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Interest rates steady at 6.5%, but a realisation of inflation risks leads to a hawkish stance

Highlights

- The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) warned against a materialisation of inflation risks.
- Despite an upward revision to the SARB's inflation projections, sustained currency weakness, international oil prices and higher-than-expected electricity tariffs continue to pose an upside threat to its forecast.
- The SARB's growth outlook has deteriorated, but risks to the downwardly-revised view are now seen as broadly balanced.
- Lower growth projections leave the SARB's estimated output gap wider in the near term, but it still expects the gap to shift favourably into positive territory by 2020.
- All members of the MPC voted unanimously to keep interest rates unchanged at 6.5%.
- Momentum Investments anticipates a steady interest rate outcome at the September 2018 meeting, but tighter global financial conditions and SA's relatively poor macro fundamentals highlight the need to maintain an attractive real interest rate profile.

Interest rates unchanged, but a more hawkish stance adopted

The MPC unanimously decided to leave interest rates unchanged at 6.5% at the July 2018 interest rate-setting meeting. This was in line with the expectation of all 25 analysts who participated in the Reuters Econometer survey in July 2018.

Despite interest rates remaining steady, the tone of the statement has, in Momentum Investments' view, taken on a more hawkish stance, given the SARB viewed risks to the inflation outlook as remaining to the upside, despite an upward revision to its headline and core (headline inflation excluding volatile components such as food and fuel) inflation projections.

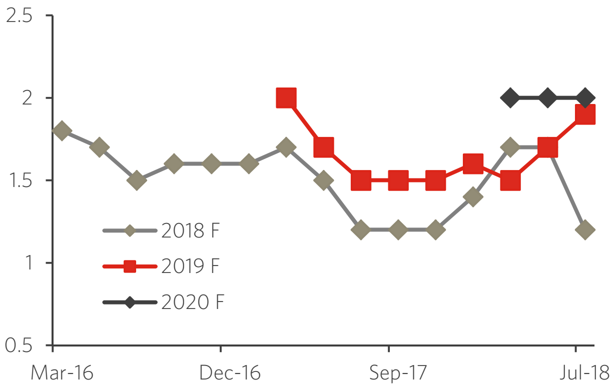
With the SARB's 2018 growth forecasts being downgraded back to its November 2017 estimate of 1.2%, the output gap is expected to be wider than previously forecasted in the near term. As such, the SARB indicated demand-pull inflation pressures are still largely absent, but rising supply-side pressures have contributed to the upward revision in the SARB's inflation forecasts.

SARB's 2018 growth estimate slashed by 0.5%

Despite suggesting the weak first-quarter outcome of the gross domestic product (GDP) would not derail the overall upward trend in growth at the May 2018 MPC meeting, the SARB downwardly revised its real GDP growth forecast for 2018 from 1.7% to 1.2% (see chart 1), after taking the first-quarter figure into account. This is lower than the July 2018 Reuters consensus of 1.5% and lower than Momentum Investments' projection of 1.7%. The firm expects the recovery in growth, from 1.3% in 2017 to an expected 1.7% in 2018, to be underpinned by firm household spend (supported by real wage gains, a revival in consumer confidence, a mild recovery in employment and marginal growth in credit), an accumulation in inventories and a slight lift in export growth (in line with an ongoing robust global economic recovery).

The SARB was expecting a 2018 growth rate of 1.2% in November 2017, during a period of elevated political uncertainty in the run up to the ruling party's national elective conference in December 2017. Growth forecasts were subsequently revised higher to 1.7% at the January 2018 interest rate-setting meeting after local confidence soared on the back of a favourably perceived political outcome.

