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Interest rates on hold at 3.5%, but committee preferences remain mixed

Highlights

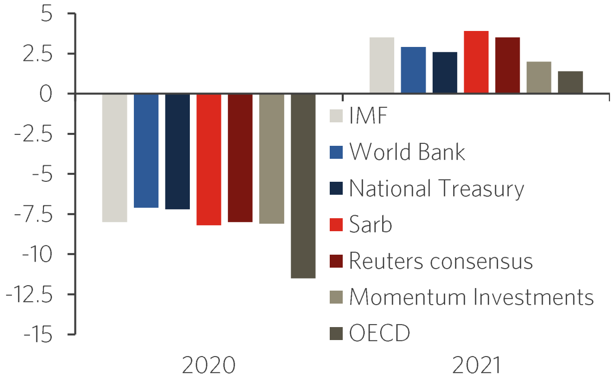
- The South African Reserve Bank (Sarb) Monetary Policy Committee (MPC) kept interest rates steady at 3.5% at the scheduled September 2020 interest rate-setting meeting despite downwardly revised growth and inflation views. This decision tied in with the view of 15 out of the 25 analysts surveyed by Reuters, while we were one of the ten favouring a 25-basis point cut. The view expressed by the forward-rate agreement (FRA) market, which had flipped to expecting a cut following a poor set of second quarter growth numbers, shifted to a reduced 20% chance of a 25-basis point cut in the run-up to the meeting.
- The Sarb's growth forecast for the local economy deteriorated to negative 8.2% for 2020 from negative 7.3%. Due to a reduction in fixed investment, the size of the forecasted negative output gap narrowed to 6.5% from 7.0% in 2020 and is expected to taper to 2.3% in 2022, from a previous forecast of 2.8%.
- The Sarb's headline inflation forecast edged lower to 3.3% for 2020 (previously 3.4%) and dipped notably from 4.3% to 4.0% for 2021. The Sarb continues to view risks to the inflation trajectory as broadly balanced, given the upside threat of administered prices (including electricity tariffs) and heightened fiscal risks balancing out muted currency pass-through and contained food inflation.
- Interest rate preferences by the MPC members remained varied, with three members favouring no move in interest rates, whereas two members suggested a preference for reducing interest rates by 25 basis points.
- The Sarb has cut interest rates by 300 basis points since the start of the year and has utilised several instruments in its toolbox to encourage lending to firms and households and to improve liquidity in fixed income markets.
- We suspect the Sarb is at the end of its cutting cycle. Despite a dismal growth trajectory and downward pressure from depressed demand on inflation in the near term, the Sarb noted longer term inflation expectations remained broadly unchanged. Also, the Sarb highlighted ongoing fiscal concerns, hinting that additional easing was less likely from here, unless, in our view, we suffer another growth setback or experience another sharp dip in inflation. We expect the Sarb to consider interest rate hikes in the second half of 2021.

Downward revision to Sarb's 2020 growth estimate

With the COVID-19 pandemic having a more negative effect on economic activity in the first half of the year than previously anticipated, the Sarb downgraded its assumption on local growth from negative 7.3% to negative 8.2%. This updated forecast now exceeds the estimates of Treasury, the Reuters consensus and the

International Monetary Fund (IMF) (see chart 1) but is milder than the 11.5% contraction forecasted by the Organisation for Economic Co-operation and Development (OECD), which was based on the assumptions of continued load shedding and a lack of internal demand.

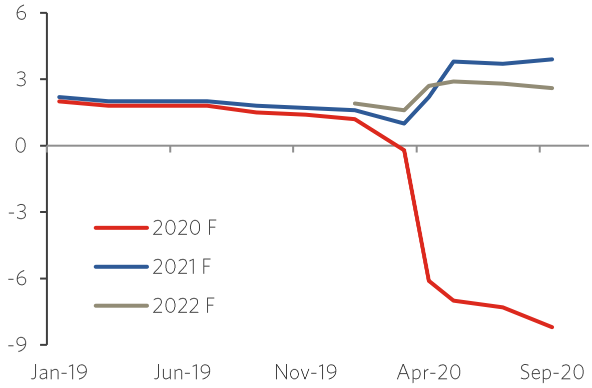
Chart 1: SA growth estimates for 2020 and 2021 (%)



Source: Sarb, treasury, IMF, World Bank, Reuters, OECD, Momentum Investments

The Sarb expects growth in the economy to recover to 3.9% in 2021, from a previous expectation of 3.7% (see chart 2) and noted the further easing of the lockdown will support growth.

