The Macro Research Desk

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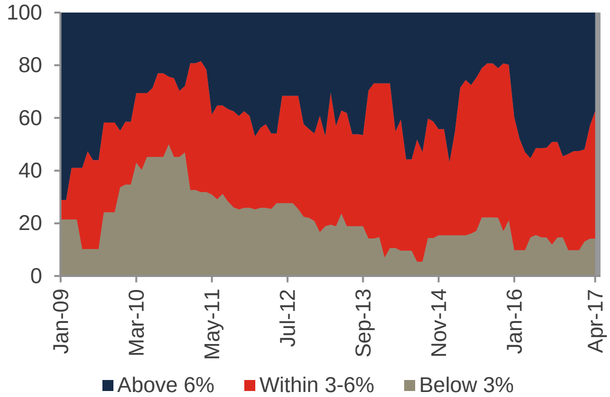
Notable drop in April 2017 headline inflation to 5.3%

Lowest income-earning deciles have reaped the largest benefit of a drop in inflation in recent months

Headline consumer price inflation (CPI) dropped from 6.1% in year-on-year (y/y) terms for March to 5.3% y/y for April 2017, but increased marginally by 0.1% in month-on-month (m/m) terms. Headline inflation positively surprised the market (consensus was anticipating a print of 5.6% y/y) and Momentum Investments' more optimistic forecast of 5.4% y/y. April is generally a lower survey month, with around 12% of the basket being reviewed, after taking account of the usual monthly surveys and the price increases related to the national budget. Relative to Momentum Investments' forecasts, food, alcoholic beverages, tobacco prices and restaurant costs surprised to the downside, while funeral costs were higher than expected.

The breakdown of the CPI basket suggests that inflation in half of the items is comfortably within the 3% to 6% inflation target (see chart 1), which is higher than the past twelve-month average of 36%. Around 37% of the basket items are currently experiencing inflation above the upper end of the target band (6%), which is lower than the 50% average recorded for the past year.

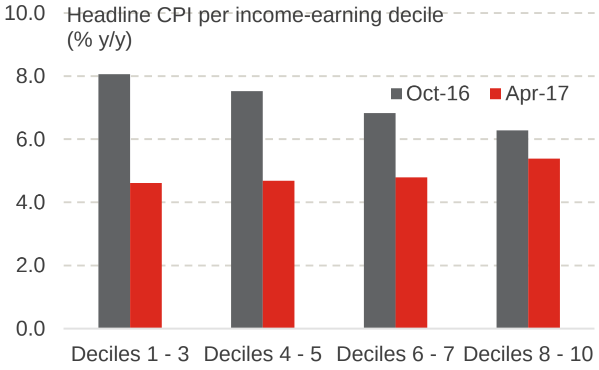
Chart 1: More of the basket is within the CPI target range



Source: Stats SA, Global Insight, Momentum Investments

The biggest beneficiaries of the dip in headline inflation since October 2016 have been lower-income earning deciles (see chart 2). These consumers spend a larger proportion of their income on food expenses and have consequently seen their headline rate of inflation decline substantially from 8.1% y/y for October 2016 to 4.6% y/y for April 2017, in line with food inflation, which correspondingly decelerated from 12% y/y to 6.6%.

Chart 2: Low income benefiting from food disinflation



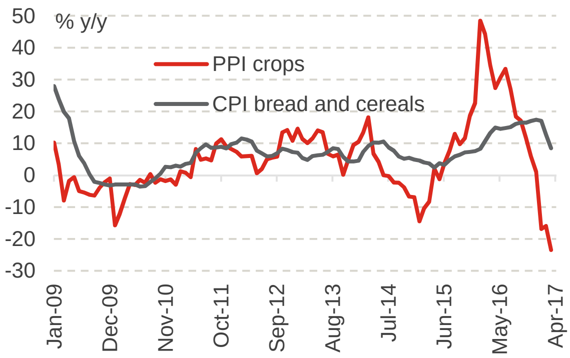
Source: Stats SA, Global Insight, Momentum Investments

Food disinflation continues

Food inflation decreased from an average of 10.8% y/y for 2016 to 6.6% y/y for April 2017, with prices displaying a sideways movement between March and April 2017. Momentum Investments expects a further fall in food inflation in upcoming months, owing to an improvement in weather conditions, which bode well for bread and cereal prices. Increased rainfall led to a plunge in crop prices at the producer price inflation (PPI) level (see chart 3), which looks encouraging for bread and cereal prices in upcoming months. The favourable inflation dynamics playing out in cereal prices, however, are likely to be partly offset by further stickiness in meat prices.

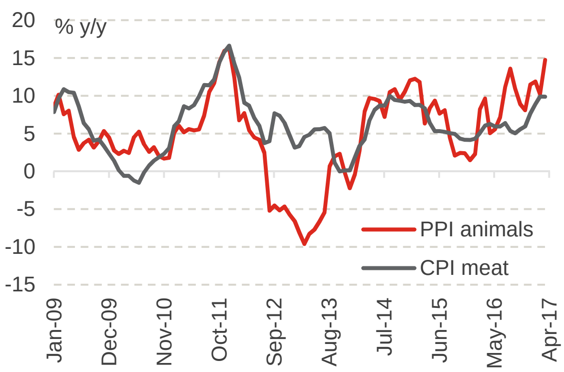
Meat prices at the producer price level increased to 14.8% y/y in the latest data for March 2017 (see chart 4), which is expected to underpin meat inflation in the near term. According to the South African Reserve Bank's (SARB) April 2017 Monetary Policy Review, beef prices are likely to be sustained at higher levels due to herd rebuilding, while an outbreak of avian influenza in Europe and brining regulations (to reduce the amount of salt water that may be injected into chicken) could keep chicken prices high.

