



Herman van Papendorp
Head of Investment
Research & Asset
Allocation



Sanisha Packirisamy
Economist

The Macro Research Desk

No change to interest rates at 6.75% as SARB lowers growth and underlying inflation forecasts

Highlights

- The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) left interest rates unchanged at 6.75%.
- Although the dip in inflation expectations was welcomed by the SARB, it noted the importance of shifting expectations down towards 4.5% to ensure lower inflation and lower borrowing costs in the economy.
- Downside risks to the SARB's weaker economic growth outlook remain a function of concerns of electricity supply and low domestic confidence levels. The size of the forecasted output gap has widened and is no longer expected to turn positive by 2021.
- The SARB left its inflation forecasts broadly unchanged, but lowered its risk assessment of the inflation outlook from "moderately to the upside" to "more or less evenly balanced". Rising electricity and water tariffs, food inflation and oil prices are viewed as upside threats to the inflation outlook, while lower global inflation and easy monetary policy in advanced economies are seen as key downside risks.
- Preferences on the MPC again revealed unanimous support for leaving interest rates unchanged.
- Momentum Investments expects interest rates to remain steady in the near term, with the positive downward trajectory in inflation expectations likely lessening the pressure on the SARB to maintain a tightening bias.

Interest rates steady at 6.75% on weaker growth and lower underlying inflation expectations

The MPC held the interest rate steady at 6.75% at its second interest-rate-setting meeting for the year. The balance of sentiment remained in line with that expressed at the previous meeting in January 2019, where all five MPC members had made arguments for interest rates to remain on hold.

The decision to keep interest rates unchanged was in line with the views of 24 surveyed analysts, who participated in the Reuters consensus poll. Heading into the interest-rate-setting meeting, Absa noted the forward-rate-agreement (FRA) curve had flattened since the January MPC meeting and incorporated steady interest rates for the next nine months, before shifting higher in 2020. This shift lower in the curve was

likely in relation to more dovish rhetoric by key global central banks.

In the latest March 2019 iteration of the United States (US) Federal Reserve's (Fed) dot plot, the median interest rate expectation of the Fed reflected no interest rate hikes in 2019, from two hikes previously. The Fed further announced its intention to slow the monthly reduction of its Treasury holdings from US\$30 billion to US\$15 billion in May (which is expected to end altogether by September 2019). Fed Chair Jerome Powell noted the European and Chinese economies had slowed substantially and stated "just as strong global growth was a tailwind, weaker global growth can be a headwind to our economy". This suggests the Fed may

tolerate higher inflation prints in its efforts to support growth.

Additionally, the monetary policy stance adopted by the European Central Bank (ECB) also shifted towards an increasingly dovish stance. Despite European

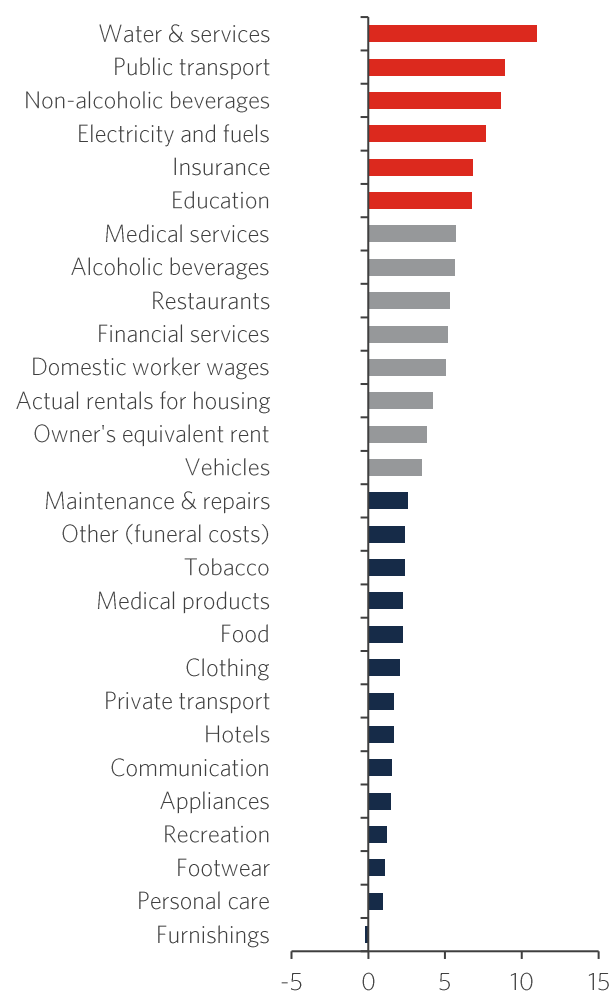
polymakers' earlier decision to end the bond-buying programme three months ago, the ECB has decided on launching new quarterly targeted longer-term refinancing operations to enable credit conditions to remain easy.

