The Macro Research Desk

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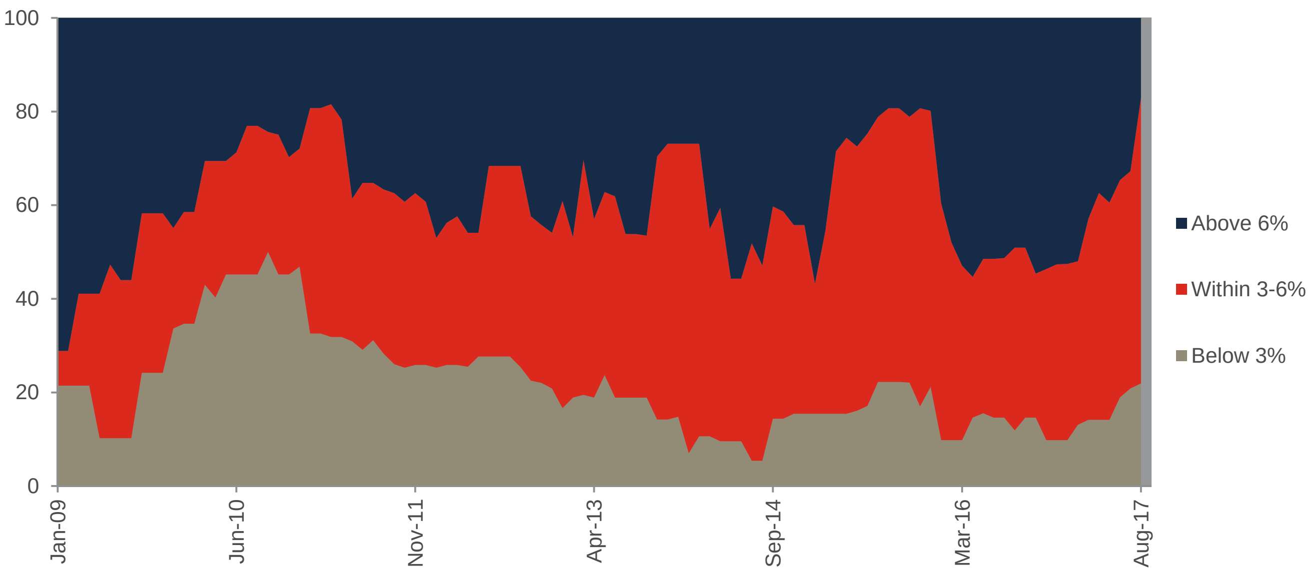
August 2017 headline inflation prints below consensus

Smallest share of the inflation basket exceeding the top end of the target band since 2009

Consumer price inflation (CPI) ticked higher to 4.8% in year-on-year (y/y) terms in August 2017, which was below the market's and Momentum Investments' expectations. In addition to the usual monthly surveys, 19% of the basket (including municipal assessment rates and television licences) was surveyed. Relative to Momentum Investments' forecasts, monthly price changes for food (negative 0.2%), non-alcoholic beverages (negative 0.6%), vehicles (0.2%) and personal care (negative 0.1%) surprised to the downside, while price increases came in above expectations for alcohol (1.9%). The breakdown of the CPI basket suggests inflation in more than 80% 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 the highest on record since the implementation of the new basket in 2009, before which a meaningful comparison is difficult to make.

Chart 1: Portion of inflation basket trading below, within and above the target band (%)

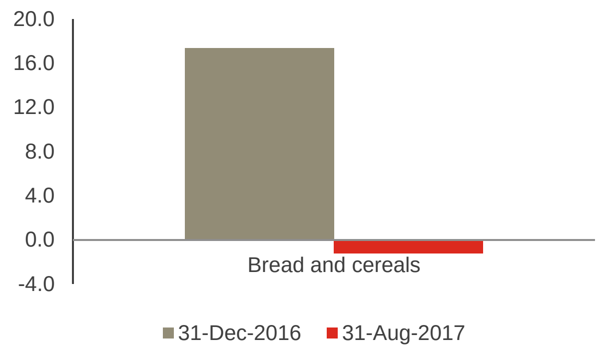


Source: Stats SA, Global Insight, Momentum Investments

Bread and cereal prices shift into deflation

The 0.2% drop in food prices in month-on-month (m/m) terms in August 2017 (5.7% y/y) was largely driven by the 1.1% decline in bread and cereal prices. With South Africa's (SA) maize crop set to double last year's harvest, high crop yields are keeping prices low. Bread and cereal inflation dropped from 17.4% y/y in December 2016 into outright deflation of 1.2% y/y in August 2017 (see chart 2).

