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South African Interest Rates Outlook - September 2017

At their last Monetary Policy Committee (MPC) meeting in July, the SA Reserve Bank (SARB) surprised the vast majority of market participants with a 25 basis point (0.25%) cut in the benchmark Repo Rate from 7% to 6.75%, the first reduction in almost five years. In this note we will set out the economic backdrop, our view for rates going forward and how this compares to the market.

Economic backdrop – Inflation surprises to the downside

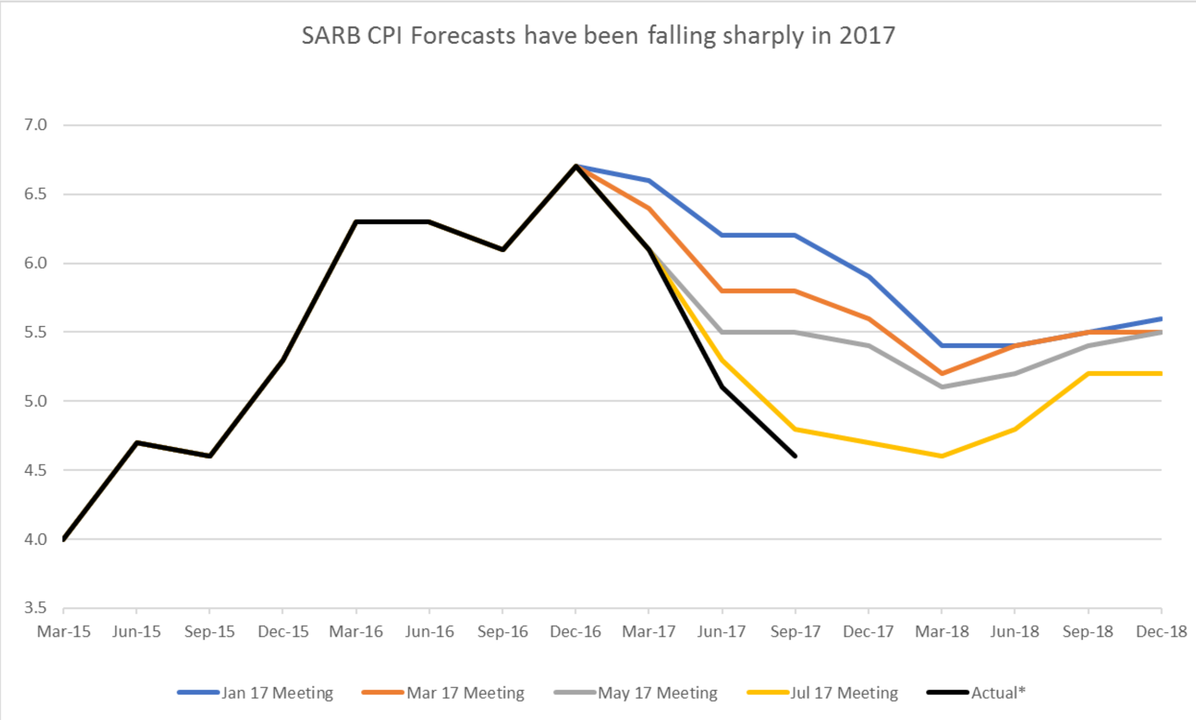
The Reserve Bank is mandated 'to achieve and maintain price stability in the interest of balanced and sustainable growth in South Africa'. To this end their primary focus is the inflationary backdrop, primarily the outlook for CPI (Consumer Price Index).

History of benchmark Repo Rate vs. Headline CPI

SARB has been successful in taming inflation to the 3% to 6% target range by pre-emptive adjustment of the target rate

The above chart shows that inflation has fallen sharply back within the target range (3% to 6%) this year, giving the Reserve Bank scope to ease monetary policy.

