momentum

investments

The Macro Research Desk

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Interest rate policy held steady, but tone remains cautious

Interest rates steady in line with expectations

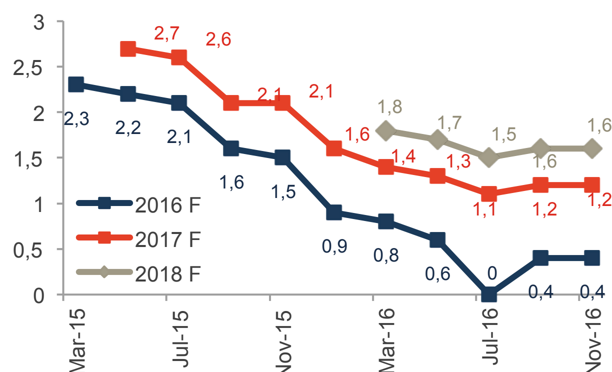
Yesterday's interest rate decision was in line with the market's expectation. All 15 respondents to the Bloomberg survey expected the repurchase rate to remain on hold at 7.0%.

Domestic growth outlook set to improve in 2017

The SA Reserve Bank (SARB) kept its growth projections steady at 0.4% in 2016, 1.2% in 2017 and 1.6% in 2018 (see chart 1). The Monetary Policy Committee (MPC) warned that the high degree of uncertainty surrounding the economic policies of the new administration in the United States (US) has created a more challenging environment for emerging markets (EM). The prospect of rising protectionism in particular has negative implications for already-weak global trade activity. The SARB noted that the sustainability of the recovery in China has also come under scrutiny once again given Trump's earlier proposals for steep tariff increases on Chinese exports.

Our own internal real GDP forecasts for 2016 and 2017 do not differ markedly from those of the SARB (0.3% in 2016 and 1.0% in 2017), but we expect a slightly better outcome of 1.9% in 2018. We anticipate a rise in global GDP growth, a mild uptick in commodity prices, better weather conditions and dissipating energy supply constraints to underpin a marginal recovery in domestic growth in 2017 and 2018.

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



Source: SARB, Momentum Investments

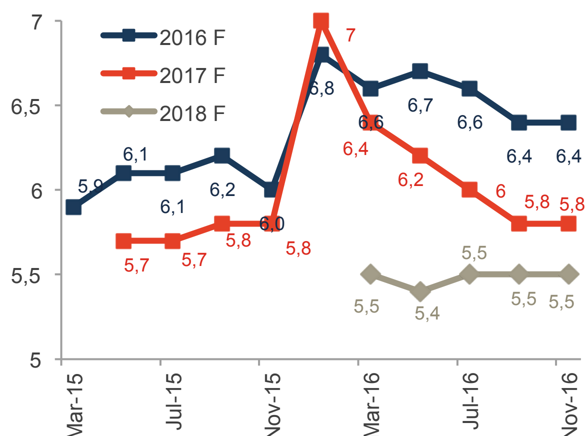
The SARB lowered its estimate of potential growth to 1.3% in 2016 from 1.4% at the September 2016 rate-setting meeting. Forecasts for 2017 and 2018 were also downwardly adjusted by 0.1% and 0.2% to 1.4% and 1.5%, respectively. Although these figures suggest a negative output gap (actual growth undershooting potential GDP in level terms) over the forecasted period, the SARB mentioned that risks to the growth outlook remain fairly balanced at this stage.

Inflation risks have risen moderately

The SARB's inflation forecast has remained broadly unchanged over the forecasted horizon (see chart 2) at 6.4% in 2016 (compared to our own internal forecast of 6.3%) and 5.8% in 2017 (relative to our projection of 5.6%). It expects inflation to peak at 6.6% in the final quarter of 2016, which is a tad lower than previously estimated. In line with our own expectations, the SARB envisages a sustained return to within the inflation target range during the second quarter of 2017.

In the SARB's underlying inflation assumptions, a slightly more appreciated exchange rate assumption has offset a higher-than-expected outcome on food inflation. It still anticipates a modest rise in international oil prices from an average of USD44/bbl in 2016 to USD53.5/bbl in 2017, but a more appreciated exchange rate assumption has left the SARB's expected petrol price inflation figures (feeding into administered prices) at a lower level in 2017.

