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Global economy

Global real Gross Domestic Product (GDP) growth improved in 2017 amid an upturn in corporate profits, which supported business and consumer confidence and a consequential rise in investment spending.

The upside surprise to growth in the Euro Union (EU) region, a key trading partner for African economies, was especially welcome. In early 2017, news flow in Europe was dominated by elections in The Netherlands and France. The defeat of Euro-sceptic parties at the polls was followed by a significant appreciation of the euro against the United States (US) dollar during the year. Despite lingering political uncertainty, partly reflected in the inconclusive result of Germany's September 2017 election, growth expectations in the region are favourable in 2018.

Following the sharp depreciation of the pound sterling in 2016, United Kingdom (UK) domestic demand and overall GDP recorded only modest growth in 2017, amid higher inflation, waning consumer confidence, and a shift towards a less accommodative monetary policy stance by the Bank of England. The 25bps hike in the Bank of England's rate in November 2017 was the first increase in the policy rate since 2007. Uncertainty around negotiations to establish the terms for the withdrawal of the UK from the European Union lingered throughout the year. Progress in this regard was achieved in early December 2017 when in-principle agreement was reached on UK and EU citizens' rights, the financial compensation to be paid by the UK, and the maintenance of an "open border" between the UK and Ireland. An extended period of uncertainty lies ahead until the new trade relationship is ultimately determined.

An encouraging feature of the global economy is the marked decline in unemployment rates recorded in recent years. Lower unemployment has not, however, translated into significant wage and inflation pressure as yet. Developed economies' headline consumer price inflation increased in the latter half of 2017, but core inflation rates have remained low, including US core consumer price inflation.

Despite this, the US Federal Open Market Committee (FOMC) continued on its gradual interest rate hiking path, increasing the federal funds target rate to 1,5% by December 2017. The US Federal Reserve also announced the start of "normalisation" of its balance sheet in October 2017, signalling its intention to no longer re-invest the principal repayments of its investments (subject to a cap).

In contrast, the European Central Bank (ECB) indicated that it will continue with its asset purchase programme, although its monthly net asset purchases were reduced from April 2017. At the conclusion of its December 2017 Governing Council meeting, the ECB left its key policy interest rates unchanged and indicated that it expects the key ECB policy interest rates "to remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases".

The year also witnessed the finalisation of comprehensive tax reform policy in the US. Included in the range of tax changes, to be implemented from 2018, are tax relief for households, a decrease in the corporate tax rate, and a more generous expensing allowance for capital investment. These measures are expected to support the nascent upswing in US fixed investment spending and provide a modest boost to GDP.

Among emerging market economies, China, another key trading partner for African countries, began 2017 on a cautious note as President Xi Jinping reportedly indicated to the communist party's financial and economic leadership group that the country's GDP growth target of 6,5% should not be pursued at the expense of financial stability. Even so, real GDP growth remained strong, increasing by an estimated 6,7% in 2017. Growth may ease in 2018 in response to tighter lending conditions and lower government expenditure growth, but is, nonetheless, expected to remain buoyant.

The global economic environment provided general support to commodity prices and GDP growth across many emerging markets, including a number of the markets in which Sanlam operates.

South Africa

South Africa's economic growth improved marginally during 2017, supported by the improving global real economic activity, increased terms of trade and a bounce in agricultural production. Real personal disposable income growth firmed from the second quarter of 2017, reflected in better, albeit still moderate consumer spending. However, real private sector investment expenditure remained soft, advancing just 1% in the year to 30 September 2017. This reflected a low level of business confidence, weak earnings momentum, and economic policy uncertainty.

At the end of 2017, the Reserve Bank's leading business cycle indicator remained consistent with continued modest real GDP economic activity. Real GDP growth is forecast to improve to 1,5% in 2018 from 0,9% in 2017.

Total gross operating surplus increased by a modest 6,1% in the first three quarters of 2017, relative to the same period in 2016. However, earnings of listed companies on the FTSE/JSE All Share Index, which, on aggregate, are skewed towards offshore earnings and export proceeds, advanced 26,3% in the year to 31 December 2017, supported by a bounce of 144,1% in the earnings of the FTSE/JSE Africa Resources Index companies. At the same time, the FTSE/JSE All Share Index and the FTSE/JSE Africa Resources Index yielded total returns of 21,0% and 17,9% in rand terms respectively. Most of this return was, however, recorded in the latter part of 2017, with the equity market reflecting volatility and no real growth for a large part of the year amid low investor confidence and political uncertainty in the run-up to the African National Congress's (ANC's) national elective conference in December 2017. As a result, average equity market levels in 2017 increased by less than 6% compared to 2016.

