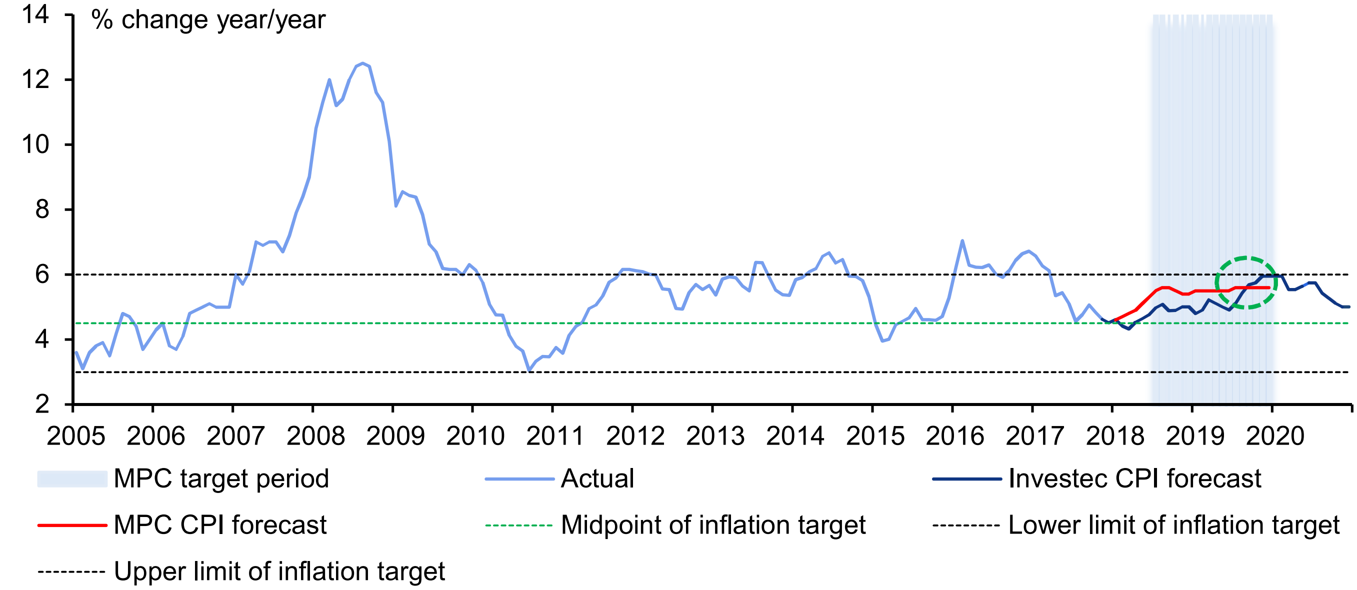
Investec

Interest rate outlook: the monetary policy outlook has likely become neutral following the market positive outcome of the recent ANC election

16th January 2018

Figure 1: SA Consumer Inflation: history and forecasts



Sources: Stats SA, Investec, SARB

South Africa saw economic growth of 2.0% to 3.0% in the last two quarters of published data, while the nominal trade weighted rand has strengthened by about 10% since the previous MPC meeting, and CPI inflation is at 4.6% y/y, versus the mid-point of the 3-6% inflation target of 4.5%. While the figures do not look poor on face value, the GDP figures are led by the recovery in most areas from SA's drought, while CPI inflation has moved lower on the moderation in food price inflation, and the rand's strength occurred only in late December/early January on Cyril Ramaphosa election to president of the ANC. The positive effects of drought alleviation are expected to wear out mostly in the first half of year, while the Monetary Policy Committee targets CPI inflation only in the six to twenty four month period, which currently translates to the second half of this year and 2019. It has specific focus on the twelve to eighteen month period, where inflation is likely to be running closer to 5.0% y/y. While we expect CPI inflation can fall further in Q1.18, it is likely to bottom, and then climb over Q2.18 and H2.18 on base effects, commodity price pressures and some improvement in demand. The SARB forecasts CPI inflation at 5.5% y/y in the second half of 2018 and 5.5% y/y in 2019, but will likely lower these forecasts to closer to 5.0% y/y and 5.3% y/y. However, the MPC's inflation revisions are unlikely to be around 4.5% y/y for the period (H2.18 and 2019), indicating that on a strict interpretation the SARB would be unlikely to cut interest rates at its January 2018 meeting, but the tone could become neutral to somewhat dovish after the hawkish stance at the previous

Figure 2: Forecasts

Period end rate %	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Repo Rate	6.75	6.75	6.75	6.75	6.75	6.75	6.75	7.00
Prime Overdraft Rate	10.25	10.25	10.25	10.25	10.25	10.25	10.25	10.50
SA rand bond (SARB)	9.25	9.06	8.91	8.78	8.88	8.99	9.10	9.23