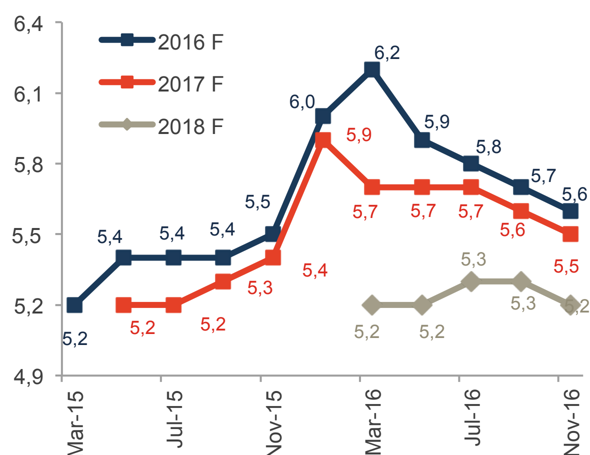
Chart 2: SARB headline CPI forecast revisions (%)



Source: SARB, Momentum Investments

The SARB's forecast on core inflation has migrated lower to 5.6% in 2016 and 5.5% in 2017 (see chart 3), but remains above our own internal forecast for a decline from an estimated 5.6% in 2016 to 5.1% in 2017. A recent working paper by the Reserve Bank points out that SA retailers do not pass on all the costs (associated with a depreciation in the rand) to the consumer. Exchange rate pass-through also shows signs of asymmetry in SA. Pass-through tends to be more muted in economic downturns in SA as retailers abstain from adjusting their prices and instead prefer to maintain their market share.

Chart 3: SARB core inflation forecast revisions (%)



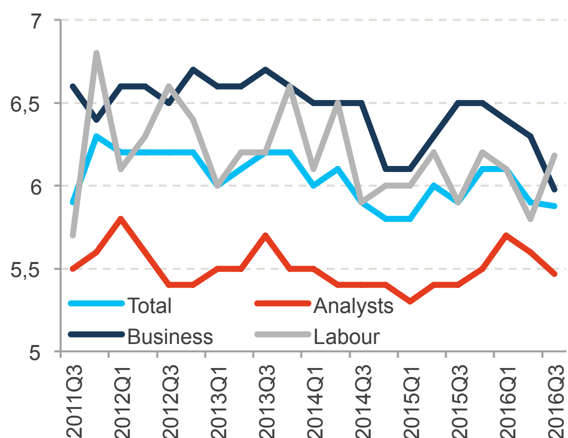
Source: SARB, Momentum Investments

The MPC signalled that risks to the inflation outlook have risen moderately. The local currency is still a key source of upside risk given that it remains sensitive to changes in the stance of US monetary policy as well as decisions regarding SA's credit ratings later this year. Moreover, nominal wage settlements remain in excess of inflation despite showing signs of moderating. The Andrew Levy Employment Publications Survey reported that the average wage settlement rate in collective bargaining agreements slowed to 7.1% in the third quarter of the year, leaving the year-to-date average at 7.5%. The MPC hinted that this could be a sign that wage settlements are becoming increasingly sensitive to a weak jobs market.

Average inflation expectations shifting lower, but still uncomfortably close to the upper end of the inflation target

The Bureau of Economic Research's (BER) Inflation Expectations Survey results for the third quarter of 2016 revealed that average expectations for 2017 declined from 6.2% in the second quarter of the year to 6.0% in the third quarter of the year. The decline in the forecast was largely owing to downward revisions made by analysts and businesses, while trade unions kept their inflation forecasts unchanged. Five-year forecasts improved from 6.3% to 6.0% for businesses, which was the lowest level recorded since they were first surveyed in 2011 (see chart 4). Yet it remains worrying that expectations are at the upper limit of the 3% - 6% inflation target range. As such, the threat of second-round inflation pressures remains.

Chart 4: Average five-year inflation expectations (%)



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

Unanimous vote by committee members

An unchanged outlook on domestic growth, constrained by weak business and consumer confidence, together with marginal upside risks to the SARB's inflation forecasts left the committee members agreeing on keeping rates unchanged.

