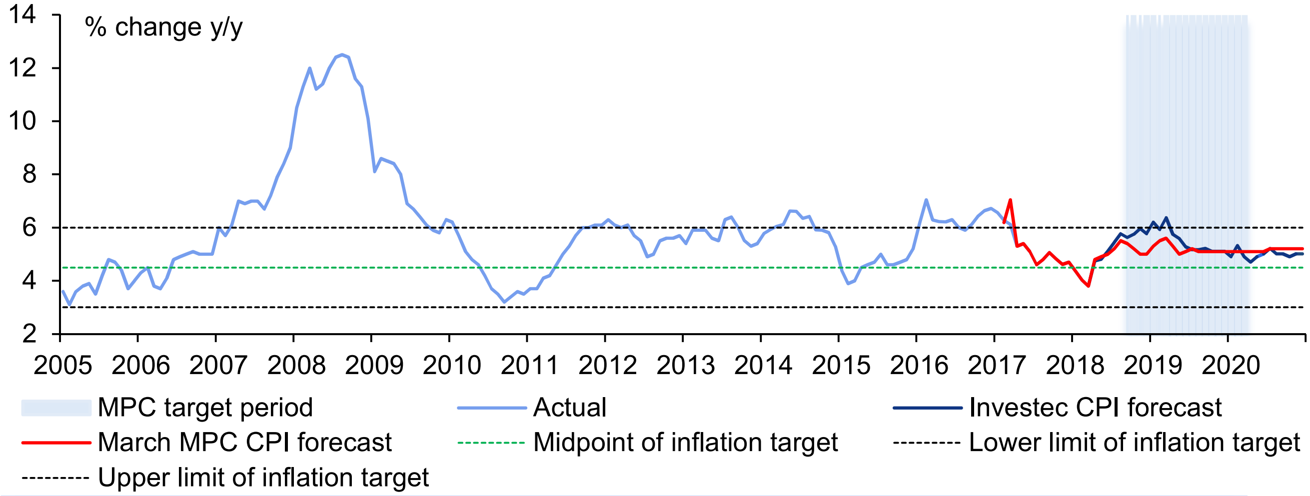
MPC preview: an unchanged interest rate decision is likely in May, with higher interest rates more likely in the longer term

17th May 2018

Figure 1: SA Consumer Inflation: history and forecasts



Source: Stats SA, SARB, Investec

Recent market volatility, and marked risk-off (heightened investor risk aversion), has seen foreigners particular sellers of rand equities and bonds, with the IIF showing that last week South Africa saw the biggest portfolio outflows compared to other EMs. Portfolio inflows on SA's capital account significantly finance the deficit on its current account, and so the rand remains very vulnerable to substantial global market swings. Currency weakness feeds through fairly soon into higher inflation for South Africa, and the trade weighted rand is currently 4.1% weaker than at the last MPC meeting, with particular weakness against the US dollar. The SARB will likely adjust its exchange rate forecast weaker (and oil higher) in its model, leading to higher inflation forecasts over its forecast period at its May MPC meeting. Volatility in financial market indicators is likely for most of the rest of the year, particularly in EMs (emerging markets). In particular, the IIF (Institute of International Finance) shows portfolio flows into EMs of US$2.5trillion since the global financial crisis and resultant very low global interest rate environment generally for developed economies. A reversal of even a significant part of these flows would likely cause severe depreciation of EM currencies. The US economy is indubitably in a rate hiking cycle, indicated out to 2020 by the FOMC (see figure 2). Globally, with economic growth running above its potential, (see "Macro-economic outlook 2018–2024: Global growth strengthens, for SA structural reforms are outstanding now the politics have subsided", 9th April, website address below), inflationary pressures are expected to emerge, placing some upwards pressure on US inflation from 2019, and so negatively impacting investor sentiment and EM currencies (see "Rand note: rand plunge towards the down case in late April temporary shift toward the down case, as global markets recalibrate US inflation (and interest rate) expectations). The risk for significant rand weakness is clear. With the SARB highly unlikely to be in an aggressive rate cutting cycle, we expect no change in the repo rate at the May MPC

Figure 2: Forecasts

Period end rate %	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Repo Rate	6.50	6.50	6.50	6.50	7.00	7.00	7.00	7.00
Prime Overdraft Rate	10.00	10.00	10.00	10.00	10.50	10.50	10.50	10.50

Source: IRESS, Investec

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MPC preview: an unchanged interest rate decision is likely in May, with higher interest rates more likely in the longer term

