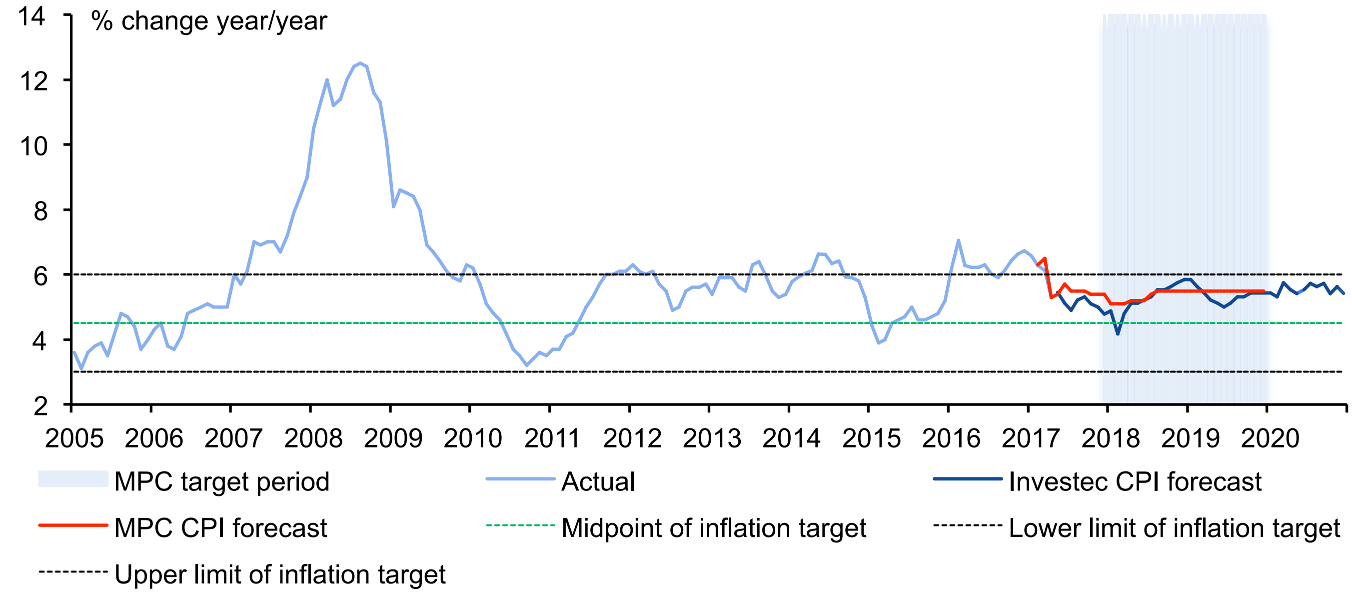
Investec

MPC preview: why South Africa's Monetary Policy Committee should cut interest rates, but probably won't, at its July meeting

17th July 2017

Figure 1: SA Consumer Inflation: history and forecasts



Sources: Stats SA, Investec, SARB

With the latest data showing South Africa's economy in recession, and with a high risk this continued into Q2.17, the Monetary Policy Committee could be expected to cut the repo rate at its meeting on 20th July. However, the South Africa economy was also in recession early last year, at that time from the expenditure side, and no interest rate cuts were forthcoming then. CPI inflation has yielded lower outcomes to date this year, versus the same period last year. Nevertheless, the SARB has been at pains to explain 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. The assumptions the SARB makes in its most recent CPI forecasts show CPI inflation expected around 5.5% y/y in the twelve to twenty four month period, a figure previously signalled as being too close to the upper end of the inflation target range of 3-6% for comfort. Much will consequently depend on the SARB inflation forecasts, which we think will be lowered by about 0.2% y/y, leading to a more dovish MPC tone, but no outright interest rate cut yet.

