

# Fixed investment still sliding

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## Weekly Comment



By Cees Bruggemans, Chief Economist FNB  
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Participating in the latest FNB Fixed Investment Round Table held in early February 2010 were:

- Cees Bruggemans, Chief Economist FNB
- Christelle Grobler, Senior Economist BER
- Charles Martin, Senior Economist BER
- Erwin Rode, CEO Rode & Associates
- Johan Snyman, CEO Medium-Term Forecasting Associates

Introduction: There has been a modest start to economic recovery since 3Q2009. Especially manufacturing activity, electricity output and passenger car sales have shown rising tendencies, with inventory and export rebounds prominent. But fixed investment spending has shown split personality tendencies during 2009, with still strong contributions from public infrastructure, non-residential building activity and information technology, but heavy slides in private machinery and equipment investment.

Bruggemans: Given the turning of the business cycle already six months ago, but with as yet a fragmented recovery profile, and fixed investment apparently still sliding, how do we see 2010 shaping?

Rode: Utterly confused, understandably, given where we are in the cycle, with the usual noise surrounding turning points, with some sectors accelerating before others. Also considering the very complex international situation, especially China's position and role in the world. Are they a global growth engine or aren't they?

Bruggemans: Chinese exports fell by a third in late 2008 and early 2009 as the Western crisis bit hard. But like the Japanese of yore (as in the 1970s), and unlike Western companies, the Chinese leadership decided to accelerate domestic spending, fixed investment as much as consumption spending, to make up for the (temporary) export shortfall.

They did so very successfully. Chinese GDP growth averaged over 8% last year, reaching 10.7% by 4Q2009. That was some recession. Indeed, Chinese consumers today contribute more to the annual INCREASE in global GDP than do Americans. Perhaps exceptionally, their domestic car sales last year DOUBLED to 12m and their domestic car market now outranks the Americans. They certainly were a locomotive in 2009.

Rode: Yet it seems Western consumers will be crucial in determining global output?

Bruggemans: They will be important, but consider the qualification. As a share of total global consumption, Western consumers still contribute far more than Chinese

consumers. But US, European and Japanese consumption is growing very, very slowly. Chinese retail volumes grow by 15% annually. Though overall Chinese consumption may be small, its annual increments are bigger than the US annual increments.

Rode: Today certainly is payback time for all the Western consumptive indulgences of recent years. There will be a long-term adjustment, towards less reliance on debt, less consumption-intensity and more saving. And greater reliance on exports and investment.

Martin: In the very short term we will probably see a slight tempering of Western growth after the inventory and fiscal boosts and export rebounds of 2009. The IMF has revised its growth outlook for the US downward to 2.5% next year after 2.7% expected this year.

Grobler: If you look at our GDP growth rate, our own inventory gain (small, really) could add 1.6% to GDP this year. We are assuming 2.7% GDP growth this year – with inventories thus contributing 60% of the total.

Just look at manufacturing and see how inventories are stimulating that sector at present. The Kagiso Purchasing Managers Index tells the story how employment prospects in manufacturing have turned around.

The inventory cycle turning up is step one, followed by further effects elsewhere in the economy – employment, income, consumption and investment effects.

Rode: There is little doubt that anecdotally confidence among property developers is being restored quite robustly.

Snyman: Latest data for transfer duty paid (90% contributed by housing) show a sharp rise. The smart money has already moved back into the property market.

Grobler: In terms of expectations there seems to be some positive overreaction at present, given the condition of the economy and the remaining international risks still very visible.

Rode: The world economy is currently a temporary fool's paradise before the storm breaks again, reminding me of the phony war situation in 1939, after the conquest of Poland but before the blitzkrieg on France. Of course, the lull couldn't last.

This isn't a normal business cycle. The Western world has for a decade lived beyond its means, lived on credit, now lives at zero interest rates, and trillions have been pumped in. That has to be withdrawn sometime, consumers will have to deleverage and that will undermine growth. Either it ends in hyperinflation or a long period of depressed growth a la Japan in the 1990s.

