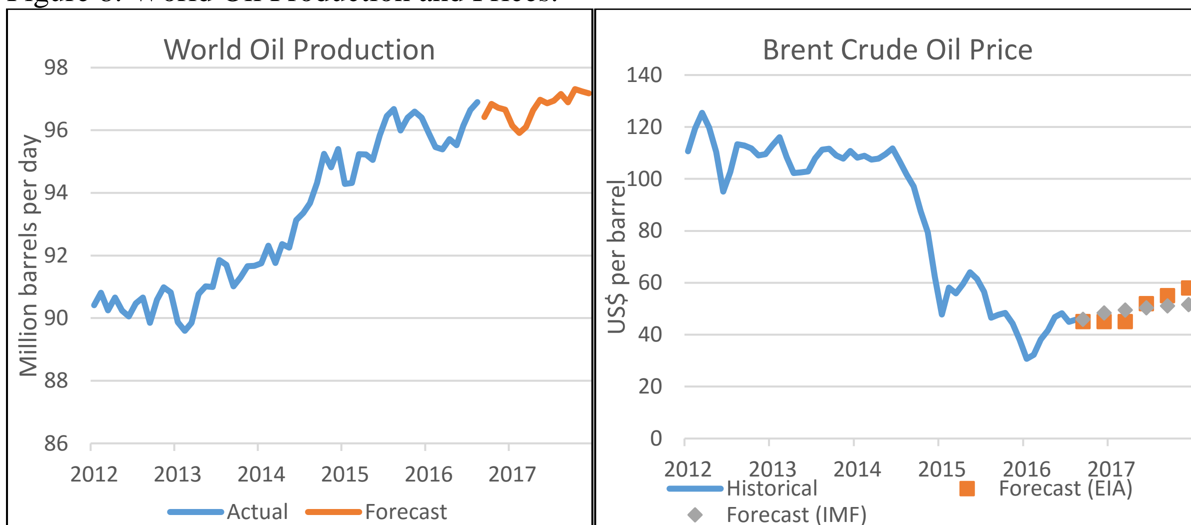
Commodity Markets

Commodity prices have stabilized somewhat, following a turbulent start to the year, but relative stability was perturbed briefly by the Brexit surprise in June. Brent crude oil prices averaged between $44/b and $49/b in the past four months, as global oil markets remain oversupplied, resulting in the ongoing build-up of stocks that is expected to continue into 2017. Growth in world oil demand slowed notably in the 3rd quarter, with global consumption reaching 97 mb/d amid weaknesses of Chinese growth and continued stagnation in Europe and Japan. Global oil demand is expected to grow by 1.3 mb/d in 2016 and 2017, with most new demand expected to come from non-OECD countries, notably China and India. On the supply side, the increase in OPEC output by 0.93 mb/d (led by Iran) was offset somewhat by the contraction in non-OPEC oil production (led by the US). Unanticipated supply disruptions amongst

OPEC producers averaging 2.4 million b/d in August, mainly in Nigeria (0.7 mb/d), Libya (1 mb/d) and Venezuela helped to lift up prices somewhat in the second quarter.

The U.S. Energy Information Administration (EIA) forecasts Brent crude to be range bound, between $40-50 per barrel in Q4, and average $43/b in 2016, edging up to $52/b in 2017 (Figure 8). However, the agreement by OPEC to cut production at the meeting in Algeria in September is raising hopes for further oil price recovery above $50/b, but details about production quotas for individual countries and when the agreement would come into effect are unclear. In the medium to long term, as global energy industry investment is undergoing the longest period of decline in nearly half a century, supply shortages may develop within a few years, leading to a more substantial recovery in prices.

Figure 8: World Oil Production and Prices.