Source: IRESS, Investec

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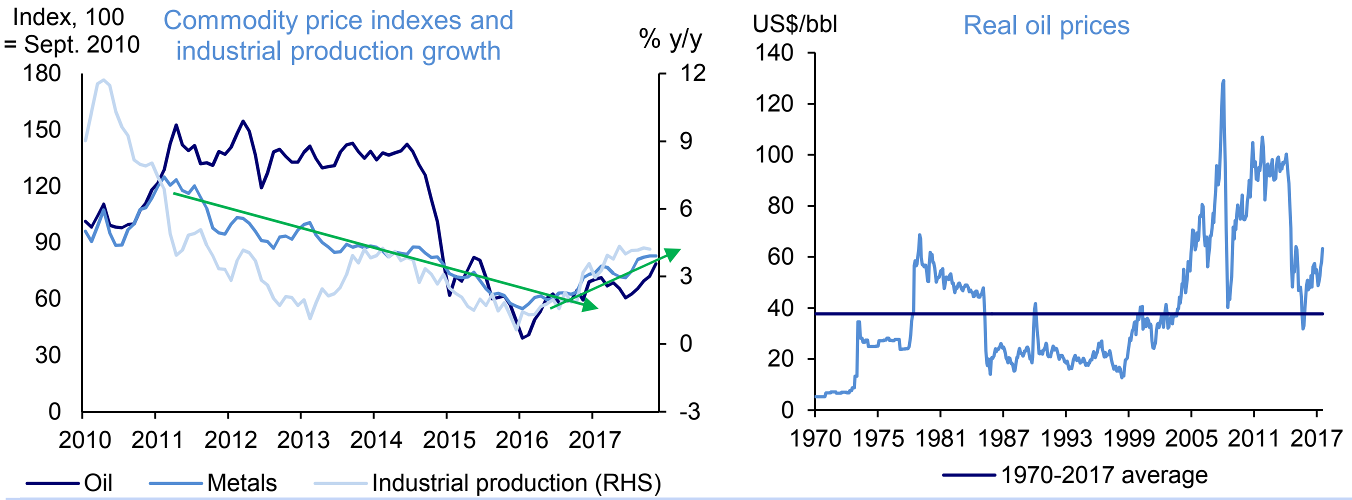
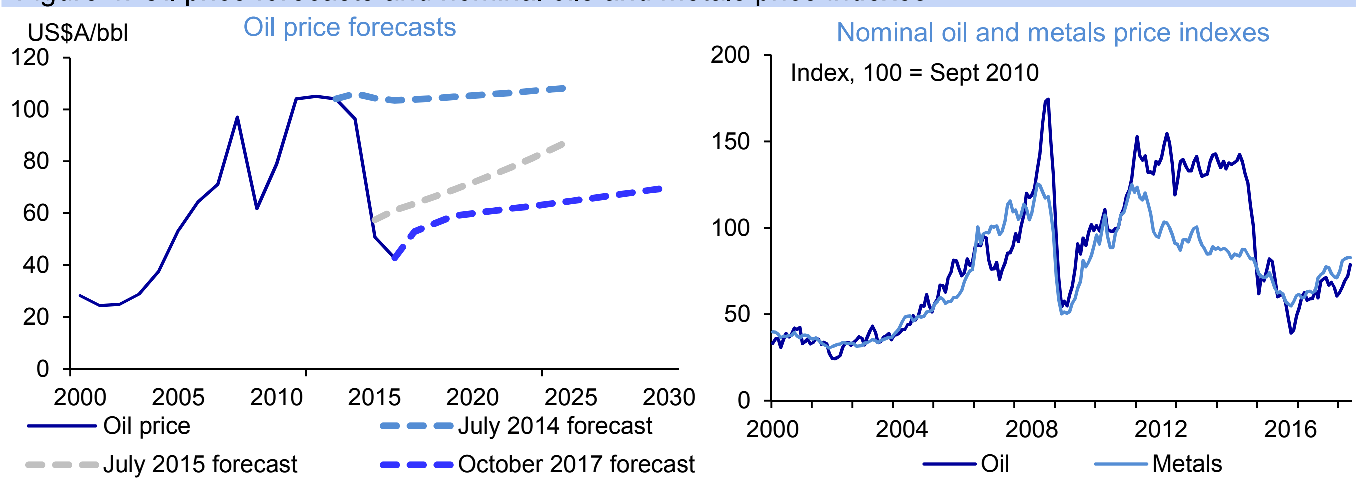
Figure 3: Commodity price indexes vs industrial production growth and real oil prices



Source: World Bank Group, Global Economic Prospects January 2018

Figure 4: Oil price forecasts and nominal oils and metals price indexes



Source: World Bank Group, Global Economic Prospects January 2018

Figure 5: Reuters January 2018 Econometer poll: Repo rate end period %

Forecast period	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	2019
Median	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75
Highest forecast	6.75	6.75	7.00	7.00	7.00	7.00	7.25	7.25
Lowest forecast	6.25	6.00	6.00	6.00	6.00	5.50	5.00	5.00
No. of forecasts	19	19	18	19	19	18	15	16

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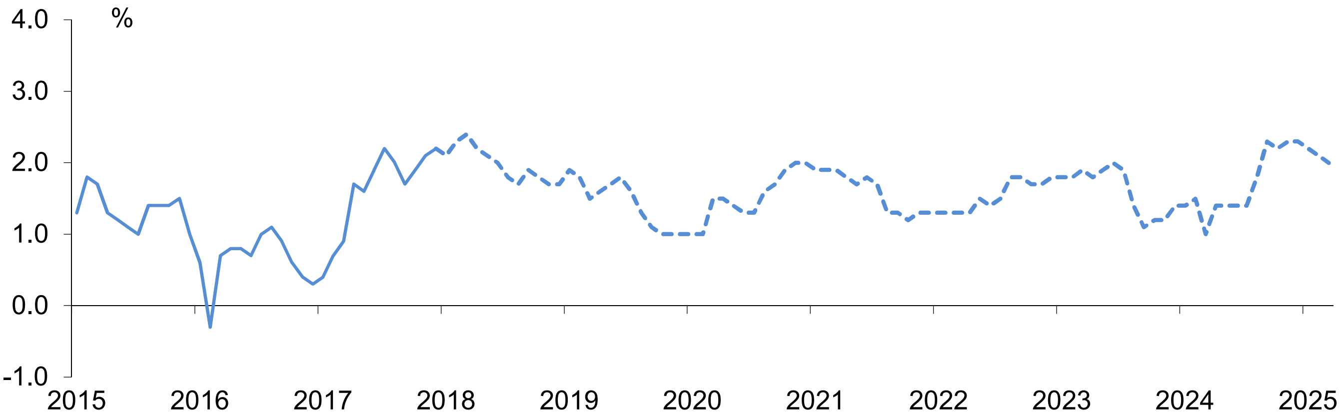
Figure 6: South Africa's real interest rate projections: (Investec CPI and repo forecasts)

