momentum investments

in the moment


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Sarb exercises caution on rising fiscal risks and keeps interest rates unchanged at 6.5%

Highlights

- The South African Reserve Bank (Sarb) Monetary Policy Committee (MPC) decided to keep the repo rate unchanged at 6.5% at its final meeting for 2019. This was likely a close decision for the MPC, given that two members expressed a preference for a rate cut, while three members opted for the repo rate to remain unchanged.
- The Sarb's Quarterly Projection Model (QPM) indicated a 25 basis point repo rate cut in the third quarter of 2020.
- Relative to the MPC's September 2019 forecasts, it still expects food prices to peak in the third quarter of 2020 at 6.1%, while headline inflation is still anticipated to peak at 5.3% in the first quarter of 2020.
- The Sarb kept its inflation forecasts for 2019, 2020, and 2021 unchanged at 4.2%, 5.1%, and 4.7%, respectively. Risks to the inflation outlook remain broadly balanced in the Sarb's opinion, but it acknowledged unusually high uncertainty regarding inflation risks.
- The Sarb dropped its growth expectation in the forecast period as local indicators continue to look weak. Relative to September's forecasts, the Sarb's estimate of the output gap (the gap between actual and trend growth) is expected to widen by 0.3% to 1.6% and by 0.5% to 1.1% in 2020 and 2021, respectively.
- The Sarb bucked the emerging market (EM) trend, whereby several EMs have continued to lower interest rates in a muted inflation environment to support growth.
- The MPC reiterated that the sustained moderation in inflation is a positive development and noted that it would like to see inflation expectations anchored closer to the midpoint of the inflation target. Fiscal dominance remains a concern amid tepid structural reform, and elevated fiscal risks could prevent further cuts in the near term in our view.

Fiscal dominance limits the Sarb's ability to lower interest rates

The Sarb MPC decided to keep the repo rate unchanged at 6.5% at its final MPC meeting for 2019. Two members voted for a rate cut, while three members voted for the repo rate to remain unchanged. In our view, this is an increasing function of fiscal dominance curbing the Sarb's ability to respond to a low inflation and weak growth environment.

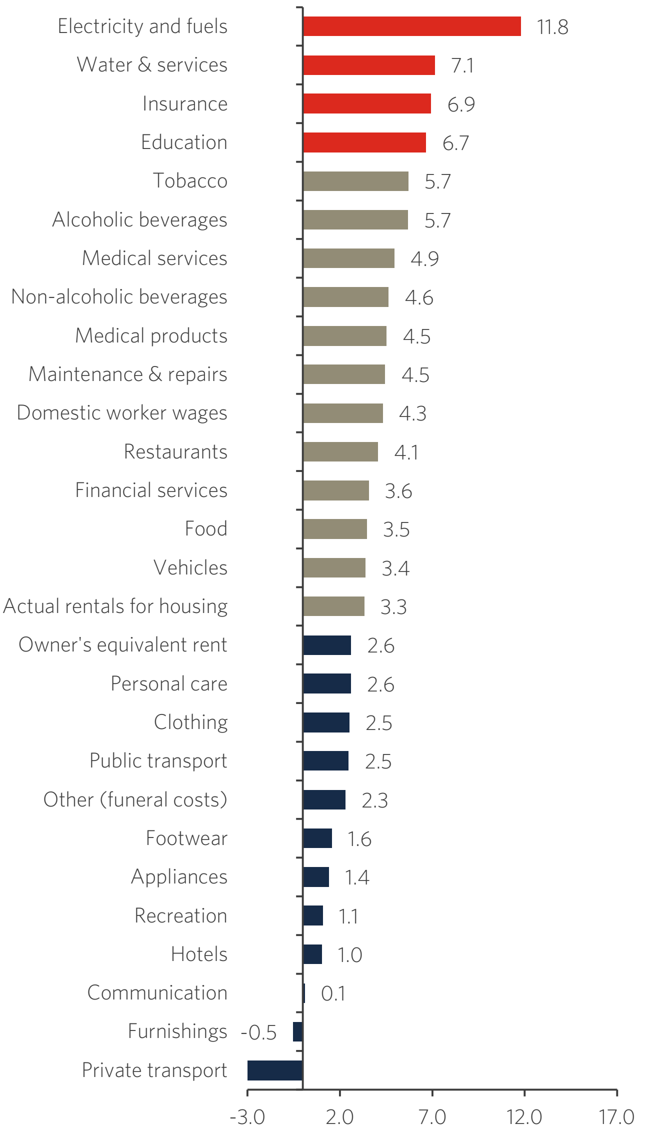
The Reuters Thompson interest rate and econometer poll surveyed 20 economists on their expectation of the repo rate decision. Four economists expected a rate cut in the November 2019 meeting. Eleven of those economists, however, expect a 25 basis point cut in the second quarter of 2020. The Sarb's QPM indicated a 25 basis point repo rate cut in the third quarter of 2020. The timing of this cut coincides with the projection of food inflation peaking.

