The Macro Research Desk

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June 2018 inflation print extends string of positive inflation surprises

Highlights

- Headline inflation has positively surprised relative to consensus estimates in ten out of the past twelve months.
- Food inflation continued to track at non-threatening levels, surprising yet again to the downside.
- However, steep increases in rand oil prices (relative to a year ago) put further upward price pressure on the overall consumer basket.
- Mild food inflation continued to disproportionately benefit low-income earners in June 2018.
- Rental inflation dipped to its lowest level since the start of comparable data in January 2008.
- Core inflation headed lower in June 2018, partly due to lower rental inflation.
- Interest rates are expected to remain on hold at the upcoming interest rate-setting meeting.

A continuation of positive surprises in headline inflation relative to consensus estimates

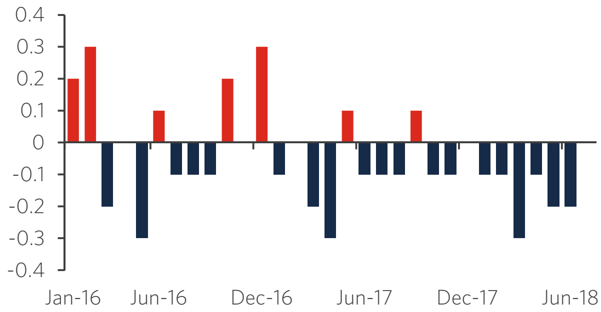
Consumer price inflation (CPI) came in lower than consensus expectations by 0.2% in June 2018. While the Bloomberg median estimate was expecting a steeper rise in inflation from 4.4% year-on-year (y/y) in May 2018 to 4.8% y/y in June 2018, Statistics South Africa (Stats SA) reported headline inflation at a lower 4.6% y/y.

Reported inflation has consistently surprised to the downside in recent months. Relative to the Bloomberg consensus projections, actual inflation came in lower than the median market expectation in ten out of the past twelve months (see chart 1).

Relative to Momentum Investments' forecasts, inflation in the food, rentals, vehicles and hotels categories reported the largest downside surprises, while inflation in public transport registered a higher-than-expected outcome for June 2018.

The percentage of items in the consumer inflation basket recording inflation below the upper end of the 3% to 6% inflation target remained high at around 75%, while a quarter of the items on a weighted basis experienced inflation rates higher than 6% in June 2018.

Chart 1: Actual less surveyed CPI (%)



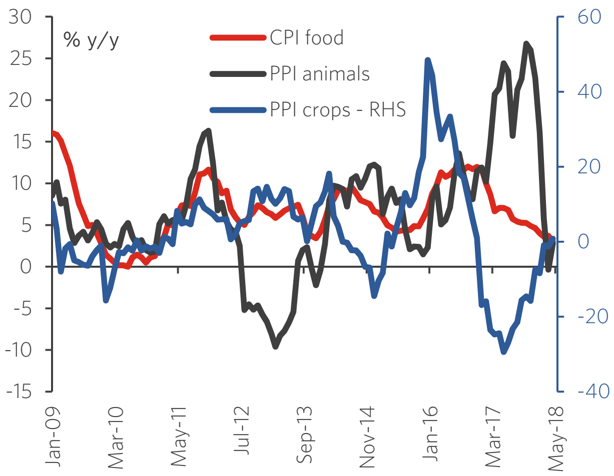
Source: Bloomberg, Momentum Investments

Food inflation could be close to a bottom, but not threatening to overall inflation outlook

Food inflation lifted slightly from 3% y/y in May 2018 to 3.1% y/y in June 2018 (and a 12% y/y peak in December 2016). Prices moved sideways relative to a month ago, with a decline in fruit (negative 0.7%), vegetable (negative 0.4%) and meat (negative 0.3%) prices being offset by a 0.8% uptick in bread/cereal prices.

Bread/cereal prices are still around 3% lower than where they were a year ago, but crop inflation at the level of producer price inflation (PPI) for May 2018 pointed to a reversal in deflation pressures. This could possibly signal a bottoming out of bread/cereal inflation at the consumer level in upcoming months (see chart 2). Price increases at the consumer level generally lag prices at the producer level by between three and six months.

