momentum

investments

The Macro Research Desk

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SA repo rate held steady, while global risks keep tone cautious

Interest rates steady in line with expectations

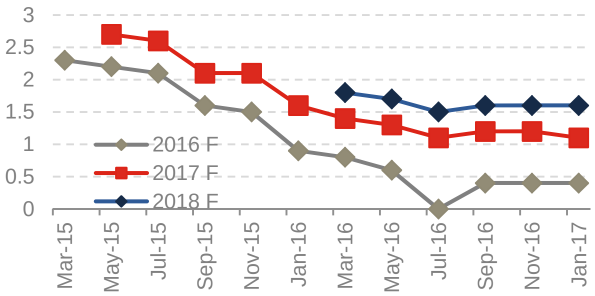
Today's interest rate decision was in line with the Reuters consensus, in which all surveyed analysts predicted that interest rates would stay on hold at 7.0%. The Monetary Policy Committee (MPC) maintained a cautious tone, pointing out the rand's vulnerability to domestic and external shocks. Even after raising its inflation forecasts, for 2017 in particular, the committee still views inflation risks to be (marginally) to the upside. The MPC has lowered its near-term domestic growth forecasts slightly, but remains wary of downtrodden business and consumer confidence. Relative to the MPC's economic forecasts, Momentum Investments expects local economic activity to surprise to the upside in 2018 in particular, while the company is of the opinion that a firmer currency (in response to an anticipated correction in the current demand-supply imbalance in commodity markets) should lower inflation more meaningfully to below 5% on average in 2018. This envisaged improvement in the medium- to longer-term inflation trajectory should allow the MPC to consider interest rate cuts in the latter half of 2017.

Marginal downward revision to domestic growth forecasts, but risks remain broadly balanced

The South African Reserve Bank (SARB) lowered its 2017 real gross domestic product (GDP) growth forecast (see chart 1) from 1.2% (in line with Momentum Investments' internal forecast) to 1.1%, but left its 2018 forecast of 1.6%, unchanged (relative to the company's more optimistic forecast of 2.0%). The SARB cited elevated risks to global growth, noting that the new administration in the United States (US) raises a great deal of uncertainty around economic policies, including the extent of fiscal stimulus and the effect it could have on the global economy. The spate of upcoming elections and referenda in the European Union were also raised as a potential destabilising factor for world growth.

In Momentum Investments' opinion, domestic demand should remain under pressure in the near term. Household debt burdens and lacklustre hiring intentions point to further stress for the SA consumer, while elevated policy uncertainty will likely delay fixed investment plans in the private sector. Nevertheless, the company expects a modest improvement in global growth, a continued mild uptick in commodity prices, dissipating energy supply constraints and a reversal in earlier drought conditions to underpin a marginal recovery in economic activity in 2017, accelerating in 2018. Momentum Investments expects confidence in the private sector to improve after the ruling party's National Executive Committee meeting in December 2017, which should drive a measured recovery in private fixed investment and jobs growth, as more light is shed on political leadership in SA. Moreover, brighter global economic prospects in 2018 should enable faster growth in SA's export sector.

Chart 1: SARB real GDP forecast revisions (% y/y)



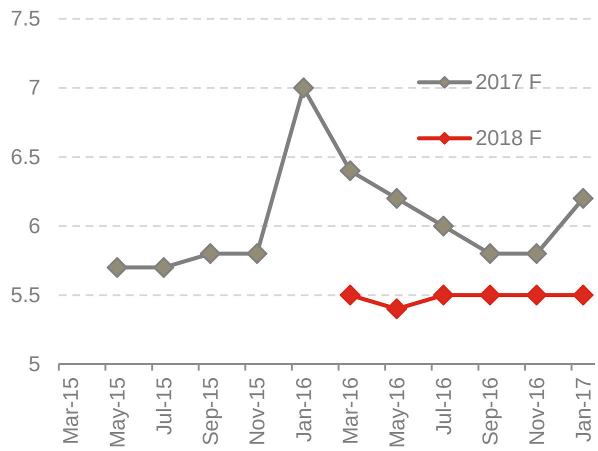
Source: SARB, Momentum Investments

Although the SARB did not give an update on its estimate of potential growth (pitched at 1.4% in 2017 and 1.5% in 2018 at the time of the November 2016 interest rate-setting meeting), it confirmed that local growth is expected to remain below potential over the forecasted horizon.