The Bank helpfully provides a history of its CPI forecasts. Going back through this year's meetings, we can see that the recent fall in inflation was greater than anticipated:



* Latest actual reading is for end-July 2017

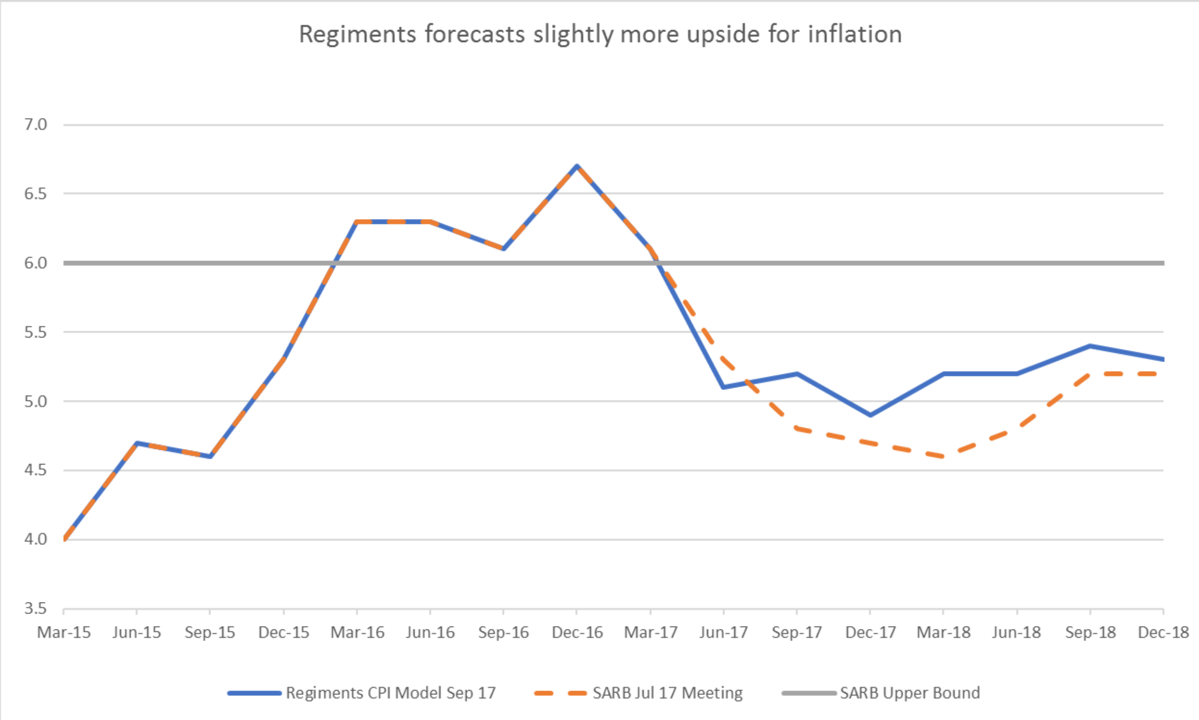
> *"Since the previous meeting of the Monetary Policy Committee the inflation outlook has improved. Food price inflation has moderated faster than expected, domestic demand pressures remain subdued and international oil prices have declined. Despite the degree of volatility, the Rand exchange rate has been relatively resilient in the face of expected monetary policy tightening in some advanced economies, as well as domestic political risks and uncertainties. Risks to the inflation outlook still remain."*

Extract from Statement of the Monetary Policy Committee, 20th July 2017

Modelling the trajectory for inflation

At Regiments we have developed a bottom-up model of CPI, projecting forward all the sub-component indices to provide a whole-economy picture of pricing pressures. The methodology has proven itself over time and we use this to inform our active bond and Forward Rate Agreement (FRA) positions.

