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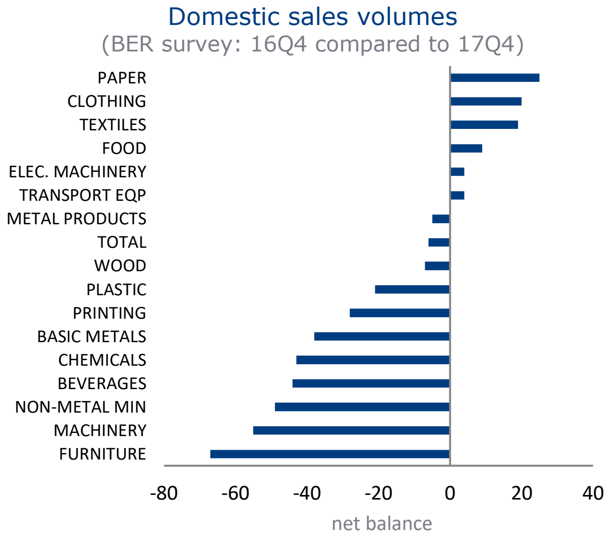
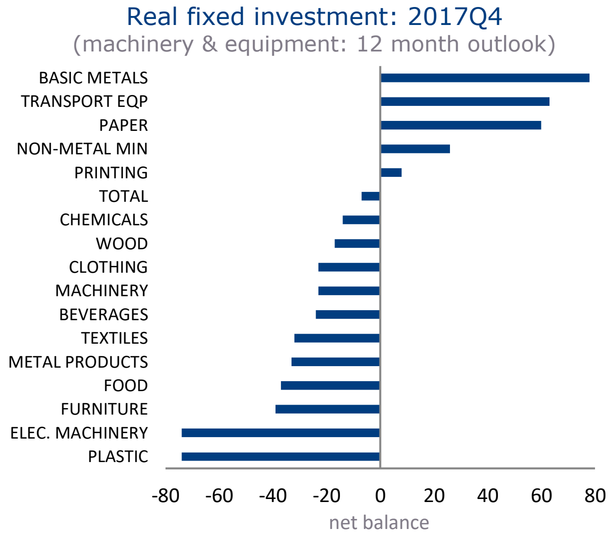
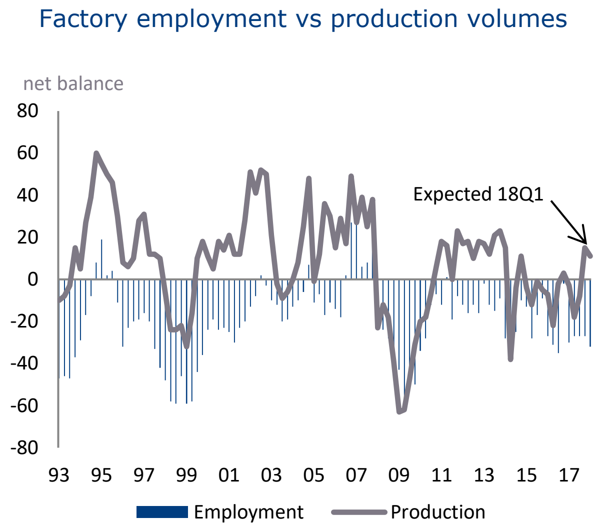
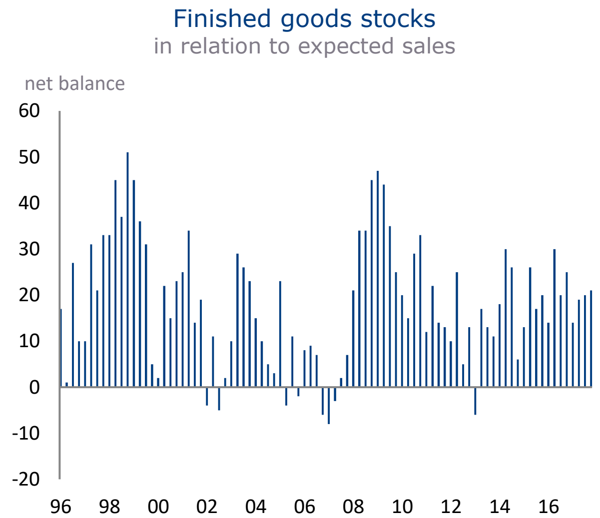
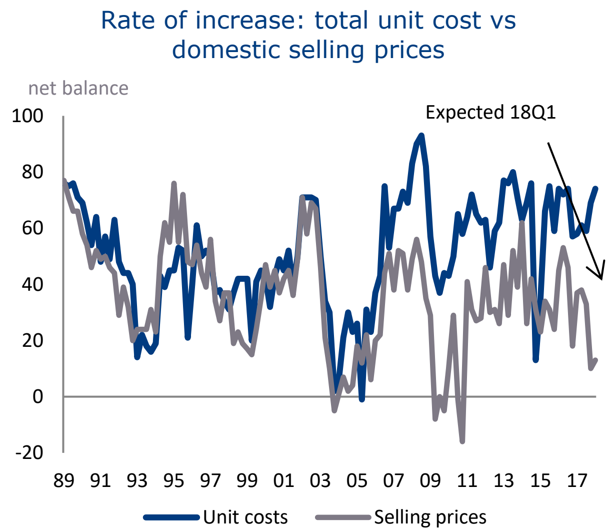
The manufacturing survey at a glance











