Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

The Macro Research Desk

No major surprises as inflation rises broadly in line with expectations to 4.1% in February 2019

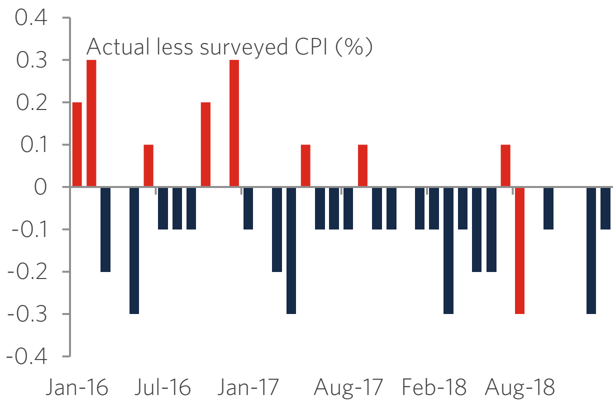
Highlights

- Headline and core measures of inflation broadly met market expectations in February 2019, with headline inflation rising to 4.1% and core inflation steadying at 4.4%.
- 80% of the items in the consumer inflation basket recorded inflation below 6% in February 2019.
- Inflation at the producer price level indicates upward pressure on bread and cereal prices, but downward pressure on meat prices, in the near term.
- The Central Energy Fund and the Department of Energy are guiding towards a sizeable rise in the fuel price for April 2019.
- The energy regulator has ruled on an above-inflation electricity tariff increase for financial year 2019/2020 (FY19/20) and FY20/21.
- The South African Reserve Bank (SARB) is likely to keep interest rates steady at the upcoming interest-rate-setting meeting given muted confidence, subdued growth and within-target inflation.

Inflation ticks unsurprisingly higher to 4.1% in February 2019

Consumer price inflation (CPI) rose from 4.0% in January 2019 to 4.1% in February 2019 (see chart 1). This was marginally lower than the Bloomberg consensus forecast of 4.2%.

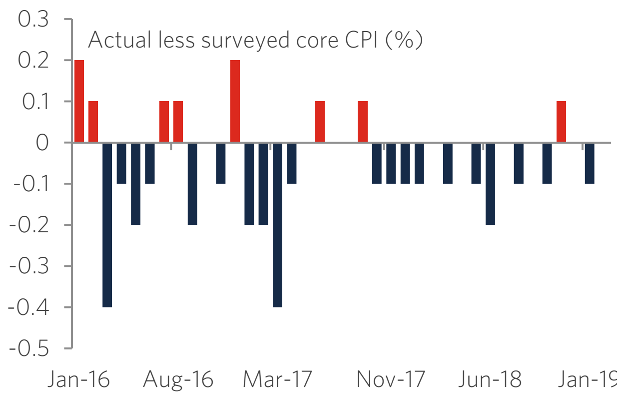
Chart 1: Marginal downside surprise in headline inflation



Source: Bloomberg, Momentum Investments, data up to February 2019

Since the start of 2016, headline and core inflation (see chart 2) has only exceeded market expectations for a fifth of the time, suggesting that inflation has largely surprised the market to the downside in recent months.

Chart 2: Core inflation in line with expectations



Source: Bloomberg, Momentum Investments, data up to February 2019

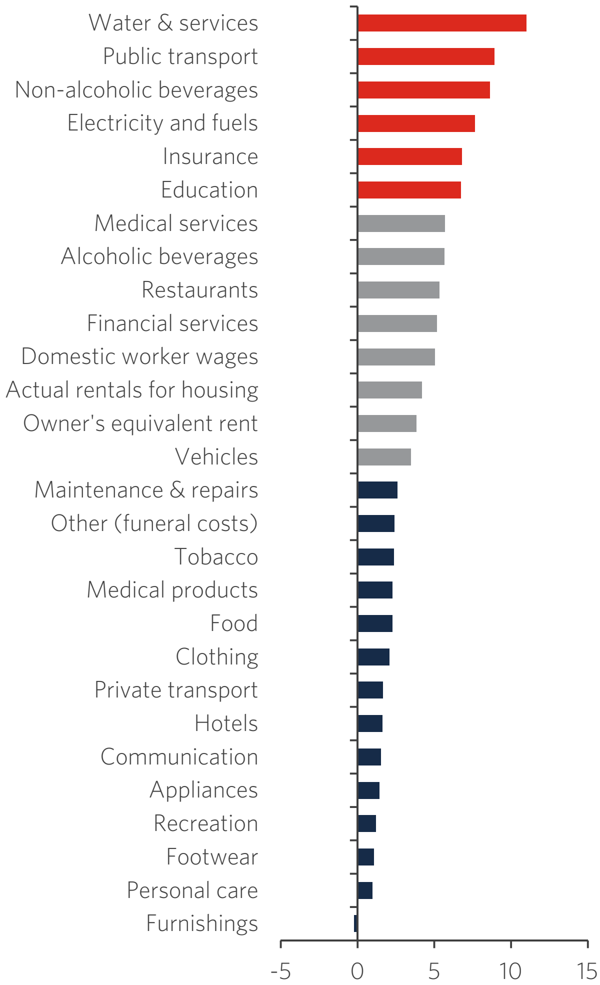
In Momentum Investments' opinion, lower-than-expected food inflation, a supressed pass-through from a weaker currency and contained services inflation contributed to the positive string of downward surprises in this period.

