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Revived inflation risks prevent an interest rate cut

Highlights

- The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) pointed to a revival in upside risks to inflation, which likely prevented a further cut in interest rates at the May 2018 meeting.
- Risks to the inflation outlook have risen on geopolitical tensions affecting oil prices, rand volatility, domestic wage developments and uncertainty around electricity tariffs.
- The likely weak outcome for the first quarter growth print is not expected to derail the upward trend in growth.
- The output gap is still expected to close in the medium term, but at a faster pace than originally anticipated.
- All members of the MPC voted unanimously to keep interest rates unchanged at 6.5%.
- Momentum Investments anticipates interest rates to remain steady at the July 2018 meeting, but acknowledges the risk of a further interest rate cut, should inflation expectations continue to trend considerably lower in a more stable rand environment.

Renewed upside inflation risks discouraged a further cut in interest rates

Despite little revision to the SARB's inflation projections, a resuscitation in inflation risks informed the MPC's decision to leave interest rates unchanged at 6.5% at the May 2018 rate-setting meeting. This follows a 25 basis point cut in interest rates in March 2018, triggered (at the time) by an improved inflation outlook and a moderation of risks to the forecasts, relative to the January 2018 meeting.

The May 2018 interest rate decision was in line with the Reuters consensus, where all 25 forecasters expected no change in interest rates. In the run up to the meeting, the forward rate agreement (FRA) market was not pricing in any material interest rate changes within the next few quarters. Following the meeting, the FRA market began to price in a small chance of an interest rate hike a year from now.

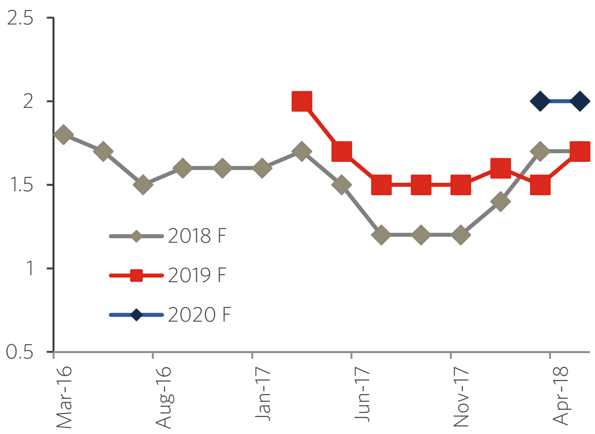
The MPC noted risks to its inflation projection were seen to be to the upside, having changed from a "more or less evenly balanced" assessment in the previous meeting. In the MPC's view, key domestic risks and uncertainties mentioned at the previous (March 2018) meeting have intensified, considering recent unfavourable movements in the local currency, adverse international oil price movements, domestic wage negotiations and Eskom's recent tariff application to the National Energy Regulator of SA (Nersa).

The rand has depreciated by 6.0% against the US dollar, but only weakened by 2.8% on a trade-weighted basis since the March 2018 meeting. These unfavourable currency movements were in large part due to US dollar strength, unfavourable emerging market (EM) risk sentiment and lingering domestic political concerns about the implications of the ongoing land reform debate.

Weak first-quarter growth outcome not expected to derail upward trend

The SARB's growth forecast of real gross domestic product (GDP) for 2018 rose to 1.7% in May 2018, from a 1.2% trough in November 2017, but remained steady relative to March 2018. The projection for 2019, however, shifted a notch higher to 1.7% in 2018, from a previous estimate of 1.5% (see chart 1). The SARB's forecasts for 2020 remained unchanged at 2%.

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



Source: SARB, Momentum Investments, data to May 2018

These forecasts remain slightly below Momentum Investments' projections of 1.8% for 2018 (Reuters April 2018 consensus = 1.9%), 2.1% for 2019 (consensus = 2.0%) and 2.4% for 2020 (consensus = 2.3%). The firm's robust forecast for growth in economic activity in 2020 depends on higher levels of business sentiment, following the national elections, translating into a faster gearing up in private fixed investment spend and firming consumption expenditure.

The SARB outlined a number of reasons why household consumption should improve. Lower near-term inflation, lower interest rates and positive wealth effects should support higher spend, in spite of slow employment growth, tax hikes and higher petrol prices. Momentum Investments expects some additional support from credit growth in upcoming quarters, as banks loosen lending criteria and consumers are more willing to take on new credit, given a large degree of deleveraging in recent years.

The SARB's projections for potential growth and expected growth for the next three years suggest the country's output gap is likely to close by 2020. No adjustments were made to the SARB's forecasts of trend growth, estimated at 1.3% in 2018 and 2019 and 1.4% in 2020. Although the SARB anticipates a closing of the output gap in the forecasted horizon, it noted demand-pull inflationary pressures are not of concern.