Executive summary

According to the Absa Manufacturing Survey[1], manufacturing business confidence declined to 24 index points in Q4, down from 27 points in Q3. At the current level, more than seven out of ten manufacturers were unsatisfied with prevailing business conditions. Manufacturing business confidence edged lower despite most of the underlying activity and demand indicators improving.

The survey showed that the business environment was tough, with all of the constraint indicators increasing or remaining unchanged at a high level compared to the previous quarter. The most serious constraint (of those surveyed) was the political climate, with the rating increasing to a record-high level. The second most serious constraint was insufficient demand, followed by the shortage of skilled labour and the shortage of raw materials.

On the domestic demand front, volume growth improved and a further uptick is expected in 2018Q1. However, domestic selling price inflation slowed significantly. This could have cancelled out the positive impact on turnover from the improvement in volumes, which would explain why business confidence did not tick up.

The export performance was better across the board. The net majorities reporting an increase in sales and order volumes rose to almost four-year-high levels, while export selling price inflation also picked up. Respondents were also more upbeat about expectations for the volume of goods exported in 12 months' time.

With domestic and particularly export volume growth increasing in Q4, production volume growth also picked up. This was facilitated by an increase in the average hours worked per factory worker, while the overall employment indicator remained stuck at a low level. The apparent recovery in output would have to be sustained for job growth to pick up.

The rate of increase in the average total cost per unit of production picked up in Q4. The acceleration was driven by higher purchasing prices of raw materials, rising to the highest level since 2016Q2.

The net majority reporting an increase in fixed investment in the current quarter rose slightly, but longer-term prospects remain significantly more downbeat.

Overall, a bigger net majority compared to Q3, expects business conditions to deteriorate in 12 months' time.

[1] The survey was conducted between 16 October and 20 November 2017.

This report was completed on 6 December 2017.
Please refer to the **glossary on the BER's website** for explanations of technical terms.

Contents

Introduction

The manufacturing sector expanded in the second and third quarter of 2017, after contracting through the second half of 2016 and first quarter of 2017. The Absa Manufacturing Survey results suggest that while confidence dipped lower, underlying activity may have improved in Q4.

Manufacturing contributes positively to GDP growth for second straight quarter

The manufacturing sector grew by 4.3% quarter-on-quarter (q-o-q)[2] in the third quarter of 2017, significantly faster than the 1.5% growth rate recorded in the second quarter. This was the second straight quarter of expansion and the fastest growth rate since the second quarter of 2016. The uptick in manufacturing gross value added contributed 0.5% percentage points (%pts) to the overall economic growth rate of 2% q-o-q. This was slower than the upwardly revised 2.8% q-o-q growth recorded in the second quarter. The biggest driver of economic growth was the solid 44.2% q-o-q increase in gross value added by the agriculture, forestry and fishing sector. This was the biggest rise in 21 years and the sector added 0.9%pts to GDP growth. A 6.6% q-o-q rise in the mining and quarrying sector added a further 0.5% pts. Continued growth in both these sectors bodes well for demand for locally produced manufactured goods. However, it is unlikely that the strong pace of agricultural growth is going to persist through 2018 as conditions normalise, after 2017 output was boosted by the drought in 2016. The water shortage in the Western Cape will also weigh on agricultural output (and exports) in that region.

However, while growth in the primary industry remained solid, there are still signs of weakness in the economy. Gross value added by the construction sector declined for a third straight quarter, falling by 1.1% q-o-q after a 0.3% drop in the previous quarter. The trade, catering and accommodation sector also contracted in the third quarter.