Chart 1: SARB's real GDP growth forecasts (% y/y)

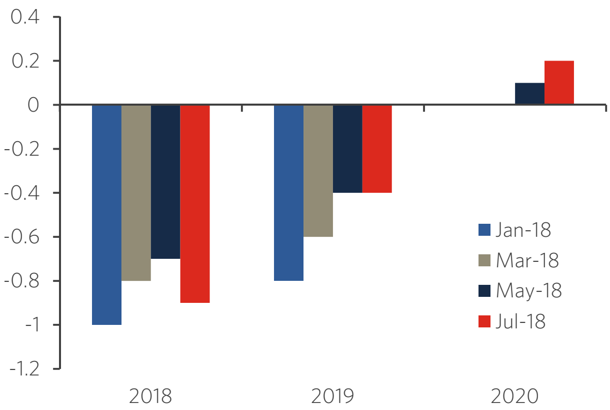


Source: SARB, Momentum Investments

The SARB's estimate of the output gap (the difference between actual and potential growth) has widened in the near term, in response to the downward revision in growth projections for 2018. Nevertheless, the output gap is still expected to recover by 2020 (see chart 2). The SARB anticipates a recovery in growth to 1.9% in 2019 (compared to the July 2018 Reuters consensus estimate of 2% and Momentum Investments' projection of 2.1%). The SARB's growth forecasts for 2020 have remained unchanged at 2% (relative to a 2.2% expectation by the July 2018 Reuters consensus and Momentum Investments) since March 2018, when they were first produced.

In the question and answer (Q&A) session, following the reading of the MPC statement, the MPC noted that SA's growth outcomes could be higher if the country managed to boost tourism, reinvigorate investment through holding the right conversations, release additional spectrum and deliver on the proposals outlined in the National Development Plan.

Chart 2: SARB's output gap expectations (%)

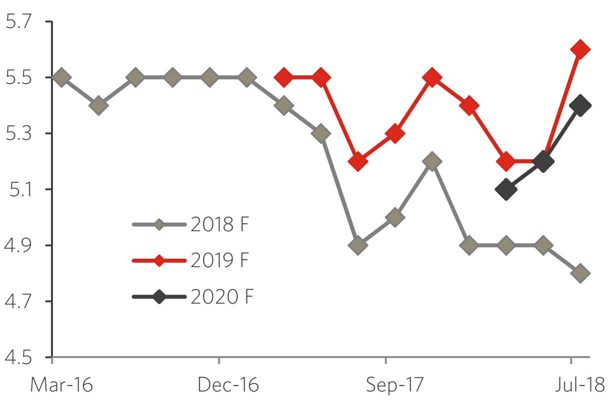


Source: SARB, Momentum Investments

SARB's inflation forecasts ratcheted higher, but risks remain to the upside

The recent spate of positive inflation surprises has likely led to the MPC's marginal downward revision in its 2018 headline inflation forecast from 4.9% to 4.8% (see chart 3). Although the July 2018 Reuters consensus estimate still reflected a 4.9% expectation for 2018, the lower-than-anticipated June 2018 print could see this figure being downwardly adjusted in the next survey results.

Chart 3: SARB's headline inflation forecasts (% y/y)



Source: SARB, Momentum Investments

The SARB noted supply-side factors have led to an upward revision of 0.4% and 0.2% to its 2019 and 2020 inflation forecasts, respectively. The SARB's updated projections suggest an increase in headline inflation to 5.6% in 2019, before dropping to 5.4% in 2020.

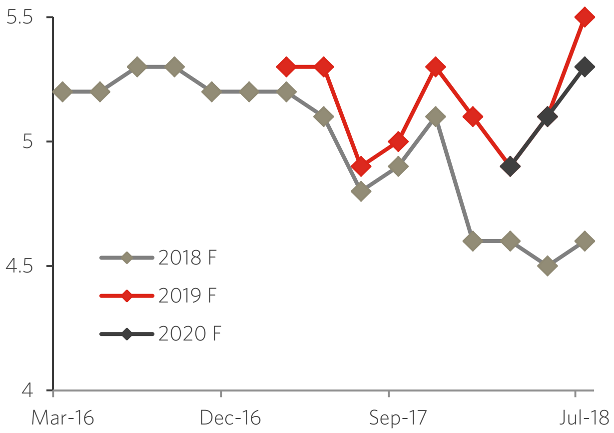
The MPC views risks to the inflation outlook being to the upside, notwithstanding its latest upward revisions. Persistently high wage settlements, the risk of a higher-than-expected electricity tariff in 2019, international oil prices and sustained rand weakness were all highlighted as key threats to the SARB's inflation view.

