momentum investments

The Macro Research Desk

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SA interest rates cut sooner than anticipated

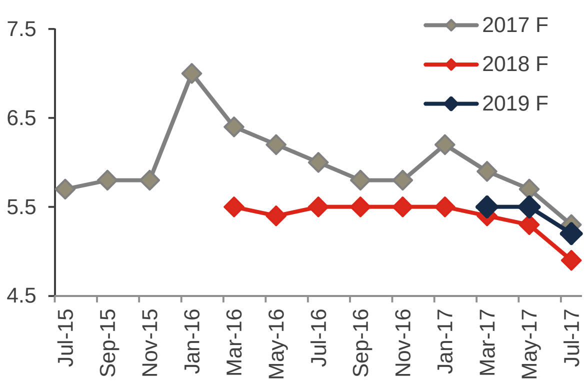
Interest rates cut by 25 basis points to 6.75%

The South African Reserve Bank's (SARB) interest rate decision was not in line with the Reuters consensus, in which 24 out of the 27 analysts surveyed predicted that the SA repo rate would remain steady at 7.0%. Only two contributors to the survey argued for a 25 basis point interest rate cut, while one held the view that a 50 basis point interest rate cut was likely. As widely expected, the SARB's Monetary Policy Committee (MPC) scaled back its growth projections (following an unexpectedly weak first-quarter print) and adjusted its forecast on headline inflation lower. The MPC did, however, affirm that it would not hesitate to reverse this decision should the outlook for inflation deteriorate.

Marked improvement in inflation outlook, while growth forecasts deteriorate

The MPC noted a significant move lower in its inflation forecasts, measured by the Consumer Price Index (CPI), for this year and next (see chart 1). It now expects headline inflation to average 5.3% for 2017 (previously 5.7%) and 4.9% for 2018 (previously 5.3%). These revised forecasts relative to the May 2017 interest rate setting meeting have moved closer in line to Momentum Investments' view, although the company sees notable upside risks to the MPC's 2019 forecast of 5.2%. A lower base on inflation (the recent inflation prints have surprised the SARB to the downside, particularly on food price prints, given favourable domestic crop estimates), a downward adjustment to international oil price assumptions (from US$54/bbl for 2017 to US$52/bbl and from US$58/bbl for 2018 to US$55), lower domestic electricity tariffs (4.6% relative to a previous 5.7% for 2017), a wider output gap and an adjustment to the real effective exchange rate were noted as key reasons underlining the downward revision in inflation assumptions.

Chart 1: SARB headline CPI forecast revisions (%)

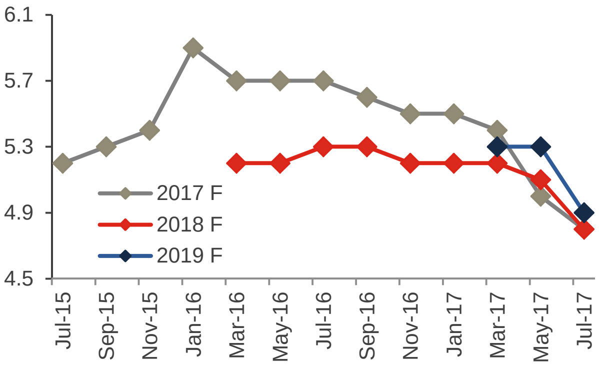


Source: SARB, Momentum Investments

At this stage, Momentum Investments sees upside risks to the MPC's forecast on electricity prices for 2018 of 5% (adjusted down from 6% previously). Should a further extension of government guarantees materialise, this may not alleviate pressure on electricity tariffs. Eskom has proposed that its clients pay on average 19.9% more for electricity from 1 April 2018 and that municipalities pay 27.3% more for bulk electricity purchases from 1 July 2018. Moreover, the renegotiation of the public sector's multi-year wage agreement in 2018 could pose a risk to the inflation trajectory.

A smaller improvement was noted in the MPC's core inflation (headline inflation less food and fuel) profile. Core inflation is expected to average 4.8% for 2017 and 2018, inching higher to 4.9% for 2019 (see chart 2). Momentum Investments sees scope for a downward surprise in core inflation measures for 2018, but is in broad agreement with the MPC's 2017 assumption on underlying inflation.

