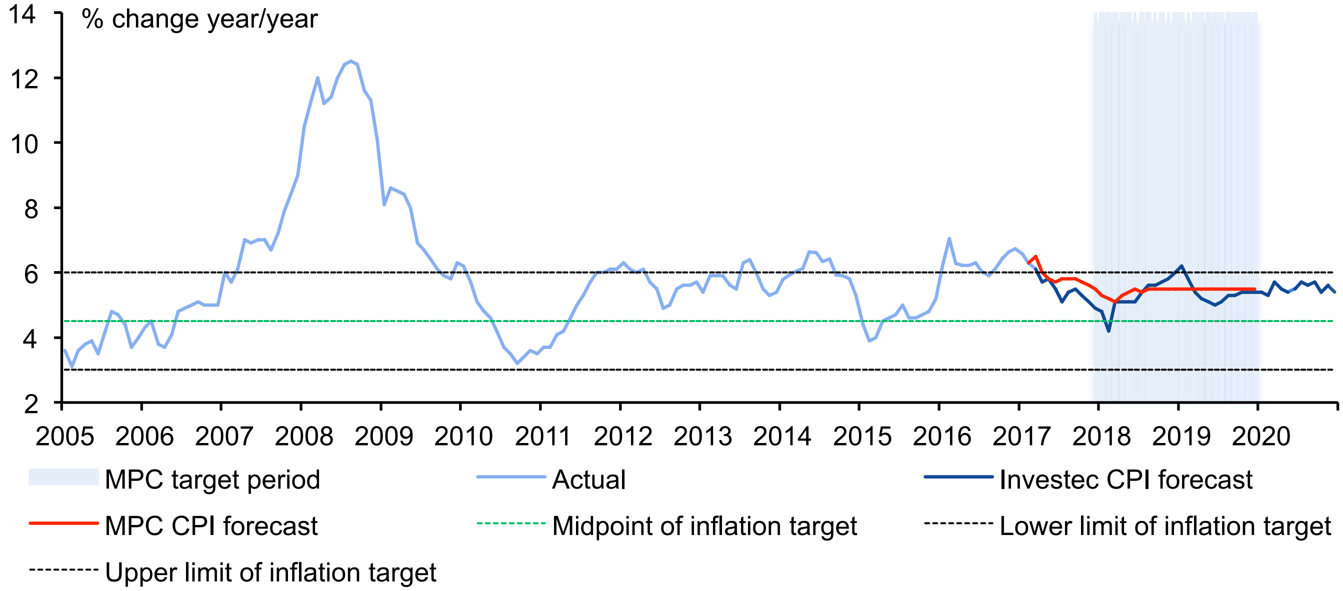
MPC preview: in this interest rate outlook we continue to expect no change in the repo rate this year, with CPI inflation above midpoint in the target period

23rd May 2017

Figure 1: SA Consumer Inflation: history and forecasts



Sources: Stats SA, Investec, SARB

The Monetary Policy Committee (MPC) meets this week and is expected to leave the repo rate unchanged at 7.00%. The recent credit rating downgrades are not expected to precipitate an interest rate hike in South Africa this year, with the impact on the rand and bonds proving limited in the global risk-on environment (see “Rand outlook: while global risk-on counteracted much of the immediate impact of the downgrades, the rand will likely remain volatile going forward”, 2nd May 2017, website address below). Foreigners have favoured local currency emerging market (EM) debt given the lower yields in developed economies, particularly the Euro area and the rand’s post-downgrade strength reflected the continuation of this global risk-on appetite, with SA still attractive in this respect as the country retains two investment grade ratings on its local currency denominated long-term sovereign debt. The rand itself is ‘undervalued’ both on a fair value (or purchasing power parity, i.e. PPP) and real effective exchange rate basis, and could have room for some further, limited strength over the medium-term, amidst likely volatility.

CPI inflation is waning and is expected to fall to 5.0% this year on some alleviation of the drought (see “Economic outlook 2017 – 2022: South Africa’s economic growth likely to remain below that of both sub-Saharan Africa and world growth, 12th May 2017), with a bumper crop anticipated, although some areas

Forecasts

Period end rate %	Q1.17	Q2.17	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18
Repo Rate	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.25
Prime Overdraft Rate	10.50	10.50	10.50	10.50	10.50	10.50	10.50	10.75
SA rand bond	8.60	8.80	8.94	8.91	8.61	8.70	8.80	8.71