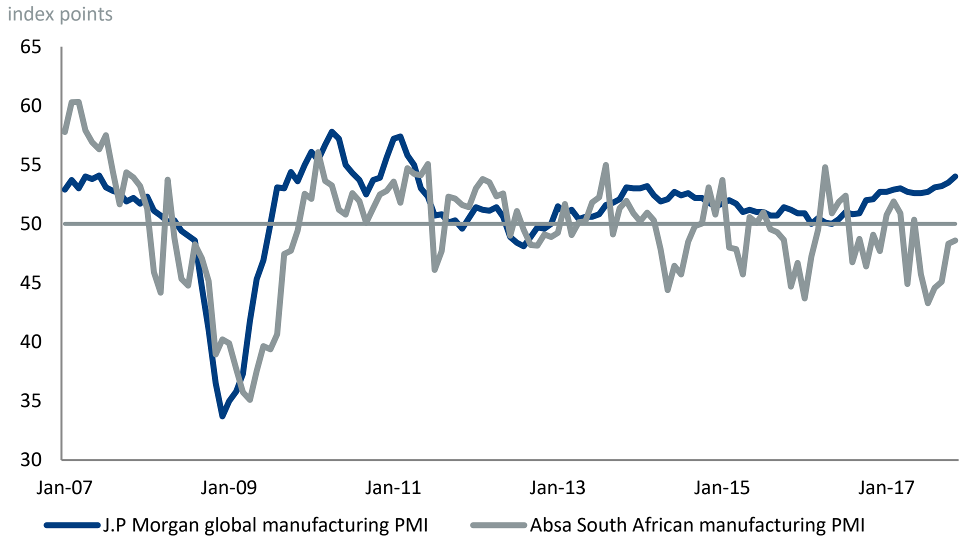
Despite the upbeat q-o-q figures for manufacturing output growth, the sector contracted for a fourth straight quarter on an annual basis. Gross value added fell by 0.7% year-on-year (y-o-y) in the third quarter, after a 2% dip in the second quarter. The Absa Manufacturing Survey results suggest, however, that the annual growth rate may improve to positive terrain in the fourth quarter of 2017. The monthly Absa Purchasing Managers' Index (PMI), albeit still stuck below the neutral 50-point mark in October and November, also suggests that output could look better in the fourth quarter.

[2] Unless stated otherwise, all the q-o-q figures referred to in this section are seasonally adjusted and annualised.

SA manufacturing sector underperforming global picture

It is, however, important to highlight that the local manufacturing sector is still significantly underperforming compared to the global picture. This is illustrated in Figure 1 by a comparison of the South African Absa manufacturing PMI and the global J.P. Morgan manufacturing PMI. The global index rose to its highest reading since March 2011 in November and has signalled expansion (i.e. has been above the neutral 50-point mark) for 21 consecutive months. The South African indicator, despite ticking up recently, remains stuck below the neutral 50-point mark. The underperformance is not limited to just the manufacturing sector. Indeed, overall GDP growth is also well below the global experience (and outlook). On a positive note, the sustained recovery in the global index does mean that export-demand may continue to improve.

Figure 1: Global manufacturing PMI well above recent South African readings



Source: BER, Markit

The remainder of the report provides an overview of the situation in the manufacturing sector as it developed during the fourth quarter of 2017 (2017Q4), expectations for the first quarter of 2018 (2018Q1) and also 12 months hence. The main section of the report discusses the trends in the overall manufacturing industry with the assistance of graphs, followed by a brief outlook for the sector. After this section, separate tables and graphical displays of the survey data are also provided for each individual sector and province[3].

[3] In this edition of the Manufacturing Survey, we cover 16 out of the 19 major subsectors and the four main provinces (Eastern Cape, Western Cape, Gauteng and KwaZulu-Natal).

The 2017Q4 Absa Manufacturing Survey results

Manufacturing business confidence edges lower

Manufacturing confidence at just 24 points in Q4

Manufacturing business confidence declined to 24 index points in Q4, down from 27 points in Q3. The current level is equal to the average confidence level recorded in the first three quarters of 2017. A confidence reading of 24 points means that more than seven of ten manufacturers were unsatisfied with prevailing business conditions.

From a subsector perspective, three subsectors had a confidence reading above or at 50. However, half of the sixteen subsectors had a confidence reading at or below ten, pointing to widespread pessimism in the broader sector.

Overall, at 24 points, manufacturers were the least satisfied compared to the other industries surveyed in the overall RMB/BER Business Confidence Index (BCI). Retailer confidence stood at 29 points, followed by new vehicle dealers (32), building contractors (34) and, finally, wholesale traders (51). This brought the overall RMB/BER BCI to 34 index points in Q4.

