momentum investments

Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

in the moment

Mixed committee preferences but interest rates remained steady at 3.5%

Highlights

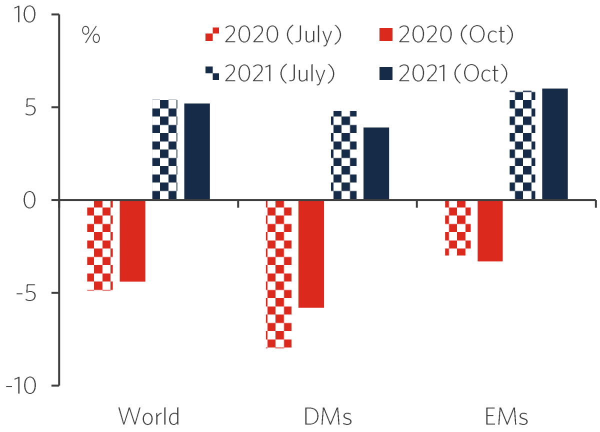
- The South African Reserve Bank (Sarb) Monetary Policy Committee (MPC) held interest rates steady at 3.5% at the November 2020 interest rate-setting meeting (the last one scheduled for 2020) despite expecting average annual inflation to remain below the midpoint of the target into 2022. The MPC's decision on interest rates was in line with 17 out the 22 surveyed analysts (including ourselves) in the November 2020 Reuters Econometer poll, while only five analysts were expecting an interest rate cut of 25 basis points. In the run-up to the meeting, the forward-rate agreement (FRA) market priced in a 20% chance of a 25-basis-point cut. The FRA market is only looking for the first interest rate increase of 25 basis points beyond a 12-month horizon, while analyst expectations are more mixed.
- The Sarb's growth forecast for the local economy edged up to negative 8% from 8.2% for 2020. Growth is expected to increase to 3.5% in 2021 (previously 3.9%). The size of the forecasted negative output gap was revised to a smaller 6.3% for 2020 and it is expected to taper to 2.7% in 2022, from a previous forecast of 2.3%.
- The Sarb nudged its headline inflation forecast lower to 3.2% for 2020 (previously 3.3%) and from 4% to 3.9% for 2021. The Sarb continues to view risks to the inflation trajectory as broadly balanced in the longer term, given the upside threat of administered prices (including electricity tariffs) and heightened fiscal risks balancing out muted currency pass-through, contained food inflation and a temporary expected dip in medical inflation in 2021.
- Interest rate preferences by the MPC members remained varied, with three members favouring no move in interest rates, whereas two members indicated a preference for cutting interest rates by 25 basis points.
- 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 as well as to improve liquidity in fixed income markets.
- We suspect the Sarb is at the end of its interest rate cutting cycle. A dismal growth trajectory and depressed demand exerts downward pressure on inflation in the near term. However, the Sarb noted risks to longer term inflation expectations remain broadly balanced. The Sarb also reiterated its concerns over the country's fiscal and debt burden. We are of the view that additional easing is less likely from here, unless SA suffers another growth setback induced by a renewed country-wide tightening in lockdown restrictions or if there is another sharp dip in inflation. We expect the Sarb to consider interest rate hikes from the second half of 2021.

Sarb's 2020 growth estimate nudged up

In its October 2020 World Economic Outlook, the International Monetary Fund (IMF) revised its forecasts for global growth in 2020 to reflect a smaller contraction of 4.4% from 4.9% previously estimated in July 2020. This was primarily due to an improvement in growth forecasts for developed markets (DMs), while its emerging market (EM) forecasts reflected a slight deterioration from negative 3% to negative 3.3% for 2020. The IMF expects a marginally lower growth expectation for the globe in 2021 of 5.2% from 5.4% (see chart 1).

A recent tightening in lockdown restrictions in Europe has, in our view, raised growth risks for 2020 in DMs, even though growth prospects have improved for the United States.

Chart 1: IMF growth estimates for 2020 and 2021

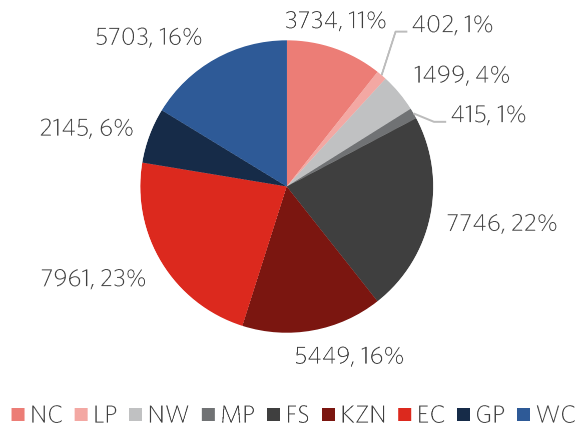


Source: IMF, Momentum Investments

The surge in COVID-19 infections in the Northern Hemisphere has raised export risks for SA with growth in some of SA's key trading partners being affected by a renewed tightening in lockdown restrictions, which were triggered to curb the effects of a second wave of COVID-19. As such, the Sarb lowered its assumptions on growth for the fourth quarter of 2020 as well as 2021.

