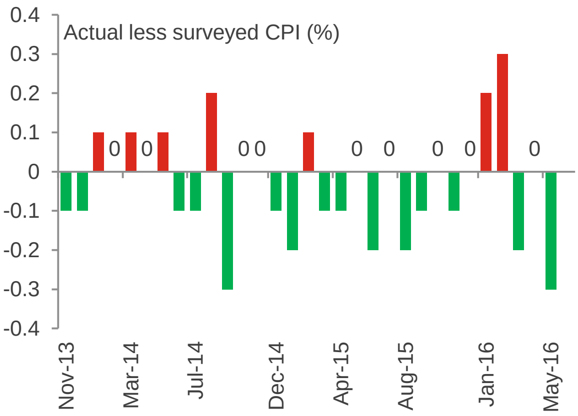
From left to right: Herman van Papendorp (Head of Macro Research and Asset Allocation), Sanisha Packirisamy (Economist)

May headline inflation print surprises positively

Smaller-than-expected rise in food prices leads to positive inflation surprise

Headline inflation dropped to 6.1% in May in year-on-year terms, undershooting our own (6.3%) and the Bloomberg consensus (6.4%) forecast (see chart 1). In monthly terms, inflation rose by 0.2% partly owing to an increase in transport prices.

Chart 1: Headline CPI undershoots market expectations



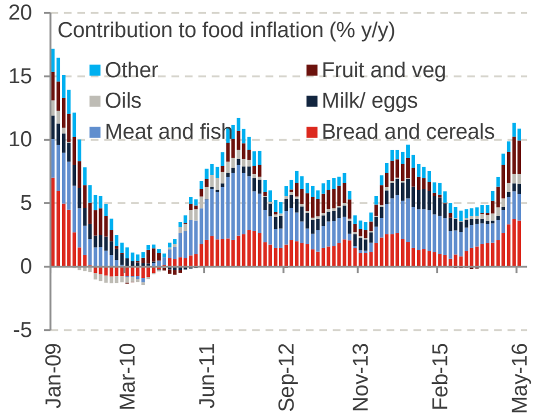
Source: Stats SA, Bloomberg, Momentum Investments

May is traditionally quite a low survey month, with only c.2% of the basket surveyed in addition to the normal monthly surveys. Relative to our own forecasts, the price increases related to food, clothing, furniture and hotels surprised to the downside, while price increases in vehicles, restaurants, banking and insurance fees surprised to the upside.

Milder-than-expected uptick in food prices

The momentum in food price inflation slowed, increasing by a mere 0.2% m/m. This is significantly lower than the average 2% m/m increase experienced over the previous four months. As a result, food inflation dipped to 10.8% in May from 11.3% in April in year-on-year terms. The largest contributor to the overall rise in food inflation remains prices of bread and cereals (see chart 2), followed by fruit/vegetables. Inflation reached 14.9% y/y in the bread and cereals category in April, but reversed course to 14.5% y/y in May. Volatile fruit and vegetable inflation slowed to 12.8% y/y and 21.4% y/y, respectively, from 19.6% y/y and 23.0% y/y in April.

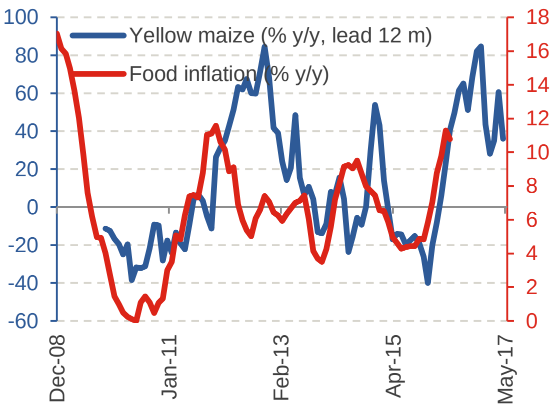
Chart 2: Food inflation dips in year-on-year terms