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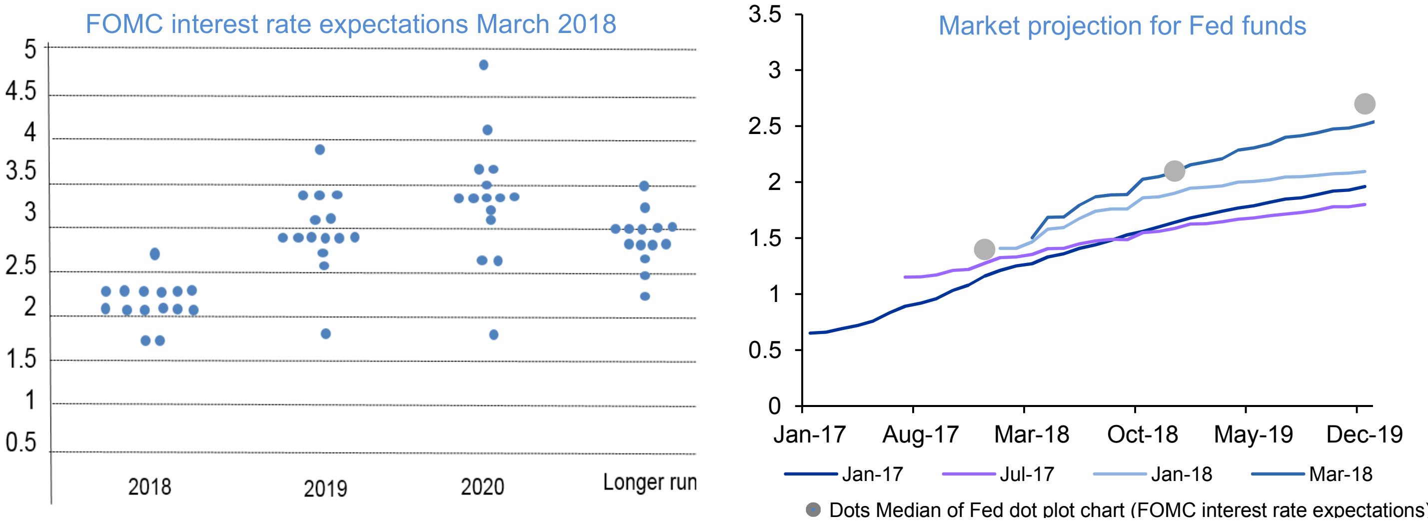
Figure 3: Evolution of US interest rate expectations



Source: FOMC, Bloomberg

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

Figure 4: FOMC 2018 Meeting Schedule

June 12th -13th	November 7th – 8th
July/Aug 31st – 1st	December 18th – 19th
September 25th 26th	

Source: Federal Reserve Bank

Figure 5: Forecast of international interest rates (%, end quarter)

	US Fed funds	Euro zone Refi rate	Euro zone deposit rate	UK Bank Rate
Current	1.50-1.75	0.00	-0.40	0.50
Q1.18	1.50-1.75	0.00	-0.40	0.50
Q2.18	1.75-2.00	0.00	-0.40	0.75
Q3.18	2.00-2.25	0.00	-0.40	0.75
Q4.18	2.25-2.50	0.00	-0.40	1.00
Q1.19	2.50-2.75	0.00	-0.40	1.00
Q2.19	2.75-3.00	0.00	-0.20	1.25
Q3.19	2.75-3.00	0.25	0.00	1.25
Q4.19	2.75-3.00	0.50	0.25	1.25
End year 2020	2.75-3.00	1.00	0.75	1.50

Source: Macrobond, Investec

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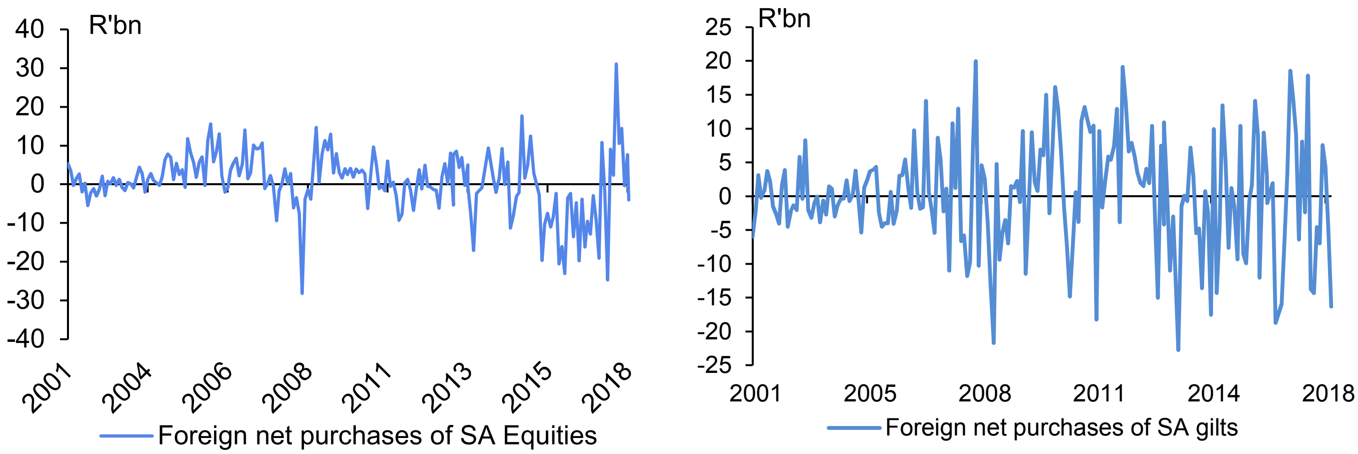
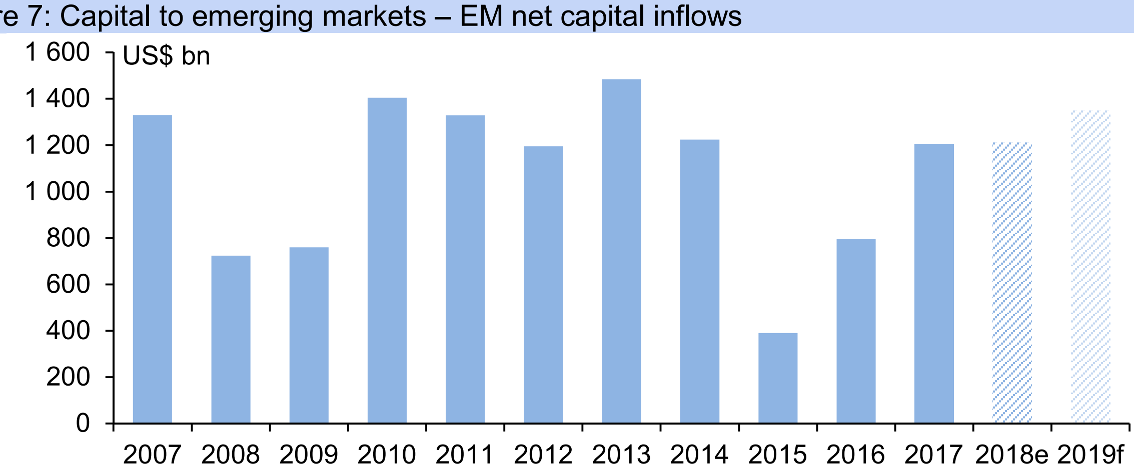
Figure 6: Foreign net purchases(+) /sales(-) of SA equities and bonds