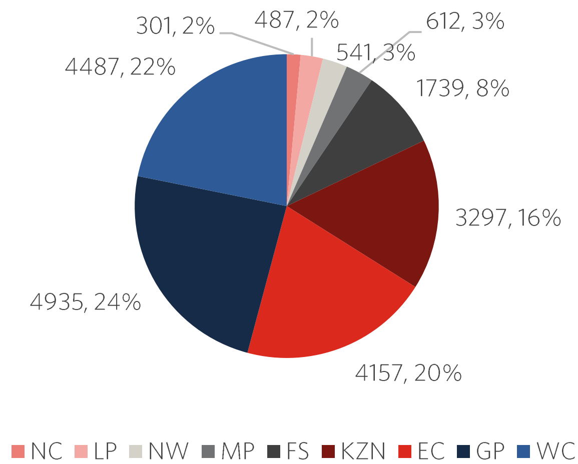
While there is little evidence of a second wave of COVID-19 infections emerging in SA, based on current testing, the country could see tighter lockdown restrictions on a localised level given the recent spike in active cases in provinces such as the Eastern Cape, which houses 11.4% of SA's total population (see chart 2 and 3).

Chart 2: Active COVID-19 cases*



Source: Wits University, Momentum Investments, snapshot as at 18 November 2020
**Number and % of total active cases reflected in pie chart*

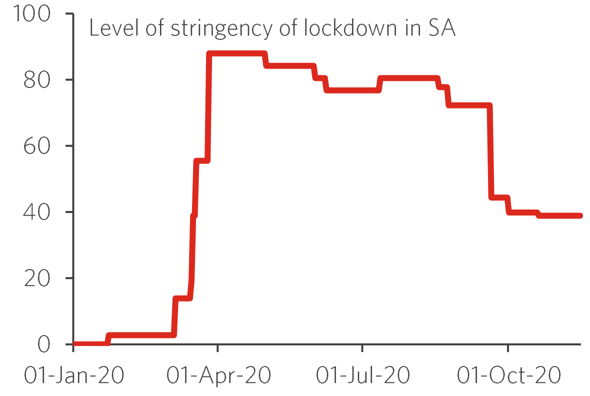
Chart 3: COVID-19 fatalities*



Source: Wits University, Momentum Investments
**Number and % of total fatalities reflected in pie chart*

Growth forecasts for 2021 remain at risk from a more severe than expected second wave of COVID-19 infections and related restrictions on the economy (see chart 4), which would further delay a recovery in sectors affected by social distancing and travel restrictions, such as hospitality and tourism.

Chart 4: Lockdown restrictions have eased in SA



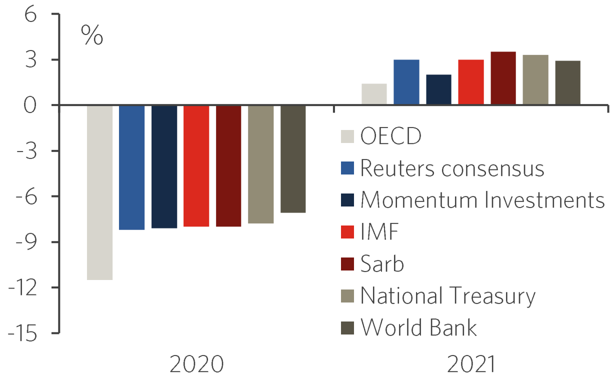
Source: Oxford Stringency Index, Momentum Investments, data up to 15 November 2020

The manufacturing and mining sector staged a recovery in the third quarter of the year. However, it appears as though the catch-up in the production or supply side of the economy has largely occurred. The economy is likely to see a softening in activity in the final quarter of the year, particularly in light of the renewed tightening of lockdown restrictions in some of SA's main trading partners, which was in response to a resurgence in active COVID-19 cases.

The Reuters Econometer poll reflects a median growth expectation for the third quarter of the year of 34.6% (compared to the Sarb's upwardly revised 50.3% quarter on quarter seasonally adjusted (% q/q saar) projection), but individual forecasts between the 12 contributing analysts reflect a wide dispersion, ranging from 4% to 65% q/q saar. The median growth expectation for the fourth quarter shows a slowing of growth to 9.9%, but estimates range from 2.2% to 27.2% q/q saar.

