momentum
investments

The Macro Research Desk

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Interest rates maintained at 6.75%, but macro trends suggest room to ease in upcoming months

Highlights

- **The South African Reserve Bank Monetary Policy Committee views the potential for additional sovereign rating downgrades and volatility in international oil prices as the main risks to setting monetary policy**
- **Risks to an improved growth outlook are seen to be more or less balanced**
- **Stronger exchange rate assumptions and a lower electricity tariff increase were behind a downward revision to headline and core inflation forecasts**
- **Longer-term inflation expectations, surveyed in the fourth quarter of 2017, remain encouragingly within the 3% to 6% target band**
- **One member favoured an interest rate cut**
- **Favourable inflation trajectory leaves room for modest monetary policy easing in upcoming months**

Downgrade potential and volatile oil prices are viewed as the main risks to setting monetary policy

In light of lingering sovereign rating downgrade risks and a recent sharp uptick in international oil prices, the South African Reserve Bank (SARB) prudently decided to leave local interest rates unchanged at 6.75% at its January 2018 Monetary Policy Committee (MPC) meeting. The decision was in line with the broader consensus, as well as Momentum Investments' expectation. From the 20 economists surveyed in the Reuters Econometer poll, 18 projected interest rates would remain unchanged, while two forecasted a cut in interest rates of 25 basis points.

Although the SARB admitted to an improvement in the inflation outlook since its November 2017 interest rate-setting meeting, it continued to view upside risks to its forecast (although to a lesser degree given stronger exchange rate assumptions and a lower-than-expected electricity tariff increase).

The MPC's growth forecasts reflect a mild expansion off a low base, while its risk assessment improved somewhat. In its November 2017 meeting, the MPC noted it "assesses the risks to the revised growth forecast to be slightly on the downside", whereas this time around risks to the growth forecast were seen to be "more or less balanced".

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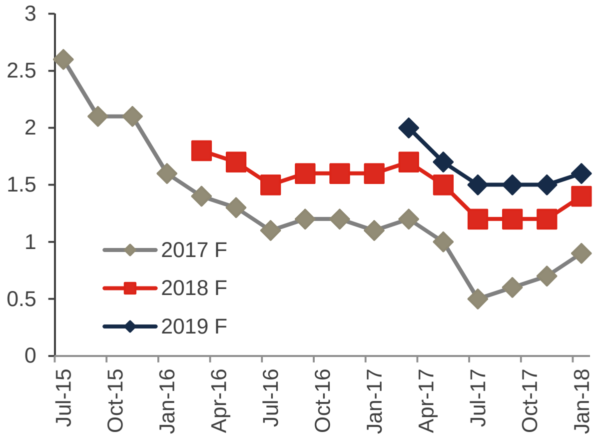
Growth risks (on an improved outlook) are more or less balanced

The SARB's real gross domestic product (GDP) growth forecast for 2017 rose to 0.9% in January 2018, from a 0.5% trough in July 2017 and a 0.7% expectation in November 2017. Projections for 2018 and 2019 have also shifted higher to 1.4% in 2018 from 1.2%, previously, and from 1.5% in 2019 to an upwardly-revised 1.6% (see chart 1). Momentum Investments expects a similar growth outcome in 2018, with marginal upside risks to the outer year (2019), potentially stemming from a faster acceleration in gross fixed capital formation, in reaction to greater certainty following the 2019 national elections. The December 2017 Reuters Econometer poll results are broadly in line with these forecasts, projecting 1.2% for 2018 and 1.6% for 2019.

The SARB similarly remarked that recent political developments, resulting in a sustained boost to consumer and business confidence, could urge growth higher in the medium term. In its question and answer (Q&A) session, the SARB pointed out the positive response by international, as well as local, investors to the African National Congress (ANC) national conference election outcome.

While the SARB noted a "slightly narrower" output gap in its November 2017 assessment, it observed a "closing" output gap "reduces the degree of downside pressure on inflation" in its January 2018 statement. The SARB estimated the output gap should narrow from 1.1% in 2017 to 0.8% in 2019 (previously 0.9%).

