momentum investments

The Macro Research Desk

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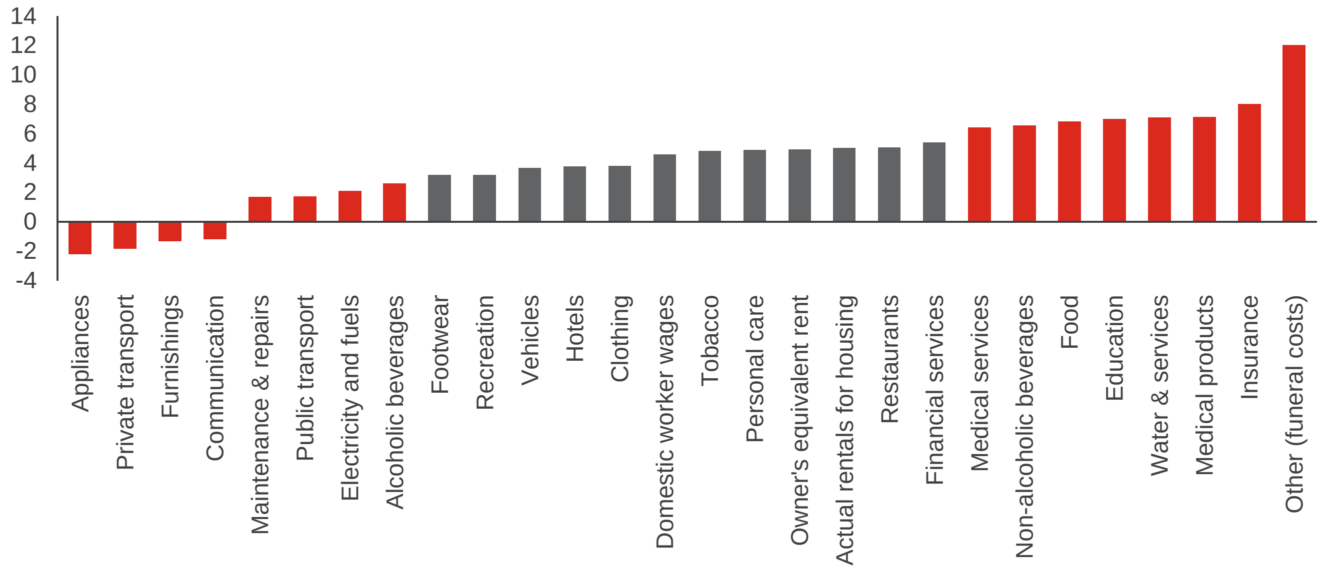
Sharp (but expected) drop in July 2017 headline inflation

Inflation moves closer towards mid-point of target band

Consumer price inflation (CPI) plunged to 4.6% in year-on-year (y/y) terms in Stats SA's July 2017 inflation print, from 5.1% y/y in June, meeting the market's and Momentum Investments' expectations. July is a relatively high survey month. In addition to the usual monthly surveys, 36% of the basket (including funeral costs, home insurance, electricity, water tariffs and property rates) was surveyed. Relative to Momentum Investments' forecasts, monthly price increases for food (0.3%) and funeral costs (4.7%) surprised to the upside, while price increases came in below expectations for water tariffs (6.4%) and vehicles (0.2%).

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

The breakdown of the CPI basket suggests inflation in more than 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 15% higher than the average recorded for the past twelve months.

Insurance inflation has exceeded the 6% upper threshold nearly 90% of the time since January 2009 (the date reflects the last reweighting and reclassification change, which had a significant effect on inflation measures). Since January 2009, medical services inflation registered above 6% every month, while price increases for medical products have only exceeded the 6% threshold 30% of time, during the same period.

Administrative price increases have struggled to adjust lower, partly owing to inefficiencies in the public sector. Although the electricity price increase in July 2017 fell below the 3% floor of the inflation target, price increases in this category have exceeded 6% in every month between January 2009 and June 2017. Nersa's (National Energy Regulator of South Africa) decision to allow Eskom's application for a tariff adjustment, in relation to the third multi-year price determination methodology, has recently been affirmed. The ruling of the SA Constitutional Court also allows Nersa to process Eskom's Regulatory Clearing Account (RCA) submissions for the 2014/15, 2015/16 and 2016/17 financial years. This will be in addition to the 20% tariff application for 2018/19 and could prompt the implementation of a larger electricity price hike in 2018, as Eskom attempts to recover a potential R60 billion through tariff increases.

Similarly, increases in water tariffs have exceeded 6% nearly 95% of the time since January 2009. A deterioration in the quality of public schooling has pushed private school fees higher, leaving price increases in the education category above 6% nearly 90% of the time since January 2009.