Growth revised lower, but downside risks prevail

The SARB lowered its growth forecasts, but weak consumer and business confidence and the threat of protracted constraints on energy supply keep risks to the SARB's growth outlook tilted to the downside.

its potential growth, the output gap widened to negative 1.1% and negative 0.7% for 2019 and 2020, respectively. The SARB no longer anticipates a closing of the output gap by 2021 (see chart 2).

Chart 1: Inflation* by category (%)



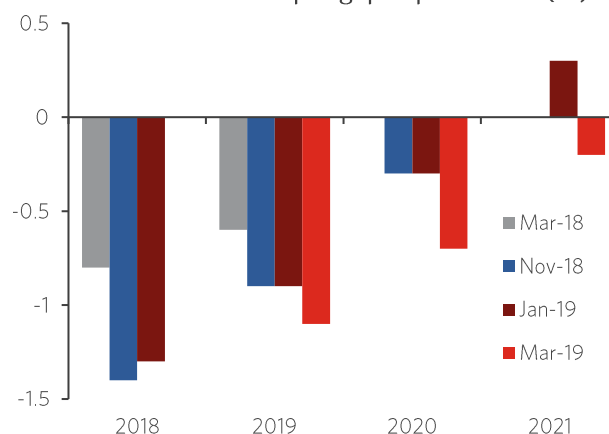
Source: Bloomberg, Momentum Investments, data for February 2019

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

With demand-pull inflation pressures still largely absent (as can be seen in the dispersion of inflation by category, see chart 1) and the economy operating below

The SARB emphasised a deterioration in global growth since the previous meeting in January 2019 and downgraded its forecast for growth in SA's main trading partners by a sizeable 0.4% to 2.9% for 2019 and by 0.2% to 3.1% for 2020. The SARB still expects global growth to rise in the medium term, but warned that risks (including trade tensions, geopolitical risks and a renewed tightening in financial conditions) remained to the downside.

Chart 2: The SARB's output gap expectations (%)

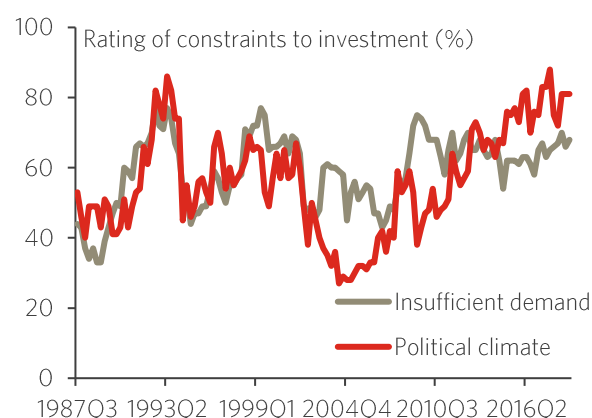


Source: SARB, Momentum Investments

Idiosyncratic downside risks to local growth were highlighted. The SARB previously pointed to the negative effects of electricity tariff increases on economic data and pointed out load shedding could drag confidence and growth lower. Uncertainty arising from negative trade developments remains a key threat to export growth, while a more meaningful slowdown in global growth in 2020 could dent export growth further in Momentum Investments' opinion. Subdued local

confidence levels have continued to hold investment prospects back, with the Bureau of Economic Research's manufacturing survey in the first quarter of 2019 pinpointing a lack of sufficient demand and uncertainty on the outlook for policy as the main constraints to business investment (see chart 3).

