momentum investments

The Macro Research Desk

Herman van Papendorp
(Head of Investment Research and Asset Allocation)

Sanisha Packirisamy
(Economist)

Reserve Bank disappoints the market by keeping the repo rate unchanged

Interest rates kept on hold at 6.75% due to heightened uncertainties

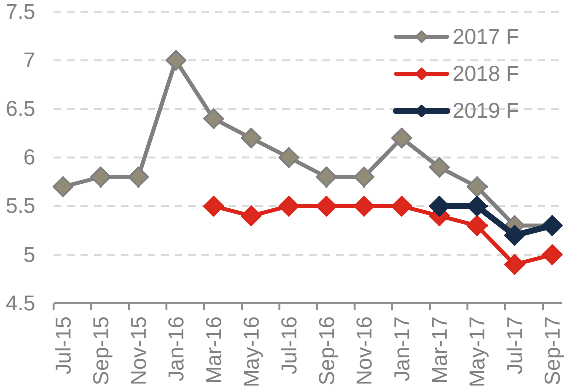
Momentum Investments, together with the majority of the economists polled by the Reuters survey, expected a 25-basis point cut in interest rates at the September 2017 meeting, based on the expectation of a favourable inflation trajectory, soft business and consumer confidence and limited negative currency movements, despite lingering domestic political and sovereign ratings risks. However, the South African Reserve Bank (SARB) decided to keep the benchmark interest rate at 6.75%, citing a marginal increase in its inflation forecast and warning against "increased uncertainty regarding a number of the main (inflation) drivers".

The SARB Monetary Policy Committee's (MPC) forecasts on growth and inflation were little changed at the September 2017 meeting, relative to its forecasts announced in July 2017, but the MPC's assessment of the balance of risks to the inflation outlook has changed from being "broadly balanced" to being "somewhat on the upside". This was in spite of the Bureau of Economic Research's (BER) Inflation Expectations survey, which pointed to average five-year inflation expectations falling to its lowest level on record since long-term expectations were first surveyed in 2011.

Little change to SARB's inflation estimates, but risks to the outlook have escalated

The MPC's inflation projections were little changed from those presented at the July 2017 interest rate-setting meeting. The SARB's 2017 headline inflation estimate remains at 5.3%, while estimates for 2018 and 2019 were nudged higher by 0.1% to 5.0% and 5.3%, respectively (see chart 1). The SARB revealed a lower repo rate, a less appreciated exchange rate, a slightly narrower output gap and higher-than-anticipated meat prices, as the main drivers behind the marginal change to its inflation forecasts. Momentum Investments' forecasts do not differ materially at 5.4% for 2017 and dropping to 4.8% in 2018. However, the company sees upside risk to the SARB's 2019 forecast.

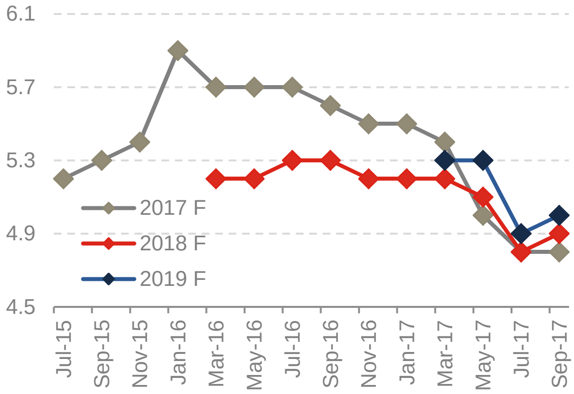
Chart 1: SARB headline CPI forecast revisions (%)



Source: SARB, Momentum Investments

The SARB admitted that recent core (headline excluding food and fuel) or underlying inflation remained relatively stable, signalling a lack of significant demand pressures. The SARB's estimate of core inflation remains unchanged at 4.8% for 2017, but projections for 2018 and 2019 have inched higher by 0.1% to 4.9% and 5.0%, respectively (see chart 2).