Our current CPI projection for this year and next is shown below, against the Reserve Bank's latest projections:

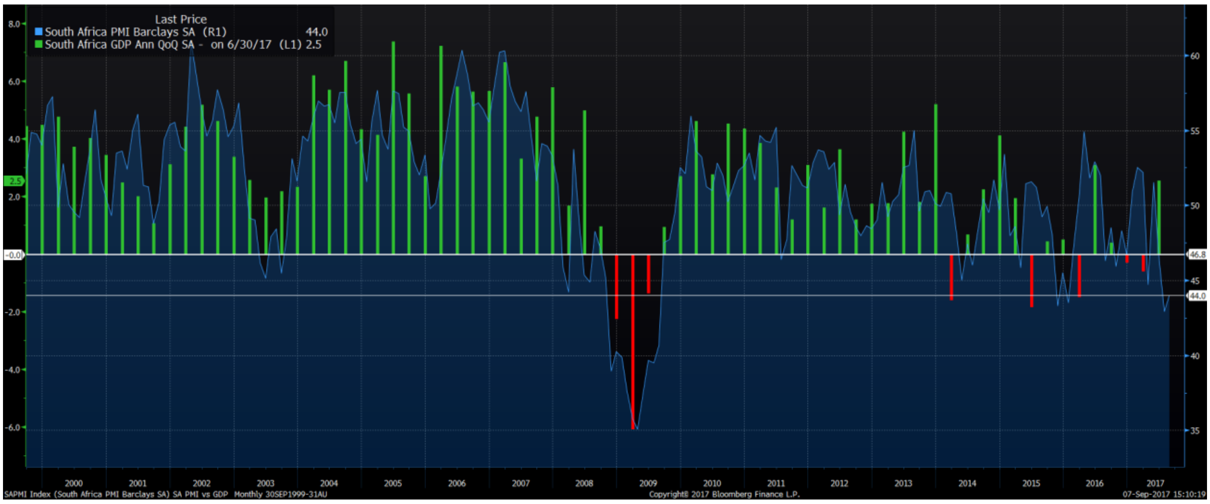


Whilst we broadly agree with the Reserve Bank regarding inflation by end-2018, we feel the likelihood is for stickier readings in the 5.0% to 5.5% range. It is likely however that the Bank would tend to disregard any lower readings given the higher end-point as shown here.

South Africa growth outlook

The secondary factor in the Reserve Bank's decision making will be to support growth. Although the Q2 GDP print shows that the country has exited technical recession (two consecutive quarters of contraction), growth prospects remain tepid and certainly below the rates of expansion needed to bring down the unemployment rate and place the public debt trajectory on a sustainable path.

With this in mind, we expect the SARB to err towards easier monetary policy so long as inflation remains behaved.



Barclay's Purchasing Manager's Index (PMI) suggests recessionary conditions continue

> *"… domestic growth prospects have deteriorated further following the surprise GDP contraction of 2017. The economy has now recorded two successive quarters of negative growth, and although a near-term improvement is expected, the outlook remains challenging. A number of sentiment indicators and data points have reached levels last seen during the 2009 recession, at the height of the global financial crisis."*

