

Watering the green shoots

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South Africans are long used to bad news, but recently the news has been better. Inflation is much lower, and the Reserve Bank cut interest rates again last week. In fact, viewed in isolation, the latest South African inflation numbers call for an even bigger interest rate cut than what was delivered. However, South Africa is not an island, physically or metaphorically. It is interconnected with a complex global environment.

Through the floor

Consumer inflation fell through the bottom end of the 3% to 6% target range in October for the first time since February 2021, when the pandemic played havoc with global prices. That disruption would soon push prices in the opposite direction, with inflation surging globally and locally in 2022 and 2023.

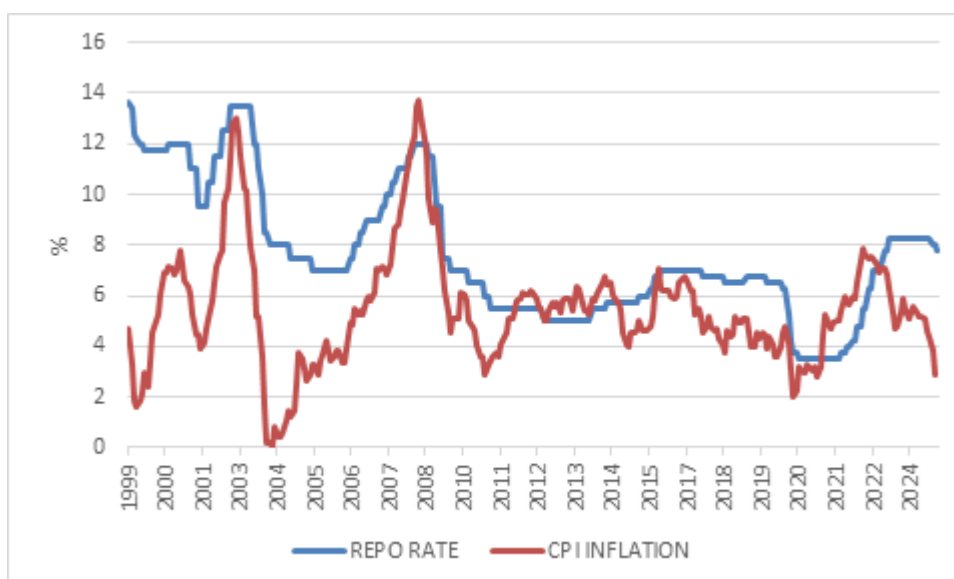
Prior to that, inflation also briefly dipped below 3% in 2010, again in the wake of a global dislocation, this time due to the financial crisis and the wild swings in the oil price. Inflation also fell through the floor in 2004, hitting 0%, after the rand appreciated from R11 per dollar to R6 between 2002 and late 2004.

This time round, the main driver has been the sharp decline in goods inflation, particularly food and fuel prices. Goods inflation fell to 1.4% year-on-year in October. On the flipside, goods inflation was also mostly responsible for the spike in headline inflation above the target band in 2022.

Goods prices make up 49% of the SA consumer price index, and services the rest. Service inflation is stickier and moves more slowly. Arguably it is also more closely linked to domestic demand, while goods prices are largely set in international markets. The good news is that service inflation has been trending lower, dipping to 4.3% in October, but we also know that hefty electricity tariff and medical aid increases still need to be reflected.

In other words, October's sub-3% inflation number is likely to be temporary.

