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Unanimous decision to keep interest rates steady at 6.5%

Highlights

- The South African Reserve Bank (Sarb) Monetary Policy Committee (MPC) unanimously decided to keep the repo rate unchanged at 6.5% in its second last meeting for 2019.
- The Quarterly Projection Model (QPM) previously projected a cut in the fourth quarter of 2020, but it has removed this after interest rates were reduced by 25 basis points to 6.5% in July 2019.
- The MPC forecasted a lower inflation print for 2019 at 4.2% from 4.4% previously and sees risks to the inflation outlook as being broadly balanced.
- Surveyed inflation expectations have continued to lower encouragingly towards the midpoint of the target band.
- The MPC's growth forecast for 2019 remained unchanged at 0.6%, but was revised significantly lower from 1.8% to 1.5% for 2020 and from 2.0% to 1.8% in 2021.
- The MPC highlighted that the continuation of structural growth deterrents were still a cause for concern. It lowered its forecast for potential growth to 1.1% from 1.3% in 2020 and from 1.4% to 1.2% in 2021.
- Global monetary policy is likely to remain accommodative in the near term amid an uncertain global backdrop and continued downside risks to global growth.
- Subdued inflation pressures and relatively high real interest rates suggest room for another cut, but the timing will likely depend on the outcome of the medium-term budget and Moody's ratings decision, which could have an effect on the local currency and hence expected inflation outcomes.

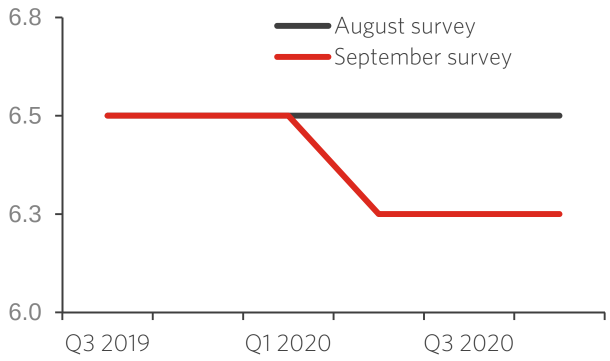
Sarb MPC unanimously keeps repo rate unchanged at 6.5%

The Sarb MPC unanimously decided to keep the repo rate unchanged at 6.5% at its second-last MPC meeting for 2019. In contrast, the MPC unanimously cut rates by 25 basis points in the previous meeting held in July 2019.

Reuters polled 25 economists, of which 20% expected a cut and the rest anticipated no change in interest rates. The September 2019 survey shows that respondents expect one rate cut in the second quarter of 2020, whereas previously (August) no repo rate cuts were expected in 2020 (see chart 1).

The forward-rate agreement (Fra) market had a 65% chance of a rate cut priced in, even though the July 2019 repo rate cut was accompanied by a hawkish statement. The QPM previously projected a cut in the fourth quarter of 2020, but it has removed this after interest rates were reduced by 25 basis points to 6.5% in July 2019.

Chart 1: Consensus expecting a repo rate cut in Q2 2019 (%)

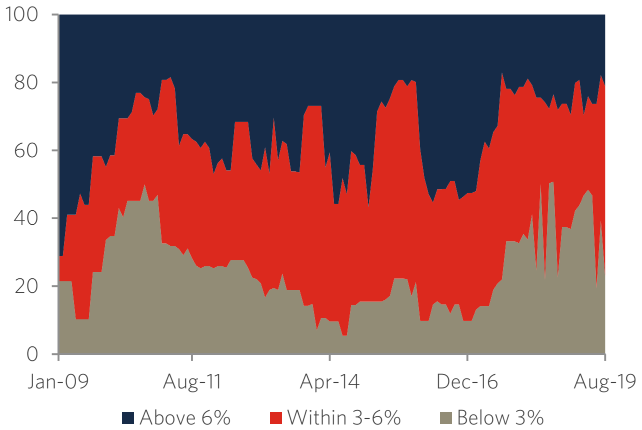


Source: Reuters, Momentum Investments

Near-term inflation outlook improves

Inflation fundamentals have been indicating that a rate cut is warranted, given muted demand pressure and the expectation of a subdued inflation trajectory. Inflation in 56% of the basket is still tracking well within the 3% to 6% target range, indicating that inflation is relatively contained (see chart 2).