The headline index jumped 1.1% between January and February 2019, with insurance costs and transport prices contributing the most to the monthly change.

February is a generally low-surveyed month. Only 12% of the basket (including medical aid contributions, hospital fees and doctor and dentist tariffs) was surveyed in addition to the regular surveys, which are conducted monthly. Relative to Momentum Investments' forecasts, inflation in health products, health services and vehicles surprised the most to the downside, while inflation in non-alcoholic beverages registered a higher-than-expected outcome for the month.

More than 80% 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 February 2019, with prices in the water and services (11%), public transport (8.9%), non-alcoholic beverages (8.6%), electricity (7.6%), insurance (6.8%) and education (6.7%) categories experiencing inflation above 6% in February 2019 (see chart 3).

Chart 3: Inflation* by category (%)



Source: Bloomberg, Momentum Investments, data for February 2019
**Inflation: red ≥ 6%, 3% > grey > 6%, blue ≤ 3%*

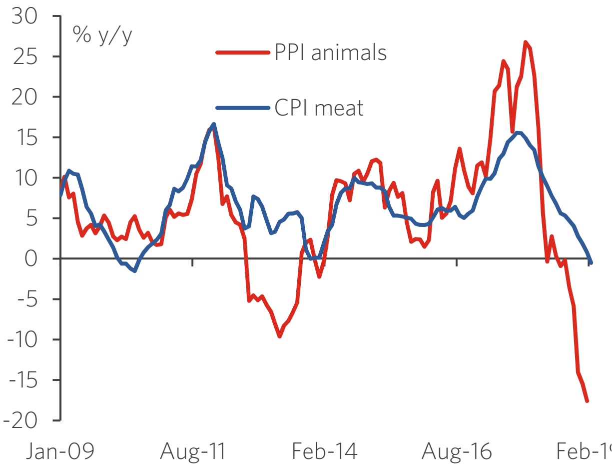
Meat deflation offsetting a rise in bread and cereal inflation

Food inflation continued to shift lower to 2.3% in February 2019, with pressure largely emanating from processed foods, which registered inflation of 4.1%, while unprocessed food inflation dipped to 0.7%.

During the month, bread prices increased by 1.8%, while meat prices fell by 1.5%. Relative to a year ago meat prices are 0.5% lower, while bread and cereal prices are 4.9% higher. Fruit prices spiked 4.5% in the month, while vegetable prices edged 0.5% lower.

Animal prices at the producer level plummeted, indicating further downside in meat prices at the consumer level in the near term (see chart 4). While a ban in exports has been increasing local meat supplies, the Agricultural Business Chamber noted that the Department of Agriculture, Forestry and Fisheries released a statement on 14 March 2019, which highlighted ongoing discussions with the Middle East and other African markets to lift the ban placed on SA meat (following an outbreak of foot-and-mouth disease). Moreover, recent trends show a decline in slaughtering rates, which could limit the increase in meat supply on the local market.