However, the Sarb reiterated that the QPM is a broad policy guide, which can change as data and risks evolve. Monetary policy actions will continue to focus on anchoring inflation at the midpoint of the inflation target range and decisions will continue to be highly dependent on data outcomes.

Inflation continues to surprise to the downside, as food inflation trends lower still

Inflation surprised to the downside yet again in the number for October 2019. The majority of the inflation items, which breached the upper 6% of the inflation target were related to administered prices (see chart 1). Administered prices represent 16% of the inflation basket and have maintained an average rate of inflation of 7% since 2009.

Chart 1: Administered prices mostly breaching the upper limit of the target (% y/y)

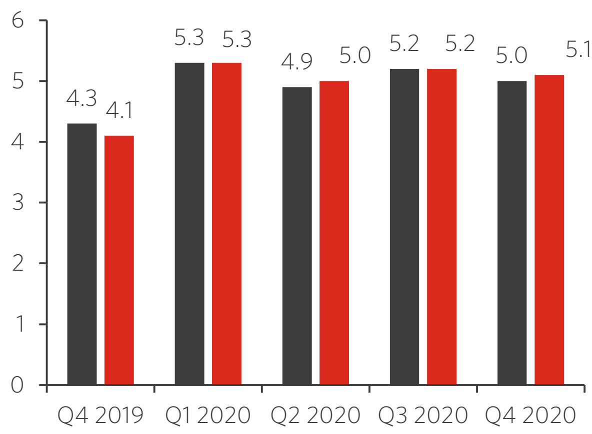


Source: Stats SA, Momentum Investments, Red=above upper 6% of the target, grey=within 3% to 6% of the target, blue= below 3% of lower end of target

Inflation risks are seen to be balanced, but the Sarb acknowledged that uncertainty about inflation risks are unusually high. The Sarb kept its inflation forecasts for 2019, 2020, and 2021 unchanged at 4.2%, 5.1%, and 4.7%, respectively.

In the question and answer session, the Sarb admitted inflation has continued to surprise to the downside (see chart 2). We think there could be further downside risks to the Sarb's 2020 inflation forecast, unless electricity tariffs surprise to the upside relative to the Sarb's forecast of around 10% for 2020. Food prices are still expected to peak in the third quarter of 2020 at 6.1%, while headline inflation is expected to rise at 5.3% in the first quarter of 2020.

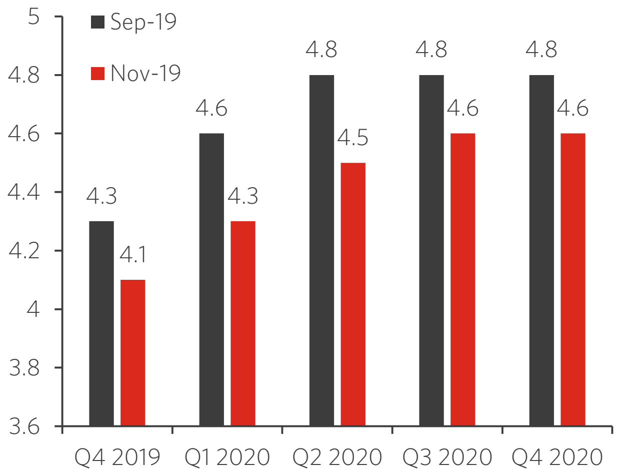
Chart 2: Sarb CPI revisions (% y/y)



Source: Sarb, Momentum Investments

Core inflation has been revised lower in 2019 and 2020 at 4.2% (previously 4.3%) and 4.5% (previously 4.7%). However, the expectation for 2021 remained unchanged at 4.6%. The projection for core inflation has been lowered from the fourth quarter of 2019 until the fourth quarter of 2020 (see chart 3). This is likely explained by lower services inflation (see chart 4).

