momentum
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2021

A year in which the global economy rebounded on generous fiscal and monetary support, a rollout of vaccinations and an increase in mobility

January:

6 Supporters of former President Donald Trump attack the United States (US) Capitol

20 Inauguration of US President Joe Biden leaves markets hungry for a renewed focus on the green agenda, support for international co-operation and a shift in trade talks with China

Britain's post-Brexit future begins after a conclusion of the transition period

February:

LOCK DOWN

11 South Africa's (SA) State of the Nation Address focuses on the economic recovery and talks tough on corruption

24 SA national budget announces some tax relief and funding for the COVID-19 vaccination rollout

28 SA's lockdown restrictions move from adjusted alert level 3 to 1

March:

11 World Health Organisation (WHO) declares COVID-19 a pandemic one year ago

April:

11 Peru hosts presidential elections for the fifth president in as many years, which goes into a runoff

22 President Biden hosts the Climate Assembly to mark the fifth anniversary of signing the Paris Agreement on climate change

May:

8 First case of the Delta variant of COVID-19 detected in SA

21 Standard and Poor's Global Ratings (S&P) and Fitch affirm SA's sovereign rating and outlook

24 Seventy-fourth World Health Assembly discusses access to vaccines, waiving of patents and manufacturing capacity

26 Syrian presidential election leaves Bashar al-Assad with 95% of the vote

30 SA's lockdown restrictions tighten from level 1 to 2

June:

G7

11 Group of Seven (G7) Summit results in pledges on COVID-19, tax and the environment

14 NATO (North Atlantic Treaty Organisation) Summit discusses how to reinforce the Alliance's unity and addresses ties with Russia

15 SA's lockdown restrictions move to level 3 due to the third wave

18 Against the backdrop of the lowest voter turnout in history, Ebrahim Raisi comfortably wins 13th presidential elections since the establishment of the Islamic Republic

28 SA's lockdown restrictions tighten to an adjusted alert level 4

July:

1 European Union launches vaccine passport

1 Celebrations mark the 100th anniversary of the founding of the Chinese Communist Party

9 Damaging riots take place in SA's major provinces, triggered by the imprisonment of former President Jacob Zuma

23 Tokyo hosts the Olympic Games after postponement due to COVID-19

August:

12 Zambian presidential elections result in a new era with Hakainde Hichilema claiming victory over incumbent president Edgar Lungu

25 Rebasing exercise leaves nominal gross domestic product 11% larger in SA

31 US Armed Forces completes its withdrawal from Afghanistan

September:

Fears of China's Evergrande Group defaulting incite market volatility

11 Twentieth anniversary of the 9/11 attacks

13 SA's lockdown restrictions ease to adjusted alert level 2

20 Canadian Prime Minister Justin Trudeau holds snap elections two years early and wins but with a smaller margin than expected

26 Green Party emerges as the kingmaker in the German federal elections

October:

1 SA eases lockdown restrictions to adjusted alert level 1

4 Fumio Kishida becomes Japan's 100th prime minister

10 After a delay, presidential elections in Iraq result in a shift in the popular vote

30 Group of 20 (G20) discusses how to accelerate the global recovery and how to tackle climate change at the G20 Summit in Rome

31 A total of 151 countries agree to slash global emissions by half by 2030 at the COP26 Climate Summit in Glasgow

November:

1 SA holds its five-yearly local government elections, in which the ruling party gets less than 50% of the votes for the first time nationally

3 US announces it will begin to taper its asset purchases by the end of the month

8 US land and air borders open to fully vaccinated international visitors

11 SA's medium-term budget shows a smaller-than-anticipated fiscal deficit relative to February's projections thanks to a commodity price lift

18 SA Reserve Bank raises interest rates for the first time in three years

19 S&P and Moody's opt not to release an update of SA's sovereign rating

21 Chile has most polarised presidential elections in decades

24 SA reports finding of Omicron variant to the WHO

December:

24 Libya holds presidential election

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in the moment

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Economic outlook for 2022: Learning to live with COVID-19