Chart 3: Political climate and insufficient demand still weighing on investment in SA



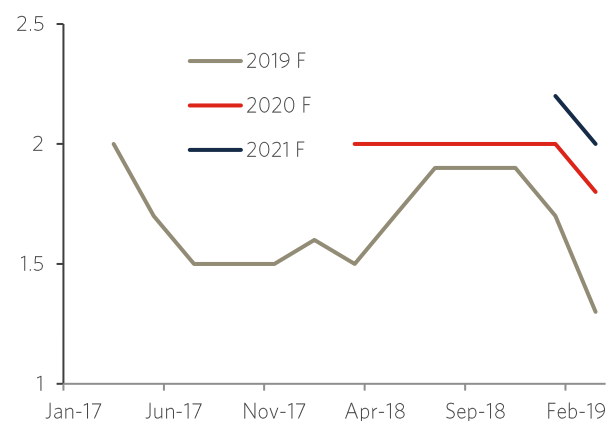
Source: SARB, Momentum Investments, data up to Q1 2019

The MPC's gross domestic product (GDP) growth forecasts were cut to 1.3% for 2019 from 1.7% previously (see chart 4). However, these remained below the March 2019 Reuters Econometer median forecast of 1.4% and is lower than Momentum

Investments' revised internal forecast of closer to 1.0%. Growth forecasts for 2020 were also cut by 0.2% to 1.8% in line with the Reuters' forecast. The SARB's estimate for 2021 is expected to reach 2.0%, down from 2.2% previously, but consistent with the Reuters' forecast.

Despite household consumption surprising to the upside in the final quarter of 2018, the SARB expects household consumption to slow to 1% in 2019, before increasing to 1.4% in 2020 and 1.8% in 2021.

Chart 4: The SARB's real GDP growth forecasts (% y/y)



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

Inflation risk assessment revised more favourably to "more or less evenly balanced"

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 projections in recent months. Mminele warned, however, that the jury was still out on

the latest disinflationary trends and whether they would persist.

From the breakdown in inflation by category, it is evident that demand-pull inflationary pressures are lacking and administered prices continue to pull overall inflation higher (see chart 1).

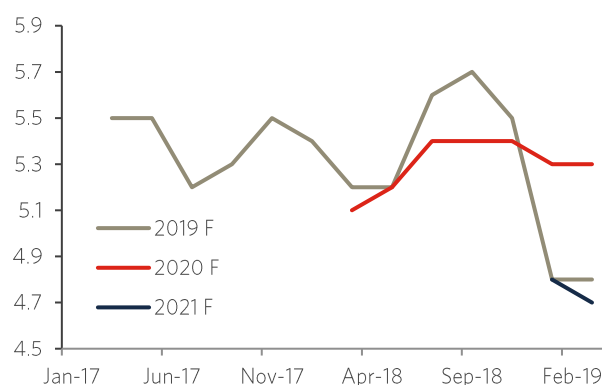
The SARB cautioned against upside inflation risks stemming from administered price increases (namely water and electricity tariffs), rising food prices particularly in the outer years and higher international oil prices. The SARB has pencilled in electricity inflation of 13% for financial year 2019/2020 (FY19/20) and 9% for FY20/21. These forecasts are marginally lower than those of Momentum Investments.

While previously the SARB saw inflation risks to the upside, on balance, it revised this view to “more or less evenly balanced” given the downside risks posed by lower global inflation and easy monetary policy in advanced economies.