Martin: There is great uncertainty out there.

Bruggemans: I don't quite see the situation so dire. There certainly has been a Great Crisis, a Great Recession in developed countries, and the world may take many years to fully undo these effects, not without encountering further disturbances along the way.

But this doesn't necessarily mean that present policies have to fail, far from it, even

though many people are unconvinced on this score. This brings us closer to home. How is the economy really shaping at present?

Grobler: The consumer remains relatively weak. Employment will take time to recover. Manufacturing is now enjoying an inventory correction but domestic demand (consumption) remains restrained. This should improve later this year, but there is reason to be worried about consumers, import competition (the level of the Rand) and underlying competitiveness (with electricity tariffs rising steeply and sticky real wages). Expectations remain uncertain.

Snyman: Consensus GDP growth expectations this year are for 2.6% (in a 2.5%-2.7% range), well below the 3.5% long-term average and half the 2004-2007 performance.

Martin: Growth will be slow/gradual, with a hesitant start. There is major concern about the pace of fixed investment recovery.

Rode: I also see a hesitant start, with a major inventory contribution now, but with next year more of a question mark. One can see higher taxes, inflation, interest rates, with growth possibly losing momentum again as harsh realities hit taxpayers and consumers. And the banks allegedly remain a bottleneck in terms of their stricter lending criteria compared to pre-crisis.

Bruggemans: Given all that as backdrop, and given the 2009 draught in fixed investment, how do we see the fixed investment outlook, Christelle (Grobler)?

Grobler: Manufacturing fixed investment in 2009 showed the biggest decline since the 1980s (nearly 20% down). Leading indicators point to the bottoming out of this decline. On a twelve month view, the BER manufacturing survey on fixed investment expects to see business and fixed investment turning up. The Kagiso PMI signals the same about inventory investment. Still, we expect only a marginal fixed investment recovery from later this year, with a small negative to flat for 2009/2010.

Manufacturing capacity utilization is still near record lows, and final demand is only now set to improve, but probably very specifically rather than broad-based (focusing on food, beverages, basic iron and steel, transport equipment, that is in only a few sub-sectors of total manufacturing). Given this profile, following shock experiences and much current uncertainty, a large portion of fixed investment should take a while to recover.

Bruggemans: How do you see prospects, Charles (Martin)?

Martin: Recovery in fixed investment is going to be rather slow. The government sector showed good growth in 2008-2009 related to the World Cup, transport and infrastructure. But going forward we need to get back to basic infrastructure. New prospects need to be identified, especially in municipalities. There are problems, not so much finance as the implementation of projects. There is a project deficit, a shortage of viable projects at local government level. New viable projects have not yet been adequately identified.

Public corporations made a major contribution to fixed investment – Eskom, Transnet, ACSA, Sanral. Yet this only constitutes 17% of fixed investment. Growth here is moderating – there isn't another major cycle of new airports, locomotives,

railway line upgrades in the pipeline. The power stations will continue, but the thrust from this sector could become less important going forward.

In the private sector I expect only slow recovery, given low current capacity utilization, slow increase in final demand driving fixed investment decisions, with the hesitancy of 2009 continuing in 2010. The main negative drivers are machinery and equipment (manufacturing and mining) and transport equipment (private commercial vehicles). A lot of capacity was created during the prosperity years, with today only a limited urge to replace/expand in view of the high overhead costs and weak demand.

Building activity could slowly recover, especially residential. I am not as negative about non-residential activity. Developers may already be dusting off plans, and the cycle may recover earlier than expected.

Rode: Our forecasts this year are still negative for residential building activity (-2.5%) and private non-residential building activity (-4%). Both should reach the cyclical bottom this year. Recovery thereafter should be exceedingly modest.

Real house prices will remain falling for many years still, a function of demand/supply, affordability and prices still being exceedingly high. For this reason new building activity should also remain subdued.

