
Herman
van Papendorp
Head of Investment Research & Asset Allocation


Sanisha
Packirisamy
Economist

The Macro Research Desk

April 2018 headline inflation increases on tax hike, but undershoots expectations

Highlights

- Following a trough in March 2018, headline inflation rose to 4.5% in April 2018, partly owing to a 1% increase in the value-added tax (VAT) rate from 14% to 15%.
- Geopolitical risks and strong global demand are the main culprits behind the surge in international oil prices.
- Food prices, in rand terms, are still in deflation.
- Underlying measures of inflation inched higher, but remained contained.
- Lower-income earners continued to benefit from subdued inflation in April 2018.
- Momentum Investments expects a stable outlook for interest rates, with a bias to one more cut in the third quarter of 2018 if inflation expectations shift meaningfully towards the mid-point of the inflation target range.

VAT increase raises inflation in April 2018

Consumer price inflation (CPI) appears to have bottomed in March 2018 at 3.8% in year-on-year (y/y) terms.
After incorporating a 1% increase in VAT rates from 14% to 15% (following the proposals outlined in the February 2018 national budget), inflation rose to 4.5% y/y April 2018.
The headline inflation print surprised the market for a seventh consecutive month, with the Bloomberg consensus looking for a larger increase in inflation to 4.7% in April 2018.

Previously, Momentum Investments indicated that 44% of the inflation basket comprised zero-rated and VAT-exempt items to protect poorer households (see table 1).
Stats SA noted, in a March 2018 media release, it would "undertake additional surveys in April and May and make automatic adjustments to selected prices to capture as much of the impact of the VAT increase as possible".

Table 1: Zero-rated and VAT-exempt items

Product group	Weighting
Food and non-alcoholic beverages	5.5
Bread and cereals	1.7
Fish (tinned)	0.2
Milk, cheese and eggs	1.9
Cooking oil	0.3
Fruits and vegetables	1.4
Housing and utilities	18.9
Actual rentals	3.5
Imputed rentals	13.3
Assessment rates	1.3
Levies	0.8
Household contents and services (domestic worker wages)	2.5
Transport	6.3
Paraffin	0.1
Unleaded petrol	3.3
Diesel	1.3
Train fares	0.1
Bus (local) fares	0.0
Taxi fares	1.5
Bus (long-distance) fares	0.0
Education	2.9
Pre-primary and primary	0.8
Secondary	0.8
Tertiary	1.0
Creche	0.4
Miscellaneous goods and services (health insurance)	7.5
Total	43.6

Source: Stats SA, Momentum Investments (items in blue font are goods, items in black font are services)

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momentum
investments

Geopolitical risks drive international oil prices higher

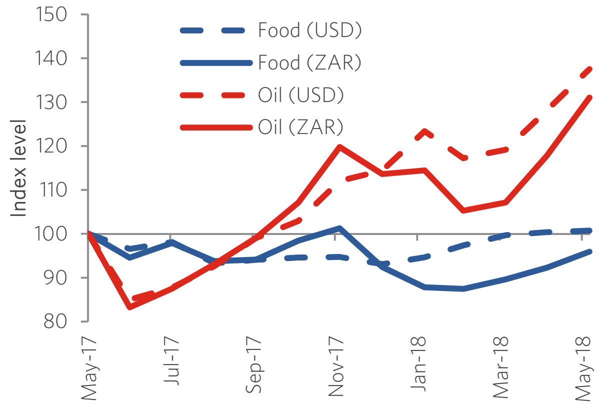
According to Bloomberg, crude oil futures are trading close to three and a half year highs, boosted by an escalation in geopolitical risks in the Middle East, United States sanctions on Iran and Venezuela, supply cuts from the globe's major producers and a strong global demand for oil.

UBS estimated the global sweet spot of oil to be between US$50/bbl and US$70/bbl, in which oil prices can contribute positively to global growth. Meanwhile, Brent crude oil prices have increased to US$79/bbl in May 2018. Sustainably higher oil prices could send consumer inflation higher, eroding growth in real incomes and dampening the outlook for overall economic activity. UBS warns an underinvestment in big oil projects could further affect supply in 2019.

In Momentum Investments' opinion, higher oil prices should spur higher levels of production, increasing relative oil supplies and placing a cap on international oil prices. Nevertheless, the firm acknowledges the upside risk to oil prices in light of heightened geopolitical tensions.

For South Africans, oil prices in rand terms are nearly 38% higher than where they were a year ago (see chart 1). Transport inflation increased by 5% y/y in April 2018, largely owing to a 9% rise in fuel prices. April's fuel price increase further included a 52c/l hike in fuel levies announced in the February 2018 national budget.

Chart 1: Surge in oil prices



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

In contrast, food price pressure remained absent. In rand terms, food prices are still 4% lower than in the same month a year ago. Bread and cereal prices continued to track in deflation territory at negative 3.7% y/y in April 2018, while meat inflation dropped further to 9% y/y in the same period.

