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in the moment

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Food prices propel May's inflation to January 2017 levels

Highlights

- According to Statistics South Africa (Stats SA), May's inflation figure reached the highest level since January 2017.
- Headline inflation jumped to 6.5% in May 2022 from 5.9% in April. The figure surprised financial markets significantly to the upside given the Reuters consensus estimate of 6.2%.
- The monthly 0.7% uplift in headline inflation was largely underpinned by an increase in food prices, with a notable rise in bread and cereal prices and the price of oils and fats.
- The Russia-Ukraine war has affected the global grains and vegetable oils trade, while floods in KwaZulu-Natal (KZN) have added an additional layer of price pressure. Rising input costs, including agrochemicals and fertilisers, continue to pose a threat to farming costs especially given the higher fertiliser requirement for replanting following the extensive flood damage in KZN.
- Although petrol prices (inland 95) dipped by 12 c/l in the May inflation report, the transport category is likely to face renewed upward pressure given the R2.33/l increase in June. Petrol prices are expected to remain elevated into July, with the Central Energy Fund (CEF) estimating a current under-recovery of R1.92/l.
- Nearly 40% of the weighted inflation basket experienced price increases above 6% in May 2022. Categories registering inflation above this mark last month included food, alcoholic beverages, electricity, transport and hotels.
- In our view, the level of South African Reserve Bank (SARB) interest rate normalisation and the extent to which the interest rate hikes are frontloaded remain a function of the Monetary Policy Committee's view on the degree to which current global inflation shocks are likely to feed through into underlying inflationary pressures by stoking higher wage growth and prompting more broad-based price increases outside of food and fuel.
- Today's higher-than-expected inflation figure reinforces our view of a 50-basis point increase at the July 2022 interest rate-setting meeting. We expect an additional three hikes of 25 basis points each to follow, ending the hiking cycle at 6%.

Inflation jump in May surprises markets negatively

Stats SA reported headline inflation at 6.5% for May 2022, which was the highest level recorded since January 2017. The figure was a negative surprise for financial markets, with the Reuters median expectation for inflation pitched at 6.2%.

May is not typically a high survey month, with an additional 2% of the basket surveyed aside from the typical monthly surveys. Soccer tickets and hospital fees are generally surveyed in May.

The monthly 0.7% rise in headline inflation was predominantly driven by an increase in food prices.

Relative to our forecasts, price increases in food, tobacco and household appliances surprised to the upside, while increases in public transport fees and insurance surprised to the downside.

International oil prices remain sticky

In its Oil Market Report for June 2022, the International Energy Agency (IEA) stated that international oil imbalances are being helped by slowing growth in demand and an expected rise in global oil supplies for the remainder of the year.

Nevertheless, the IEA points to lingering risks. Inventory levels remain weak after seven consecutive quarters of extensive inventory drawdowns. Meanwhile, tougher sanctions on Russia (countries in the European Union have agreed to ban 90% of the bloc's imports of Russian crude oil over the next six to eight months), an expected ramp up in Chinese oil demand (following a relaxation of aggressive lockdowns) and cuts to Libyan crude oil production (due to a shutdown of oil facilities to pressure the incumbent prime minister to hand over power to the parliament-appointed government) continue to pose risks to the imbalance in international oil markets.

The US Energy Information Administration's (EIA) Short-term Energy Outlook for June 2022 indicated it expected international oil prices to average US$108/bbl in the second half of this year before dropping to an unchanged projected average of US$97/bbl in 2023. The EIA continues to forecast volatility in oil markets given the low level of oil inventories and uncertainty around additional bans on oil imports from Russia.

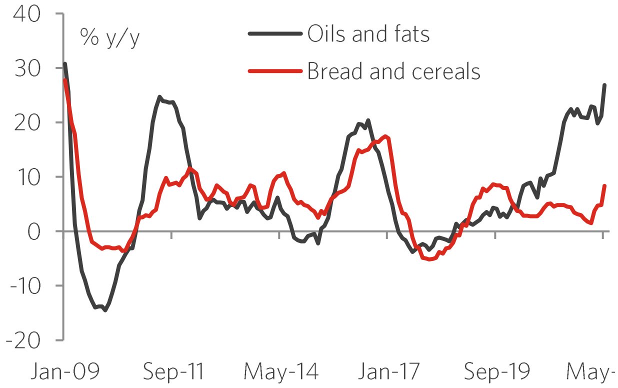
Transport inflation remained steady at 15.7% year on year (y/y) in May. The price of petrol (95 inland) dropped by 12c/l in May, keeping a lid on private transport inflation. Nonetheless, a R2.33c/l increase in petrol prices for June 2022 will see renewed pressure. Moreover, the CEF's estimate of the current under-recovery points to an increase of R1.92c/l for July 2022.

