
Herman van Papendorp
Head of Investment Research & Asset Allocation


Sanisha Packirisamy
Economist


Roberta Noise
Economic Analyst

in the moment

The Sarb cuts repo rate by 25 basis points, but maintains a hawkish tone

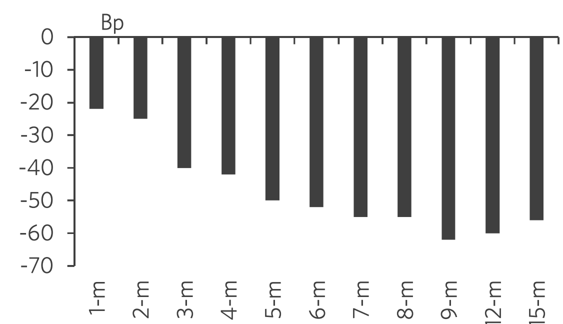
Highlights

- The South African Reserve Bank's (Sarb) Monetary Policy Committee (MPC) unanimously cut the repurchase rate (repo rate) by 25 basis points to 6.5% per annum on more-or-less balanced risks to a benign inflation outlook.
- The average five-year ahead inflation expectation according to the Bureau of Economic Research's (BER) inflation expectations survey remained at its all-time low of 5.1% in the second quarter of 2019.
- Headline and core inflation forecasts were revised marginally lower in the near term on a reduction in the oil, fuel and electricity price assumptions, but medium-term forecasts remained unchanged.
- The Sarb downgraded its growth assumption for 2019 to 0.6%. Consequently, its assessment of the output gap has widened further. High-frequency data still alleviated fears of a technical recession (two consecutive quarters of negative growth) in the second quarter of the year.
- Monetary policy globally has similarly shifted towards further easing to bolster disappointing growth and inflation outcomes.
- Momentum Investments' expects a shallow interest rate cutting cycle, given the limited ability of monetary policy to fix structural constraints in the economy.

The much-anticipated repo rate cut materialises

The Sarb's MPC cut the repo rate by 25 basis points in the July 2019 interest-rate-setting meeting. This lowered the repo rate from 6.75% to 6.50%. The decision was in line with the market consensus. In the run-up to the meeting, the forward rate agreement (FRA) curve had fully priced in a cut of 25 basis points in the next two months (see chart 1).

Chart 1: Implied change in the repo rate based on the FRA curve



Source: Bloomberg, Momentum Investments

The Sarb's publicly-made comments on monetary policy being less accommodative in the last ten months likely contributed to the expectation of an interest rate cut. Two MPC members voted for a repo rate cut at the previous meeting in May 2019, which was another tell-tale sign to the market that an interest rate cut was likely on the horizon. This breath of fresh air alleviates the pressure on relentless price hikes since the beginning of 2019.

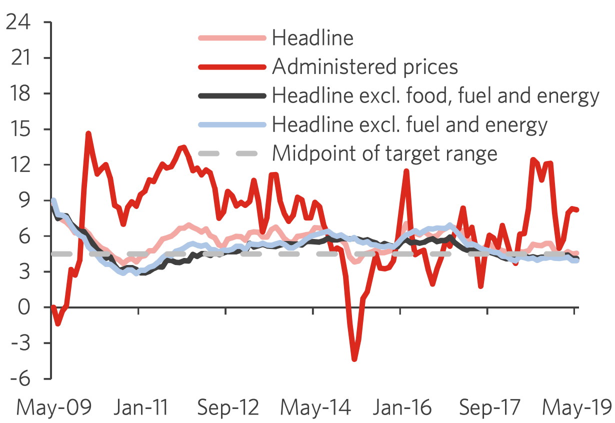
Domestic price pressure from fuel and utility costs has constrained consumers' purchasing power and has contributed to lacklustre demand in the economy. Nonetheless, the recent downward trend in inflation outcomes was welcomed by the Sarb and risks to the inflation outlook were seen to be more-or-less evenly balanced. These factors were cited as motivators for the repo rate cut of 25 basis points. The Sarb exercised caution in extrapolating an interest rate cutting trend, by admitting that no discussion over a cut of 50 basis points was considered and warned future monetary policy decisions would be data dependent and would take into account potential second-round inflation effects. The Sarb further acknowledged that monetary policy alone cannot solve for the low growth quandary and emphasised the need for structural reform.