The deterioration of the South African Government's fiscal position remained a focal point of news flow throughout the year. Following the removal of the Finance Minister, Pravin Gordhan, from his post on 31 March 2017, Standard & Poor's (S&P) downgraded South Africa's long-term foreign currency sovereign debt rating from BBB- to sub-investment grade (BB+).

The National Treasury's Medium Term Budget Policy Statement (MTBPS), released in October 2017, indicated significant deterioration in the Government's primary budget balance, reflecting a large revenue collection shortfall. Furthermore, the National Treasury warned that the gross loan debt ratio could breach 60% of GDP by 2021/22 should additional fiscal consolidation not be implemented.

The disappointing MTBPS was followed by a further downgrade of South Africa's long-term foreign currency debt rating by S&P to BB from BB+ and the long-term local currency debt rating to BB+ from BBB-. These downgrades severely hampered business and investor confidence.

Despite concern over the potential negative impact of South Africa's weakening fiscal position, notably the risk posed by the deteriorating financial position of state owned companies, the rand appreciated markedly in the month leading up to Cyril Ramaphosa's election to the leadership position of the ANC in December 2017, seemingly reflecting financial market participants' expectation of reforms and improved economic policy certainty and implementation. The change in the rand exchange rate against the currencies of the major countries where Sanlam operates, is reflected in the following table (negative variances indicate a strengthening of the rand exchange rate):

Foreign currency/ Rand	Euro	GBP	US$	BWP	INR	MYR	MAD	Rest of Africa (weighted)
2015/12/31	16,84	22,83	15,49	1,405	0,235	3,620	–	
2016/12/31	14,43	16,92	13,68	1,299	0,202	3,051	–	
	(14,3%)	**(25,9%)**	**(11,7%)**	**(7,5%)**	**(14,3%)**	**(15,7%)**	**0,0%**	**(19,6%)**
2016/12/31	14,43	16,92	13,68	1,299	0,202	3,051	1,358	
2017/12/31	14,87	16,75	12,38	1,278	0,194	3,052	1,327	
	3,0%	**(1,0%)**	**(9,5%)**	**(1,6%)**	**(3,6%)**	**0,0%**	**(2,3%)**	**(12,9%)**
Average 2016	16,22	19,69	14,65	1,368	0,219	3,560	1,485	
Average 2017	15,00	17,13	13,30	1,302	0,205	3,104	1,388	
	(7,5%)	**(13,0%)**	**(9,2%)**	**(4,8%)**	**(6,6%)**	**(12,8%)**	**(6,5%)**	**(14,8%)**

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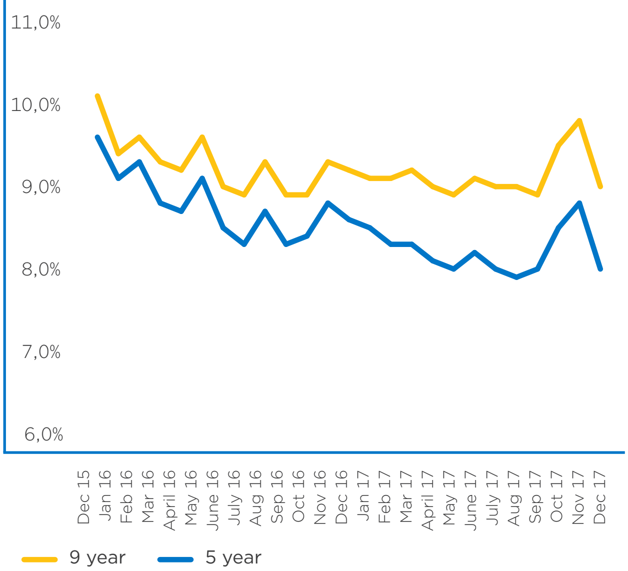
The stronger rand exchange rate negatively impacted the key performance indicators of our foreign currency operations. Refer to the Financial and Operational review from page 70 for more information.

