

Moving targets

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The curveballs keep coming. The ongoing uncertainty surrounding US President Donald Trump's tariff policies was ratcheted up again, after a federal court ruled that he exceeded his authority in imposing "reciprocal" tariffs on many countries. Setting tariffs has always been the preserve of Congress, but legislation contains loopholes for the President to act in emergencies. The court believes the Trump administration overstepped the mark, however, the tariffs will remain in place while they appeal the judgement. The end goal of US trade policy remains a moving target.

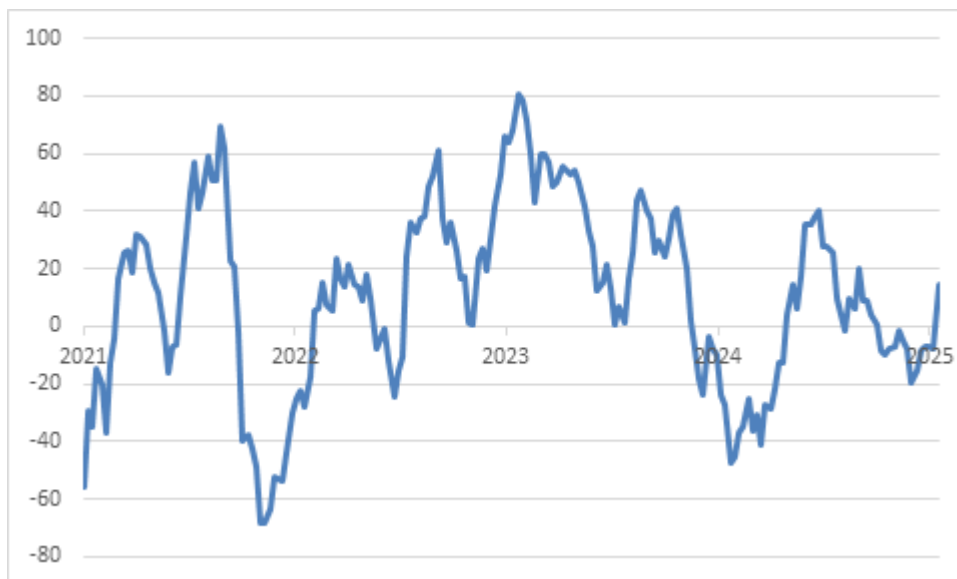
Other loopholes remain open. While courts are unlikely to block all the tariffs, the judiciary is one of the factors that restrains Trump. Another constraint is political. Tariffs will be very unpopular once the impact starts hitting consumers, and this will make Republican politicians nervous ahead of the November 2026 mid-term vote. They will want him to steer his attention to the other elements of his agenda that are more friendly to both voters and the big donors that support their election campaigns.

The other constraint is the markets. The signals from investors have been clear: asset prices fall when tariffs are threatened and rise when concessions are made. However, it is possible that a degree of complacency will set in. Based on the pattern of the past few weeks, markets now clearly expect that Trump will always compromise. The unflattering acronym TACO (Trump Always Chickens Out) has been floating around in the financial media in the past few weeks. Perhaps that is why he made tough noises against China again on Friday. There is a "boy who cried wolf" quality to all this, and we should remember that Aesop's fable did not have a happy ending.

Nonetheless, all of this suggest that the risk of extreme outcomes has diminished. We are not going to return to the status quo before Trump took office, but we're unlikely to settle at tariff levels as high as was announced in that first week of April.

Meanwhile, US economic data has held up better than expected in the last few weeks, though it still does not capture the full extent of higher tariffs, given the amount of stockpiling by companies and households earlier in the year. The 90-day tariff reprieve has opened up another window for stockpiling, but much of this will be bringing forward demand. It still suggests that growth will slow into the second half.

Chart 1: US economic surprise index



Source: Citigroup

This creates a difficult backdrop for the US central bank, the Federal Reserve. Tariffs point to higher goods prices as well as downward pressure on economic growth, though loose fiscal policy relieves some of the economic pressures. Inflation also remains above the Fed's target. Its preferred inflation measure, the personal consumption expenditure deflator, was 2.1% in April.

The Fed is also not just grappling with cyclical factors, but structural questions too. Minutes from the recent FOMC meeting show officials discussed the risk that a reduction in the safe haven status of US Treasuries and the dollar could have long-term economic implications. One example (of many) is a clause tucked away in the new budget bill that would allow the government to tax holdings of US assets by investors from countries deemed unfriendly to the US. It has yet to become law but could act as a disincentive for foreigners to invest in the US.