Chart 1: SARB's real growth forecasts (% y/y)



Source: SARB, Momentum Investments

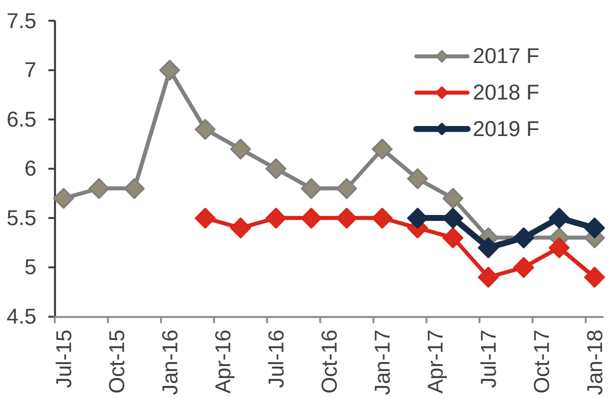
Revised rand assumptions and a lower electricity tariff increase are behind lower inflation forecasts

The MPC adjusted its 2018 and 2019 headline inflation forecasts lower from 5.2% to 4.9% for 2018 and from 5.5% to 5.4% for 2019 (see chart 2). This compares to predictions of 5.2% for 2018 and 5.4% in 2019 in the Reuters Econometer Poll for December 2017, which were surveyed before the recent favourable movements in the local currency, following the ruling party's national conference. Momentum Investments sees marginal downside risk to the SARB's 2018 forecasts and a potentially higher outcome for 2019.

In its Q&A session, the MPC proposed stable commodity prices and a weak dollar, as well as a favourable response to local political developments, as the key drivers of recent rand strength.

The final electricity tariff granted by the National Energy Regulator of SA further aided a downward revision to the SARB's inflation forecasts. The SARB had initially pencilled in an 8% increase (Momentum Investments had assumed a 10% increase), whereas the final tariff adjustment resulted in a lower 5.2% increase.

Chart 2: SARB's headline inflation forecasts (% y/y)



Source: SARB, Momentum Investments

The inclusion of a sugar tax partly counts these positive effects on inflation. The SARB assumes the sugar tax will increase headline inflation by 0.1% (a 0.6% increase to overall food inflation) in 2018. The SARB's food inflation forecast increased from 4.5% in 2018 to 5.2% and from 5.9% to 6.0% in 2019.

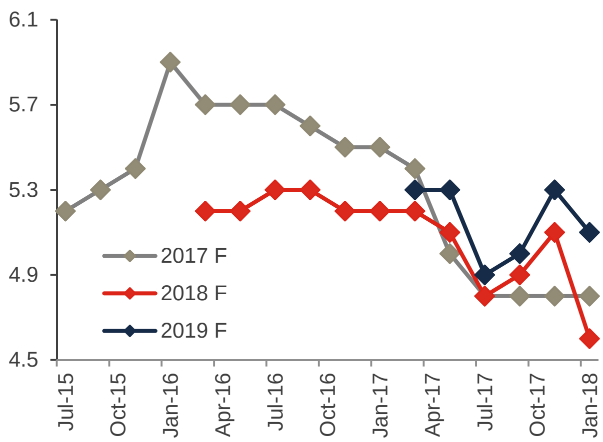
Lower-than-expected rainfall in key areas has dimmed the outlook for the agricultural sector's 2017/2018 output. Dry conditions in the Free State and North West, which collectively account for nearly 70% of the 2017/2018 planned maize-planting area and more than 85% of the sunflower seed expected production (according to the Agricultural Business Chamber), have led to delays in crop planting this summer. Consequently, farmers have only planted up to three quarters of the maize area they had originally planned to harvest and a quarter of the intended sunflower seed crop. While the 2017/2018 planting season is a concern for the agricultural sector, high stock levels from the previous season should prevent a sharp rise in overall food inflation in the medium term.