Source: IRESS, Investec

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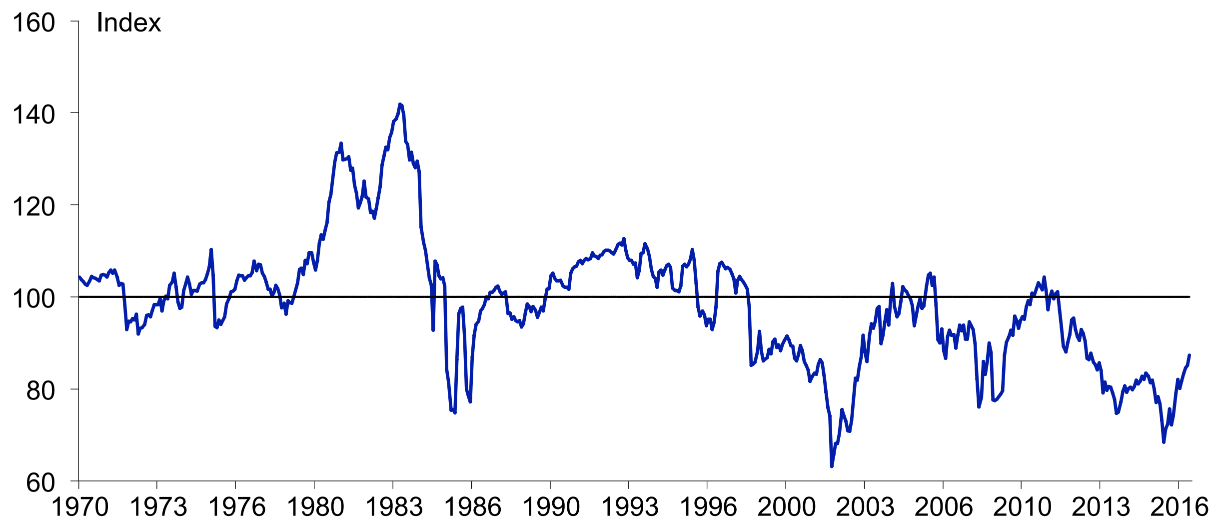
MPC preview: in this interest rate outlook we continue to expect no change in the repo rate this year, with CPI inflation above midpoint in the target period

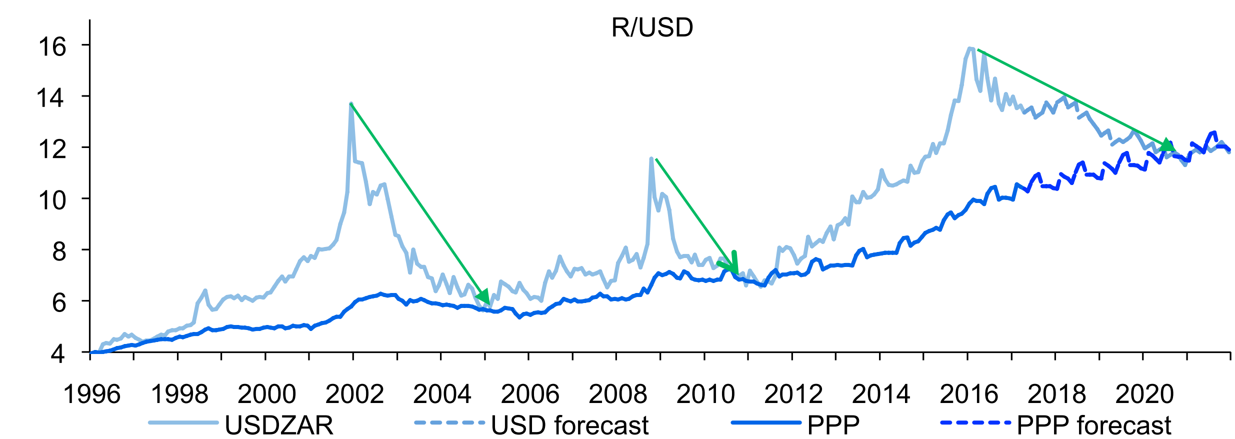
23rd May 2017

Figure 3: SA's real effective exchange rate



Source: Reserve Bank

Figure 4: PPP value of the Rand vs USD



Source: Investec, IRESS

Figure 5: Reuters May 2017 Econometer poll: Repo rate

Forecast period	Q2.17	Q3.17	Q4.17	Q1.16	Q2.18	Q3.18	2017	2018	2019
Median	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Highest forecast	7.00	7.25	7.50	7.50	7.50	7.50	7.50	7.50	7.50
Lowest forecast	7.00	6.75	6.75	6.50	6.50	6.50	6.50	6.25	6.25
No. of forecasts	25	25	25	22	22	21	25	25	16