Chart 1: SA repo rate and consumer inflation



Source: LSEG Datastream

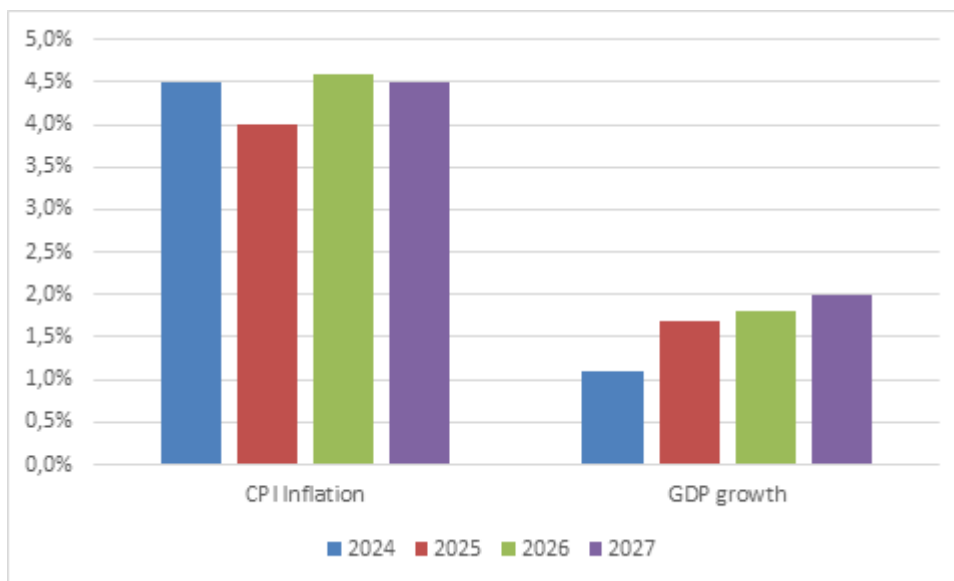
Unanimous

The members of the Reserve Bank's Monetary Policy Committee (MPC) unanimously decided to lower the repo rate from 8% to 7.75%, maintaining the gradual pace of rate cuts.

The Reserve Bank's forecast expects inflation to average 4% next year, before hovering around the 4.5% target in 2026 and 2027. The Bank's economic growth forecasts are broadly unchanged, with growth rising to 2% by 2027. This remains a conservative outlook compared to many private sector forecasters. The MPC statement describes the risks to its growth outlook as "balanced" meaning if the forecast is wrong, it can be wrong in both directions. If the risks are viewed as being to the "upside", it means the forecast is more likely to underestimate than overestimate.

The statement also views the risks to its inflation outlook as balanced. Despite this, the statement and Governor Kganyago's post-announcement comments placed a lot of emphasis on factors that could place upward pressure on inflation, including electricity tariff increases locally, but more importantly, increased global uncertainty following the US election. The statement noted that "new inflation pressures and heightened uncertainty" suggest diminished policy space for central banks internationally.

Chart 2: Reserve Bank growth and inflation forecasts



Source: SA Reserve Bank

What this means in simple English is that if the gap between interest rates in the US and elsewhere widens due to the Federal Reserve cutting less than other major central banks, capital will tend to flow to the US and the dollar will gain. A stronger dollar means weaker currencies elsewhere and potentially higher inflation. Therefore, central banks in those other currencies may decide to scale back planned rate cuts to avoid excessive currency moves. The South African Reserve Bank in particular is always nervous about the possibility of a disorderly decline in the rand, which could lead to higher inflation. The current level of the exchange rate around R18 per dollar is not a concern, but the rapid decline following the US election will have raised some eyebrows.

Before we blame everything on Donald Trump, it is worth pointing out that the US interest rate outlook started shifting before the US election due to resilient economic growth and inflation proving to be somewhat sticky on the way down.

Another persistent inflation risk – a jump in global oil prices – reemerged after Russia fired intercontinental ballistic missiles at Ukraine. However, at \$75 per barrel, the price of Brent oil remains towards the lower end of its broad trading range of the past two years. In rand terms, the oil price is still lower than a year ago, and therefore still detracting from headline inflation. But this also creates a low base from which inflation will be measured a year from now. These are all factors that are included in the MPC's conservative approach.

Target

The question of whether South Africa should move to a lower inflation target remains up in the air. Officially, nothing has been decided, and the MPC will set policy based on the target as it stands today, namely 3% to 6%. National Treasury sets the inflation target, but the MPC has operational discretion in implementing the target.