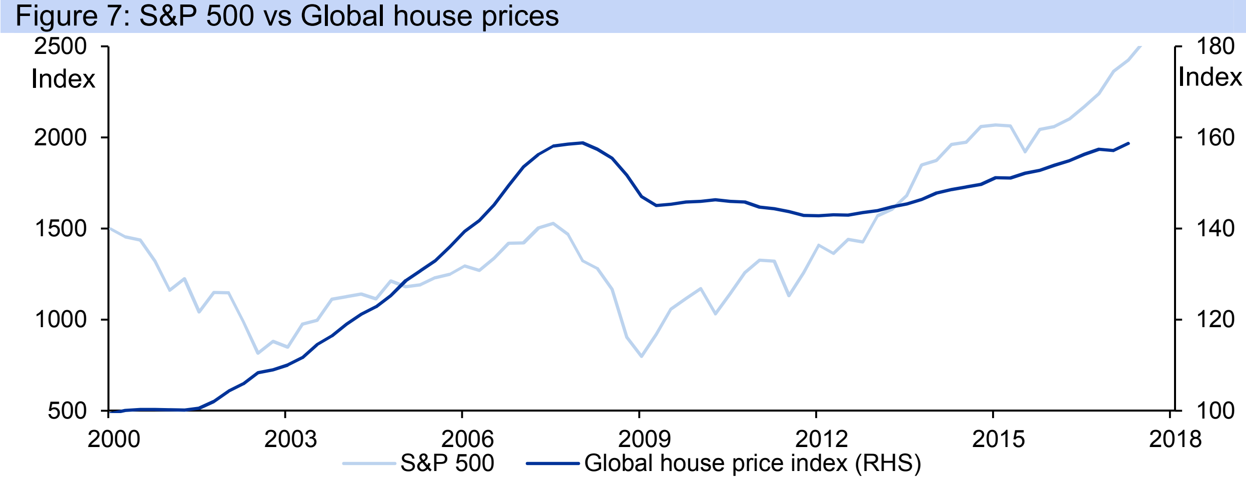


Source: Investec, IRESS

MPC meeting (November 2017) where the Committee outlined that its model (QPM) showed repo rate hikes of 75bp in total by the end of 2019. We forecast only one 25bp increase in that period, in November 2019, to support the neutral real interest rate, which the SARB identifies at 2.0% to 2.2% in that period, although we have it closer to 1.5%, which is around the SARB average from 2014 to 2017 inclusive. Indeed, the committee's model is likely to show fewer, if any hikes in the forecast period to end 2019, given the expected improvement on its inflation outlook.

The SARB is not expected to cut the repo rate at its meeting on 18th January given that the CPI inflation outlook is likely to be well elevated away from the mid-point of the inflation target in the MPC's inflation targeting period. Previously, the SARB has explained that its CPI inflation forecast would need to fall below 4.5% y/y over the six to twenty-four month period (but specifically over twelve to twenty four months) for it to consider a cut. While the recent strength in the rand is likely to feed through into CPI inflation fairly

Figure 7: S&P 500 vs Global house prices



Source: Bloomberg and IMF

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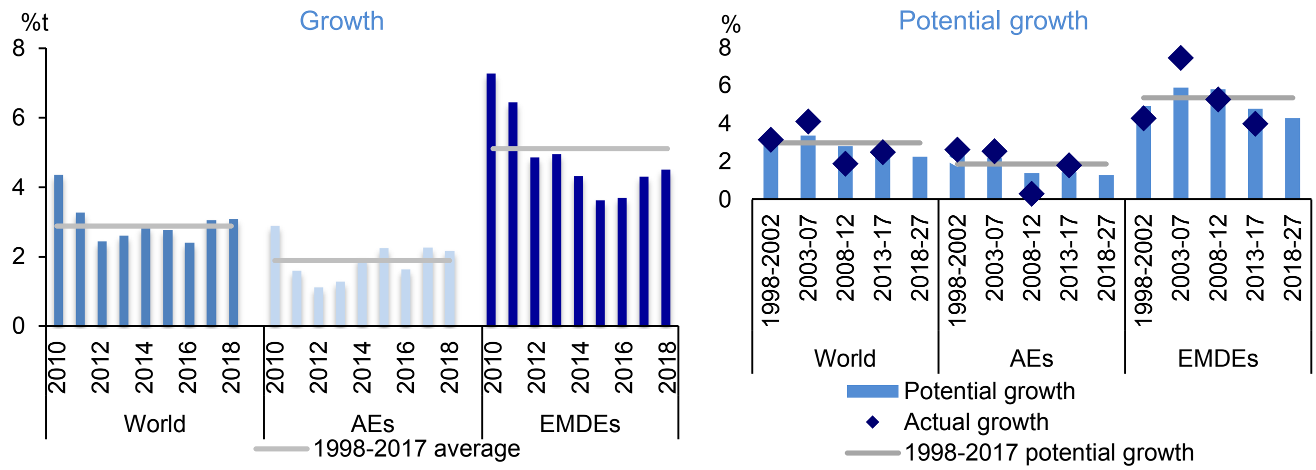
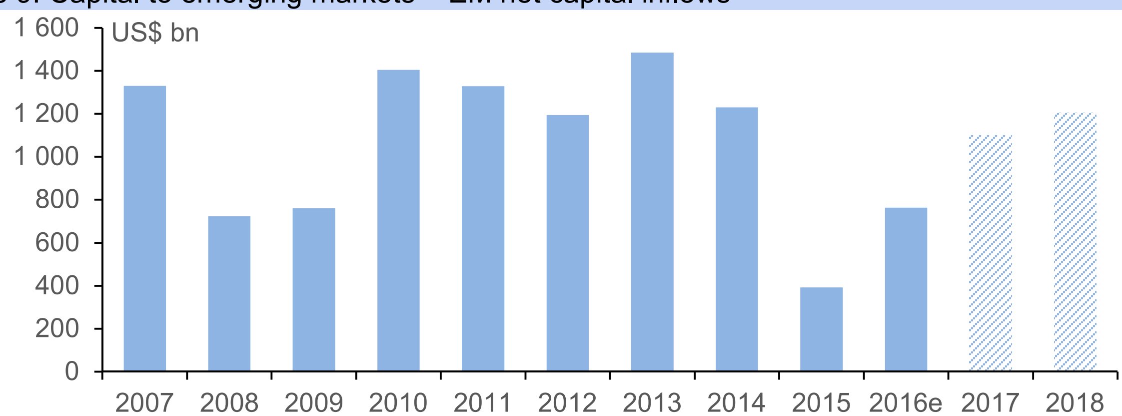
Figure 8: Global growth and potential growth



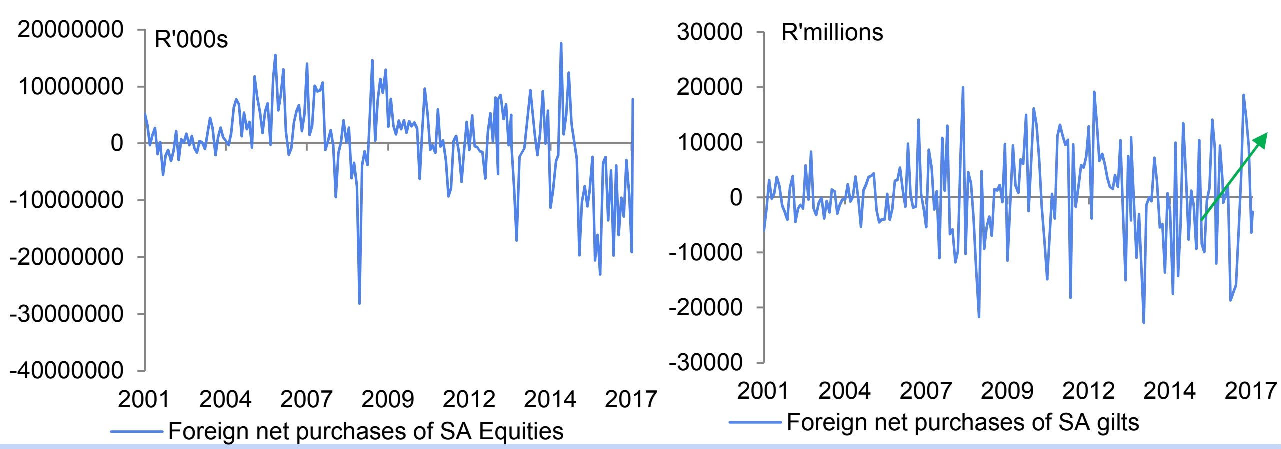
Source: World Bank Group, Global Economic Prospects January 2018

