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in the moment

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Sarb unexpectedly cuts interest rates to 6.25% in January 2020

Highlights

- The South African Reserve Bank (Sarb) Monetary Policy Committee (MPC) unexpectedly cut the repo rate by 25 basis points in January 2020 on a unanimous decision.
- 21 out of the 24 analysts polled by Reuters expected an unchanged stance on interest rates for January 2020.
- The Sarb downwardly adjusted both its inflation and growth forecasts, but these remain above consensus. It noted that inflation risks remain broadly balanced, while risks to growth remain tilted to the downside.
- Surveyed inflation expectations shifted encouragingly lower with the expected five-year average inflation rate in five years' time declining to its lowest level on record at 4.8%.
- The Sarb Quarterly Projection Model (QPM) suggests one more interest rate cut of 25 basis points in 2020, while the forward-rate agreement (FRA) curve has repriced to include an additional 45 basis points of easing in 12 months' time.
- While Moody's March ratings review is likely to dissuade the committee from cutting interest rates again at the March 2020 interest rate-setting meeting, further expected downgrades to the Sarb's inflation and growth forecasts prevent us from ruling out an additional cut later in the year.

Lower inflation and a decline in the domestic risk profile supported a rate cut

The Sarb MPC unexpectedly reduced the repo rate by 25 basis points in January 2020 to 6.25%. The decision to cut the repo rate was unanimous across the five members. The Sarb signalled the possibility of easier monetary conditions in their November 2019 MPC meeting where two members voted for a 25 basis-point cut. The January 2020 cut was justified by lower projected inflation and improved inflation risk profile.

The MPC reiterated it would like to see inflation anchored closer to the midpoint for a longer period. The Sarb noted that subdued demand pressures, modestly higher food prices and muted rental inflation balance out the upside threats to inflation including the currency, nominal wages and administrative tariffs.

The FRA market repriced from only expecting a 25 basis-point cut in the second quarter of 2020 to anticipating up to 45 basis points worth of additional easing in the next 12 months, following the January interest rate cut. The Reuters interest rate and Econometer poll surveyed 24 economists on their expectations for the repo rate decision in the run up to the January rate-setting meeting. 21 out of 24 surveyed analysts called for interest rates to remain unchanged at the January meeting.

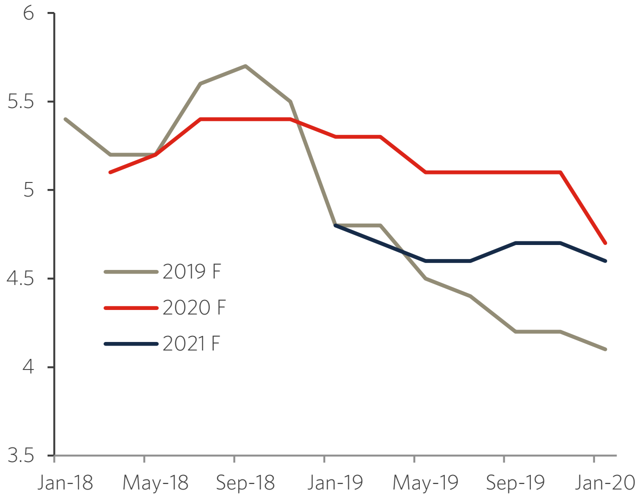
In November 2019, the MPC had warned about the potential negative implication for capital flows and the exchange rate in the event of negative ratings action. In the November 2019 meeting the Sarb's QPM indicated a 25 basis-point repo rate cut in the third quarter of 2020. The

January 2020 QPM suggests one more cut of 25 basis points in the fourth quarter of 2020, following January's cut. The MPC suggested it would continue to assess data and risk changes and use the QPM as a guiding tool for future monetary policy decisions.

