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Data dependent Sarb cuts repo rate by 25 basis points to 3.5%

Highlights

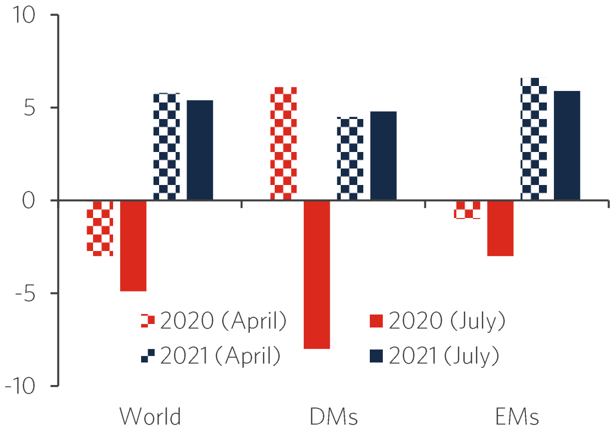
- The South African Reserve Bank (Sarb) Monetary Policy Committee (MPC) reduced interest rates by 25 basis points to 3.5% at the scheduled July 2020 interest rate-setting meeting on benign inflation and fragile growth. This matched the view of 13 out of the 28 analysts surveyed by Reuters (including our own view) and was similar to the view expressed by the forward-rate agreement (FRA) market.
- The Sarb's growth forecast for the local economy weakened further to negative 7.3% for 2020 from negative 7.0%, factoring in continued pressure expected on investment, exports and jobs. The size of the forecasted negative output gap widened to 7.0% from 6.7% in 2020 and is expected to narrow to 2.8% in 2022, from 2.5% previously.
- The Sarb's headline inflation forecast remained unchanged at 3.4% in 2020 and dipped slightly from 4.4% to 4.3% for 2021. The Sarb sees risks to the inflation view as broadly balanced, given the upside threat of electricity prices and heightened fiscal risks balancing out muted currency pass-through and contained food inflation.
- Interest rate preferences by the MPC members remained varied, with three members arguing for a cut of 25 basis points, whereas two members suggested a preference for keeping interest rates steady.
- The Sarb has cut interest rates by 300 basis points since the start of the year and has utilised several instruments in its toolbox to encourage lending to firms and households and to improve liquidity in fixed income markets.
- We suspect the Sarb is nearing the end of its cutting cycle, with modest room for further monetary policy relief of 25 basis points given downside risks to its inflation forecasts. Despite paltry growth forecasted for this year and next and downward pressure from muted demand on inflation in the near term, the Sarb maintained a cautious view on longer term inflation expectations, suggesting that significant easing was less likely from here.

Slight downward revision to Sarb's growth estimates

With the COVID-19 pandemic having a more negative effect on economic activity in the first half of the year than previously anticipated, the International Monetary Fund (IMF) downgraded its assumption on global growth from negative 3% in 2020 to negative 4.9% (see chart 1). The projected rebound has also been pared back from 5.8% to 5.4% for 2021. Significant downgrades were made to the United States and Euro area in developed markets (DMs) and Brazil and India in emerging markets (EMs).

The Sarb's estimate of growth in SA's main trading partners moved lower to negative 4.7% from negative 3.4% for 2020 but remained unchanged at 4.3% for 2021. Lower estimated growth for 2020 will have deeper negative consequences for SA's external trade. Nevertheless, a compression in imports due to strangled demand will lead a sizeable contraction in the current account deficit.

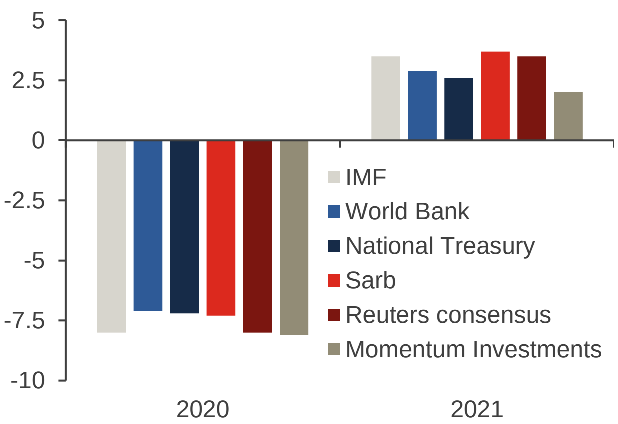
Chart 1: Downward growth revisions by the IMF (%)



Source: IMF, Momentum Investments

Weaker global demand and smashed sentiment locally led the Sarb to downwardly revise its growth forecast for the local economy for 2020, marginally, from negative 7% to negative 7.3%. This updated forecast lies between the estimates of treasury and the IMF (see chart 2).