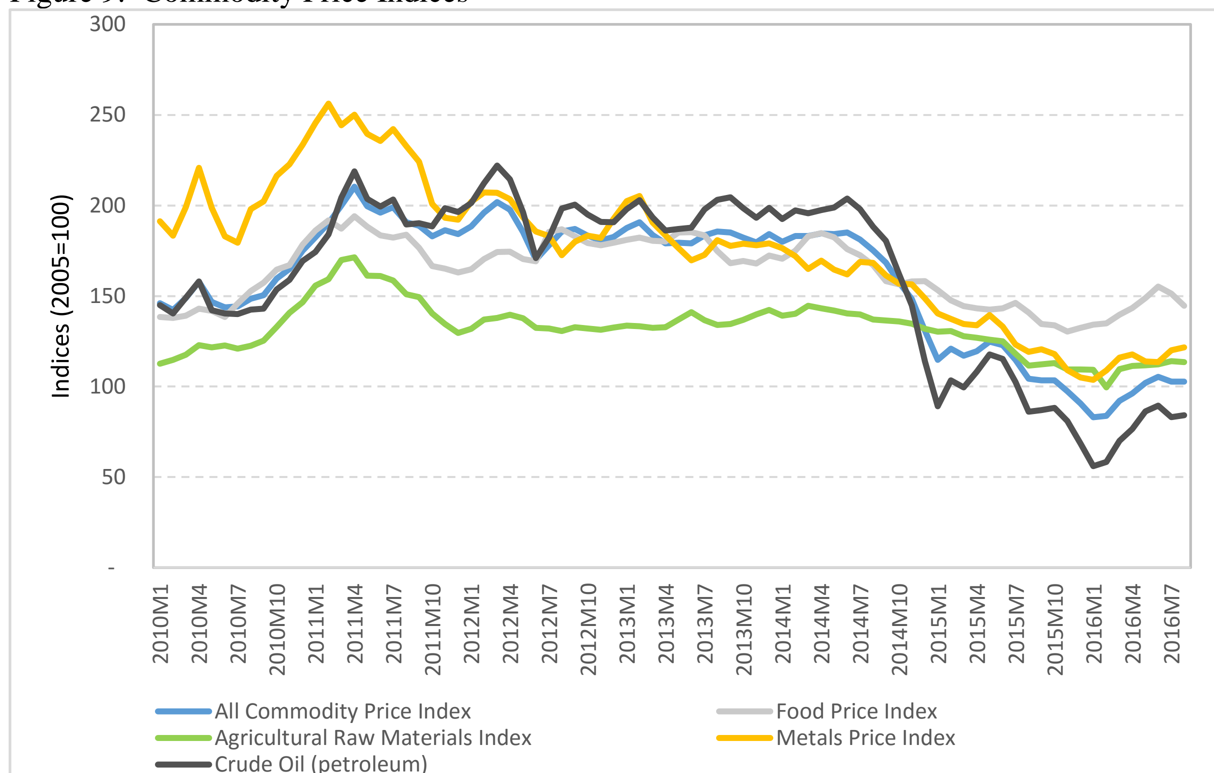
Source: EIA

Precious metal prices (gold and silver) have continued their upward trend since bottoming out in January 2016 because of their safe haven appeal, especially after the Brexit vote. The exception is platinum, which fell in September due to stronger output in South Africa. Precious metal prices are expected to remain on the upside as the store-of-value remains attractive, but weak global industrial activity and demand are likely to act as partial drags on these prices. There has been a pick-up in the prices of most base metals in the second quarter, compared to the first quarter, led by nickel and zinc (17 percent each), lead (8 percent) and tin (7.6 percent), supported by recent stimulus in china. Copper, iron ore and aluminum recorded small increases. The outlook for base metal prices is for little change over the next five quarters, except for iron ore prices which could slump as demand remains soft in the face of global overcapacity. The growth of the Chinese economy (which accounts for about half of global demand for most base metals) in the short term will largely determine the direction of commodity prices, given the fragile global economy and ample supplies from investments made in the 2000s.

Agricultural commodity prices continued to fall as markets remained oversupplied, especially maize, soybeans and wheat (captured by the food price index in Figure 9). The outlook for grain prices is largely on the upside, with wheat and maize expected to strengthen modestly in the coming five quarters, while rice prices could be robust. The prices of beverage commodities (coffee, tea and cocoa) all increased in the third quarter, but the prospects are mixed, with a moderate rise expected for coffee,

seasonal price declines in cocoa beans and stable prices for tea over the coming year. The outlook for timber prices is stable over the next five years as gains in demand are expected to be matched by expanded supply. For Sub-Saharan Africa (SSA), the outlook for the agriculture sector largely depends on both demand drivers (e.g. income growth, population expansion, urbanisation, a growing middle class, shifting dietary patterns) and supply-side factors (e.g. agro-ecological conditions, climate variability and change).