Benign inflation temporarily exacerbated by electricity and fuel price shocks

Headline inflation in May 2019 edged up slightly higher to 4.5% in year-on-year terms (y/y) previously 4.4% y/y. Food inflation showed a mild uptick, driven by fish and poultry prices alongside bread and cereals. The Sarb expects food inflation to peak at 5.6% in the second and third quarter of 2020.

Administered prices have moderated slightly, but remain high. Higher fuel and electricity prices have kept upward pressure on overall inflation outcomes in the last five months (see chart 2). In spite of this, weak demand-pull inflation forces have kept headline inflation within the 3% to 6% target range for 26 consecutive months.

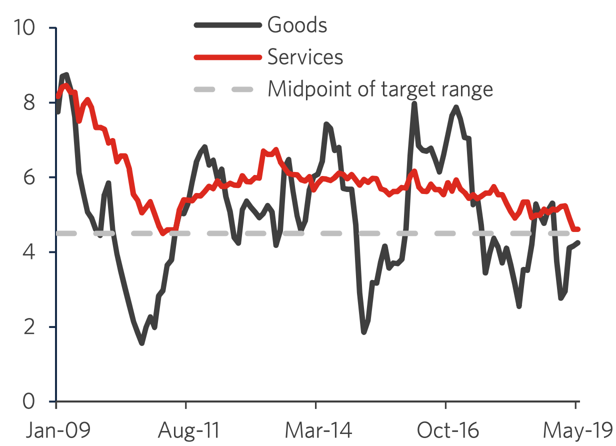
Chart 2: Inflation trends (% y/y)



Source: Sarb, Momentum Investments

Goods inflation has been on an upward trend and reported a 4.3% y/y rise in May 2019 from 4.2% y/y in April 2019. This is still however below the 4.5% midpoint of the inflation target range (see chart 3). Traditionally-sticky services inflation has moderated encouragingly in the last few months and is now trending closer to the midpoint of the target range. Services inflation remained unchanged at 4.6% y/y between April and May 2019. Subdued rental inflation has been a significant contributor to the slowdown in services inflation. A reduction in services inflation has a positive bearing on inflation expectations, which generally tracks the movement of services inflation.

Chart 3: Goods and services inflation (% y/y)



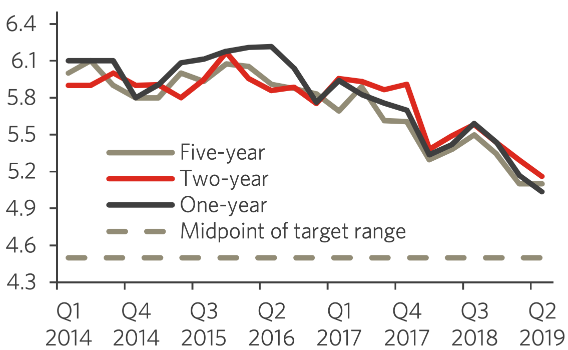
Source: Stats SA, Momentum Investments

Inflation expectations published by the BER has responded positively to increased transparency displayed by the MPC in the last few years, amid lower labour costs and continued downside surprises in the food inflation cycle.

Average inflation expectations for the five years ahead remained unchanged at an all-time low of 5.1%, but the two-year and one-year-ahead inflation expectations series have continued to trend lower (see chart 4). Inflation forecasts by the Sarb and consensus (measured by Reuters) have been revised downwards in 2019. The Sarb has kept its 2020 and 2021 forecast unchanged, but consensus has also revised its 2020 forecast lower, while keeping its forecast for 2021 unchanged (See chart 5).

