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Inflation drops to 2.1% in May 2020 in line with expectations

Highlights

- Headline inflation sank to 2.1% in May from 3% in April 2020 (published on 24 June 2020). This number was broadly anticipated by analysts and triggered little stir in markets.
- The release date for May's consumer price index (CPI) was delayed due to lockdown restrictions, limiting Statistics South Africa's (Stats SA) fieldwork used to collect survey data.
- In line with international best practice, Stats SA has used an imputed price methodology for items and services that were not available for sale during the lockdown. Our previous inflation report (published on 24 June 2020) highlighted the nuances of the differences in methodology.
- Stats SA's fieldwork team resumed in-store collection of prices at the end of May 2020 and, as such, June's number (to be published on 29 July 2020) will revert to the more frequently used methodology.
- In our view, decimated demand and anchored inflation expectations leave room for the SA Reserve Bank (Sarb) to ease interest rates by up to a cumulative 50 basis points in 2020. Given front-loaded bolder policy decisions taken earlier in the year, we could see the Sarb move to increments of 25 basis points.

Headline inflation back to levels last seen in the third quarter of 2004

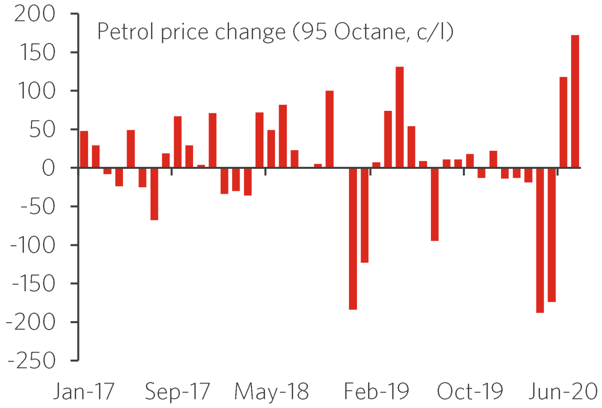
With significant methodology and basket changes made in 2008, the history of headline inflation before this date was not strictly comparable. Nevertheless, the dip in inflation to 2.1% year on year (y/y) represented the lowest level of headline inflation reported since the third quarter of 2004.

May's inflation figure was calculated on the same methodology (using imputed prices and online surveys) as for April's number. We highlighted the survey challenges faced by Stats SA in our previous inflation report and explained the main differences behind the new methodology used for the inflation numbers reported for April and May 2020.

The fall in headline inflation from 3% in April 2020 to 2.1% in May 2020 was largely anticipated by the market, despite the increased forecast uncertainty based on the imputation methodology.

Headline inflation dropped by 0.6% month on month (m/m) largely owing to the transport category. The price of 95 Octane was cut by 174c/l in May, which contributed to the decline in transport inflation. According to the Central Energy Fund (CEF), petrol prices were hiked by 118c/l in June 2020 and 172c/l in July 2020 (see chart 1). Currency and international oil price movements between 26 June 2020 and 14 July 2020 indicated an under-recovery of 33 cents for August 2020. Despite these increases, petrol price inflation in y/y terms is expected to remain negative, given the high base from a year earlier.

Chart 1: Petrol price changes

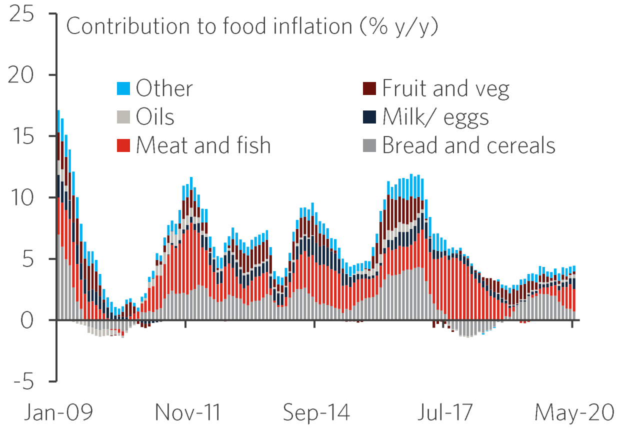


Source: CEF, Momentum Investments, data up to July 2020

Food inflation rose from a previous bottom of 2.4% in April 2019 to 4.9% y/y in May 2020. Food prices were up 0.6% m/m largely owing to milk, cheese and egg prices, which rose 3.7% in the month, and fruit prices which picked up 2.8% in May 2020 relative to April 2020.