Encouraging shift to lower inflation expectations

The Sarb lowered its headline inflation forecast in the January 2020 MPC meeting across the forecasted period to 4.1 (previously 4.2%) in 2019, 4.7% (previously 5.1%) in 2020 and to 4.6% (previously 4.7%) in 2021 (see chart 1). The decline in surveyed inflation expectations and recent downside surprises has likely contributed to the downward revision in the Sarb's inflation projections. The Reuters consensus inflation expectation for 2020 moderated to 4.6% from 4.7% and to 4.7% in 2021 from 4.8% The Sarb expects food inflation to increase at a slower rate in 2020 at 4.7% from 5.8% (previously) on a slower normalisation in meat inflation due to the recurring outbreak in foot and mouth disease.

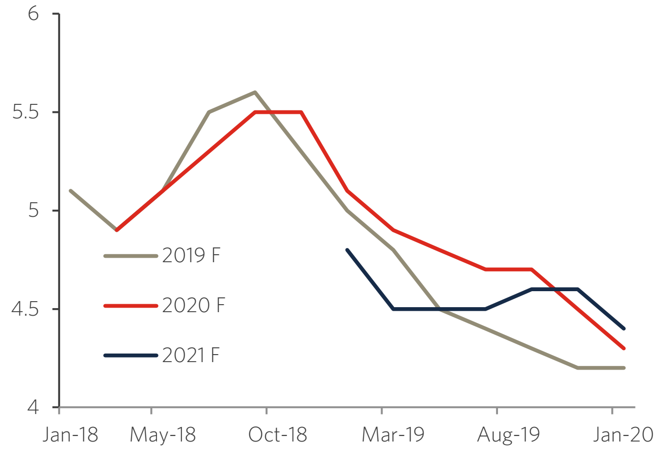
Chart 1: Sarb CPI revisions (% y/y)



Source: Sarb, Momentum Investments

Core inflation has however remained unchanged at 4.2% in 2019, but was revised down to 4.3% (down from 4.5%) in 2020 and is now forecasted at 4.4% (down from 4.6%) in 2021.We expect core inflation to reach a moderate level of 4.2% in 2019 and 2020 and to rise to 4.4% in 2021.The exchange rate has continued to remain stable underpinned by a lower pass through than what was reported in the past (see chart 2). The slowdown in services inflation has contributed to the lower core inflation outlook.

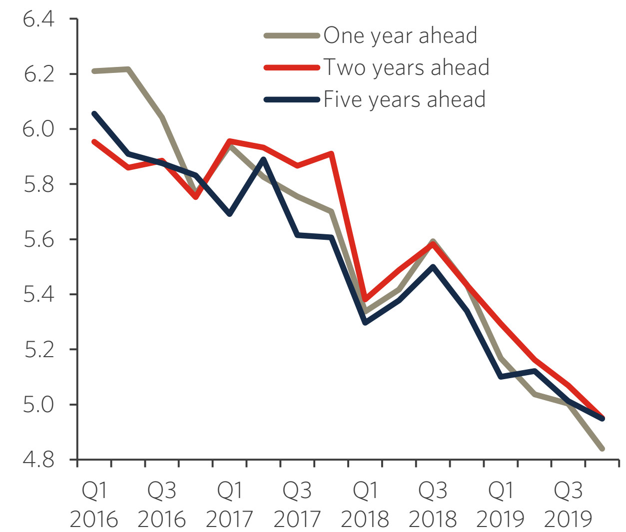
Chart 2: Sarb core CPI revisions (%y/y)



Source: Sarb, Momentum Investments

The Bureau of Economic Research's (BER) Inflation Expectations Survey reported a further improvement in expected inflation in the 2020 fourth quarter survey.

Chart 3: Surveyed inflation expectations continue to shift lower (% y/y)