Source: IRESS

meeting. While our expected case is that the rand could see some minor strength this year, the risks to the downside are real, and growing (see figure 8 where we have changed the probabilities of the scenarios to have an increased tilt to the downside on the perceived rise in riskiness of global events that could have a negative impact on SA, particularly from a rand view, and so inflation and interest rates view). The World Bank says in its latest Commodity Markets Outlook that "(l)ooking ahead, policy actions currently under discussion, such as additional tariffs, production cuts, and sanctions, present risks to the short-term outlook." The down and extreme down scenario cases have increased relevancy, both due to the risks of international and domestic shocks (see Rand outlook: Trade (and other) wars, Trump and the Fed funds hike trajectory - the US continues to influence the outlook for the rand", 13th April 2018). International shocks in the down case include the risk of an escalation either in a US-led

Figure 7: Capital to emerging markets – EM net capital inflows



Source: IIF

Figure 8: Economic Scenarios – note updated probabilities

Extreme Up case 1%

	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Rand/USD (average)	11.96	10.75	10.00	9.50	9.00	8.60	7.90	7.60
Repo rate (end rate)	6.50	6.00	5.50	5.25	5.00	5.00	5.00	4.50

Fast, sustainable economic growth of 5.0-7.0% y/y plus. SA sees change in political will with growth creating economic reforms in line with global norms that structurally lift private sector investor confidence and so fixed investment. Global growth boom (including commodities), SA export and domestic growth boom lifts employment and incomes to the degree that poverty is eliminated. Fiscal consolidation, credit rating upgrades to A grade ultimately, interest rate cuts.

Up case 12%

	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Rand/USD (average)	11.96	11.15	10.70	10.50	10.50	10.30	10.25	10.20
Repo rate (end rate)	6.50	6.25	6.00	5.50	5.50	5.25	5.25	5.25

Persistent economic growth of 3.0 – 5.0%, with growing probability of extreme up case thereafter. Better governance, growth creating economic reforms in line with global norms (structural constraints are overcome) and greater socio-economic stability. This lifts business confidence and so private sector fixed investment growth rises to double digits, fixed investment inflows occur, resulting in faster GDP growth and fiscal consolidation. Strong global growth and commodity cycle. Stabilisation of credit ratings, with ultimately credit rating upgrades.

Base line case 45%

	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Rand/USD (average)	11.96	12.32	12.40	12.30	12.25	12.10	12.15	12.15
Repo rate (end rate)	6.50	6.50	6.50	6.50	7.00	7.00	7.00	7.00

Annual growth rate of 2.0% y/y reached by 2018, 3.5% y/y by 2024. Higher confidence and investment levels than past decade. Rand structurally stronger on political change, quicker return to PPP (by 2020). SA retains one investment grade (Moody's) rating on its local currency long-term sovereign debt this year. Sedate global monetary policy normalisation – avoid severe global risk-off environment, neutral to global risk-on. Modestly strengthening global demand.