Highlights

- Cuts to projected growth have been made in line with a resurgence in COVID-19 cases and lingering supply-chain disruptions, which have dimmed the outlook for 2022.
- The Bloomberg median consensus forecast expects growth of 3.9% in developed markets (DM) and 5% in emerging markets (EM) for 2022. These figures remain above trend, arguing against fears of stagflation.
- Demographic movements in China have prompted a shift in focus towards the quality of growth and a more equitable distribution of economic gains. We expect increased government influence and more emphasis on redistribution and structural changes in the economy, with a lesser focus on shorter-term cyclical outcomes.
- Pent-up demand has been a distinguishing factor driving global inflation higher this time around, unlike in the 1970s, when supply shocks sent prices soaring.
- We expect a normalisation of household savings, an unwinding of supply-chain bottlenecks and a return to the labour force to alleviate global inflation pressures. Inflation expectations have remained reasonably well anchored, lowering the impact of the second-round effects of high headline inflation.
- Against a backdrop of milder global growth, shaped by less accommodative fiscal and monetary policy, demand for South Africa's (SA) exports are likely to soften. Moreover, lingering unemployment will take the shine off consumption spending in 2021. As such, we see growth slowing from an estimated 4.9% in 2021 to 2% in 2022 and 1.8% in 2023.
- A more fragmented political landscape presents challenges to fast-tracking key structural reforms to resolve low trend growth in SA.
- Restraining expenditures, defunct municipalities and increased allocations to financially- and operationally-ill state-owned enterprises (SoEs) remain key risks to SA's fiscal consolidation path.
- While potentially permanent increases in government spending threaten a looser fiscal policy stance relative to government's envisioned consolidation path, monetary policy has shifted into tightening mode.
- We believe that elevated fiscal risks in the medium term, concerns around trend growth and an unwinding in SA's terms of trade will continue to drive a weakening bias in the currency in the medium term. Nevertheless, the level of passthrough into inflation remains low.
- A tempered rise in rental inflation and reduced increases in medical aid tariffs are likely to drive an atypical response in local inflation. We expect headline inflation to average 4.5% in 2021, 4.6% in 2022 and 4.3% in 2023.
- In our view, well-behaved inflation, anchored inflation expectations and a pedestrian growth outlook advocate for a more moderate interest rate hiking cycle. We expect the SARB to hike interest rates by 150 basis points on a staggered basis in the next two years.

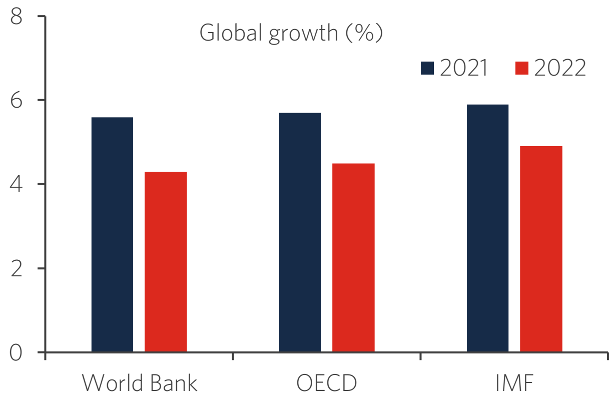
Learning to live with COVID-19 as an endemic illness

Predictions for 2020 were promptly tossed out the window as the world shifted gears to navigate a global pandemic, which plundered growth and health outcomes in both developed and emerging economies. Analysts' sights were, nevertheless, soon set on one of the fastest-paced economic recoveries in the post-war era, in 2021, as unprecedented fiscal and monetary policy support catapulted projections for economic activity in all corners of the world. But unsynchronised lockdown restrictions following fresh waves of the COVID-19 pandemic, an unequal distribution of vaccinations and differing levels of government support soon gave way to an uneven path to recovery over the globe; one in which richer nations faced a quicker reversion to pre-pandemic levels.

While achieving a high level of vaccinations is likely to protect swathes of the population against severe disease, this alone may not be enough to stop the virus from circulating across the globe. As we round off 2021, a new and more transmissible variant of COVID-19, Omicron, has incited fear in financial markets and triggered fresh travel bans. As Europe enters its fifth wave of COVID-19, authorities and health officials have succumbed to the reality of having to adapt to living with the virus. Analysts are already guiding toward a lower growth outcome for the fourth quarter of 2021, as the latest surge in COVID-19 cases dampens consumer and business morale.

Base effects from a deep global economic contraction in 2020 overstated the extent of the rebound in 2021. Global growth is set to moderate in 2022, from 2021, by an estimated range of between 0.7% (World Bank) and 1.2% (Organisation for Economic Co-operation and Development (OECD)), see chart 1. Cuts to projected growth have been made in line with a resurgence in COVID-19 cases and lingering supply-chain disruptions, which have dimmed the outlook for 2022. The Bloomberg median consensus forecast for growth in DMs in 2022 rose from 3.2% in January 2021 and peaked at 4.1% in September, before rolling over to 3.9% in November. Growth forecasts for 2022 for EMs followed a similar trend, increasing from 5.1% in January 2021, peaking at 5.3% in April and softening to 5% by November 2021. Nonetheless, these figures remain above trend, dispelling fears of a stagflationary outcome; a scenario in which high inflation coincides with notably weak growth. Commodity exporters are expected to bear the brunt of the growth slowdown in 2022 as the rotation from goods to services demand and lower commodity prices hurt commodity exporters disproportionately. Moreover, the lagged effects of tighter fiscal and monetary policy will result in more onerous financial conditions for these countries.