Figure 9: Capital to emerging markets – EM net capital inflows



Source: IIF

Figure 10: Foreign net purchases(+) /sales(-) of SA equities and bonds



Source: IRESS

Figure 11: Reuters June 2017: Econometer poll: SARB GDP end period										
Forecast period	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	2018	2019
Median	1.0	0.9	1.3	1.3	1.6	1.7	1.7	1.7	1.3	1.6
Highest forecast	2.8	2.1	2.5	2.2	2.5	2.7	2.7	2.5	2.0	2.3
Lowest forecast	0.2	-1.2	0.2	0.4	0.5	0.3	0.8	0.4	1.0	1.2
No. of forecasts	13	14	14	14	14	10	10	9	23	23

Source: Reuters

immediately in Q1.18 via the petrol price, it will likely have less impact on CPI inflation longer-term as many retailers will likely use the domestic currency's strength to claw back the impact of their absorption of price pressures following previous marked currency depreciation. Additionally, the rand's recent strength has yet to be maintained and the domestic currency could weaken just as quickly as it has strengthened over the turn of the year, rendering any interest rate cut made this month having to be reversed at the next meeting. Should the rand strengthen notably further this year, and the new levels be maintained, the SARB may consider an interest rate cut on consequent expected lower inflation. Without further changes in key leadership positions in SA that are seen as significantly positive by the financial markets, we expect that the rand will remain largely around current levels, with interest rates flat as a consequence. While a neutral to risk-on period is anticipated for most of this year, should marked risk-off ensue, the rand could experience substantial weakness, as could requirements for government to honour key SOEs guarantees should one of these utilities run into severe financial difficulties with its debt obligations. The Budget, and hence the credit rating agencies reviews will also be key for the domestic currency, particularly Moody's on whether to allow SA to maintain its investment grade credit ratings or not (see "Risk update: will the market optimism on the outcome of the ANC elections be sustained, and meaningfully feed through into the economy?", 12th January 2018, see website address below). Moody's will make a decision in February, after the Budget on 21st.

The rand has seen substantial support from risk-on as foreign investors favoured local currency EM debt given the comparative lower yields on developed economies debt, particularly in the Euro area. The synchronized broad based global economic growth upswing is expected to continue this year, with interest rates in many countries accommodative. Global growth is expected to be led by the Euro Area, United States, India, Japan and Canada. Expectations of stronger global growth fuel risk-on, as growth in low income economies and EMs is also then expected to rise, improving both equity performance and fiscal health of EMs and low income economies. Confidence levels are elevated, and so investor sentiment

Figure 12: SA Monetary Policy Committee (MPC) meeting dates for 2018		
Month	Date	Forecast
January 2018	17th – 18th	6.75
March 2018	26th – 28th	6.75
May 2018	22nd – 24th	6.75
July 2018	17th – 19th	6.75
September 2018	18th – 20th	6.75
November 2018	20th – 22nd	6.75

Source: SA Reserve Bank, Investec

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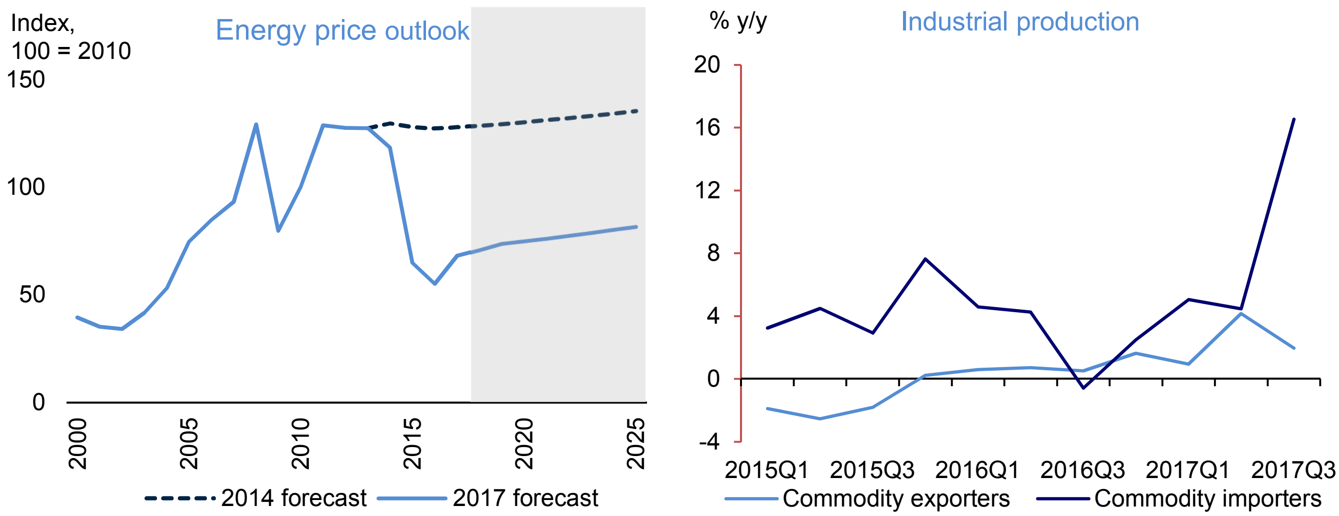
16th January 2018