Down case 26%

	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Rand/USD (average)	11.96	13.50	14.90	15.80	16.90	17.00	16.50	15.50
Repo rate (end rate)	6.50	7.00	7.50	8.00	8.50	8.50	8.50	8.50

Partial loss of private sector property rights (land) under state custodianship without compensation, widescale land grabs. Confidence and investment depressed, marked rand weakness. SA sub-investment grade, increased chance of further credit downgrades. Faster than expected global monetary policy normalisation, global sharp economic slowdown (commodity slump), escalation of US-China trade war, short global financial crisis (SA V shaped recession).

Extreme down case 16%

	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19
Rand/USD (average)	11.96	14.50	17.00	19.00	21.00	22.80	24.00	25.50
Repo rate (end rate)	6.50	8.50	10.50	14.00	16.50	18.00	21.00	21.50

Loss of private sector property (assets and land) rights under state custodianship without compensation. Credit ratings drop to junk, sovereign debt default (restructure), state bankruptcy - a failed state. Partial to no payment of public sector employees' wages and social grants, persistent government services outages, civil unrest/war. Global economy falls into recession, severe global trade war, severe lengthy global financial crisis, WW3, SA economic depression.

Note: Event risk begins Q2.18. Source: IRESS, Investec Annabel Bishop

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Figure 9: Reuters April 2018 Econometer poll: Repo rate end period %

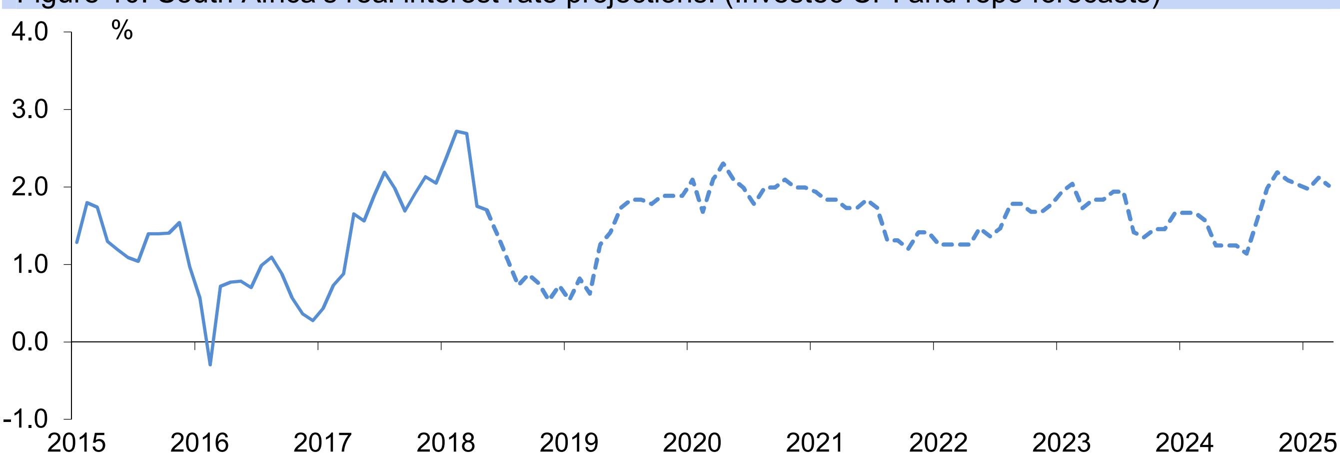
Forecast period	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19	2019	2020
Median	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.63
Highest forecast	6.76	6.75	6.75	7.00	7.00	7.00	7.00	6.75	7.25
Lowest forecast	6.25	6.00	6.00	6.00	5.50	5.00	5.00	5.00	5.00
No. of forecasts	14	17	17	17	17	16	17	19	18

Source: Reuters

trade war with China, or in geo-political conflict (Syria-Russia–US,UK), or both, as well as the risk of a faster than anticipated upwards trajectory in US interest rate hikes, or a global financial crisis. The extreme down case (as with the extreme up case) is one of more extreme events than in the down (up) case. EMs are likely to be increasingly vulnerable to marked currency weakness as a reflationary (rising inflation) environment increasingly comes to the fore globally, particularly for DMs (developed economies). It should be noted though that US monetary policy is not expected to be tightened this year or in the next couple of years, but rather return to neutral levels instead on interest rate hikes. So a reduction, and then elimination of extremely stimulatory monetary policy, is envisaged, as opposed to an actual tightening in US monetary policy. Indeed, as figure 3 shows, FOMC rate hike forecasts are expected to approach their neutral level in 2020, then retreat somewhat in the longer term. In this environment it is difficult to picture further interest rate cuts for South Africa, and so the SARB instead is likely to eventually return the repo rate to a more neutral level (see figure 10).

We continue to maintain that the benchmark US treasury (10 year bond) will likely move above 3.0% this year on a more permanent basis, and indeed begin approaching 4.0% (rising further) from as early as the second half of this year into 2019. Higher US market interest rates are likely to stimulate further inflows into the US and so portfolio outflows out of EMs, sparking EM currency weakness, and so in turn contributing to global inflation pressures.