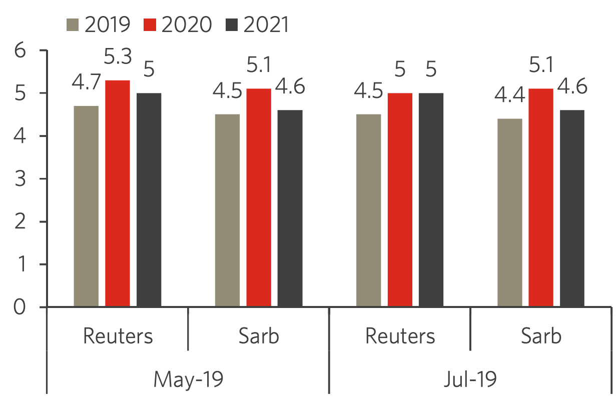
Contributors to the downward inflation revision included a lower Brent crude oil forecast from US$69.50 to US$67 for 2019, while the assumption for 2020 and 2021 remained unchanged at US$68. The Sarb's electricity price forecast for 2019 and 2020 was reduced from 10.2% to 9.7% and from 10.7% to 10.4%. Although global food prices are expected to rise, the momentum of the increase is now assumed to be slower at 0.6% (previously 0.9%) in 2019 and 1.6% (previously 2.6%) in 2020.

Chart 4: Slowdown in inflation expectations (% y/y)



Source: BER, Momentum Investments

Chart 5: Headline inflation forecasts (% y/y)

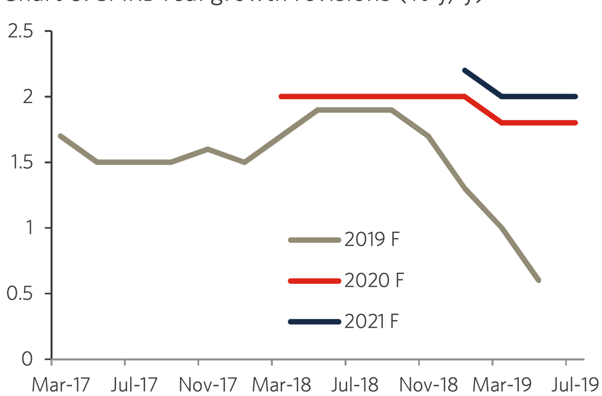


Source: Reuters, Sarb, Momentum Investments

Growth expectations revised lower for 2019, with negative implications for the output gap

Unsurprisingly, the Sarb's growth forecast for 2019 was reduced once again, from 1.0% y/y to 0.6% y/y, in light of a wider-than-expected contraction in the first quarter of 2019 due to electricity supply constraints and weak demand. The Bank however still expects the economy to grow by 1.8% and 2.0% in 2020 and 2021, respectively (See chart 6).

Chart 6: SARB real growth revisions (% y/y)



Source: Sarb, Momentum Investments

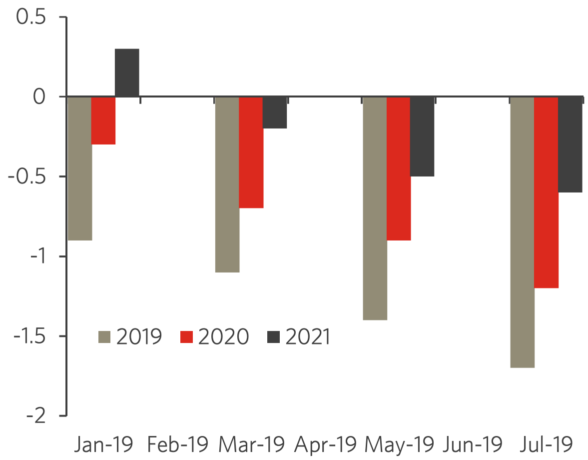
Early indications of high-frequency data for the second quarter of 2019 suggests growth is likely to rebound from negative territory, abating fears of a technical recession. Citibank's gross domestic product (GDP) tracker currently estimates second quarter growth of 2.1%, but this could increase to 2.8% if other sectors outperform the current sideways expectation. An escalation in the trade war could nevertheless detract from local growth through SA's exposure to China.

The Sarb assesses risks to the growth forecast to be balanced in the near term, although long-term risks remain a concern. The Sarb reiterated its intention to manage inflation expectations towards the midpoint of the target range, in the interest of balanced and sustainable growth.

The downward growth revision in the near term has exacerbated the Sarb's assessment of the output gap and as such it is likely to take longer to close. The Sarb forecasts that the output gap is now at negative 1.7%, previously negative 1.4% in 2019. Its assessment has widened by

0.3% to 1.2% in 2020 and to 0.6% in 2021 (wider by 0.1%) (See chart 7).

