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May 2018 headline inflation beats expectations marginally at 4.4%

Highlights

- At 4.4%, the May 2018 inflation print positively surprised consensus expectations for a sideways movement from April's 4.5%.
- Food prices are not exerting upward pressure on the inflation basket, but the rand price of oil poses a greater threat to the upside.
- The combined electricity price tariff increment is still uncertain.
- A real wage increase has been awarded to the public sector.
- Lower-income earners are still experiencing lower rates of headline inflation, but the gap with inflation experienced by higher-income earners is started to narrow.
- Renewed upside risks to the inflation outlook point to a steady interest rate environment for the remainder of the year.

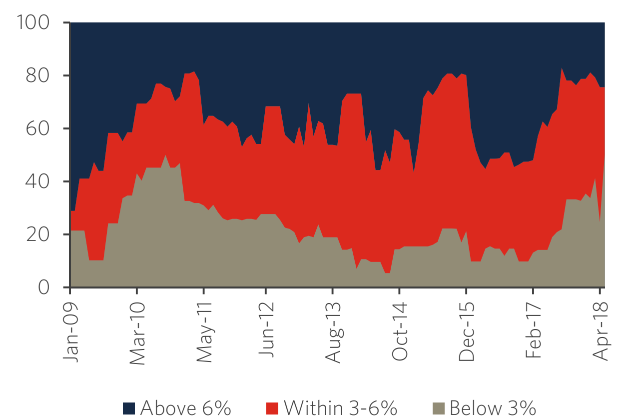
May 2018 inflation print positively surprises consensus

According to Statistics South Africa (Stats SA), consumer price inflation (CPI) dipped to 4.4% in year-on-year (y/y) terms in May 2018, relative to 4.5% in April, but still increased by 0.2% compared to a month ago. This came in lower than Momentum Investments' own forecast for a 4.5% increase and the consensus estimate for a rise to 4.6%.

May is not typically a high survey month, with only sport tickets, hospital fees and electrician and plumber costs being reviewed in addition to the normal monthly surveys.

For the first time since September 2010, more than half of the consumer inflation basket categories, on a disaggregated basis, recorded inflation below 3% (see chart 1). This was largely attributable to a further fall in vehicle inflation, to below 3% y/y in May, which accounts for more than 11% of the consumer inflation basket.

Chart 1: Proportion of inflation categories below, within or above the inflation target band



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

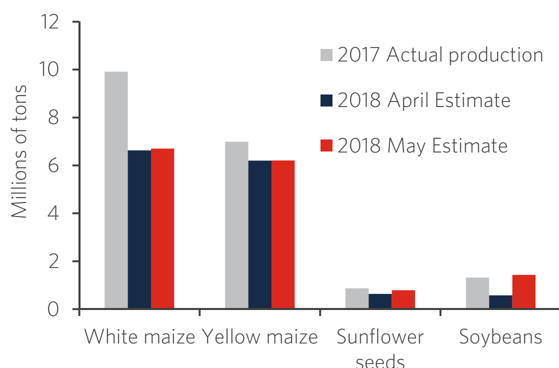
No pressure from food inflation, but oil prices are a problem

Food inflation fell from 3.7% y/y in April 2018 (and 7.0% a year ago) to 3.0% in May. Bread and cereal prices continued to deflate at 4.1% y/y, while meat inflation dropped to 7.8% y/y, from a peak of 15.6% in September 2017.

According to the SA Weather Service Seasonal Climate Watch for June to October 2018, there is a high likelihood of above-normal rainfall for July to August 2018. Agbiz suggested this would be favourable for winter wheat crops in the Western Cape, in particular.

According to its latest crop estimates, the Department of Agriculture, Forestry and Fisheries Crops Estimates Committee expects the white and yellow maize crops to be smaller than last year's (see chart 2), but they are still recording above-average harvest levels, which bodes well for food inflation.