Governor Kganyago acknowledged that discussions with the Treasury are ongoing on the matter and denied that the MPC has "implicitly or informally" lowered its target. As he correctly noted, there is "no point setting a target that is a secret because the usefulness of the target is to influence inflation expectations". In other words, people need to know what the target is and believe that the central bank is serious about achieving it.

The MPC has since 2017 explicitly aimed for the mid-point of the target and communicated as such. The fact that inflation is now expected to hover around that level over the medium term suggests a measure of success. The general public seems to have internalised the idea that inflation should be around 4.5%.

The MPC could, therefore, start emphasising the lower end of the 3% to 6% target range in their communication, and lay the groundwork for an eventual official lowering of its objective without necessarily impacting the path of interest rates over the short term.

Over the long term, lower inflation would benefit the country, as it will result in lower interest rates over time, less rand depreciation and a more stable business environment. However, the adjustment phase could be uncomfortable in the sense that interest rates might be higher in the short term than would be the case otherwise. For instance, if the target is officially 3%, then next year's inflation forecast of 4% would be unacceptably high, and there would be no room to cut rates further. That doesn't mean there would have to be rate increases, however. A repo rate of 7.75% and inflation of 4% would still imply a real repo rate of 3.75%, which the bank would consider as "restrictive". The Reserve Bank assumes a real repo rate of around 2.75% is "neutral". Anything above, is believed to be a drag on domestic demand, while a level below is stimulative.

Navigating by the stars

This concept of a neutral interest rate – where supply and demand in the economy can be nicely balanced and causes no major upward or downward pressures on inflation – is not without problems. Intuitively, it makes sense. But practically, it cannot be directly measured. We can only really know that interest rates are too high or too low by observing the impact on economic activity, especially interest rate and credit-sensitive parts of the economy like housing and car sales. We can look back and say that rates were "restrictive" or "accommodative" based on how the economy performed, but it is difficult to project forward.

Arguably, the 2.75% neutral real repo rate estimate, also called r^* by economists (pronounced r-star), is on the high side for the South African economy. Most South Africans borrow at rates linked to prime, which is 3.5% higher. A real neutral prime rate of 6.3% is steep when real economic growth is less than 2%.

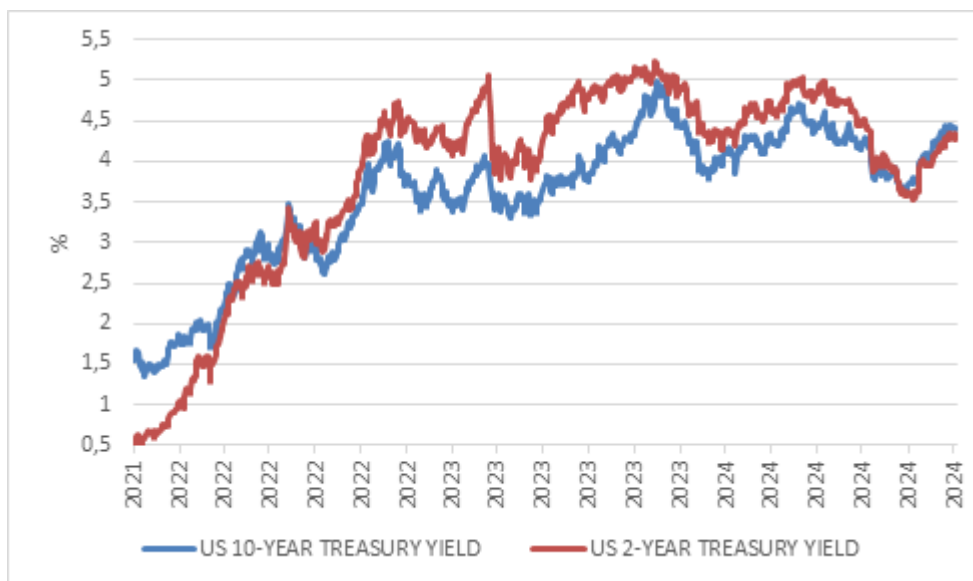
But the level of r^* has been particularly puzzling in the US context where real interest rates have been and continue to be well above the estimated real neutral rate of around 0.5% to 1%. Despite this, the US economy has been resilient. It could be that the neutral rate is much higher than previously thought, or that there are special one-off factors that have blunted the impact of a high r^* , notably loose fiscal policy.

