momentum investments

in the moment

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Inflation risks mounting on higher international oil prices

Highlights

- Headline inflation steadied at 5.7% in February 2022, unchanged from January 2022 and came in slightly below the Reuters and Bloomberg consensus estimate of 5.8%.
- The monthly 0.6% rise in headline inflation was largely driven by increases in food prices (bread and cereals and fish in particular) and transport (private (fuel) and public) costs.
- International oil prices have once again jumped on news that countries in the European Union may join the United States in a Russian oil embargo, following another Houthi attack on Saudi Arabian oil facilities. Global inventories remain at multi-year lows, while the Organisation of Petroleum Exporting Countries' (OPEC) Monthly Oil Market Report for March 2022 shows that some producers are still falling short of their agreed supply quotas.
- Services inflation remains muted and the gap with goods inflation remains wide. While the effect of commodity prices on the headline reading has become more apparent, underlying measures of inflation remain largely intact.
- The latest surge in international oil prices has triggered a large upward revision in the Reuters consensus forecast for inflation. The consensus expects headline inflation to average 5.5% (January 2022 estimate: 4.8%) for 2022, 4.4% in 2023 (marginally below the January 2022 estimate of 4.5%) and 4.4% in 2024 (unchanged since the January 2022 estimate).
- Despite the significant upward revision to expected headline inflation for this year, the Reuters consensus still expects the repo rate to end the year at 4.75%. In our view, the risk of sustained higher international oil prices and an accelerated hiking cycle globally could bring forward the local interest rate cycle, even though we still expect the terminal interest rate to reach 5.75%.

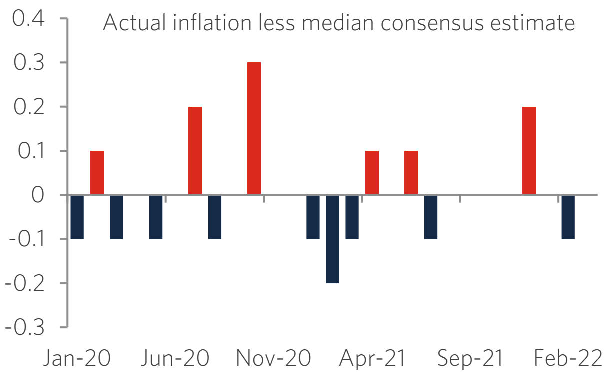
Marginal downside surprise in the February headline figure

According to Statistics South Africa (Stats SA) headline inflation steadied at 5.7% in February 2022, unchanged from the rate published for January 2022 and was marginally above the Reuters and Bloomberg median consensus figure of 5.8% (see chart 1).

The monthly 0.6% rise was largely driven by increases in food (bread and cereals and fish in particular) prices and transport (private (fuel) and public) costs.

Relative to our forecasts, price increases in non-alcoholic beverages, hotels and public transport surprised to the upside, while insurance costs (medical aid) surprised to the downside.

Chart 1: Inflation surprises (%)

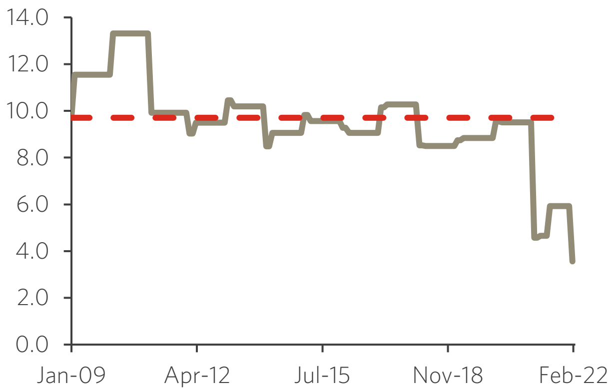


Source: Bloomberg, Momentum Investments

Medical insurance inflation fell to its lowest level in history in February 2022 at 3.6% y/y. This is significantly below the long-term average of 9.7% (see chart 2). According to Citi Research, only half of the medical aid providers surveyed by Stats SA implemented increases in February this year (with the remainder that have not already pushed through increases scheduled for April and September). Typically, medical aid tariffs are surveyed annually in February, but Citi notes increases are coming through at different times in the year given lower demand for medical treatment during the pandemic.