Chart 1: Global growth poised to soften in 2022



Source: World Bank, International Monetary Fund (IMF), OECD, Momentum Investments

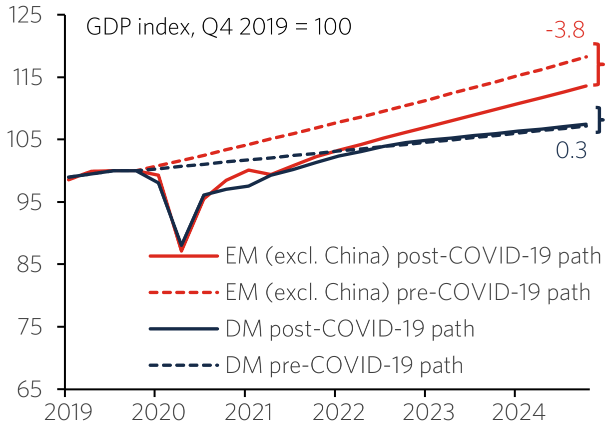
The future path of the pandemic will continue to shape the extent of economic scarring. The IMF previously pointed out that severe recessions in the past were associated with persistent output losses from reduced productivity. Even though the COVID-19 pandemic has spurred innovation and digitalisation, the IMF warns that resource allocation needed to adapt to new conditions may be larger than in the past and this can negatively affect growth and productivity. Unlike what followed the Global Financial Crisis (GFC), this time around, the IMF expects EMs to suffer deeper economic scars, with low-income developing economies expected to be the laggards in this economic recovery due to adverse effects on skills acquisition and learning. JP Morgan notes that by the end of 2024, generous stimulus efforts are expected to leave DMs 0.3% larger than pre-pandemic trends would have suggested. The

EM aggregate (excluding China), on the other hand, is expected be 3.8% smaller following on from less leeway for a larger fiscal response and a slower pace of vaccination rollout preventing a further relaxation of restrictions on mobility, particularly in high contact sectors (see chart 2).

Pandemic scarring is also evident in the jobs market. The IMF predicts employment losses of up to 2% worldwide (2.75% for EMs) relative to the pre-pandemic trend. A behavioural trend has further exacerbated low rates of labour market participation. Many have dropped out of the labour market in the so-called Great Resignation. This may, in part, be due to stimulus cheques which dissuaded workers from participating in the jobs market, while others were locked out due to restrictions on legal immigration.

Some have also left the jobs market due to COVID-19-related illnesses or to care for sick family members.

Chart 2: Longer-term pandemic effect on growth



Source: JP Morgan, Momentum Investments

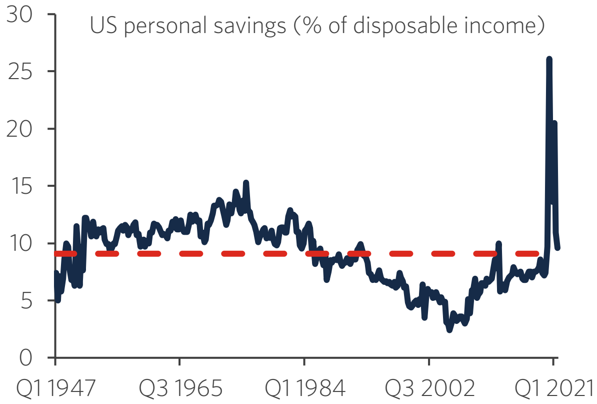
Inflation could get worse before it gets better

The labour force participation rate has ticked up but remains far below pre-pandemic levels. This has left conditions tight in the labour market and has spurred anxiety in financial markets over a potential wage-price spiral. While entrenched early retirement trends and more permanent behavioural shifts in the labour market remain a risk to wage price pressures, in our view, the so-called Great Resignation could unwind as fiscal transfers run out for households (allowing financial strains to rebuild). More entrants may also return to the labour market, based on a relaxation in legal immigration of workers. Many of those who fell ill to COVID-19, or left work to care for sick family members, may, in addition, return to the workforce. Similarly, some older workers may choose to come back as health concerns subside.

Former United States (US) Secretary Larry Summers warned the American Rescue Plan would be too inflationary, but critics argue that without the aggressive action, to provide pandemic relief, we may have experienced another jobless recovery and weaker household balance sheets. Moreover, the IMF shows that expansions in the monetary policy base, which potentially blur the demarcation between monetary and fiscal policy, do not necessarily de-anchor inflation expectations if central bank actions are understood as an effort to target macroeconomic stabilisation goals instead of being perceived as acting on fiscal pressures. Using data from 1950, the IMF proves that an expansion of the monetary base is followed by only a modest increase in inflation if the starting point of inflation is low, if the central bank operates under a high degree of independence and if the fiscal deficit is modest. The opposite does, however, also hold true. The IMF warns that monetary expansions are likely to fuel sharper price responses if central bank credibility is weak, if the starting point of inflation is high and if fiscal positions are precarious.

Bridgewater Capital shows that the gap between nominal demand and aggregate supply is similar to that of the 1970s, but pent-up demand has been a distinguishing factor driving inflation higher this time around. This is unlike the inflation experience of the 1970s, when supply shocks sent prices soaring and demand remained relatively unchanged. Under current conditions, supply has already started to recover but it has been unable to catch up to surging demand. Demand ballooned as lockdown restrictions were eased, unleashing accumulated savings and driving the prices of goods higher. Nevertheless, US household savings as a share of disposable income has dropped from a peak of 26.1% in the second quarter of 2020 to more normalised levels of 9.6% in the third quarter of 2021 (see chart 3). Moreover, a rotation from goods demand to contact services will further help to correct the imbalance, in the coming months.