Source: Stats SA, Global Insight, Momentum Investments

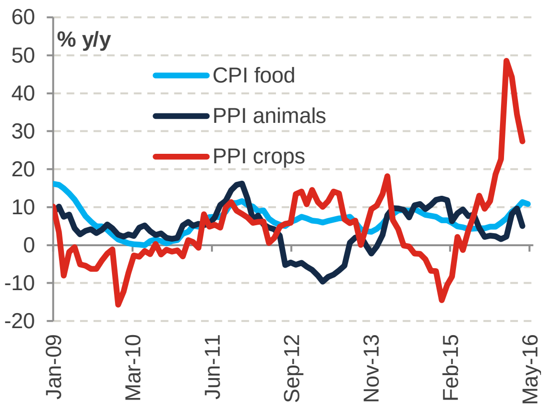
A recent reversal in maize prices bodes well for food inflation further down the line. Leading the rand value of yellow maize prices (% y/y) by twelve months suggests an improvement in the food inflation trajectory in 2017 (see chart 3). This downward move has already been partly captured at the producer price inflation (PPI) level, where PPI crop inflation reversed sharply from 44.3% y/y in February to 27.3% y/y in April (see chart 4).

Chart 3: Maize prices stabilising and turning lower



Source: Stats SA, Global Insight, Momentum Investments

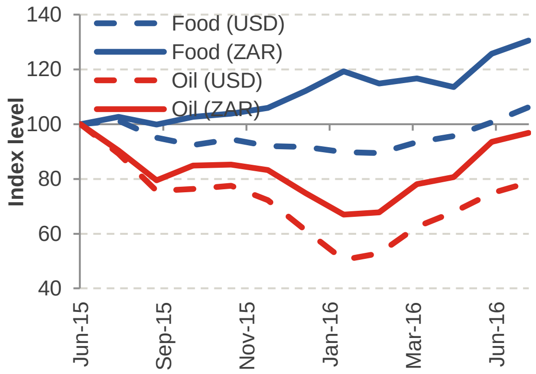
Chart 4: Crop inflation at PPI level reversing



Source: Stats SA, Global Insight, Momentum Investments

Nonetheless, short term risks remain. Imports to cover SA's maize shortfall are expected later in the year which could drive food prices higher before more favourable weather conditions drive food inflation lower in 2017. Moreover, global food prices, although still low, have started ticking up in recent months (see chart 5).

Chart 5: Global food prices inching higher (% y/y)

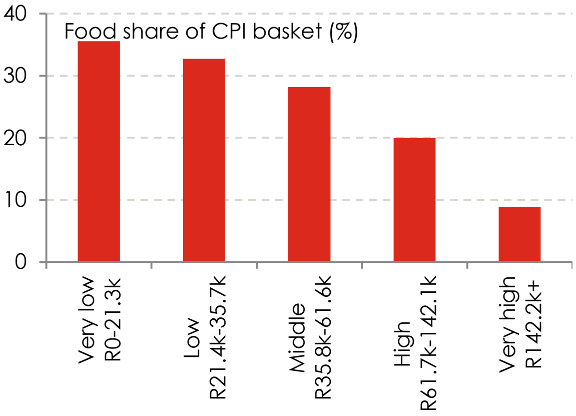


Source: Stats SA, Global Insight, Momentum Investments

Low-income households hit by rising food inflation

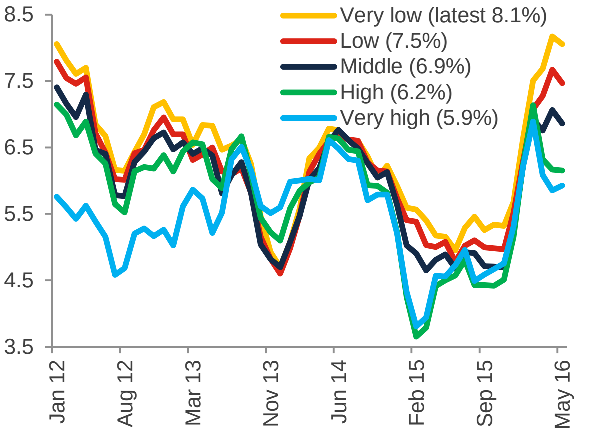
Low-income households (classified as earning under R21 300 per annum) are more heavily exposed to rising food inflation given that over 35% of their basket is allocated to food costs (see chart 6), while less than 10% of the very high-income earners' (classified as earning above R142 200 per annum) consumer basket is spent on food. It is this discrepancy that has led to a major divergence (over a 2% gap) in consumer price inflation outcomes between the various income-earning groups (see chart 7).