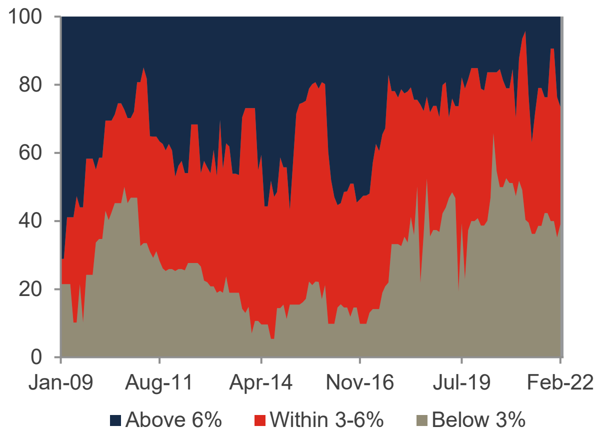
With food inflation remaining above 6% in February, inflation in more than a quarter of the consumer basket increased at a rate above 6%. Meanwhile, inflation in nearly 40% of the items in the consumer basket rose by less than 3% in the February 2022 reading (see chart 3).

Chart 2: Subdued medical aid inflation (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

Chart 3: Inflation dispersion (% of basket)



Source: Stats SA, Global Insight, Momentum Investments

International oil prices pose the largest upside risk to headline inflation

The United States Energy Information Administration's (EIA) Short-term Energy Outlook for March 2022 indicated the invasion of Ukraine by Russia and subsequent sanctions on Russia created further pressure on prices and exacerbated already low global inventories. The EIA suspects that oil inventories fell even further in the first two months of this year, with commercial inventories at their lowest level since the middle of 2014.

The EIA forecasts Brent oil prices to average US$116/bbl in the second quarter of this year and US$102/bbl in the second half of this year, before falling to an average of US$89/bbl in 2023. These forecasts are subject to many prevailing uncertainties, including any potential future sanctions, or independent corporate actions that may affect Russia's sale of oil in the global market. Moreover, the rise in geopolitical conflict may further dent global demand for oil.

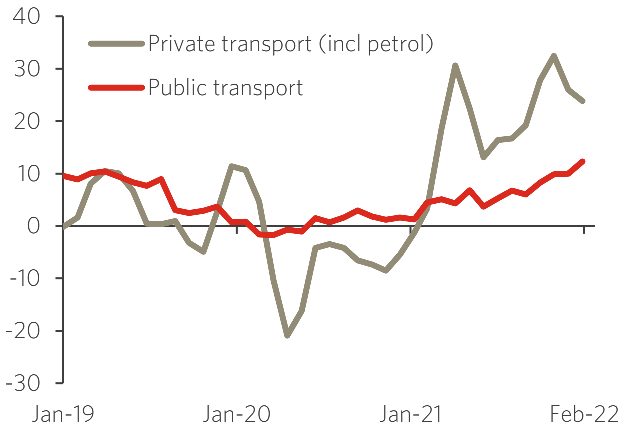
Transport inflation rose to 14.3% y/y in February 2022. Private transport (predominantly fuel prices) costs increased by 2.3% m/m in February 2022 owing to a 53c/l increase in the price of petrol (95 inland). Private transport inflation averaged 24.9 %y/y for the first two months of this year, while public transport inflation averaged at a lower 11.2% for the same period (see chart 4).

According to the Central Energy Fund, the price of petrol (95 inland) rose by 53c/l in February. Petrol prices increased by 146c/l in March and the current under-recovery of 194c/l suggests another steep increase in local fuel prices is on the horizon.

Elsewhere in the transport category, new vehicle prices rose by 5.5% y/y in February 2022, while inflation in used vehicles increased by 7.4%. This is the highest recorded level of inflation in used vehicles since comparable data began in January 2009.