The more it is pulled in different directions, the less likely the Fed is to do anything. For now, at least. For central banks outside the US, it is a more straightforward story. US trade policy has little direct impact on inflation, but poses downward risks to the growth outlook. This is a demand shock that central banks know how to respond to. Fourteen cut rates in the month of May.

Repo rate reduction

One is the South African Reserve Bank. Its Monetary Policy Committee reduced the repo rate by 25 basis points to 7.25% in a five to one vote. The dissenting voice argued for a bigger cut, suggesting the door to a further reduction remains open. This is especially given that the Bank's estimate of the neutral interest rate, the theoretical level of interest rates that keep the economy on an even keel, is around 7% based on the latest inflation forecast.

Chart 2: South African interest rates and inflation

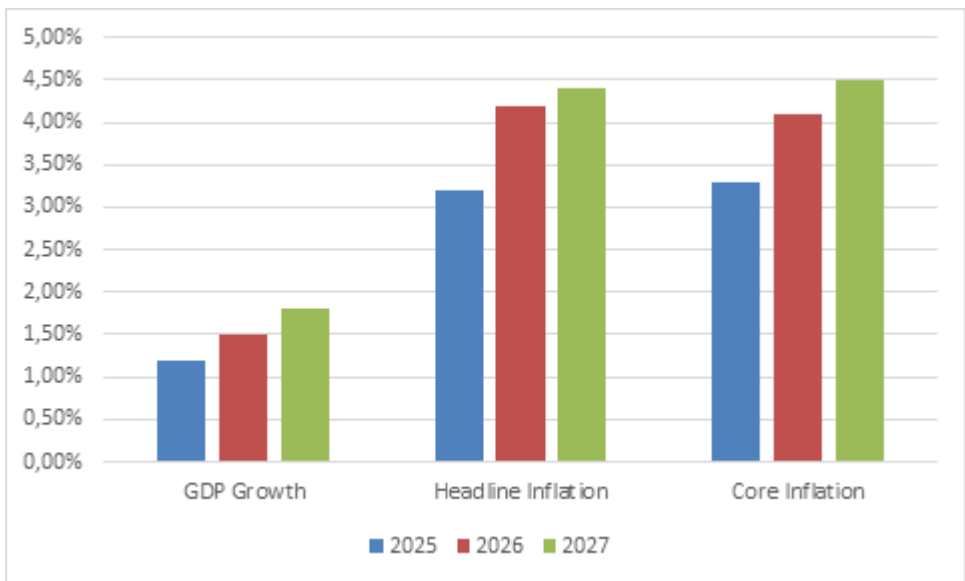


Source: LSEG Datastream

The Bank expects inflation to average only 3.2% this year, with consumer inflation below the bottom end of the 3% to 6% target range for three months in a row. This is partly due to the decline in global fuel prices, but core inflation, which excludes food and fuel, has also declined to 3%. The forecast for 2026 and 2027 is 4.1% and 4.2% respectively.

The stabilisation of financial markets in recent weeks, notable the exchange rate, gave the Bank confidence to lower rates. However, the damage to the global growth outlook described above means that the Bank’s forecast for GDP growth this year was cut to 1.2% from 1.7% at the time of the previous MPC meeting in March. Ongoing supply side reforms still result in an expected rising medium-term growth profile.

Chart 3: SA growth and inflation forecasts



Source: SA Reserve Bank

Aiming lower

The Reserve Bank also modelled a scenario where a 3% inflation target is achieved and released a White Paper on the implications of lowering the inflation target. It has been making the case for a lower inflation target for many years now, but it is the National Treasury that sets the target, not the Reserve Bank. Discussions have been ongoing, but the MPC statement notes that they are at an advanced stage. It seems to be a case of when, not if.

When the inflation target was first adopted in 2000, the idea was to move it from 3% to 6% to 2% to 4% within a few years. That never happened, mainly because there was a massive inflation spike not long after implementation. The most likely option today seems to be a 3% target with a 1% tolerance band on either side, but it could also be a 4% target that moves lower after a few years. The former is preferable, based on the earlier failure to lower the target as promised. Either way, inflation will still be cyclical, and so will interest rates.

The transition to lower implies some short-term pain for longer-term gain. In the short term, rates probably remain higher with a lower target than if the current target remained in place. To put it simply, if the aim was 3%, then inflation is currently on target and will rise above target over the medium term, limiting the case for rate cuts. If the goal is 4.5%, inflation sits well below target, and will only rise towards the target over time, creating more room for cuts.