Specifically, we expect the MPC CPI inflation forecast will fall towards ours of 5.4% y/y this year (MPC currently forecast 5.7% y/y for 2017, and we expect this could fall to 5.5% y/y). For 2018 Investec forecasts

Figure 2: 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	7.00
Prime Overdraft Rate	10.50	10.50	10.50	10.50	10.50	10.50	10.50	10.50
SA rand bond	8.56	8.65	8.62	8.59	8.53	8.46	8.42	8.38

Source: IRESS, Investec

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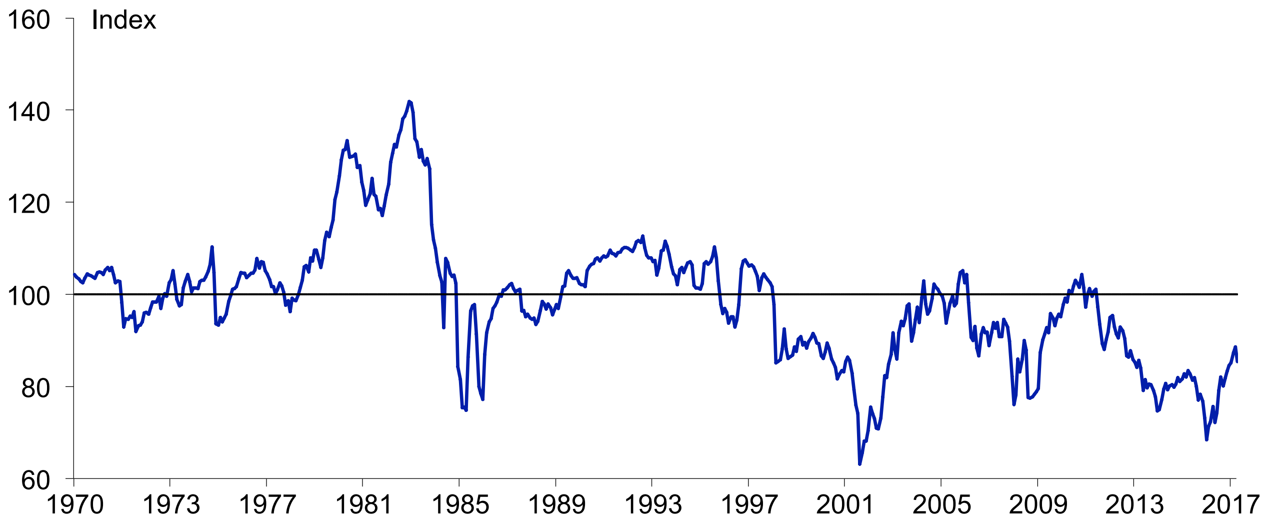
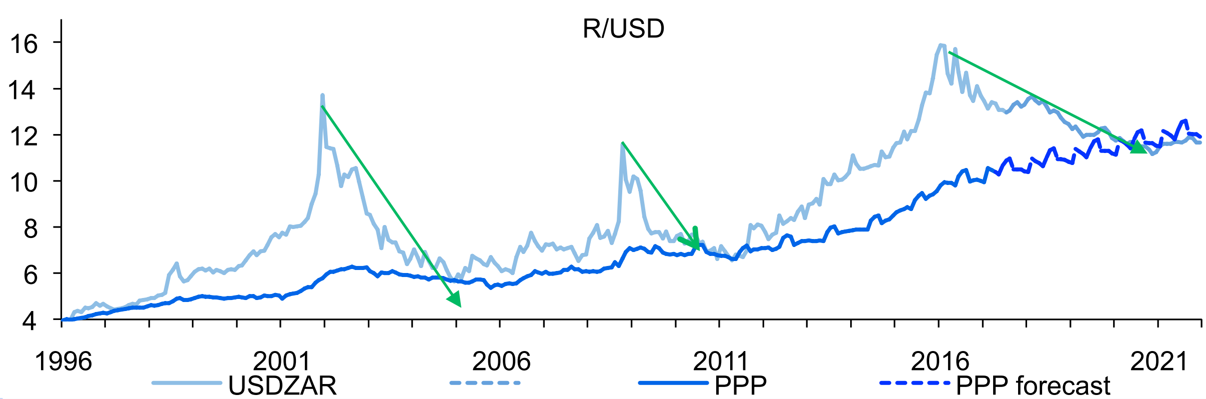
Figure 3: SA's real effective exchange rate



Source: Reserve Bank

Figure 4: PPP value of the Rand vs USD



Source: Investec, IRESS

Figure 5: Reuters June 2017 Econometer poll: Repo rate

Forecast period	Q2.17	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	2017	2018	2019
Median	7.00	7.00	7.00	6.75	6.75	6.88	6.75	7.00	6.75	6.50
Highest forecast	7.00	7.00	7.00	7.00	7.25	7.25	7.25	7.00	7.25	7.25
Lowest forecast	7.00	6.50	6.00	5.50	5.00	5.00	5.00	6.00	5.00	5.00
No. of forecasts	20	21	21	21	21	18	19	24	23	18