Source: Reuters

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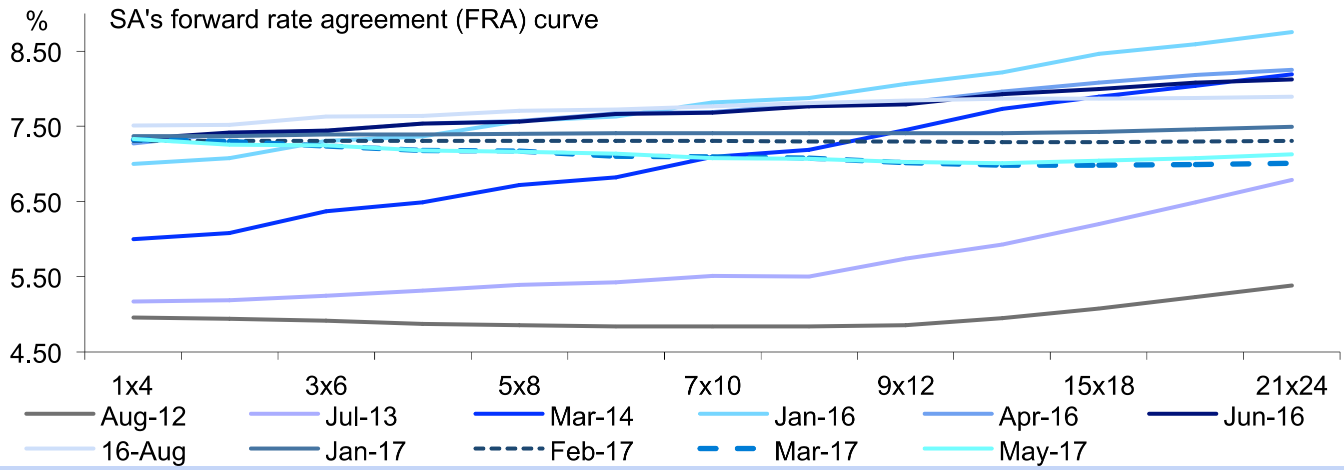
Figure 6: Forward Rate Agreement (FRA) curve

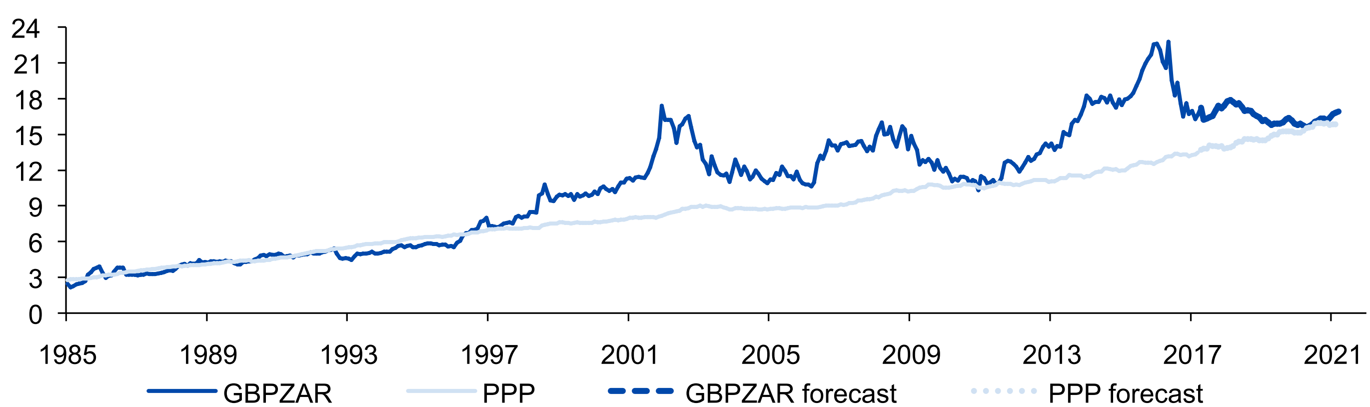


Source: Reuters

are yet to have meaningful relief, and will likely take more than a year to recover due not least to farm debt. Even if rain relief comes to the regions, meat price inflation will battle to recover in particular. El Nino (drought) remains a risk for year end. Agbiz has stated that the "overall summer crop production is estimated at 16.9 million tonnes, which is an 80% annual increase", "(t)he most notable increases are in maize and soybeans. Total maize production is estimated at 14.5 million tonnes, which is the second-biggest crop on record after 1980/81 season. Soybeans are set to be the biggest on record, estimated at 1.2 million tonnes." Consequently, our inflation forecasts fall, but not permanently (see figure 1).

The SARB is also pencilling in further credit rating downgrades as a high risk for rand weakness. However, commodity prices are believed to have stabilised for the next two years (see figure 8) which will be a positive for the rand (if we avoid further credit rating downgrades). We see a 50/50 chance of further