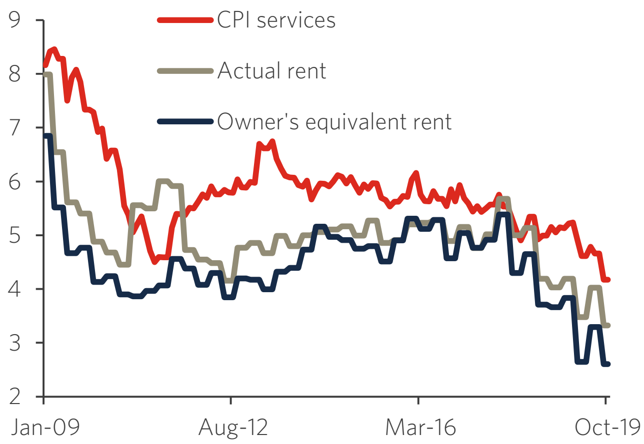
Chart 3: Sarb core CPI revisions (%y/y)



Source: Sarb, Momentum Investments

The MPC assumes marginally lower international oil prices of US$64.0/bbl (previously US$65.0/bbl) for 2019, but forecasts remained unchanged at US$66.0/bbl for 2020 and 2021. The Sarb still expects a higher increase in fuel taxes of 5.8%, up from 5.3% in 2019, before slowing to 5.5% (down from 5.9%) in 2020.

Chart 4: Services inflation trends lower (% y/y)

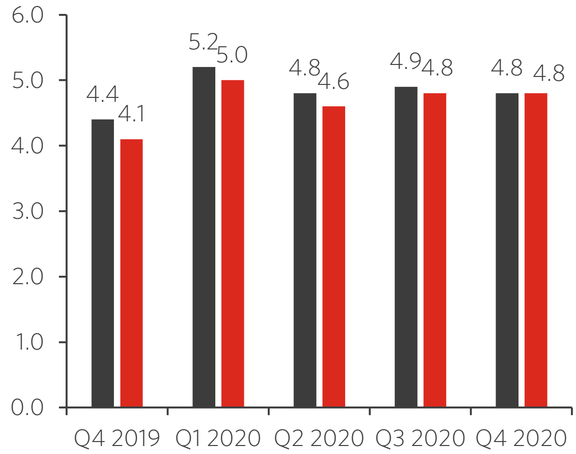


Source: Stats SA, BER, Momentum Investments

Services inflation has subsided below the midpoint of the inflation target, alongside actual rent and owner's equivalent rent (see chart 4). The decline in services inflation continues to propel a decline in the Bureau of Economic Research (BER) Inflation Expectations Survey. The survey showed that average five-year inflation expectations eased to 5.0% from 5.1% in the third quarter of 2019. The Sarb, however, expects house rental prices to increase at moderate rates in the near term.

The Reuters Thompson survey showed that economists have also lowered their headline inflation projections between the fourth quarter of 2019 up until the third quarter of 2020 (see chart 5).

Chart 5: Reuters Thompson CPI revisions (%y/y)



Source: Reuters, Momentum Investments

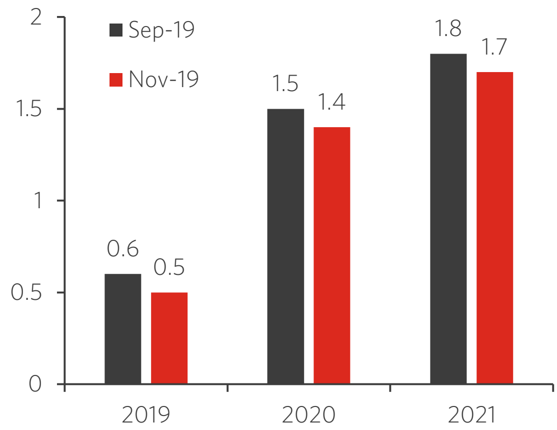
Food price inflation has persistently surprised to the downside but delayed and below-average rainfall, alongside increasing food import prices, raise uncertainty for the trend in food prices. The MPC mentioned that upside risk surprises from wage growth, fuel prices, electricity, and water could arise.

Wider the output gap projected

The Sarb lowered its growth expectation in the forecast period, as local indicators continue to remain weak (see chart 6). Growth in 2019 is now expected to reach 0.5% (previously 0.6%), 1.4% (1.5%) in 2020 and 1.7% (1.8%) in 2021.

We think there are considerate downside risks to the MPC's growth forecast in 2020 and 2021 on ongoing headwinds for consumer and investment spend against a backdrop of sideways growth in the global environment. High-frequency numbers indicate that the third-quarter growth number is unlikely to remain as robust as reported in the second quarter of 2019. The Sarb highlights that global factors, including geopolitical risks and heightened protectionist risks, are likely to impede supply channels in the forecast period.

