momentum investments

The Macro Research Desk

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SARB holds interest rates steady, but paves the way for hikes

Overview

The South African Reserve Bank (SARB) kept interest rates on hold at 5.75% today, in line with our in-house view and the unanimous prediction among the 26 analysts polled by Bloomberg. The hawkish tone of the statement, however, led to a temporary strengthening of the currency from 11.76 against the US dollar prior to the governor's speech, to 11.71 just before the rate announcement, with the rand weakening again to 11.84 directly after the interest rate announcement. Although the SARB expressed concern over the health of the domestic economy, only minor growth downgrades were made to their internal forecasts. The Reserve Bank, nevertheless, struck a hawkish tone on inflation, revising forecasts higher and flagging a more pronounced reversal in rand-oil prices, wage pressures and the potential for markedly higher electricity tariffs as the largest threats facing the inflation outlook. Even against a backdrop of weak growth, the expected acceleration in inflation and still-sticky inflation expectations suggest that further monetary policy tightening remains necessary for the SARB to follow through on their inflation targeting mandate. As a result thereof, we expect a 25 basis point hike later this year and a further 100 basis points worth of hikes over the course of 2016.

Inflation outlook again upwardly revised

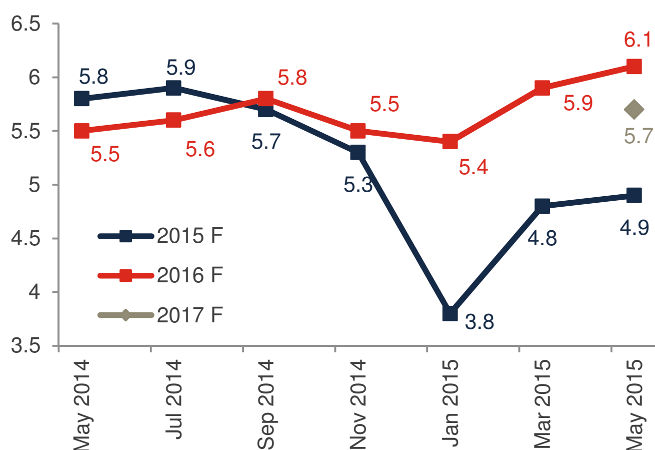
The c.40% recovery in international oil prices since mid-January, driven by war in the Middle East and speculative financial investors betting on rising oil prices, has partly reversed the previous favourable inflation impact of previous petrol price cuts. Higher fuel levies, announced in the February budget, further eroded earlier fuel price gains. Food prices are also expected to underpin the V-shaped inflation profile in 2015, as drought-induced cuts to this year's maize crop, forecasted to be approximately a third lower than last year's crop, put further pressure on overall food prices. Given that yellow maize comprises more than 60% of chicken feed, meat prices, which account for nearly a third of the food CPI basket, are likely to increase as well, albeit with a lag. As such, we see food inflation averaging around 5.5% this year, moving closer to c.7.0% in 2016.

Since the previous Monetary Policy Committee (MPC) interest rate announcement (26 March), the rand has risen 1.6% against the US dollar, but has depreciated by a marginal 0.8% against the euro, placing the rand's performance roughly in the middle of a broader emerging market (EM) currency comparison. Earlier this year, the Institute of International Finance (IIF) warned that based on an analysis of past US Federal Reserve (Fed) interest rate tightening cycles, it could be another stressful year for capital flows to EMs, potentially dipping by USD25 billion this year should the Fed begin to raise policy rates. In their more recent May report, the IIF's early warning indicator for EM capital flows pointed to a sharp decline in portfolio flows across EM since early May, much of which was concentrated in bond markets. This move was potentially triggered by a jump in developed market bond yields, as a result of an upward shift in inflation expectations. In spite of the Reuters consensus calling for a contraction in SA's current account deficit from 5.4% of GDP in 2014 to 4.6% in 2015, any adverse movement in foreign capital flows could still threaten SA's relatively vulnerable external deficit position.