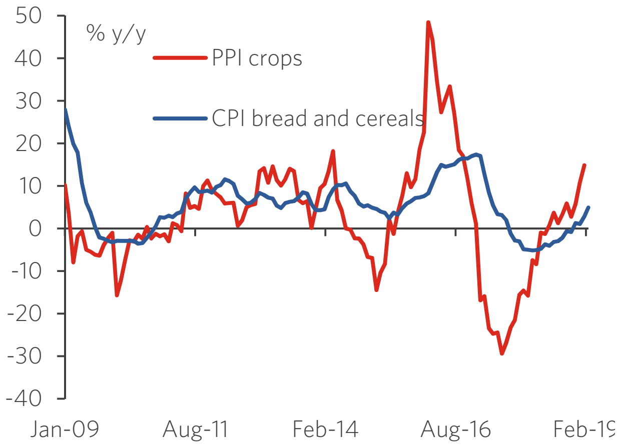
Chart 4: Further downside in meat inflation



Source: Stats SA, Global Insight, Momentum Investments

Meanwhile, crop inflation at the producer level is rising and will likely exert upward pressure on bread and cereal prices in the near term (see chart 5). Research conducted by the Agricultural Business Chamber suggests wheat crops (winter plantings) are likely to be 5% higher than the 2018/2019 production season, due to favourable soil moisture relative to the previous season (when the country was emerging from drought conditions) and above-normal rainfall being forecasted between May and July 2019.

Chart 5: Further upside in bread/cereal inflation



Source: Stats SA, Global Insight, Momentum Investments

Hefty fuel price increase in the pipeline

Petrol prices increased by 7c/l (Gauteng 95) in February and by a larger 74c/l in March 2019. The under-recovery calculated between 1 and 19 March points to a 97c/l increase in the fuel price for April 2019. The under-recovery, however, does not include the taxes announced in the February 2019 national budget. Finance Minister Tito Mboweni announced a further 5c/l increase in the general fuel levy and a 20c/l hike in the Road Accident Fund levy, which will be added to the petrol price hike for April 2019. This is likely to drive private transport inflation higher to close to 10% by April 2019.

Electricity tariffs to bite in the first year

The resultant average electricity price increase awarded to Eskom (including the previously awarded Regulatory Clearing Account (RCA) amount of R7.7 billion and the fourth multi-year price determination (MYPD4)) amounts to 13.87% in FY19/20, 7.81% in FY20/21 and 5.1% in FY21/22. Moreover, the approval of R3.87 billion from the latest RCA application has yet to be applied. No timing has been given for when this will be applied, but it is unlikely to materialise this year given tight timelines. The increase for FY2019/2020 is marginally higher than Momentum Investments' previous assumption of 12.5%, but slightly lower for the second and third year. Given that electricity and other fuels account for 3.8% of the consumer inflation basket, the changes to the electricity price forecasts are likely to have a small effect on the forecasted inflation outlook.

The effect on the inflation basket will be most visible in July, when the increase will be implemented for municipal customers. Non-municipal users will experience the increase from 1 April 2019.

Interest rates likely to remain steady at the upcoming interest-rate setting meeting

In a keynote address at the S&P Dow Jones Indices SA Seminar, SARB Deputy Governor Daniel Mminele pointed out the recent encouraging signs in price trends. He noted that after remaining stubbornly above 5% for a four-year period up to February 2017, core inflation has been in the 4.0% to 4.5% range for more than a year.

Mminele admitted that lower-than-expected food inflation, a more subdued pass-through from value-added tax, a lower pass-through from the weaker exchange rate, a slowdown in housing costs (amid a lacklustre property market) and a moderation in private-sector wage inflation led to inflation forecasts undershooting the SARB's forecasts in recent months. Mminele warned, however, that the jury was still out on the latest disinflationary trends and whether they would persist.

That said, the Monetary Policy Committee still found risks to the inflation outlook to be skewed to the upside at its January 2019 meeting.

In Momentum Investments' view, the rand, international oil prices and electricity tariffs are still viewed as the major upside threats to the inflation outlook. Although developed market central banks have adopted a more dovish rhetoric on monetary policy, a potential rise in geopolitical risks, a negative shift in sentiment towards emerging markets a or a ramp up in protectionist policies could result in a materialisation of upside inflation threats.

It is likely that interest rates will remain steady at 6.75% at the upcoming meeting given subdued inflation, downbeat sentiment and muted growth prospects. While Momentum Investments is not expecting an aggressive interest rate hiking cycle in light of struggling growth and inflation, the likelihood of an interest rate hike of 25 basis points later in the year cannot be ruled out, given the SARB's emphasis on driving inflation expectations closer to the midpoint of the 3% to 6% inflation target over time.