The SARB kept its 2019 headline inflation forecast at 4.8% for 2019 (see chart 5), which is slightly higher than the Reuter’s consensus forecast for an increase to 4.7% for 2019 (and Momentum Investments’ forecast of 4.6%).

The SARB’s forecast for 2020 remained steady at 5.3%, matching the Reuters consensus estimate, but higher than Momentum Investments’ projection of 4.8%.

Chart 5: The SARB’s headline inflation forecasts (% y/y)



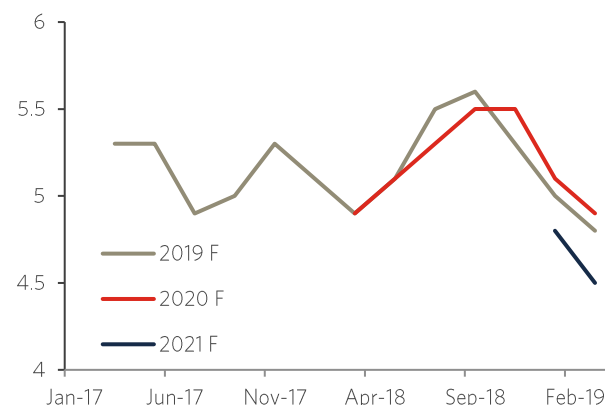
Source: SARB, Momentum Investments, data up to March 2019

The SARB once again revised upwards its forecast on the international price of oil by \$2/bbl in 2019 to US\$64.4/bbl for 2019, but kept its 2020 and 2021 forecasts unchanged at US\$65/bbl. Oil price futures anticipate the price to drop from US\$66/bbl to US\$62.5/bbl level in the next three years, whereas the Bloomberg median consensus forecast estimates oil prices to average US\$67/bbl in 2019 and US\$70/bbl in 2020 and US\$69/bbl 2021.

The SARB’s core or underlying inflation projections (excluding food and fuel prices) based on the Quarterly Projection Model, were downwardly revised by 0.2% for 2019 and 2020, to 4.8% and 4.9%,

respectively, while forecasts for 2021 were brought down by 0.3% to 4.5% (see chart 6).

Chart 6: The SARB’s core inflation forecasts (%)

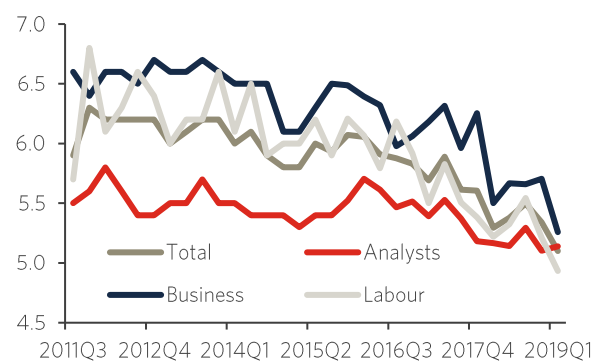


Source: SARB, Momentum Investments, data up to March 2019

First-quarter data for inflation expectations (surveyed by the Bureau of Economic Research (BER) between 5 February and 12 March 2018) 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 (see chart 7).

The downward revision was largely driven by a downward adjustment to expectations by businesses, who lowered their estimate from 5.7% to 5.3%. Trade unions also lowered their forecasts from 5.2% to 4.9%, while analysts maintained their projection of 5.1%. In Momentum Investments’ opinion, the downward revisions by businesses and labour are significant given their influence on setting prices in the economy.

Chart 7: The average expected inflation for the next five years (%)



Source: BER, Momentum Investments

Unanimous decision to leave interest rates unchanged at 6.75%

The interest rate decision was unanimous with all five members preferring to leave interest rates unchanged at 6.75% (see table 1).