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



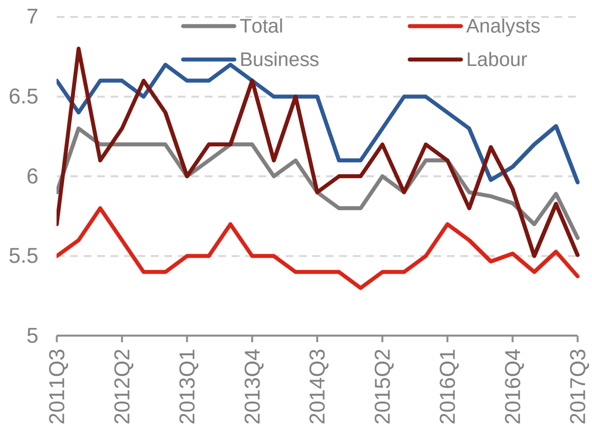
Source: SARB, Momentum Investments

Despite a negligible deterioration in the MPC's inflation forecasts, the SARB pointed to a rising number of risks posed to the inflation outlook. The rand is seen as the major threat to its inflation outlook. The prospect of a further sovereign ratings downgrade, political events and global monetary policy tightening cloud the outlook for the rand's trajectory against major currencies.

The SARB also noted a steeper-than-expected electricity increase (of around 20%) could add 0.2% to 0.3% to headline inflation with the potential for further second-round effects. The SARB is currently pencilling in an electricity price increase of 5.1% in 2017 and 8.0% in 2018. Momentum Investments sees upside risks to the SARB's 2017 electricity tariff assumption and expects an increase closer to 11%.

While the MPC voiced its concerns over inflation expectations remaining sticky at the upper end of the 3% to 6% target at the July 2017 interest-rate-setting meeting, average five-year inflation expectations (as per the BER's Inflation Expectations survey) in the third quarter of 2017, dropped to an all-time low since the survey began in 2011 (see chart 3). Instead, this time around, the MPC placed more emphasis on the one- and two-year-ahead inflation expectations of trade unions and businesses, which remained nearly 1% higher than analysts' expectations.

Chart 3: Expected inflation for the next five years (%)



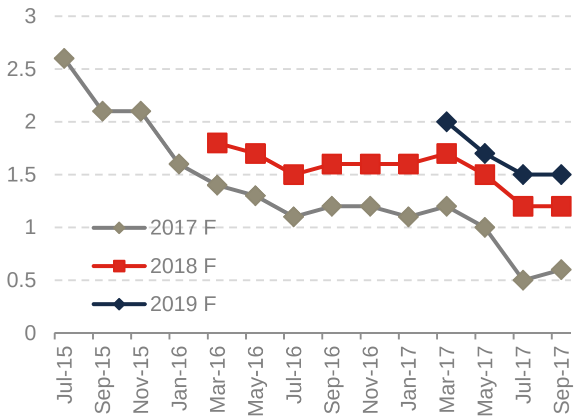
Source: SARB, Momentum Investments

Growth forecasts broadly unchanged and risks remain to the downside

The MPC lifted its 2017 real gross domestic product (GDP) assumption from 0.5% to 0.6% (see chart 4), but left its 2017 and 2018 growth forecasts unchanged at 1.2% and 1.5%. These do not differ materially from Momentum Investments' projections. The SARB noted the second quarter bounce in growth in household spend was unlikely to be maintained, taking its direction from the uninspiring moves on SA's lead indicator in recent months.

The MPC's estimates of potential growth remained unchanged at 1.1% in 2017, 1.2% in 2018 and 1.3% in 2019. Meanwhile, its negative output gap projection has narrowed to 0.7% in 2017 and 2018, declining to 0.5% in 2019, reflecting a 0.2% improvement.

Chart 4: SARB GDP forecast revisions (%)



Source: SARB, Momentum Investments

Divided views on the MPC

One more member relative to the July 2017 meeting favoured no move in interest rates, leaving the number of members favouring no move equal to those favouring a 25 basis point cut (see table 1). Previously, one of the key reasons supporting the view of members favouring no move in interest rates was the stickiness of longer-dated inflation expectations at the upper end of the target band. Despite the average five-year inflation expectations dropping to its lowest level since 2011 (with all groups of survey respondents recording lower inflation expectations), there was more support for no move in interest rates at this interest rate-setting round.

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
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
20 September 2017	3	-	-	3

Source: SARB, Momentum Investments

Space for further monetary policy easing

In Momentum Investments' view, a steadily recovering global macro backdrop, an improvement in the inflation trajectory, a meaningful shift lower in inflation expectations and still muted domestic confidence justifies further monetary policy easing in the current interest rate cycle. Momentum Investments expects up to 50 basis points of easing (two interest rate cuts of 25 basis points each) before the end of the first quarter in 2018.

With the SARB choosing to stay put at its September 2017 meeting, the timing of further expected monetary policy easing will depend on the outcome of a number of high-risk events, including potential material fiscal slippage announced in the October 2017 Medium Term Budget Policy Statement, the ratings agencies' November 2017 reviews and the political outcome of the African National Congress elective conference in December 2017.