Figure 7: PPP value of the Rand vs GBP



Source: Investec, IRESS

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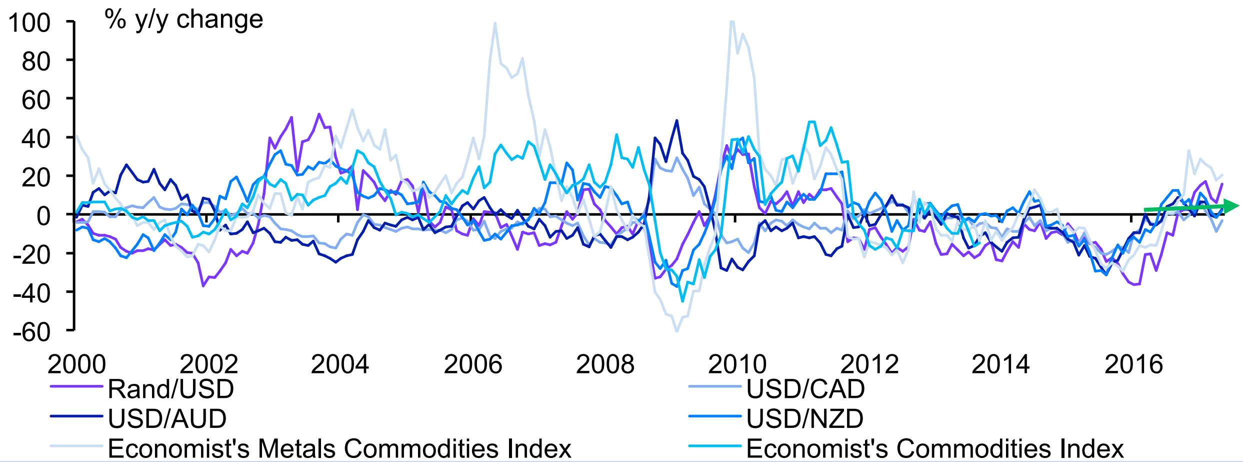
Figure 8: Commodity currencies vs Economist's metals commodity price index



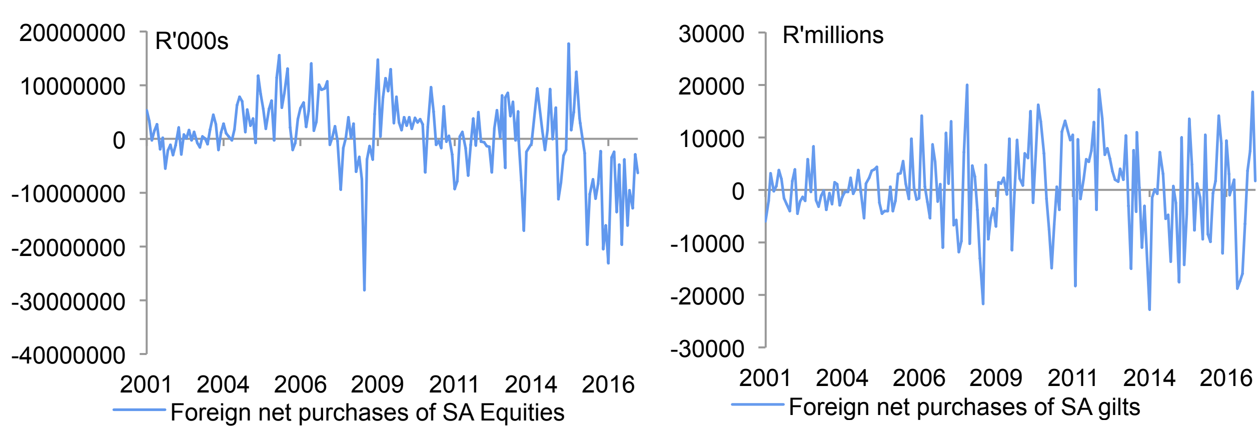
Source: IRESS

Figure 9: SARB's CPI inflation forecasts (% y/y)

	2016	2017	2018	2019
SARB 30th March 2017		5.9	5.4	5.5
SARB 24th January 2017	6.4	6.2	5.5	
SARB 24th November 2016	6.4	5.8	5.5	
SARB 22nd September 2016	6.4	5.8	5.5	
SARB 21st July 2016	6.6	6.0	5.5	
SARB 19th May 2016	6.7	6.2	5.4	
SARB 17th March 2016	6.6	6.4	5.5	
SARB 28th January 2016	6.8	7.0		

Source: SA Reserve Bank

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



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Source: IRESS

Figure 11: Reuters May 2017 Econometer poll: SARB CPI, unadjusted % ch y/y, average for period									
Forecast period	Q2.17	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	2017	2018	2019
Median	5.7	5.5	5.3	5.2	5.3	5.6	5.7	5.5	5.4
Highest forecast	6.1	6.0	5.8	5.8	5.9	6.0	6.3	7.1	6.0
Lowest forecast	5.4	5.0	4.5	4.3	4.7	5.1	5.2	5.0	5.1
No. of forecasts	17	17	17	17	17	16	25	25	15

Source: Econometer

sub-investment (SG) downgrades to SA's local currency (LC) long-term sovereign debt (LSD) as the down and expected cases are equally weighted (see "Risk update: probability of extreme down case rises to 19%, up case drops to 10% on downgrades, baseline case weaker growth and rand", 18th May 2017). On the topic of probability scenarios it should be noted that previous fears of heightened strike action and electricity blackouts (that prevailed in 2014 see "Macro-economic update and outlook", 4th August 2014) have reduced with the improved working relationship between business, labour and government on the former, and new power station builds on the latter, with incoming units from Ingula, Medupi and renewable energy, along with the first unit from Kusile expected this year, and the possibility of Inga dam in the future (see "Electricity update: production improvement with unit synchronised to grid", 31st March 2016).

However, tariff increases from SOE's are likely to elevate the inflation outlook in the medium-term. On this note, while the electricity tariff appears set for about a 2% y/y increase this year, previous high increases and the utility's need for funding will likely see upward pressure from this source potentially as early as next year. The MPC targets inflation around six to twenty four months out, and so will be watching the factors influencing next year's figures instead. With CPI inflation rising to 5.5% average next year this likely precludes any interest rate cuts this year.