Although SA imports the bulk of its oil from Saudi Arabia, Nigeria, Angola and Ghana, crude oil prices are determined at a global level and the upward trend in international oil prices will have a negative effect on local inflation.

Chart 4: Transport inflation (% y/y)



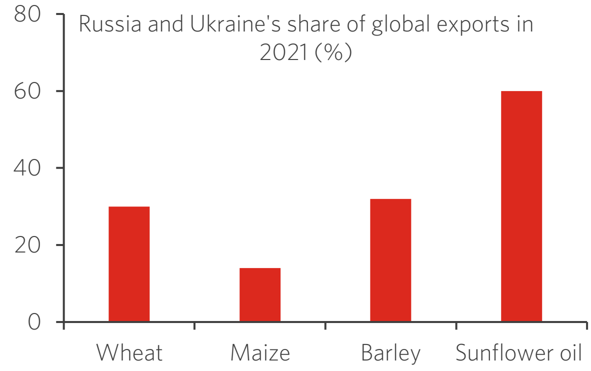
Source: Stats SA, Global Insight, Momentum Investments

Higher input costs pose a risk to food inflation

Excessive rains at the start of the 2021/22 production season did not cause as much damage to SA's crops as initially feared. The Agricultural Business Chamber (Agbiz) notes that the expected harvest remains well-above long-term average levels.

Agbiz warns that a favourable expected harvest will be overshadowed by a significant rise in input costs (up 50%). This will be especially true for the poultry industry, where maize and soybeans account for half of the industry's input costs.

Chart 5: Russia and Ukraine supply a large share of the globe's agricultural exports (%)



Source: Agbiz, Momentum Investments

Agbiz notes the spike in geopolitical conflict has sent fertiliser costs soaring given that Russia accounts for 14% of the globe's fertiliser material exports. Moreover, SA's fruit exports may also be hampered this year. According to Agbiz, 7% of SA's citrus exports and 12% of the country's apples and pears are destined for Russia.

The global grains and oilseeds markets were initially affected by dry weather conditions in South America. The Russia-Ukraine war has added additional pressure given these countries' dominance in global agricultural exports (see chart 5).

Agbiz anticipates global wheat prices to remain elevated given the expected 3% decline in global wheat stocks and conflict in the Black Sea region. Despite an improvement in global maize stocks, Agbiz sees sustained higher prices for global maize given limited exports from Russia and Ukraine.

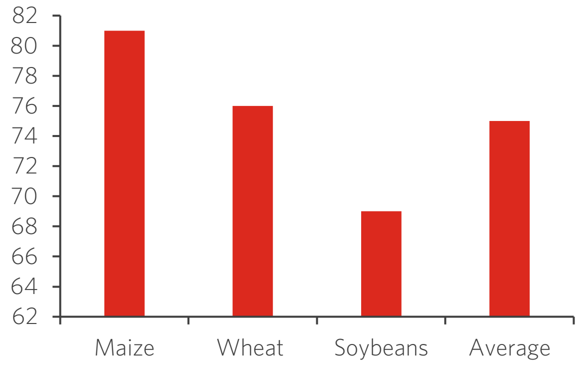
The Global Food Price Index measured by the United Nations Food and Agricultural Organisation (UN FAO) reached a new all-time high in February 2022, led by gains in vegetable oils and dairy prices. International cereal and meat indices shifted marginally higher, while sugar prices declined for a third consecutive month.

Local food prices increased by 0.7% m/m in February 2022, led higher by a 2.4% m/m increase in bread and cereals prices, a 2.3% rise in the prices of fish and a 1.8% m/m jump in fruit prices. In y/y terms, inflation is highest for oils and fats (22.7%) and lowest for fruit (negative 1.6%). Given that SA is a net importer of vegetable oils and fats, local prices have continued to mimic global trends and have remained elevated on higher soybean oil demand from India and concerns over the palm oil harvest in Indonesia.

Agbiz notes that cattle slaughtering activity was lower in 2021 than 2020 due to rebuilding of herds and foot-and-mouth disease last year. Continued herd rebuilding could present upside risks to meat inflation this year.

