momentum
investments

The Macro Research Desk

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High levels of uncertainty keeps SA interest rates on hold at 7.0%

Interest rates steady in line with consensus

The South African Reserve Bank's (SARB) interest rate decision was in line with the Reuters consensus, in which all 24 surveyed analysts predicted that the SA repo rate would remain steady at 7.0%. Despite the SARB paring back its growth projections and adjusting its inflation forecasts lower, the SARB Monetary Policy Committee (MPC) noted that the current level of the repo rate (7%) was appropriate for now, but signalled that it is likely at the end of the tightening cycle.

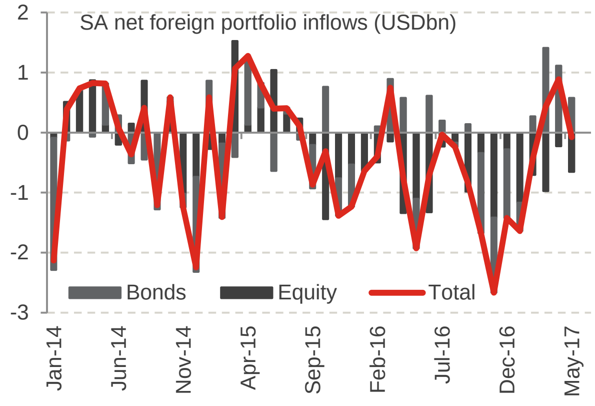
SARB admits to limited headroom to absorb adverse inflation shocks

The recent negative moves in SA's sovereign rating and ongoing political noise has, in Momentum Investments' view, raised inflation risks and lowered growth prospects. Political tensions and an unclear outlook on the direction of economic policy continue to suppress consumer and business sentiment, holding back a firmer recovery in domestic demand. The SARB raised concerns over higher funding costs and more difficult access to funding for domestic private sector fixed investment, following the sovereign credit ratings downgrade to junk status.

A measured pace of interest rate hikes by the United States Federal Reserve (Fed) and an anticipated slow initial pace of Fed balance sheet reduction (as signalled in the latest Fed meeting minutes for May 2017) is unlikely to upset emerging market (EM) currencies. Moreover, a correction in the demand-supply imbalance in key commodity markets in the medium term should support EM investments, including the rand. Forecasts for commodities driving SA's terms of trade dynamics (export prices relative to import prices) point to a favourable outlook for the currency in the medium term. However, the rating agencies have warned against politically-motivated events detracting from the progress on growth-enhancing reform implementation and negatively affecting the direction of government policy. Consequently, ongoing political friction raises the threat of further ratings downgrades, which could hurt the currency's performance. The currency remains a key source of upside risk to the inflation trajectory (particularly as inflation expectations remain uncomfortably at the top end of the target), despite the MPC downwardly revising its inflation forecasts in its latest assessment of the economy.

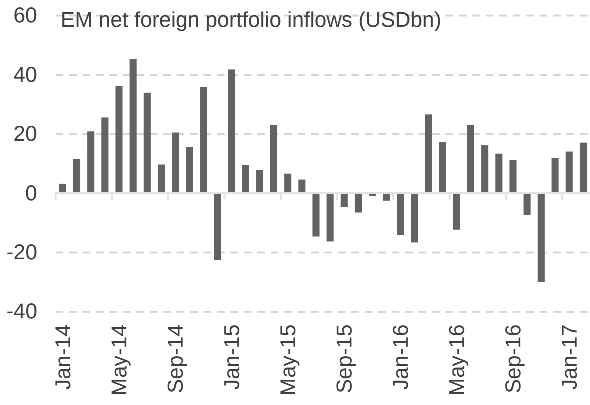
SA's reliance on foreign capital inflows (see chart 1) to cover SA's external imbalance (which is set to widen from the 1.7% deficit relative to the gross domestic product (GDP) in the fourth quarter in 2016), should further limit the SARB's ability to lower interest rates aggressively. Though fund flow data suggests that the EM asset class is still attracting investors (see chart 2), recent developments in China (weaker high-frequency data) and Brazil (political challenges) suggest that political risks can sour the positive sentiment towards EM and have a negative effect on EM investments.