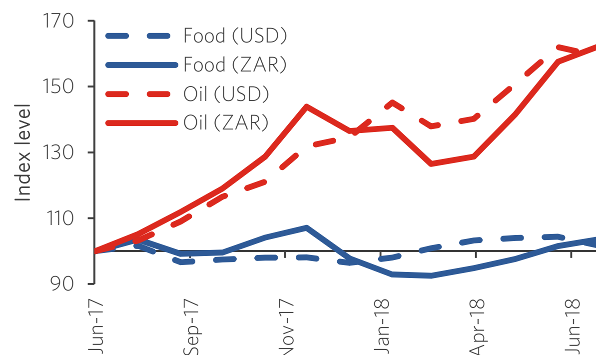
Chart 2: Grain production and crop estimates



Source: Crop Estimates Committee, Momentum Investments

Relative to a year ago, food prices are only 1.6% higher in rand terms, whereas oil prices pose a far larger threat, up 59.1% relative to a year ago (see chart 3).

Chart 3: Surge in oil prices



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.

Effect of combined electricity tariff still uncertain

In mid-June 2018, the National Energy Regulator of SA (Nersa) awarded energy utility Eskom R32.7 billion of the R66.6 billion revenue under-recovery applied for by Eskom through the regulatory clearing account (RCA) applications (a backward-looking reconciliation) for year two (R12.6 billion in 2014/15), year three (R12 billion in 2015/16) and year four (R8.1 billion in 2016/17) of the third multi-year price determination (MYPD 3).

In its media statement to the public, Nersa stated it would decide how the R32.7 billion will be phased in by September 2018, with the first increment likely applied for 2019. Standard Bank assumes an increase of 3% per year based on the clawback (excluding the usual annual tariff Eskom still needs to apply for in its next multi-year tariff application for future years). Standard Bank further noted an additional RCA application for 2018/19 of around R20 billion would also have an effect on the increase of the combined electricity tariff.

In its May 2018 Monetary Policy Committee (MPC) meeting statement, the SARB pointed out that it expected an 8% increase in electricity tariffs for 2019 and 2020. Given the increase is likely going to be slightly above 12%, inflation forecasts could adjust 0.2% higher (electricity accounts for 3.8% of the consumer basket).

A real wage increase awarded in the public sector

A signature from the National Education Health and Allied Workers Union (Nehawu) during the first half of June 2018 ended wage negotiations. A three-year wage deal (backdated to 1 April 2018), which includes a 7% increase for junior employees, 6.5% for mid-level employees and 6% for senior staff in the first year, has been pushed through for all public sector workers. In years two and three, junior employees will receive an increase of CPI plus 1% and mid-level employees will receive an increase of CPI plus 0.5%. Senior staff are not expected to receive any increase in real terms in the outer two years of the three-year deal (see table 1).

The average wage increase amounts to 6.5% in the first year, 5.8% in the second and 6.0% in the third. In its MPC meeting statement, the SARB noted it expected nominal wage growth to average 7% in the forecasted period. It previously warned that wage negotiations in the public sector set the tone for wage agreements in the private sector and, as such, remains

important for overall wage inflation, despite only directly affecting 20% of employment.

The Public Service Co-ordinating Bargaining Council (PSCBC) has stated that parties have agreed to the equalisation of pay across the public service (education and police service). The agreement includes a delinking of the housing allowance for spouses of employees on salary level 1 to 5 with effect from 1 September 2018 and for spouses of employees on salary level 6 to 12 with effect from 1 September 2019. The housing allowance was increased in line with CPI from the previous financial year.