Figure 10: South Africa's real interest rate projections: (Investec CPI and repo forecasts)

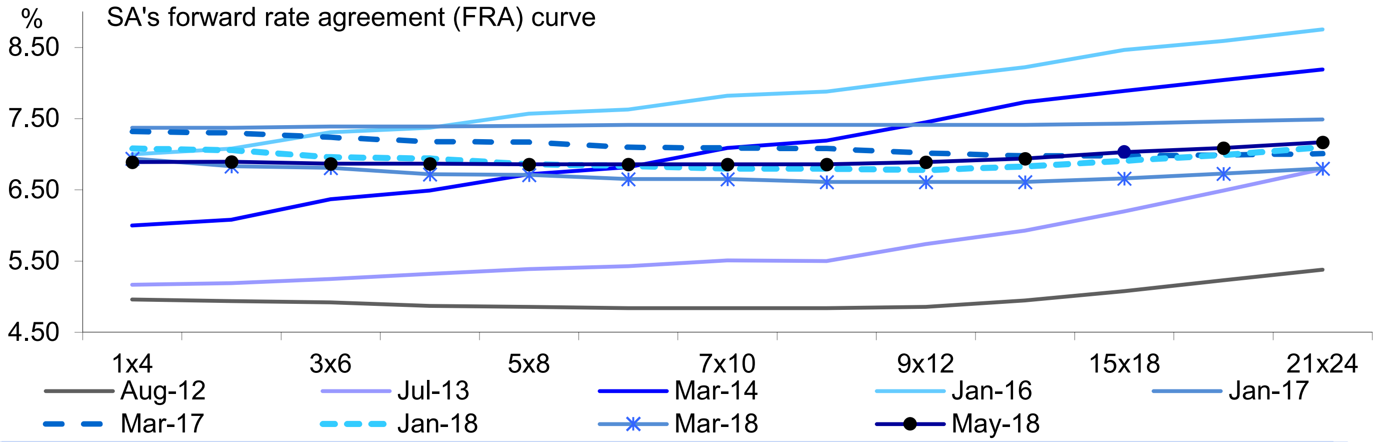


Source: Investec, IRESS

MPC outlook: the tone is likely to have become more dovish now Moody's has upgraded SA's outlook to stable with no rating change