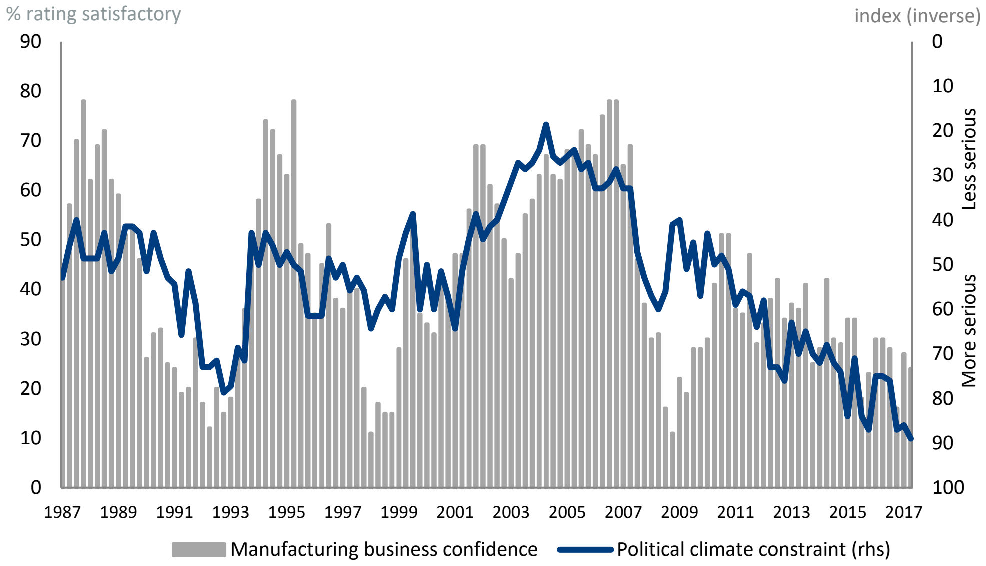
Political climate constraint rises to all-time high level

Manufacturing business confidence edged lower despite most of the underlying activity and demand indicators improving. In fact, most indicators reached levels not seen in a few years. However, the survey also showed that the business environment become tougher, with all of the constraint indicators[4] increasing or remaining unchanged at a high level compared to the previous quarter. A rise in a constraint indicator means that it was rated as a more serious constraint on business conditions. The most serious constraint (of those surveyed) was the political climate, with the rating increasing to a record-high level of 89 points in Q4 – the series starts in 1987. Further underscoring the height of the current level and thus the seriousness of the constraint is the fact that the long-term average level of this indicator is at 52. As illustrated in Figure 2, the political climate indicator has a clear negative relationship with manufacturing business confidence and, in part, explains why confidence is currently so low. The uptick in the political climate indicator in Q4 likely reflects continued political uncertainty ahead of the ANC conference in December. However, it is probably also linked to concerns about the possibility of South Africa’s sovereign credit

[4] The only indicator that did not increase was the constraint that the shortage of unskilled labour poses on general business conditions. However, the index is at such a low level (4 points in Q4 compared to 5 in Q3), that the availability of unskilled labour can hardly be seen as a constraining factor. This makes sense in the South African context where employers have access to a large low- and unskilled workforce.

rating being downgraded to junk status in November. This possibility and the detrimental implications have dominated news headlines over the past few months, particularly after National Treasury's Medium Term Budget Policy Statement (MTBPS) in late October.

Figure 2: Manufacturing business confidence and the political climate constraint

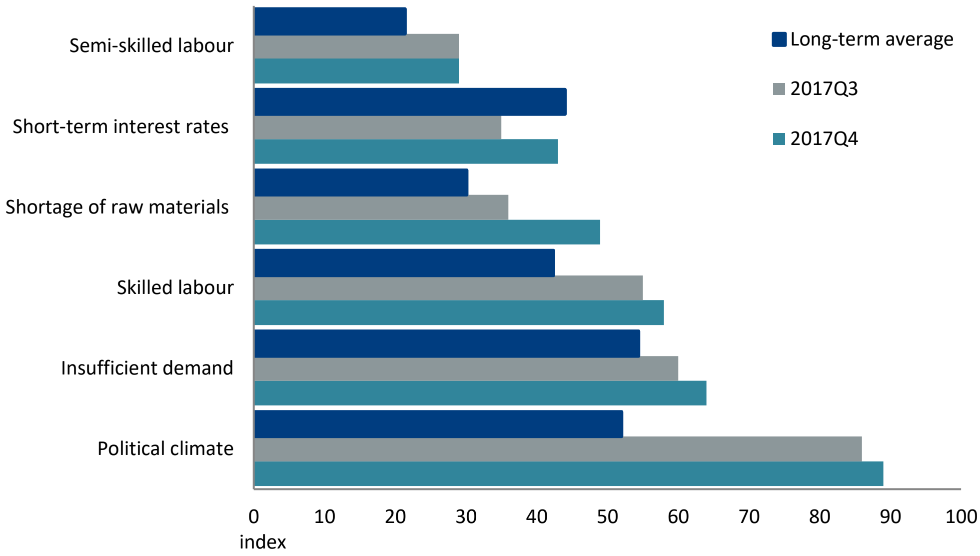


Source: BER

Insufficient demand, shortages of skilled labour and raw materials also rated as serious constraints

