momentum investments

in the moment

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Inflation creeps higher to 4.5% in May in line with expectations

Highlights

- Headline inflation increased to 4.5% in May from 4.4% in April 2019, meeting market expectations captured by Bloomberg.
- Nearly three quarters of the items in the consumer inflation basket (on a weighted basis) registered inflation below the upper end of the 3% to 6% inflation target, suggesting little sign of broad-based inflation pressure.
- An uptick in food inflation is likely in the coming months, due to meat prices, which should increase on the back of the lifting of the export ban on beef, a reduction in slaughtering and higher tariffs on poultry imports.
- A sizeable cut in the petrol price could be possible for July, should the rand stabilise at current levels (or strengthen) and if the international price of oil steadies (or improves) from current levels.
- Inflation in services remained muted at a seven-year low at 4.6%, thanks to subdued rental inflation.
- Administered price inflation remained stubbornly above the inflation target range, but dropped to 8.2% in May.
- The South African Reserve Bank (Sarb) acknowledged the degree of monetary policy accommodation has declined in the past 10 months in particular. Moreover, subdued measures of core and services inflation and depressed growth should further prompt an interest rate cut by the Sarb in the near term.
- Should interest rates drop in the near term, Momentum Investments expects the cycle to be shallow, given the Sarb believes monetary policy space needs to be created by microeconomic reforms, which raise potential growth.

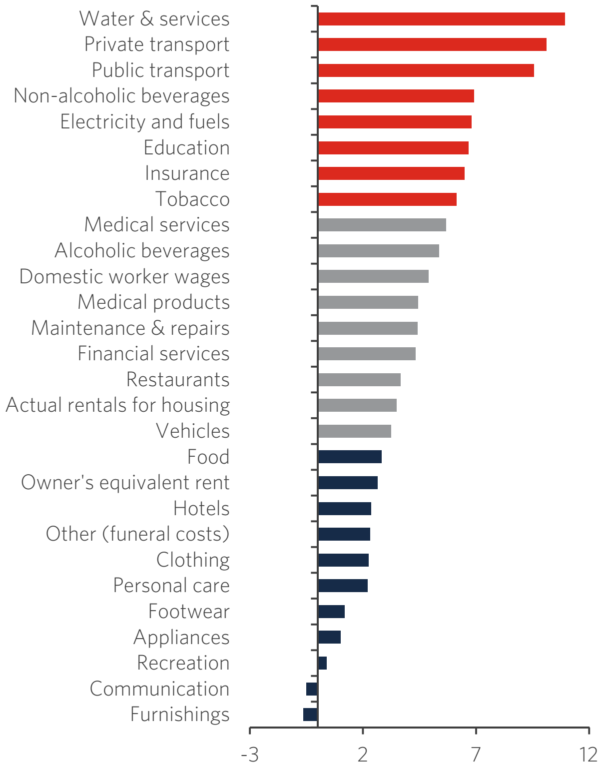
No surprises in the May 2019 inflation print

Headline inflation increased to 4.5% in May from 4.4% in April 2019, meeting market expectations captured by Bloomberg. The 0.3% rise in consumer prices during the month was largely attributable to an increase in the price of petrol, which jumped 54c/l for 95 Octane in May 2019.

May is generally a low-surveyed month. Less than 1% of the basket was surveyed in addition to the regular surveys, which are conducted monthly. Additional items surveyed included tickets for sporting events, hospital fees and electrician and plumber costs. Relative to Momentum Investments' forecasts, inflation for non-alcoholic beverages, vehicles and public transport surprised to the downside, while inflation for tobacco, medical products and maintenance was higher than expected.

Nearly three quarters of the items in the consumer inflation basket (on a weighted basis) registered inflation below the upper end of the 3% to 6% inflation target in May 2019, suggesting little sign of broad-based inflation pressure in the consumer basket. Inflation in categories printing above 6% in May 2019 included water and sewerage costs (10.9%), private and public transport (10% on average), non-alcoholic beverages (6.9 from 10.2% two months ago), electricity (6.8%), education (6.7%) and insurance (6.5%) (see chart 1).