More recently, public sector unions and the state reached an agreement on a 7.0% (CPI + 2.2%) wage increase (backdated from April) and inflation plus 1% in year's two and three of the multi-year wage agreement. We view this recent wage deal as positive for the inflation and growth trajectory, setting the bar lower for private sector wage negotiations and eliminating the risk of a full-blown public-sector worker strike. This could also be seen as positive for SA's ratings outlook, given the marginal impact on the budget outcome as long as government adheres to its plan for a headcount freeze. Nonetheless, the SARB cited a potential wage-price spiral as a key source of upside pressure to the inflation trajectory, quoting the 7.9% average wage settlement recorded by the Andrew Levy Employment publications for 1Q15. Unresolved settlements in the gold and coal mining sectors pose a further threat to wage pressures going forward.

The above-mentioned factors have prompted the SARB to revise their headline CPI forecasts (see chart 1) from 4.8% to 4.9% in 2015 (only slightly lower than our forecast of around 5% in 2015) and from 5.9% to 6.1% in 2016 (a touch higher than our c.6% projection). The expected peak in the profile is still seen to breach the upper end of the target in 1Q16, but the MPC warns of a more protracted infringement of the target band should Eskom's full electricity tariff request be accepted. Eskom recently applied for a selective reopening of the Third Multi-Year Price Determination (MYPD3) decision for 2015/16 – 2017/18. They have requested a 25.3% tariff increase, comprising 10.1% for the excess usage of the open-cycle gas turbines and power purchase agreements and 2.5% for the increase in the environmental levy. The remainder of the increase is related to the c.12.7% already granted in the previous tariff negotiations. Energy regulator Nersa is expected to only make a decision regarding Eskom's 25.3% tariff-hike application by the end of June 2015; however, to take account of the likelihood of higher energy prices, we have already factored in an electricity price increase of around 20% for this year and c.10% for next. According to the SARB, full implementation of Eskom's request could increase their average inflation estimate by c.0.5% over a year, as they are currently applying a 13.0% increase in their numbers.

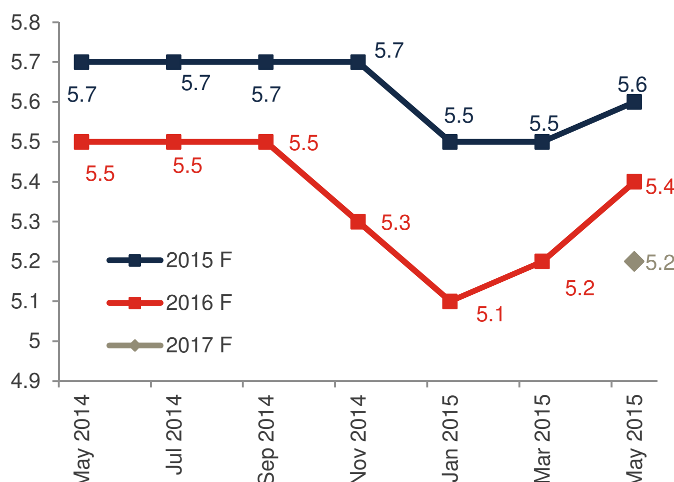
Chart 1: SARB headline CPI forecast revisions (%)



Source: MAM

Core inflation remains persistent and is expected to average 5.6% in 2015 (relative to their previous forecast of 5.5%) and 5.4% in 2016, from 5.2% previously (see chart 2). These figures are more-or-less in line with our own internal forecasts for underlying inflation in 2015, but marginally higher than our 2016 forecasts. The Bank also extended their projection horizon releasing forecasts for headline inflation of 5.7% and core inflation of 5.2% in 2017. The SARB admitted that the actual pass-through co-efficient (stemming from the currency) could be nearly half that implied by the Bank's forecast model, given the subdued growth environment. They remain reluctant to lower it as it could merely reflect a temporary phenomenon. In our view this suggests that, by using a higher level of currency pass-through, their forecasts (excluding the impact of additional electricity tariffs) could be slightly overestimated.