Meat inflation shifts higher, but downward trend in overall food inflation still intact

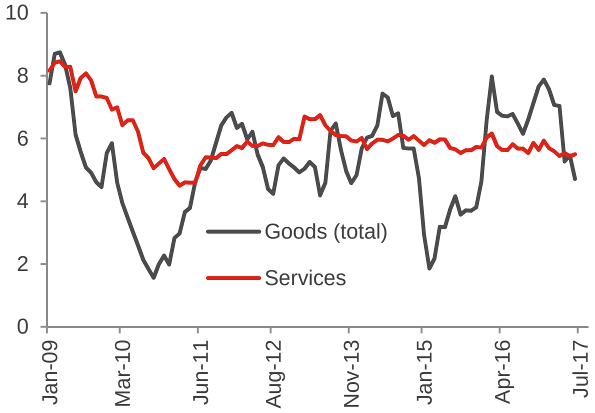
Food prices rose 0.3% in month-on-month (m/m) terms in July 2017 (6.8% y/y). Inflation in the bread and cereals component continued to decline to the lowest level recorded since late 2010 (2.0% y/y), while meat inflation ticked higher to 14.4% y/y. Insufficient grazing capacity led farmers to increase culling of their herds during the drought. Now, as farmers attempt to rebuild their herds, the supply-demand imbalance has urged meat prices higher. The price of eggs has also come under pressure, as egg producers faced increased feed costs due to an earlier drought. Prices in the milk, cheese and eggs category increased by 0.4% m/m in July 2017.

Despite higher meat inflation, lower bread and cereal prices should see food inflation moving lower in upcoming months. The crops estimates committee announced that its July 2017 forecast for commercial maize increased to 16 million tonnes, which will register as the largest produced crop on record (the previous record harvest was set in 1981 at 14.7 million tonnes). 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. 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 remainder of the year, boding well for food inflation trends.

Services inflation ticks higher, but a meaningful drop in goods inflation observed

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 2). Vehicle prices increased by a mere 0.2% m/m in July 2017, reflecting poor buying conditions. In its August 2017 statement, the National Association of Automobile Manufacturers of SA (Naamsa) pointed out that while the recent interest rate reduction of 25 basis points should provide some relief for hard-pressed consumers, the number of new vehicle sales are likely to remain flat in 2017 from 2016 levels, as consumers remain pessimistic about the outlook for the local economy.

Chart 2: Falling goods inflation (% y/y)



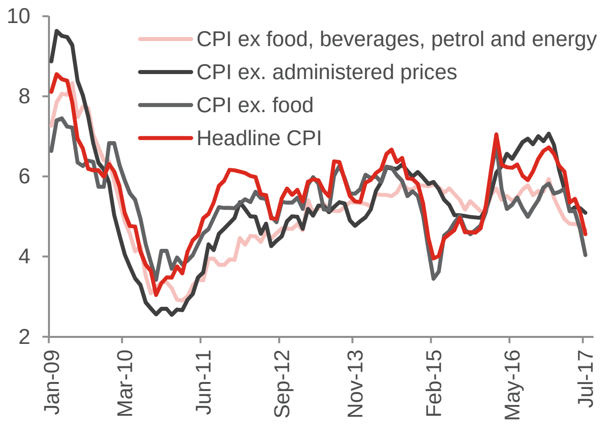
Source: Stats SA, Global Insight, Momentum Investments

Underlying measures of inflation track lower in July 2017

Core inflation (headline excluding food, beverages and petrol) declined from 4.8% y/y in June to 4.7% in July 2017 (see chart 3). This rate is notably lower than the 5.4% average for the past two-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% 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% in 2017, declining to 4.5% in 2018.

Chart 3: Underlying inflation heads lower (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

Further interest rate easing expected

At its latest Monetary Policy Committee meeting, the SA Reserve Bank (SARB) scaled back its growth projections (following an unexpectedly weak first-quarter print) and adjusted its forecast on headline inflation lower. A lower base on inflation (the recent inflation prints – food price prints in particular – have surprised the SARB to the downside), a downward adjustment to international oil price assumptions, lower domestic electricity tariffs, a wider output gap and an adjustment to the real effective exchange rate were noted as key reasons underlining the downward revision in inflation assumptions from an average of 5.7% for 2017 to 5.3% and from 5.3% for 2018 to 4.9%.

Should inflation continue to track lower in line with expectations and remain well within the target band for the foreseeable future, it is likely the SARB will respond by cutting interest rates further by an additional 50 basis points by the end of the first quarter of 2018. The timing of the two additional interest rate hikes will likely depend on currency moves, in reaction to a potential rise in global risk aversion and domestic political developments. Momentum Investments still expects the current interest rate cutting cycle to be comparatively shallow relative to previous cycles, given the lingering risk of further ratings downgrades (which could negatively affect the currency and inflation expectations), ongoing political uncertainty, potential negative swings in emerging market sentiment and uncomfortably high domestic inflation expectations.