While we are not expecting any substantial adjustment in the SARB's CPI inflation forecasts with 2017 currently 5.9% y/y, it could ease somewhat to closer to 5.7%, with the SARB acknowledging "(a) further downside risk comes from electricity price increases, which could turn out to be lower than the 8.0% currently in the forecast from mid-2017." Additionally the SARB had a previously higher oil price assumption, which could moderate slightly. The MPC 2018 CPI inflation forecast is unlikely to change much from 5.4% y/y. The latter is the forecast period most affecting their interest rate decisions currently. The SARB adds "(o)verall, the MPC assesses the risk to the inflation outlook to be moderately on the upside, mainly due to the high degree of exchange rate uncertainty."

Figure 12: SA Monetary Policy Committee (MPC) meeting dates for 2017		
Month	Date	Forecast
May 2017	23rd – 25th	7.00
July 2017	18th – 20th	7.00
September 2017	19th – 21st	7.00
November 2017	21st – 23rd	7.00

Source: SA Reserve Bank, Investec

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Figure 13: Reuters May 2017: Econometer poll: SARB GDP end period

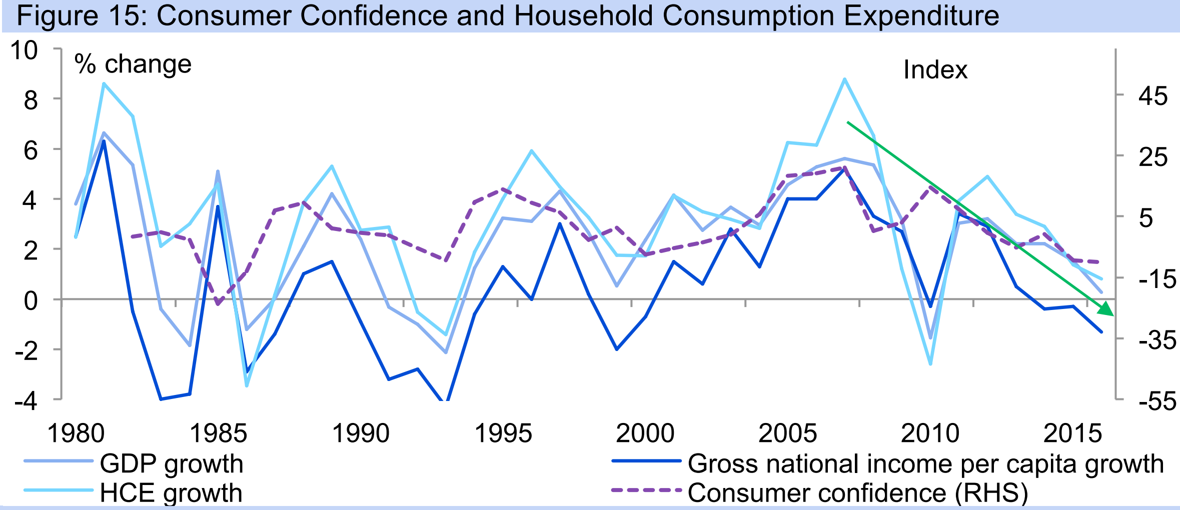
Forecast period	Q1.17	Q2.17	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	2017	2018	2019
Median	1	0.8	0.9	1	1.2	1.4	1.3	0.9	1.3	1.7
Highest forecast	2.1	1.8	2.0	1.5	1.9	2.1	2.9	2.0	2.2	2.5
Lowest forecast	-0.3	0.0	-1.8	0.0	-1.5	0.8	0.9	0.2	0.5	1.3
No. of forecasts	13	14	14	14	14	14	13	26	25	17

