The Macro Research Desk

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Slower-than-expected rise in October 2018 inflation print to 5.1%

Highlights

- Headline inflation surprised the market positively at 5.1% for October 2018.
- Nearly three quarters of the items in the consumer inflation basket recorded inflation below the upper end of the 3% to 6% inflation target in October 2018.
- Food inflation registered another positive downside surprise. Deflation continued in the bread and cereals category, while animal prices at the producer price level have indicated further downside in meat prices at the consumer level in the near term.
- The Central Energy Fund and the Department of Energy are leading towards a sizeable cut in the fuel price for December 2018.
- The bottom 30% of income earners have been experiencing lower rates of inflation relative to the top 30% of income earners since March 2017, due to the heavier weighting of food in the lower-income earners' consumption baskets.
- Well-behaved services inflation likely contributed to lower core inflation, given its relatively high weighting in the consumer inflation basket, while administered price inflation is running at double the rate of the upper end of the inflation target.
- The upcoming interest rate decision by the South African Reserve Bank (SARB) is likely to be a close call, but the SARB's recent guidance on managing inflation expectations away from the upper end of the inflation target and towards the midpoint suggests interest rates are likely to be raised by 25 basis points at the November 2018 interest-rate setting meeting.

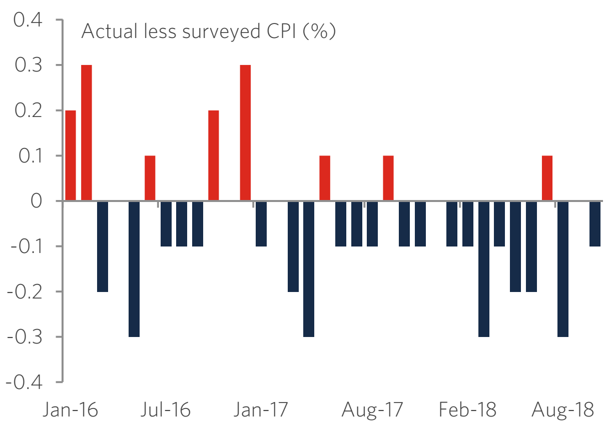
Another positive inflation surprise for October 2018

Consumer price inflation (CPI) surprised the market positively at 5.1% and came in 0.1% lower than the consensus expectation for a 5.2% rise in October 2018 (see chart 1). The monthly increase in fuel costs, however, left the price index 0.5% higher relative to a month earlier.

According to the data provided by Statistics South Africa (Stats SA), actual inflation prints have either surprised positively (lower than market expectations) or met expectations three quarters of the time since the start of 2016. In Momentum Investments' view, well-behaved services inflation, a muted pass-through from previous currency depreciation and subdued food inflation contributed to the positive string of downward surprises in this period.

October is generally a low surveyed month. Only 11% of the basket was surveyed in addition to the regular surveys, which are conducted monthly. Relative to Momentum Investments' forecasts, inflation in the food, non-alcoholic beverages and insurance categories reported the largest downside surprises, while inflation in vehicles registered a higher-than-expected outcome for the month.

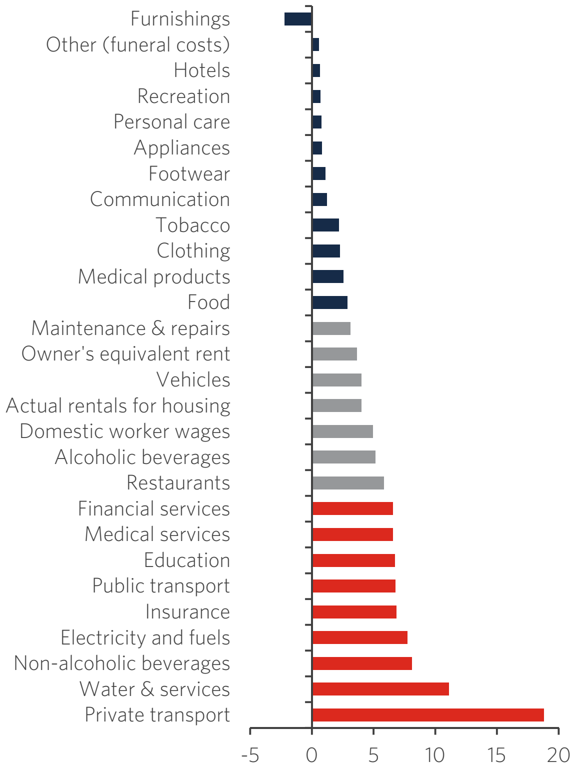
Chart 1: Another positive inflation surprise