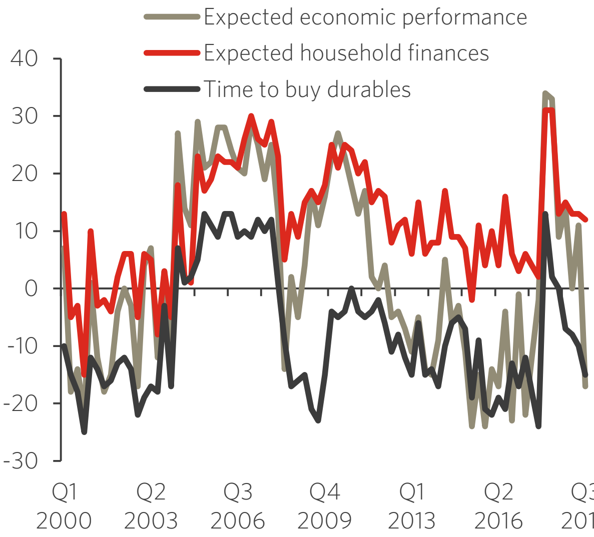
Chart 6: Sarb real GDP revisions (%y/y)



Source: Sarb, Momentum Investments

Consumer confidence has reversed to negative seven index points from five index points in the third quarter of 2019. The sub-indices that make up the consumer confidence index have all declined in the third quarter of 2019 (see chart 7). The most significant decline was in the expected economic return for the year, indicating that consumers do not have confidence in the economy growing significantly in a year for them to buy durable goods. Demand-side inflation pressure is likely to remain subdued in this low-confidence environment.

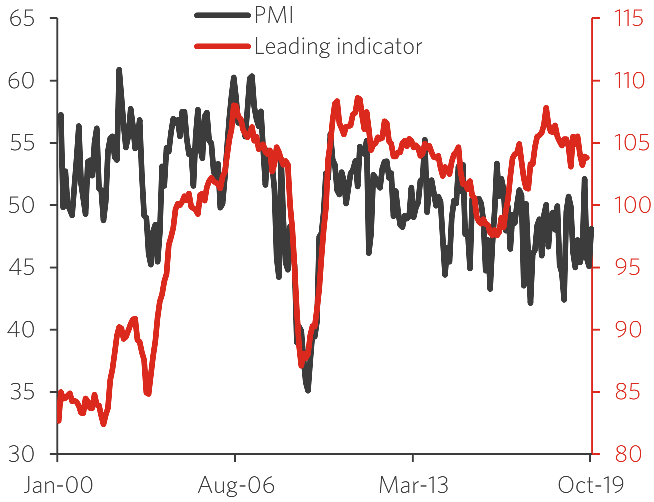
Chart 7: Consumer confidence sub-indices (index)



Source: BER, Momentum Investments

The manufacturing Purchasing Managers' Index (PMI) and the Sarb's leading indicator also continued to deteriorate in the latest numbers for October and August 2019, respectively (see chart 8). Global manufacturing PMI has also been weak in 2019, but the weakness has not spilled over into the services sector, which has remained relatively resilient. Fears of this resiliency fading are rising, as risks of a recession mount.

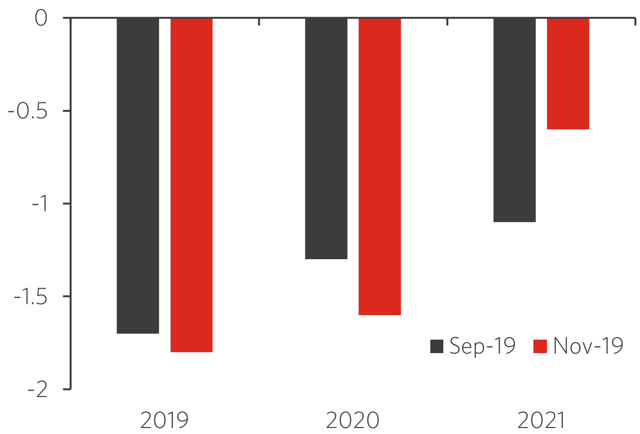
Chart 8: Business outlook indicators remain weak (index)



Source: BER, Sarb, Momentum Investments

The downward revisions in the Sarb's growth forecasts translate into a larger output gap throughout the forecast period (see chart 9). The output gap widens in 2020 and 2021 by 0.3% and 0.5%, respectively.