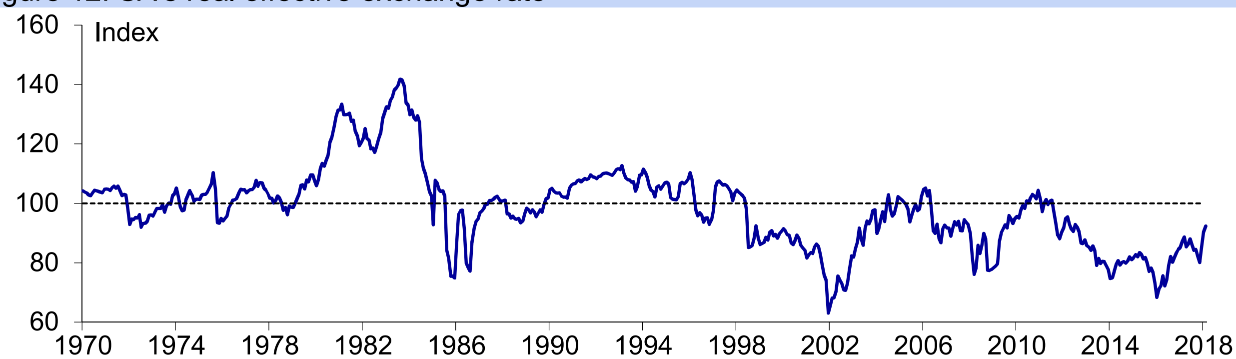
17th May 2018

Figure 11: Forward Rate Agreement (FRA) curve



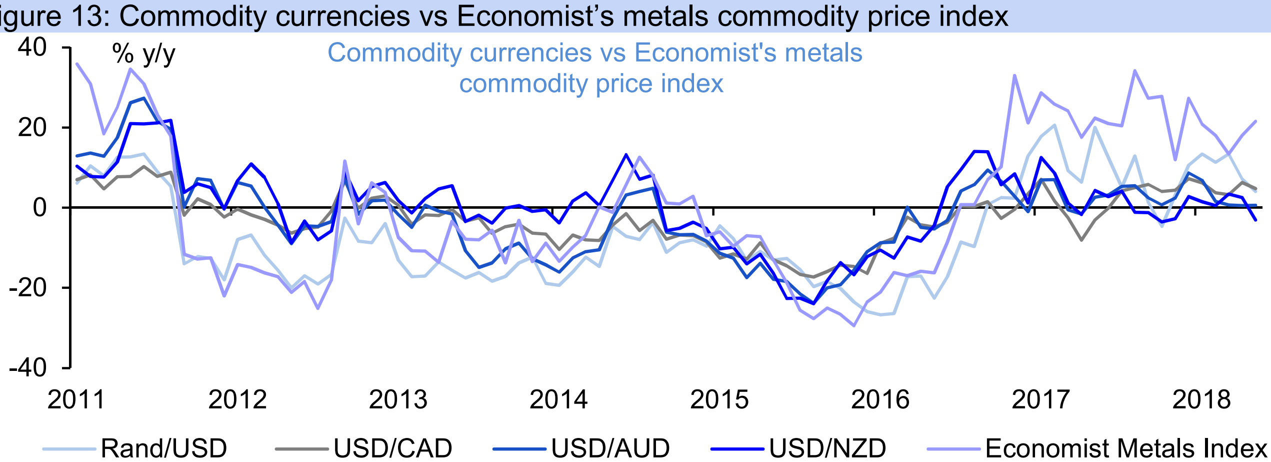
Source: Reuters

Figure 12: SA's real effective exchange rate



Source: Reserve Bank

Figure 13: Commodity currencies vs Economist's metals commodity price index



Source: IRESS

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Figure 14: Reuters April 2018: Econometer poll: SARB GDP end period											
Forecast period	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	2018	2019	2020	2021
Median	1.3	1.8	1.7	1.8	1.7	1.9	2.0	2.2	1.9	1.9	2.3
Highest forecast	2.2	2.5	2.3	3.8	2.6	4.5	2.6	4.0	2.3	2.9	3.5
Lowest forecast	-1.2	1.3	0.4	1.4	-0.4	0.8	0.5	1.5	1.3	1.5	1.5
No. of forecasts	13	14	14	14	14	14	14	13	20	20	18
											Source: Reuters

In South Africa, almost a R2.00/litre hike in the petrol price is indicated for April to June, which will place significant upward pressure on consumer price inflation in those months. Indeed, with the oil price reaching US$80/bbl today, and the rand at R12.57/USD, R14.81/EUR and R16.95/GBP, and with the oil price and exchange rates unlikely to dramatically drop in the week ahead, it is unlikely the MPC will see fit to cut interest rates in May. The FRA curve currently has a relatively flat outlook for this year and next, with only a mild possibility of a 25bp cut in the repo rate at the end of this year.

Indeed, a rate cut (at the May MPC meeting – not expected) so soon after the March MPC meeting would signal a more aggressive interest rate cut cycle that the SARB likely would be comfortable with. The World Bank adds that "Meanwhile production has been held back for several commodity- specific reasons, including continued OPEC and non-OPEC oil production restraint, measures by China to reduce polluting metals and energy production, and lower grain planting intentions in the United States. Concerns about mounting geopolitical tensions have lifted oil and some precious metals prices." South Africa remains an oil importer, and higher rand oil prices translate through into higher petrol prices fairly immediately, and so higher inflation in that month, due to the survey methodology of CPI. However, as the World Bank notes, still from its Commodities Market Outlook, "(t)he rise in prices has supported a recovery in U.S. shale production, with total crude production increasing by more than 1.1mb/d in January 2018 relative to the previous year", which should provide some limit to the pace of upwards ascent of oil prices. Further in its report, the World Bank says "(m)ore than half of commodity prices (and all non-coal energy prices) are expected to increase in 2018 but four-fifths of them will remain below their 2011 peaks. Energy prices are forecast to rise 20 percent in 2018—a 16 percentage point upward revision from October 2017—and stabilize in 2019".

Indeed the World Bank warns "(h)igher oil prices are expected to eventually feed into higher natural gas prices while coal prices will continue to decline as energy demand shifts towards less polluting sources. Upside risks to the forecasts include potential supply losses arising from geopolitical events, a deterioration in República Bolivariana de Venezuela, deeper cuts by OPEC and non-OPEC

Figure 15: SA Monetary Policy Committee (MPC) meeting dates for 2018		
Month	Date	Forecast
May 2018	22nd – 24th	6.50
July 2018	17th – 19th	6.50
September 2018	18th – 20th	6.50
November 2018	20th – 22nd	6.50
		Source: SA Reserve Bank, Investec

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Figure 16: 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	104.7	4.7	0.5	4.7	2017	5.3		
Jan 2018	105.0	4.4	0.3					
Feb 2018	105.8	4.0	0.8					
Mar 2018	106.2	3.8	0.4	4.1			Mar 2017/18	4.7
Apr 2018	107.3	4.7	1.0					
May 2018	107.6	4.8	0.4					
Jun 2018	108.2	5.1	0.5	4.9				
Jul 2018	108.8	5.5	0.6					
Aug 2018	109.3	5.8	0.4					
Sep 2018	109.6	5.6	0.4	5.6				
Oct 2018	110.1	5.7	0.4					
Nov 2018	110.4	6.0	0.3					
Dec 2018	110.7	5.8	0.3	5.8	2018	5.1		
Jan 2019	111.5	6.2	0.7					
Feb 2019	112.1	5.9	0.5					
Mar 2019	113.0	6.4	0.8	6.2			Mar 2018/19	5.7
Apr 2019	113.4	5.7	0.4					
May 2019	113.7	5.6	0.2					
Jun 2019	113.9	5.3	0.2	5.5				
Jul 2019	114.4	5.2	0.5					
Aug 2019	114.9	5.2	0.4					
Sep 2019	115.4	5.2	0.4	5.2				
Oct 2019	115.7	5.1	0.3					
Nov 2019	116.1	5.1	0.3					
Dec 2019	116.4	5.1	0.3	5.1	2019	5.5		