Chart 1: Inflation per category (%)



Source: Stats SA, Global Insight, Momentum Investments
red = above target, blue = below target, grey = within target

Uptick in food inflation likely in the coming months

According to the Agricultural Business Chamber (Agbiz), the key driver of local maize prices in the past months has been higher maize prices in the United States (US), which were pushed higher by abnormally wet weather conditions. Going forward, Agbiz expects a potential cooling off in prices (due to an improvement in crop conditions in the US Midwest) to be offset by higher demand for maize in Mozambique and Zimbabwe, which suffered delayed plantings on the back of droughts and crop damage caused by cyclone Idai.

Although recent rains have increased winter crop plantings in the Southern Cape and Overberg regions (plantings were previously delayed due to dry conditions), low precipitation forecasts in the next weeks could weaken this recent positive development. Agbiz nonetheless expects a generally good season for winter crops (canola, wheat and barley) given healthy dam levels.

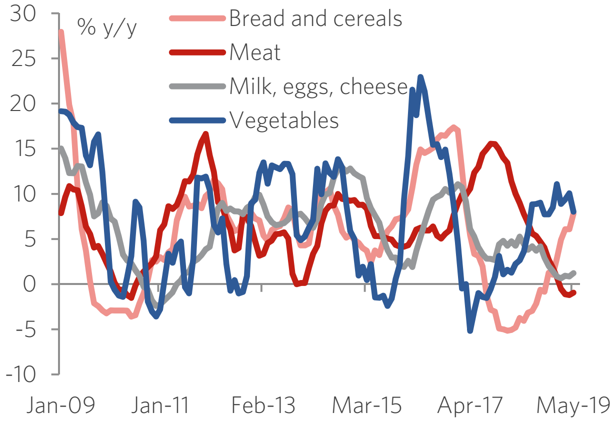
Agbiz anticipates SA will remain a net exporter of maize in 2019/20, although the volume exported is expected to drop by half to 1.1 million tonnes. While SA is still a net importer of wheat, imports are likely to fall this season due to the recent recovery in production.

Bread and cereal inflation rose to 7.8% in May 2019 and remained above the upper end of the 3% to 6% inflation target range for the third consecutive month (see chart 2). Crop inflation has averaged 9.7% in the past six months at the producer price level, indicating further upward pressure on bread and cereal inflation at the consumer level in the near term.

Meat prices have been deflating for the past four months. This is largely due to the outbreak of the foot-and-mouth disease earlier this year, which led to a ban on SA beef in some of the country's key export markets.

Nevertheless, Agbiz expects a reversal in price trends in upcoming months. A number of African and Middle Eastern countries have lifted the ban on SA's beef exports and the slaughtering of sheep and cattle has slowed, which could cap supply and underpin higher meat prices. In addition, an expected increase in import tariffs is expected on poultry products, which could lift prices further in the near term. Moreover, Agbiz warns higher global pork prices (induced by low stocks in China and Vietnam, which were affected by the outbreak of swine fever) could spill over to the local market.