Chart 2: Sarb's real growth revisions (%)

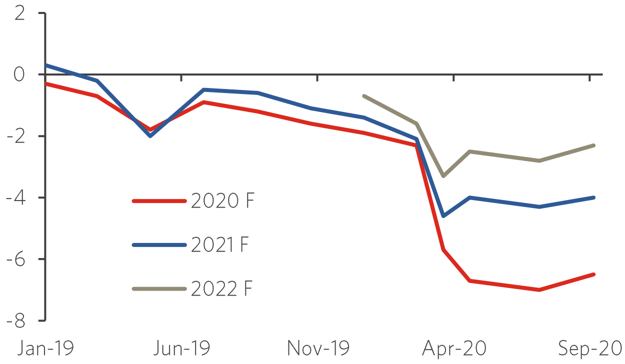


Source: Sarb, Momentum Investments

Due to sharply lower investment, the expected gap between actual and potential growth was revised to a shallower 6.5% from 7.0% in 2020 and is expected to taper to 2.3% (previously 2.8%) by 2022, see chart 3. The Sarb downwardly revised potential growth for 2020 from negative 2.1% to negative 3.2% and upwardly revised potential growth for 2021 from 1.1% to 1.4%. The Sarb's estimate for 2022 was lowered from 1.3% to 0.9%.

The Sarb's growth forecast for 2020 shifted past the median consensus view appearing in the August 2020 Reuters Econometer, which pointed to an anticipated contraction in SA's economy of 8% in 2020, before climbing to 3.1% in 2021. We have maintained our growth projection of negative 8.1% for 2020 and expect a mild rise of only 2% in 2021. Weak fundamentals (including heavy fiscal constraints), a rise in firm liquidations and insolvencies, significant job losses and continued load shedding are likely to constrain the upturn, underlying our weaker-than-consensus growth assumption for 2021. The OECD has downwardly revised its 2021 growth estimate for SA to 1.4% and reflects one of the more bearish outlooks for growth.

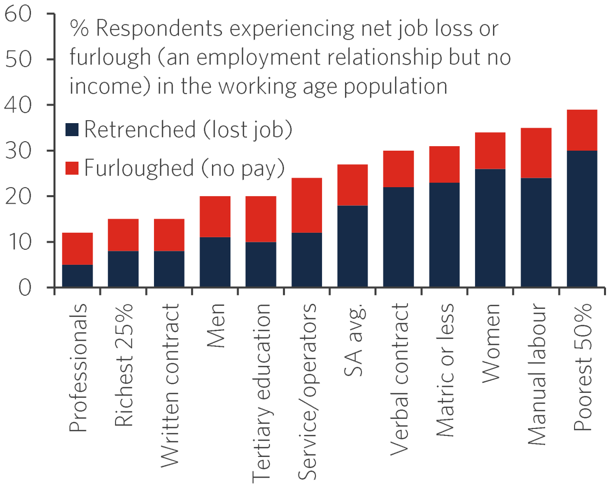
Chart 3: Sarb's output gap revisions (%)



Source: Sarb, Momentum Investments

The National Income Dynamics Study – Coronavirus Rapid Mobile Survey (Nids-Cram), which telephonically surveys 7 000 respondents monthly, noted job losses between April and May 2020 were the most severe for the poorest half of workers and more prevalent for jobs involving manual labour. Those without tertiary education also suffered a bigger loss in employment (see chart 4).