The second most serious constraint was insufficient demand, followed by the shortage of skilled labour and the shortage of raw materials. The latter indicator rose the highest level since 2008Q1. This indicator reached an all-time high level in the Western Cape specifically, which suggests that the drought in the region may be a factor. The seriousness of the short-term interest rate constraint also ticked up in Q4. This could be because manufacturers anticipated a cut in the policy interest rate in September, which did not materialise. In addition, large companies that access capital markets directly are affected by higher rates on the back of higher South African government bond yields.

Figure 3: Constraint indicators



Source: BER

Domestic volume growth picks up, as selling price inflation slows

Domestic selling price inflation slows to multi-year low

A net majority of just 6% reported a decline in domestic sales volumes received in Q4, which is a significant improvement from the net 26% that reported this in Q3. The net majority reporting a decline in domestic order volumes also fell to its best level since 2015Q2. There may be some element of seasonality in the uptick despite the survey questionnaire referring to the year-on-year change in conditions which should filter out the seasonal Q4-boost. However, manufacturers expect a further improvement in 2018Q1. The subsectors that were the most optimistic about domestic demand include paper, clothing, textiles and food, while the furniture, machinery and non-metal minerals subsectors were the most downbeat.

While overall volume growth improved, domestic selling price inflation slowed significantly. The indicator tracking the rate of increase in the average domestic selling price per unit of production fell sharply to 10 from 33 in Q3. Manufacturers expected a slight slowdown in inflation, but not to this extent. Indeed, the indicator is now at the lowest level since 2010Q4 and well below the long-term average level of 38. For six of the sixteen subsectors, this indicator was even in negative terrain.

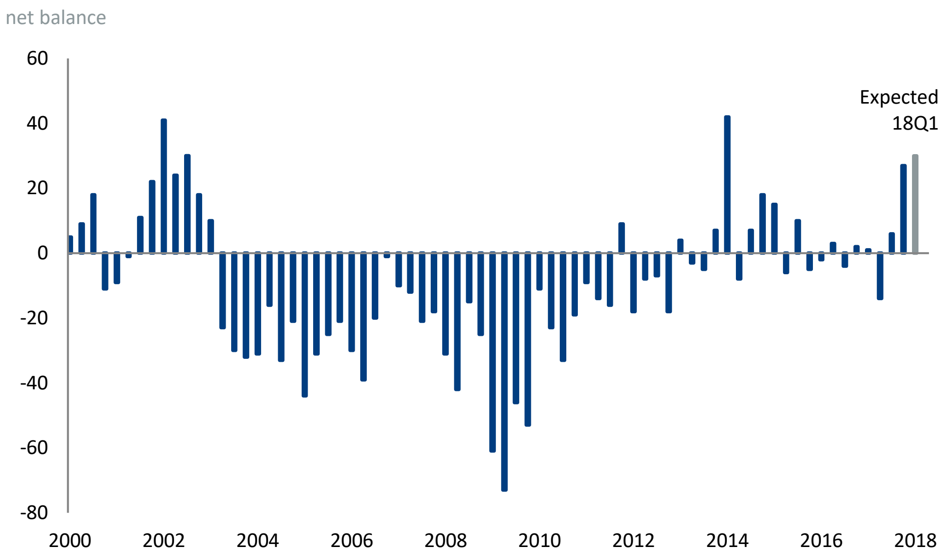
As evident in previous surveys, there seems to be a trade-off between volume and price growth. In this case, the slowdown in price inflation may have boosted volumes. This could have cancelled out the positive impact on turnover from the improvement in volumes, which would explain why business confidence did not tick up.

Export performance improves notably in Q4

Export sales and order volume indicators reach almost 4-year high levels

Unlike the domestic picture, where the slowdown in selling price inflation takes some of the shine off the improvement in orders, the export performance was better across the board. Firstly, the net majorities reporting an increase in export sales and order volumes rose significantly in Q4. A net 26% (up from 3% in Q3) currently reports higher sales volumes, while a net 27% (up from 6%) reports higher order volumes. These are the biggest net majorities since 2014Q1, when the export indicators spiked for a single quarter. The last time respondents were this upbeat about export sales and orders for a few consecutive quarters was in 2002 – see Figure 4. It is therefore encouraging to see that manufacturers expect both order and sales volumes to hold up in 2018Q1. The subsectors with the biggest net majorities seeing higher export order volumes include metal products, clothing, paper and food, while printing, wood and transport subsectors reported declining orders.