Despite being unobservable, the Federal Reserve must explicitly or implicitly take a view on where r^* is. As Fed Chair Jerome Powell once noted, policymakers “navigate by the stars,” but they do so with cloudy skies.

Similarly, investors need to take a view of whether interest rates are too high, too low or just right. If rates are too high, economic pressure will build and ultimate company profits will decline, hurting the stock market. If rates are too low, the economy will heat up again, which will deliver a short-term boost to earnings and potentially share prices, but inflation will also revive, leading ultimately to a new cycle of rate increases.

For now, the market is still pricing in that short-term rates will be falling, albeit not as much as a few weeks ago, as evidenced by higher bond yields. However, as chart 3 shows, these yields have not breached previous peaks. Further rate hikes are not discounted.

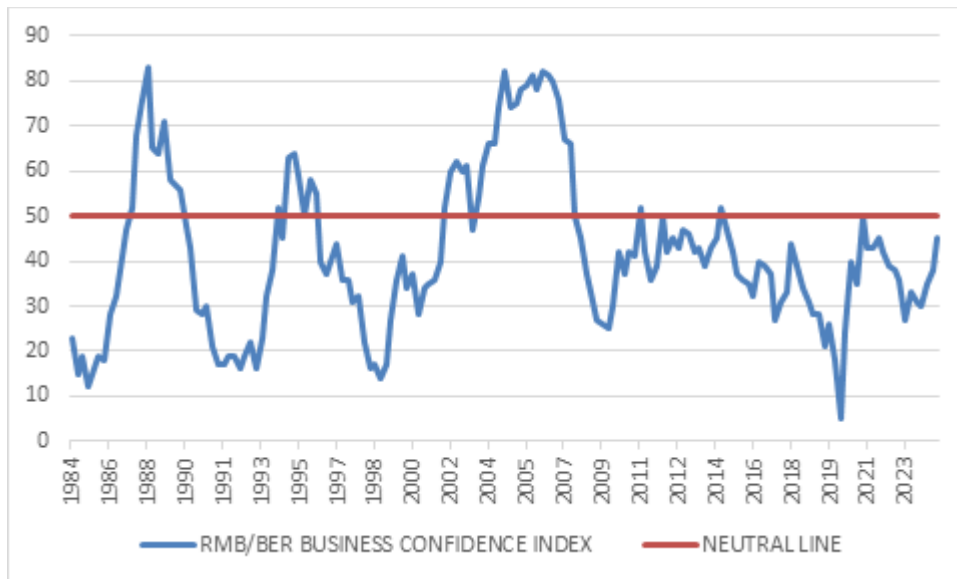
Chart 3: US bond yields, %



Source: LSEG Datastream

Back in South Africa, for the time being, we can count on lower domestic interest rates to provide further relief to consumers. While it is still likely to be a relatively shallow cutting cycle, it coincides with lower inflation which boosts households' real purchasing power. This has already showed up in a decent rise in retail sales in third quarter, ahead of the financial injection from two-pot pension withdrawals. Business confidence, as measured by the Bureau for Economic Research's longstanding survey, has also picked up strongly over the past three quarters, though the index is not in positive territory. More businesses are optimistic, but a small majority are still pessimistic. There are clearly still a lot of challenges in the business environment, including water supply problems in Gauteng and elsewhere. South African businesses have proven themselves to be resilient in tough conditions, but they ultimately do need their customers to spend. This now seems to be happening.

Chart 4: Business confidence in SA



In other words, we are witnessing the green shoots of an improved economic performance in South Africa, which can be watered by declining interest rates. Despite an uncertain global backdrop, this bodes well for longer-term returns from South African asset classes that remain attractively valued.