Chart 6: Low-income highly exposed to food inflation



Source: Stats SA, Momentum Investments

Chart 7: Low-income experiencing higher inflation (% y/y)

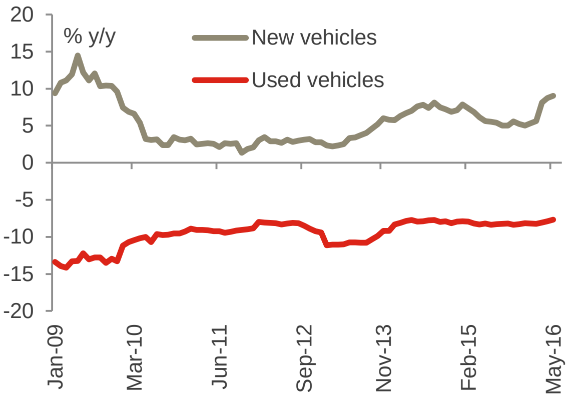


Source: Stats SA, Momentum Investments

New vehicle prices on the rise

Prices in the vehicle market continue to reflect steep increases in the new vehicle market (+9.0% y/y in May) related to previous currency depreciation, while used vehicle prices dropped by 7.7% y/y (see chart 8). According to the National Association of Automobile Manufacturers of SA (Naamsa), new vehicle prices could rise between 10% and 15% this year, putting further downward pressure on new vehicle sales.

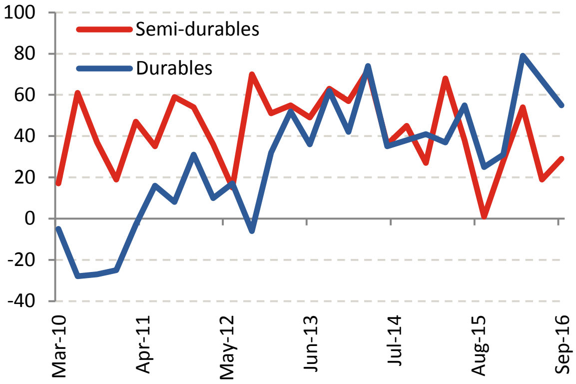
Chart 8: New vehicle inflation increases further over May



Source: Global Insight, Momentum Investments

Mounting headwinds for the SA consumer, including weak employment growth, low credit extension, rising interest rates and muted consumer confidence, have depressed discretionary goods sales volumes. Although 82% of semi-durable (clothing) retailers surveyed by the Bureau of Economic Research (BER) suggest that purchase prices have increased, only 29% plan to increase selling prices over 3Q16 (see chart 9).

Chart 9: Percentage of retailers experiencing an increase in average selling prices



Source: Global Insight, Momentum Investments, 3Q16 = expected (previous = realised)

Core inflation slightly below expectations

Core inflation (excluding food, beverages, petrol and energy) declined to 5.5% y/y in May from 5.7% in February, despite clear indications of rand-related price pressure in recent months. We expect core inflation to track marginally higher over upcoming months, but to remain below the upper band of the 3% - 6% inflation target band.

Reserve Bank likely to hold interest rates steady at July Monetary Policy Committee meeting

Even after taking today's positive surprise on inflation into account, we expect inflation pressures to build towards year end on the back of higher food prices and pass-through from previously unfavourable currency movements. Potential currency shocks and wage cost pressures provide significant upside risks to the inflation trajectory, which is expected to remain outside the target band in upcoming quarters. Moreover, inflation expectations (businesses and trade unions in particular) remain stubbornly high posing a threat to second-round inflation pressures.

In addition, a still-elevated current account deficit and recent comments by the SA Reserve Bank (SARB), suggesting that monetary policy remains highly accommodative, suggest that a further 25 basis point hike later this year is still likely. However, the SARB is unlikely to do more in response to subdued growth expectations and depressed confidence levels pointing to a shallow growth recovery.