momentum investments

The Macro Research Desk

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

SARB presses the pause button and keeps interest rates steady at 7%

Important downside risk for the world economy materialises

In its latest World Economic Outlook Update, the International Monetary Fund (IMF) noted that the global outlook for 2016/17 has worsened on the back of an increase in political uncertainty. This is likely to have negative repercussions for confidence and investment as well as growth prospects ultimately. The IMF's baseline projections have largely been revised in advanced European economies with a limited impact elsewhere. Nevertheless, the IMF warns that a larger than expected increase in economic barriers, further disruptions to financial markets and a more severe political fallout following the referendum could result in an increasingly negative outcome. Whereas the IMF's baseline scenario assumes real global GDP growth of 3.1% in 2016 and 3.4% in 2017, a more adverse outcome (arising from an intensification of financial stress in advanced Europe, tighter financial conditions and a larger knock to sentiment) could see growth lower at 2.8% in 2016 and 2017.

The IMF warns that although the scope for short-run demand support varies across emerging economies, it may be limited in periods of heightened global risk aversion and as such policymakers should build a buffer against persistent global financial turbulence and increasingly challenging external financial conditions.

The South African Reserve Bank (SARB) once again noted that heightened uncertainty clouds the outlook for monetary policy. In its assessment of the global economic backdrop, they mentioned a number of key economic risks threatening the outlook for global economic activity, ranging from geopolitical risks to lower commodity prices. The Monetary Policy Committee (MPC) views the outlook for domestic economic growth as "extremely challenging" and anticipate a weak recovery to follow the first quarter contraction in real GDP growth. While growth estimates were revised sharply lower, the marginal improvement in the outlook for inflation (thanks to recent developments in the currency) has created some breathing space for the SARB.

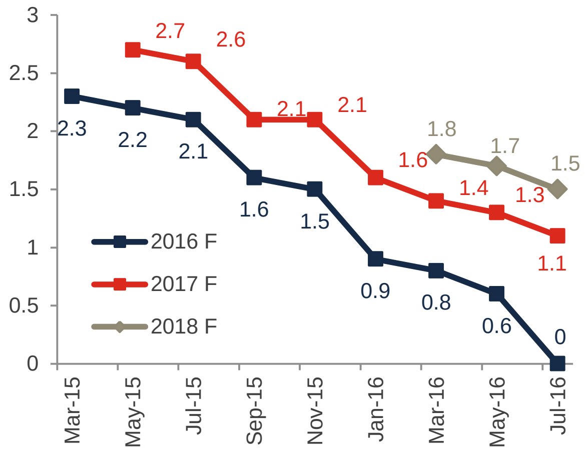
Today's interest rate decision was in line with our and the market's expectation. All 25 respondents to the Bloomberg survey expected the repurchase rate to remain steady at 7.0%, with the forward rate agreement (FRA) market having priced in a relatively low probability (c.10%) of a 25 basis point hike in the run up to the meeting.

SARB grows increasingly bearish on the domestic growth outlook

The Bank slashed its growth estimates from 0.6% in 2016 to 0% and from 1.3% in 2017 to 1.1% (see chart 1) in response to further downside surprises. In the Q&A session, the Reserve Bank governor stated that real GDP in the remainder of the year would have to grow between 2.1% and 2.5% per quarter for the rest of the year to meet its May 2016 real GDP growth estimate of 0.6%. The downward revision to 0% is based on the expectation that real GDP growth ranges between 0.8% and 1% per quarter for the remainder of 2016.

In our own internal forecasts, we see real GDP growth closer to 0.5% in 2016 given healthier than expected high-frequency data in May 2016, whereas our 1% growth estimate for 2017 is largely in line with that of the Bank. That said, we acknowledge downside risks to this year's growth forecast posed by downbeat domestic confidence.

Chart 1: SARB real GDP forecast revisions (% y/y)



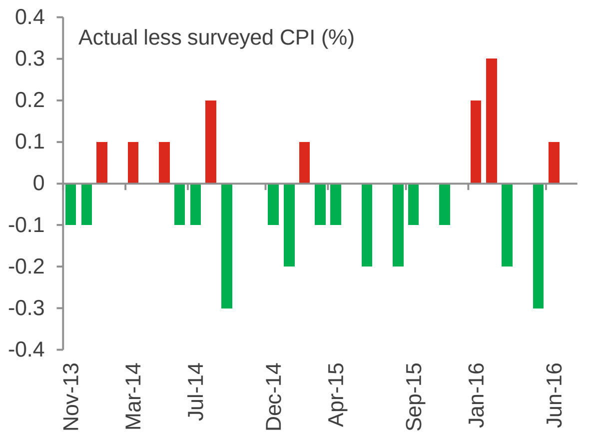
Source: SARB, Momentum Investments

Depressed sentiment and a weak lead indicator have driven the downward revisions in the SARB's growth forecasts. The Reserve Bank's assessment of trend growth has further been pared back in the latest set of assumptions. The SARB sees potential output at 1.4% in 2016 (previously 1.6%), edging higher to 1.7% (previously 1.8%) in 2017.