Figure 13: Energy price outlook and Industrial production



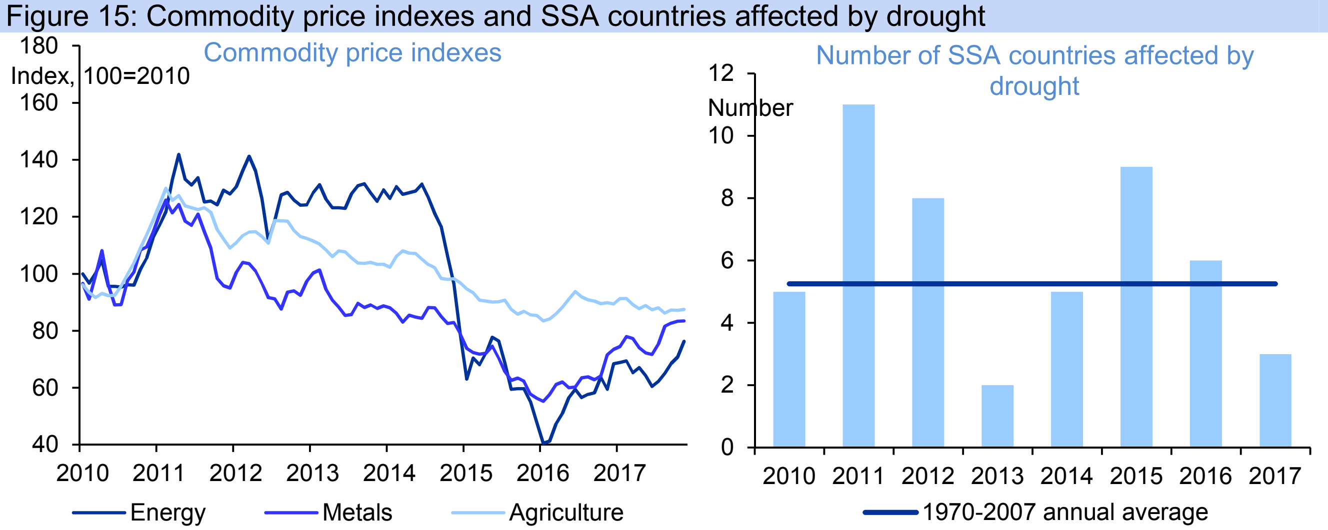
Source: World Bank Group, Global Economic Prospects January 2018

Figure 14: Reuters Jan 2018 Econometer poll: SARB CPI, unadjusted % ch y/y, average for period

Forecast period	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	2018	2019	2020
Median	4.5	4.9	5.2	5.0	5.2	5.3	5.2	5.1	5.4	5.5
Highest forecast	4.8	5.3	6.1	6.4	6.1	5.5	5.6	5.6	5.6	5.8
Lowest forecast	3.3	3.5	3.6	4.3	3.6	3.6	3.2	3.7	3.3	4.1
No. of forecasts	13	14	13	14	13	14	12	22	22	12

Source: Econometer

Figure 15: Commodity price indexes and SSA countries affected by drought



Source: World Bank Group, Global Economic Prospects January 2018

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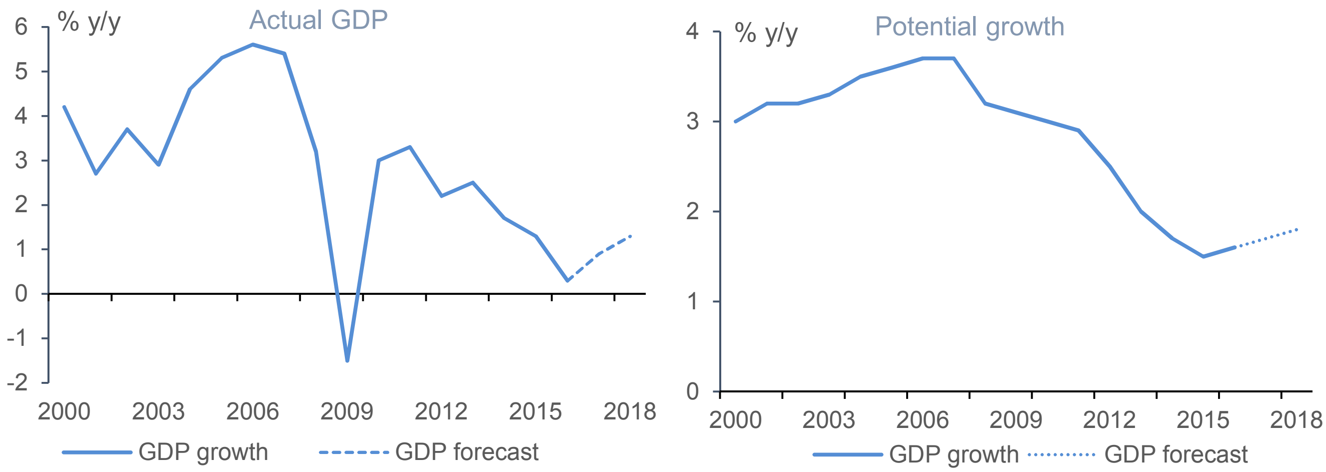
Figure 16: GDP growth



Source: Stats SA and SARB

with volatility levels subdued and SA JSE gaining on the back of this run in global markets. Commodity prices are seeing modest growth, and this is expected this year and next limiting the lift in global inflation, with international commodity prices not expected to move into a super-cycle in this period. With the feed through from international prices into SA's inflation, SA's CPI inflation rate is not expected to meaningfully breach the inflation target this year or next in the expected case. Long-term SA's inflation rate is likely to average 5.5% as obdurately high underlying inflation pressures stem from state administered price increases, with particular pressure coming from water tariffs. While the electricity tariff increase in 2017 was 5% y/y the utility has heavy planned funding requirements which, in the absence of restructuring and cost cutting at Eskom, will see upward pressure for the consumer from this source.