The Sarb raised its assumption on full year growth for 2020 to negative 8%, from negative 8.2% estimated at the September 2020 MPC meeting. This is only marginally firmer than our expectation of negative 8.1%, but a tad weaker than the negative 8.2% expectation in the November 2020 Reuters Econometer poll (see chart 5). This forecast exceeds the estimates of Treasury and the IMF, but it is milder than the 11.5% contraction forecasted by the Organisation for Economic Co-operation and Development (OECD), which was based on the assumptions of continued load shedding and a lack of internal demand.

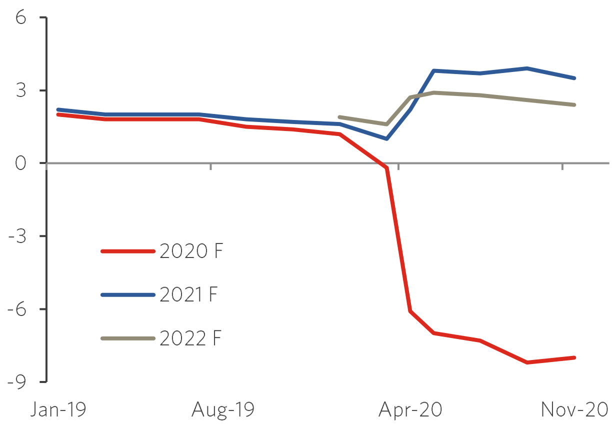
Chart 5: SA growth estimates for 2020 and 2021 (%)



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

The Sarb expects growth in the economy to recover to 3.5% in 2021, from a previous expectation of 3.9% (see chart 6) and noted the rise in infections in the Northern Hemisphere is likely to dent SA's export prospects. We are more cautious on the anticipated recovery in 2021 and expect growth of 2% given the downside risks posed by ongoing load shedding, a likely rise in bankruptcies (given the delay in liquidation proceedings in SA), lingering levels of elevated unemployment and significant fiscal constraints. While the Sarb expects growth of 2.4% (previously 2.6%) in 2022, we are pencilling in a shallower recovery of 1.6%.

Chart 6: Sarb's real growth revisions (%)



Source: Sarb, Momentum Investments

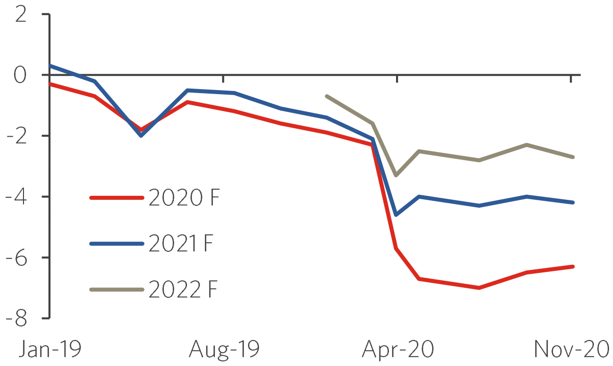
The Sarb revised its expectation on the output gap (the difference between actual and potential growth) to negative 6.3% (from negative 6.5%) in 2020. The Sarb expects the output gap to taper to a wider 2.7%

(previously 2.3%) by 2022 (see chart 7). The Sarb left its potential growth estimates unchanged at negative 3.2% for 2020, negative 1.4% for 2021 and negative 0.9% for 2022.

The Sarb noted the risks to its growth view remained balanced and were contingent on the sensitivity of sentiment to news flow as well as the transmission mechanism of previous moves in monetary policy.

While the economy is expected to experience a sharp bounce in activity in the third quarter of 2020, the Sarb warned it comes off a low base and acknowledged that it would take time for the economy to recover to pre-pandemic levels.

Chart 7: Sarb's output gap revisions (%)



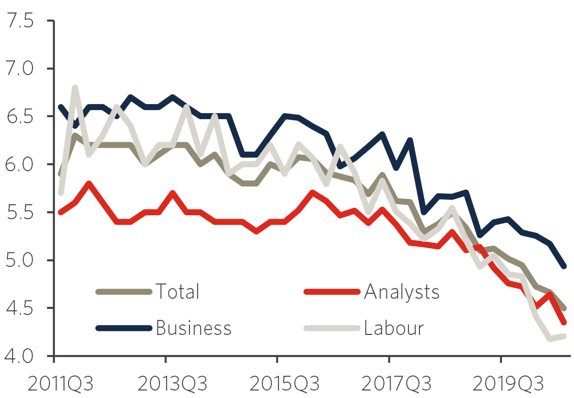
Source: Sarb, Momentum Investments

Sarb's core inflation forecast revised notably lower for 2021

The Sarb continues to view risks to the longer term inflation trajectory as being broadly balanced, given the upside threat of administered prices (including electricity tariffs) and heightened fiscal risks balancing out muted currency pass-through, contained food inflation and a temporary dip in medical inflation in 2021.

