

Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

Roberta Noise
Economic Analyst

The Macro Research Desk

Interest rates steady at 6.75%, but bias shifting towards a more accommodative stance

Highlights

- The South African Reserve Bank (Sarb) Monetary Policy Committee (MPC) kept interest rates steady at 6.75%.
- Although the dip in inflation expectations for the next five years to 5.1% was welcomed by the Sarb, it noted the importance of structurally shifting expectations lower towards 4.5% for broader macroeconomic stability.
- Downside adjustments to the Sarb's economic growth outlook were a function of electricity supply concerns and low domestic confidence levels. The size of the forecasted output gap has widened further and it is expected to remain negative for the forecasted horizon.
- The Sarb's inflation forecasts were revised down since the March 2019 MPC meeting. It continues to view risks to the inflation outlook as "more or less evenly balanced". Lower global inflation and accommodative monetary policy in advanced economies are viewed as the major downside risks to the expected inflation trajectory, while rising electricity and water tariffs, food inflation and oil prices are viewed as key upside threats.
- Interest rate preferences on the MPC changed since the last two meetings, where there was unanimous support for leaving interest rates unchanged. This time around, two members preferred to cut interest rates by 25 basis points, most likely in accordance with a lower inflation trajectory and a softer growth outlook.
- Momentum Investments expects interest rates to remain steady in the near term, with a bias to a more accommodative monetary policy stance, given the positive downward trajectory in inflation expectations.

Interest rates steady at 6.75%, but balance of sentiment is shifting towards easing

The MPC held the interest rate steady at 6.75% at its third interest-rate-setting meeting for the year. The balance of sentiment shifted relative to the previous two meetings. In the January and March 2019 MPC meetings, the decision to keep interest rates on hold was unanimous across the five members. However, at the recent May 2019 meeting, two members preferred to lower interest rates by 25 basis points, most likely in response to a softer growth outlook and continued downside surprises in recent inflation prints.

The decision to keep interest rates unchanged was in line with the views of all 30 surveyed analysts, who participated in the Reuters consensus poll for May 2019. Eighteen of those surveyed expect no change in interest rates by the fourth quarter of 2019, while two expect a cut of 25 basis points. On balance, more (four economists) expect a rate hike of 25 basis points by the end of the year.

Heading into the interest-rate-setting meeting, Absa noted that, in line with a strengthening of the local currency, the forward-rate-agreement (FRA) curve had flattened slightly since the March MPC meeting and was pricing in a two-thirds chance of an interest rate cut of 25 basis points in the next nine months.

Globally, expectations for interest rate hikes have moderated substantially on the back of heightened uncertainty and slowing growth. Although the volatility index (VIX) measure of implied equity price volatility has fallen back to below its historical average, global policy uncertainty remains elevated. Consequently, the market-implied paths for interest rate policy in the United States (US), United Kingdom (UK) and Euro area have fallen considerably since November 2018.

In the latest March 2019 iteration of the US Federal Reserve's (Fed) dot plot, the median interest rate expectation of the Fed reflected no interest rate hikes in 2019 and one hike in 2020. In the May 2019 statement, the Fed mentioned "in light of economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes".

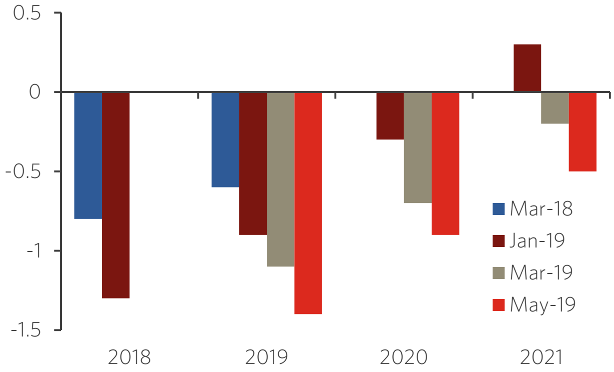
In April 2019, the European Central Bank (ECB) President Mario Draghi confirmed the ECB's intention to keep interest rates unchanged for 2019 or longer until inflation sustainably converged closer to 2%. This accommodative stance was also adopted by the Bank of Japan, which committed to keeping interest rates low until its price target of 2% was achieved.

Growth revised lower, but downside risks prevail

Extensive electricity supply constraints and a protracted strike in the gold mining sector at the beginning of the year point to a likely contraction in growth for the first quarter of 2019. Downtrodden consumer and business sentiment and the threat of protracted constraints on energy supply have kept risks to the Sarb's growth outlook tilted to the downside. In the question and answer (Q&A) session, the Sarb noted uncertainty around the future availability of electricity hampers current and future investment decisions.

Three quarters of the consumer inflation basket is tracking below the upper end of the 3% to 6% inflation target. This is indicative of a widespread lack of demand-pull inflation pressures leading to the economy operating below its potential growth.