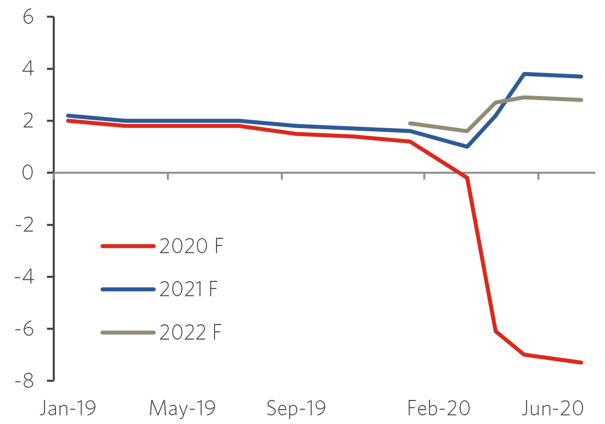
Chart 2: SA growth estimates for 2020 and 2021 (%)



Source: Sarb, National Treasury, IMF, World Bank, Reuters, Momentum Investments

The Sarb cited weak investment and exports and an estimated rise in job losses as the major drivers behind the change in its growth forecast. The Sarb expects the economy to recover by 3.7% in 2021, from a previous expectation of 3.8% (see chart 3).

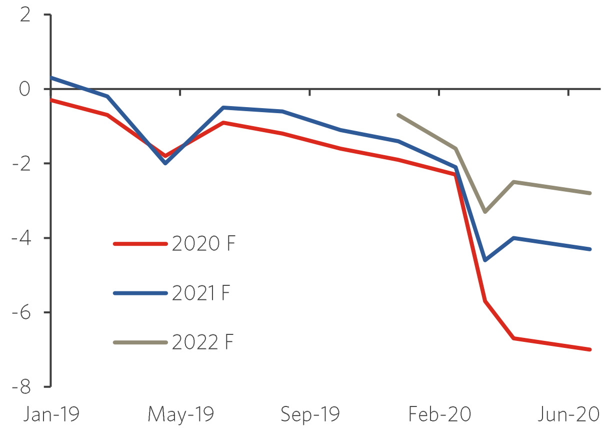
Chart 3: The Sarb's real growth revisions (%)



Source: Sarb, Momentum Investments, data up to July 2020

The expected gap between actual and potential growth is expected to widen from 6.7% to 7.0% in 2020, before declining to 2.8% (previously 2.5%), see chart 4.

Chart 4: The Sarb's output gap revisions (%)



Source: Sarb, Momentum Investments, data up to July 2020

The Sarb's growth forecast shifted closer to the median consensus view appearing in the July 2020 Reuters Econometer, which pointed to an expected contraction in SA's economy of 8.0% in 2020, before resetting to growth of 3.5% in 2021. We have maintained our growth projection of negative 8.1% for 2020 and expect a mild rise of only 2% in 2021. Weak fundamentals (including heavy fiscal constraints), a rise in firm liquidations and insolvencies as well as significant job losses are likely to constrain the upturn, underlying our weaker growth assumption for 2021.

The Old Mutual Savings and Investments Monitor, which was conducted in June 2020 shows 32% of those surveyed with a loan arrangement with a financial institution have fallen behind (or no longer able to meet) on payments. This increased to 34% for those with loans from microlenders and 39% with loans from family or friends. Indebted consumers have also fallen behind on credit card payments (28% compared to 15% a year ago), store card payments (30% compared to 32% a year ago) and home loan payments 26% relative to 7% a year ago). According to the Andrew Levy Employment Publications, the average wage settlement in collective bargaining agreements declined to a 14-year low of 6.4% in the first quarter of 2020. Poor economic and labour market conditions (including excess labour supply and weaker bargaining power) suggest pressure on household incomes, which will further keep a lid on household spending going forward.

The National Income Dynamics Study – Coronavirus Rapid Mobile Survey (NIDS-CRAM), which telephonically surveys 7 000 respondents monthly, noted job losses between February 2020 and April 2020 have been most severe for the poorest half of workers and more prevalent for jobs involving manual labour. Those without tertiary education also suffered a bigger loss in employment.