Downside inflation surprises and tepid economic growth prompted the South African Reserve Bank (SARB) to cut its repo rate to 6,75% on 21 July 2017 from 7% – the first interest rate cut following a cumulative 200bps increase in the SARB's policy interest rate from January 2014 to March 2016. However, the Bank's Monetary Policy Committee left its repo rate unchanged during the remainder of 2017, given the risk posed to the rand by sovereign debt rating downgrades, uncertainty around the scale and pace of the likely shift towards less accommodative monetary policy in developed economies, and political uncertainty.

Long-term interest rates trended higher in the run-up to the ANC's national elective conference and following the sovereign downgrades, but recovered sharply during December 2017 to end the year lower than the end of December 2016.

SA bond yields



The All Bond Index (ALBI) produced a return of 10,2% for the year ended December 2017. The decline in long-term interest rates benefited the valuation of the Group's operations for GEV purposes as well as the value of new life business, which are, in general, based on discounted cash flow models. Refer to the Financial and Operational review from page 70 for more information.

Rest of Africa

The growth slowdown recorded in sub-Saharan Africa (SSA) in 2016 reached a trough in 2017, as a firmer global economy and higher commodity prices supported real economic activity.

Of the large oil-producing economies on the continent, indications are that Nigeria posted mildly positive real GDP growth in 2017, partly underpinned by an increase in oil production, while foreign exchange liquidity conditions improved in response to the introduction of the market-determined Nigerian Autonomous Foreign Exchange Rate Fixing (NAFEX) for investors and exporters. The investment inflows that followed have been supportive of economic activity. Sustained high inflation has, however, constrained real income growth. In addition, under-capitalised banks have been a drag on activity and the recovery in growth remains constrained. In response to the stabilisation of Nigeria's economy, the equity market recorded a total return in US dollars of 30,2% in 2017.

Likewise, in Angola, even though oil production increased, growth has been tepid, as the economy grappled with significant macro-economic imbalances against the backdrop of an over-valued, pegged exchange rate and a shortage of foreign exchange. In addition, a relatively high level of non-performing loans and unsatisfactory banks' capital adequacy ratios weighed on activity. The Central Bank of Angola, nonetheless, announced a change in the exchange rate regime early in 2018, which appeared to signal an intention to allow the exchange rate to depreciate towards a market-clearing level over time.

Among other commodity producers, a period of macro-economic adjustment has been enforced in some countries in recent years, including Ghana and Zambia. Growth improved in both economies in 2017, most notably in Ghana where oil production increased. This helped Ghana's equity market to yield a total return of 45,4% in US dollars in 2017.

Debt sustainability, however, remains a concern in both countries. Zambia's fiscal deficit and debt level remained excessive, implying ongoing risk of debt stress and currency weakness. In Ghana, too, fiscal adjustment has disappointed and state owned enterprises' financial positions are weak.

In Namibia, a member of the Common Monetary Area (CMA) of the rand, growth disappointment and excessive consumption expenditure, including a high wage bill, produced another large fiscal deficit in 2017. Given the deterioration in government finances, amid material contingent liabilities associated with state owned companies, Namibia's sovereign debt rating was downgraded to sub-investment grade by Moody's Investors Service in August 2017. The government indicated its intention to pursue fiscal consolidation, while increased mining production is expected to lift real GDP growth in 2018, after stalling in 2017.

Given Namibia's membership of the CMA, the Namibia dollar appreciated along with the South African rand against the US dollar in 2017. This partly supported a stellar 40,2% total return in US dollars in the equity market in 2017, despite the weak economic background.

Namibia's level of real economic activity should increase in 2018, although growth is likely to remain modest.

Despite some progress, Botswana has not managed to reduce its dependence on diamond production, but the country has, nonetheless, continued to maintain macro-economic stability and its debt level is low. Real GDP is expected to advance by around 4,5% in 2018, a little firmer than the estimate for 2017. Against this stable background, Botswana's equity market produced a total return of 7,8% in US dollars in 2017.

Meanwhile, Zimbabwe's economy remained stressed in 2017, given foreign exchange shortages and liquidity constraints. The country requires comprehensive structural economic reform, including a focused fiscal adjustment. The regime change during 2017 signalled positive sentiment that these measures might be implemented.