The SARB increased its oil price expectation from US$70/bbl to US$72/bbl in 2018 and from US$67/bbl to US$70/bbl in 2019, more or less in line with Momentum Investments' own expectations.

Momentum Investments has pencilled in a higher prediction for electricity tariff adjustments of around 12% for 2019, relative to the SARB's projection of 7.3%. In the Q&A session, the MPC clarified that its inflation forecast captures the second-round effect of the expected electricity tariff increase.

Underlying or core measures of inflation were also adjusted higher in the SARB's July 2018 revised estimates (see chart 4). Core inflation is now expected to average 4.6% in 2018 (previous: 4.5), 5.5% in 2019 (previous: 5.1%) and 5.3% in 2020 (previous: 5.1%).

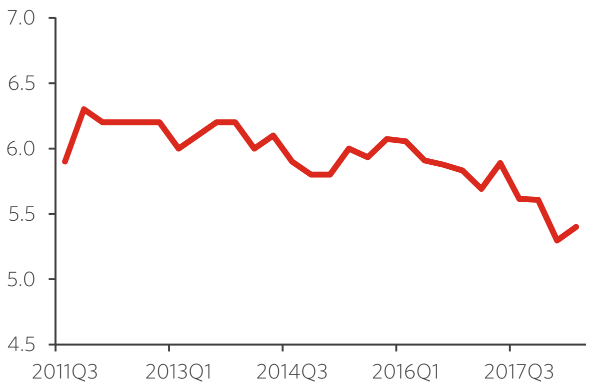
Chart 4: SARB's core inflation forecasts (%)



Source: SARB, Momentum Investments

Longer-dated inflation expectations, as calibrated by the Bureau of Economic Research (BER), remained well-behaved. The average five-year inflation expectation shifted marginally higher to 5.4% in the second quarter of 2018, from a low of 5.3% in the previous quarter (see chart 5).

Chart 5: Average expected inflation for the next five years (%)



Source: BER, Momentum Investments

Unanimous decision to keep interest rates unchanged

The SARB announced its decision, to keep interest rates unchanged at 6.5%, was unanimous. The SARB reiterated its approach of looking through the first-round effects on inflation and focusing on the second-round effects. It cautioned it would "not hesitate to act should there be second-round effects that take us significantly away from the midpoint of the target range".

Table 1: Committee members' views in recent meetings

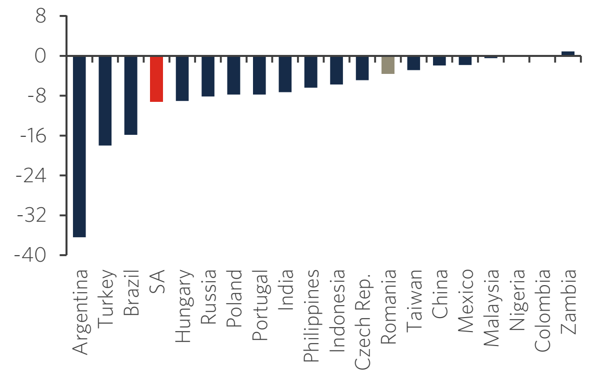
Number of committee members	Favoured no move	Favoured a 25 basis point hike	Favoured a 50 basis point hike	Favoured a 25 basis point cut
24 January 2017	6	-	-	-
30 March 2017	5	-	-	1
25 May 2017	5	-	-	1
20 July 2017	2	-	-	4
21 September 2017	3	-	-	3
23 November 2017	6	-	-	-
18 January 2018	5	-	-	1
28 March 2018	3	-	-	4
24 May 2018	7	-	-	-
19 July 2018	7	-	-	-

Source: SARB, Momentum Investments, six members views reflected prior to March 2018 meeting

Tighter global financial conditions remain a risk to the rand

The rand's performance against the United States (US) dollar ranked as the fourth-worst for the year to date, when compared to a basket of EM currencies (see chart 6).