Source: Stats SA, Investec

Figure 17: Reuters Apr 2018 Econometer poll: SARB CPI, unadjusted % ch y/y, average for period										
Forecast period	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19	Q4.19	2018	2019	2020
Median	4.9	5.3	5.1	5.4	5.1	5.1	5.2	4.9	5.2	5.3
Highest forecast	5.2	5.7	5.5	5.8	5.6	5.9	6.0	5.2	5.7	5.8
Lowest forecast	3.5	3.6	3.9	3.6	3.6	3.2	2.5	3.7	3.3	4.1
No. of forecasts	15	15	15	15	15	15	15	20	20	18
										Source: Econometer

countries or an extension of the agreement to a longer term horizon. Conversely, a weakening of the agreement, or further efficiency gains among U.S. shale producers could depress prices."

For South Africa 2019 is likely to see CPI inflation average 5.5% y/y, close to the upper limit of the inflation target in the MPC's forecast period. This should scupper any chance of an interest rate cut at the upcoming MPC meeting at the end of this month. The very real risk remains that the oil price could rise materially further (see "Oil note: rising oil prices and rand weakness spells higher petrol prices and inflation for SA, disincentivising for an interest rate cut at the next MPC meeting", 9th May 2018). Exogenous shocks, such as a sharp rise in the rand oil price tend not to lead to interest rate hikes, unless the rise is sustained and feeds into consumer price increases, i.e. develops into second round effects. With likely close to a R2.00/litre hike in the petrol price before mid-2018, retailers could already be considering the cost effects of such transport increases. Currently a 74c/litre hike in the petrol price ss now building for June, with a risk of similar material hikes in H2.18. A markedly higher petrol price resulting in higher inflation (if these petrol price hikes are not reversed), will feed through into a higher start point for inflation in 2019, likely raising the inflation rate in 2019, from a current forecast of 5.2% y/y. This forms a crucial part of the MPC's inflation targeting period of six to twenty four months, but particularly twelve to twenty four months, and we expect the MPC's inflation forecast to rise towards 5.5% y/y for 2019, with some smaller upwards pressure on its 2020 CPI forecast. The second and third quarter in any case is the US summer vacation/driving season, and with the oil market already tight, and uncertainty has risen somewhat over oil supplies meeting demand in the next few months, and price pressure is likely to be on the upside for this commodity. This is likely to place upwards pressure on oil prices and so SA's inflation as outlined above.

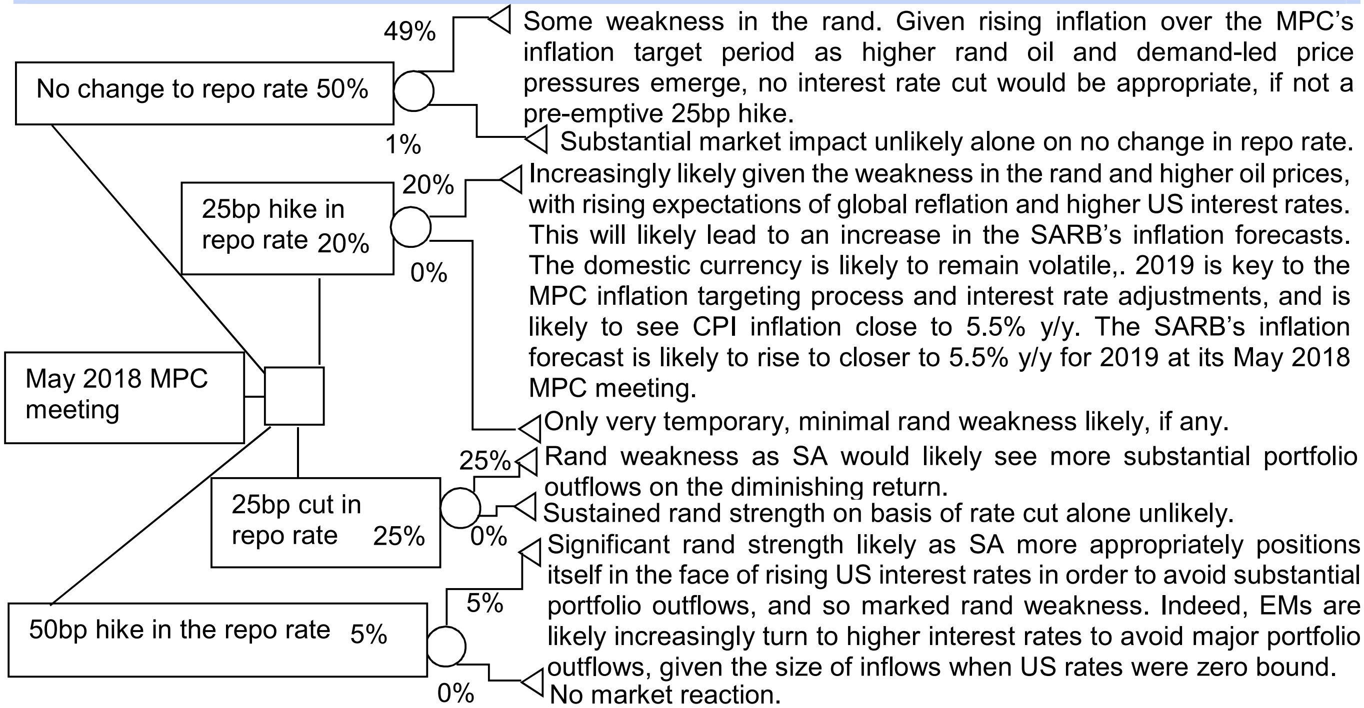
Figure 18: Inflation forecasts	2017	2018	2019	2020	2021	2022	2023
Consumer Inflation (Av: %)	5.3	5.1	5.5	5.0	5.4	5.5	5.4
(year-end: %)	*4.7*	*5.8*	*5.1*	*5.0*	*5.6*	*5.2*	*5.6*
Producer Inflation (Av: %)	4.9	4.3	5.0	5.4	5.1	5.2	5.3
(year-end: %)	*5.2*	*3.8*	*5.1*	*5.4*	*4.7*	*5.5*	*4.9*
Salary & wage increases (%)	6.5	6.5	6.9	6.9	6.9	7.2	7.3
							Source: Investec