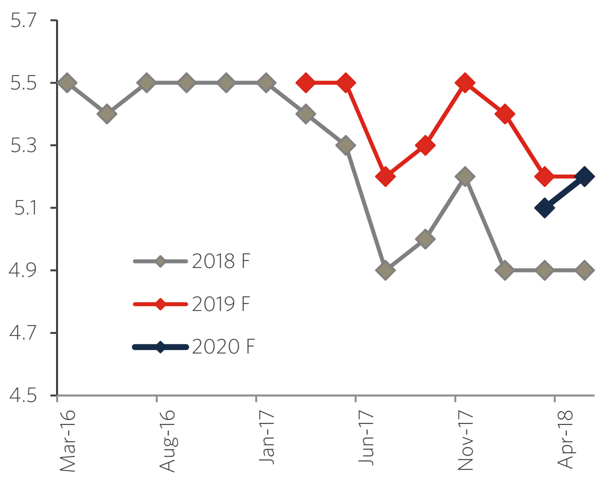
Upside inflation risks have re-emerged

The MPC's 2018 forecast for headline inflation of 4.9% takes account of the increase in value-added tax (VAT) rates from 14% to 15%, but the SARB warned the full effect of the VAT increase may still be felt in the coming months. The increase in the VAT rate is expected to be applied for four quarters from the second quarter of 2018 (with inflation peaking at 5.5% in the first quarter of 2019) and the SARB anticipates only marginal second-round effects in subsequent quarters.

Forecasts for 2019 and 2020 are expected to remain within the target band at 5.2% in 2019 (unchanged from previous) and 5.2% in 2020 (5.1% previously).

Momentum Investments' inflation expectations are in line with the SARB's forecast and the Reuters consensus at 4.9% in 2018, but higher in 2019 (5.3%, relative to the consensus expectation of 5.2%) and marginally lower in 2020 (5.2% relative to 5.3%).

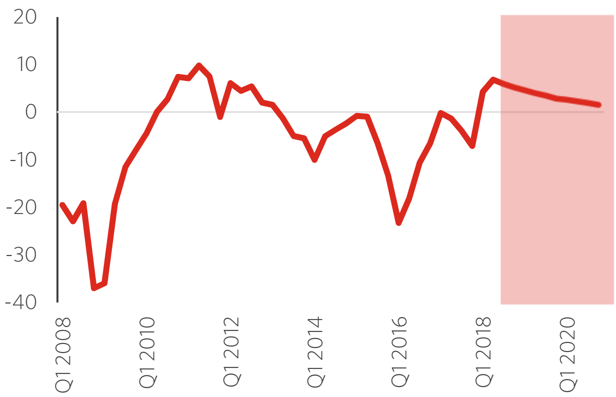
Chart 2: SARB's headline inflation forecasts (% y/y)



Source: SARB, Momentum Investments, data to May 2018

The SARB noted some of the key risks to the outlook for the rand have re-emerged. In a March 2018 speech, at the National Asset and Liability Management Conference, the SARB pointed to the likelihood of the prolonged period of easy money and highly liquid markets coming to an end and warned there could be negative spillovers to emerging markets. In its April 2018 Monetary Policy Review, the SARB revealed its currency model for the real effective exchange rate (REER) pointed to the rand being somewhat overvalued (see chart 3). Since then, the SARB acknowledged the recent depreciation has reversed a significant amount of the previous overvaluation.

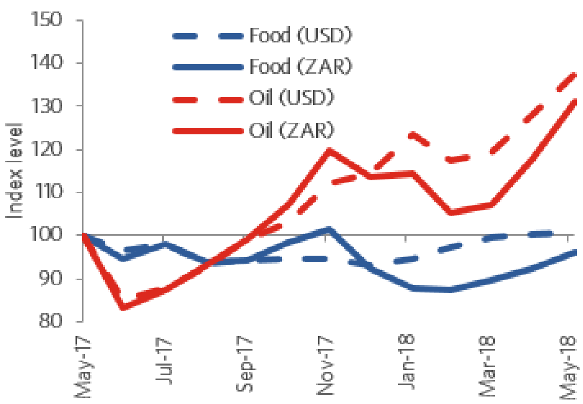
Chart 3: SARB noted the level of overvaluation assessed in April 2018 has largely been unwound



Source: SARB, Momentum Investments

The MPC predicts nominal average wage growth of 7% for the forecasted period, highlighting that the outcome for the public sector wage negotiations was still unclear.

Chart 4: Surge in oil prices

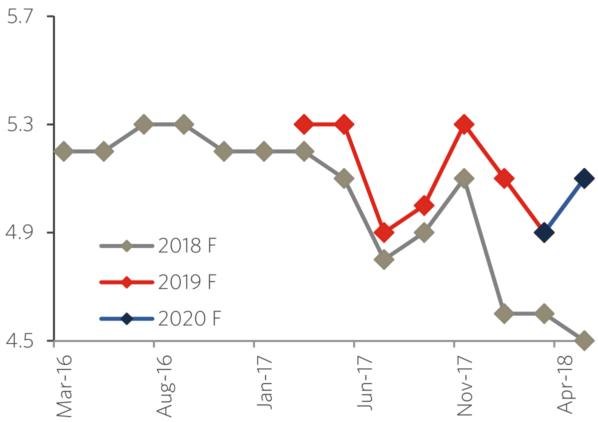


Source: Stats SA, Global Insight, IRESS, Momentum Investments

While previously the SARB only warned about the upside risks to the international oil price, recent movements and heightened geopolitical factors prompted the SARB to raise its oil price forecasts to US$70 per barrel (bbl) (from US$63/bbl) in 2018 and to US$67/bbl (from US$62/bbl) in 2019. Oil prices in rand terms are nearly 38% higher than where they were a year ago (see chart 4).