Chart 2: Food inflation by category

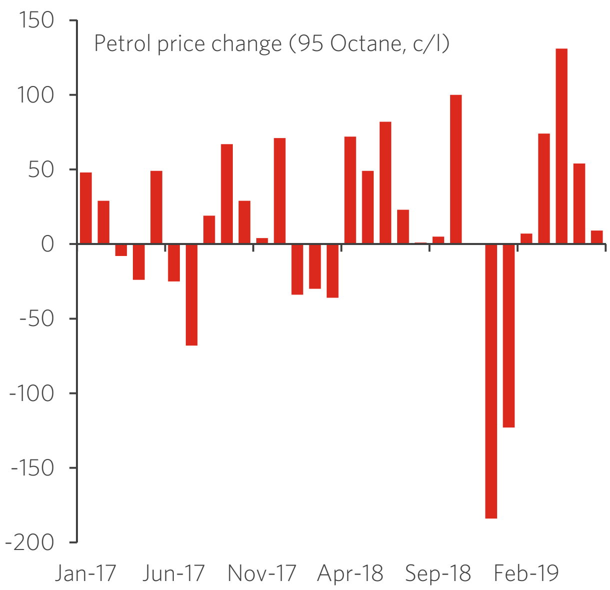


Source: Stats SA, Global Insight, Momentum Investments

Significant petrol price dip expected in July 2019 if the rand and oil price holds

Petrol prices increased by R2.75c/l (95 Octane) between February and June 2019 (see chart 3), but a current over-recovery between 31 May and 18 June 2019 calculated by the Central Energy Fund (CEF) suggests a cut of 90c/l could be possible for July 2019, should the rand stabilise at current levels (or strengthen) and if the international price of oil steadies (or improves) from current levels.

Chart 3: Petrol price changes



Source: CEF, Momentum Investments, data up to June 2019

The international price of oil peaked at US$74/bbl in late April 2019, but has since retraced to below US$62/bbl on lower global demand for oil on the back of a slowing world economy. The International Energy Agency recently cut its oil demand growth forecast and warned the slump in world trade growth has had consequences for oil demand.

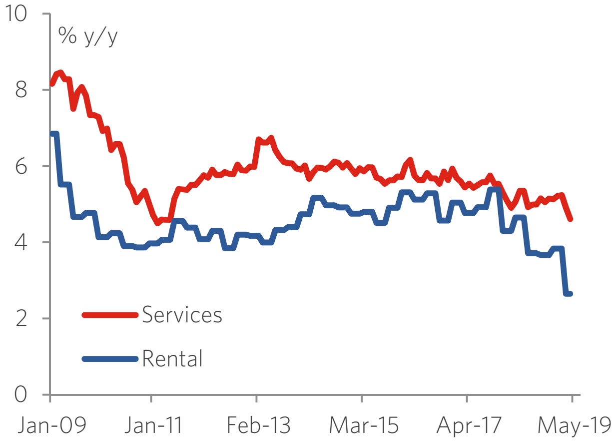
Meanwhile, IHS Markit warns against higher oil prices in the near term, given disruptions in the Middle East. Moreover, favourable developments on a potential trade deal between the US and China as well as more accommodative monetary policy stances by the European Central Bank and US Federal Reserve could see oil prices backing up in the near term.

Inflation in the transport category increased by 1% between April and May 2019 and rose by 7.1% relative to a year ago. Within the transport category (which accounts for 14.3% of the total consumer basket) private transport (largely fuel costs) dropped from 10.4% year on year (y/y) to 10.1% in May 2019, but increased by 2.6% month on month (m/m). Meanwhile, public transport costs dropped 1.2% in the month, leaving the y/y rate at 9.5%. New vehicle prices increased by 3.5% y/y in May 2019, while used vehicle prices dropped by 0.5% in the same period.

Services inflation remained at a seven-year low

Core or underlying inflation inched higher to 4.3% in May 2019, leaving the past one-year average at 4.4%, which is marginally below the midpoint of the targeted inflation range. Inflation in services remained muted at a seven-year low at 4.6%, thanks to subdued rental inflation (see chart 4). Rental inflation, which is a significant component of services inflation, remained low at 2.7%.