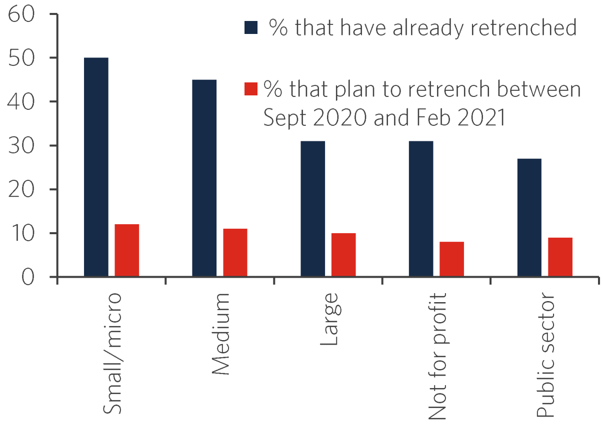
Chart 4: Job losses in April-May 2020 by category



Source: NIDS-CRAM Survey (April – May 2020), Momentum Investments

Survey data from Redflank Management Consultants highlighted that job losses were the most severe for small/micro and medium-sized businesses, similar to the trend experienced during the global financial crisis (see chart 5).

Chart 5: Job losses by business size (%)



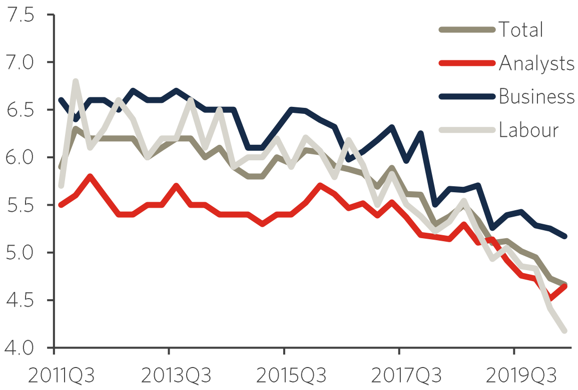
Source: NIDS-CRAM Survey (April – May 2020), Momentum Investments

Sarb's inflation forecast revised notably lower for 2021

The Sarb continues to view risks to the inflation trajectory as being broadly balanced, given the upside threat of administered prices (including electricity tariffs) and heightened fiscal risks balancing out muted currency pass-through and contained food inflation.

It warned about longer term inflation expectations remaining higher. The five-year average inflation rate expected in five years (as surveyed by the Bureau of Economic Research (BER)) remained at 4.7% in the second quarter of the year (see chart 6).

Chart 6: Longer-dated inflation expectations (%)



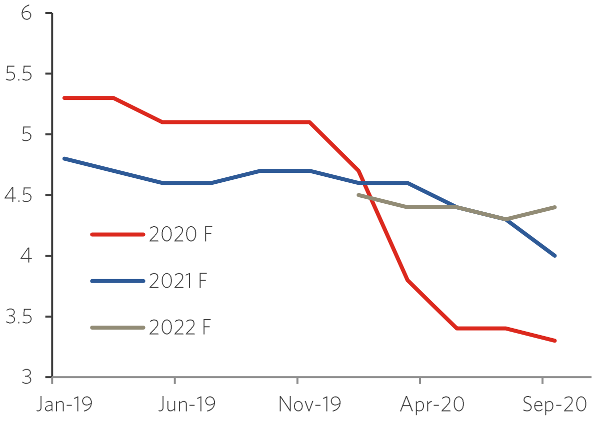
Source: BER, Momentum Investments, data up to Q2 2020

The Sarb upped its annual average oil price forecast for 2020 from US$40/bbl to US$42/bbl and from US$45/bbl and US$50/bbl in 2021 and 2022 to US$47/bbl and US$52/bbl, respectively. This compares to our average annual forecasts of US$43/bbl for 2020, US$50/bbl for 2021 and US$57/bbl for 2022.

Although strong demand from Southern Africa, a delay in deliveries due to COVID-19 restrictions and currency weakness pushed up current maize prices. SA's maize harvest is estimated at 15.5 million tonnes and will outstrip domestic consumption of 11 million tonnes. Global maize production is also up 5% from the previous season (the largest on record). SA's winter harvest has also increased to its most abundant in a decade, which will limit imports. Although poultry prices are likely to be affected by import tariffs, lower restaurant demand, downward pressure on household income and the substitution effect (as consumers trade lower due to reduced incomes) should help to contain meat inflation. As such, these factors are likely to bode well for local food inflation.