Figure 19: Interest rate forecast: end rates

Date	Prime forecast	Prime less Inflation	Repo	Repo less Inflation
Jan 2018	10.25	5.9	6.75	2.4
Feb 2018	10.25	6.2	6.75	2.7
Mar 2018	10.00	6.2	6.50	2.7
Apr 2018	10.00	5.3	6.50	1.8
May 2018	10.00	5.2	6.50	1.7
Jun 2018	10.00	4.9	6.50	1.4
Jul 2018	10.00	4.5	6.50	1.0
Aug 2018	10.00	4.2	6.50	0.7
Sep 2018	10.00	4.4	6.50	0.9
Oct 2018	10.00	4.3	6.50	0.8
Nov 2018	10.00	4.0	6.50	0.5
Dec 2018	10.00	4.2	6.50	0.7
Jan 2019	10.25	4.0	6.75	0.5
Feb 2019	10.25	4.3	6.75	0.8
Mar 2019	10.50	4.1	7.00	0.6
Apr 2019	10.50	4.8	7.00	1.3
May 2019	10.50	4.9	7.00	1.4
Jun 2019	10.50	5.2	7.00	1.7
Jul 2019	10.50	5.3	7.00	1.8
Aug 2019	10.50	5.3	7.00	1.8
Sep 2019	10.50	5.3	7.00	1.8
Oct 2019	10.50	5.4	7.00	1.9
Nov 2019	10.50	5.4	7.00	1.9
Dec 2019	10.50	5.4	7.00	1.9
Jan 2020	10.50	5.6	7.00	2.1
Feb 2020	10.50	5.2	7.00	1.7
Mar 2020	10.50	5.6	7.00	2.1
Apr 2020	10.50	5.8	7.00	2.3
May 2020	10.50	5.6	7.00	2.1
Jun 2020	10.50	5.5	7.00	2.0
Jul 2020	10.50	5.3	7.00	1.8
Aug 2020	10.50	5.5	7.00	2.0
Sep 2020	10.50	5.5	7.00	2.0
Oct 2020	10.50	5.6	7.00	2.1
Nov 2020	10.50	5.5	7.00	2.0
Dec 2020	10.50	5.5	7.00	2.0

Source: IRESS, Investec

Figure 20: Decision tree for South Africa's 22nd to 24th May 2018 MPC meeting



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

The largest component of the CPI inflation basket is food in SA, and Agbiz notes that "South Africa's 2018/19 maize supplies are in good shape, estimated at 16.4 million tonnes, well above annual consumption of 10.7 million tonnes, according to data from the national Supply and Demand Estimates Committee. This includes both the expected harvest from the current production season, as well as large opening stock form the previous season." This could provide some respite from higher hard commodity and oil prices, but the alleviation is likely to be modest in comparison. Indeed, in the current environment and outlook, the SARB is likely to find it hard to cut interest rates again this year or next, particularly as US interest rates return to neutral levels. Indeed, the next interest rate move from the MPC could well be up – we forecast increases in the repo rate so that it can return to a more neutral level (see figure 19) as we have revised up the forecasts in the later years given out long-term inflation forecast is around 5.5% y/y.

Figure 21: Forecasts

Period end rate %	2018	2019	2020	2021	2022	2023	2024
Repo Rate (year-end: %)	6.50	7.00	7.00	7.00	7.00	7.25	7.25
Prime Overdraft Rate (year-end: %)	10.00	10.50	10.50	10.50	10.50	10.75	10.75

Source: Investec

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