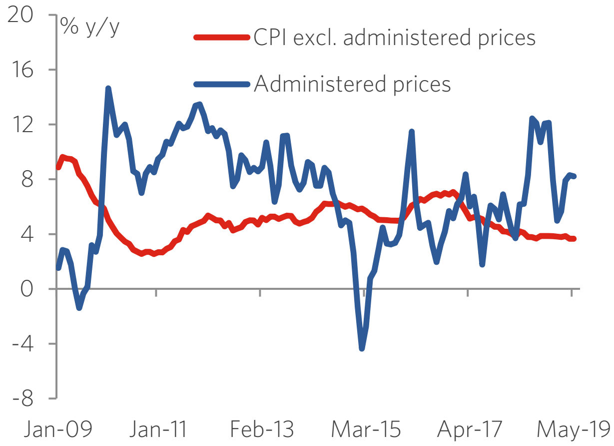
Chart 4: Services inflation heading lower (%)



Source: Stats SA, Global Insight, Momentum Investments

Administered price inflation remained stubbornly high at 8.2% in May 2019, from 8.3% the month before (see chart 5). After excluding administered prices, inflation recorded at 3.7% in May 2019 and at an average of 3.8% for the past year. Fuel and electricity prices accounted for more than half of the 8.2% rise in May 2019, relative to a year ago.

Chart 5: Price pressure stemming from administered costs



Source: Stats SA, Global Insight, Momentum Investments

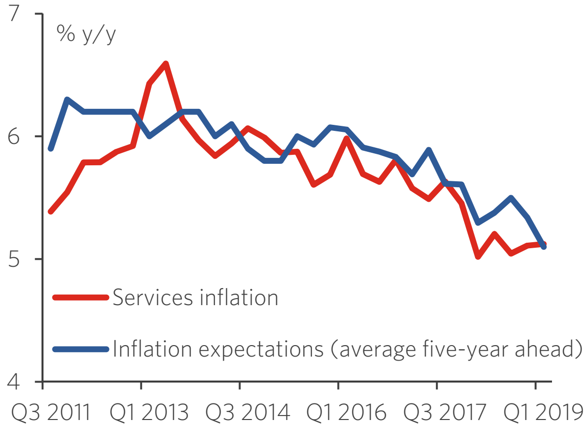
An interest rate cut in the near term is likely

In a recent speech by the adviser to the governors of the Sarb, Fundi Tshazibana highlighted concerns around the sharp contraction in local growth in the first quarter of the year, which was broad-based. In addition, depressed business confidence (which stagnated at 28 index points in the second-quarter reading, significantly below the neutral level of 50 according to the Bureau of Economic Research (BER)), the potential for further shortages in electricity supply and lofty debt levels at a number of key state-owned enterprises remain downside risks to the outlook for local growth.

The Sarb noted monetary policy has been accommodative, but acknowledged the degree of accommodation has declined in the past 10 months in particular. The Sarb attributes this decline to lower-than-expected inflation (due to declining nominal wage growth, lower imported inflation and a drop in meat prices), which has allowed real interest rates to rise.

Subdued measures of core and services inflation should further prompt an interest rate cut by the Sarb. In the past, the Sarb closely monitored inflation expectations, surveyed by the BER. In the latest survey for the first quarter of 2019, the average inflation expectation for the next five-year period dropped to 5.1%, which was the lowest on record (the survey began in 2011). Inflation expectations have closely followed services inflation in the past (see chart 6), boding well for a sustained drop in inflation expectations, closer to the midpoint of the 3% to 6% target band.

Chart 6: Inflation expectations should drop in line with lower services inflation



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

Should interest rates drop in the near term, Momentum Investments anticipates the cutting cycle to be shallow, given the structural nature of SA's projected low-growth profile. The Sarb recognises inflation in SA remains elevated relative to its trading partners and ascribes this to pricing practises, market structure and supply-side rigidities that need to be addressed through the implementation of structural reforms.

The Sarb is of the view that macroeconomic stimulus could cause higher inflation, further currency depreciation and higher interest rates, rather than growth in investment and employment.
Where structural constraints are prominent, the Sarb sees the effectiveness of monetary policy being impeded. As such, the Sarb believes monetary policy space needs to be created by microeconomic reforms, which raise potential growth.