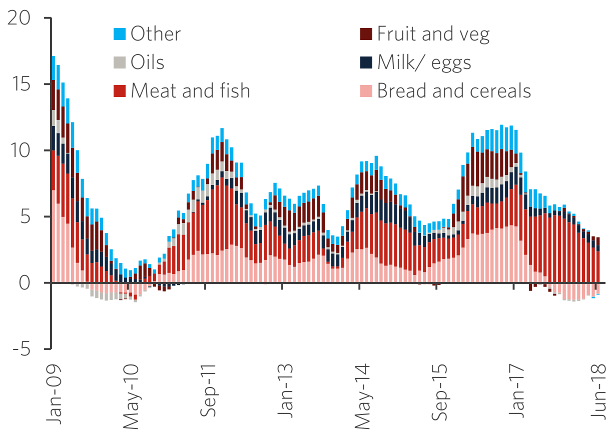
Chart 2: A reversal in crop price deflation



Source: Stats SA, Global Insight, Momentum Investments

Meat inflation at the consumer level decelerated from 7.8% y/y in May 2018 (and from a peak of 15.6% in September 2017) to 6.8% y/y in the latest data for June 2018. Given the significant weighting of meat in the overall consumer food basket (32%), meat continued to contribute the most to overall food inflation in June 2018 (see chart 3).

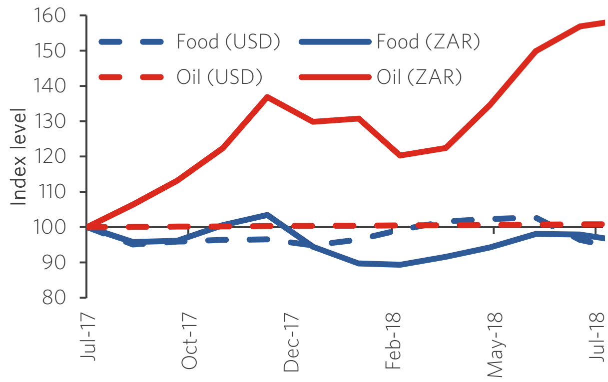
Chart 3: Contribution to food inflation (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

Relative to a year ago, food prices are 4% lower in rand terms, whereas oil prices pose a far larger threat, nearly 60% higher relative to a year ago (see chart 4).

Chart 4: Oil prices are a threat to the inflation outlook



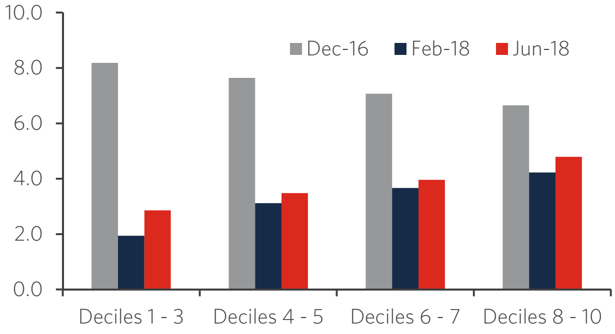
Source: Stats SA, Global Insight, IRESS, Momentum Investments

In Momentum Investments' view, the SA Reserve Bank (SARB) forecasts for international oil prices of US$70/bbl for 2018 and US$67/bbl for 2019 and 2020 could potentially be revised higher for the outer two years in its upcoming July 2018 Monetary Policy Committee (MPC) meeting.

Inflation is still muted for low-income earners as a result of mild food inflation

At its peak, the inflation gap between the highest and lowest three income-earning deciles registered at 2.5% in December 2017. Although this gap narrowed to 2.1% in June 2018, lower-income earners are still disproportionately benefiting from lower food inflation. Inflation for this income category inched higher to 2.9% y/y for June 2018, while the higher-income earning group experienced inflation of 4.8% in the same period (see chart 5).