Higher transportation costs, in our view, continue to pose upside risks to local food costs, given the reliance on road transport (see chart 6). Winter crops (wheat, barley, canola and oats) will be predominantly affected in the coming weeks, while summer crops (including maize) are less affected.

Chart 6: Share transported by road in SA (%)

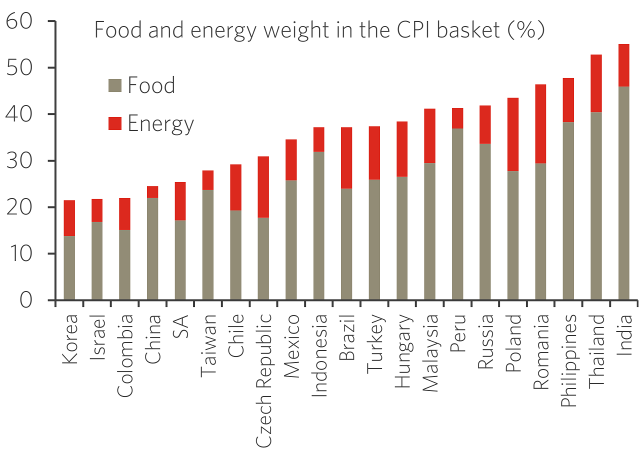


Source: Agbiz, Momentum Investments
Average = all crops

Frontloading monetary policy normalisation

While underlying measures of inflation, including the trimmed mean and core inflation, remain considerably lower than the headline measure, we continue to view international oil prices (due to rising geopolitical concerns), local electricity tariffs and worker wages as the main upside risks to the inflation trajectory.

Chart 7: Core inflation components account for a larger relative share of SA's consumer basket



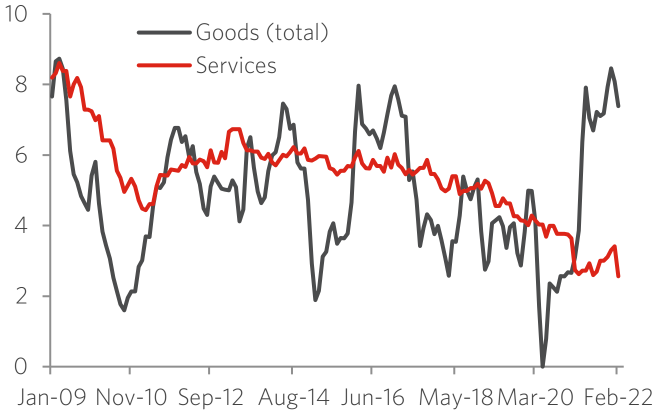
Source: Citi, Haver, Momentum Investments

While inflation in the emerging market aggregate has deviated significantly from its longer-term average, inflation in SA has had an atypical response. This is possibly due to differences in central bank credibility, the degree of anchoring in inflation expectations and the weight of food and energy in the respective consumer baskets (see chart 7).

The large gap between goods inflation (7.4% y/y) and services inflation (2.6% y/y) in February 2022 further points out the effect of rising fuel prices on the headline level of inflation, while underlying measures of inflation remain more subdued (see chart 8).

The latest surge in international oil prices has triggered a large upward revision in the Reuters consensus forecast for inflation. The consensus expects headline inflation to average 5.5% (January 2022 estimate: 4.8%) in 2022, 4.4% in 2023 (marginally below the January 2022 estimate of 4.5%) and 4.4% in 2024 (unchanged since the January 2022 estimate).

Chart 8: Services inflation remains muted



Source: Global Insight, Momentum Investments

Despite the significant upward revision to expected headline inflation for this year, the Reuters consensus still expects the repo rate to end the year at 4.75% versus the forward-rate-agreement market which is looking for a further 200 basis points worth of increases this year.

In our view, the risk of sustained higher international oil prices and an accelerated hiking cycle globally could bring forward the local interest rate cycle, even though we still expect the terminal interest rate to reach 5.75%.