At the September 2020 MPC meeting, the committee warned about longer term inflation expectations remaining at a higher level. The five-year average inflation rate expected in five years (as surveyed by the Bureau of Economic Research (BER)) remained at 4.5% in the second quarter of the year (see chart 8).

Chart 8: Longer-dated inflation expectations (%)



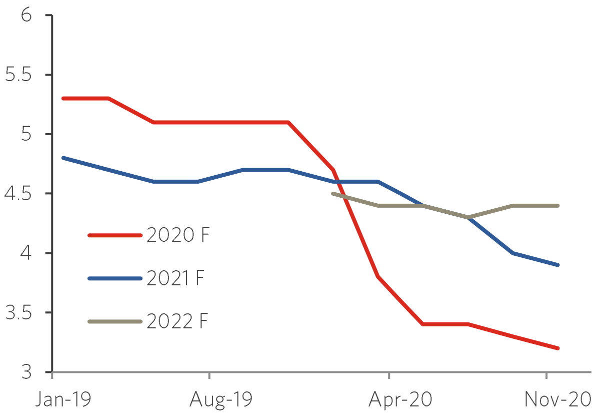
Source: BER, Momentum Investments, data up to Q3 2020

The Sarb lowered its annual average oil price forecast for 2020 from US$42/bbl to US$40.8/bbl and from US$47/bbl and US$52/bbl in 2021 and 2022 to US$45/bbl and US$50/bbl, respectively. This is lower than our expected average annual forecasts of US$41/bbl for 2020, US$50/bbl for 2021 and US$57/bbl for 2022.

Statistics (Stats) SA typically measures medical aid tariffs in February each year. However, Investec noted that several medical companies have indicated an intention to adjust premiums in July 2021, rather than February 2021. This would be out of the regular survey schedule, but Stats SA would likely adjust its schedule to accommodate this. Medical aid has a non-negligible weight in the inflation basket. A 7% increase would translate into a 0.7% increase at a monthly level.

Overall, the Sarb expects a marginally lower headline inflation rate of 3.2% in 2020 (compared with 3.3% previously). This is higher than our forecast of 3.1%, but lower than the Reuters median consensus of 3.3%, which was surveyed in November 2020. The Sarb's estimate of headline inflation for 2021 inched lower to 3.9% from 4%, matching the Reuters consensus but slightly higher than our expectation of 3.8%. For 2022, the Sarb sees inflation remaining below the midpoint of the target at an average of 4.4%, relative to our projection of 4.6%. The Sarb's 2022 forecast is in line with that of the Reuters projection (see chart 9).

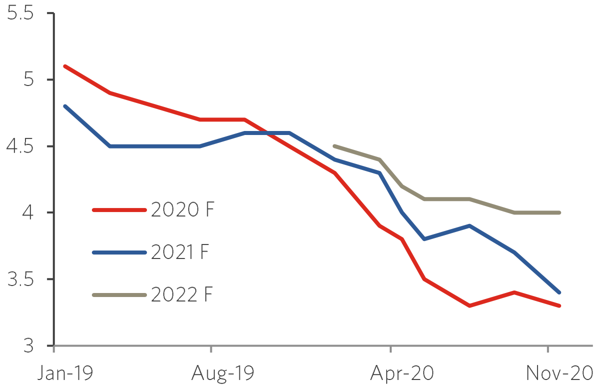
Chart 9: Sarb's headline inflation forecasts (%)



Source: Sarb, Momentum Investments

The Sarb's core or underlying inflation projections (excluding food and fuel prices) were revised down by 0.1% for 2020 to 3.3% (compared with our estimate of 3.1%) and lowered by a meaningful 0.3% to 3.4% for 2021, relative to our forecast of 3.5% (see chart 10). Relative to its September 2020 projections, the Sarb still expects core inflation to average 4% in 2022.

Chart 10: Sarb's core inflation forecasts (%)



Source: Sarb, Momentum Investments

Mixed MPC preferences

At the September 2020 MPC meeting, two MPC members preferred an interest rate cut of 25 basis points, while three members favoured unchanged interest rates (see table 1). Today's interest rate decision reflected a continued division in preferences, with the same split.