Chart 3: Normalisation in US savings levels



Source: Federal Reserve Bank of St. Louis, Momentum Investments
Data up to Q3 2021

Disruptions to logistics networks and capacity constraints have spawned supply chain disruptions, resulting in huge increases in freight costs and delivery times. A sharp rise in supplier delivery times has given suppliers greater pricing power, which slowed down production and caused a jump in prices. The Bank for International Settlements (BIS) claims that initial shortages have been aggravated by the so-called "bullwhip effect", in which precautionary hoarding takes place at different stages of the supply chain, in already-lean production networks. The BIS notes that bottlenecks in some upstream industries tend to have a larger negative impact on growth given a larger associated output multiplier, such as energy-related commodities and semi-conductors. Instead of addressing supply chain issues through interest rates, a number of measures can be considered to alleviate shortages. The US administration has increased efficiencies in custom clearances, adjusted import duties on essential raw materials and expanded operating hours at ports to ensure a smoother transportation of goods. Moreover, a switch to warmer weather in the second quarter of 2022 in the Northern Hemisphere should ease demand for oil and allow suppliers to ramp up oil balances, leading to a reversal in the oil price.

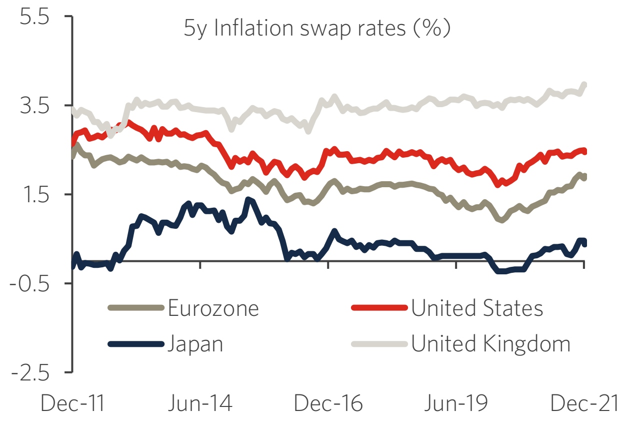
While headline inflation has spiked for many DMs and EMs, underlying measures of inflation for most countries remain intact. The OECD has shown that core inflation for the median advanced economy remains in line with historical precedent. The IMF notes that sectoral price dispersion for the global consumer basket remains relatively subdued and it attributes the swings in inflation to three main categories, including transport, food and housing. This suggests that inflation in these categories has not created second-round inflationary effects in the remainder of the global consumer basket, denoting a very different response from monetary policy authorities.

The IMF also argues that longer-run inflation expectations present a relatively strong degree of anchoring, gradually trending back to 2% on average for DMs. Even in a worst-case scenario, which assumes continued strong increases in commodity prices and broader sectoral dispersion in inflation, inflation expectations are expected to revert in the medium term, after overshooting in the short term. As such, the IMF emphasises the importance of a well-communicated plan for a gradual exit from exceptionally accommodative monetary policy and observes that sound and credible communication can keep inflation expectations well anchored, without necessarily having to take aggressive monetary policy decisions.

While those countries, which are worried about control over inflation expectations, are likely to follow a steeper path of monetary policy to lean against inflation, central banks who have explicitly expressed more tolerance for inflation, through an average inflation targeting framework, may demonstrate increased tolerance for periods of higher inflation. With the US Federal Reserve (Fed) considering an earlier end to its tapering of asset purchases, this could create space for the interest rate hiking cycle to commence in 2022. Though the unknown negative effect of Omicron on growth likely prompted a decision to keep interest rates steady in the United Kingdom (UK) in November 2021, fears of a wage-price spiral (exacerbated by the decrease in migration figures following the UK's exit from the European Union, namely Brexit) argue for a tightening in monetary policy.

Meanwhile, the medium-term inflation outlook for the Eurozone remains weak despite current transitory inflation pressures. The European Central Bank's (ECB) new symmetric 2% inflation target and more substantiative criteria for determining whether or not this target has been met, suggest, in our view, that current price pressures are not enough to trigger interest rate hikes before the end of 2023, at the earliest. While the Pandemic Emergency Purchase Programme (PEPP) is likely to expire early in 2022, the ECB is expected to ramp up its Asset Purchase Programme and may revise limits on holdings of sovereign debt to accommodate the expansion. Similarly, even while fiscal policy becomes more expansionary in Japan, the Bank of Japan remains committed to keeping monetary policy accommodative to support corporate funding. Moreover, the BOJ confirmed it has no plan to begin selling its asset holdings. In our opinion, corporates will continue to favour so-called "shrinkflation" (when the product reduces in size, but the price remains the same) over outright price increases in fear of losing customers. In our opinion, low longer-dated inflation expectations (see chart 4) and a tepid outlook on growth attests to a continuation of the BOJ's ultra-accommodative monetary policy stance for the foreseeable future.