Figure 9: Commodity Price Indices



Source: *Source*: IMF Primary Commodity System. Note: Index (2005=100)

Commodity prices are expected to remain modest, with small changes in the coming few quarters, as supply remains adequate. The gradual rebalancing in most markets remains in place and market and macroeconomic fundamentals are expected to largely define the direction of commodities prices towards the end of this year and into next year. (Detailed report on the commodity markets, is available at: QGRL Commodities Market Outlook, 4th Quarter, 2016)

Risks to monitor

The outlook for many countries, especially in Africa, remains overshadowed by downside risks. On the external front, the risks relate to the uncertainty on the nature and pace of withdrawal of the UK from the EU and negotiations on key issues of access to the EU single market and immigration. This could continue to dampen global economic growth, which is already fragile. In September the WTO trimmed its forecast for trade growth for 2016 by a third. An environment of uncertainty could weaken investment, trade, tourism and development aid from Europe to Africa and exacerbate the decline in commodity prices. Investors need to monitor UK/Europe links with the world economy, especially financial, investment and trade contagion effects.

Although the Chinese economy has improved in the first two quarters, the rebalancing process is still an important risk factor shaping the outlook of most African

economies. The underlying growth trend is still pointing towards deceleration, while the recent pick-up was supported by a stimulus package and a rebound in the housing market, which could fade in 2017. There are also some worries about China's credit growth, high local government debt and shadow banking. The possible sharper-than-expected slowdown of the Chinese economy could continue to depress commodity prices, reduce export demand, dampen global economic recovery and ignite volatility in the financial markets.

While oil and other commodity prices have improved somewhat since the beginning of the year, the ample supply backdrop amid sluggish demand growth continues to hold back sustained price recovery. We expect oil prices to remain range bound and still lower than the 2014 levels. This will likely keep other commodity prices down, as global trade and global economic activity remains lacklustre. While the persistent decline in commodity prices has strong effects on commodity exporters, the effects can also spill over to non-commodity countries through trade and financial transmissions.

The possible interest rate hike in the US in December is another important risk to monitor in emerging markets and African economies. The Fed has signaled in September that conditions for a rate hike are now visible, but would like to confirm their durability. The hike could further tighten financial conditions and trigger a further decline in capital flows to emerging and frontier economies in SSA and possibly affect corporate balance sheets.

There is also considerable uncertainty around US elections in November. While victory by Clinton could ensure continuation of most of Obama's policies, there is considerable uncertainty surrounding Trump's policies, which could imply a significant shift in both domestic and foreign policies should he win the election. There is growing sentiment across the world of de- globalisation with forces in the political divide advocating for more inward looking policies. Elsewhere, the elections in Spain in 2016, and upcoming elections in German and France next year, a referendum in Italy, and the implied policy direction need to be monitored closely, as these are important economies in the global economy. Continued geopolitical and unstable security conditions in the Middle East, especially in Syria (despite an attempt for a ceasefire) and Iraq, continue to present the risk of a continued tide of refugees, disruption to trade, tourism and economic activity. Recent terror attacks in Florida, New York and Turkey also continue to raise concerns.

Political instability associated with elections present added risk for some African countries as it raises both actual and perceived risks. Elections in Uganda, Gabon and Zambia were rocked with violence and were disputed. Planned elections to monitor in Africa in 2016 are in Ghana and 2017 elections are in Kenya, Angola, DRC, Rwanda, Senegal, Sierra Leone and Liberia. [24] In DRC elections, there is a risk of instability amid attempts to extend the presidential term to a third term by President Kabila. Meanwhile, the parties have agreed to form a caretaker government to run until the elections. Political and security uncertainties in Burundi, Burkina Faso, Mali, Kenya, Egypt and Nigeria are also stifling economic activity and hampering efforts to focus on more pressing economic issues. In Nigeria, the continued attacks on the oil infrastructure by the Niger Delta Avengers and other militant groups is hampering oil production.