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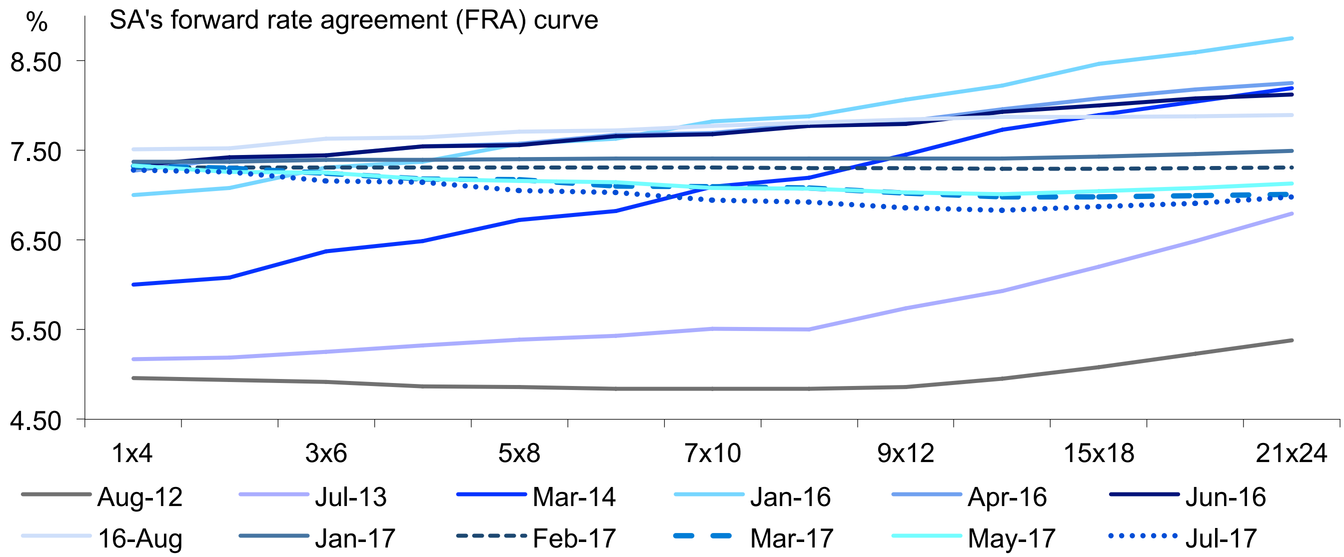
Source: Reuters