Going into today's interest rate decision, 17 out of 22 analysts (including ourselves) surveyed by the November 2020 Reuters Econometer poll were expecting interest rates to remain steady and five anticipated a cut of 25 basis points. The view expressed by the forward-rate agreement (FRA) market reflected a 20% chance of a 25-basis point cut in the run-up to the meeting.
According to the MPC, the Quarterly Projection Model (QPM) indicated no further interest rate cuts and two hikes in 2021 (the first one in the third quarter and the second in the fourth quarter).

In the question and answer session, the Sarb governor confirmed it is still searching for an additional member or two for the MPC. The governor explained that in the event there is an even number of committee members and the preferences are split, the casting vote lies with the Chair.

Table 1: Differing MPC member views at the scheduled November 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	-	-
17 September 2020	3	2	-	-
19 November 2020	3	2	-	-

Source: Sarb, Momentum Investments

Interest rates likely to remain steady from here

Today's interest rate decision to keep interest rates steady at 3.5% was accompanied by a split of preferences on the MPC. The MPC reiterated its focus on data and the sensitivity of inflation and growth to the balance of risks. The Sarb explained this influences future monetary policy decisions in a highly uncertain environment.

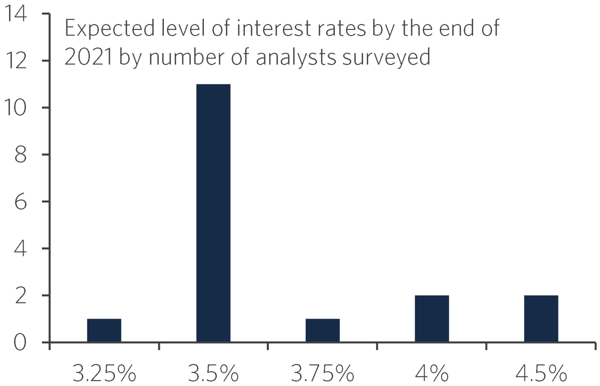
The Sarb has been clear that monetary policy has its limitations in trying to boost potential growth, but by cutting interest rates, it aims to help consumers and firms, with debt, to better manage their cash flows.

Real interest rates based on realised September 2020 headline inflation (3%) registered at 0.5%. Real interest rates are negative 0.9% if the one-year ahead inflation expectation is used in the calculation of real interest rates. The Reuters median consensus expects headline inflation of 4.4% for the fourth quarter of 2021, while the Sarb anticipates an unchanged inflation rate of 4.5% relative to its previous forecasts for the same period. Although running negative real interest rates could put pressure on the local currency to depreciate, the level of pass-through has remained muted in an environment where retailers are trying to protect growth in sales volumes. Moreover, the currency has strengthened in the recent month on vaccine optimism and general alleviation of volatility in financial markets.

We expect the Sarb to keep interest rates on hold for now unless growth experiences another negative shock or if inflation shoots sharply lower. We are projecting interest rates to shift higher in the second half of 2021 (two hikes of 25 basis points each) as the Sarb 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. In the past, the MPC has also warned against the threat of fiscal dominance and the challenges it raises to run looser monetary policy.

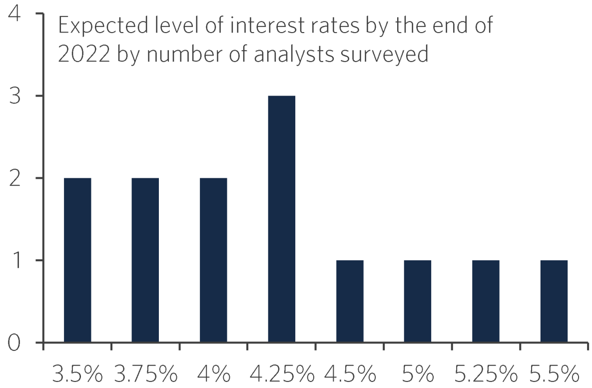
The majority of analysts surveyed by the Reuters Econometer in November 2020 expect interest rates to end 2021 at 3.5% (see chart 11), but a greater divergence of views is apparent from the survey data for the expected level of interest rates at the end of 2022 (see chart 12).

Chart 11: Majority of analysts expect interest rates to end 2021 at 3.5%



Source: Sarb, Momentum Investments

Chart 12: Mixed analyst views on the anticipated level of interest rates at the end of 2022



Source: Sarb, Momentum Investments

The MPC dates for 2021 have been scheduled as follows:

- 21 January
- 25 March
- 20 May
- 22 July
- 23 September
- 18 November