momentum investments

The Macro Research Desk

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SA repo rate unchanged, but tone less hawkish than before

Interest rates steady in line with expectations

Today's interest rate decision was in line with the Reuters consensus, in which all 29 surveyed analysts predicted that interest rates would stay on hold at 7.0%.

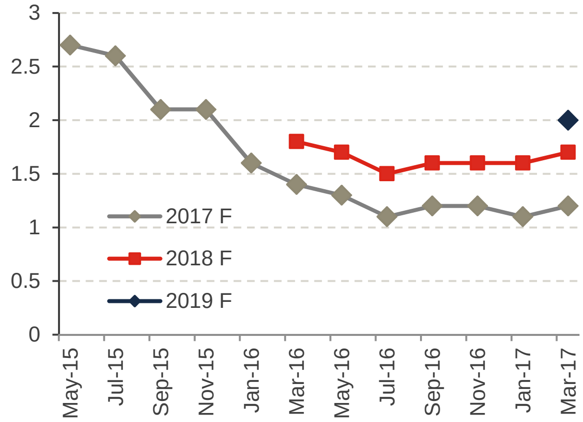
Despite marginally raising its growth projections and adjusting its inflation forecasts lower, the Monetary Policy Committee's (MPC) noted that it would like to see a more sustained improvement in the outlook for inflation before reducing rates. Relative to the MPCs' forecasts, Momentum Investments expects real growth in economic activity to surprise to the upside in 2018 and 2019, in particular, as domestic demand stages a modest recovery in response to sustained strength in global growth and increased clarity on the direction of economic policy, following the ruling party's National Executive Committee meeting in December 2017. Momentum Investments expects inflation to fall further in 2018 relative to the SA Reserve Bank's (SARB) forecast, on an envisaged improvement in the currency outlook. In the company's opinion, an anticipated correction in the current demand-supply imbalance in key commodity markets in the medium term should support emerging market assets, including the rand, particularly if the US Federal Reserve maintains a modest pace of interest rate hikes and we do not see a rise in protectionist policies (which could be damaging to world trade growth). Forecasts for commodities driving SA's terms of trade dynamics (export prices relative to import prices) point to a favourable outlook for the currency in the medium term. As such, Momentum Investments expects the MPC to consider commencing a shallow interest-rate-cutting cycle in late 2017. Uncomfortably high inflation expectations and the need to maintain an attractive real interest rate profile (to attract foreign capital to cover SA's external imbalance, which is set to widen from levels observed in the fourth quarter of 2016) are likely to limit the extent of interest rate cuts, in the company's view.

Domestic growth expectations edge higher, but risks are tilted to the downside

The MPC raised its 2017 real GDP growth forecast (see chart 1) back to 1.2% (in line with Momentum Investments' internal forecast) from 1.1% at the January 2017 MPC meeting and 1.2% at the November 2016 meeting and lifted its 2018 GDP assumption to 1.7%, marginally lower than the company's internal estimate of 2.0%. Momentum Investments is also more optimistic on real economic activity in 2019, projecting an increase to 2.3%, whereas the SARB pitches its growth estimate at 2.0%. The SARB noted that it estimates potential growth to be at 1.4%, increasing to 1.6% in 2019. The output gap (actual relative to potential growth levels) is expected to narrow during the forecasted horizon.

With political uncertainty remaining elevated, consumer and business sentiment are likely to remain in the doldrums. As such, growth risks (particularly to household consumption spend and gross fixed capital formation) remain titled to the downside. With domestic demand likely to remain depressed in 2017, Momentum Investments expects the improvement in growth to be a function of an inventory rebuild (following a severe drawdown in 2016) and a recovery in export growth, leveraging off brighter global growth prospects.