Little change to Sarb's inflation forecast

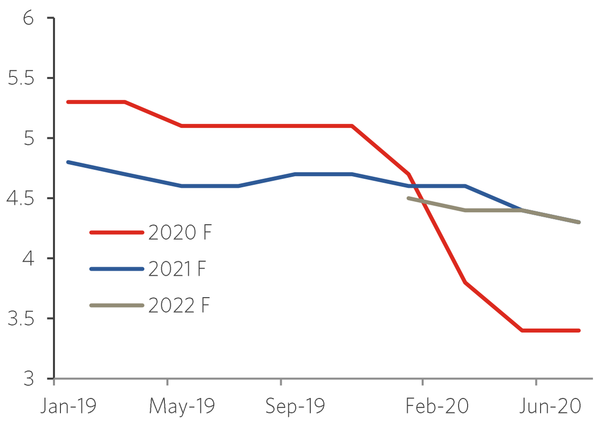
The Sarb sees risks to inflation as being broadly balanced, given the upside threat of electricity prices and heightened fiscal risks balancing out muted currency pass-through and contained food inflation. It warned about longer term inflation expectations remaining higher. The five-year average inflation rate expected in five years' time (as surveyed by the Bureau of Economic Research) remained at 4.7% in the second quarter of the year.

The Sarb upped its annual average oil price forecast for 2020 from US$37/bbl to US$40/bbl but kept its forecast for 2021 and 2020 stable at US$45/bbl and US$50/bbl, respectively. Inflation should drift higher in the coming months as the extent of transport deflation begins to fade in the basket. Decent global maize production levels could keep grain prices under pressure this year, boding well for local food inflation. According to Agbiz, SA's 2020/21 commercial maize harvest is estimated at 15.5 million tonnes, which will be the second-highest harvest on record.

Overall, the Sarb expects an unchanged headline inflation rate of 3.4% in 2020 (compared with our forecast of 3.1% and the Reuters median consensus for July 2020 of 3.4%), 4.3% in 2021 from a prior estimate of 4.4% (relative to our expectation of 3.6% and the Reuters median consensus for July 2020 of 4.1%) and a marginally lower figure of 4.4% for 2022 (relative to our projection of 4.9% and a lowered Reuters median consensus of 4.3% from 4.5% previously), see chart 5.

The Sarb reiterated a temporary breach of the bottom end of the 3% to 6% inflation target would be treated the same as a momentary breach of the upper end of the target band. The Sarb would look through the shock and determine the existence of any second-round effects.

Chart 5: The Sarb's headline inflation forecasts (% y/y)

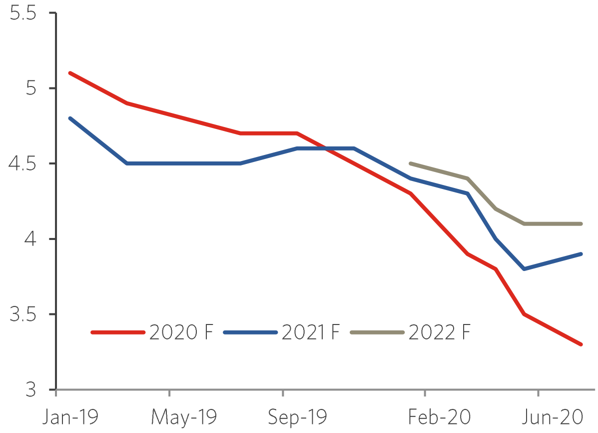


Source: Sarb, Momentum Investments, data up to July 2020

The Sarb's core or underlying inflation projections (excluding food and fuel prices) were downwardly revised by 0.2% for 2020 to 3.3% (compared with our estimate of 2.7%) and upwardly revised by 0.1% to 3.9% for 2021, relative to our forecast of 3.3% (see chart 6). Relative to its May 2020 projections, the Sarb expects core inflation to be unchanged at 4.1% in 2022.

While inflation reports for April 2020 and May 2020 were affected by imputed pricing methodologies for unavailable items during the more stringent levels of lockdown, the June 2020 figure was based on fieldworker surveys and should reflect some normalisation in methodology. Markets will be closely watching the trajectory of rental prices, which will likely be affected by declining household incomes and an overhang of supply in the market. Rental prices are a significant contributor to core and services inflation.

Chart 6: The Sarb's core inflation forecasts (%)



Source: Sarb, Momentum Investments, data up to July 2020

MPC preferences were not unanimous

At the May 2020 MPC, three MPC members preferred an interest rate cut of 50 basis points, while two members favoured a cut of 25 basis points (see table 1). Today's interest rate decision reflected a continued division in preferences, where three members favoured a 25 basis-point cut to 3.5%, while two members preferred interest rates to remain unchanged at 3.75%.

Going into today's interest rate decision, 13 out of 28 analysts surveyed were expecting an interest rate cut of 25 basis points (similar to the view expressed by the FRAs), 13 anticipated no change in the repo rate and two were looking for a larger cut of 50 basis points.

