momentum investments

The Macro Research Desk

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Further ease in headline inflation

Highlights

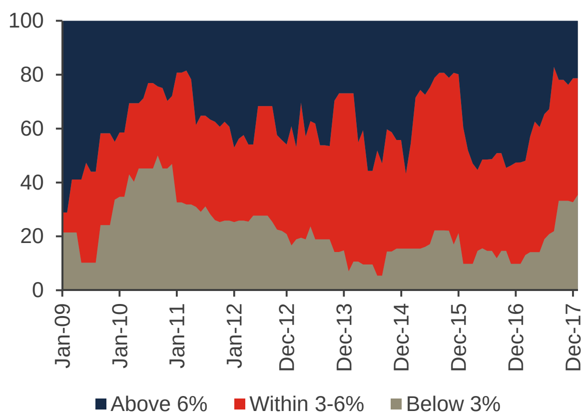
- The majority of the items in the inflation basket are tracking below 6%
- Meat prices are still elevated, but grain deflation is keeping overall food inflation low
- International oil prices and wage price developments are driving upside risks to the inflation forecast
- Services inflation continues to track in a tight range along the upper end of the inflation target band
- Underlying measures of inflation softened further
- There is an inflation reprieve for lower-income earners
- A favourable inflation trajectory leaves room for modest monetary policy easing in upcoming months

Nearly 80% of the items in the inflation basket are tracking below 6%

Stats SA (South Africa) announced a drop in consumer price inflation (CPI) from 4.7% in December 2017 to 4.4% in January 2018. This was exactly in line with the consensus figure and only marginally above Momentum Investments' estimate. January is a relatively high survey month with more than a quarter of the basket being surveyed, in addition to the usual monthly surveys. Relative to Momentum Investments' forecasts, monthly price changes for food (1.4%), non-alcoholic beverages (0.9%), vehicles (1.0%) and bank charges (4.5%) surprised to the upside. Meanwhile, price increases were below expectations for public transport (negative 2.5%), hotels (negative 0.5%) and insurance (0.2%).

Inflation pressures have eased significantly across all sectors of the CPI basket. The breakdown of the CPI basket points to almost 80% of the items (on a weighted basis) tracking below the 6% upper end of the inflation target band (see chart 1), which compares favourably to historic data.

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



Source: Stats SA, Global Insight, Momentum Investments

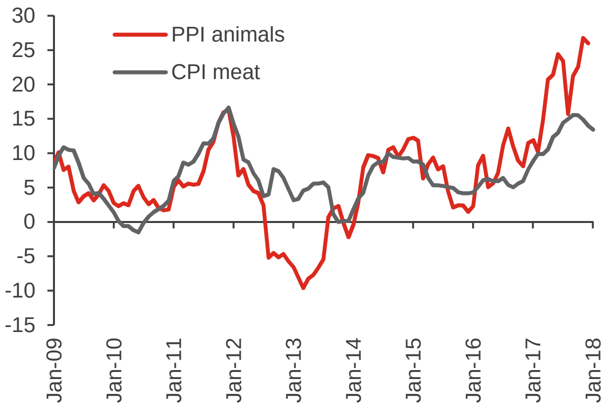
Bread and cereal deflation continues to offset elevated meat price pressures

The descent in food inflation continued in January 2018 and is expected to continue declining in the short term, as long as rainfall conditions remain favourable. Overall food inflation dropped to 4.6% in January 2018 from 4.9% in December 2017. During the month, meat prices rose 2.3% (13.4% year-on-year (y/y)) and bread/cereal prices inched higher by 0.8% (negative 5.1% y/y).

Final maize crops for 2017 were 76 000 tons higher than estimated, with white maize having brought in an extra 23 250 tonnes and yellow maize surprised positively by an additional 52 750 tonnes. Global maize estimates appear healthy, while the Agricultural Business Chamber estimates an SA crop of 11.2 million tonnes. Given that consumption averages 10.5 million tonnes in SA, there will likely be an opportunity to export excess maize (depending on quality). Still low maize prices should additionally benefit feedstock costs for livestock producers, driving down meat inflation in upcoming months.