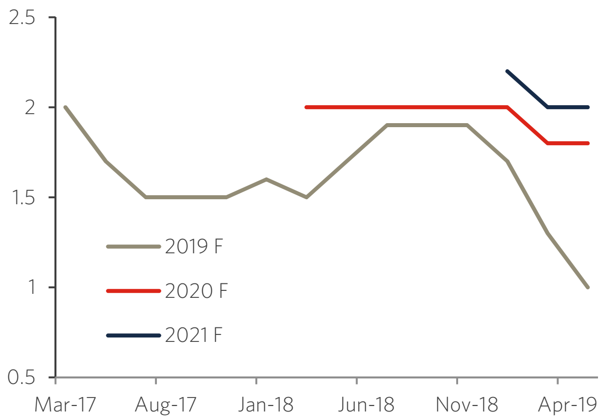
Chart 1: The SARB's output gap expectations (%)



Source: SARB, Momentum Investments

The Sarb's projection for the country's output gap widened to negative 1.4% (from negative 1.1%) and negative 0.9% (from negative 0.7%) for 2019 and 2020, respectively. The persistence of this negative output gap is expected to stretch in 2021 at negative 0.5% from negative 0.2% previously (see chart 1).

Chart 2: The SARB's real growth forecasts (% y/y)



Source: SARB, Momentum Investments, data up to May 2019

The Sarb's forecast for growth in SA's main trading partners stabilised at 2.9% for 2019, but edged lower by 0.1% to 3.0% for 2020. Although global growth is anticipated to pick up in the medium term, trade tensions, geopolitical risks and a renewed tightening in financial conditions remain as risks to the downside.

In the Q&A session, the Sarb reiterated there were no winners in a trade-war scenario. Estimates from the International Monetary Fund in its April 2019 World Economic Outlook indicated tariff increases could shave 0.8% off global growth. Since this study was completed, additional trade tariffs have been considered. A potential escalation in trade tensions was further emphasised as a threat to local growth, given the relatively small size and openness of the SA economy.

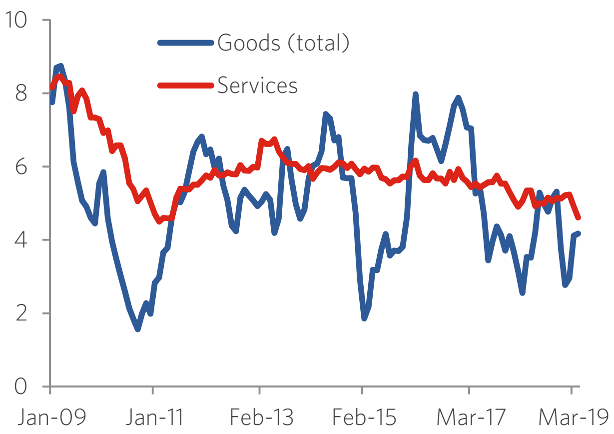
The Sarb stressed weak sentiment and pressure on disposable incomes were key factors capping growth in the short term. The Sarb forecasts real fixed investment to contract by 0.3% in 2019 and has kept its growth forecast for household consumption at 1% for the same period.

The MPC's gross domestic product (GDP) growth forecasts were cut to 1.0% for 2019 from 1.3% previously (see chart 2). This shifted below the May 2019 Reuters Econometer median forecast of 1.1% and is in line with Momentum Investments' internal forecast. Growth forecasts for 2020 remained unchanged at 1.8%, while the Reuters' forecast adjusted lower in May 2019 to 1.5%. The Sarb's estimate for 2021 is still expected to reach 2.0%, which is marginally higher than the Reuters' forecast of 1.9%.

Inflation risk assessment still viewed as "more or less evenly balanced"

Headline inflation has either met market expectations or surprised positively in 21 out of the past 24 months. This string of positive inflation surprises was likely driven by lower-than-expected food inflation, a supressed pass-through from a weaker currency and contained services (including rental) inflation. Inflation in services dipped encouragingly to its lowest level in nearly seven years to 4.6% in April 2019 (see chart 3). Rental inflation, which is a significant component of services inflation, remained muted at 2.7%.

Chart 3: Services inflation heading lower (%)



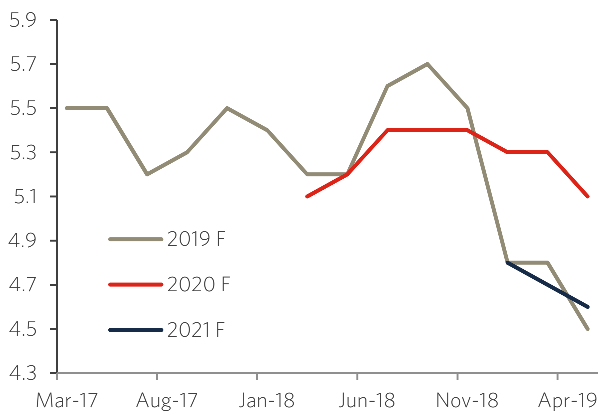
Source: Stats SA, Global Insight, Momentum Investments, data up to April 2019

Although there is little sign of widespread inflation pressure in the consumer basket, administered prices remain stubbornly high.