Building contractor profit margins will be under pressure for many years. The boom years ending 2008 were exceptional good years, not normal years. One should not base expectations or any forecast on this exceptionally generous base period.

Non-residential building activity remains in the upward phase of the long cycle. It is only temporarily being interrupted by the current business cycle downswing. Still, this disruption has knocked developer confidence and uptake. Hence vacancy rates are rising. So the next 18 months is making developers more cautious.

In sum, I see the building cycle bottoming this year, no growth in 2011, in other words a U-shape recovery.

Snyman: Leading indicators have been turning up from about March/April last year, but the turn in the real economy takes longer. The SARB leading indicator leads by as much as 6-9 months. The lead is longer at upper turning point (as existing projects take long to be completed) than at lower turning points (as new projects are taken up).

Regarding new house building activity, total private building plans passed for dwellings (square metres) were about -50% y/y during 2Q2009 and are now -32%. Thus the downswing is moderating.

For flats and townhouses the comparable data are -60% y/y in 3Q2009 and now -40%.

My forecast for 2010 is zero growth for total residential building activity, +3% in 2011 and +5% in 2012. This is not phenomenally high by historic standards (though reflects average annual growth – somewhat greater acceleration can be observed by quarter).

It goes without saying that the building boom during 2000-2007 showed

exceptionally high growth.

Rode: Interest-rate fuelled.

Bruggemans: Very high octane.

Martin: Jet fuel equivalent.

Snyman (sounding wistfully): It made it so much easier to afford a house .....

Bruggemans: How do you see non-residential building prospects, Johan?

Snyman: In offices and banking, vacancies are rising. The number of square metres of office building plans passed is dropping.

Retail space data is unstable, with lumpy investments. Huge malls being built in one period and next to nothing in the next. The peak of the retail building cycle was reached last year.

Rode: Retail building activity was amazingly high last year, but has fallen off a cliff, going nowhere this year. The country is seriously oversupplied with retail space. For a number of years there will be no good returns on shopping centres. These will underperform the rest of the property sector, unlike the past 40 years when retail was the outperformer. Rentals will fall in some instances.

Snyman: Industrial space moves in seven-year cycles, has peaked and is now in a downward phase. The latest data suggest the lower turning point in industrial building plans passed was 4Q2009.

Martin: Hotels are experiencing increased Fifa demand, with extra hotels being constructed. These needs are being met, with no further growth prospect for some while. Indeed expect some downward pressure on rates, with vacancy rates rising after the World Cup.

Snyman: Non-residential private fixed investment should be -9% in 2010 and -11% in 2011.

Martin: That seems too negative. If you add the government sector (prisons, schools, clinics, police stations, magistrate's courts) the overall outlook should not be as bad.

Snyman: Government sector growth could mitigate the downswing. Total non-residential building activity could be -6% in 2010 and -5% in 2011.

Bruggemans: When can we expect the next cyclical peak?

Rode: We are in a long cyclical upswing now, in the case of residential building activity ten years (taking us to 2020) and for non-residential building activity five years (2015).

Snyman: For residential activity 2010 is the bottom, with the next peak in 2015. Allow that interest rates may mildly rise during 2012 with the SARB responding to rising inflation signals. By 2013/2014 there may be extra interest rate increases, knocking housing activity.

Non-residential building activity may peak by 2017 when allowing for the usual two-year lag compared to residential building activity.

Martin: I foresee a gradually upward modulating recovery. It won't be a cycle with high amplitude. Instead, look for a muted growth cycle.

Bruggemans: It would seem that although the cyclical bottom lies behind us, the next fixed investment cycle will be a rather modest affair, given low capacity utilization at the start, slow final demand recovery and considerable uncertainty following the abruptness and depth of recent disturbances.

That's sobering. The Great Exuberance is clearly at an end and a new realism has taken hold. But we are in a new cyclical upturn!

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