Figure 4: Export order volumes rise notably in Q4



Source: BER

The second positive trend on the export front was the fact that manufacturers were not only more upbeat about the next quarter, but also upwardly adjusted their expectations for the volume of goods exported in 12 months' time. A net majority of 27% expects an increase, up from 5% in Q3. The more optimistic outlook may be supported by improved growth forecasts for South Africa's key trading partners (the Eurozone and Sub-Saharan Africa). Encouragingly, the transport subsector – which is the biggest single manufacturing export product category – is the most optimistic about export prospects in the year ahead.

Finally, the indicator tracking export selling price inflation rose for a third straight quarter to reach 29 – a one and a half year high and significantly above the

Export selling price inflation also picks up

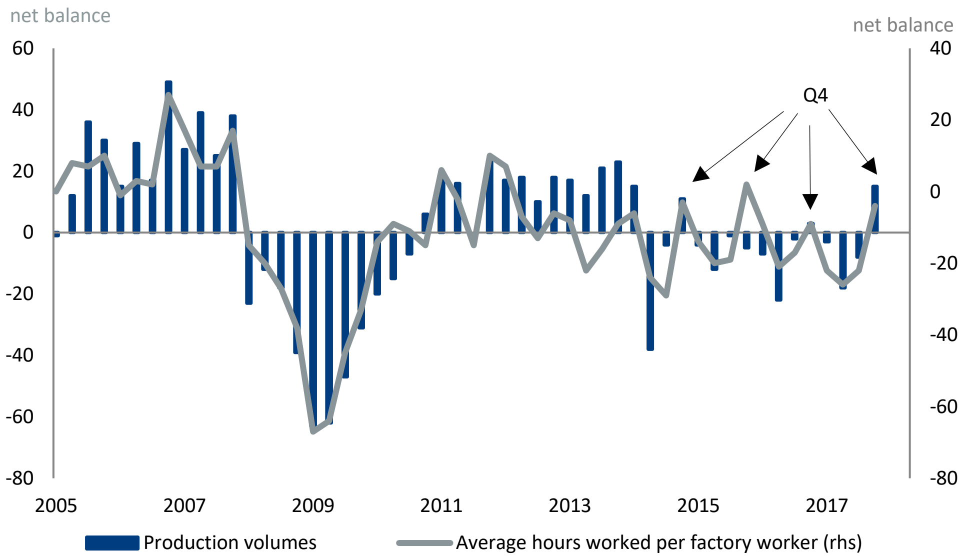
long-term average reading of 12. This could have been supported by the weaker rand exchange rate in Q4 compared to Q3, which leads to manufacturers receiving more rand income for the same foreign currency denominated products.

Production volume growth accelerates

Production in positive terrain for the first time in 2017

With domestic and particularly export volume growth increasing in Q4, production volume growth also picked up. Indeed, the biggest net majority since 2014Q1 (15%) reported an increase in production volumes. This is the first time this year that a net majority reported an increase in volumes, rather than a decline. As illustrated in the figure below, there tends to be a slight seasonal impact in the production volume and average hours worked indicator (more on this below), with both of these picking up in the fourth quarter. However, the magnitude of the improvement in 2017Q4 was significant and even a seasonally-adjusted series shows the net majority swinging from a negative to a positive reading in 2017Q4. This bodes well for output growth in the quarter.

Figure 5: Production volumes pick up well into positive terrain



Source: BER, Stats SA

Job growth prospects remain dismal

It seems that the uptick in output growth was facilitated by an increase in the average hours worked per factory worker. The indicator rose to -4 from -22 in Q3, but is expected to fall back again in 2018Q1 to -29. The indicator tracking the number of factory workers remained unchanged at a low -27 for a third straight quarter and is expected to dip to -32 in 2018Q1. This suggests that employment prospects in the sector remain bleak. The apparent recovery in output would have to be sustained for job growth to pick up.

Increased pressure on the cost front

Cost of raw materials ticks up in Q4

The rate of increase in the average total cost per unit of production picked up in Q4. This was in contrast to manufacturers' earlier expectations. The acceleration was likely driven by higher purchasing prices of raw materials, rising to the highest level since 2016Q2. The weaker rand exchange rate, which pushes up the costs of imported raw materials and intermediate products, as well as higher commodity and fuel prices likely drove the upward trend. On the other hand, the indicator tracking the rate of increase in the average labour cost per unit of production ticked down from 75 (the highest level since 2008Q3) to 67. The current reading remains well above the long-term average reading of 53.