Chart 2: Significant share of inflation basket tracking in the target range

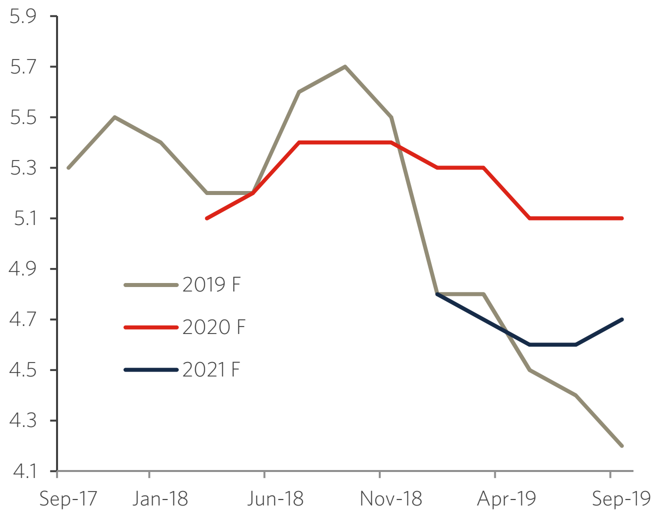


Source: Stats SA, Momentum Investments, data up to August 2019

The Sarb forecasted a lower inflation print for 2019 at 4.2% from 4.4% in the July 2019 MPC meeting, underpinned by fuel inflation expected to average 2.4%. The inflation forecast for 2020 remained unchanged at 5.1% and the 2021 forecast increased to 4.7% from 4.6% (see chart 3).

Inflation is expected to peak at 5.3% in the third quarter of 2020, which is lower than the peak of 5.4% peak previously forecasted for the first quarter of 2020 as per the July 2019 statement. This peak is likely to be driven by food inflation, which is expected to top out at 6.0% in the third quarter of 2020. Fuel inflation is expected to reach 11.8% in the first quarter of 2020.

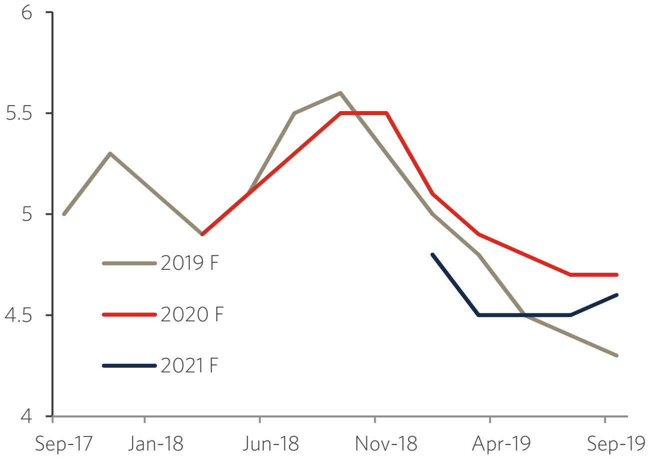
Chart 3: Sarb CPI revisions (% y/y)



Source: Sarb, Momentum Investments

The Sarb's forecast for core inflation in 2019 declined to 4.3% from 4.4%, while the forecast for 2020 remained unchanged at 4.7%. Core inflation is anticipated to rise to 4.6% from a slightly lower 4.5% in 2021 (see chart 4).

Chart 4: Sarb core CPI revisions (%y/y)

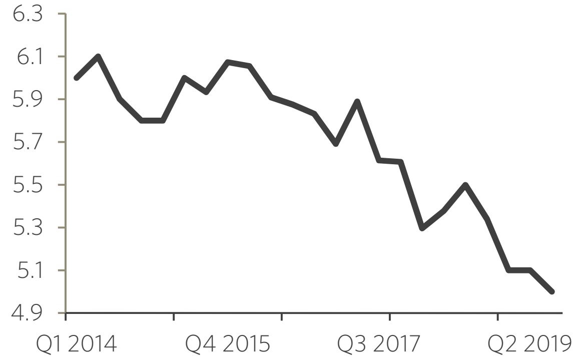


Source: Sarb, Momentum Investments

The Sarb noted that fuel, water and electricity prices continued to pose upside risks to the inflation outlook, despite a downward revision in its oil price projection (from US$67/bbl in 2019 to US$65/bbl and from US$68/bbl for 2020 to US$66/bbl) and a lowering of its assumption on electricity prices from 10.4% to 9.7% for 2020.

