

The first cut is the deepest

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It was a big week for South African investors, as the two most important central banks in their universe lowered policy interest rates. Of the two, the US Federal Reserve is the big gorilla, since its decisions can influence the South African Reserve Bank (SARB), but it is definitely not the case the other way round. Moreover, almost all global investments price off the Fed's policy interest rate directly or indirectly. Therefore, Fed decisions ricochet across the world, including to South African markets. Nonetheless, the SARB's decisions also matter to local asset classes.

Front-loading

Let's start with the US Fed, which announced a 50-basis points reduction in the fed funds rate on Wednesday evening. Going into the meeting, there was some uncertainty over the size of the move. The case for front-loading interest rate cuts makes sense in light of the recent weakening of the labour market. Given progress on the inflation side of the Fed's dual mandate, it is prudent to shift focus to its other goal of maintaining full employment and taking a pre-emptive step to prevent the recent rise in unemployment from accelerating.

However, the risk with a bigger cut is that it is interpreted as a sign of panic. The Fed has traditionally only cut by more than 25 basis points at times of crisis, such as when Covid hit in 2020, and in the Global Financial Crisis in 2007 and 2008. Therefore, the messaging is important.

Fed chair Jerome Powell was at pains to argue that the Fed was not responding to a crisis or panicking, but rather that lower inflation afforded it room to make a bigger cut and forestall any further weakening of the labour market. Powell characterised the US economy as still being quite healthy and that he wants to keep it that way.

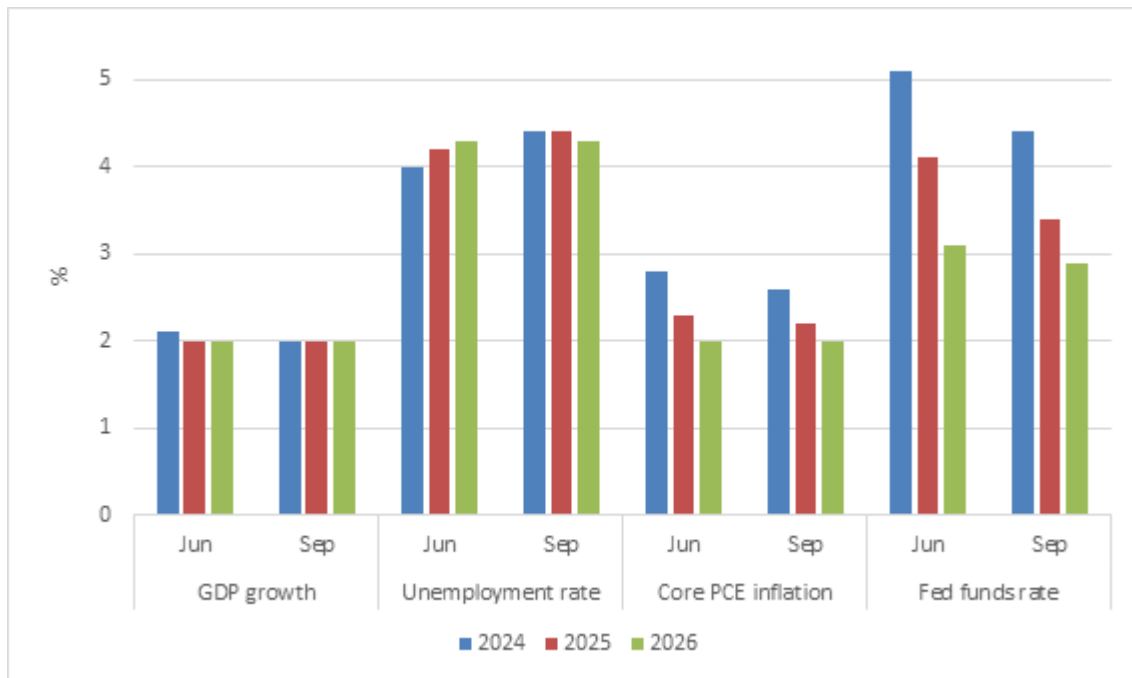
The plot thickens

Probably more important than the size of individual cuts is where rates ultimately settle. Every quarter, the forecasts of top Fed officials from across the country are collated anonymously in the so-called dot-plot. This is not cast in stone but gives an indication of how the collective wisdom in the central bank system sees economic and policy variables evolving.