According to the MPC, the Quarterly Projection Model (QPM) indicated one repo rate cut of 25 basis points in the fourth quarter of 2020. Today's decision front loaded the QPM's indication, as the QPM is run before the interest rate decision is made.

Table 1: Differing MPC member views at the scheduled July 2020 meeting

Number of committee members	Favoured no move	Favoured a 25 basis point cut	Favoured a 50 basis point cut	Favoured a 100 basis point cut
17 January 2019	5	-	-	-
28 March 2019	5	-	-	-
23 May 2019	3	2	-	-
18 July 2019	-	5	-	-
19 September 2019	5	-	-	-
21 November 2019	3	2	-	-
16 January 2020	-	5	-	-
19 March 2020	-	-	-	5
14 April 2020	-	-	-	5
21 May 2020	-	2	3	-
23 July 2020	2	3	-	-

Source: Sarb, Momentum Investments

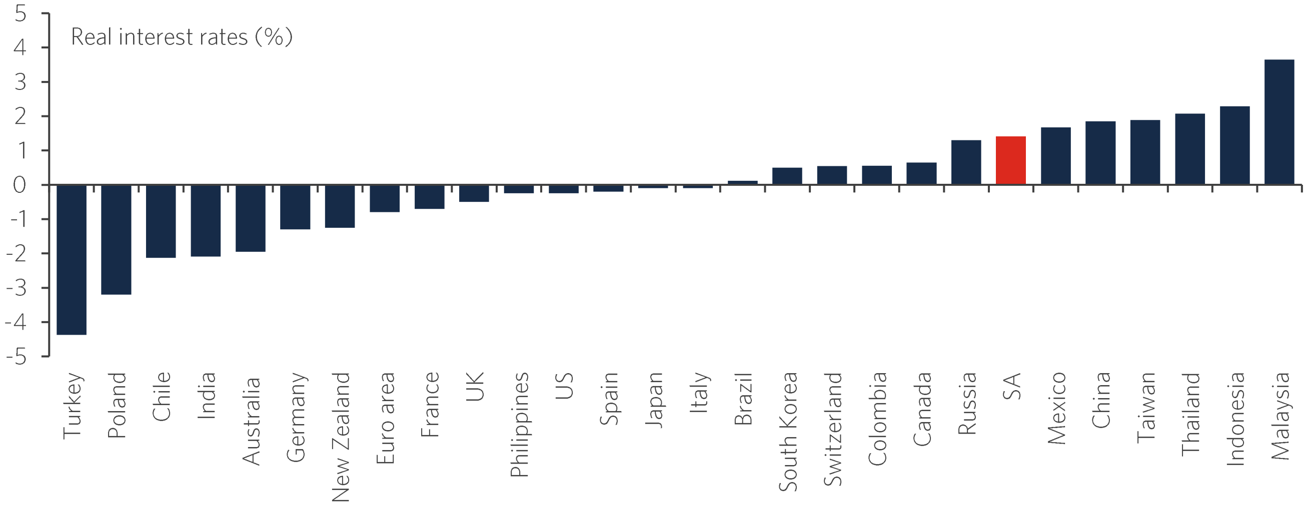
Unlikely to cut interest rates aggressively from here

Today's interest rate decision to cut by 25 basis points instead of 50 basis points and the split of preferences on the MPC reflect an element of caution by the Sarb, in our view. In the question and answer session, the MPC reiterated its focus on the directionality of inflation and growth data and how this will influence future monetary policy decisions.

In our opinion, the Sarb may be inclined to temporarily cut real interest rates by more than usual to play its role in softening the blow of the virus shock on the local economy and, as such, see further space for marginal easing to 3.25% in the coming months. The Sarb has been clear that monetary policy has its limitations in trying to boost potential growth, but by cutting interest rates, it aims to help consumers and firms, with debt, to better manage their cash flows. While real interest rates based on realised inflation have picked up on the back of the collapse in headline inflation in May 2020 (see chart 7), real interest rates are negative if the one-year ahead inflation expectation (the Reuters median consensus expects headline inflation 4.5% for the third quarter of 2021, while the Sarb anticipates an average of 4.3% relative to our forecast of around 4%) is used. Although running negative real interest rates could put pressure on the local currency to depreciate, the level of pass-through remains muted in an environment where retailers are trying to protect growth in sales volumes.

We expect the Sarb to consider raising interest rates by the first half of 2021 as it has warned against the dangers of running negative real interest rates for a protracted period. When inflation is running higher than nominal interest rates, savings tend to fall in value. Moreover, a long period of too low real interest rates could distort financial markets and elevate the risk of financial instability.

Chart 7: Comparative real interest rates using the latest realised inflation figure (%)



Source: Bloomberg, Momentum Investments