Chart 1: Total net foreign portfolio inflows into SA



Source: SARB, INET BFA, Momentum Investments

Chart 2: Total net foreign portfolio flows into EM



Source: Bloomberg, Momentum Investments

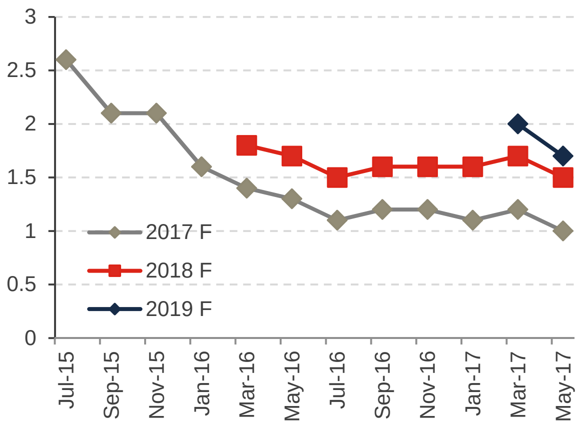
Domestic growth expectations drift lower, while risks remain tilted to the downside

The MPC lowered its 2017 real GDP growth forecast (see chart 3) to 1.0% (a notch higher than Momentum Investments' expectation of 0.9%) from 1.2% at the March 2017 MPC meeting and 1.1% in January 2017. Further downside risks to domestic demand have prompted the MPC to cut its 2018 and 2019 growth forecasts as well, from 1.7% and 2.0%, respectively, in March 2017 to 1.5% and 1.7% in May 2017, similar to Momentum Investments' projections of 1.4% and 1.7%, respectively. The SARB maintained its view on potential growth at 1.4% for 2017, increasing to 1.6% for 2019, but cautioned that the output gap (actual relative to potential growth levels) had likely widened.

Elevated political tensions are expected to weigh heavily on consumer and business sentiment in upcoming quarters. As such, growth risks (particularly to household consumption spend and gross fixed capital formation) remain titled to the downside. With domestic demand likely to remain downbeat in 2017,

Momentum Investments expects the improvement in growth (relative to the 0.3% rate in 2016) to be a function of an inventory rebuild (following a severe drawdown in 2016) and a recovery in export growth, leveraging off brighter global growth prospects, which remain intact.

Chart 3: SARB real GDP forecast revisions (% y/y)



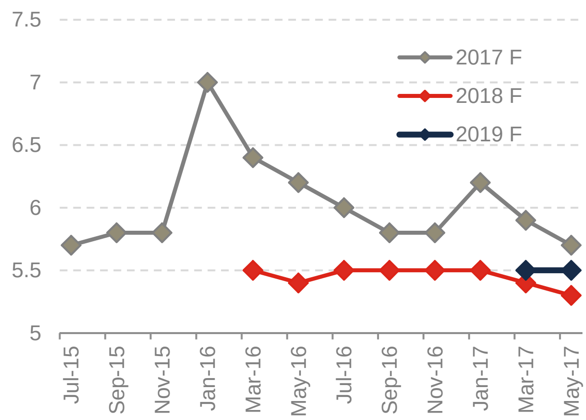
Source: SARB, Momentum Investments

Inflation risks are viewed as balanced

The SARB's inflation forecast has improved since the beginning of the year (see chart 4) primarily owing to a more appreciated exchange rate assumption. The SARB now expects headline inflation to average 5.7% for 2017 (previously estimated at 6.2% in January 2017), a touch higher than Momentum Investments' view of 5.6%.
The MPC's inflation trajectory assumes that the headline figure remains within the 3% to 6% target range for the forecasted period. The SARB disclosed that a lower international oil price assumption (US$54/bbl in 2017 and US$58/bbl in 2018, from US$56/bbl and US$60/bbl previously) and the final electricity price determination by the energy regulator (a tariff increase of 4% has been assumed by the SARB, from a previous 8%) resulted in the downward revision, while a less appreciated exchange rate assumption and a slower decline in food inflation partly offset these revisions.

Core inflation (headline inflation excluding food and energy) forecasts were cut more aggressively, particular in the near term. The SARB expects core inflation to average 5% for 2017 (5.4% previously) and 5.1% for 2018 (5.2% in March 2017), while projections further out (2019) remain unchanged at 5.3%. Momentum Investments sees scope for a further downside surprise in core inflation for 2018. The SARB admitted that the recent April 2017 inflation figures and the National energy regulator of SA's (Nersa) decision to cap municipal electricity tariffs at 1.9% could lead to further downside in inflation projections.

Chart 4: SARB headline CPI forecast revisions (%)



Source: SARB, Momentum Investments

Committee members' views unchanged from the March 2017 MPC meeting

The SARB stated that a reduction in interest rates from current levels would be possible in the event inflation continues to surprise on the downside and should the forecast for the 12-to-18-month policy horizon remain sustainably within the target range. In line with the previous March 2017 MPC meeting, only one MPC member voted to cut interest rates by 25 basis points, whereas the remaining members were happy to keep interest rates unchanged in light of downside risks to the currency (and accordingly upside risks to the inflation outlook) on the back of unfolding domestic political uncertainty.

Table 1: Committee members' views in recent meetings

Number of committee members	Favoured no move	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	-	-	-
24 January 2017	6	-	-	-
30 March 2017	5	-	-	1
25 May 2017	5	-	-	1

Source: SARB, Momentum Investments