Medium-term trajectory for inflation still a concern, despite improvement in near-term prospects

Successive downside surprises in the headline rate of inflation (see chart 2) have led to an improvement in the near-term prospects for inflation, with this trend extending to core (headline excluding food and energy) inflation. The SARB has pencilled in currency forecasts that are weaker than current levels in order to provide a buffer to the projections given that the outlook for the currency remains highly uncertain on the back of the currency's sensitivity to domestic and external event risk.

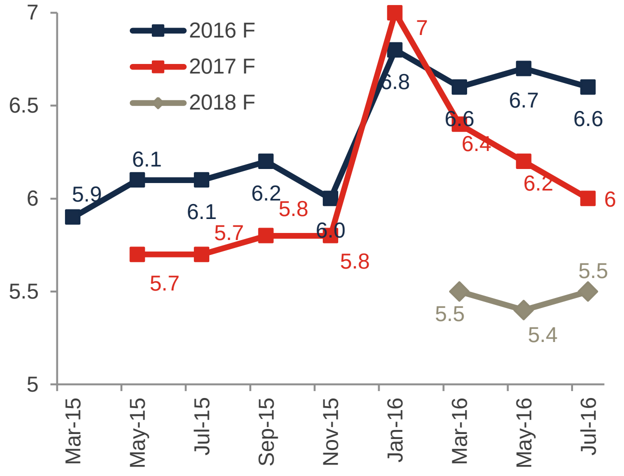
Chart 2: CPI has surprised to the downside more often than not in recent history



Source: Stats SA, Bloomberg, Momentum Investments

The MPC shaved 0.1% off its inflation forecast for 2016 from 6.7% in May 2016 to 6.6% (marginally higher than our own internal forecast of 6.4%) in its latest set of assumptions (see chart 3), while cutting its 2017 forecasts by 0.2% to 6.0% (0.2% higher than our own internal forecast of 5.8%). The downward revision in the Bank's inflation assumptions have largely been on the back of lower administered price inflation (mostly petrol), more than offsetting a modest upward revision in its assumption on international oil prices from USD42/bbl in May 2016 to USD44.6/bbl in July 2016

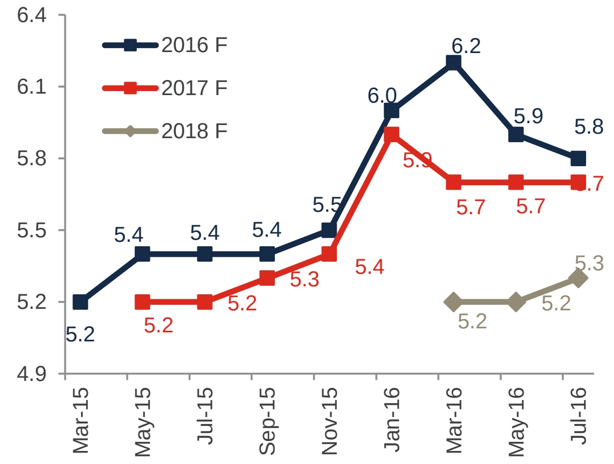
Chart 3: SARB headline CPI forecast revisions (%)



Source: SARB, Momentum Investments

The MPC's outlook for core inflation improved marginally in the near term from 5.9% to 5.8% for 2016 as a whole, but has inched higher in the longer term from 5.2% to 5.3% in 2018 (see chart 4). The SARB had previously forecasted the core inflation measure to remain outside of the target band for a period of four quarters from 3Q16 onwards, but recent revisions are expected to leave the core inflation estimate outside of the target for a period of one quarter only in the final quarter of 2016.

Chart 4: SARB core inflation forecast revisions (%)

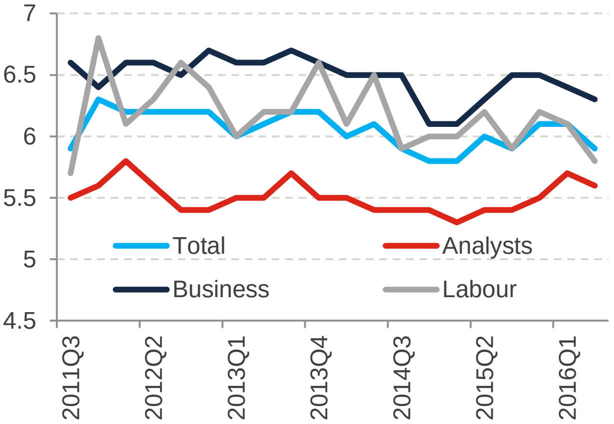


Source: SARB, Momentum Investments

Average inflation expectations remained relatively anchored at the upper end of the inflation target