Although underlying inflation ticked higher, it remained contained

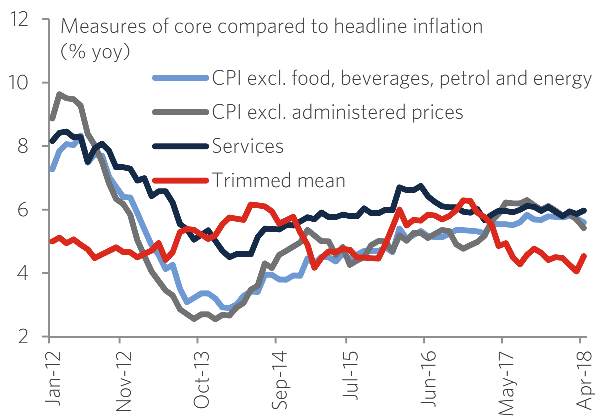
The South African Reserve Bank (SARB) noted a reversal in the long upward trend in underlying inflation in its April 2018 Monetary Policy Review. This trend was evident across sticky price inflation (slow-moving inflation items, which account for 16% of the inflation basket), trimmed mean inflation (excluding the top 5% and bottom 5% of the inflation basket) and core inflation (headline excluding the effect of food and fuel).

April's inflation report suggested a slight uptick in the trimmed mean inflation measure to 4.5% y/y from 4.1% previously, but this remained considerably lower than the 5.1% average recorded since the series began in January 2012.

Similarly, services inflation rose to 5.3% y/y in April 2018 from 4.9%, two readings ago, but inflation in this category remained significantly lower than the average 5.8% recorded since January 2012.

Chart 2 below indicates a comparable trend in core inflation, which picked up to 4.5% y/y from 4.1% in March 2018. Nonetheless, this measure of underlying inflation remained notably below the average registered from 2012 (5.1%).

Chart 2: Underlying inflation remained contained



Source: Stats SA, Global Insight, Momentum Investments

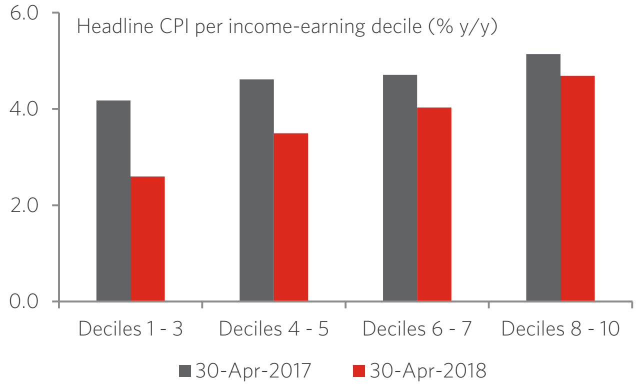
Subdued inflation for lower-income earners benefiting real wage growth

Lower-income earners tend to spend a larger portion of their income on food. With food inflation dropping sharply from 10% y/y a year ago to 3.7% y/y in April 2018, overall rates of inflation for lower-income earners declined faster than those for higher-income earners (who tend to spend more on rental, insurance and transportation costs).

Headline inflation registered at 2.6% y/y for the three-lowest income-earning deciles in April 2018 (1.9% previously in March 2018) and 4.7% y/y (previously: 4.0%) for the highest-three income-earning deciles (see chart 3).

Government attempted to shelter the lower-income earning groups from the increase in VAT by allowing for VAT exemptions on a number of items, as well as by ensuring real increases in social grants. More subdued inflation among the lower income-earning groups points to favourable real wage gains and should be positive for growth in household consumption.

Chart 3: Poorer households are experiencing lower rates of headline inflation



Source: Stats SA, Global Insight, Momentum Investments

Steady interest rates expected in the base case, but a marked drop in inflation expectations could pave the way for one more interest rate cut

The SARB previously noted the effect of monetary policy normalisation in advanced economies on capital flows and global financial markets will create certain challenges for central banks. While it admits “emerging markets are better placed to weather the storm than was the case five years ago”, a faster pace of interest rate hikes in the United States and the Eurozone continue to pose a threat to financing the current account deficit, which could negatively affect the local currency.

In addition, the SARB drew attention to rand risks posed by the rising threat of global trade protectionist measures, in its April 2018 Financial Stability Review.

Moreover, although a number of positive political developments have unfolded since the African National Congress National Conference in December 2017 and economic prospects have improved, the SARB cautioned the domestic fiscal position remains vulnerable to rising contingent exposures of government to state-owned enterprises (SoEs). In its April 2018 Financial Stability Review, the SARB highlighted SoE liquidity shortfalls could place additional pressure on government’s finances and increase the risk of further sovereign rating downgrades.

The above mentioned rand risks together with the threat of higher oil prices (as a consequence of heightened geopolitical tensions) could prevent inflation expectations from nearing the mid-point of the inflation target band.

Lastly, the SARB may opt to leave interest rates unchanged for some time, given the expectation of a closing output gap and its reluctance to act in a pro-cyclical manner.

Although Momentum Investments’ base case entails interest rates remaining steady at 6.5%, the risk of a further interest rate cut of 25 basis points cannot be completely ruled out should the first-quarter growth number significantly disappoint and should inflation expectations move decisively lower in the second quarter results of the Bureau of Economic Research’s Inflation Expectations Survey.