Chart 5: CPI per income-earning decile (% y/y)



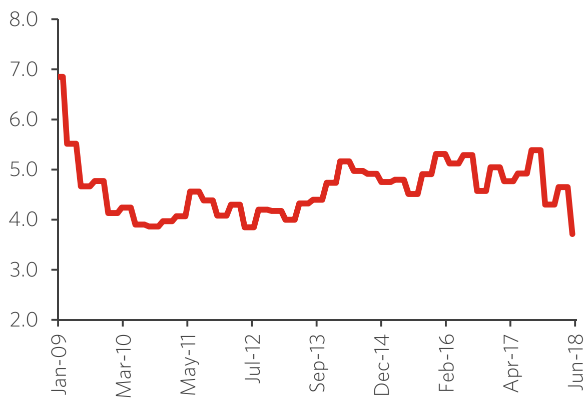
Source: Stats SA, Global Insight, Momentum Investments

Lowest rental inflation since the 2008 basket changes and reweighting

Rental inflation continued to surprise to the downside in the June 2018 print. Owners' equivalent rental dropped to 3.7% y/y in June 2018 (see chart 6), which was nearly a percent lower than the average recorded since January 2008, before which data cannot be compared.

In its May 2018 report, the Tenant Profile Network Credit Bureau indicated rental property vacancies from a national perspective had increased from 5.4% in 2017 to 5.9% in the first quarter of 2018. It suggested, although interest rates had been lowered by 25 basis points in March 2018 by the SARB, landlords were under pressure to apply rental escalations, given the hike in value-added taxes and a decline in rental payment behaviour.

Chart 6: Owners' equivalent rental (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

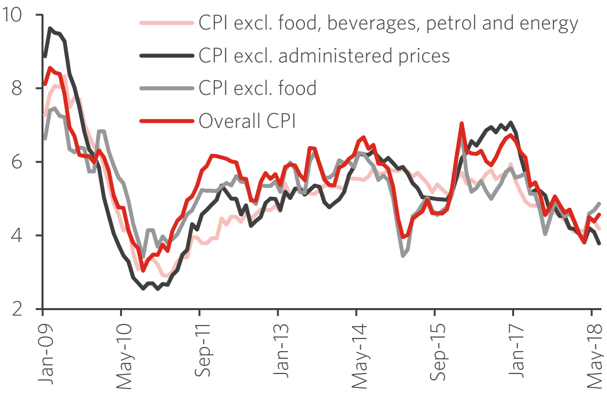
Core inflation headed lower in June 2018

Inflation, excluding the effect of volatile food/beverages and fuel/energy prices, dropped to 4.2% y/y in June 2018, from 4.4% y/y in the prior month (see chart 7). Lower rental inflation likely contributed to lower core inflation given its relatively high weighting in the consumer inflation basket.

CPI, excluding the effect of administered prices, declined to 3.8% y/y in June 2018, given the rise in administered price inflation to 8.3% y/y. This was the highest recorded level since March 2017 and exceeded the long-term average by 1.4%.

Lower rental inflation likely caused the fall in services inflation from 5.3% y/y in May 2018 to 4.9% y/y in June 2018, while an acceleration in prices of non-durable goods (food and energy) prompted a rise in goods inflation from 3.5% y/y to 4.2% y/y during the same period.

Chart 7: Core measures of inflation (% y/y)



Source: Stats SA, Global Insight, Momentum Investments, data up to June 2018

Interest rates expected to remain on hold at the upcoming MPC meeting

Despite continued positive surprises on headline inflation relative to the median consensus estimate, Momentum Investments still views risks to the inflation trajectory as being to the upside. Headline inflation is likely to rise from the 3.8% low reached in April 2018. However, prints are expected to remain within the target band in the medium term. Further sustained rand weakness and higher international oil prices present the largest upside threats to the inflation trajectory, while higher-than-expected rainfall and healthy stock levels should keep a lid on food inflation.

Although a notable downward shift was reported in the Bureau of Economic Research's inflation expectations survey for the first quarter of 2018, the SARB still views these as being too high in light of the 4.5% midpoint of the inflation target band.

In Momentum Investments' opinion, while it is likely too early to hike interest rates just yet considering a still-negative output gap, a slow hiking cycle is expected to commence at the start of 2019, given the importance of maintaining attractive real interest rates in a global environment where liquidity is being added at a diminishing rate.