Overall, the Sarb expects a marginally lower headline inflation rate of 3.3% in 2020 (compared with our forecast and the Reuters median consensus for August 2020 of 3.1%), a downwardly revised 4.0% (from 4.3%) in 2021 (matching the Reuters consensus of 4.0% and slightly higher than our expectation of 3.8%) and 4.4% for 2022 (relative to our projection of 4.6% and the Reuters projection of 4.3%), see chart 7.

Chart 7: Sarb's headline inflation forecasts (%)

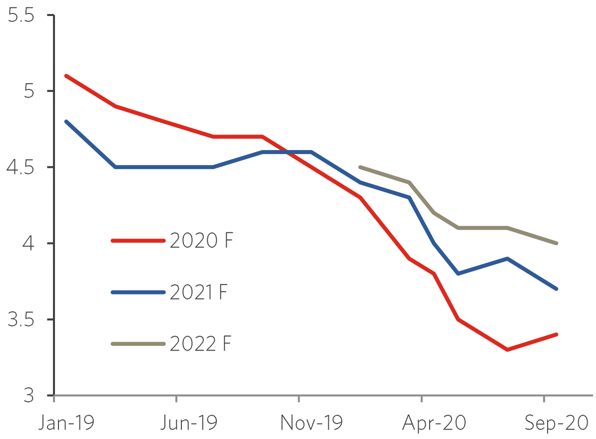


Source: Sarb, Momentum Investments

The Sarb's core or underlying inflation projections (excluding food and fuel prices) were revised up by 0.1% for 2020 to 3.4% (compared with our estimate of 3.1%) and downwardly revised by 0.2% to 3.7% for 2021, relative to our forecast of 3.5% (see chart 8). Relative to its July 2020 projections, the Sarb expects core inflation to be marginally lower at 4.0% in 2022.

Markets will be closely watching the trajectory of rental prices, which will likely be affected by declining household incomes and an overhang of supply in the market. Rental prices are a significant contributor to core and services inflation.

Chart 8: Sarb's core inflation forecasts (%)



Source: Sarb, Momentum Investments

MPC preferences were not unanimous

At the July 2020 MPC, three MPC members preferred an interest rate cut of 25 basis points, while two members favoured unchanged interest rates (see table 1). Today's interest rate decision reflected a continued division in preferences, where three members favoured interest rates to remain unchanged at 3.5%, while two members preferred a 25 basis-point cut to 3.25%.

Going into today's interest rate decision, 15 out of 25 analysts surveyed by Reuters were expecting interest rates to remain steady and 10 (including ourselves) anticipated a cut of 25 basis points. The view expressed by the forward-rate agreement (FRA) market, which had flipped to expecting a cut following a poor set of second quarter growth numbers, shifted to a 20% chance of a 25-basis point cut in the run-up to the meeting.

According to the MPC, the Quarterly Projection Model (QPM) indicated no further interest rate cuts and two hikes in 2021 (the first one in the third quarter and the second in the fourth quarter).

Table 1: Differing MPC member views at the scheduled September 2020 meeting

Number of committee members	Favoured no move	Favoured a 25 basis point cut	Favoured a 50 basis point cut	Favoured a 100 basis point cut
17 January 2019	5	-	-	-
28 March 2019	5	-	-	-
23 May 2019	3	2	-	-
18 July 2019	-	5	-	-
19 September 2019	5	-	-	-
21 November 2019	3	2	-	-
16 January 2020	-	5	-	-
19 March 2020	-	-	-	5
14 April 2020	-	-	-	5
21 May 2020	-	2	3	-
23 July 2020	2	3	-	-
17 September 2020	3	2	-	-

Source: Sarb, Momentum Investments

Interest rates likely to remain steady from here

Today's interest rate decision to keep interest rates steady at 3.5% was accompanied by a split of preferences on the MPC. In the question and answer session, the MPC reiterated its focus on the direction of inflation and growth data and how this will influence future monetary policy decisions.