Source: Reuters

Figure 14: Growth in private sector credit extension to households

Source: SA Reserve Bank

Figure 15: Consumer Confidence and Household Consumption Expenditure



Source: SA Reserve Bank, Investec

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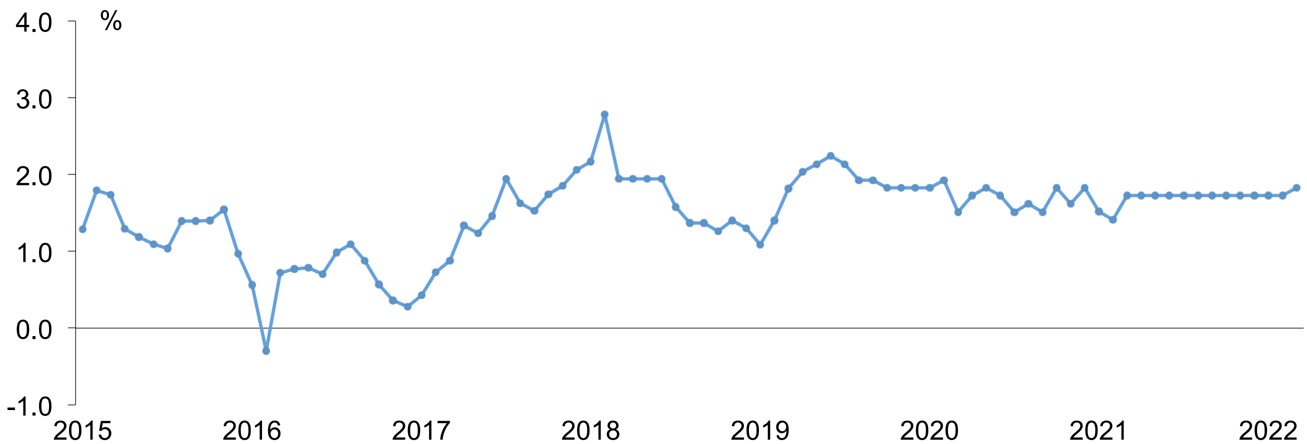
Figure 16: South Africa's real interest rate projections: (Investec CPI and repo forecasts)



Source: Investec, IRESS

While SA's upward interest rate cycle may be drawing to a close, the SARB cautioned strongly against interest rate cuts. "The MPC is of the view that we may have reached the end of the tightening cycle. However the Committee would like to see a more sustained improvement in the inflation outlook before reducing rates. This assessment may however change if the inflation outlook and the risks to the outlook deteriorate."

South Africa has lost growth momentum, with the economy in a downward growth trend over the past several years. In fact "(t)he MPC sees no evidence of significant demand pressures impacting on inflation. The growth outlook remains disappointing, and the MPC is concerned that increased political uncertainty could impact negatively on private sector investment and household consumption expenditure, and further undermine employment growth. The risks to the growth outlook are therefore assessed to be on the downside." The SARB forecasts GDP growth this year of 1.2% and 2018 of 1.7% with 2.0% in 2019.

While SA's current upward interest rate cycle may be drawing to a close, the US is expected to hike by a couple of 25bp increments in 2017, with further interest rate hikes over its forecast period. This could lead to a small 25bp lift in SA's repo rate, which we have kept pencilled in for end 2018. Expansionary fiscal policy in the US is still expected to drive US and global growth, allowing for the economy to stomach further

Figure 17: Monetary Sector

Period end rate %	2016	2017	2018	2019	2020	2021	2022
Repo Rate (year-end: %)	7.00	7.00	7.25	7.25	7.25	7.25	7.25
Prime Overdraft Rate (year-end: %)	10.50	10.50	10.75	10.75	10.75	10.75	10.75

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SA rand bond	9.02	8.81	8.71	8.69	8.79	8.91	9.00

Source: IRESS, Investec

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Figure 18: FOMC Meeting Schedule			
2016		2017	
September	20th- 21st	Jan/Feb	31st -1st
November	1st - 2nd	March	14th -15th
December	13th - 14th	May	2nd -3rd
		June	13th-14th
		July	25th-26th
		September	19th-20th
		Oct/Nov	31st-1st
		December	12th-13th

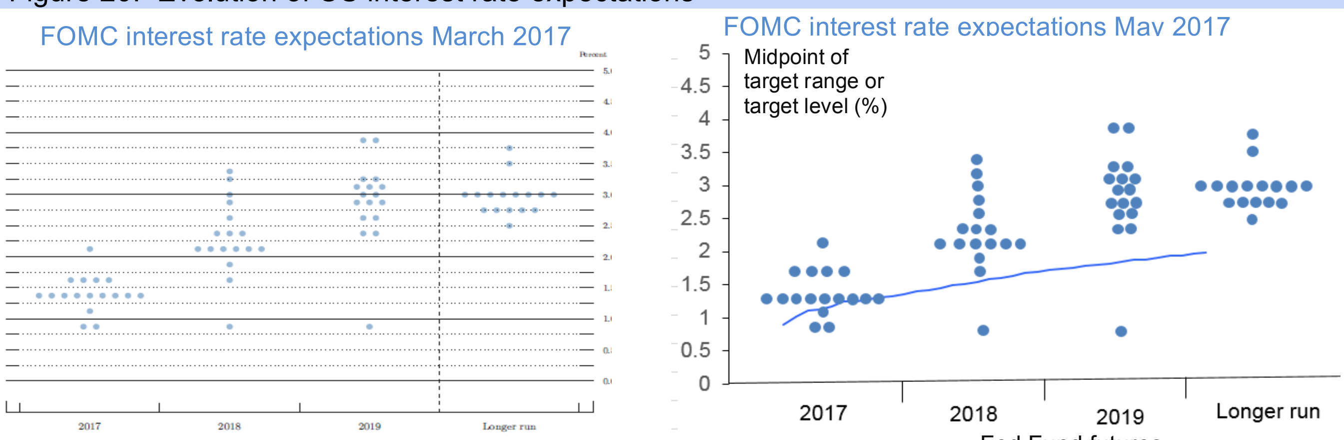
Source: Federal Reserve Bank

Figure 19: Forecast of international interest rates (%, end quarter)