Food inflation reflects the Russia-Ukraine war and local flooding

Local food prices increased by a hefty 2.2% month on month (m/m) in May 2022, led higher by a sharp 10.1% increase in the prices of oils and fats and a 3.4% m/m uptick in the prices of bread and cereals. Inflation in the oils and fats category reached 26.9% y/y, while inflation in bread and cereals climbed to 8.4% y/y in May 2022 (see chart 1), mirroring price movements in global agricultural markets.

Meanwhile, price pressures elsewhere in the local food basket have been more muted. Y/y inflation in fruit and vegetable prices remained low at 2.1% and 3.5%, respectively, in May 2022. The Agricultural Business Chamber (Agbiz) attributes low prices in the fruit and vegetable categories to a sizeable local harvest and the disruption in fruit exports in the Black Sea region.

Chart 1: Global factors driving oil and bread inflation



Source: Stats SA, Global Insight, Momentum Investments

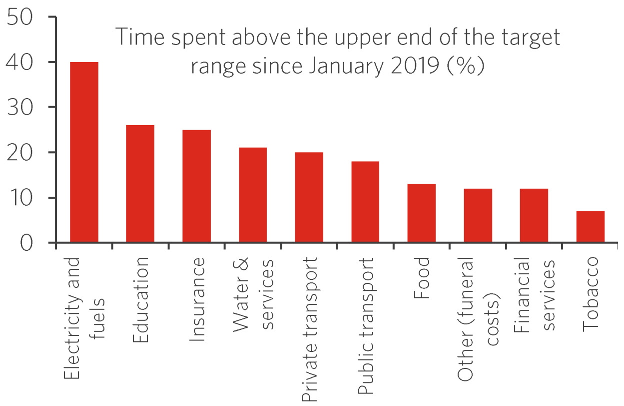
Within the meat category, higher poultry prices could potentially work against lower red meat prices. According to Agbiz, recent outbreaks of foot-and-mouth disease have temporarily closed some key export markets for SA's red meat industry, which dampens price pressures locally. Meanwhile, upward pressure is likely to emerge in poultry product prices as a result of higher feed costs and a potential expansion of trade protection duties.

Extent of monetary policy front-loading depends on underlying inflation fears

The SARB is likely to continue raising interest rates to fend off second-round effects on wages and prices. The rand has remained under pressure due to elevated global risk aversion as increasingly hawkish rhetoric from developed market central banks and downside risks to growth in China, induced by aggressive lockdown measures, have rattled markets.

The SARB is likely to be concerned about a feedthrough of cost pressures from food into other areas of the consumer basket resulting in higher second-round inflation effects.

Chart 2: Culprits behind higher inflation pressure since January 2019



Source: Stats SA, Global Insight, Momentum Investments

Looking at trends in the inflation basket since January 2019, it is evident that inflation in electricity, education, insurance, water and transport costs have spent the most time trending above 6%, causing upward inflationary pressures on the basket (see chart 2). However, many of these costs are regulated. As such, the monetary policy transmission mechanism has a limited effect on the demand for and prices of these goods and services.

Nonetheless, elevated international oil prices, the potential feedthrough into food prices and an accelerated hiking cycle globally are likely to support a further normalisation in local interest rates to curb inflation expectations.

In our view, the level of SARB interest rate normalisation and the extent to which the interest rate hikes are frontloaded remain a function of the MPC's view on the degree to which current global inflation shocks are likely to feed through into underlying inflationary pressures by stoking higher wage growth and prompting more broad-based price increases outside of food and fuel.

Ongoing weakness in the local currency, the SARB's fear of higher underlying inflation outcomes and the recovery in overall economic activity to pre-pandemic levels are likely to prompt the SARB to hike interest rates by 50 basis points at the next (21 July 2022) rate-setting meeting. We expect an additional three hikes of 25 basis points each to follow, ending the hiking cycle at 6%. We continue to view the interest rate expectations embedded in the forward-rate agreement market as being too aggressive given our inflation forecasts and the dampening effect of higher interest rates on economic activity.