The Bureau of Economic Research's (BER) Inflation Expectations Survey results for the second quarter of 2016 revealed that average expectations for 2016 drifted higher from 6.2% to 6.3%. Average expectations for 2017 remained steady at 6.2% and edged lower to 5.9% for 2018. On a five-year view, total average inflation expectations moved encouragingly lower to 5.8% from 6.1%. Meanwhile, on a disaggregated basis, businesses' expectation of longer-term inflation remained elevated at 6.3% (see chart 5). In previous statements the MPC warned over the potential for second-round inflation impacts stemming from high inflation expectations by the price-setters of the economy, namely businesses and trade unions. With the current inflation trajectory expected to remain outside the target band for an extended period of time, the threat of second-round inflation pressures remains concerning.

Chart 5: Average five-year inflation expectations (%)



Source: SARB, Momentum Investments, data up to 2016Q2

Unanimous vote by committee members

Though a high degree of uncertainty remains, the Q&A session revealed that a rate cut was "not seriously considered" given the discrepancy between risks in the short term and those in the longer term. The SARB continues to view upside risks to the longer term inflation and currency profile despite near-term relief and have reinforced that the MPC remains ready to react appropriately to any significant change in the inflation outlook.

Table 1: Committee members' views more aligned in the recent two meetings

No. of committee members	Favoured no hike	Favoured 25 basis point hike	Favoured 50 basis point hike	Favoured a 25 basis point cut
19 November 2015	2	4	-	-
28 January 2016	1	2	3	-
17 March 2016	3	3	-	-
19 May 2016	5	1	-	-
21 July 2016	6	-	-	-

Source: SARB, Momentum Investments

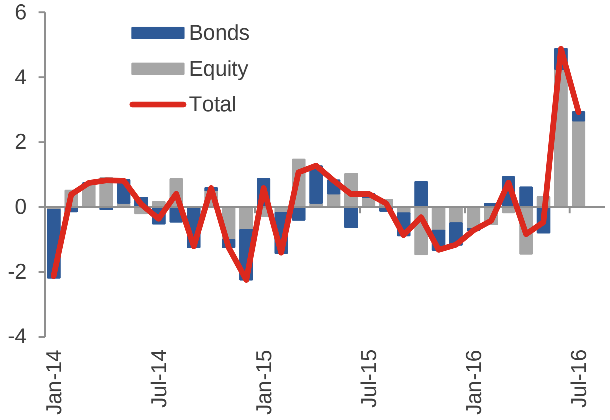
Less hawkish tone, but SARB has not ruled out the potential for further interest rate tightening

Internationally expectations of further interest rate hikes have been pushed back as the market interpreted the Brexit outcome as growth negative, instead looking for further monetary support by global central banks. While the European Central Bank (ECB) kept its deposit rate at minus 0.4% and the main refinancing rate at 0% (both at record lows) at today's interest rate decision meeting, it also left unchanged its guidance that rates would stay at current or lower levels for an extended period and well beyond its asset purchase horizon. Nevertheless, the ECB is expected to release revised economic forecasts at its September rate-setting meeting, where the market anticipates additional stimulus measures to be announced.

A recovery in economic data surprises in the United States (US) has led to a repricing in interest rate expectations implied in the fed futures market. However, the probability of an interest rate hike by the end of the year remains below 50% at 47%, despite having increased from 12% at the beginning of the month.

The increased expectation of interest rates on a global scale to remain lower for longer, in response to the lack of clarity regarding the Brexit process going forward, has led to a recovery in the rand in recent weeks. Even so, the SARB has warned against a rise in currency volatility owing to adverse changes in global risk perceptions. A global search for yield was put forward by the Reserve Bank as a key driver of recent rand strength. Even though a sharp increase in non-resident inflows, into the equity market in particular, has been observed in June and July to date (see chart 6), the MPC cautioned against possible changes in US monetary policy expectations and the possibility of a ratings downgrade later in the year.

Chart 6: Net foreign portfolio inflows into SA (USD bn)



Source: INET BFA, Momentum Investments, end point = July 2016 to date

With risks to the inflation outlook still assessed to be to the upside (although less so relative to the previous meeting) and inflation expectations still recording at uncomfortable levels, the Bank remains mindful of potential second-round impacts which could lead to more generalised price pressures in the remainder of the consumer basket. As such, we cannot rule out the possibility of a further interest rate hike of 25 basis points before the year is up.

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