Chart 3: Downward pressure on bread and cereal prices



Source: Stats SA, Global Insight, Momentum Investments

Chart 4: Upward pressure on meat prices

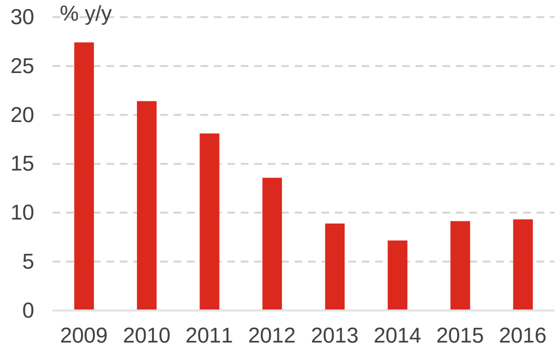


Source: Stats SA, Global Insight, Momentum Investments

Lower 2017/18 electricity tariff to benefit near-term inflation

The National energy regulator of SA (Nersa) has approved a 1.9% average price increase in electricity tariffs for 2017/18, which will be implemented in July 2017 for municipalities. This compares favourably to the 9.3% increase in electricity tariffs in 2016 (see chart 5) and, as such, should accordingly benefit the trajectory of administered price inflation, which slowed to 6% y/y in April 2017 (6.6% y/y on a year-to-date basis). Power utility Eskom will be submitting a new tariff application for 2018/19 by next month. It has requested from the regulator that some of the additional regulatory requirements (imposed to improve oversight over Eskom's coal purchases) are waived. If the tariff application is stalled, regulated tariffs could remain steady into the next financial year, posing risks to Eskom's finances.

Chart 5: Historic annual electricity inflation



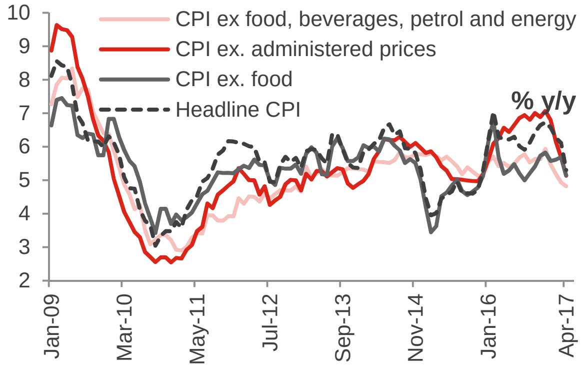
Source: Stats SA, Global Insight, Momentum Investments

Underlying measures of inflation decline for the fourth consecutive month

Core inflation (headline excluding food, beverages, petrol and energy) decelerated to 4.8% y/y for April 2017 from 4.9% y/y recorded for March (see chart 6). This rate is notably lower than the 5.5% average for the past twelve-month period. Disinflation in core goods has largely been responsible for the downward trend in overall core inflation, while core services inflation has persisted at higher levels.

Although core inflation is expected to remain below 5% in upcoming months, the lower rate of currency pass-through observed recently suggests that inflation may not experience the full benefit of previous rand strength. Momentum Investments expects core inflation to average 4.9% for 2017, declining to around 4.5% for 2018.

Chart 6: Core inflation dips further



Source: Stats SA, Global Insight, Momentum Investments

SARB to exercise caution at upcoming interest rate-setting meeting

The SARB has warned, in its April 2017 Financial Stability Review, that financial stability risks continue to pose a threat to the domestic financial system. Globally, it noted that a faster-than-expected pace of interest rate increases by the United States Federal Reserve or a lower commodity price environment (led weaker by reduced Chinese demand) pose a threat to the currency, while domestically, the risk of further downgrades could lead to a weaker outlook for the rand. As such, the SARB is likely to view currency risks as a key upside risk to the inflation profile, even though it may lower its inflation forecasts from its March 2017 projections of 5.9% for 2017 and 5.4% for 2018.

Inflation expectations (as calibrated by the Bureau of Economic Research in its Inflation Expectations Survey of labour, business and analysts) have drifted lower in recent quarters, but the level hovers close to the upper end of the inflation target band and remains uncomfortably high. Should the rand weaken considerably in light of above-mentioned reasons, inflation expectations could pick up again.

Even though Momentum Investments projects inflation to reach close to 5% on average for 2018, the above arguments limit the scope for interest rate cuts. Ongoing political noise has raised the risk of higher inflation and lower growth outcomes in the domestic environment, while SA's ongoing vulnerability to foreign capital flows sustains rand risks. As such, Momentum Investments expects the SARB to maintain interest rates at the current 7% level at the upcoming meeting.