Table 1: Committee members' views more aligned in recent 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	-	-	-
22 September 2016	6	-	-	-
24 November 2016	6	-	-	-

Source: SARB, Momentum Investments

Trump's presidency could usher in an era of dollar strength

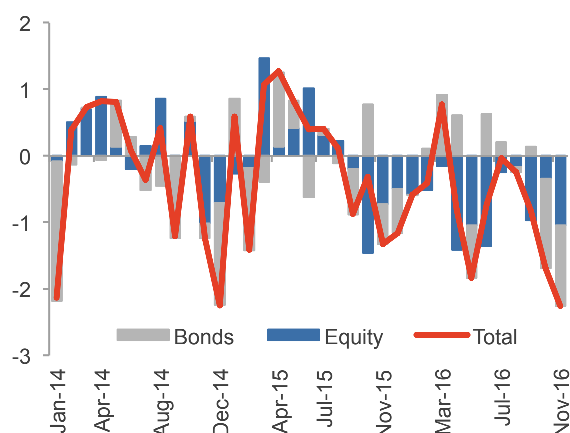
In the wake of the United States (US) election outcome, analysts are expecting that Trump's promised policies announced in the run up to the November 2016 election could usher in an era of dollar strength, spurring inflation and further interest rate hikes from the US Federal Reserve (Fed). A negative adjustment in foreign capital inflows into EM could trigger rand weakness which, if sustained, could manifest in higher inflation rates for SA. Following the US election results, the SARB governor confirmed that any longer-term impacts influencing domestic inflation (and affecting second-round inflationary pressures) could imply a change in SA's monetary policy stance, altering the trajectory of the current interest rate cycle.

The Fed minutes from the November 2016 rate-setting meeting in the US showed that Fed officials increasingly believe that the Fed should raise interest rates soon, provided that incoming data confirms further improvements in the labour market and progress towards the committee's 2% inflation target. The Fed funds futures are now indicating a 100% chance for a December 2016 rate hike and a 64.9% probability of another hike in June 2017.

Cautious stance on the interest rate outlook

EM outflows have accelerated in line with a rise in US bond yields. According to SBG Securities, EM economies have seen outflows from debt and equity portfolio assets totalling USD7.3 billion since the outcome of the US elections. SA experienced the fourth-largest outflow from equities and the largest debt outflow over the corresponding period when compared to key emerging economies. For the month to date, net foreign portfolio outflows from SA have accelerated to levels last observed two years ago (see chart 5). With the credit rating reviews around the corner (Moody's set to publish its review on November 25 and Standard and Poor's (S&P) Global Ratings on December 2), inflows are likely to be limited. Although recent announcements suggesting that some progress is being made in relation to labour market reforms, which could stave off a downgrade to junk status by S&P this time around, the underperformance of potential growth in relation to SA's population growth could still trigger a downgrade to sub-investment grade in June 2017, in our view.

Chart 5: Net foreign portfolio inflows into SA (USD bn)



Source: INET BFA, Momentum Investments, November 2016 includes month-to-date data

In the Q&A session, the governor suggested that a positive repricing in domestic assets is possible in the event that a downgrade does not materialise in SA, particularly if it has already been priced in at this stage. He reiterated that the SARB does not follow US interest rate moves “basis point for basis point” and stressed that the SARB commenced the current interest rate hiking cycle early on in order to deal with inflationary pressures. A rate hike in the US, should it be in response to higher US growth and an acceleration in inflation, could be good news for emerging economies, including SA. Nevertheless, he cautioned against the potential for second-round inflationary impacts, suggesting that domestic interest rate policy would be forced to respond.

Although domestic inflation is expected to come back within the target on a more sustainable basis by the second quarter of next year, the MPC will most likely keep a watch on the degree of monetary policy tightening in the US over upcoming months, particularly if this is not viewed as a short-term risk to the local currency and consequently the domestic inflation outlook.

As such, we cannot rule out the possibility of a further interest rate hike of 25 basis points early in 2017, but we maintain our view that we are likely close to the end of the current rate hiking cycle. With lingering upside risks to the inflation profile, elevated inflation expectations, signs of sticky core inflation and an elevated current account deficit requiring an attractive real interest rate profile to ensure foreign funding, we see limited scope for imminent interest rate cuts.

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