Severe weather conditions associated with the El-Nino-induced drought in East and Southern Africa continues to constrain economic activity in the agriculture sector

[24] National Democratic Institute: https://www.ndi.org/electionscalendar

and undermine food security in 2016. Food shortages are expected to intensify as the lean season progresses, necessitating food imports to the region. Concomitant exchange rate pressures are exacerbating inflationary pressures in the affected countries. Although the El Nino weather conditions are expected to fade later in 2016, the expected La Nina weather cycle could bring severe flooding, which could also affect agriculture production in 2017.

Policy Implications

Prudent policies are needed to respond to challenges confronting countries. Commodity exporting countries experiencing declining fiscal space and diminishing foreign reserves and experiencing inflationary pressures need to adjust to reestablish their macroeconomic balances. While they can tighten their monetary policies to contain inflationary pressures, they need to balance between excessive tightening and promotion of economic activity. Oil importers with easing constraints could cut interest rates to stimulate economic activity. Where possible, some exchange rate flexibility could be allowed to smoothen the adjustments to external shocks. Administrative controls on foreign exchange need to be avoided to avert economic distortions.

As the persistent commodity price shock has widened fiscal deficits and raised debt levels in many countries, especially in Africa, finding an appropriate fiscal response remains a challenge for many countries, as deeper fiscal adjustment is needed to contain fiscal deficits. Commodity exporting countries can reduce fiscal deficits and rebuild policy buffers through better prioritization of spending initiatives, expanding the tax base to non-resource sectors and improving the efficiency of tax administration, while gradually adjusting to the 'new normal' of low commodity prices within the framework of fiscal consolidation programs.

African countries should also address structural constraints to growth, notably infrastructure gaps. The biggest challenges are in power supply and transport, which should be given greater priority. For power, more focus could be given to investing in new power generation capacities and transmission, especially encouraging private sector participation in power projects, by creating robust policy frameworks, regulatory environments and incentives. There is also a need to accelerate diversification and structural transformation in the long term, to insulate the economies from boom-bust cycles associated with commodities.

Conclusion.

Although global economic activity is showing signs of picking up, following the turbulent start of the year and the Brexit shock in June, it remains subdued. Global economic growth is projected at 2.4 percent in 2016, supported by better gradual and slowly easing of conditions in some emerging and developing countries, which experienced significant drags last year. The initial impact of the Brexit vote has been less severe than initially envisaged, but the main economic impact will likely only be felt once the UK actually exits the EU. Global growth remains fragile as downside risks continue to dominate the outlook.

Monetary conditions remain accommodative, with ample policy stimulus in the Euro area, UK, China and Japan, while the pace of normalisation of US monetary policy is expected to remain

gradual. Global financial markets have relatively stabilized after two episodes of volatility in the year. Long-term bond yields in advanced economies have declined, while stock markets have improved especially in emerging markets. Growth of global trade is expected to remain sluggish in the remainder of 2016 on the back of China's rebalancing process and cyclical headwinds in EMEs and the Brexit shock. Global inflation will remain low as slackness in commodity prices and disinflationary conditions in advanced economies persist.

The slowdown in China is continuing at a measured pace, with growth firming up in recent quarters due to policy support, but concerns remain. Risks are related to a bumpier adjustment than expected, amidst high stock of corporate debt, concerns about disorderly unwinding of high credit growth, high local government debt and high level of shadow banking. The outlook for other emerging market and developing economies is quite uneven. Growth in Sub-Saharan Africa will remain less robust in 2016, amid continued external and internal headwinds facing the economies.

Commodity prices have improved somewhat since the slump at the beginning of the year and the Brexit shock in June. Oil prices are expected to average about $43 per barrel in 2016 and are projected improve slightly to around $52 per barrel in 2017. Other commodity prices are also expected to strengthen marginally. The global economy is expected to firm to a rate below 2.8 percent in 2017, as commodity prices stabilise somewhat and conditions in several economies improve. The outlook is still subject to downside risks emanating from the forthcoming US elections in November, a possible hike in the US interest rate in December, persistent low commodity prices, continued slowdown in China and uncertainties on the UK's exit from the EU, geopolitical risks, political and security risks and drought. While short-term policy measures can be considered to deal with the challenges, African countries also need to consider long term policies for economic diversification and structural transformation and address structural bottlenecks, such as infrastructure deficits, to promote sustainable growth and development.