Meat inflation (contributing towards one third of the food inflation basket) remained elevated at 13.4% y/y at the consumer level and 26% y/y at the producer price level (see chart 2), in line with a decline in slaughtering rates. Total slaughtering for December 2017 recorded at 262 727, down from 322 554 in December 2016 (a y/y decline of 19%). Momentum Investments expects slaughtering rates to normalise in upcoming months, which should increase meat supplies and lower price pressures. Poultry imports were 0.6% lower in 2017 compared to 2016, with Brazilian imports supplying more than 60% of poultry due to Avian Influenza bans on European Union imports. Meat prices have shown an upward trajectory from May 2017, as the Avian Influenza outbreak spread.

Chart 2: Meat inflation is still high (% y/y)



Source: Stats SA, Global Insight, Momentum Investments

Egg prices have soared in the last five years, showing a 52% increase between 2012 and 2017. The Avian Influenza has driven the rise in egg prices in the recent year (a 12% increase between 2017 and 2016). Milk, cheese and egg prices were up 4.2% y/y in January 2018.

Fruit prices were down 3.6% y/y in January 2018. The Business Report noted fruit prices might see a possible increase in upcoming months, given deciduous fruit crops were likely to be around 20% smaller than the previous year. While a drought-inflicted decline in the quality of fruit and vegetables could negatively affect export volumes, a higher supply in the domestic market could limit upward pressure on prices due to the drought.

Currency, oil and wage price developments posing upside risks to the inflation forecast

At its January 2018 Monetary Policy Committee (MPC) meeting, the SA Reserve Bank (SARB) warned that international oil prices, wage developments and the currency continued to drive upside risks to its inflation forecast.

International oil prices have remained elevated on recent border issues in Syria. Moreover, an agreement between members of the Organisation for Petroleum Exporting Countries (OPEC) and select other producers (including Russia), to curb production by 1.8 million barrels per day until the end of 2018, has underpinned the rise in oil prices. Nonetheless, there has been a surge in United States (US) production. The rise in the US oil rig count (798 – the highest since April 2015) is indicative of increased production in upcoming months, which is expected to prevent a further rise in international oil prices.

Public sector wage negotiations pose a further threat to the inflation outcome. According to Business Day, a standoff between government and labour on salary adjustments persists. Government offered to increase compensation by the following, for the first year of the three-year deal:

- CPI plus 1.5% (employee levels 1 to 7)
- CPI plus 1% (levels 8 to 10)
- CPI (levels 11 to 12)

Labour, however, demands the following:

- CPI plus 3% (levels 1 to 7)
- CPI plus 2% (levels 8 to 10)
- CPI plus 1% (levels 11 to 12)

Furthermore, the outcome for the civil servant wage agreement is likely to set the tone for wage negotiations in the private sector this year.

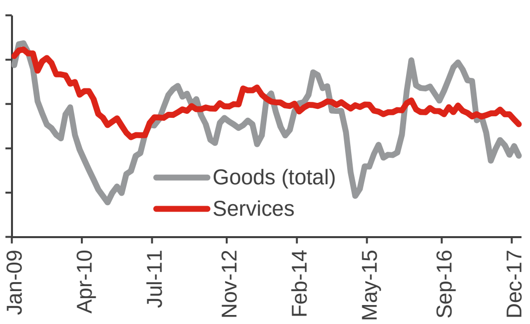
The MPC acknowledged the currency risks associated with a potential downgrade to SA's sovereign rating. While Momentum Investments is of the view that there is a slightly better-than-even chance for Moody's to keep SA's sovereign rating on hold at its upcoming review, a significant budget disappointment (including no clear economic plan to propel growth in the medium term) could be enough to trigger a downgrade.

Services inflation stuck at the upper end of the inflation target band

Goods inflation has averaged 5.2% since January 2009, while services inflation has averaged at a higher 6.0% rate for the same period. Since 2012, services inflation has tracked within a narrow band around the 6% upper end of the inflation target range, but the recent data shows services inflation moving lower (see chart 3).

Previously, weak consumer demand prevented retailers from passing on higher price increases.
Durables (furniture and cars) inflation, in particular, averaged 2.4% in the past year. Recent rand appreciation could limit the increase in durables inflation in upcoming months.