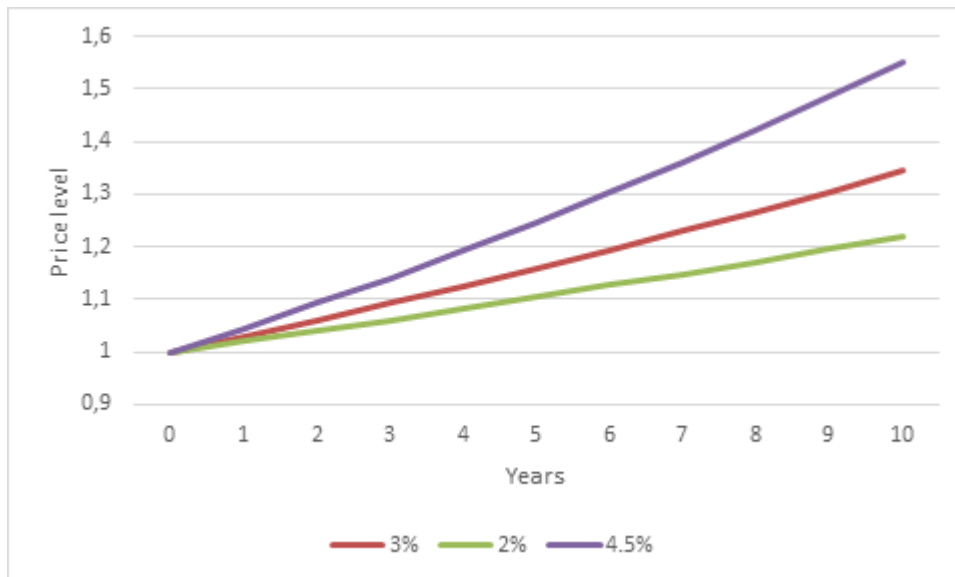
This implies some sacrifice of economic growth to achieve lower inflation, hence Treasury's reluctance to move too quickly. There is disagreement on how big this "sacrifice ratio" is, but the Bank's own modelling suggests it is small. Interest rates are only somewhat higher in the short term, and economic growth only somewhat lower. By 2027, rates are lower and growth higher than projected in the baseline forecast.

The other complicating factor is that the government itself is the biggest culprit, with administered prices running well above the current 3% to 6% target.

As for the long-term benefits, they fall in three categories. Firstly, when inflation is high, price signals get muddled. When prices are generally stable, but the price of one item jumps, it says something about that product. There is obviously a rising demand for it, or there is a supply problem. However, if prices consistently rise across a broad front, it becomes difficult to know what is signal and what is noise. At worst, this can distort incentives and reduce economic efficiency.

Secondly, if the price level of a country rises more than its peers, it will lose competitiveness over time. Most members of South Africa's emerging market peer group moved towards a 3% inflation target. If South Africa's price level rises 4.5% per year, and the peer group by 3% per year, the difference over 10 years will be 20%. Against developed countries with a 2% inflation target, the difference will be 35%. Seemingly small differences compound over time.

Chart 4: Hypothetical price level at different annual inflation rates



Source: Authors calculations

The theory of purchasing power parity (PPP) suggests that exchange rates must ultimately adjust to compensate for this loss of competitiveness. While PPP does not hold in the short term when sentiment and capital flows dominate, it tends to hold over the long term, and indeed the experience with the rand since it became a truly free-floating currency has been one of long-term depreciation. In other words, sustained lower inflation will reduce the pace at which the rand loses value in foreign exchange markets over time.

There is also a different angle to this. If the rand does depreciate and inflation remains low, it will give South African producers a boost in export markets. This is what economists call a real exchange rate depreciation, as opposed to a nominal one. One of the reasons why South Africa does not have a booming export industry despite the rand's steady fall is because of the relentless rise in the cost base of local producers. It is by no means the only reason, and indeed the rand's habit of appreciating strongly after periods of weakness is also a problem. Volatility makes it difficult for businesses to plan. There is some evidence that lower inflation could reduce the volatility of the currency, not just the level of the exchange rate.

A long-term boost

Thirdly, and quite simply, sustained lower inflation should help maintain the purchasing power of households over time, particularly low income households. Interest rates will also decline. There will still be cycles, but the peaks and troughs should be lower. Lower borrowing costs will raise economic activity. It will also make South African bonds, equities and real estate more valuable over time, all else being equal.

In summary, in contrast to President Trump's headline-grabbing actions, inflation targeting is not the sort of thing that will get people excited about. But it is a big deal. It would be an important structural reform, along with others pursued by the government that will ultimately improve the functioning of the economy, which supports the outlook for domestic investments. While the Reserve Bank has made mistakes, it is a crucial institution that contributes to the country's prosperity and a source of stability in an uncertain world. At a time of political

uncertainty at home and abroad, that is hopefully a source of comfort for investors that dissuades them from emotional decision-making and helps them hit their own targets.