Figure 6: Forward Rate Agreement (FRA) curve

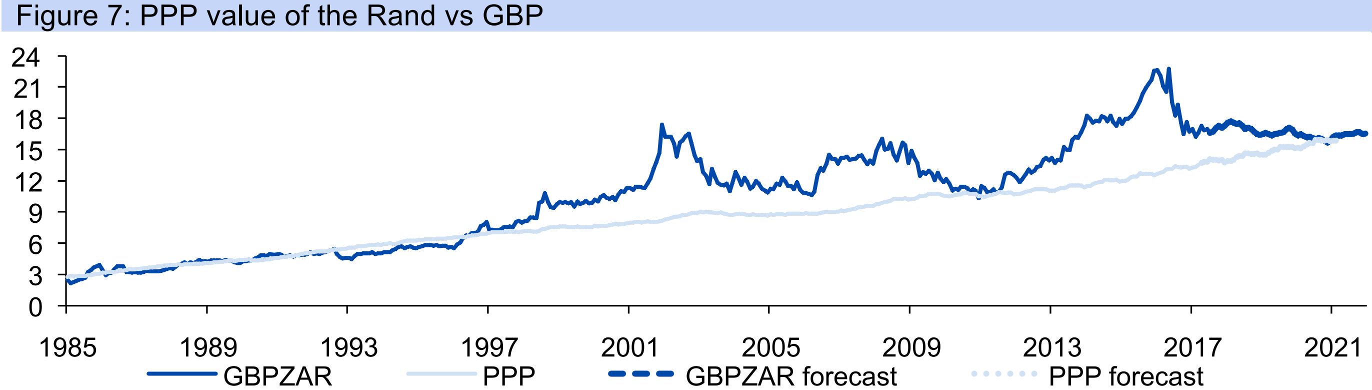


Source: Reuters

5.2% y/y (MPC currently forecast 5.3% y/y for 2018 and we expect this could fall to 5.1% y/y) and Investec forecasts 5.4% y/y for 2019 (MPC currently forecast 5.5% y/y for 2018 and we expect this could fall to 5.4% y/y or 5.3% y/y). With the likely fall of the MPC's inflation forecasts, the assumptions the SARB bases these forecasts on then need to fall. Actual growth continues to fall well below potential economic growth in South Africa, with the SARB expecting GDP growth of 1.0% y/y in 2017, 1.5% y/y in 2018 and 1.7% y/y in 2019, versus our forecasts of 0.6% y/y, 1.1% y/y and 1.6% y/y respectively. We expect the SARB will also moderate its GDP forecast closer to Investec's as the economy continues to underperform, and the output gap widens as demand led inflation is extremely weak.

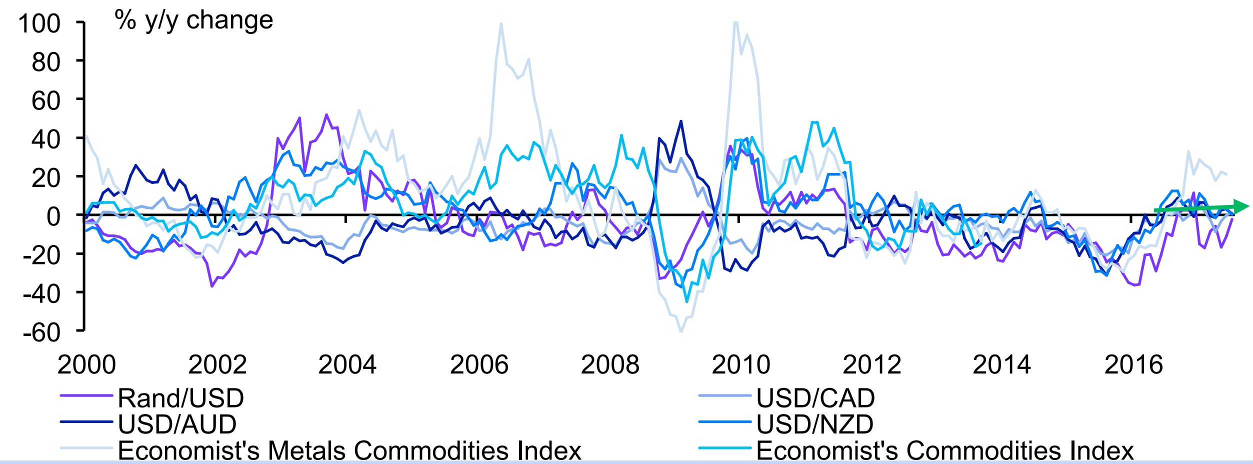
On the supply side, inflationary pressures are significant, but the SARB will likely have room to lower its