Despite continued downside surprises in inflation, the Sarb warned oil prices were likely to remain high and global food prices have showed signs of bottoming out. The Sarb has upwardly revised its forecast for international oil prices to US$69.5/bbl from US$S64.4/bbl for 2019 and from US$65/bbl to US$/68/bbl for 2020.

Moreover, the Sarb cautioned against upside inflation risks stemming from administered price increases, including water and electricity tariffs. The Sarb has pencilled in electricity inflation of 10.2% for 2019 and 10.9% for 2020.

Chart 4: The SARB's headline inflation forecasts (% y/y)



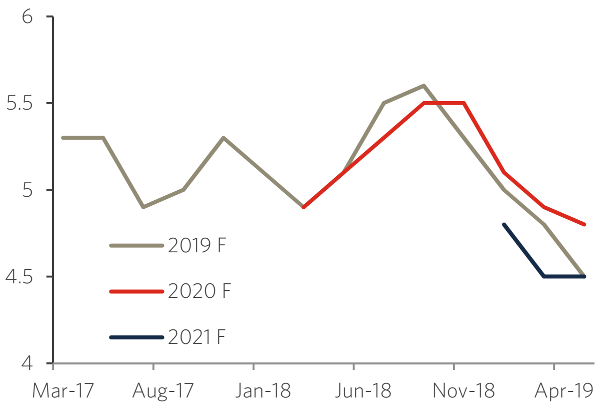
Source: SARB, Momentum Investments, data up to May 2019

The Sarb lowered its 2019 headline inflation forecast to 4.5% from 4.8% for 2019 (see chart 4), which is slightly lower than the Reuter's consensus forecast for an increase to 4.7% for 2019 (and Momentum Investments' forecast of 4.6%). Risks to this view are still seen to be "more or less evenly balanced". The Sarb's forecast for 2020 dipped from 5.3% to 5.1%, a notch below the Reuters consensus estimate of 5.2%, but higher than Momentum Investments' projection of 4.8%.

The Sarb's core or underlying inflation projections (excluding food and fuel prices) based on the Quarterly Projection Model, were downwardly revised by 0.3% for 2019 and 0.1% for 2020, to 4.5% and 4.8%, respectively, while forecasts for 2021 were steady at 4.5% (see chart 5).

First-quarter data for inflation expectations (surveyed by the Bureau of Economic Research (BER) between 5 February and 12 March 2019) showed a slight downward shift in the average five-year ahead inflation expectation from 5.3% to 5.1%, which is the lowest level on record starting in 2011. Second-quarter data on inflation expectations should be released in July 2019 and are expected to show a further downward trend given its correlation with services inflation, which has declined to its lowest level in seven years.

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



Source: SARB, Momentum Investments, data up to May 2019

Split preferences leading up to the decision to leave interest rates unchanged at 6.75%

Table 1: Split preferences for the May 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
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	-	-	-
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

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.*

Preferences among the MPC were split in the lead up to the final decision to leave interest rates unchanged at 6.75%. Three members preferred to leave interest rates steady, while two members preferred to cut interest rates by 25 basis points (see table 1).

In the Q&A session, the MPC repeated the appointment of the third deputy governor is a decision to be taken by the president in consultation with the finance minister. Meanwhile, a sixth member has, however, been appointed to the MPC. Chris Loewald, head of economic policy and development and research at the bank, will join the MPC from 1 June 2019 for a three-year term.

Building the case for a more accommodative stance

Despite a further cut to growth forecasts, the Sarb still views risks to the outlook as being to the downside. Meanwhile, it lowered its inflation forecasts with risks to the inflation outlook remaining more or less evenly balanced.

The forward guidance from the Quarterly Projection Model (QPM) and the change in preferences on the MPC have further raised the probability of an interest rate cut in the coming quarters. The QPM has shifted to a more dovish stance, from previously guiding towards a hike of 25 basis points in the fourth quarter of 2019 in the March 2019 iteration, to pointing towards easing by the end of the first quarter of 2020.

In Momentum Investments' view, it may still be too early to trigger an interest rate cut, given a worsening fiscal position and the restricted ability for lower interest rate policy to resolve structural issues in the economy, which are hampering growth prospects. In addition, the Sarb has noted it would feel more comfortable with inflation expectations closer to the midpoint of the target on a sustainable basis to allow for more room to manoeuvre in the event of external shocks. As such, it is the view of Momentum Investments that the Sarb may wait for further corroborating data of a sustained downward trend in inflation expectations in the coming quarters before lowering interest rates.