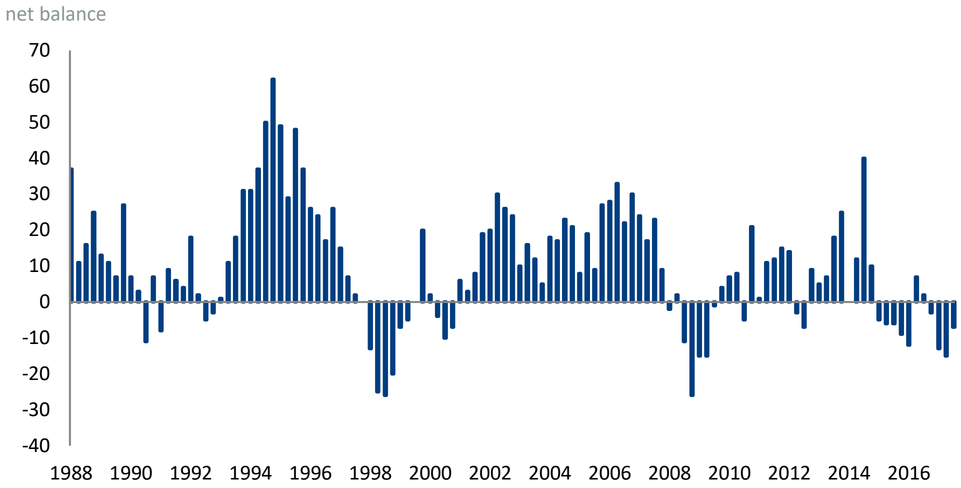
The acceleration in cost increases, coupled with the significant slowdown in domestic selling price inflation likely weighed on profitability levels. This could explain why business confidence did not improve, despite higher volumes.

Current fixed investment outlays tick up, longer-term prospects remain very weak

Total fixed investment expected to decline going forward

The net majority reporting on an increase in fixed investment in the current quarter rose from 3% to 6% in Q4. However, longer-term prospects remain significantly more downbeat. Not only does a net majority of 12% expect a decline in fixed investment in 2018Q1, but a net 7% expects a decline in real investment in machinery and equipment in 12 months' time. While this is an improvement from the net 15% (the biggest since 2009Q3) that expected this in the previous quarter, it is well below the long-term average reading of (a positive) 11%. Indeed, as illustrated in Figure 6, fixed investment expectations rarely remain in negative terrain for extended periods. Barring two positive quarters in the second half of 2016, machinery and equipment investment expectations have been stuck in negative terrain since 2015Q2. The subdued outlook is widely shared among subsectors, with only five out of sixteen subsectors expecting an increase.