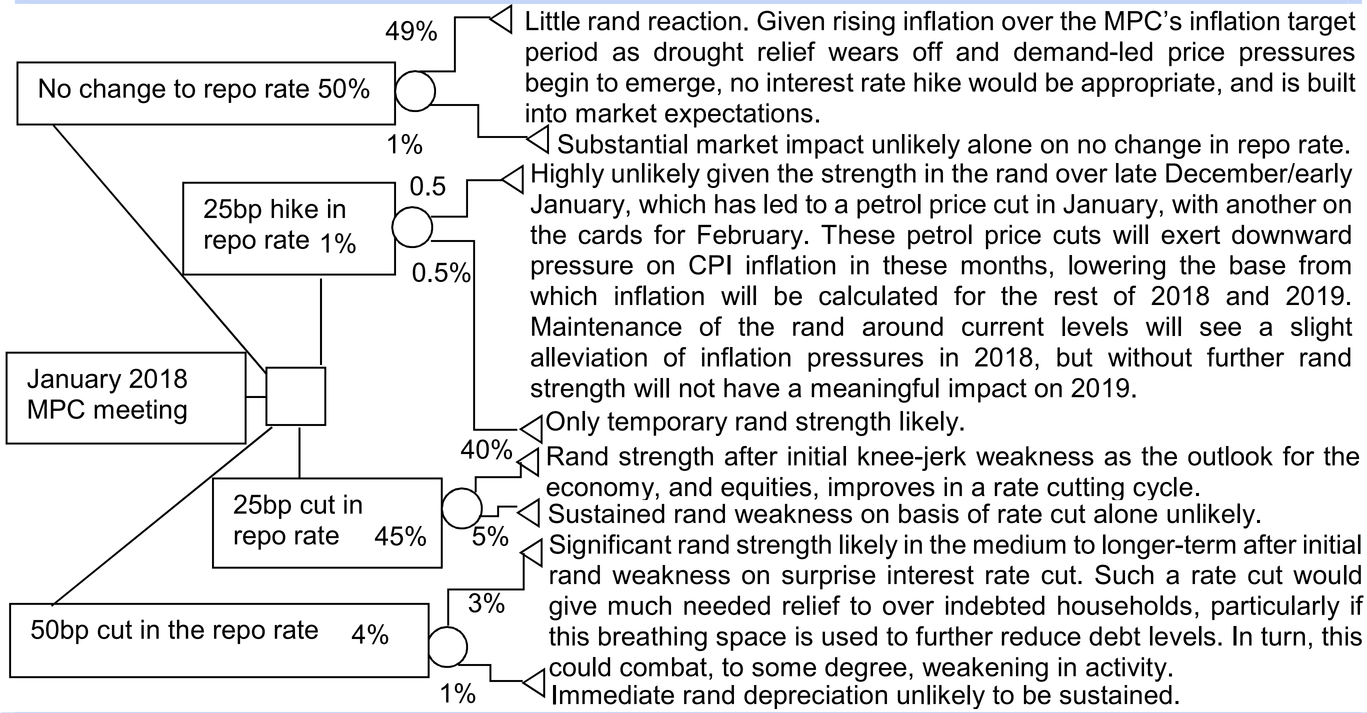
While SA's CPI inflation continues to fall currently, and we expect it to trough at 4.3% y/y in March this year, on moderating food prices from alleviation of the drought in many areas, Agbiz warns that previously expected "La Nina weather conditions during the 2017-18 summer"…which "essentially meant that the country was expected to receive above-normal rainfall, which would have been good for agricultural activity" …are not materialising across the board. Excess rain and hail has damaged crops in some areas, while other areas have received very little precipitation, with the latter delaying summer crop planting in areas which Agbiz says account for 68% of the maize crop and 86% of the sunflower crop. Agbiz adds, "(t)he optimal maize planting window has already been closed, so even if sudden, widespread showers occurred, there would be minimal improvement in planting activity in these provinces." "The outlook on

Figure 17: Forecasts

Period end rate %	2017	2018	2019	2020	2021	2022	2023
Repo Rate (year-end: %)	6.75	6.75	7.00	7.00	7.00	7.00	7.00
Prime Overdraft Rate (year-end: %)	10.25	10.25	10.50	10.50	10.50	10.50	10.50
SA rand bond	9.02	9.20	8.78	9.23	8.65	8.56	8.56

Source: Investec

Figure 18: Decision tree for South Africa's 16th to 18th January 2018 MPC meeting



Key: squares are decision nodes, circles chance nodes and triangles end nodes. Source: Investec

food inflation will not change significantly in the near to medium term due to the buffer of large stocks from the previous season." However, this will not last and rain is desperately needed in many provinces, not just the Western Cape with crops in many areas already wilting. Without the hoped for La Nina to replenish soil moisture content upwards pressure on food inflation will return.

The SARB has communicated that while inflation is lower currently, it could well be temporary and a reduction in long-run inflation expectations would provide a better support for lower interest rates. Globally, a faster normalisation of interest rates than currently expected would erode risk-on sentiment, likely to the point of risk-off, which would likely result in marked rand weakness. The domestic currency is likely to remain volatile, with a weakening bias above PPP over the long-term. We expect the SARB may lift its GDP forecast fractionally from 1.2% for 2018 and 1.5% for 2019. Investec forecasts 1.3% y/y for 2018 and 1.7% y/y 2019. South Africa's actual economic growth is consequently expected to run at, or above the potential economic growth rate of just above 1.0% estimated by the SARB this year and next, which indicates the potential for some small, but growing demand led price pressures towards the end of the period. Wage growth is expected to remain elevated above the 6.0% upper limit of the inflation target range, and as such is expected to continue to place upward pressure on inflation expectations, while capacity utilisation pressures are expected to emerge in SA on a lift in the economic growth trajectory, given the deindustrialisation, and low rate of fixed investment growth which has been marked since 2009. With many factors pointing to some upwards pressure on SA's inflation, particularly towards next year, the scope for significant interest rate cuts appears limited, and the SARB could likely lift its H2.19 CPI inflation forecast (see figure 1).

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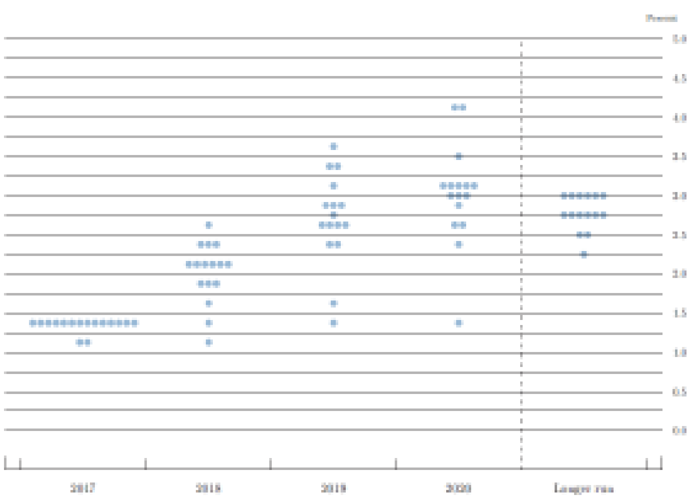
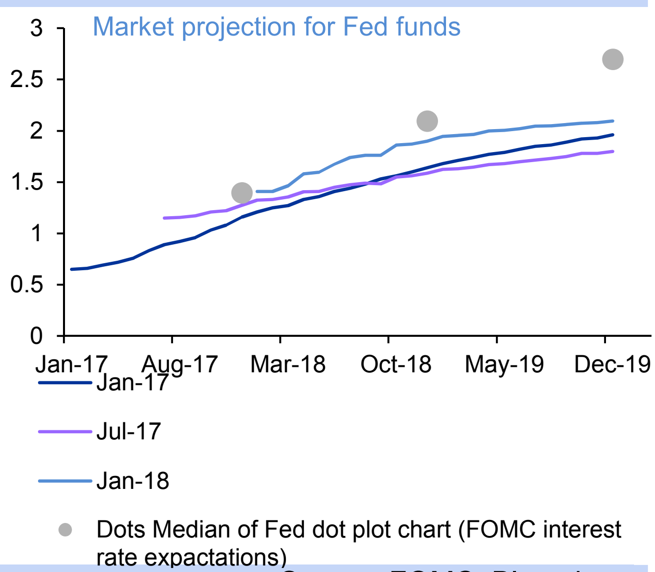
Figure 19: FOMC 2018 Meeting Schedule	
January 30th – 31st	July/Aug 31st – 1st
March 20th – 21st	September 25th 26th
May 1st - 2nd	November 7th – 8th
June 12th -13th	December 18th – 19th
	Source: Federal Reserve Bank