Chart 1: SARB real GDP forecast revisions (% y/y)



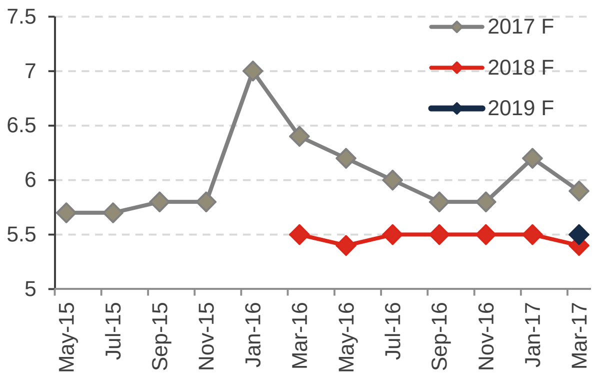
Source: SARB, Momentum Investments

Negative rand reaction a significant upside risk to favourably adjusted inflation forecasts

The SARB's inflation forecast has improved relative to its January 2017 projections (see chart 2), mainly owing to a more appreciated exchange rate assumption. The SARB now expects headline inflation to average 5.9% in 2017 (previously estimated at 6.2%), but this remains marginally higher than Momentum Investments' projection of 5.6%. The MPC's inflation trajectory now assumes that the headline figure retraces to within the target range by the second quarter of 2017 (previously the fourth quarter) and remains below the upper target of 6% for the rest of the forecasted trajectory. The SARB further acknowledged that currently lower oil prices and the final electricity price determination by the energy regulator could result in a lower inflation outlook. Although the level of the rand as at 30 March 2017 is stronger than the SARB's forecasts, it views a sustained weakening trend in the currency (in response to a potential further reaction to unfolding political events), as a key source of upside risk to the inflation profile.

As a consequence of the inflation revisions being supply-side driven, the SARB's estimate of core inflation (headline inflation excluding the effect of food and energy costs) remained relatively steady at 5.4% (previously 5.5%) in 2017 and 5.2% (unchanged) in 2018.

Chart 2: SARB headline CPI forecast revisions (%)



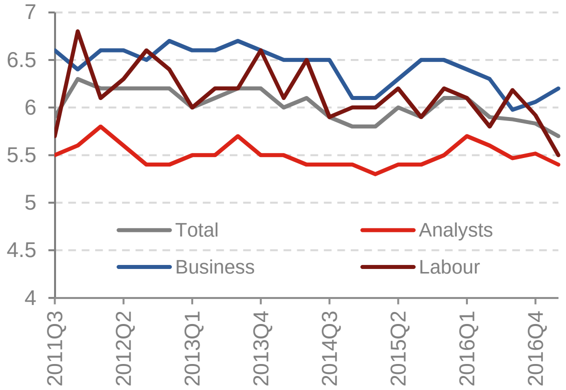
Source: SARB, Momentum Investments

Average inflation expectations shifting lower, but still uncomfortably close to the upper end of the inflation target

The Bureau of Economic Research's (BER) Inflation Expectations Survey results for the first quarter of 2017 revealed that average expectations for the current year deteriorated from 6.0% in the final quarter of 2016 to 6.2% in the first quarter of 2017, largely owing to a sharp 0.5% jump in the expectations of trade unions, while analysts and businesses revised their forecasts for the current year lower by 0.5% and 0.2%, respectively.

Five-year forecasts edged down from 5.8% to 5.7%, thanks to a 0.4% decline in trade unions' expectations, while inflation projections by the business community rose to 6.2%. This left a 0.7% gap in five-year inflation expectations between businesses and labour. Despite the drop in the overall expectation of inflation five years out, the SARB reiterated that expectations remain uncomfortably anchored at the top end of the 3% to 6% inflation target range and, as such, the threat of second-round inflation pressures remains.

Chart 3: Average five-year inflation expectations (%)



Source: BER, Momentum Investments, data up to 2017Q1

MPC member views beginning to diverge

A marginally firmer outlook on domestic growth (although still constrained by subdued business and consumer confidence and elevated global uncertainty posing downside risks) together with a notable downward revision in inflation forecasts led the MPC to conclude that we may have reached the end of the tightening cycle. However, it would like to see a more sustained improvement in the outlook for inflation before implementing an interest rate cut. This time around, one MPC member voted to cut interest rates by 25 basis points, following four meetings previously, where all members were happy to keep rates unchanged.

Table 1: MPC members' views in recent meetings

Number of MPC 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

Source: SARB, Momentum Investments