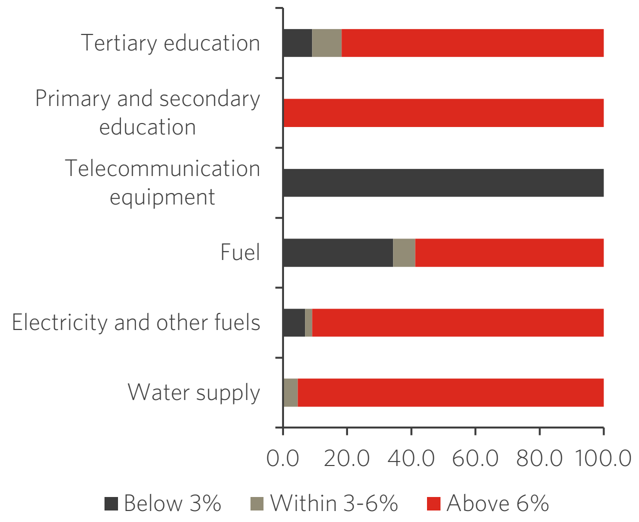


Source: BER, Momentum Investments, data up to Q4 2019

The BER's one-year ahead inflation expectation slowed to 4.8% in 2019 from 5.0% alongside a decline in the two-year ahead inflation expectation to 5.0% from 5.1% (see chart 3). Surveyed expectations for average five-year inflation in five years' time dropped to 4.9% from 5.0% in the fourth quarter of 2019.

Administered prices have historically risen at rates above the upper limit of the inflation target across the board (see chart 4). Administered price increases coming in at above the upper limit of the target will likely persist in 2020 and remain a key risk to the inflation forecast. The Bank expects electricity tariff price increases to rise by double digits (10.4%, below our forecast of 15.5%) in 2020 and slow to 7.4% in 2020. Fuel taxes are however expected to grow marginally slower in 2020 by 5.5%, down from 5.9% according to the Sarb.

Chart 4: Administered prices mostly breaching the upper limit of the target (% of time since 2009)

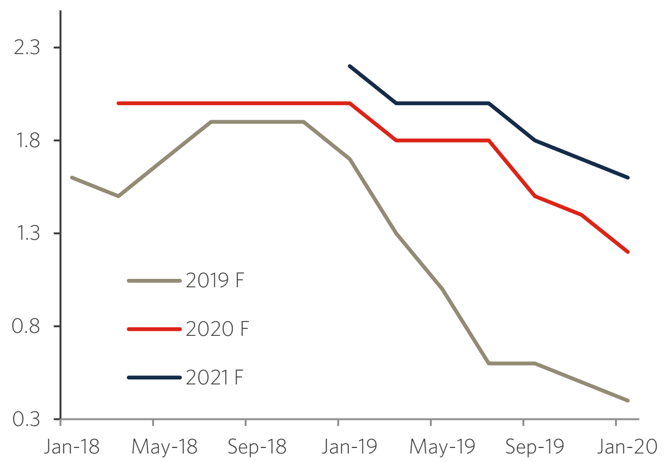


Source: Stats SA, Momentum Investments

Growth remains constrained by load shedding

Growth was revised lower for 2019 to 0.4% from 0.5% explained by persistent load shedding in the last quarter of 2019. The Sarb also revised 2020 and 2021 growth lower to 1.2% (from 1.4%) and 1.6% (from 1.7%), respectively (see chart 5). Our 2019 growth forecast is in line with the consensus and the bank's 0.4% expectation, however we see growth in 2020 still below 1%, growing by 0.8%. We therefore only expect growth in 2021 to improve slightly beyond 1%, at 1.3%.

Chart 5: Sarb real GDP revisions (%y/y) –



Source: Sarb, Momentum Investments

Similarly the output gap has widened in all three years to 1.9% in both 2019 (from negative 1.8%) and 2020 (from negative 1.6%). Meanwhile, the output gap for 2021 is expected to widen to 1.4% from 1.1% as per the MPC November 2019 meeting. Load shedding will continue to limit production, which remains a key downside to growth risk.

Confidence has repeatedly weakened in 2019 in the wake of a slow pace of structural reform efforts and retrenchment announcements by an array of corporations in the year. Although global growth is expected to improve moderately in 2020, forward-looking indicators do not indicate a surge in growth ahead and load shedding continues to dampen the outlook.

While Moody's March ratings review is likely to dissuade the committee from cutting interest rates again at the March 2020 interest rate-setting meeting, further expected downgrades to the Sarb's inflation and growth forecasts prevent us from ruling out an additional cut later in the year.

Table 1: Unanimous 25 basis point cut in January 2020

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
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	-	-	-
21 November 2019**	3	-	-	2
16 January 2020**	-	-	-	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*