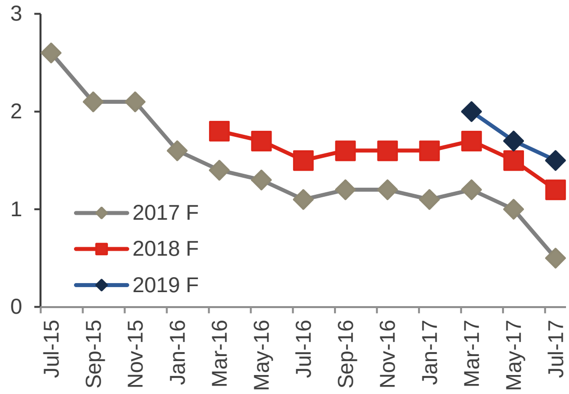
Chart 2: SARB core inflation forecast revisions (% y/y)



Source: SARB, Momentum Investments

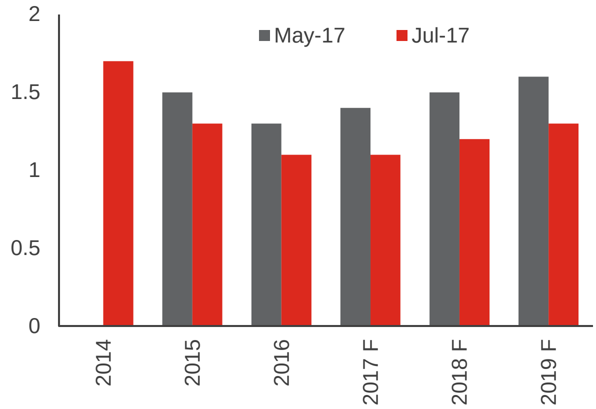
In response to a surprise broad-based gross domestic product (GDP) contraction during the first quarter of 2017, the MPC revised its GDP growth forecasts marginally below Momentum Investments' projections. It lowered its GDP forecast to 0.5% for 2017 (from 1.0%), 1.2% for 2018 (from a previous 1.5%) and 1.5% for 2019 (compared with 1.7% in the MPC's May 2017 projections, see chart 3). Growth risks, in spite of these downward revisions, are still viewed as being to the downside. The SARB highlighted that the output gap has widened (currently estimated at negative 1.9%), even with a downward revision to potential growth (see chart 4). It now views potential growth at 1.1% for 2017 (previously 1.4%), increasing to 1.3% by 2019 (compared with 1.6% before). Worryingly, growth according to these forecasts will struggle to outpace the growth rate of SA's population, which remains a concern for the ratings agencies. This trend could see employment rates ticking higher, raising the risks of social unrest further down the line.

Chart 3: SARB GDP forecast revisions (%)



Source: SARB, Momentum Investments

Chart 4: SARB trend growth revisions (% y/y)



Source: SARB, Momentum Investments

In its question and answer session following the reading of the statement, the SARB emphasised the SA growth problem is not cyclical in nature and an uncertain direction on policy continues to exacerbate the weak state of the economy. However, with growth at these low levels, even a marginal boost via an interest rate cut, becomes important.

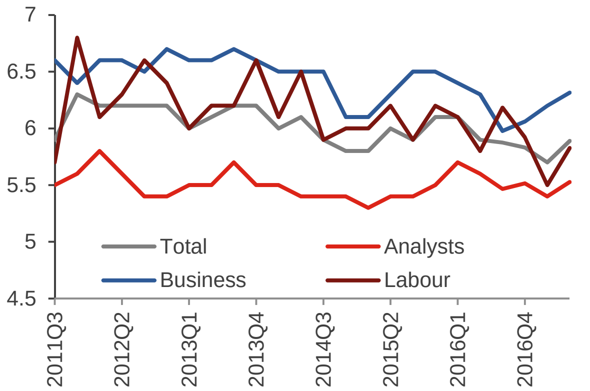
Sustained period of low inflation may lower inflation expectations

According to the Bureau of Economic Research's Inflation Expectations survey, average inflation expectations for the second quarter of 2017 nudged only slightly lower for 2018 (5.9% to 5.8%) and 2019 (6.0% to 5.9%). Nevertheless, a more noticeable improvement was evident for 2017 (5.9% compared with 6.2% previously in the first quarter of 2017).