Source: Bloomberg, Momentum Investments, data up to October 2018

More than 60% of the items in the consumer inflation basket registered inflation below the upper end of the 3% to 6% inflation target in October 2018, in line with the 63% average recorded since the beginning of 2016. The weighted share of items recording inflation below 3% has dropped from 50% in August 2018 to 38% in October 2018, primarily due to a rise in vehicle inflation to 4% in the same period (see chart 2).

Chart 2: Inflation* by category (%)



Source: Bloomberg, Momentum Investments, data for October 2018

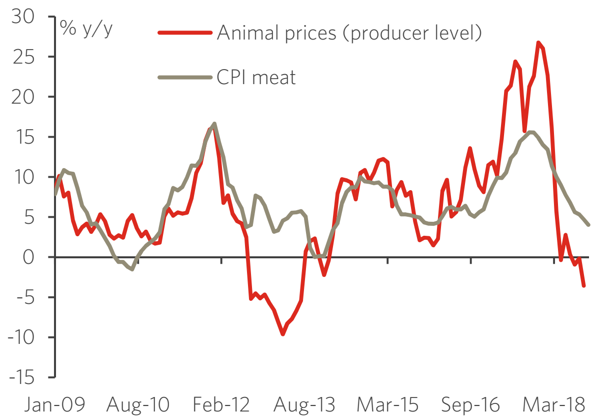
**Inflation: red ≥ 6%, 3% > grey > 6%, blue ≤ 3%*

Muted food inflation to shift gradually higher in upcoming quarters

Food inflation remained below the bottom end of the inflation target band at 2.9% in year-on-year (y/y) terms in October 2018. Food inflation at the processed and unprocessed levels remained below 3%.

Deflation continued in the bread and cereals category (accounting for a fifth of the food inflation basket) for the 15th consecutive month. The pace of deflation has, however, slowed to 0.8% y/y in the October 2018 print. The further dip in meat inflation to 5% y/y contributed to a muted increase in food prices, given its hefty contribution to the consumers' food inflation basket (accounting for a third of the total food basket). Animal prices at the producer price level are indicating further downside in meat prices at the consumer level in the near term (see chart 3).

Chart 3: Further downside in meat inflation

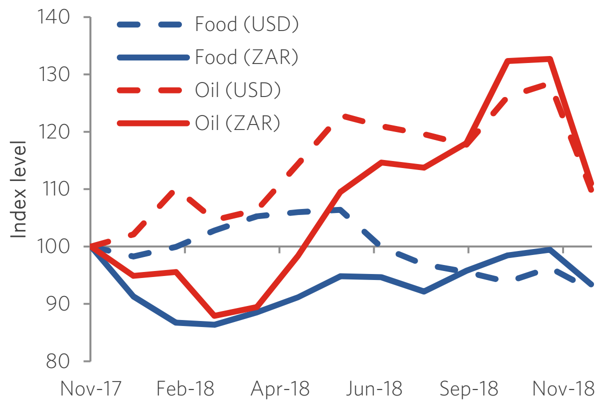


Source: Stats SA, Global Insight, Momentum Investments, data up to October 2018

Pressures on international food prices remain weak. The international food price index is down 7% relative to the same time a year ago (see chart 4). The November 2018 Food Outlook report by the Food and Agriculture Organisation (FAO) of the United Nations pointed out that crop production remained in line with earlier forecasts made in June 2018. The FAO's outlook for global supplies of agricultural commodities in the 2018/19 season have remained broadly in line with earlier projections.