Figure 7: PPP value of the Rand vs GBP



Source: Investec, IRESS

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



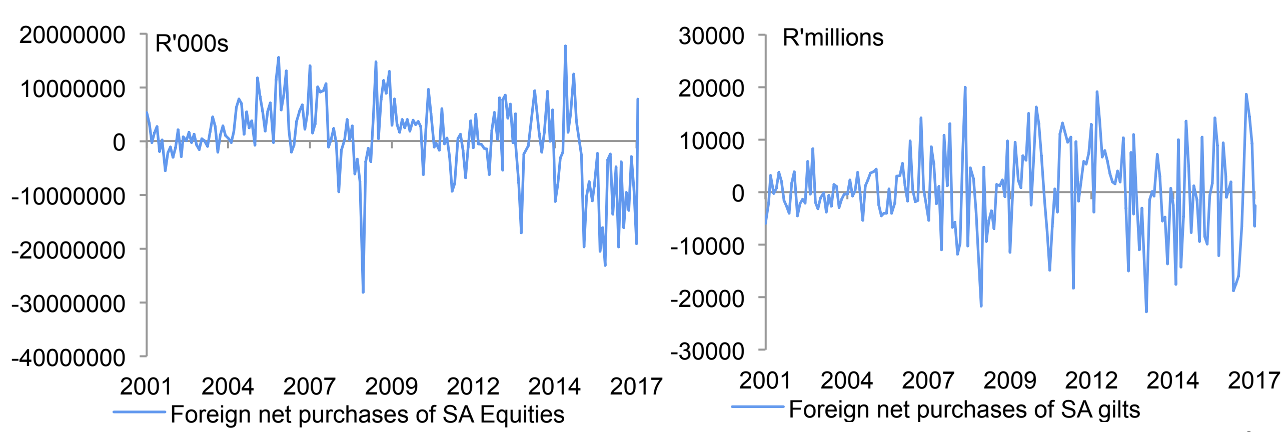
Source: IRESS

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

	2017	2018	2019
SARB 25th May 2017	5.7	5.3	5.5
SARB 30th March 2017	5.9	5.4	5.5
SARB 24th January 2017	6.2	5.5	
SARB 24th November 2016	5.8	5.5	
SARB 22nd September 2016	5.8	5.5	
SARB 21st July 2016	6.0	5.5	
SARB 19th May 2016	6.2	5.4	
SARB 17th March 2016	6.4	5.5	

Source: SA Reserve Bank

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



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Source: IRESS

Figure 11: Reuters June 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	Q4.18	2017	2018	2019
Median	5.3	5.1	5.0	4.9	5.2	5.5	5.5	5.5	5.4	5.4
Highest forecast	5.8	5.5	5.4	5.5	5.6	5.8	6.1	6.2	7.1	6.0
Lowest forecast	5.0	4.6	4.3	3.8	3.9	4.1	3.5	5.0	4.0	2.9
No. of forecasts	18	18	18	18	18	17	17	25	25	17

Source: Econometer

petrol price expectations on the back of lower oil price forecast. The SARB forecasts Brent crude oil at US$54/bbl this year, with the average to date of US$52/bbl, and the actual at US$49/bbl, 2018 and 2019 are given as US$58/bbl and US$60/bbl. A small downward adjustment in the MPC oil forecast for this year is possible, closer to the actual to date, but if the SARB is looking to lower its 2018 and 2019 CPI forecasts, more material adjustment on the oil price would be likely in these latter years. The SARB may also adjust its exchange rate view somewhat on the rand against the US dollar, allowing a lower feed through from the rand oil price.

CPI inflation continues to fall, and we expect it to fall further, below 5.0% this year, on the alleviation of the drought in many areas. Indeed, Agbiz says the "(m)aize harvest process is in full swing across the country with excellent yields. This supports the National Crop Estimate Committee's (CEC) view of a possible record crop of 15.63 million tonnes. ... The forecast warm and drier weather conditions across the maize belt within the next two weeks could add momentum to the harvest process." Indeed, the harvest is expected at "double the previous season's crop. This comes on the back of an increase in area plantings, as well as expected higher yields due to favourable weather conditions."

For soybeans "(h)arvesting is over across the country with yields above average. This supports the National Crop Estimate Committee's (CEC) view of a record crop of 1.34 million tonnes, which is 81% higher than the previous season. An update of this will be released on 26 July 2017." On meat Agbiz notes, "the beef market is showing some levels of normalisation after the 2015-16 El Nino-induced drought. Data from the Red Meat Levy Admin shows that South African farmers slaughtered 202 886 head of cattle in May 2017, up by 5% from the previous month. With that said, this is still 18% lower than the corresponding period last year (drought year with higher slaughtering rate)." While the poultry sector is seeing recovery Agbiz warns that "(t)he recent outbreak of avian influenza in the poultry sector also presents risks. With that being said, the virus is still in isolated farms in Mpumalanga and Free State."

We believe that CPI inflation could temporarily drop below 4.5% y/y early next year as the full effects of

Figure 12: SA Monetary Policy Committee (MPC) meeting dates for 2017		
Month	Date	Forecast
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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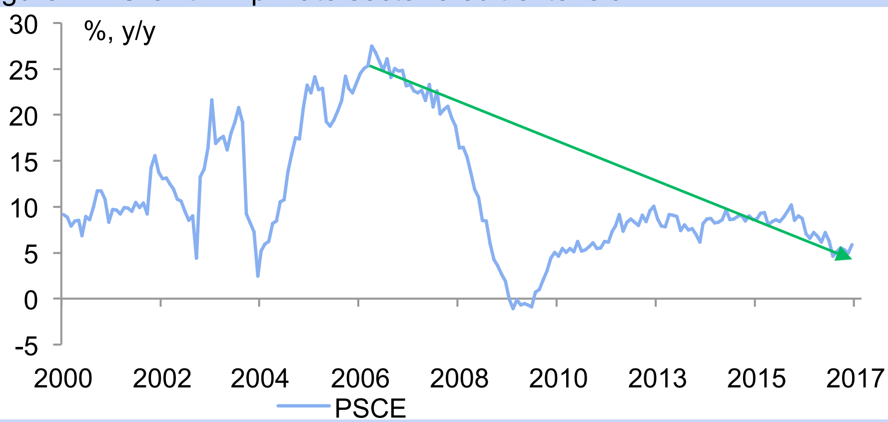
Figure 13: Reuters June 2017: Econometer poll: SARB GDP end period