In y/y terms, inflation in bread and cereals continued to drop from a previous high of 8.5% y/y in October 2019 to 2.8% y/y in May 2020. With the International Grains Council lifting its estimate for 2020/21 global maize production to 5% up from the previous season, low global maize prices are likely to exert downward pressure on local food inflation. This could be partly countered by upside risks to meat prices, given base effects and import tariffs on poultry. Meat inflation decelerated to 5.5% y/y in May 2020 from 6.1% in April 2020, but rose consistently between April 2019 (negative 1.2%) and April 2020 (6.1%). Meanwhile, fruit prices jumped to 16.9% y/y in May 2020 from 9.1% y/y in April 2020.

Chart 2: Meat inflation has been the largest contributor to food inflation in recent readings



Source: Global Insight, Momentum Investments

Core or underlying inflation (excluding food, non-alcoholic beverages, fuel and energy prices) declined by 0.2% m/m in May 2020 and dropped from 3.2% y/y in April to 3.1% y/y in May 2020.

Room for modest monetary policy easing from here

The Sarb has undertaken several actions to support the economy during the COVID-19 crisis. The Sarb lowered rates by 275 basis points since the start of the year, while also providing regulatory relief to the financial sector to sustain the flow of credit to households and corporates. It has also provided funding for small and medium enterprises through the loan guarantee scheme and aided the smooth functioning of fixed income markets by purchasing bonds in the secondary market.

Despite the support to the financial sector, growth in credit in the private sector continued to slow in May 2020. Growth in total household credit grinded lower to 3.8% y/y from 4.5% in April 2020, while corporate credit growth dipped from 9.3% y/y to 8.4% y/y in May 2020. The weakening credit trend was mostly broad based across all categories of credit.

Moreover, government's loan guarantee scheme has only delivered 5% of the R200 billion facility created to assist small businesses, which experienced a liquidity crunch during the harsher levels of lockdown. The latest update from the Banking Association of SA highlighted that only R10.6 billion in loans had been disbursed to nearly 7 500 firms. More than a third of applications for the loan guarantee scheme have been rejected on the grounds they do not meet the eligibility criteria.

Payment relief (three-month payment holidays) made available by banks has been more successful with 95% of the 140 000 applications received being approved.

The Sarb's purchases of government bonds slowed in June 2020 to R5 billion from R10.2 billion in May 2020, bringing the total to R36 billion. In our view, this is an indication that relative stability has returned to fixed income markets and the Sarb has been successful in restarting price discovery and encouraging the entry of private sector participants, while still adhering to a credible inflation-targeting mandate.

The Sarb's decision on interest rates on 23 July 2020 will likely consider the smaller-than-expected contraction in economic growth in the first quarter of the year. However, with government recently announcing the nine provinces will likely show a peak in COVID-19 infection rates at different times, this could influence the speed of recovery in the third quarter of the year. Moreover, a colder-than-anticipated winter season has led to higher demand on the electricity grid. With the breakdown in generation units and units out for maintenance, energy utility, Eskom, notes that power supply will remain constrained in the short term and this could lead to further load shedding.

In line with our expectations, headline inflation has fallen close to the 2% mark on suppressed demand in the COVID-19 crisis. Inflation expectations are likely to remain well anchored in an environment of downtrodden economic activity, allowing for room for the Sarb to ease interest rates further, in our view. We see scope for up to another 50 basis points of easing in the repo rate in light of depressed growth and a breach of the inflation target to the downside. With the Sarb having frontloaded bold policy moves early on in the crisis, it could start moving in increments of 25 basis points in our view, particularly as upcoming high-frequency data should provide more colour on the anticipated recovery, once the economy reached level three lockdown regulations in June 2020, which allowed for a higher level of economic activity.