momentum investments

The Macro Research Desk

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Inflation continues on its downward trajectory in October 2017

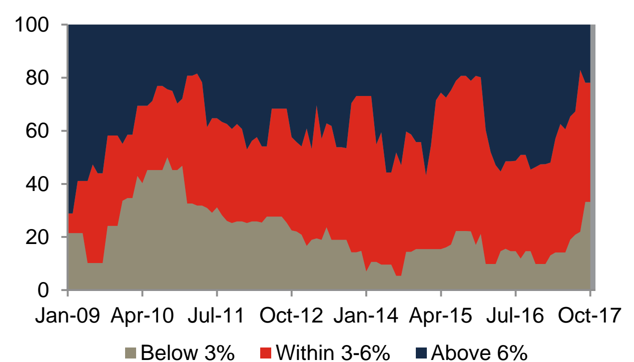
Highlights

- Majority of the items in the inflation basket are tracking below 6%
- Bread and cereal prices now 3% lower than a year ago
- Stubborn services inflation tracking close to the upper band of the target
- Underlying measures of inflation soften further
- Lower food inflation a big benefit to low-income earners
- Fiscal deterioration and vulnerability to further rating downgrades reduce chances of further easing for now

Majority of the items in the inflation basket are tracking below 6%

Consumer price inflation (CPI) edged lower to 4.8% in year-on-year (y/y) terms in October 2017, from 5.1% in September, registering broadly in line with the market's and Momentum Investments' expectations. October is generally a low-surveyed month, with only an additional 11% of the basket being surveyed (including funeral expenses, gym fees and television licences) in addition to the usual monthly surveys. Relative to Momentum Investments' forecasts, monthly price changes for food (0.8%) and alcoholic beverages (0.5%) surprised to the upside, while price increases came in below expectations for clothing (no change) and were flat for other goods and services, which include funeral services.

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



Source: Stats SA, Global Insight, Momentum Investments

A moderation in inflation pressures is evident across the basket. The breakdown of the CPI basket suggests inflation in more than 80% of the items (on a weighted basis) is comfortably tracking below the upper end of the 3% to 6% inflation target range (see chart 1), which is close to the highest on record, since the implementation of the new basket in 2009, before which a meaningful comparison is difficult to make.

Bread and cereal prices now 3% lower than a year ago

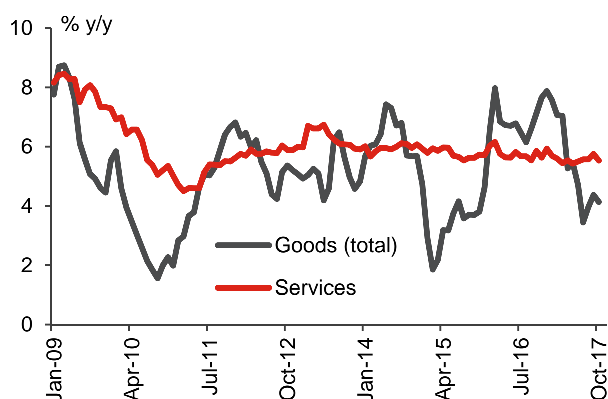
Overall food inflation dropped to 5.3% y/y and is likely to slow further in upcoming months, before rising again. Although bread and cereal prices inched 0.2% higher in October 2017, relative to a year ago, prices in this food category are nearly 3% lower relative to a year ago. Given this year's bumper crop depressed farmers' selling prices, the Crop Estimates Committee and the agricultural business chamber have been guiding towards less maize planting in the 2017/2018 season, as farmers switch to more profitable crops, including oil seeds.

Meat prices on the other hand, which account for more than a third of the food basket, are reporting a 15.5% increase in prices relative to a year ago. 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%. A number of factors, including the avian influenza and a legislation requiring decreased brine content of frozen chicken portions, have driven up poultry prices in recent months. Although cattle slaughtering rates are still below the long-term average, following many dry seasons during which culling rates soared,
Momentum Investments expects slaughtering rates to increase from here, leading to less pressure on meat prices in upcoming months.

Stubborn services inflation tracking close to the upper band of the target

Services inflation remains sticky close to the upper band of the inflation target range (see chart 2).

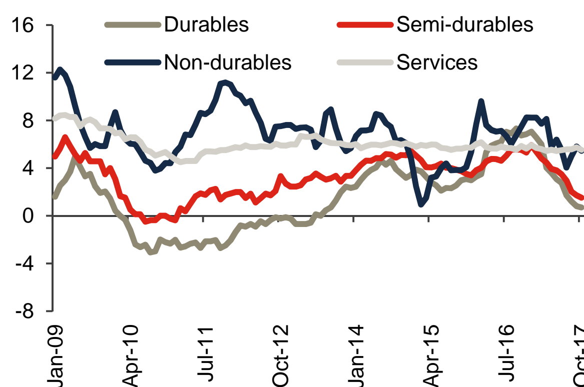
Chart 2: Goods and services inflation (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

Meanwhile, goods inflation has fallen from a recent peak of 8% in December 2016 to 4% in October 2017, in response to weaker consumer demand (see chart 3), which prevented retailers from passing on higher price increases. Within goods inflation, durables inflation grinded lower to 0.7% y/y in October 2017 (from a previous peak of 7.1% in December 2016), back to levels last seen in the third quarter of 2013. Furniture prices declined nearly 4% y/y in October 2017, while inflation in the combined new and used vehicle category dropped to 2.8% y/y. Clothing inflation, which is the largest contributor towards semi-durables inflation, decreased to 2.1% y/y in August 2017.