	US Fed funds	Euro zone Refi rate	Euro zone deposit rate	UK Bank Rate	Japan Call rate
Current	0.75-1.00	0.00	-0.40	0.25	-0.10
Q1.17	0.75-1.00	0.00	-0.40	0.25	-0.10
Q2.17	1.00-1.25	0.00	-0.40	0.25	-0.10
Q3.17	1.00-1.25	0.00	-0.40	0.25	-0.10
Q4.17	1.25-1.50	0.00	-0.40	0.25	-0.10
Q1.18	1.25-1.50	0.00	-0.40	0.25	-0.10
Q2.18	1.50-1.75	0.00	-0.40	0.25	-0.10
Q3.18	1.75-2.00	0.00	-0.40	0.25	-0.10
Q4.18	2.00-2.25	0.00	-0.40	0.25	-0.10
End year 2019	2.75-3.00	+0.50	+0.25	0.50	-0.10

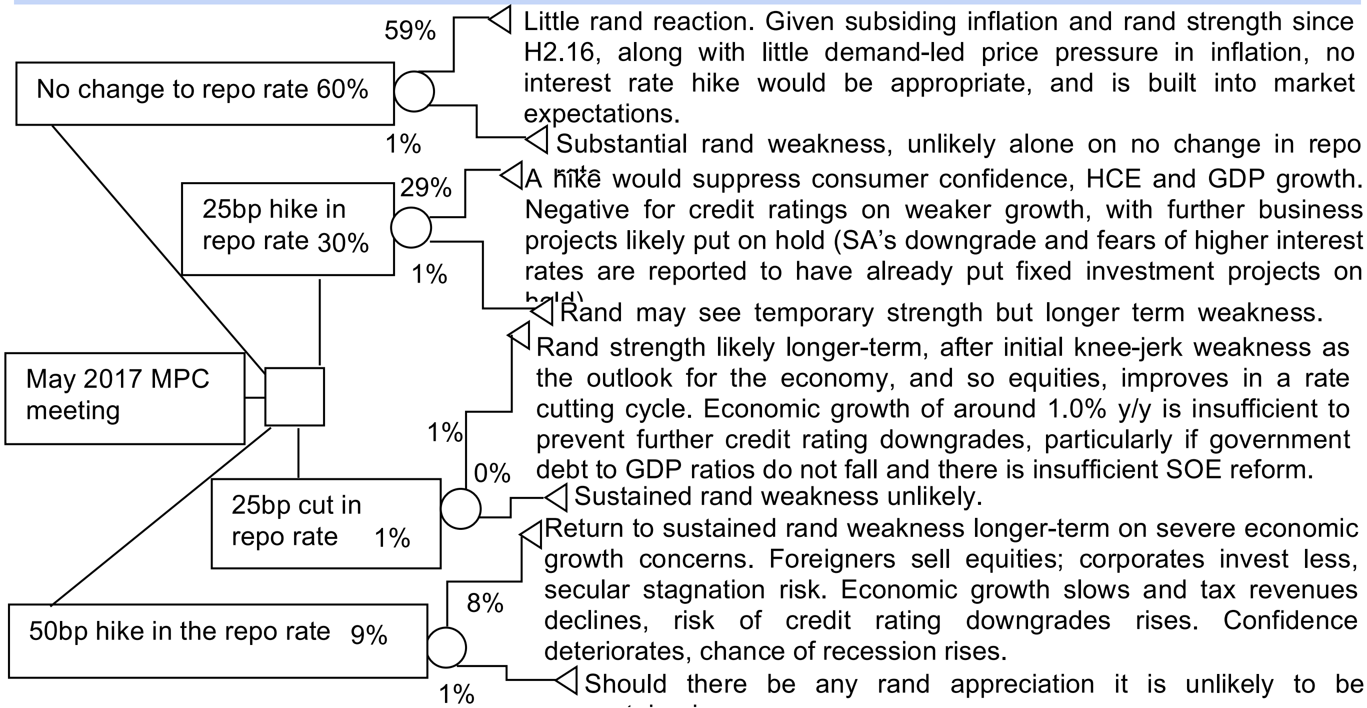
Source: Reuters, Investec

Figure 20: Evolution of US interest rate expectations



Source: FOMC. Note: each circle/dot is individual's judgement of appropriate fed funds rate per period

Figure 22: Decision tree for South Africa's May 23rd to 25th 2017 MPC meeting



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

interest rate hikes without negatively affecting market sentiment. However, increased global protectionism, should it occur, with the threat of potential trade wars, remains a risk to both the long-term global growth outlook and financial market stability.

Foreigners have purchased R34.4bn worth of SA government bonds, less sales, this year on the global risk on environment, with low yields in advanced economies driving both the appetite for local currency EM debt, and lowering these EM yields somewhat. The R186 is 30bp weaker than before April's downgrades, having jumped 60bp higher on the downgrade initially, then recovering 30bp. The differential, or spread, between SA local currency bond yields and advanced economy bond yields has narrowed somewhat consequently, and so the total risk premium. The currency strength post downgrade has been driven by this, with the downgrades themselves also having been priced in by the markets well before they occurred. Indeed, this rebound in a currency after the fact of the downgrade to the country's credit ratings on its sovereign debt is not unprecedented, with the "sell on rumour buy on fact" phenomenon prevailing.