Whereas the June dot-plot only pointed to a single 25 basis point cut by year end, the latest version signals a further 50 basis points reduction on top of what was delivered last week (there are two meetings left this year). Rates are projected to fall towards 3.4% by end 2025 and 2.9% by end 2026. The dot-plot suggests that 2.9% is the "neutral" interest rate which theoretically allows the economy to operate on an even keel.

The projected end point for the cycle has not changed much since the previous version of the dot-plot, but the path to getting there has sped up.

Chart 1: Federal Reserve 'dot-plot' projections



Source: Federal Reserve Board of Governors

As chart 1 shows, the reason for this is concern over higher unemployment, now projected to hit 4.4%, but crucially, not increasing beyond that. Economic growth is expected to be around 2% over the medium term, which represents a downshift from a faster pace over the past year or so. Inflation is also declining somewhat faster than expected.

Any forecast is just a stake in the ground. Anything can still happen, and therefore central banks like to say they are “data dependent,” making policy based on what the numbers tell them. However, being too dependent on backward-looking data can obscure rather than illuminate the future, and lead to being behind rather than ahead of the curve. No one said this is easy.

In the end, investors need to ask themselves whether rates are falling for “good” or “bad” reasons. A good decline in interest rates would be a scenario where inflation is under control, growth is slower but not contracting, and unemployment still low – a soft landing, in other words. A bad decline would be if the Fed was to slash interest rates as the economy tips into recession. A soft landing is positive for equity markets, a recession is not. The Fed and its global counterparts continue to try engineering a soft landing by guiding rates lower. Time will tell if they are successful, or if they’ve left cutting rates too late.

Cautious cuts

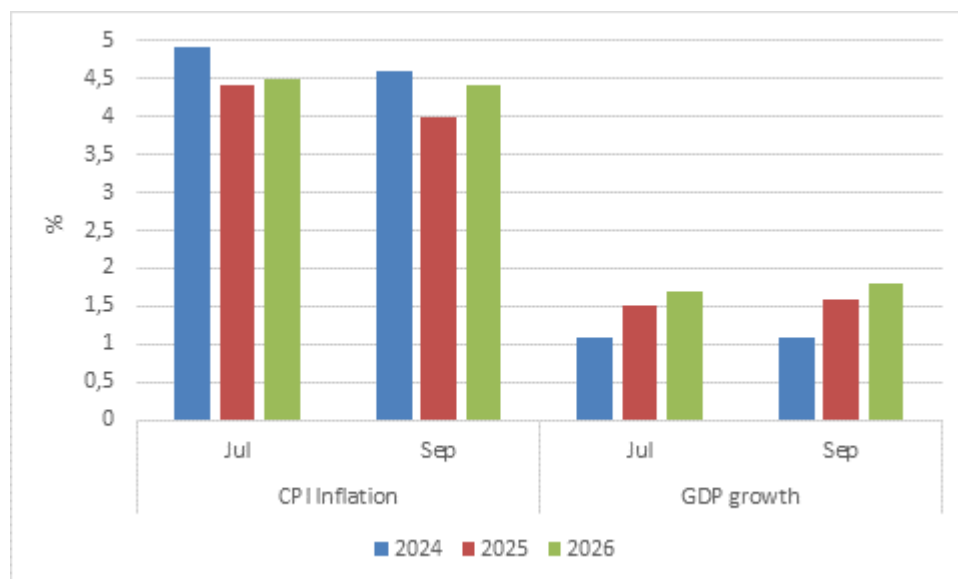
The SA Reserve Bank’s Monetary Policy Committee took a more cautious approach to its first rate cut of the cycle. As with the Fed, its policy stance was probably too restrictive given the state of the economy. Before the recent cuts, the real short-term interest rate had risen to 3% in the US and 4% in South Africa due to falling inflation.