Chart 6: Currency movement against US$ (year-to-date, %)

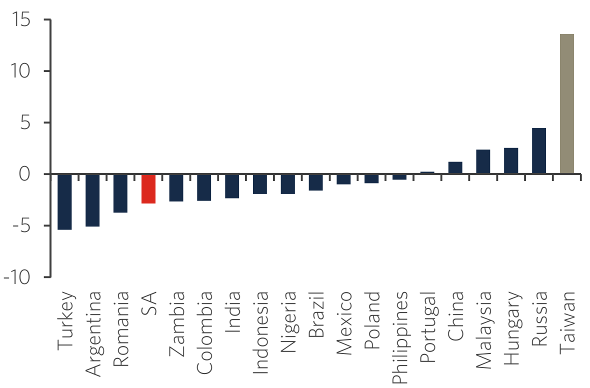


Source: Bloomberg Momentum Investments

EM currencies have in general experienced a sell-off in recent months in a firmer US-dollar environment. Negative trade-war rhetoric and concerns about tighter global financial conditions have, in addition, weighed on the EM composite.

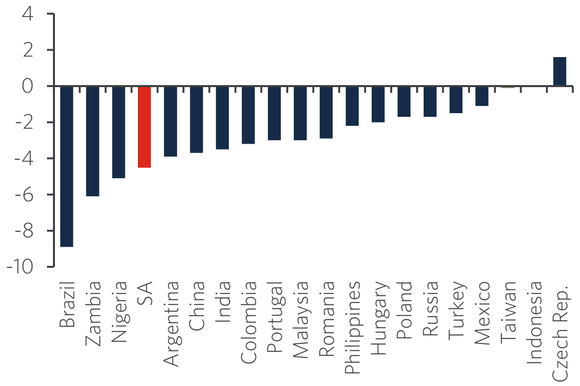
Currencies, such as the Taiwanese dollar, have not depreciated to the same extent, given better macro fundamentals enhancing its ability to absorb external shocks. These macro fundamentals include healthier current account balances (see chart 7), smaller fiscal deficits (see chart 8), lower government debt levels (see chart 9) and higher foreign exchange reserves as a share of GDP (see chart 10).

Chart 7: Current account balances (2017, % of GDP)



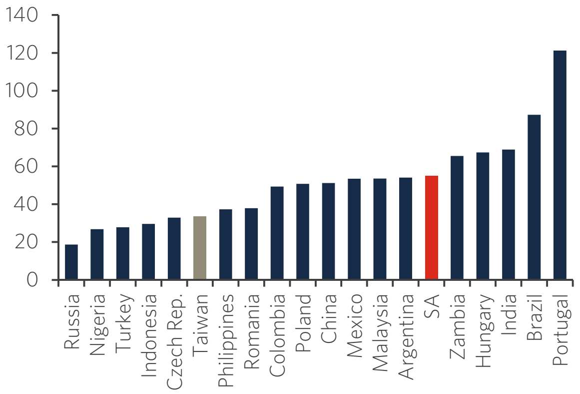
Source: Bloomberg, Momentum Investments

Chart 8: Government budget balances (2017, % of GDP)