Chart 7: Widening output gap (%)

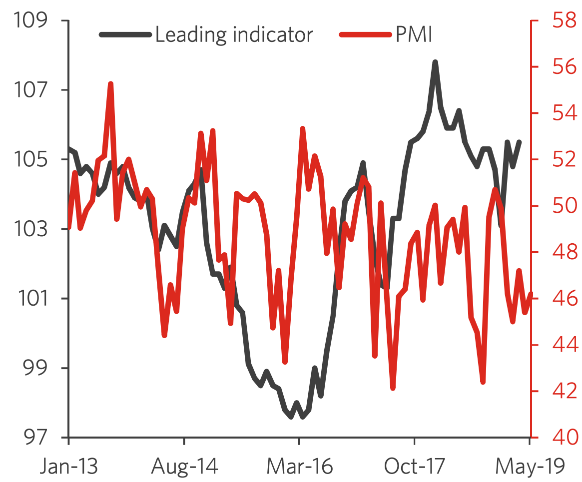


Source: Sarb, Momentum Investments

Forward-looking growth indicators are still signalling weakness in the economy given tepid domestic demand. The Sarb leading indicator and the BER purchasing managers index (PMI) has remained volatile and has not given a clear indication of the growth trend ahead (See chart 8).

Global growth momentum is likely to see slight improvement, supported by additional monetary policy accommodation. The Sarb expects global growth of 3.3% in 2019, improving to 3.6% in 2020. Anti-globalisation sentiment weighing down confidence and unsustainable debt levels in specific countries are key growth detractors according to the Sarb.

Chart 8: Forward-looking growth indicators (Index)



Source: Bloomberg, Momentum Investments

Several central banks have already cut policy rates or have signalled towards a cut

Table 1: More dovish emerging market (EM) central banks in the second quarter of 2019 (%)

Country	Latest inflation print	Latest interest rate move	Current interest rate
India	3.1	-0.25 (June 2019)	5.75
Chile	2.8	-0.25 (June 2019)	2.50
Czech Republic	2.7	+0.25 (May 2019)	2.00
Malaysia	0.2	-0.17 (May 2019)	3.00
Philippines	2.7	-0.25 (May 2019)	4.50
Russia	4.7	-0.25 (June 2019)	7.50

Source: Bloomberg, Global interest rate.com, Momentum Investments

A string of EM central banks have paused monetary policy normalisation and have shifted to a more accommodative stance between the first and second quarter of 2019 (See table 1). Capital Economics is of the view that China, India, Brazil, Russia and Mexico (among other EM central banks) is likely to cut policy rates further or join the cutting cycle from the second half of 2019 and well into 2020. The rhetoric from developed market central banks has also been more dovish. Developed market central banks have signalled policy rate cuts ahead amid renewed growth risks and lacklustre inflation.

The United States Federal Reserve is expected to cut policy rates in the near term, while the Eurozone is likely to embark on a more accommodative path towards the end of the year. Even the Bank of England has done an about-turn, cautioning against Brexit risks.

All five MPC members unanimously decided to lower rates to 6.50%

Table 2: Unanimous support for an interest rate cut in July 2019

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
18 July 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*

The unanimous decision to cut the repo rate by 25 basis points was largely anticipated by the market, however the MPC has not explicitly signalled appetite for a cutting cycle. The Bank highlighted that global financial conditions could tighten and unexpectedly pose a risk. Moreover, domestic structural deficiencies exist that could threaten currency stability and the long-term interest rate.

In the Q&A session, the governor highlighted that a cut of 50 basis points was not debated and stressed the point that reform support is integral to sustained domestic demand and growth.

The reappointment of Governor Lesetja Kganyago and the appointments of Ms Nomfundo (Fundi) Tshazibana and Dr Rashad Cassim as deputy governors were well received by the market. Currently, the uneven number of MPC members' rules out tied votes.

A number of local and international constraints continue to cap significant economic growth in the near term, however the repo rate cut could support sentiment at the margin. Momentum Investments' well-diversified outcome-based solutions provide protection against SA economic weakness. It has appropriate exposure to local fixed income investments that benefit from the poor-performing economy and low inflation, and has meaningful global exposure unaffected by weak local growth conditions, while gaining from the rand weakness likely associated with fragile local growth conditions.