The recent dip in oil prices from a peak of US$86/bbl at the start of October 2018 to US$63/bbl at the time of writing has led to a part reversal in pressures on oil prices. International oil prices and oil prices in rand terms are around 10% higher than where they were a year ago, whereas in October 2018 oil prices in rand terms were nearly 30% higher than the same period a year ago.

Chart 4: Muted food inflation and a part reversal in pressures on oil prices

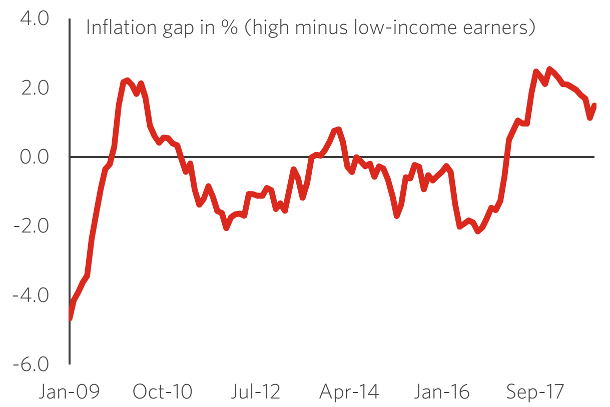


Source: Stats SA, Global Insight, IRESS, Momentum Investments

Subdued food inflation has lowered price pressures for low-income earners

The bottom 30% of income earners in SA have been experiencing lower rates of inflation relative to the top 30% of income earners since March 2017. The gap extended to 2.5% at its peak in December 2017, but narrowed to 1.1% in September 2018 before rising to 1.5% for October 2018 (see chart 5).

Chart 5: Inflation gap (high minus low-income earners, %)



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

This difference can partly be explained by the different items and weightings of items in consumer baskets belonging to the various income groupings in SA. Food and non-alcoholic beverages account for a larger portion of spend for lower income earners (48% for the lowest income-earning decile), while the transport component constitutes a larger share of total consumer spend by the higher income-earning deciles (21% for the highest income-earning decile).

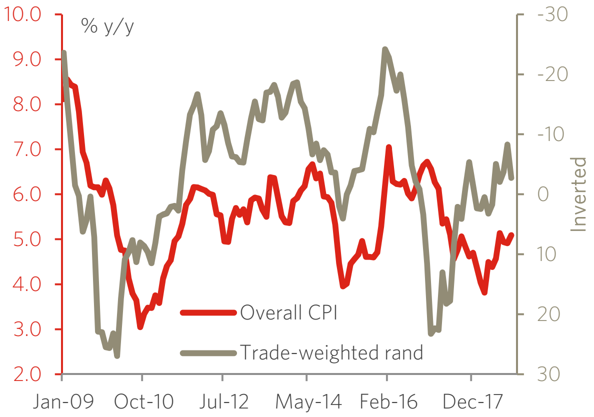
Public transport accounts for 2.3% of the overall basket (split between rail, road (predominantly) and air), while private transport includes costs for personal vehicle operation (spares, fuel, maintenance) and accounts for 5.9% of the overall consumer basket. Public transport, on which the lower income-earning deciles are largely reliant, increased by 6.7% y/y in October 2018, while private transport increased by 18.8% y/y. For the year to date, private transport has experienced an average inflation rate of 11.8%, relative to the 6.6% print recorded for the same period a year ago.

The inflation print for October 2018 captured a 100 cents per litre (c/l) increase in the price of petrol. In November 2018, the Department of Energy announced no change to the petrol price despite the Central Energy Fund (CEF) data having indicated an over-recovery of 22 c/l. The department noted the negative slate balance for petrol and diesel of R2.2 billion required a 21.9 c/l adjustment, which was implemented into the price of petrol and diesel on 7 November 2018. The CEF is leaning towards a sizeable over-recovery of 164 c/l for December 2018, which could see fuel inflation fall significantly in y/y terms in December's inflation print.