Table 1: Final public sector wage agreement

Employee salary level	2018/19	2019/20	2020/21
1 to 7	7.0%	CPI + 1% = 6.3%	CPI + 1% = 6.5%
8 to 10	6.5%	CPI + 0.5% = 5.8%	CPI + 0.5% = 6.0%
11 to 12	6.0%	CPI = 5.3%	CPI = 5.5%

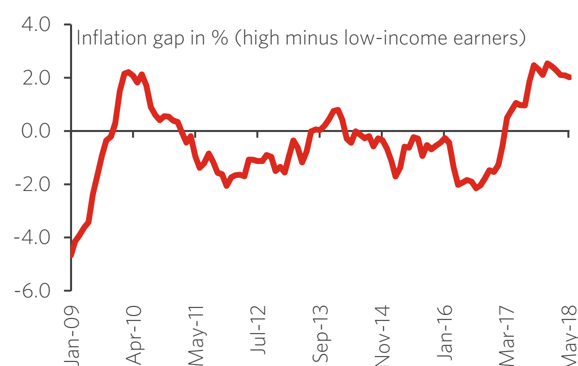
Source: PSCBC, National Treasury

Lower-income earners still experiencing lower inflation rates, but the gap is closing

Lower-income earners tend to spend a larger portion of their income on food. With food inflation dropping sharply from a peak of 11.9% y/y in December 2016 to 3.0% y/y in May 2018, overall rates of inflation for lower-income earners have 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 lowest-three income-earning deciles in May 2018 (from a 1.9% low in March 2018) and 4.6% y/y for the three-highest income-earning deciles. The inflation gap between the two groupings peaked at 2.5% in December 2017, but has marginally rolled over since then (see chart 4).

Chart 4: Poorer households are experiencing lower rates of headline inflation



Source: Stats SA, Global Insight, Momentum Investments

Renewed upside risks to inflation point to a steady interest rate path

In a June 2018 speech to the Asset and Risk Management Forum, SARB deputy governor Daniel Mminele noted that the “era of low policy rates and quantitative easing seems to be drawing to a close” and, as such, “we are entering new and unchartered territory”. The effect normalisation of monetary policy in advanced economies on capital flows and global financial markets will likely create challenges for central banks in emerging markets (EMs). Although EM macroeconomic fundamentals are better to withstand a withdrawal of liquidity than was the case five years ago, a faster pace of interest rate hikes in the United States (US) and the Eurozone continue to pose a threat to financing the current account deficit, which could negatively affect the local currency.

Rising global trade protectionist measures, which had been previously highlighted in the SARB’s April 2018 Financial Stability Review, have hurt investor sentiment and stung EM currencies in recent weeks. Increasing prospects of a prolonged global trade war have added to the pressure on EMs stemming from a more hawkish US Federal Reserve.

Idiosyncratic risks in Turkey (aggressive monetary policy tightening in response to a steep rise in inflation), Brazil (labour unrest and investor apprehension in the run up to the October 2018 elections) and Argentina (soaring inflation, a falling currency and a request for another bailout from the International Monetary Fund) have additionally soured EM sentiment.

The dollar has strengthened in an environment of diminishing global liquidity, which has pushed down the value of EM currencies. Similarly, rising US yields have shifted sentiment for a wider range of EM investments.

Although wage negotiations have been settled in the public sector, overall wage growth is likely to remain a threat to the inflation outlook. The latest round of public sector wage negotiations has resulted in above-inflation increments. Minister of Public Service and Administration Ayanda Dlodlo noted the 2018 salary agreement exceeded the amount envisioned in the medium-term expenditure framework

(R110 billion between fiscal year 2018/19 and 2020/21) by nearly R30 billion. Although employment in the public sector accounts for 20% of total employment in SA, the SARB has warned in the past that negotiations in the public sector set the tone for wage agreements in the private sector.
Rising transport costs (on the back of a surge in international oil prices and a depreciation in the local currency) could further tilt wage increases higher.

Nonetheless, a still-negative output gap is likely to defer any tightening of interest rates to 2019 in
Momentum Investments' view. The company expects interest rates to remain steady at 6.5% for the remainder of the year, with interest rate hikes on the cards for 2019, in line with the firm's view on rising inflation.

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