Chart 4: Longer-dated inflation expectations have drifted higher but have not spiked



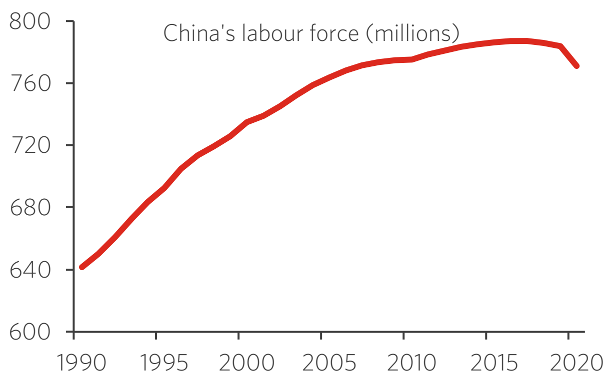
Source: Bloomberg, Momentum Investments

China moves from "making the pie bigger" to "dividing the pie more evenly"

China celebrated its 100th anniversary of the founding of the Chinese Communist Party in July 2021. Here, President Xi Jinping announced that the party had achieved its first centenary goal, which was to build a moderately prosperous society and declared that the party was marching towards its second goal of building a great modern socialist country. Authorities in China have shifted their stance away from making the economic pie bigger towards focusing on higher quality growth and a more equitable distribution of gains.

Changes in China's demographics have urged this shift. Previously, a growing labour force necessitated higher levels of growth to accommodate many new entrants into the labour market. However, the negative consequences of the previous one-child policy have led to a shrinking labour market, urging Chinese authorities to focus on common prosperity for its citizens, instead (see chart 5).

Chart 5: China's shrinking labour force



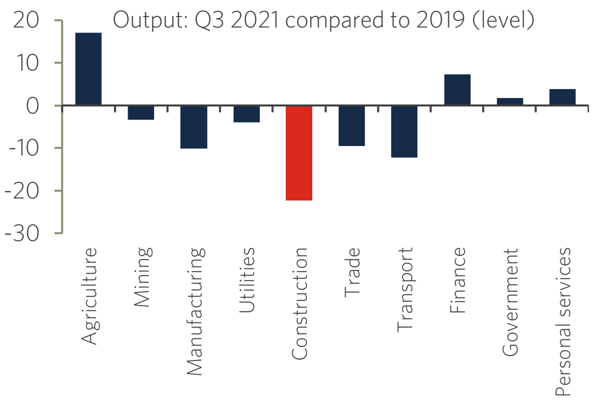
Source: World Bank, Momentum Investments

This bold level of restructuring, in which China has more willingly made aggressive policy changes, is more feasible in the context of a softer growth target, which gives authorities space to experiment. Under this shift in regime, the relative emphasis of China's policies will shift in favour of increased government influence, a more concerted focus on equality and redistribution and a larger emphasis on structural changes in the economy, while concentrating less on shorter-term cyclical outcomes. Private sector firms and innovation will, nevertheless, unlikely thrive under these conditions and China may take longer to achieve its rebalancing efforts towards a consumption-driven economy. Under this regime shift, the ideological battle between China and the US is set to continue on social systems and areas involving economics and politics. The Economist publication argues that conditions are ripe for China to challenge the US in terms of its relative perceived success of authoritarian governance against the US's model of democratic capitalism. While Beijing will host an orderly 20th party congress in the second half of 2022, America will be facing the risk of a divided government in the mid-term congressional elections in November 2022.

Economic rebound losing momentum in SA

Against a backdrop of milder global growth, shaped by less accommodative fiscal and monetary policy, demand for SA's exports are likely to soften. Moreover, even as a faster-than-anticipated rebound in wages spurred household spending in 2020, the dark cloud of lingering unemployment will take the shine off consumption spending in 2021. Tepid credit growth and further interest rate increases suggest that credit-driven purchases are unlikely to be a major contributor to household spending in 2022. While restrictions on economic activity went from affecting 45% of the economy to under 3% of the economy, as the COVID-19 pandemic evolved from the first wave (March to October 2020) to the second (November 2020 to January 2021) in SA, moving from the second to the third wave (which started in June 2021) did not have as large a positive effect on growth. Similarly, moving towards lower level of restrictions during 2022, will likely have a smaller positive effect on growth utcomes. As such, we see growth slowing from an estimated 4.9% in 2021 to 2% in 2022 and 1.8% in 2023.

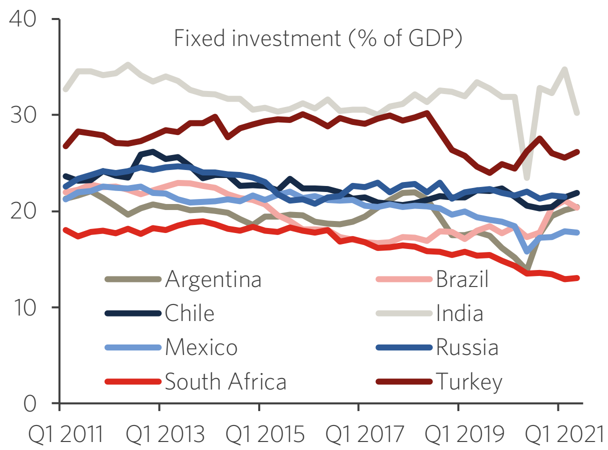
Chart 6: Construction sector lags the recovery



Source: SARB, Momentum Investments

While Treasury and the SA Reserve Bank (SARB) pitch SA's longer-term economic growth potential at 2%, this likely relies on the implementation of additional structural reform measures. In our view, trend growth remains capped by weak fixed investment trends. Growth data from the second quarter of 2021 showed that the construction sector was still 21% below pre-pandemic levels, with the next worst-performing sector (transport, storage and communication) only 9% weaker (see chart 6). SA's fixed investment to gross domestic product (GDP) ratio slipped to 13.1% by the middle of 2021, from 19% at the end of 2013 and remains below its EM peers, such as Mexico (17.7%), Turkey (26.1%), India (30.3%), Chile (21.9%) and Brazil (20.3%), see chart 7.