Chart 3: Further breakdown of goods inflation (% y/y)



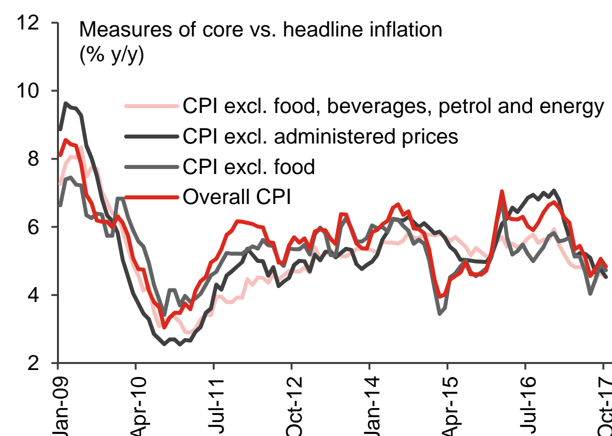
Source: Stats SA, Global Insight, Momentum Investments

Underlying measures of inflation soften further

Core inflation (headline excluding food, non-alcoholic beverages and petrol) declined from 4.6% y/y in September to 4.5% in October 2017 (see chart 4), to the lowest level observed since the third quarter of 2012. This rate is notably lower than the 5.3% average recorded between the third quarter of 2012 and the most recent figure. 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.

Chart 4: Measures of core inflation (% y/y)

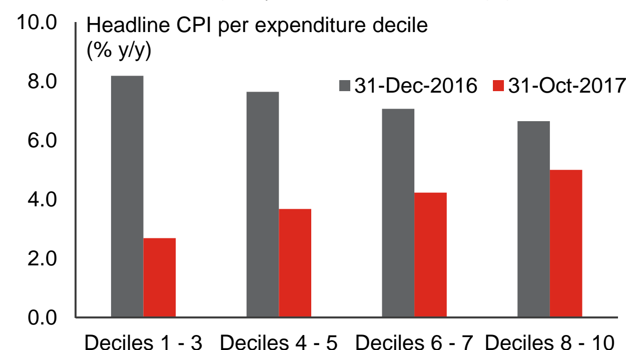


Source: Stats SA, Global Insight, Momentum Investments

Lower food inflation a big benefit to low-income earners

Consumers based in the three lowest expenditure deciles have experienced a large drop in overall inflation between December 2016 and October 2017. The decline from 8.2% to 2.7% y/y, during this period, is largely owing to continued food disinflation, which is a vital price driver for consumers classified under this income category. Consumers in the highest three expenditure deciles tend to spend a smaller share of their earnings on food (allocating more to rental, insurance and transportation costs) and, have such, experienced a much smaller drop in overall inflation in the same time period from 6.6% to 5% y/y (see chart 5).

Chart 5: Inflation by expenditure decile (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

Fiscal deterioration and vulnerability to further rating downgrades reduce chances of further easing for now

Although inflation moderated in recent months and has tracked comfortably within the target range, the current environment has created additional challenges for monetary policy. The Medium Term Budget Policy Statement in October 2017, showed a significantly wider fiscal deficit ratio and a marked rise in the country's expected debt profile, highlighting a shift towards an easier fiscal stance in the medium-term horizon. Fitch rating agency was displeased by the shift away from fiscal consolidation. This was followed by a response from Moody's, which suggested that debt sustainability would be at risk, unless a more credible fiscal consolidation plan was revealed at the time of the February 2018 national budget.

Moreover, the South African Reserve Bank (SARB) warns that inflation expectations, as measured by the Bureau of Economic Research, remain close to the upper end of the target range, particularly for the prices-setters (namely labour and businesses) in the economy. The SARB has expressed its preference for expectations to settle closer to the midpoint of the 3% to 6% inflation target band to reflect a higher degree of monetary policy credibility. This would also allow it to operate with more headroom, in the event of adverse supply-side shocks, which could shift inflation meaningfully higher for a protracted period.

As such, Momentum Investments believes the chances of further interest rate easing have been reduced in the near term. Further out, a positive outcome at the December 2017 National Elective Conference of the ruling party and a potential implementation of further revenue options and expenditure cuts, at the upcoming February 2017 national budget, prevent the firm from ruling out the possibility of marginally lower interest rates in the medium term, should the currency remain well behaved and inflation forecasts stay well within the target band.

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