Figure 6: Fixed investment outlook stuck in negative terrain

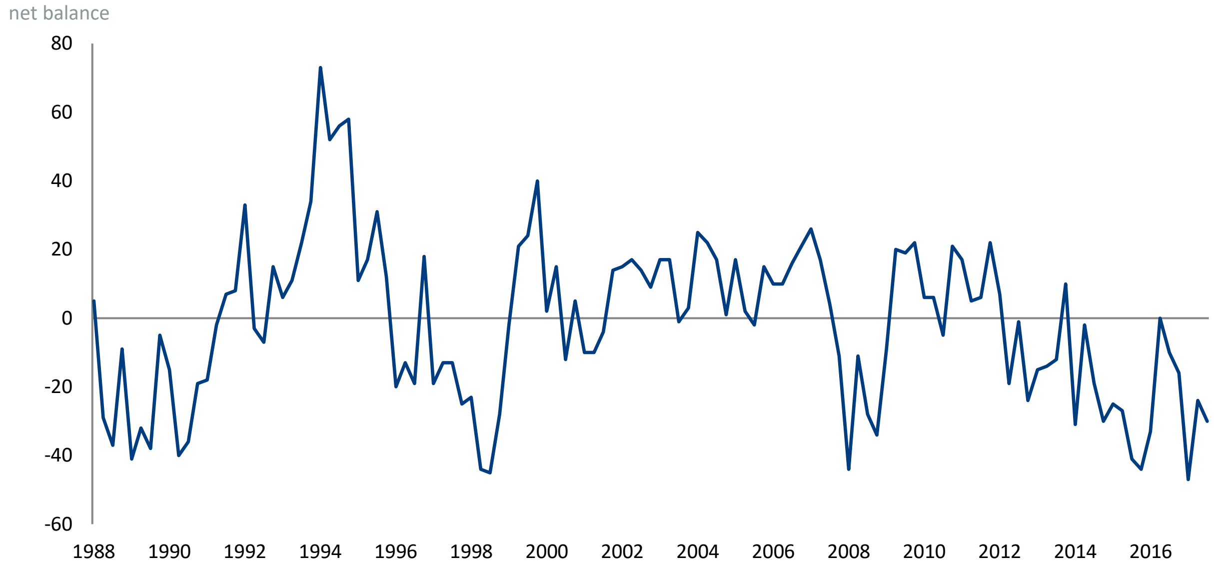


Source: BER

Outlook

Despite an improvement in most of the underlying activity and demand indicators, manufacturing business confidence declined in 2017Q4. Sentiment was soured by high ratings of all of the constraint indicators pointing to a tough business environment. Furthermore, manufacturers might be hesitant to turn more optimistic before seeing whether the current improvement is sustained in coming quarters. Should demand and, in turn, activity move lower again through 2018, business confidence could remain at the current weak levels. Indeed, as illustrated in Figure 7, manufacturers turned more downbeat about expected business conditions in 12 months' time – with a net majority of 30% expecting a worsening in conditions.

Figure 7: Expectations about business conditions in 12 month's time turn lower



Source: BER

The subdued expectations are surprising if one considers that the outlook for our key trading partners, and indeed, to some extent, also for domestic demand has improved. However, the souring of expectations, coupled with the record-high rating of the political climate constraint, likely reflects the impact of the current political uncertainty. Until the outcome fo the ANC December conference, there seems to be a wait-and-see approach – hence the downbeat fixed investment expectations. On a positive note, should the conference bring forward confidence-inspiring leadership, manufacturing (and general) business confidence could increase significantly at the start of 2018.

Technical note

The aim of the business survey is to obtain information on economic movements before the numerical (official) data is available, by making direct contact with the entrepreneur. Short-term planning is hampered as numeric (official) data is released with a time lag. Business survey results not only reveal beforehand the direction of sales, production, employment, selling prices, etc. (for which official figures are published), but also provide **unique information**, such as business confidence, rating of business conditions and respondents' expectations for the next quarter for which no official data exist. *It is now widely recognised that these subjective individual expectations play a key role in economic developments*. Furthermore, the survey results of successive quarters provide a means of tracking cyclical movements, pinpointing trend changes and establishing forecasts. The survey technique, which the BER applies - the so-called *Konjunkturtest* - was developed during the 1950s in Germany, by the IFO Institute.

The survey results are obtained from questionnaires completed by senior executives in the trade, manufacturing and building sectors during the final month of every quarter. The business survey questionnaire contains a number of questions. These questions are of a qualitative nature, e.g. "Compared to the same quarter a year ago, are the volume of sales up the same or down?" No hard statistics are requested. The sample of executives remains the same from the one survey to the next. A panel is effectively established. The sample is divided according to main sectoral categories. Each firm receives a weighting in relation to turnover or size of workforce to provide for widely differing company sizes. Participants have to complete a "participant details form" every few years to ensure that they are correctly classified and to provide for changes in size. The list of participants is also reviewed regularly to ensure an appropriate representation of the universe.

The survey results reflect trends and not actual measured amounts. The respondents indicate "up", "same" or "down" when comparing a current activity with that of a corresponding quarter of a year ago. These responses are quantified by converting them into percentages and portraying them as **net balances**, *i.e. the difference between percentages "up" and percentages "down".* In this manner, the net balances vary from -100 to 100, where:

- -100 = the most negative response;
- 0 = a situation of no change; and
- 100 = the most positive response.

Thus, a net balance above 0 indicates that more respondents assessed an "up" than a "down", in other words an *improvement* from the situation during the corresponding quarter a year ago. A net balance below 0 registers a majority of "down" responses, in other words a *deterioration* from the situation during the corresponding quarter a year ago.

The net balance statistic is therefore a qualitative yardstick of the pace of business conditions and could be compared to year-on-year growth rates in actual volumes. A positive net balance implies positive year-on-year growth and *vice versa*. The higher the value of the net balance (positive/negative), the more dispersed the improvement/deterioration is in the aggregate sector.

All the indices, except those depicting *business confidence* and *constraints*, vary from -100 to 100. The **business confidence indices** vary between 0 and 100. These are measured in gross percentage terms. Respondents are asked to rate current business conditions as "satisfactory" or "unsatisfactory". The business confidence index is derived as the gross percentage of the respondents responding "satisfactory". The business confidence index should therefore be interpreted in the same manner as all the other indices, i.e. a value of 50 is indicative of neutrality, 100 indicates extreme confidence and 0 indicates extreme lack of confidence.

Constraint indices are calculated as: the answer of respondents rating a particular constraint as "serious" is weighted by 0,67%; those rating it as "slightly" by 0,33% and those rating it as "not a constraint at all" is discarded. The results are then multiplied by 100/67 = 1,49 to convert it to an index that can vary between 0 and 100.