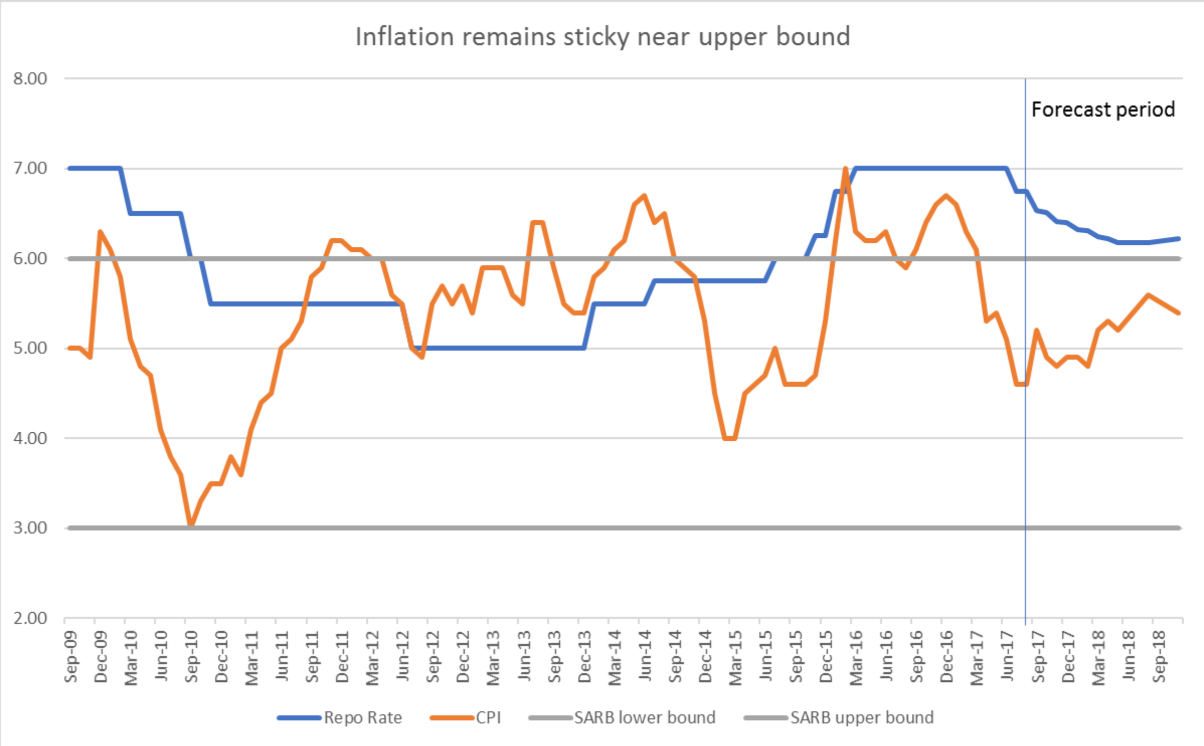
Extract from Statement of the Monetary Policy Committee, 20th July 2017

How far can rates fall over the next 18 months?

Given the above, the Reserve Bank was justified in commencing the rate cutting cycle at its last meeting in July - there was ample leeway in both growth and inflation. The next question is how much more will the bank do?

The inflation projection charts shown above suggest that the scope for further cuts is modest compared to previous cycles, given that CPI is set to remain near the 6% upper end of the SARB's target range.

The chart below brings together data shown above for historic rates and inflation, appended to our in-house inflation forecasts and market-implied REPO rates backed out of the current FRA curve:



The Repo Rate trajectory above shows us that the market currently expects approximately two further 25 basis point cuts to a 6.25% Repo Rate by mid-2018.

This looks reasonable to us – there is little scope for more than 50 basis points of rate cuts given our projected path of inflation. As explained above, using the SARB's inflation forecasts would produce a similar conclusion. The minor differences in trajectory would most likely be ignored by the SARB's Monetary Policy Committee.

Risks to the outlook

The Reserve Bank has been at pains to point out that uncertainty is high moving into year end, as we navigate through:

- Finance Minister Gigaba's first Medium-Term Budgetary Policy Statement (MTBPS) in October
- Credit agency sovereign ratings reviews (with further potential downgrades) in November – December
- The ANC's National Elective Conference in December

Any or all of the above events have the potential to trigger a major risk-off move in investor sentiment. This would cause a sharp fall in the Rand, which in turn creates inflationary pressures, and would be of far greater concern to the Reserve Bank than the growth outlook at that point in time.

Concluding remarks are once again from Lesetja Kganyago, Governor of the SARB, from the July 2017 MPC meeting:

> *"As we have emphasised on numerous occasions, the MPC does not view monetary policy as the solution to the structural growth constraints in the economy. Nor does it believe that a reduction in interest rates will provide a significant stimulus to growth in the current environment of low confidence and political uncertainty.*
>
> *In this highly uncertain environment, future policy decisions will be dependent on data outcomes and our assessment of the balance of risks. We remain vigilant and would not hesitate to reverse this decision [the 25 basis point cut] should the inflation outlook and risks deteriorate."*

Extract from Statement of the Monetary Policy Committee, 20th July 2017