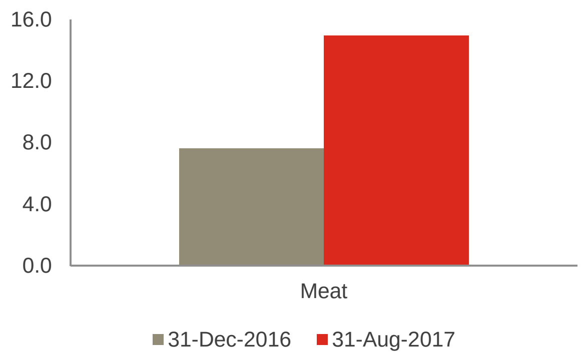
Chart 2: Bread and cereals inflation (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

Meat prices on the other hand, which account for more than a third of the food basket, are currently 15% higher than a year ago (see chart 3). Previously, farmers were rebuilding herds, following a high slaughtering rate in the previous season, given the drought-inflicted rise in feed costs. More recently, the rate of slaughtering has increased, suggesting SA is nearing the peak in meat prices. Avian flu outbreaks in the poultry industry may also be influencing rising meat prices. Chicken accounts for 14% of the overall food basket, while beef holds an 8% share, followed by pork and lamb, which together account for 5%.

Chart 3: Meat inflation (% y/y)

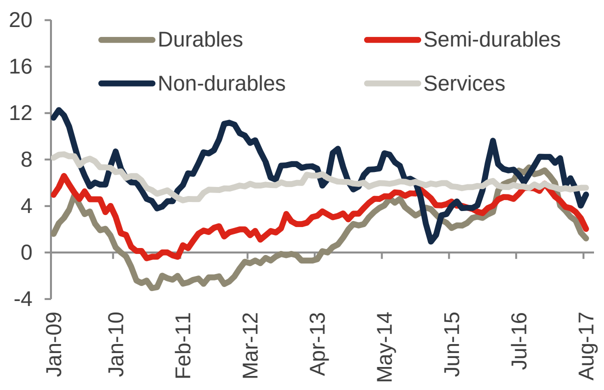


Source: Stats SA, Global Insight, Momentum Investments

Services inflation moves sideways, but goods inflation heads lower

Services inflation continues to track within a narrow band close to the upper end of the inflation target range, while goods inflation has dropped in response to weaker consumer demand (see chart 4). Within goods inflation, durables inflation shifted lower in August 2017, back to levels last seen in the third quarter of 2013. Furniture prices declined 3% y/y in August 2017, while inflation in the combined new and used vehicle category dropped to 3.5% y/y. Clothing inflation, which is the largest contributor towards semi-durables inflation, decreased to below 3% y/y in August 2017.

Chart 4: Goods and services inflation (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

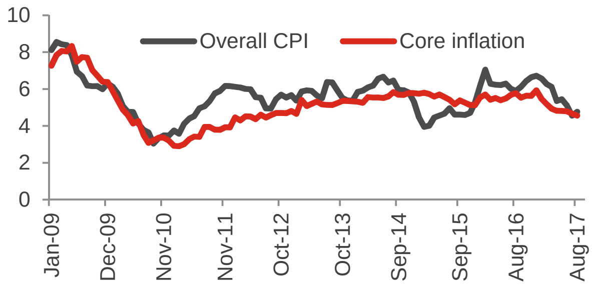
Underlying measures of inflation reaching levels last observed in the third quarter of 2012

Core inflation (headline excluding food, non-alcoholic beverages and petrol) declined from 4.7% y/y in July to 4.6% in August 2017 (see chart 5). This rate is notably lower than the 5.2% average for the past one-year 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% well into 2018, the lower rate of currency pass-through observed recently suggests inflation may not experience the full benefit of previous rand strength. Momentum Investments expects core inflation to average 4.8% in 2017, declining to 4.5% in 2018, while headline inflation is expected to average 5.4% in 2017 (he Reuters median forecast is 5.3%), dipping to 4.8% (the Reuters median forecast is 5.1%) in 2018.

Chart 5: Headline and core inflation (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

Further interest rate easing expected

The SA Reserve Bank's (SARB) medium-term headline and core inflation trajectories allow for a window of opportunity in which to cut interest rates by 25 basis points at its upcoming September 2017 Monetary Policy Committee meeting. If there are no prolonged negative currency adjustments following the credit rating agencies' updates and the ruling party's elective conference in December 2017, the SARB is likely to cut interest rates by an additional 25 basis points before the end of the first quarter of 2018. In the absence of increased certainty around the direction of economic policy, monetary policy alone is unlikely to solve the country's low growth problem. However, easier monetary policy will provide some relief to highly indebted households, albeit at the margin.