Unlike in the US, however, the economic growth outlook is improving as structural reforms are implemented, notably easing the electricity constraint. The Reserve Bank expects economic growth to rise from around 1% to 1.8% over the medium term, a forecast that still seems on the pessimistic side.

It should also be noted that the SARB is just an inherently conservative institution and was always unlikely to launch into the cutting cycle with a jumbo move, particularly since there is heightened uncertainty over how the two-pot retirement fund withdrawals will impact consumer spending and inflation in the short term (probably not by much).

However, more rate cuts are certainly on the way. The inflation outlook has improved from the July MPC meeting, and the SARB's official forecast suggests inflation will be somewhat below the 4.5% target over the next two years.

Chart 2: SA Reserve Bank forecasts

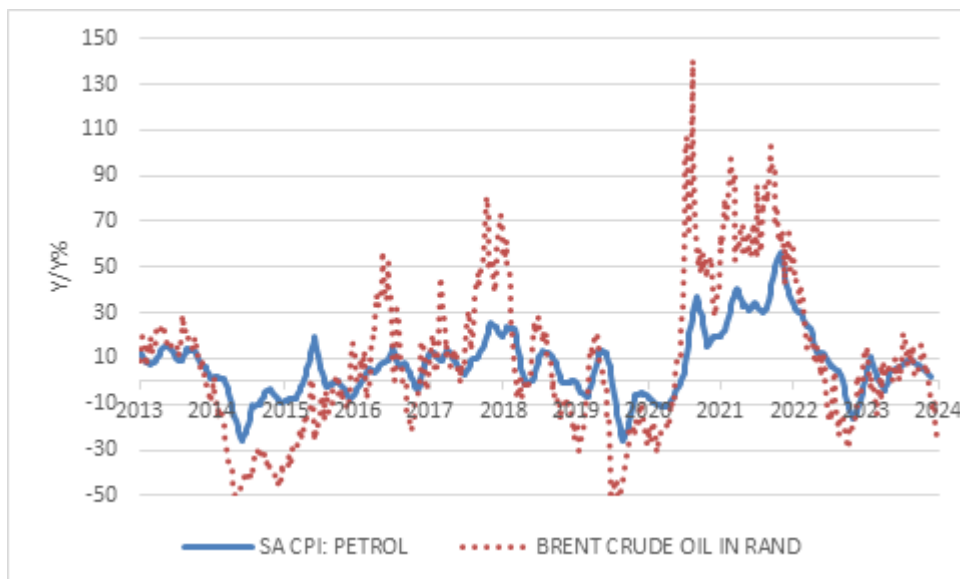


Source: SA Reserve Bank

One of the reasons behind the better inflation outlook is a lower global oil price, which has declined from a 2024 peak of \$94 per barrel to \$74.

But with the rand also firmer, more petrol price cuts loom for South African motorists. While petrol inflation was still positive in the August CPI report at 1.7% year-on-year, the October report will reflect two more rounds of fuel price cuts, taking petrol inflation down to around -20% year-on-year. Since petrol is 5% of the overall basket, this will subtract around one percentage point from overall inflation, which was at a three-year low of 4.4% in August.

Chart 3: South African fuel inflation



Source: LSEG Workspace

The Reserve Bank will not cut rates directly in response to oil price declines, since central banks typically look through the “first round” effects of energy price changes. What they care about is the “second round” effects, how those price changes ripple through the economy and how firms pass on (or not) the higher or lower input costs to consumers. This is why core inflation, which excludes volatile food and fuel prices, is a useful measure. It fell to 4.1% in August. The Reserve Bank expects core inflation to average 4.1% next year and 4.3% in 2026.