Of more concern was the surveyed expectation for inflation for the next five years. On average, inflation expectations for this period rose to 5.9% in the second quarter from a previous 5.7% (see chart 5). This comprised a 0.3% increase in expectations of labour unions (5.5% to 5.8%), a 0.1% adjustment higher by businesses (from 6.2% to 6.3%) and analysts (from 5.4% to 5.5%).

Despite a deterioration in the longer-term inflation expectations survey results, the MPC noted in the question and answer session that a sustained period of low inflation (as projected over its forecast horizon) can lower inflation forecasts going forward, given that inflation expectations are backward as well as forward-looking.

Chart 5: Expected inflation for the next five years (%)



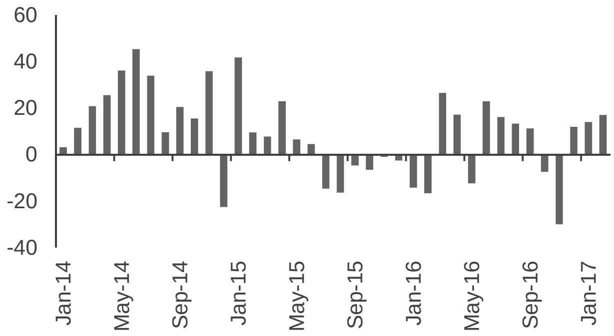
Source: SARB, BER, Momentum Investments

Higher real interest rates creating space for monetary policy easing

Momentum Investments had previously argued that, before the July 2017 interest rate decision, real interest rates in SA were the fourth-highest across a wider range of emerging market (EM) peers (when using a one-year ahead inflation forecast). With lower trend growth forecasted for the next three years, the economy can arguably operate in a lower real interest rate environment.

The MPC pointed out that investor sentiment towards EMs has been positive (see chart 6), which has likely played a role in the rand's relative resilience.

Chart 6: Net foreign portfolio flows into EM (US$ billion)



Source: Bloomberg, Momentum Investments

Committee members' views have clearly shifted in favour of monetary policy easing

Unlike the previous May 2017 MPC meeting, where only one member favoured an interest rate cut, the view swung to four members preferring a 25 basis point reduction this time around, compared with two members who opted to keep interest rates unchanged at 7.0% (see table 1).

Table 1: Committee members' views in recent meetings

No. of committee members	Favoured no move	Favoured 25 basis point hike	Favoured 50 basis point hike	Favoured a 25 basis point cut
19 November 2015	2	4	-	-
28 January 2016	1	2	3	-
17 March 2016	3	3	-	-
19 May 2016	5	1	-	-
21 July 2016	6	-	-	-
22 September 2016	6	-	-	-
24 November 2016	6	-	-	-
24 January 2017	6	-	-	-
30 March 2017	5	-	-	1
25 May 2017	5	-	-	1
20 July 2017	2	-	-	4

Source: SARB, Momentum Investments

Further monetary policy easing expected

Although the decision to cut interest rates at the July 2017 MPC meeting came earlier than expected, the MPC admitted that a very intense discussion was held with regard to whether the recent move was in line with the SARB's inflation target objective. The SARB defended its move, in response to a question regarding the credibility and independence of the SARB, by stating that the institution had earned its credibility and it will continue to protect the value of the currency in the interest of balanced and sustainable growth.

The SARB clearly stated the move was made in reaction to its improved outlook on inflation and in response to the deteriorated view on domestic growth. Should inflation continue to track lower in line with expectations and remain well within the target band for the foreseeable future, it is likely the SARB will respond by cutting interest rates further by an additional 25 basis points in the near future. Momentum Investments agrees with the SARB's sentiments that SA's growth problems are not cyclical in nature, but are tied to the elevated level of policy uncertainty, which has been extremely damaging to consumer and business confidence. Nevertheless, easier monetary policy should, at the margin, help indebted households.

Momentum Investments still expects the current interest rate cutting cycle to be comparatively shallow relative to previous cycles, given the lingering risk of further ratings downgrades (which could negatively affect the currency and inflation expectations), ongoing political uncertainty, potential negative swings in EM sentiment and uncomfortably high domestic inflation expectations.