Forecast period	Q2.17	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	2017	2018	2019
Median	0.8	0.9	1.3	0.8	1.3	1.4	1.4	0.7	1.2	1.6
Highest forecast	2.6	2.0	2.8	1.3	2.3	2.6	2.0	1.3	2.2	2.5
Lowest forecast	-0.3	0.0	0.0	-1.2	0.7	0.4	0.3	0.0	0.8	1.3
No. of forecasts	15	15	15	14	14	14	13	25	25	17

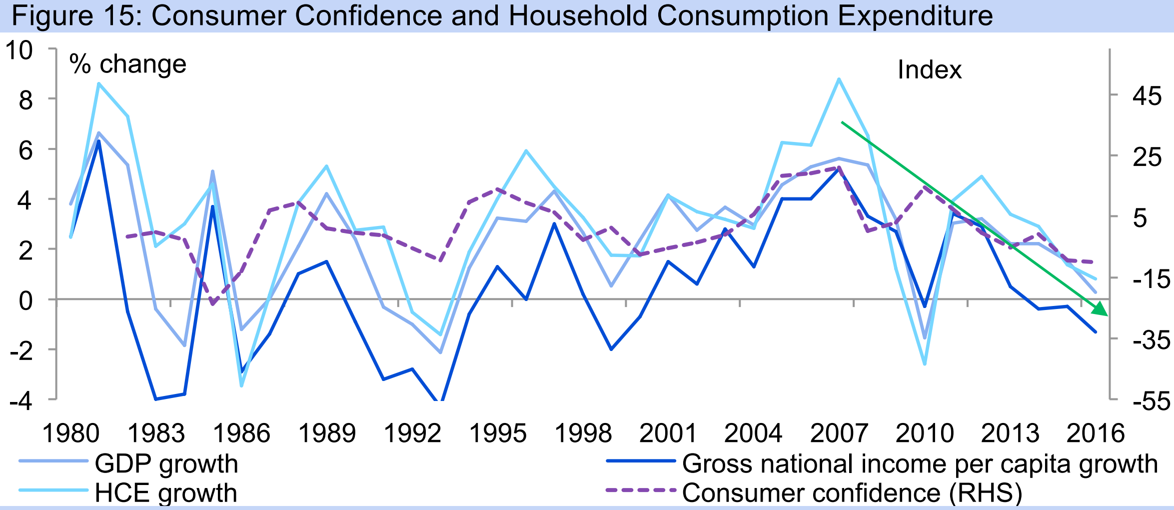
Source: Reuters

Figure 14: Growth in private sector credit extension



Source: SA Reserve Bank

Figure 15: Consumer Confidence and Household Consumption Expenditure



Source: SA Reserve Bank, Investec

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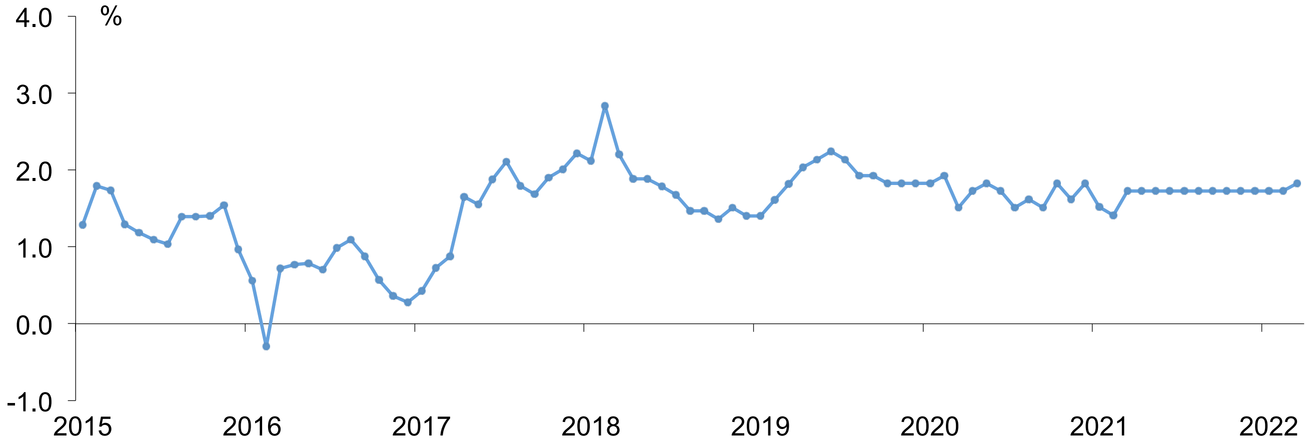
Figure 16: South Africa's real interest rate projections: (Investec CPI and repo forecasts)



Source: Investec, IRESS

the recovery from the drought feed through. However, this subsidence in CPI inflation is likely to be temporary, and headline inflation is likely to almost immediately return to 5.0% y/y. Obdurately high underlying inflation pressures in South Africa tend to stem from state administered price increases, with particular pressure coming from water tariffs. While the electricity tariff is 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.

In the year ahead, commodity prices are expected to firm only slightly, but global industrial activity recover, with confidence levels consequently lifting. While commodity exporters continue to see a differentiated performance, particularly amongst EM (emerging market) and low income countries, this has come down to the main commodity exported. SA is chiefly a metals exporter, and so is falling into the lowest growth category predicted, tracking below some other sub-Saharan countries.

