momentum investments

The Macro Research Desk

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June 2017 headline inflation drops to 5.1% in line with expectations

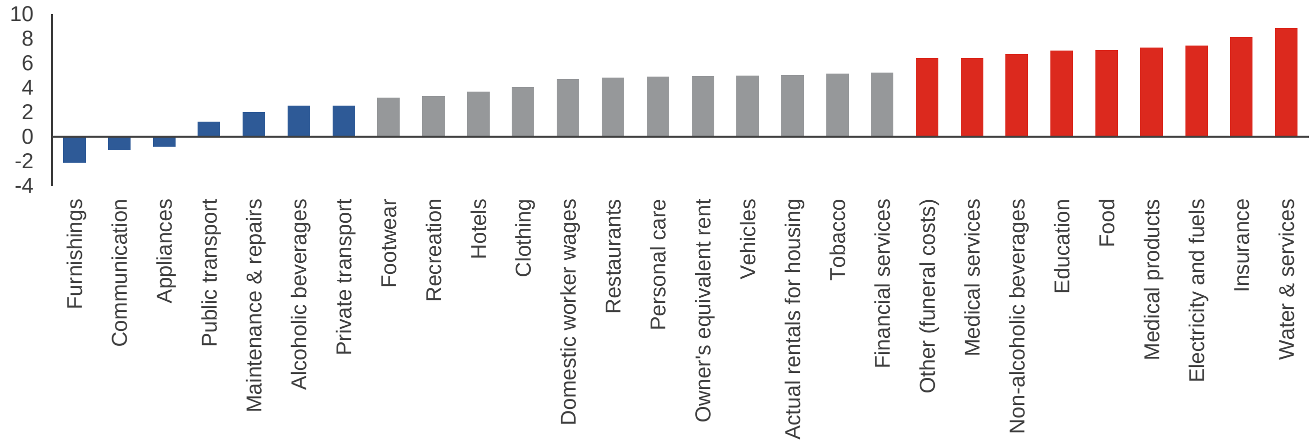
Inflation in nearly two thirds of the inflation basket is tracking below the upper 6% band of the inflation target

Headline inflation measured by the consumer price index (CPI) drifted lower to 5.1% in year-on-year (y/y) terms for June 2017 from 5.4% previously, meeting the market's and Momentum Investments' expectations. June is a relatively high survey month, with an additional 36% of the basket being surveyed relative to the monthly surveys. One of the largest survey items, rentals, performed in line with expectations (5% y/y). Meanwhile, price increases for non-alcoholic beverages, furnishings, vehicles, restaurants and hotels surprised slightly to the downside.

Marginal upside surprises were noted in the price increases for domestic worker wages, alcoholic beverages, personal care and insurance.

The breakdown of the CPI basket suggests that inflation in nearly two thirds of the items (on a weighted basis) is comfortably below the upper end of the 3% to 6% inflation target range (see chart 1), which is nearly 15% higher than the average recorded for the past twelve months.

Chart 1: Inflation rate per category (% y/y)

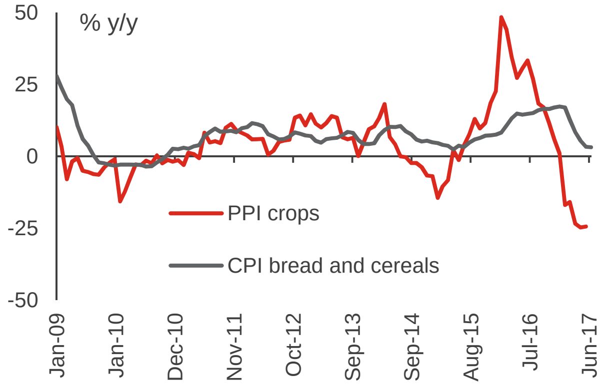


Source: Stats SA, Global Insight, Momentum Investments, blue = below inflation target band, grey = within inflation target band, red = above inflation target band

Food prices moved sideways during the month

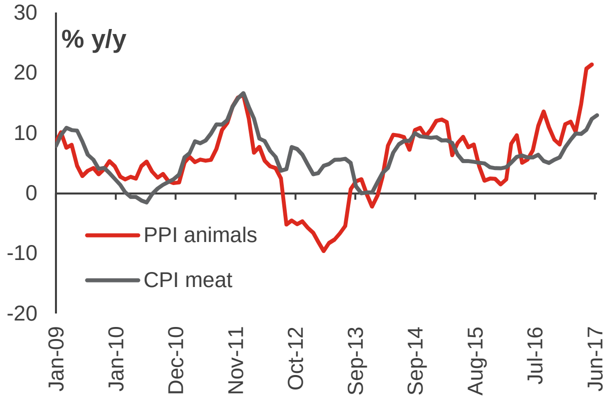
Food prices stayed flat in month-on-month terms in June 2017. A 0.6% uptick in meat prices was largely offset by a slight 0.1% decline in bread and cereals prices and a more substantial 2.3% and 3.9% decrease in fruit and vegetable prices, respectively. Agricultural prices at the crop level, under the producer price index (PPI) data, showed a sharp decline in prices, as supply expectations rose on the back of improved weather conditions. Inflation in the bread and cereals category decelerated from 17.4% y/y for December 2016 to 3.1% y/y for June 2017 (see chart 2). However, bread and cereal prices, which account for a third of the food basket, are being partially offset by higher meat inflation. Animal prices at the PPI level are more than 20% higher than they were a year ago, due to the limited availability of slaughter stock, which continues to filter through into higher meat prices at the consumer level. Currently, South African (SA) consumers are paying 13% more for meat products than they were a year ago (see chart 3).