Chart 7: SA's fixed investment ratio has grinded lower



Source: World Bank, Momentum Investments
Data up to Q2 2021

Since the tabling of the February 2020 national budget, a number of growth-enhancing political and economic reforms have been introduced. More notably, the raised cap for electricity self-generation should unleash additional projects in the mining and minerals sector, in particular. Moreover, new project announcements in relation to Bid Window 5 of the renewable energy independent power producer programme and secured concessional climate financing have been positive announcements in the energy space, while the prospect of private sector participation, to scale up capacity at the ports and reduce logistic costs, is likely to increase efficiencies and competitiveness in the logistics sector.

Despite these, and other reforms in the areas of investment attractiveness and governance, a number of underlying measures in the World Bank's Worldwide Governance Indicator for SA have yet to show a marked improvement and in some cases (government effectiveness and rule of law) have shown a deterioration relative to a decade ago. While efforts to shore up institutional credibility have been noted by the major rating agencies, this pillar will remain under scrutiny in future reviews. A weaker medium-term growth and fiscal picture further weigh on SA's rating outlook in the medium term (see table 1).

Table 1: Sovereign rating matrix

Long-term rating	S&P (29 Apr 2020)	Fitch (20 Nov 2020)	Moody's (20 Nov 2020)
Investment grade (IG)	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-IG	BB+	BB+	Ba1
	BB	BB	Ba2
	BB-	BB-	Ba3
Outlook	Stable	Negative	Negative

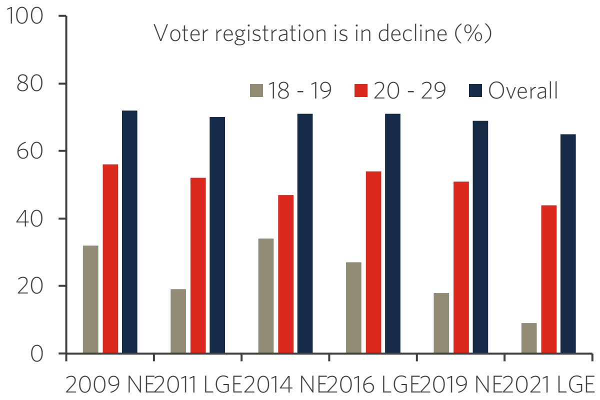
Local currency rating
Foreign currency rating
Both ratings

Source: Standard and Poor's, Moody's, Fitch, Momentum Investments

Election results complicate the growth and fiscal outlook

The evolution of SA's political scene is likely to affect both growth and the fiscal trajectory given the surprising electoral outcome of the 2021 local government elections. Firstly, the trend of stayaway voters became more entrenched, reflecting the decline in citizens' trust in key government institutions and authorities.

Chart 8: Voter disillusionment among the youth



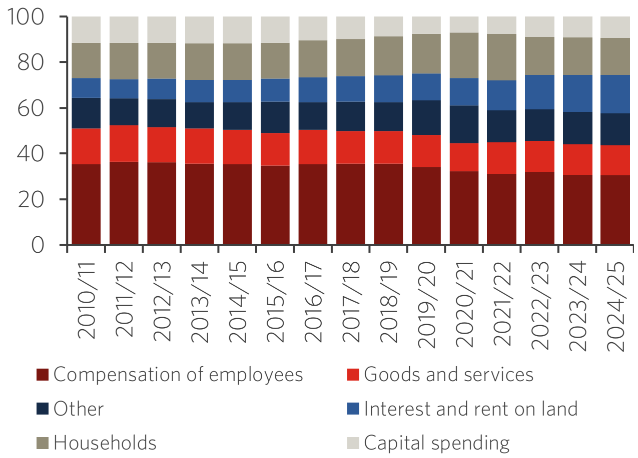
Source: Independent Electoral Commission, Mail and Guardian, Afrobarometer, Momentum Investments
N E= National election, LGE = Local government election

A staggering 14.2 million registered voters did not turn up on the day to cast their ballot, with voter turnout rates dropping as low as 33% in some townships (such as Tembisa) on rising frustration over inadequate service delivery. Voter abstention appears to be the highest among younger age cohorts (see chart 8), threatening an expression of frustration outside of the formal voting channels and contributing to the already-high level of social delivery protests and unrest in SA.