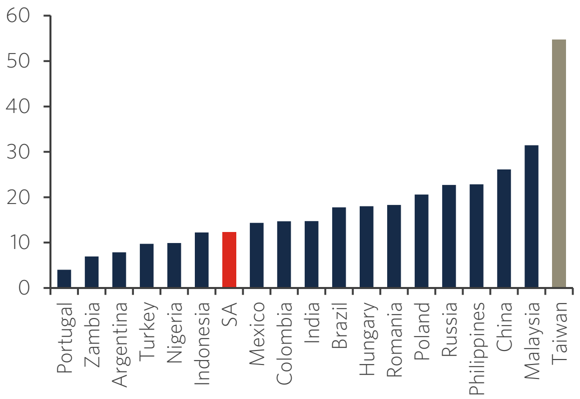
Source: Bloomberg, Momentum Investments

Chart 9: Government debt ratios (2017, % of GDP)



Source: Bloomberg, Momentum Investments

Chart 10: Foreign exchange reserves (2017, % of GDP)

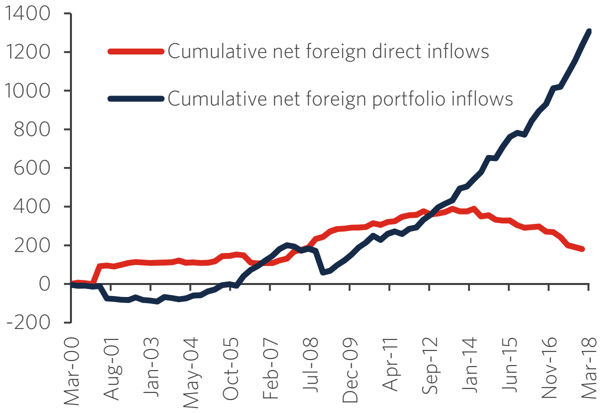


Source: Bloomberg, Momentum Investments

The SARB previously noted the effect of normalisation in monetary policy in advanced economies on capital flows and global financial markets will create certain challenges for central banks. Although it admitted "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 US and the Eurozone continue to pose a threat to financing the current account deficit (see chart 7), which could negatively affect the local currency (see chart 6).

Political strife in recent years has dented investor confidence, which has in turn eroded the cumulative net inflows of foreign direct investment into SA (see chart 11). The funding for SA's current account deficit has primarily been dominated by net foreign portfolio inflows (foreigners' purchases of SA bonds and equities), which are inherently more volatile.

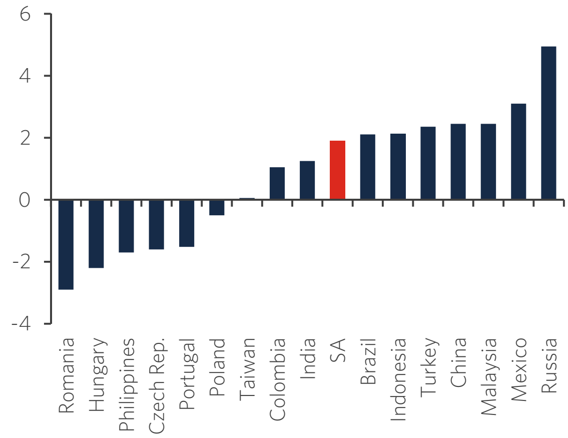
Chart 11: Cumulative net foreign investment (R'bn)



Source: SARB, Momentum Investments

The SARB has revised its current account deficit expectation from 3.0% of GDP in 2018 to 3.9% and from 3.6% of GDP in 2019 to 3.8%. It anticipates the deficit to remain wide at 3.9% in 2020. In light of a persistently wide current account deficit, Momentum Investments deems it important to maintain an attractive real interest rate profile on a comparative basis (see chart 12).

Chart 12: Real interest rate comparison (%)



Source: Bloomberg Momentum Investments

Although Momentum Investments' base case entails interest rates remaining steady at 6.5%, until the first 25 basis point interest rate increase in January 2019, the rising risk of increasing protectionist policies could prompt an earlier hike, given SA's vulnerability to a global trade war, given its extensive linkages into global value chains and the likelihood of higher price pressures in this scenario.