Figure 20: Forecast of international interest rates (%, end quarter)				
	US	Euro zone	Euro zone	UK
	Fed funds	Refi rate	deposit rate	Bank Rate
Current	1.25-1.50	0.00	-0.40	0.50
Q1.18	1.50-1.75	0.00	-0.40	0.25
Q2.18	1.50-1.75	0.00	-0.40	0.25
Q3.18	1.75-2.00	0.00	-0.40	0.25
Q4.18	1.75-2.00	0.00	-0.40	0.50
Q1.19	1.75-2.00	0.00	-0.40	0.50
Q2.19	2.00-2.25	0.00	-0.40	0.75
Q3.19	2.00-2.25	0.00	-0.40	0.75
Q4.19	2.00-2.25	0.00	-0.40	0.75
End year 2020	2.50	1.00	0.75	1.25
				Source: Reuters, Investec

Figure 21: Evolution of US interest rate expectations

FOMC interest rate expectations December 2017





Source: FOMC, Bloomberg

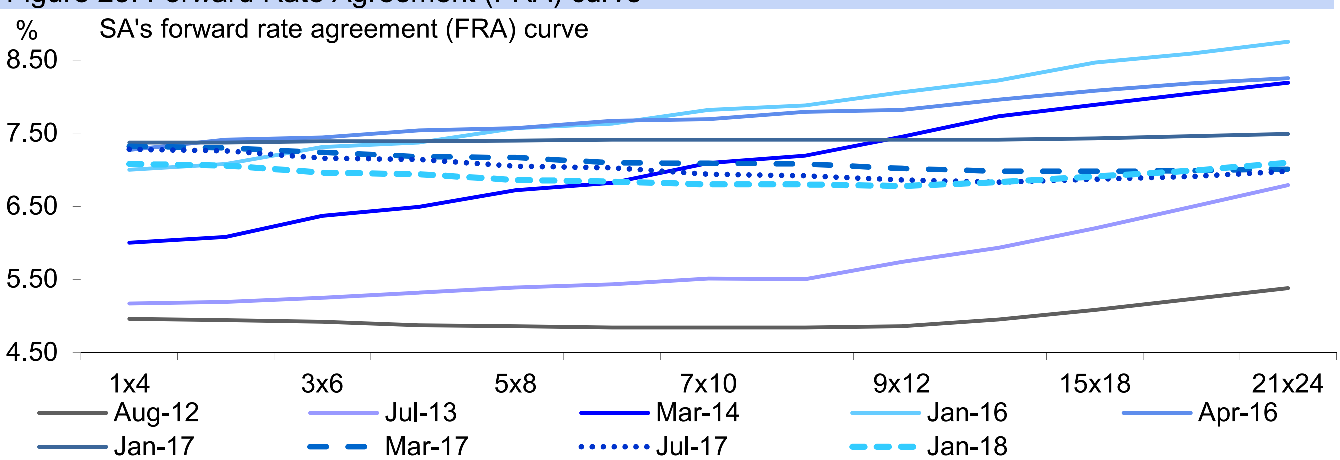
Note: in left graph each circle/dot is individual's judgement of appropriate fed funds rate per period

Figure 22: Interest rate forecast: end rates

Date	Prime forecast	Prime less Inflation	Repo	Repo less Inflation
Jan 2018	10.25	5.6	6.75	2.1
Feb 2018	10.25	5.8	6.75	2.3
Mar 2018	10.25	5.9	6.75	2.4
Apr 2018	10.25	5.7	6.75	2.2
May 2018	10.25	5.6	6.75	2.1
Jun 2018	10.25	5.5	6.75	2.0
Jul 2018	10.25	5.3	6.75	1.8
Aug 2018	10.25	5.2	6.75	1.7
Sep 2018	10.25	5.4	6.75	1.9
Oct 2018	10.25	5.3	6.75	1.8
Nov 2018	10.25	5.2	6.75	1.7
Dec 2018	10.25	5.2	6.75	1.7
Jan 2019	10.25	5.4	6.75	1.9
Feb 2019	10.25	5.3	6.75	1.8
Mar 2019	10.25	5.0	6.75	1.5
Apr 2019	10.25	5.1	6.75	1.6
May 2019	10.25	5.2	6.75	1.7
Jun 2019	10.25	5.3	6.75	1.8
Jul 2019	10.25	5.1	6.75	1.6
Aug 2019	10.25	4.8	6.75	1.3
Sep 2019	10.25	4.6	6.75	1.1
Oct 2019	10.25	4.5	6.75	1.0
Nov 2019	10.50	4.5	7.00	1.0
Dec 2019	10.50	4.5	7.00	1.0