Inflation expectations released by the Bureau of Economic Research (BER) for 2019 continued to decline marginally in the third quarter of 2019 to 4.6% from 4.8% in the second quarter. The survey showed that inflation expectations remained unchanged at 5.0% for 2020 and eased to 5.1% from 5.2% for 2021. The five-year-ahead inflation expectation slowed encouragingly to 5.0% from 5.1% (see chart 5).

Chart 5: Five-year-ahead inflation expectation at lowest level on record



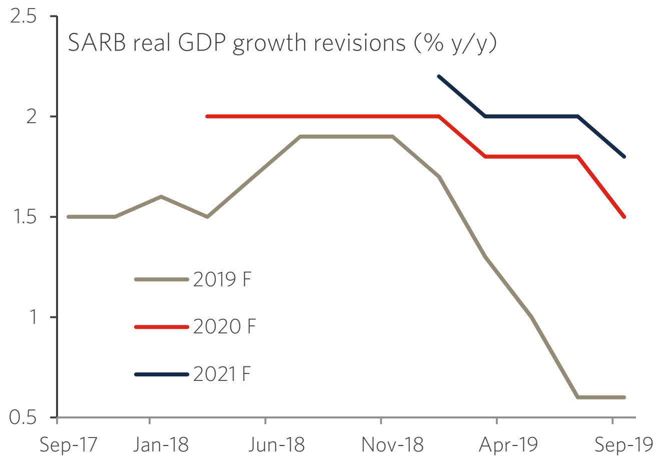
Source: BER, Momentum Investments

Further deterioration in medium-term growth outlook

Although the higher-than-expected second quarter growth print likely also surprised the MPC, growth fundamentals are still weak. Citi's gross domestic product (GDP) tracker (accounting for 40% of visible high-frequency data) for the third quarter of 2019 tentatively indicates 1.1%, highlighting a softening in momentum. The Sarb noted its early assessment of third-quarter growth suggests activity was relatively muted in comparison to the second quarter. The Reuters September 2019 survey forecasts the third quarter to grow by 1.6% in quarter-on-quarter (q/q) seasonally-adjusted terms (saar), which is higher than the 1.4% q/q saar expectation from the August survey.

The MPC highlighted structural growth deterrents are still a cause for concern. It kept the growth forecast for 2019 unchanged at 0.6%, but reduced its expectation for 2020 to 1.5% from 1.8% and revised its projection for 2021 to 1.8% from 2.0% (see chart 6). According to Reuters, the market consensus lowered its growth forecast in 2019 to 0.5% in their September survey from 0.6% in the August survey.

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



Source: Sarb, Momentum Investments

The BER business confidence print for the third quarter plummeted to a 20-year low, with all the sub-indices remaining significantly below 50, highlighting the broad-based weakness in growth. The Sarb leading indicator also continued to deteriorate in the latest print for June 2019.

The Sarb lowered its forecast for potential growth to 1.1% from 1.3% in 2020 and from 1.4% to 1.2% in 2021. The output gap forecasts remained unchanged in 2019 at negative 1.7%, while 2020 showed a widening in the gap to negative 1.3% (previously negative 1.2%). The forecasted gap remained unchanged at 0.6% for 2021.

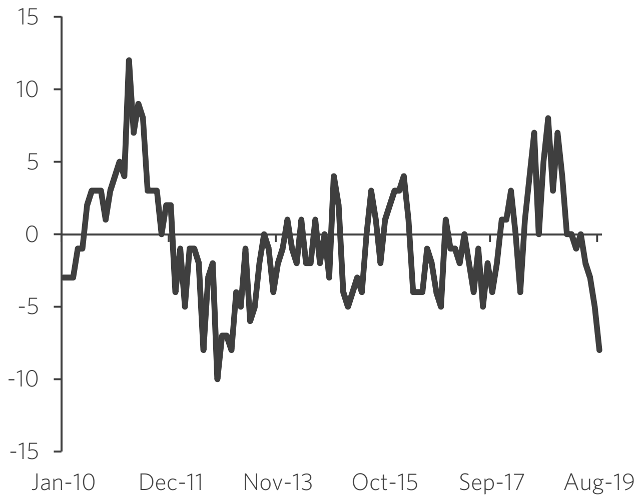
Further geopolitical threats are reflected in the Sarb's downward adjustment of growth expectations for SA's trading partners. Moreover, local supply constraints could see local growth forecasts weaken further. Nevertheless, the MPC sees risks to the growth forecast as balanced in the near term.