Chart 9: Output gap widens significantly in 2021 (%)



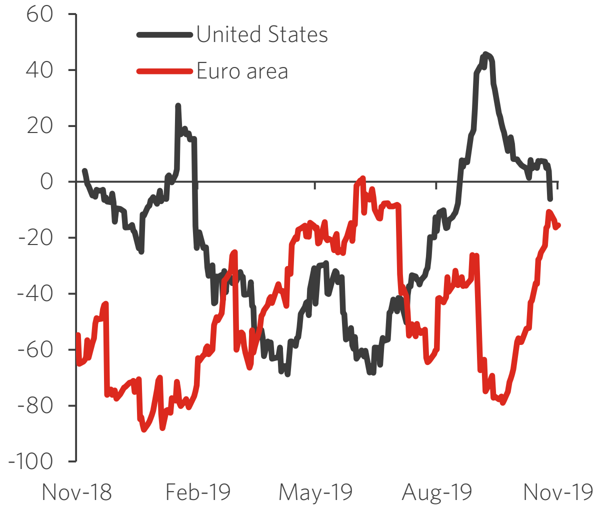
Source: Sarb, Momentum Investments

Growth risks are still viewed as being to the downside, given lingering global and local headwinds.

Global monetary conditions ease further

Although the Federal Reserve cut its monetary policy rate twice in 2019, so far, further easing is seen as unlikely according to the MPC. High-frequency releases show that economic conditions have improved marginally in the Euro area, but economic numbers have been softer than expected in the United States (see chart 10), preventing a complete ruling out of further monetary policy easing to support growth, in our view.

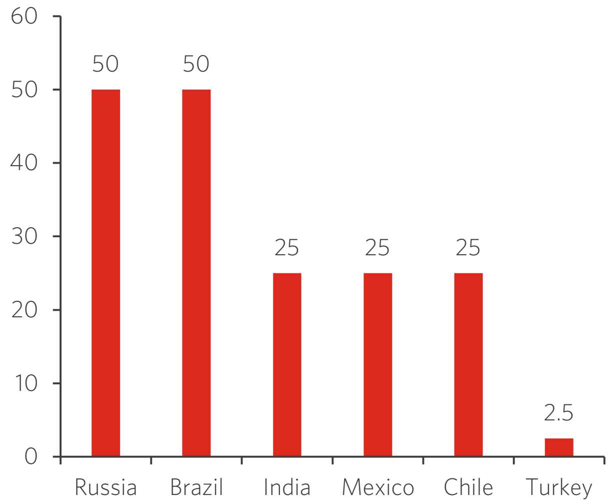
Chart 10: Developed-market economic surprise data



Source: Bloomberg, Momentum Investment

EMs have, however, continued to cut rates between October and November 2019 (see chart 11). Russia, Brazil, India, Mexico, Chile and Turkey have all cut their monetary policy rates to help stimulate the local economy in the wake of the looming global slowdown. China has also lowered its loan prime rate in November 2019 to help cushion the local growth slowdown.

Chart 11: EM policy rate easing between October and November 2019 (%)



Source: World Central Bank rates.com, Momentum Investments

The MPC would like to see inflation expectations trend towards the midpoint

The MPC kept the repo rate unchanged at the November 2019 meeting even though two members preferred a cut (see table 1). Fiscal dominance remains a pressing factor in the local economy amid rising fiscal risks and could keep the Sarb's hand steady in spite of lower inflation and muted growth outcomes.

The rand strengthened by around 10 cents on the interest rate announcement. The risks to the rand include local growth concerns and the rise in fiscal risks.

The MPC reiterated that a sustained moderation in inflation is a positive development and it would like to see inflation expectations anchored closer to the midpoint of the inflation target. Fiscal dominance remains a concern for the MPC amid tepid structural reform.

In the questions and answers session, the MPC noted it is likely to see a change in its make up with a new appointment likely to be announced in the first half of 2020.

Table 1: Preference for no cut at the November 2019 meeting

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
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	-	-	-
20 September 2018*	4	3	-	-
22 November 2018	3	3	-	-
17 January 2019**	5	-	-	-
28 March 2019**	5	-	-	-
23 May 2019**	3	-	-	2
18 July 2019**	0	-	-	5
19 September 2019 **	5	-	-	-
21 November 2019**	3	-	-	2

Source: SARB, Momentum Investments

**The March, May, July and September meetings for 2018 reflected the views of seven members*

***Meetings reflected the views of five members*