Secondly, the election results revealed bruising losses for the largest political parties in SA. According to the Independent Electoral Commission, the African National Congress (ANC) amassed 16.5 million votes in 2011, but this dropped to 10.7 million in 2021, likely on the back of internal party dysfunctionalities, a poor economic setting and mismanagement at the municipal level. Likewise, the number of votes plunged from 8 million to 5 million for the Democratic Alliance (DA) over the same timeframe. Despite the Economic Freedom Fighters (EFF) expressing satisfaction with the 2021 election results, votes for the party dropped from 2.4 million in 2016 to 1.3 million in 2021. Instead, the largest victory was seen by the minority parties, where support grew from 11% to 22% of the vote. These trends have given rise to a third observation, which is the rising trend of coalition governments given the record number of hung councils (a third of the total) which emerged from the 2021 local elections. The huge dip in support for the ANC has left analysts questioning the chances for the incumbent ruling party to secure a majority vote in the 2024 national elections. While the 2021 election outcome provides an opportunity to build more solid coalitions with smaller parties that have found themselves in a kingmaker position, a more fragmented political landscape presents challenges to fast-tracking key structural reforms to resolve low trend growth.

Some political commentators have warned that the results of the vote may tempt the introduction of more populist policies as the ruling party attempts to win back defected voters. If the focus has indeed shifted from more localised issues, such as service delivery, to concerns over national policy, this would pose a further threat to government's fiscal consolidation and debt stabilisation goals.

Chart 9: Government wage bill expected to decline as a share of total expenditure (%)

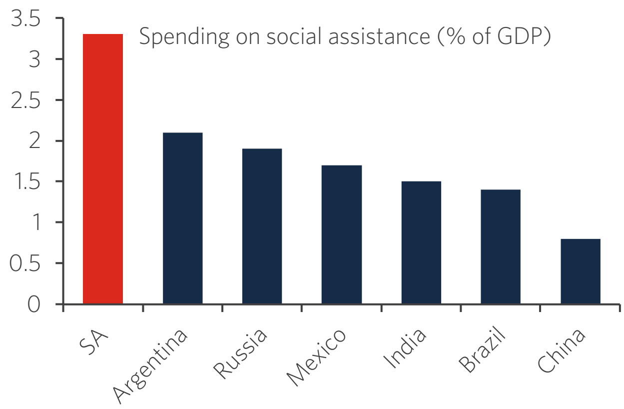


Source: Treasury, Momentum Investments

Though Finance Minister Enoch Godongwana's maiden budget broadly appeased financial markets (mostly thanks to an outsized revenue outcome following a commodity price boon, an upward revision to nominal GDP through a reweighting exercise and deferred decisions on expenditure items), the size of SA's (gross) debt burden is still large at R3.9 trillion. Risks to restraining expenditures, defunct municipalities and increased allocations to financially and operationally ill state-owned enterprises, in addition, remain high in our view. The two largest risks to the short- to medium-term expenditure profile arise from the civil servant wage bill and the undeniable need to address high levels of poverty in SA. Despite the compensation of government employees accounting for a smaller share of consolidated expenditure (32.2% in fiscal year (FY) 2020/2021 from 35.2% in FY2010/11 (see chart 9), the R20 billion overrun in the current FY was partly funded from the Infrastructure Fund. Time is running short for government and labour unions to reach a wage agreement for the next fiscal period and indecision by the end of March 2022 runs the risk of a continuation in the cash gratuity to government employees.

The second key risk to the short- to medium-term expenditure profile stems from high levels of poverty in SA. According to Social Development Minister Lindiwe Zulu, the SA Social Security Agency (SASSA) had received 11 237 724 applications for the Social Relief Distress (SRD) grant by 25 August 2021. With the SRD grant (R350 per month) set to expire at the end of March 2022 and nearly a third of SA living below the food poverty line, government needs to urgently address economic hardship for a large portion of the SA population. This is challenging in the context of SA already spending a high percentage of its wallet on social expenditure (3.3% of GDP relative to 2.1% in Argentina, 1.7% in Mexico, 1.5% in India or 1.4% in Brazil, see chart 10).

Chart 10: SA's relative social wallet is big



Source: World Bank, Momentum Investments

According to JP Morgan, bringing the population up to the food poverty line (R624 per month) will cost the fiscus an additional R30 billion every year, while raising living standards to the lower-bound poverty line (R890 per month to include some non-food necessities) will require R60 billion every year. While officials at Treasury have highlighted the need to cover these households in a deficit neutral manner, the decision was deferred to the February 2022 national budget. While a larger expansion of the public sector works programme may be a more favourable solution, media leaks leading up to the medium-term budget in 2021 hinted at the introduction of a family grant.

A modest unwinding of an accommodative monetary policy stance

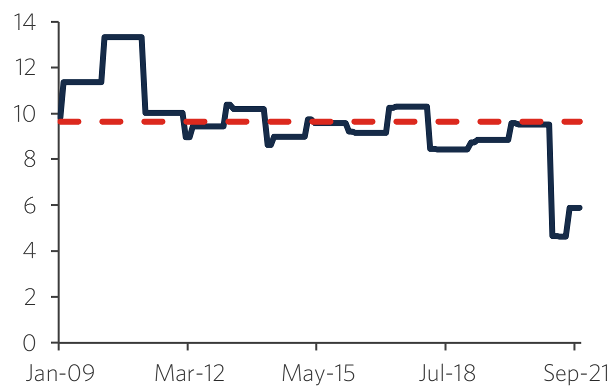
While potentially permanent increases in government spending threaten a looser fiscal policy stance relative to government's envisioned consolidation path, monetary policy has shifted into tightening mode. The SARB has expressed an interest to unwind its accommodative monetary policy stance and shift real interest rates into positive territory. While the SARB's quarterly project model (QPM) calculates a steep interest rate hiking cycle, resulting in interest rates of 5.75% by the end of 2023 and 6.75% by the end of 2024, in our view, well-behaved inflation, anchored inflation expectations and a pedestrian growth outlook advocates a more moderate interest rate hiking cycle. We expect the SARB to hike interest rates thrice (by an accumulative 75 basis points) in 2022 and a further three times (total of 75 basis points) in 2023. Hailing from a global and local backdrop of ultra-accommodative monetary policy, we do not see the neutral interest rate recovering as far as to 2.4% in the medium term as indicated by the QPM and, instead, see this rate closer 1% by the end of 2023.