Chart 3: Goods and services inflation (% y/y)



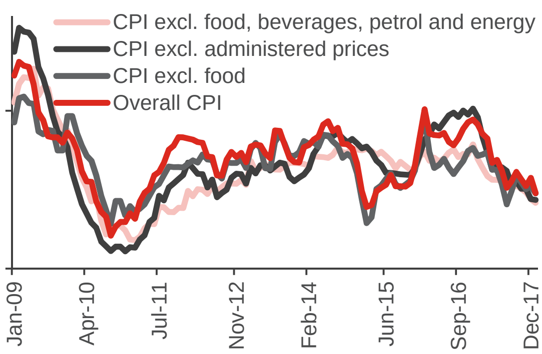
Source: Stats SA, Global Insight, Momentum Investments, data up to 31 January 2018

Core price pressures diminishing

Underlying measures of inflation receded further in the January 2018 print. Core inflation (headline excluding food, non-alcoholic beverages and petrol) dipped to 4.1% from 4.2% in December 2017 and 5.5% a year ago (see chart 4). 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 average below 5% in 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)

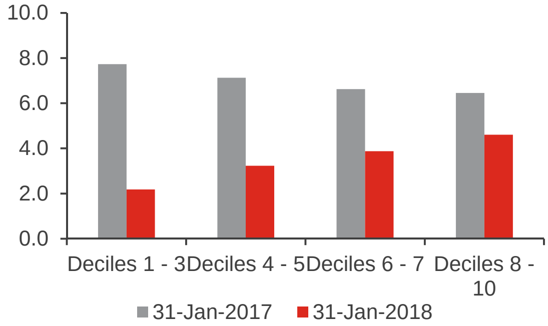


Source: Stats SA, Global Insight, Momentum Investments, data up to 31 January 2018

Inflation reprieve for low-income earners

Lower-income earners tend to spend a larger portion of their income on food. With food inflation dropping sharply, overall rates of inflation for lower-income earners declined faster than that for higher-income earners (who tend to spend more on rental, insurance and transportation costs). Headline inflation registered at 2.2% for the three-lowest income-earning deciles in January 2018 and 4.6% for the three-highest income-earning deciles (see chart 5). As such, real wage gains for lower-income earners has improved and bodes well for spending in this income category, in particular.

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



Source: Stats SA, Global Insight, Momentum Investments

Favourable inflation trajectory leaves room for further modest monetary policy easing

Inflation moderated from 6.6% y/y a year ago in January 2017 to 4.4% in January 2018, while the forecast for inflation in the medium term is expected to remain within the target band. Momentum Investments expects headline inflation to moderate to 4.6% in 2018 from 5.3% in 2017, before rising to 5.4% in 2019 and 5.6% in 2020. Despite a more favourable inflation outlook relative to its November interest rate-setting meeting, the MPC remained concerned fiscal woes could lead to a downgrade in SA's sovereign rating. The SARB anticipates a downgrade would negatively affect the currency, which could lead to an unwanted rise in inflation expectations.

Although the Bureau of Economic Research's (BER) Inflation Expectations survey showed average inflation expectations for 2018 declining from 5.8% to 5.7%, (forecasts unchanged at 5.9% for 2019), on a more granular level, businesses had revised their forecasts higher, concerning the SARB.

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 the central bank to operate with more headroom, in the event of adverse supply-side shocks, which could shift inflation meaningfully higher for a protracted period.

In Momentum Investments' view, the rand remains vulnerable to negative swings in global (a faster than anticipated slowdown in China or a more rapid interest rate tightening in developed markets) and local (political disruption or fiscal woes) sentiment. An expected deterioration in the country's terms-of-trade (export relative to import prices) points to some currency weakness in the medium term. However, even after factoring in a mildly depreciating currency trajectory from current levels, inflation should still remain comfortably within the target band in upcoming months.

Momentum Investments sees space for one interest rate decrease of 25 basis points (with the possibility of a further 25 basis point cut, should conditions remain favourable) at the most, given the medium-term outlook for inflation and policy uncertainty, as the new administration seeks to shift the economy to a higher growth trajectory over time, while focusing on the upcoming 2019 national elections.