Global monetary conditions remain accommodative

Monetary policy will likely remain accommodative in advanced economies, as they continue to attempt to abate the global slowdown (see chart 7). The United States Federal Reserve reduced the policy rate again by 25 basis points in September 2019, while the Bank of England (BoE) and the European Central Bank (ECB) kept their policy rates unchanged in September 2019. The BoE is only likely to move on interest rates once there is a clear way forward around Brexit.

Emerging markets (EMs) on the whole have continued to loosen policy in the third quarter of 2019 (see chart 8). EMs that lowered policy rates in August and September 2019 include Brazil (declined to 5.5% from 6.0%), Chile (declined to 2.0% from 2.5%), Turkey (declined to 16.5% from 19.75%), Russia (declined to 7.0% from 7.25%) and Mexico (declined to 8.0% from 8.25%).

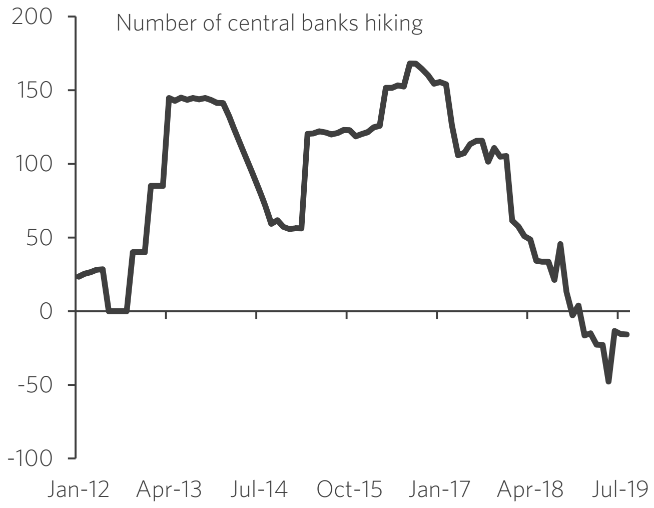
Chart 7: Global quantitative easing (US$'billions)



Source: Capital Economics, Momentum Investments

Monetary policy is likely to remain accommodative in the near term amid an uncertain global backdrop and continued downside threats to growth. Global growth is expected to slow to 3.2% in 2019 (from 3.8% in 2018) and partly rebound to 3.5% in 2020. The global manufacturing sector and trade volumes continued to deteriorate, as trade conflict escalated. The global Purchasing Managers Index (PMI) declined to below the 50 neutral point, indicating that the manufacturing sector is contracting globally.

Chart 8: EM interest rate diffusion index



Source: Capital Economics, Momentum Investments

Economic events calendar could cause rand weakness

Table 1: Unanimous preference for no cut at the September 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	-	-	-

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 MPC unanimously decided to keep the repo rate unchanged at 6.5% from previously unanimously deciding to cut the repo rate by 25 basis points in the July 2019 meeting (see table 1). The MPC emphasised its preference to anchor inflation expectations closer to the midpoint of the target on a sustained basis.

The medium-term budget on 30 October 2019 and the Moody's sovereign ratings announcement on 1 November 2019 pose risks to the local currency insofar as the outcomes are negatively interpreted by the market. The rand depreciated by 4.6% against the dollar since the last MPC meeting in July 2019. The MPC's implied starting point for the rand moved to R14.88 to the US dollar relative to R14.40. The MPC expects the rand to remain slightly undervalued.

In the question-and-answer session, Governor Lesetja Kganyago mentioned that the recent drone strikes on the Saudi Arabian oil refineries were not accounted for in the QPM Brent crude oil assumptions. The Governor, however, mentioned that such oil price shocks are risks to the inflation trajectory if these shocks become permanent.

The Sarb revised its neutral real rate higher to 2.2% in 2019, 2.4% in 2020 and 2.4% in 2021, from 2.1%, 2.2% and 2.3%, respectively. This was as a result of lower international policy rates and an unchanged interest rate in SA.

Subdued inflation pressures and relatively high real interest rates suggest room for another cut, but the timing will likely depend on the outcome of the medium-term budget and Moody's ratings decision, which could have an effect on the local currency and hence expected inflation outcomes.