Chart 11: Wages could rebound from a low base

Source: SARB, Momentum Investments
Data up to Q2 2021

Although regulated administered prices (including electricity tariffs and water costs) and wage settlements pose an upside threat to SA's inflation trajectory (see chart 11), rental inflation and increases in medical aid tariffs are likely to prevent a surge in inflation outcomes given their weighty contribution to services inflation. Rental inflation is expected to rise into 2022. However, an overhang in housing supply, an increased number of first-time home buyers and reduced demand for rental in key nodes as work-from-home trends continue, will likely temper the rise in rental inflation. Moreover, medical aid schemes have guided towards lower increases in medical aid tariffs between 5% and 6%, which is lower than the longer-term average of 9.7% (see chart 12).

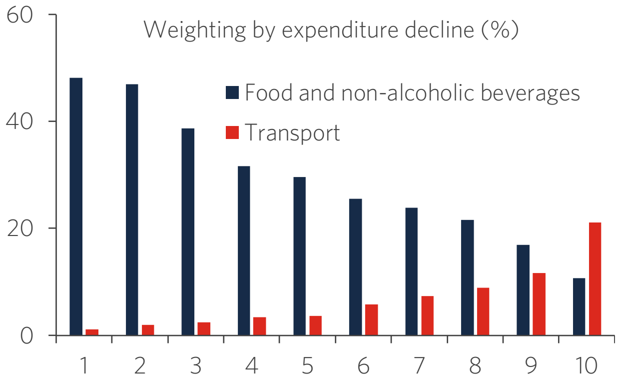
Chart 12: Medical aid inflation temporarily deviating from long-term trend



Source: Statistics SA, Momentum Investments
Data up to October 2021

The surge in global food prices is less likely to translate into soaring local food prices, subsequent to the drop in correlation in SA's food prices relative to global food prices, from 0.8 prior to the GFC to 0.5 after. This is particularly good news for lower income earners, who spend a significant portion of income on food expenses (see chart 13). Elevated energy costs pose a risk to transport inflation (and indirectly to food inflation) in the near term, but warmer weather expected in the Northern Hemisphere, by the second quarter of 2022, should lower oil demand and allow a recovery in supply, driving oil prices lower. Petrol inflation accounts for 4.6% of the consumer basket, but the broader transport category (which includes vehicle purchases) accounts for an average of 13.9% for the top three highest income-earning deciles. We expect headline inflation to average 4.5% in 2021, 4.6% in 2022 and 4.3% in 2023.

Chart 13: Food and transport consumer basket weighting per expenditure decile



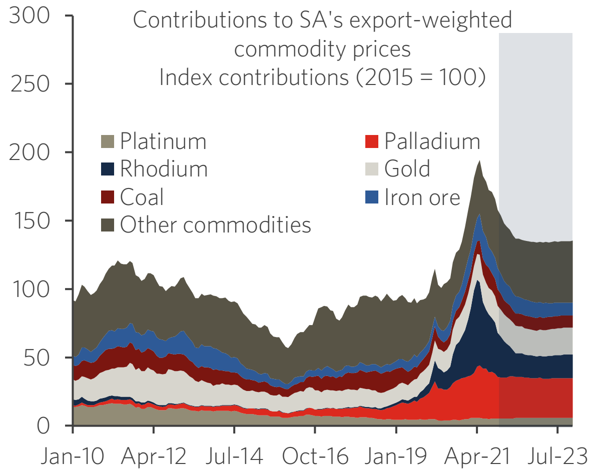
Source: Statistics SA (2016 weights), Momentum Investments

A low level of currency passthrough further limits upside pressure to the path of local inflation from recent rand depreciation. Uncertainty over the spread of Omicron weakened the real effective exchange rate to one standard deviation below its longer-term trend.

While negative sentiment driven by the unknowns of the new viral strain could cause further temporary weakness in the currency, we largely see the spike to R16.31 to the US dollar as overdone.

We expect the rand to recover from current levels (R16.07 at the time of writing) but warn that the rollover in SA's exported commodity prices (see chart 14) will unwind recent gains in SA's terms of trade and as such will cap the extent of the rand recovery from these levels. Further out, we see a weakening bias embedded in the currency on elevated fiscal risks in the medium term and concerns around trend growth.

Chart 14: Prices of SA's exported commodities rolling over



Source: SARB, Momentum Investments