Muted core and services inflation, but administered price pressures remained elevated

Inflation, excluding the effect of volatile food/beverages and fuel/energy prices, remained steady at 4.2% in October 2018. Well-behaved services inflation has likely contributed to lower core inflation, given its relatively high weighting in the consumer inflation basket. A muted pass-through from previous currency depreciation has further prevented a spike in inflation (see chart 6).

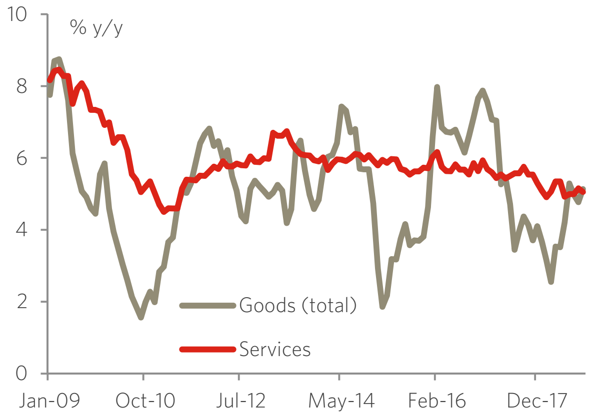
Chart 6: Muted pass-through from previous currency depreciation



Source: Global Insight, Momentum Investments, data up to October 2018

Services inflation has printed below 5.5% for the last 11 months and matched goods inflation at 5.1% in October 2018 (see chart 7). Rental inflation, which accounts for nearly 16% of the basket (when combining the owners' equivalent rent and rentals for housing categories), has shown little price pressure since 2009. During this period, rental inflation averaged close to the midpoint of the inflation target band and has moderated further to 3.7% y/y in October 2018.

Chart 7: Services inflation is tracking lower



Source: Global Insight, Momentum Investments, data up to October 2018

Inflation in administered prices (which account for nearly 15% of the overall consumer price basket), on the other hand, have shot up to an average of 11.8% y/y in the past four months. This category includes assessment rates, refuse removal, water, electricity, paraffin, petrol, public transport, motor licences and registration costs, telephone fees, postage fees, cell calls, television licences, school fees and tertiary schooling fees. Momentum Investments expects price pressure in this category to remain elevated in 2019 on the back of higher electricity tariffs. The firm expects an increase of around 12% in electricity tariffs for 2019, in comparison to the 7.6% projection used by the SARB.

Shallow interest rate hiking cycle expected

Momentum Investments expects headline inflation to rise from a projected 4.6% in 2018 to 5.2% in 2019. Although subdued services inflation, muted food price pressures and a dulled rate of currency pass-through have kept inflation outcomes surprising to the downside in recent months, the rand, international oil prices and electricity tariffs are still viewed as the major upside threats to the inflation outlook.

Since the previous Monetary Policy Committee held on 20 September 2018, the rand appreciated by 1.8% against the US dollar and is 5.3% stronger against the euro. During this period, the international price of oil fell by 19.4%. Although these moves have been positive for the outlook for inflation in SA, a potential rise in geopolitical risks, a faster-than-anticipated rise in global interest rates or a ramp up in protectionist policies could result in a materialisation of upside inflation threats.

The upcoming interest rate decision by the SARB is likely to be a close call. Out of the 18 economists surveyed by Bloomberg, nine are expecting an interest rate hike of 25 basis points, while the remainder expects interest rates to remain on hold at 6.5%. Momentum Investments expects interest rates to be raised by 25 basis points at the upcoming meeting in line with the SARB's guidance to manage inflation expectations away from the upper end of the inflation target towards the midpoint. The firm is not expecting an aggressive interest rate hiking cycle in light of struggling growth and inflation, which is expected to remain within the 3% to 6% target for the medium term.

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