Source: IRESS, Investec

Figure 23: Forward Rate Agreement (FRA) curve



Source: Reuters

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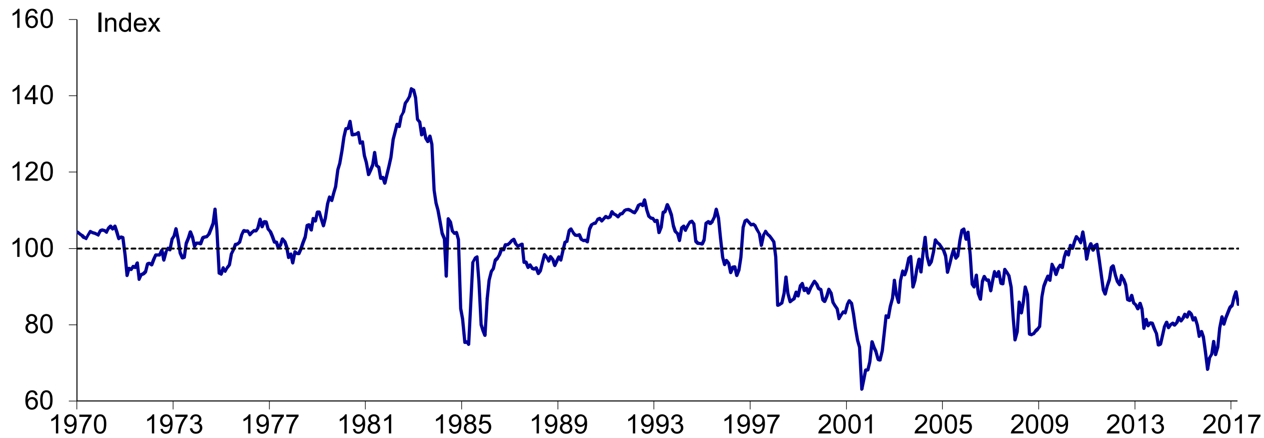
MPC preview: in this interest rate outlook we continue to expect no change in the repo rate this year, with CPI inflation above midpoint in the target period

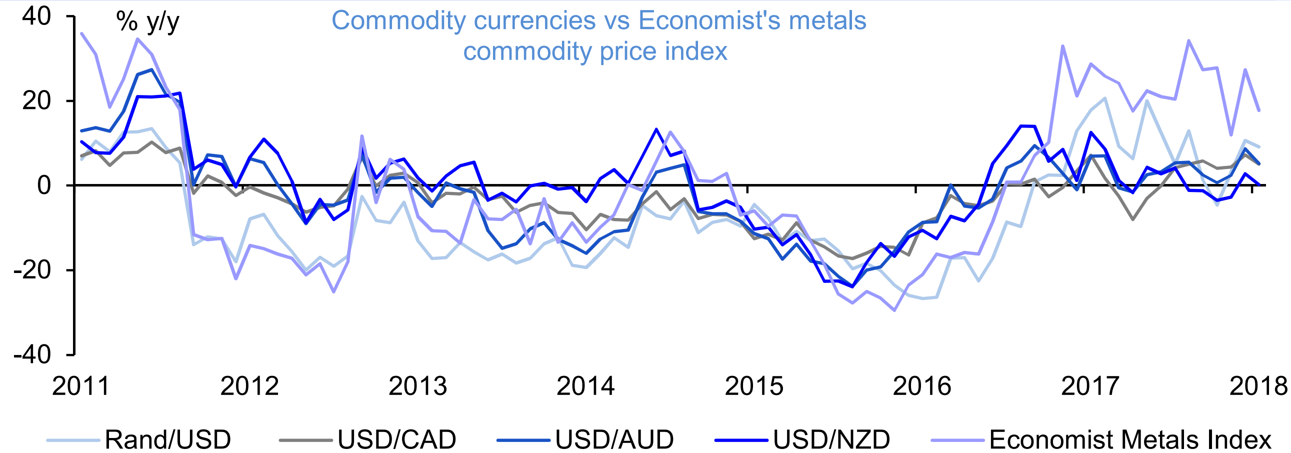
22nd May 2017

Figure 24: SA's real effective exchange rate



Source: Reserve Bank

Figure 25: Commodity currencies vs Economist's metals commodity price index



Source: IRESS

Figure 26: Inflation	2017	2018	2019	2020	2021	2022	2023
Consumer Inflation (Av: %)	5.3	4.8	5.3	5.5	5.4	5.5	5.4
(year-end: %)	*4.5*	*5.0*	*6.0*	*5.0*	*5.7*	*5.2*	*5.6*
Producer Inflation (Av: %)	4.9	4.3	4.4	5.1	5.4	5.5	5.5
(year-end: %)	*5.2*	*2.9*	*5.4*	*4.9*	*5.4*	*5.5*	*5.5*
Salary & wage increases (%)	6.7	6.5	6.6	7.0	6.9	7.2	7.3

Source: Investec

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Figure 27: CPI forecast averages

Date	Index Base 2010	Annual y/y	Monthly m/m	Quarterly y/y	Calendar year y/y		y/y	
Jan 2017	100.6	6.6	0.6					
Feb 2017	101.7	6.3	1.1					
Mar 2017	102.3	6.1	0.6	6.3			Mar 2016/17	6.2
Apr 2017	102.4	5.3	0.1					
May 2017	102.7	5.4	0.3					
Jun 2017	102.9	5.1	0.2	5.3				
Jul 2017	103.2	4.6	0.3					
Aug 2017	103.3	4.8	0.1					
Sep 2017	103.8	5.1	0.5	4.8				
Oct 2017	104.1	4.8	0.3					
Nov 2017	104.2	4.6	0.1					
Dec 2017	104.5	4.5	0.3	4.7	2017	5.3		
Jan 2018	105.2	4.6	0.7					
Feb 2018	106.2	4.4	0.9					
Mar 2018	106.7	4.3	0.5	4.5			Mar 2017/18	4.7
Apr 2018	107.0	4.5	0.3					
May 2018	107.5	4.6	0.4					
Jun 2018	107.8	4.8	0.3	4.6				
Jul 2018	108.3	5.0	0.5					
Aug 2018	108.5	5.1	0.2					
Sep 2018	108.9	4.9	0.3	5.0				
Oct 2018	109.2	4.9	0.3					
Nov 2018	109.4	5.0	0.2					
Dec 2018	109.7	5.0	0.3	5.0	2018	4.8		
Jan 2019	110.3	4.8	0.5					
Feb 2019	111.4	4.9	1.0					
Mar 2019	112.3	5.2	0.8	5.0			Mar 2018/19	4.9
Apr 2019	112.5	5.1	0.2					
May 2019	112.9	5.0	0.3					
Jun 2019	113.1	4.9	0.2	5.0				
Jul 2019	113.9	5.1	0.7					
Aug 2019	114.4	5.4	0.5					
Sep 2019	115.1	5.7	0.6	5.4				
Oct 2019	115.5	5.7	0.4					
Nov 2019	115.9	6.0	0.4					
Dec 2019	116.3	6.0	0.3	5.9	2019	5.3		

Source: Stats SA, Investec

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