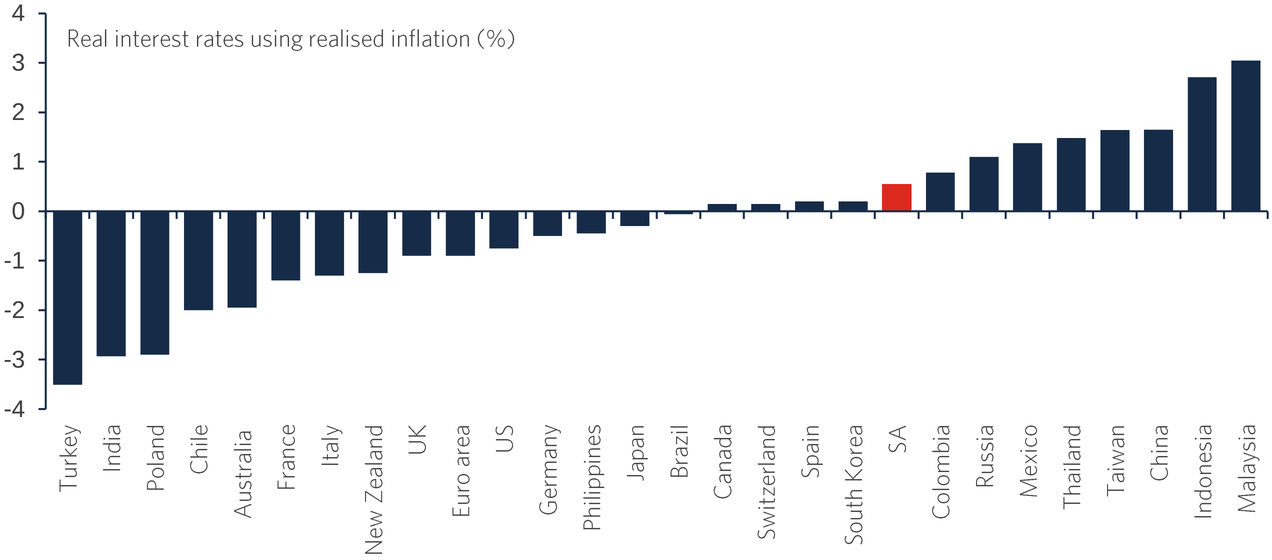
In our opinion, the Sarb has been inclined to temporarily cut real interest rates by more than usual to play its role in softening the blow of the virus shock on the local economy. The Sarb has been clear that monetary policy has its limitations in trying to boost potential growth, but by cutting interest rates, it aims to help consumers and firms, with debt, to better manage their cash flows.

Real interest rates based on realised July 2020 headline inflation (3.2%) registered at 0.3% (see chart 9), real interest rates are negative if the one-year ahead inflation expectation (the Reuters median consensus expects headline inflation of 4.1% for the third quarter of 2021, while the Sarb anticipates a downwardly revised average of 4%, which is in line with our view) is used. Although running negative real interest rates could put pressure on the local currency to depreciate, the level of pass-through has remained muted in an environment where retailers are trying to protect growth in sales volumes.

We expect the Sarb to keep interest rates on hold for now unless growth experiences another negative shock or if inflation shoots sharply lower. We are projecting interest rates to shift higher in the second half of 2021 (two hikes of 25 basis points each) as the Sarb has warned against the dangers of running negative real interest rates for a protracted period. When inflation is running higher than nominal interest rates, savings tend to fall in value. Moreover, a long period of too low real interest rates could distort financial markets and elevate the risk of financial instability.

In the past the MPC have also warned against the threat of fiscal dominance and the challenges it raises to running looser monetary policy. In an opening address in September 2020 at the fourth Annual Distributed Sovereign Debt Research and Management Conference, the Sarb governor warned "high indebtedness also presents risks to the implementation of monetary policy and financial stability. A high level of public debt also raises the risk of fiscal dominance. This is where monetary policy is subordinated to keeping the debt servicing burden manageable, at the expense of price and financial stability."

Chart 9: Comparative real interest rates using the latest realised inflation figure (%)



Source: Bloomberg, Momentum Investments