The Absa Agri Trends report for November 2017 noted grazing conditions were likely to improve in the summer months, which could enable farmers to rebuild stock levels, keeping meat prices high in the short term. Firmer seasonal demand for red meat further supports higher meat prices in the near term, although consumer demand for more expensive red meat products was noted as being under pressure. The report also indicated upward pressure on poultry prices. Internationally, tight supplies on the back of bird flu outbreaks pushed poultry prices higher in recent months. Meanwhile, locally, downward substitution by consumers into cheaper protein products could have additionally had an effect on higher prices. Nonetheless, Momentum Investments expects a tapering off in meat inflation in upcoming months as supplies begin to normalise.

The SARB reacted to the higher levels of international oil prices by marginally adjusting its 2018 and 2019 average forecasts higher to US$62/bbl.

The MPC's revised currency assumptions have additionally led to a notable downward revision of its core inflation forecasts from 5.1% in 2018 to 4.6% and from 5.3% in 2019 to 5.1% (see chart 3).

Chart 3: SARB's core inflation forecasts (%)



Source: SARB, Momentum Investments

Although the SARB referred to wage inflation as a an additional upside threat to inflation, it should be noted trade unions revised their inflation forecasts 0.6% lower in 2018 (to 5.5%) and 0.2% lower to 5.8% in 2019 in the Inflation Expectations survey conducted by the Bureau of Economic Research in the final quarter of 2017.

Longer-term inflation expectations remain encouragingly within the target band

The BER Inflation Expectations survey showed the average inflation expectation for 2018 dipping from 5.8% to 5.7%, while forecasts for 2019 remained unchanged at 5.9%. On a more granular level, businesses revised their forecasts higher, while trade unions had shifted their inflation expectations lower.

Encouragingly, five-year ahead inflation expectations remained comfortably within the target band at 5.6% in the fourth quarter of 2017.

One member favoured an interest rate cut

The SARB admitted, in its discussions, one MPC member favoured an interest rate cut of 25 basis points, relative to the November 2017 meeting, where all members favoured no move in interest rates ahead of the African National

Congress's national conference in December 2017 (see table 1).

Earlier in the week, the SARB announced a new adviser to the governors had been appointed to become the seventh member of the MPC (effective from 19 February 2018). Going forward, this appointment will alleviate pressure on a split committee outcome.

Table 1: Committee members' views in recent meetings

No. of committee members	Favoured no move	Favoured 25 basis point hike	Favoured 50 basis point hike	Favoured a 25 basis point cut
28 January 2016	1	2	3	-
17 March 2016	3	3	-	-
19 May 2016	5	1	-	-
21 July 2016	6	-	-	-
22 September 2016	6	-	-	-
24 November 2016	6	-	-	-
24 January 2017	6	-	-	-
30 March 2017	5	-	-	1
25 May 2017	5	-	-	1
20 July 2017	2	-	-	4
21 September 2017	3	-	-	3
23 November 2017	6	-	-	-
18 January 2017	5	-	-	1

Source: SARB, Momentum Investments

Favourable inflation trajectory leaves room for modest monetary policy easing

In Momentum Investments' view, the local unit remains vulnerable to negative swings in global and local sentiment. A sharper-than-expected slowdown in China or a faster pace in developed market monetary policy tightening could trigger emerging market-wide currency weakness, whereas a perception of a shift to the left in SA policy, to appease a disgruntled electorate, could see the rand weakening in isolation.

Taking this and the expectation of a resilient global economy into account, the company expects some depreciation in the currency during 2018 and 2019. Even after factoring in a mildly depreciating currency trajectory from current levels, inflation should still remain comfortably within the target band in upcoming months. Although the SARB maintained interest rates at 6.75% at the January 2018 meeting, citing the potential for a sovereign ratings downgrade and higher international oil prices as risks, falling inflation potentially leaves room for further modest monetary policy easing in 2018.

Momentum Investments only sees space for up to 50 basis points worth in interest rate decreases (two cuts of 25 basis points each, at the most), given the medium-term outlook for inflation and political uncertainty, as the 2019 national elections draw near.