Chart 2: SARB core inflation forecast revisions (%)



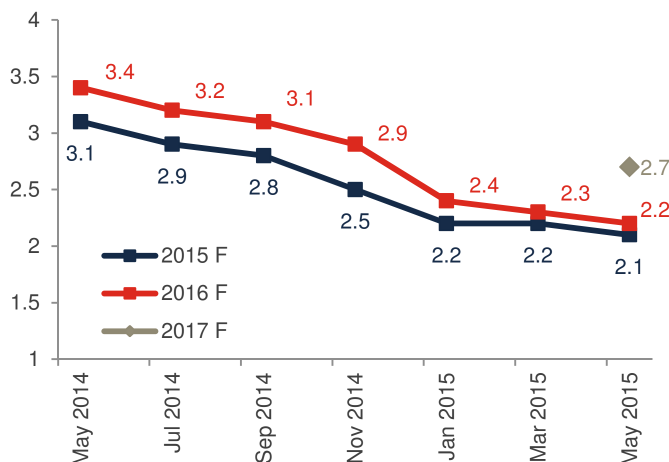
Source: MAM

Despite the lack of new data on inflation expectations (the Bureau of Economic Research's quarterly Inflation Expectations Survey will only be available in June 2016) the Bank remains concerned about the stickiness in longer-term inflation expectations, pointing to potential second-round inflationary pressures.

Power crunch still the largest risk facing SA's growth potential

The SARB still views the global economic outlook as mixed, with downside risks prevailing. While sentiment has improved in the euro area and Japan, momentum has softened considerably in the US and activity has slowed further in China. In addition to a still-uncertain global backdrop, fragile domestic demand and electricity shortages pose further downside risks to SA's growth prospects. The committee anticipates real GDP growth of 2.1% in 2015 and 2.2% in 2016, a tad lower than the previous 2.2% and 2.3% forecast respectively (see chart 3). These figures are broadly in line with our own forecast of 2.2% in 2015, but less optimistic than our 2.5% projection in 2016. Still, their longer-term growth forecast of 2.7% in 2017 is closely aligned with our 2.8% assumption.

Chart 3: SARB real GDP forecast revisions (% y/y)



Source: MAM

Some committee members now favouring a rate hike

In the published statement, the Governor claimed that the committee's views were mixed. Four members preferred to keep rates unchanged, while two members proposed reasons to hike the base interest rate by 25 basis points. The MPC have further committed to publishing its assumptions underlying the Bank's forecasts as from the July 2015 meeting, but did not give any clarity on the range of variables that can be expected.

An earlier rate hike now likely

Although the April Fed minutes quelled expectations for a June rate hike in the US, we still think a September US rate hike may be on the cards given better growth expectations in 2H15. It is evident that the SA Reserve Bank remains cognisant of the potential negative domestic effect of a rise in US short rates should it materialise later this year. In the event that global capital flows to EMs are negatively impacted, the rand could sell off further, potentially raising future inflation expectations, which already are above the upper-end of the target band for the price-setters of the economy, namely businesses and trade unions.

In our view, a weak domestic growth outlook is unlikely to stave off further interest rate hikes in SA. In fact, a lower short-term trend growth rate, recently revised down to between 2.0 and 2.5% by the SARB (implying a negative output gap – that is the difference between actual versus potential growth - of c.1.5%), coupled with an expected acceleration in inflation and still-sticky inflation expectations suggest that further monetary policy tightening remains necessary. The Bank pointed to the vulnerability of the inflation profile, which remains close to the upper band in the longer term. Any minor unfavourable change in upside pressures could tip the inflation scales. In our view, the overall hawkish tone of today's MPC statement, the likely further upward revisions to the Bank's inflation profile in reaction to higher electricity tariffs in coming meetings and the revelation that two MPC members already are in favour of higher rates, point to an increasing probability that the SARB will pull the trigger on higher interest rates sooner rather than later. We hence expect the SARB to hike interest rates, in line with their inflation targeting mandate, by 25 basis points, potentially as early as 3Q15 (and not in 4Q15 as we previously expected), with a further 100 basis points likely forthcoming in 2016.

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