Moderate upside risks to inflation remain in spite of upward revision

The SARB's inflation forecast has deteriorated relative to its November 2016 projections (see chart 2) largely owing to supply-side factors. The SARB upwardly revised its assumption on oil prices to US$56/bbl for 2017 (US$53.5/bbl previously) and US$60/bbl (US$57.5/bbl previously) for 2018, roughly in line with Momentum Investments' forecasts. Meanwhile, the higher-than-expected food inflation print in the December 2016 inflation reading has led the MPC to upwardly revise its average 2017 food inflation forecast from 6.5% to 7.0% (relative to Momentum Investments' internal forecast of 5.3%). Although the SARB expects a moderation in food prices, it remains circumspect over the extent of expected disinflation in this category given a slight uptick in global food prices and higher fuel costs.

Chart 2: SARB headline CPI forecast revisions (%)



Source: SARB, Momentum Investments

According to Grain SA, following SA's drought-induced maize deficit in 2016, better rainfall conditions suggest SA could be a net exporter of maize this year, which could dampen food inflation significantly in 2017. However, Momentum Investments acknowledges the risks of a potentially weaker-than-forecasted currency and higher-than-expected meat prices, owing to herd rebuilding following an extended period of culling.

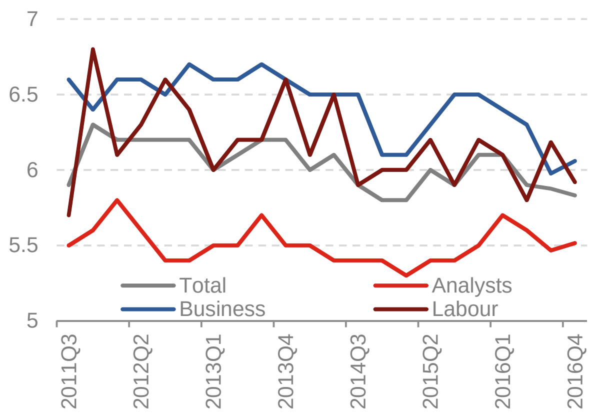
The MPC's headline inflation forecast shifted notably from 5.8% on average in 2017 to 6.2% (considerably higher than Momentum Investments' forecast of 5.5% and even higher than the 5.8% print in the Reuters poll), but remained intact at 5.5% for 2018 (relative to Momentum Investments' forecast of 4.8%). While previously the committee expected inflation to return to within the 3% to 6% target band in the second quarter of 2017, it now only sees a return to the inflation target band in the final quarter of the year.

As a consequence of the inflation revisions being supply-side driven, the SARB's estimate of core inflation (headline inflation excluding the effect of food and energy costs) remained steady at 5.5% (relative to Momentum Investments' forecast of 5.2%) in 2017 and 5.2% (against Momentum Investments' view of 4.7%) in 2018. Although oil price forecasts were revised upwards, the SARB is not anticipating an oil price spiral and, as such, these revisions have had no effect on its estimates of core inflation.

Average inflation expectations shifting lower, but still uncomfortably close to the upper end of the inflation target

The Bureau of Economic Research's (BER) Inflation Expectations Survey results for the fourth quarter of 2016 revealed that average expectations for 2017 declined from 6.0% in the third quarter of the year to 5.8% in the final quarter of 2016. The decline in the forecast was largely owing to downward revisions made by trade unions, while businesses and analysts kept their inflation forecasts relatively unchanged. Five-year forecasts deteriorated from 6.0% to 6.1% for businesses, while analysts' forecasts remained unchanged at 5.5% (see chart 3). Trade unions meanwhile downwardly revised their estimate by 0.3% to 5.9%. Although the five-year forecast (on average) dropped to its lowest level since the first quarter of 2015, the SARB remains concerned that expectations are at the upper limit of the 3% to 6% inflation target range. As such, the threat of second-round inflation pressures remains.

Chart 3: Average five-year inflation expectations (%)



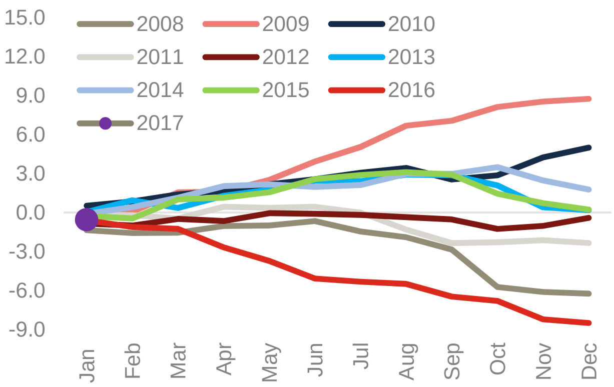
Source: BER, Momentum Investments

Rand vulnerable to domestic and external shocks

In the Q&A session, the MPC pointed out that SA's current account deficit is too wide for SA's current low level of growth. As such, the domestic currency remains vulnerable to adverse global and domestic-led shocks.