Underlying or core inflation (headline excluding the effect of food and fuel) is projected by the SARB to steady near 5% for the majority of the forecasted horizon (see chart 5).

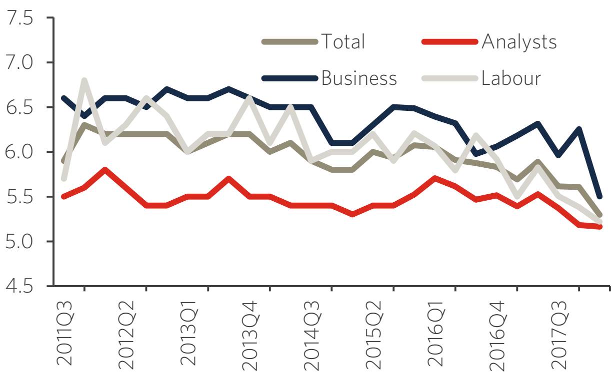
Chart 5: SARB's core inflation forecasts (%)



Source: SARB, Momentum Investments

The downward adjustment in inflation expectations, as calibrated by the Bureau of Economic Research's Inflation Expectations Survey, was a welcome move, but in the question and answer (Q&A) session, the SARB reiterated the desire for inflation expectations to reach the mid-point of the inflation target band. The first-quarter survey for 2018 suggested average inflation expectations for the next five years had dropped to its lowest level on record, to 5.3% (see chart 6). The second-quarter survey results will only be available for the July 2018 MPC meeting.

Chart 6: Average expected inflation for the next five years (%)



Source: BER, Momentum Investments, data up to Q1 2018

Unanimous decision to keep interest rates unchanged

The SARB admitted the decision to keep interest rates unchanged at 6.5% was unanimous. In the Q&A session, the SARB refused to classify the recent cut, as part of an interest rate cutting cycle and pointed out that further interest rates moves will be dependent on data.

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
28 January 2016	1	2	3	-
17 March 2016	3	3	-	-
19 May 2016	5	1	-	-
21 July 2016	6	-	-	-
22 September 2016	6	-	-	-
24 November 2016	6	-	-	-
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	-	-	-

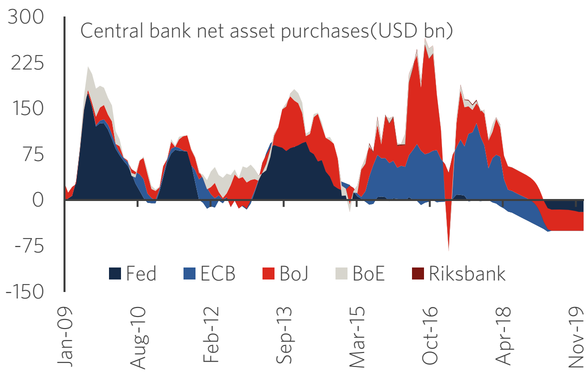
Source: SARB, Momentum Investments, six members' views reflected before the March 2018 meeting

Environment of steady interest rates likely to persist, but a significant drop in inflation expectations could spur an additional 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 (see chart 5).

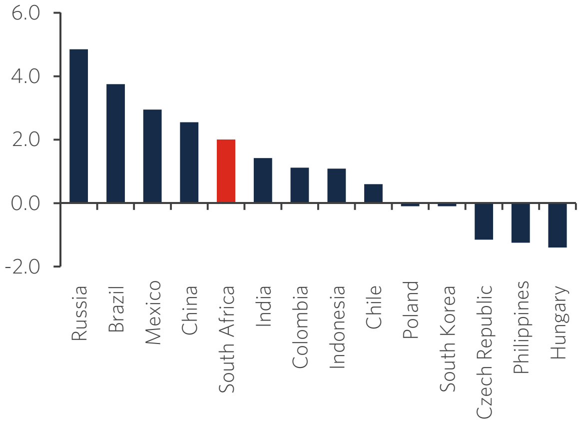
While it admits "emerging markets are better placed to weather the storm than was the case five years ago", a faster pace of interest rate hikes in the United States and the Eurozone continues to pose a threat to financing the current account deficit, which could negatively affect the local currency. As such, it will be important to maintain an attractive real interest rate profile on a comparative basis (see chart 6).

Chart 5: Tapering off in additions to global liquidity



Source: Citi, Momentum Investments

Chart 6: Real interest rate comparison (%)



Source: Bloomberg Momentum Investments

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 BER survey results.