Chart 2: Deflation at PPI level for crops persists



Source: Stats SA, Global Insight, Momentum Investments

Chart 3: High PPI meat prices filtering through



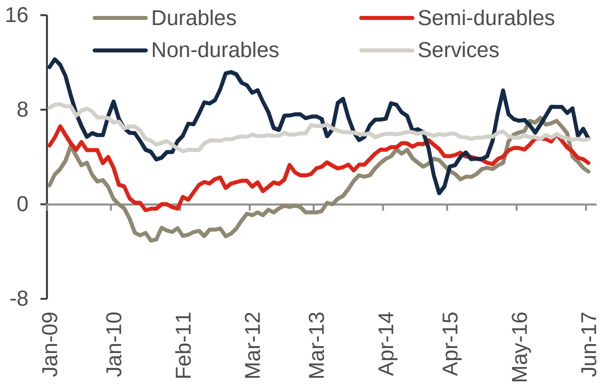
Source: Stats SA, Global Insight, Momentum Investments

The crops estimates committee announced their fifth production forecast for commercial maize remained unchanged at 15.6 million tonnes, which could register as the largest-produced crop on record. Increased supply expectations have exerted downward pressure on grain prices. Moreover, healthy global stock levels should keep prices low and weather conditions in the United States are shaping up well for grain production this season. Although only between 10 and 10.5 million tonnes are likely to be used for domestic consumption, Santam has warned the amount exported may be limited given the country's difficulty in competing on the global market. While concerns of an impending El Nino weather pattern (often associated with periods of warmer and drier conditions in SA) had been raised earlier in the year, the Australian Government Bureau of Meteorology suggests that models are now pointing to neutral conditions for the second half of the year, boding well for food inflation trends.

Remarkably steady services inflation, while goods inflation falls further

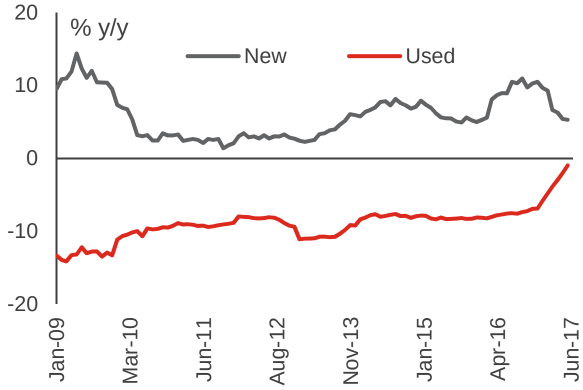
Services inflation has tracked within a narrow band for the best part of four and a half years, while goods inflation has dropped in response to weaker consumer demand (see chart 4). Within durable goods, new vehicle inflation slowed from 11% y/y for September 2016 to 5.3% y/y for June 2017, while used vehicle deflation reversed from negative 7.4% to negative 1% y/y for the corresponding period (see chart 5). The National Association of Automobile Manufacturers of SA (Naamsa) admitted the number of domestic new vehicle sales is likely to remain flat in 2017 from 2016 levels, as consumers remain pessimistic about the outlook for the local economy.

Chart 4: Falling goods inflation (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

Chart 5: New and used vehicle prices (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

Underlying measures of inflation steady for June 2017

Core inflation (headline excluding food, beverages and petrol) remained steady at 4.8% y/y for June 2017 from a month earlier. This rate is notably lower than the 5.4% average for the past twelve-month period. Disinflation in core goods has largely been responsible for the downward trend in overall core inflation, while core services inflation has persisted at higher levels.

Although core inflation is expected to remain below 5% in upcoming months, the lower rate of currency pass-through observed recently suggests that inflation may not experience the full benefit of previous rand strength. Momentum Investments expects core inflation to average 4.9% for 2017, declining to 4.6% for 2018.

SA Reserve Bank (SARB) to exercise caution at upcoming meeting, but narrative could sound more 'dovish'

In Momentum Investments' view, the latest Monetary Policy Committee (MPC) statement (May 2017) signalled an end to the interest rate hiking cycle, while lower-than-expected growth and positive inflation surprises have likely lowered the bar for interest rate cuts. Ongoing disinflation is expected to lead to a rise in real interest rates (nominal less inflation). This should allow the SARB to consider easing monetary policy by up to 50 basis points. Though Momentum Investments expects the SARB MPC to lower its inflation and growth forecasts at the upcoming meeting (given a disappointing first-quarter growth print and lower-than-anticipated inflation figures relative to the SARB's earlier forecasts), interest rate cuts are likely be deferred, as rand risks (in light of continued political and sovereign ratings uncertainty) continue to provide an upside threat to the inflation trajectory. This remains the case, particularly as inflation expectations are still uncomfortably anchored at the top end of the inflation-target band.