The non-resource-rich countries and East Africa continued to deliver the highest growth rates on the African continent in 2017, although real GDP growth moderated in Uganda due to drought and weaker credit extension. A slowdown in credit extension was also evident elsewhere in the East African community, including in Kenya and Rwanda. Credit demand softened amid increasing non-performing loan ratios, while the introduction of interest rate caps in Kenya dampened the willingness of commercial banks to lend. Despite this, real GDP growth remained high in Rwanda and Tanzania and, to a degree, in Uganda and Kenya.

Continued firm economic growth supported the East African stock exchanges with total equity market returns of 33,5% and 12,7% in US dollars in Kenya and Tanzania respectively in 2017.

In West Africa, Côte d'Ivoire recorded strong growth in real GDP per capita in recent years, albeit off a low base due to the benefits of economic reform and infrastructure spending. Inflation has remained low, reflecting the peg of the currency to the euro. GDP growth eased in 2017, partly due to lower cocoa prices, which weighed on the government revenue collection. Accordingly, the country's budget deficit increased in 2017. Meanwhile, political unrest surfaced, following mutiny among military personnel regarding payment demands. Despite this, the government's debt level is moderate, the current account deficit is relatively small, and the balance of payments was supported by positive foreign direct investment inflows. Ongoing global financial conditions have also been supportive and economic growth is expected to remain strong in 2018.

SSA real GDP growth is expected to increase by almost 3,5% in 2018 from an estimated 2,5% in 2017. The aggregate growth rate, however, masks a significant degree of divergence between countries. For example, excluding Nigeria and South Africa, real SSA GDP growth is forecast to increase by around 5% in 2018 from nearly 4,5% in 2017.

Even though growth is expected to increase, the need for fiscal adjustment is likely to remain a key theme in SSA. In 2017, SSA economies benefited from buoyant global risk appetite and the search for yield. Sovereign debt spreads on the continent declined. However, sovereign risk increased. Although fiscal deficits, generally, are no longer expanding, they remain large, and government debt levels have continued to increase. Debt servicing costs are also high in a number of countries, particularly in the oil-producing economies, including Nigeria where the Government increasingly relies on the bank sector for funding.

Even among fast-growing non-resource-rich countries, fiscal consolidation is required, for example in Kenya.

Ultimately, persistent sizeable macro-economic imbalances imply vulnerability to the shift towards a more restrictive monetary policy in the US, and any potential tightening of global financial conditions.

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In North Africa, growth among oil importers improved significantly in 2017, including Morocco where growth is supported by lower oil prices and foreign direct investment inflows. In addition, monetary policy was accommodative, although non-performing loans increased. The upturn in economic activity underpinned a 14,6% total equity market return in US dollars in 2017.

Public sector investment spending is expected to underpin medium-term growth in Morocco, although a degree of fiscal consolidation is expected, focused on government consumption spending. After increasing by more than 4% in 2017, Morocco's real GDP is forecast to advance by 3% in 2018.

India and Malaysia

India's equity market posted a stellar 38,7% total return in US dollars in 2017, against the backdrop of relatively high economic growth and moderate appreciation of the Indian rupee against the US dollar. The currency was supported by robust capital inflows, including direct investment.

Although still buoyant, real GDP growth eased in 2017, partly reflecting the impact of India's demonetisation programme implemented in late 2016. Household real income growth and consumption spending was supported by lower inflation. In October 2017, a recapitalisation programme was announced for India's public sector banks with high levels of non-performing loans, aimed at supporting credit extension and investment spending. Higher inflation may prompt the Reserve Bank of India to hike its policy interest rate in the year ahead, but real GDP growth in 2018 is expected to be slightly firmer than the estimate of 6,6% for 2017.

Elsewhere, in the Association of Southeast Asian Nations (ASEAN), Malaysia's economy surprised to the upside, supported by higher oil and gas production and prices. Given an elevated consumer debt level, household spending was surprisingly robust. The buoyancy of Malaysia's economy was reflected in the 25% total return in US dollars on the equity market in 2017.

Infrastructure investment should help maintain Malaysia's growth momentum in 2018, but it seems unlikely that the pace of household consumption growth can be maintained, especially since the central bank is expected to adopt a less accommodative monetary policy stance. On balance, Malaysia's real GDP growth is expected to moderate to less than 5% in 2018 from 5,5% in 2017.

With a few exceptions, the economic environments in the Rest of Africa, India and Malaysia were, in general, supportive of the Group's operations in these markets. Long-term growth prospects remain intact, in line with Sanlam's strategic focus on these regions.