Table 1: Unanimous preferences for the March 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
30 March 2017	5	-	-	1
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	-	-	-

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

In the question-and-answer session, the MPC clarified that although the dip in inflation expectations to 5.1% was welcomed, it would prefer inflation expectations closer to 4.5%. It admitted it was too early to assess whether this move lower was indeed a structural development, which would have positive consequences for inflation outcomes and borrowing costs for the government and the private sector.

In a response to a question on the vulnerability of the rand to contagion effects, the SARB noted its view that market players are starting to distinguish between various countries and subsequently expects a lower risk of contagion going forward.

Voicing its opinion on potential negative ratings action by Moody's, the SARB explained a depreciation in the currency and a rise in borrowing costs could arise should the downgrade not already be priced into market expectations. The SARB has run stress tests, however, which indicate the banking sector would comfortably withstand downgrade action.

Inflation falling back within target where interest rates were raised in emerging markets

A number of emerging markets (EMs) raised interest rates in the past six months. In most cases, inflation has come back within target, allowing interest rates to remain steady (see table 2) to support growth. Meanwhile, India has already lowered interest rates by 25 basis points on the back of growth concerns.

Table 2: EMs that have raised interest rates in the last six months

Country	Latest inflation print*	Latest interest rate move	Current interest rate	Reason
Argentina	49.7%	+6%	66.9%	Forced to raise interest rates to stem inflation pressure, arising from a sharp depreciation in the peso, despite sluggish economic growth.
Chile	1.8%	+0.25%	3.0%	Normalising the stance of monetary policy by removing stimulus.
Czech Republic	2.7%	+0.25%	1.75%	Keeping ahead of rising inflation due to tightening labour markets.
Indonesia	2.6%	+0.25%	6.0%	Attempting to curb a further sell-off in the Indonesian rupiah
Mexico	4.0%	+0.25%	8.25%	Deterioration in inflation outlook with second-round inflation risks lingering.
Pakistan	8.2%	+0.25%	10.25%	Rising inflation and high current account and fiscal deficits.
Philippines	3.8%	+0.25%	4.75%	Reining in inflation expectations and pre-empting second-round inflation effects.
Russia	5.2%	+0.25%	7.75%	Inflation risks mounting amidst a slumping currency and US sanctions.
South Korea	0.5%	+0.25%	1.75%	Concerns over high consumer debt and fiscal imbalances. ⁰
Thailand	0.7%	+0.25%	1.75%	Curbing financial stability risks and building policy space.

Source: global-rates.com, cbrates.com, Reuters, Mexico News Daily, Momentum Investments, * below or within target = blue, above target = red

Positive trend in inflation expectations, but too early to assess if it will be sustained

In a recent speech, SARB Governor Lesetja Kganyago indicated “a consistently lower rate (of inflation) in the near term, at the midpoint of our target band (4.5%), would lower long-term interest rates and be more supportive of balance in the economy”.

Moreover, in the speech, Kganyago further intimated rapidly rising debt levels and fiscal spend “on projects that do little to generate long-run economic growth” puts direct upward pressure on inflation. In Momentum Investments’ view, the expansionary stance on fiscal policy and the effect of ongoing fiscal deterioration on

net capital inflows may limit the SARB’s ability to run a more accommodative monetary policy stance, in an effort to maintain an attractive real interest rate.

In Momentum Investments’ view, 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 EMs or a ramp up in protectionist policies could derail the downward trajectory in SA’s inflation expectations and result in a materialisation of upside inflation threats.

In Momentum Investments' view, interest rates are likely close to a peak and the positive trajectory in inflation expectations likely lowers the pressure on the SARB to maintain a tightening bias. Should the recent downward trend in inflation expectations persist, further interest rate hikes would likely be unnecessary,

particularly considering the weaker growth outlook. However, in the firm's view, it is likely too early to consider lowering interest rates given that the SARB would feel more comfortable with inflation expectations closer to the midpoint of the target to allow for more room to manoeuvre in the event of external shocks.