The rand has also been supported by the improvement in both SA's trade balance and terms of trade, as weak domestic demand (which will help to subdue inflation in the absence of unexpected price shocks) has contributed to moderating imports. The mild improvement in both global demand (which is expected to lead SA economic growth slightly stronger over the medium-term) and commodity prices has also been a factor in the improvement in SA's exports, as well as having played some part in the currency's

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strength since last year. Under the expected case bonds are not expected to see a material lift in yields, unlike the down case scenario (see "Economic outlook 2017 – 2022, 12th May 2017).

Figure 23: 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					
Forecasts begin	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	102.7	5.7	0.4					
	May 2017	103.0	5.8	0.3					
	Jun 2017	103.3	5.5	0.3	5.7				
	Jul 2017	103.7	5.1	0.4					
	Aug 2017	103.9	5.4	0.2					
	Sep 2017	104.2	5.5	0.3	5.3				
	Oct 2017	104.5	5.3	0.3					
	Nov 2017	104.7	5.1	0.2					
	Dec 2017	104.9	4.9	0.2	5.1	2017	5.6		
	Jan 2018	105.5	4.8	0.5					
	Feb 2018	106.0	4.2	0.5					
	Mar 2018	107.5	5.1	1.4	4.7			Mar 2017/18	5.1
	Apr 2018	107.9	5.1	0.4					
	May 2018	108.2	5.1	0.3					
	Jun 2018	108.6	5.1	0.3	5.1				
	Jul 2018	109.3	5.4	0.7					
	Aug 2018	109.7	5.6	0.4					
	Sep 2018	110.1	5.6	0.3	5.6				
	Oct 2018	110.5	5.7	0.4					
	Nov 2018	110.9	5.8	0.3					
	Dec 2018	111.2	6.0	0.3	5.8	2018	5.3		
	Jan 2019	112.0	6.2	0.7					
	Feb 2019	112.2	5.8	0.2					
	Mar 2019	113.3	5.4	1.0	5.8				
	Apr 2019	113.5	5.2	0.2					
	May 2019	113.8	5.1	0.2					
	Jun 2019	114.0	5.0	0.2	5.1				
	Jul 2019	114.9	5.1	0.8					
	Aug 2019	115.6	5.3	0.6					
	Sep 2019	115.9	5.3	0.3	5.3				
	Oct 2019	116.5	5.4	0.5					
	Nov 2019	116.9	5.4	0.3					
	Dec 2019	117.2	5.4	0.3	5.4	2019	5.4		

Source: Stats SA, Investec

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Figure 24: Interest rate forecast: end rates

Date	Prime forecast	Prime less Inflation	Repo	Repo less Inflation
Jan 2017	10.50	3.9	7.00	0.4
Feb 2017	10.50	4.2	7.00	0.7
Mar 2017	10.50	4.4	7.00	0.9
Apr 2017	10.50	4.8	7.00	1.3
May 2017	10.50	4.7	7.00	1.2
Jun 2017	10.50	5.0	7.00	1.5
Jul 2017	10.50	5.4	7.00	1.9
Aug 2017	10.50	5.1	7.00	1.6
Sep 2017	10.50	5.0	7.00	1.5
Oct 2017	10.50	5.2	7.00	1.7
Nov 2017	10.50	5.4	7.00	1.9
Dec 2017	10.50	5.6	7.00	2.1
Jan 2018	10.50	5.7	7.00	2.2
Feb 2018	10.50	6.3	7.00	2.8
Mar 2018	10.50	5.4	7.00	1.9
Apr 2018	10.50	5.4	7.00	1.9
May 2018	10.50	5.4	7.00	1.9
Jun 2018	10.50	5.4	7.00	1.9
Jul 2018	10.50	5.1	7.00	1.6
Aug 2018	10.50	4.9	7.00	1.4
Sep 2018	10.50	4.9	7.00	1.4
Oct 2018	10.50	4.8	7.00	1.3
Nov 2018	10.75	4.9	7.25	1.4
Dec 2018	10.75	4.8	7.25	1.3
Jan 2019	10.75	4.6	7.25	1.1
Feb 2019	10.75	4.9	7.25	1.4
Mar 2019	10.75	5.3	7.25	1.8
Apr 2019	10.75	5.5	7.25	2.0
May 2019	10.75	5.6	7.25	2.1
Jun 2019	10.75	5.7	7.25	2.2
Jul 2019	10.75	5.6	7.25	2.1
Aug 2019	10.75	5.4	7.25	1.9
Sep 2019	10.75	5.4	7.25	1.9
Oct 2019	10.75	5.3	7.25	1.8
Nov 2019	10.75	5.3	7.25	1.8
Dec 2019	10.75	5.3	7.25	1.8

Source: IRESS, Investec

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