Also supporting further interest rate cuts is that inflation expectations, as measured by the Bureau for Economic Research’s (BER’s) quarterly survey, have declined further. According to the BER, unions, businesspeople, analysts and households expect inflation to average 4.7% over the next five years, down from 5.5% in early 2023. Inflation expectations tend to lag overall inflation and should continue drifting lower over time. It remains an important part of the Reserve Bank’s thinking on the path of future inflation, the theory being that expectations shape behaviour.

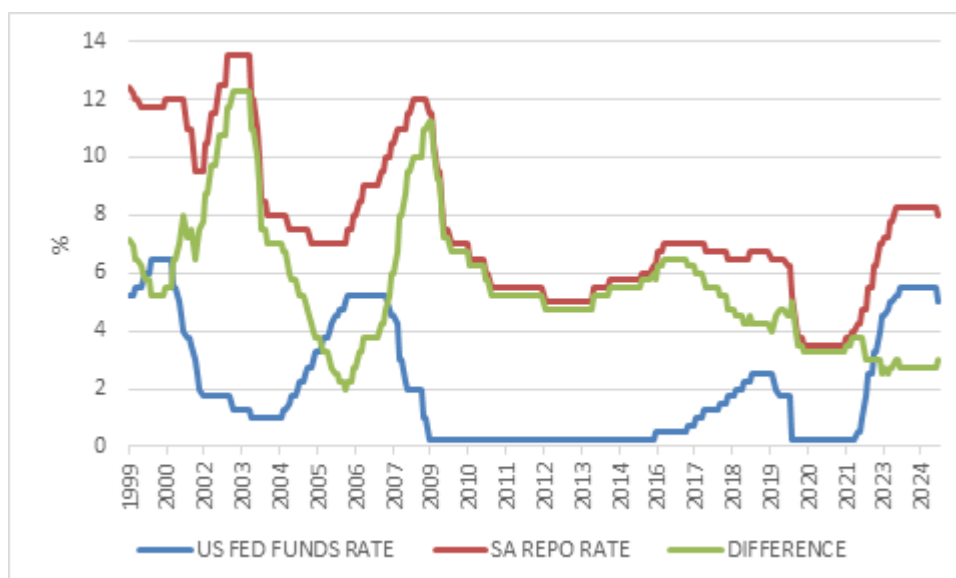
However, given the better economic outlook, the cutting cycle is likely to be moderate. The repo rate looks likely to return to its pre-Covid level of around 7%, rather than falling back to the emergency 2020 level of 3.5%. The Reserve Bank assumes that a real (after inflation) repo rate of 2.7% is “neutral” neither stimulating nor constraining the economy. If inflation is at target, the assumed neutral nominal rate is therefore around 7%.

This still seems like a fairly high interest rate, bearing in mind that few borrowers pay the repo rate; most loans are linked to the prime rate, which is 3.5% higher. Nonetheless, falling rates should provide some relief for consumers and businesses.

Good or bad

What about the impact on markets? The interest rate difference between the US and South Africa is a key (but by no means the only) driver of the rand-dollar exchange rate. This gap has declined over the past decade, which goes some way to explaining the weaker rand over this period, though the dollar also strengthened against other currencies. The interest rate difference should widen again somewhat as the Fed is expected to cut by more than the SARB. This should support the rand, all else equal.

Chart 4: South African and US policy interest rates



Source: LSEG Datastream

Mechanically speaking, lower interest rates should boost the valuations of other asset classes though cash returns will fall. However, as with many things in life, it depends. Interest rates can fall for good or bad reasons as noted above.

South African interest rates are mostly falling for good reasons. Inflation is expected to be on target over the medium term, inflation expectations are falling, and supply-side reforms should reduce some sources of upward inflationary pressure. The economic outlook is also improving. Lower rates in this context should boost bond and equity returns.

The US picture is a bit more ambiguous. US rates can be said to be falling for the wrong reason if it is because of the growth outlook deteriorating meaningfully. For now, that is a risk, and far from a certainty, and global equities ended the week higher. Nonetheless, the outlook for the US economy remains crucial. Now that the Fed's easing cycle is underway, the next big hurdle for investors is the presidential election in early November.

This note will return on 7 October after a short break.