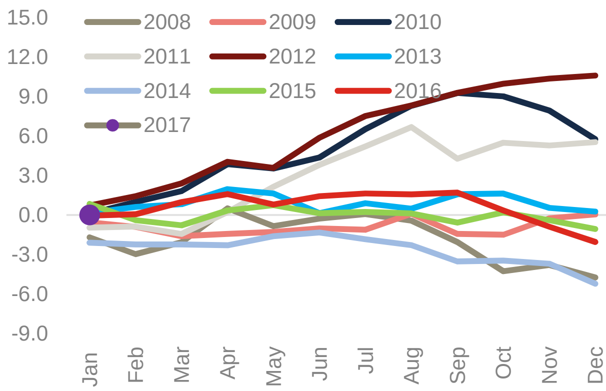
Net foreign equity outflows in 2016 exceeded those experienced in the aftermath of the global financial crisis, while bond outflows were not far behind (see chart 4 and 5). Although total net foreign outflows have declined from an average of US$1.2 billion in the past six months to US$0.9 billion on a month-to-date basis, the currency remains exposed to negative bouts of sentiment.

Chart 4: Cumulative net equity inflows (US$ bn)



Source: INET BFA, Momentum Investments

Chart 5: Cumulative net bond inflows (US$ bn)



Source: INET BFA, Momentum Investments

Unanimous vote by committee members

A marginally weaker outlook on domestic growth, constrained by subdued business and consumer confidence and elevated global uncertainty, together with marginal upside risks to the SARB's upwardly-revised inflation forecasts left the committee members in agreement on keeping interest rates unchanged.

Table 1: Committee members' views more aligned in recent meetings

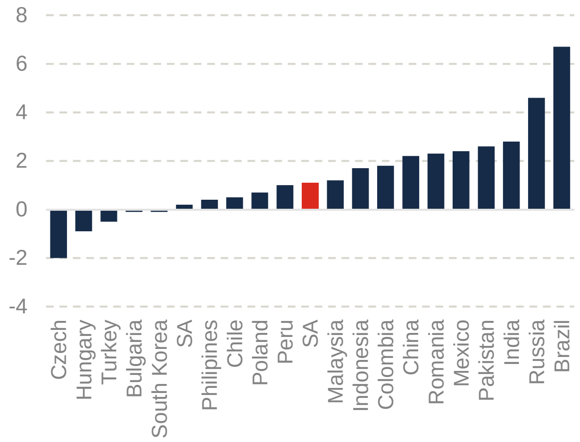
No. of committee members	Favoured no move	Favoured 25 basis point hike	Favoured 50 basis point hike	Favoured a 25 basis point cut
19 November 2015	2	4	-	-
28 January 2016	1	2	3	-
17 March 2016	3	3	-	-
19 May 2016	5	1	-	-
21 July 2016	6	-	-	-
22 September 2016	6	-	-	-
24 November 2016	6	-	-	-
24 January 2016	6	-	-	-

Source: SARB, Momentum Investments

Interest rate stance still viewed as accommodative

In the Q&A session, the MPC reiterated that SA's monetary policy stance remains accommodative. Real interest rates in SA appear to be less attractive than those in other key emerging markets (see chart 6), while SA's current account deficit remains uncomfortably wide. As such, any wobble in global risk sentiment could put the domestic currency at risk. In Momentum Investments' view, the sustainability of recent rand strength remains the key source of upside risk to SA's inflation profile. However, if inflation continues to moderate in line with the company's expectations from around 5.5% this year to below 5.0% in 2017, this trajectory should create some leeway for the SARB to consider cutting interest rates in the latter half of 2017. Admittedly, there are risks to this view. Interest rates could rise more aggressively than expected in the US, international oil prices could tick significantly higher and/or negative global trade policies could gain traction. Under this scenario, emerging market currencies (including the rand) could weaken, thereby lowering the prospect of interest rate cuts domestically, particularly if the sell-off in the local unit is sustained and manifests in the form of higher inflation expectations.

Chart 6: Emerging market real interest rate comparison (%)



Source: Bloomberg, Momentum Investments