The rand has seen substantial support from risk-on this year, as foreign investors favoured local currency EM debt given the comparative lower yields on developed economies debt, particularly in the Euro area. The mild pick up in global growth begun in 2016 continued over the first half of 2017, broadening as international trade lifted, along with industrial production. Expectations of stronger global growth fuel risk-on, as growth in low income economies and EMs is also expected to rise, improving both equity

Figure 17: Monetary Sector

Period end rate %	2016	2017	2018	2019	2020	2021	2022
Repo Rate (year-end: %)	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Prime Overdraft Rate (year-end: %)	10.50	10.50	10.50	10.50	10.50	10.50	10.50
SA rand bond	9.03	8.61	8.45	8.37	8.45	8.53	8.62

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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

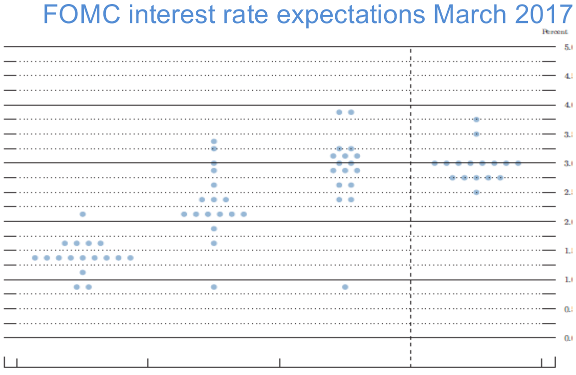
Figure 19: Forecast of international interest rates (%, end quarter)

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

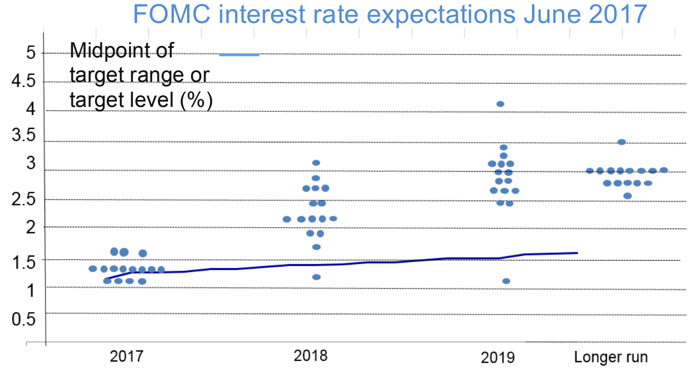
Source: Reuters, Investec

Figure 20: Evolution of US interest rate expectations

FOMC interest rate expectations March 2017



FOMC interest rate expectations June 2017



Fed Fund futures

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

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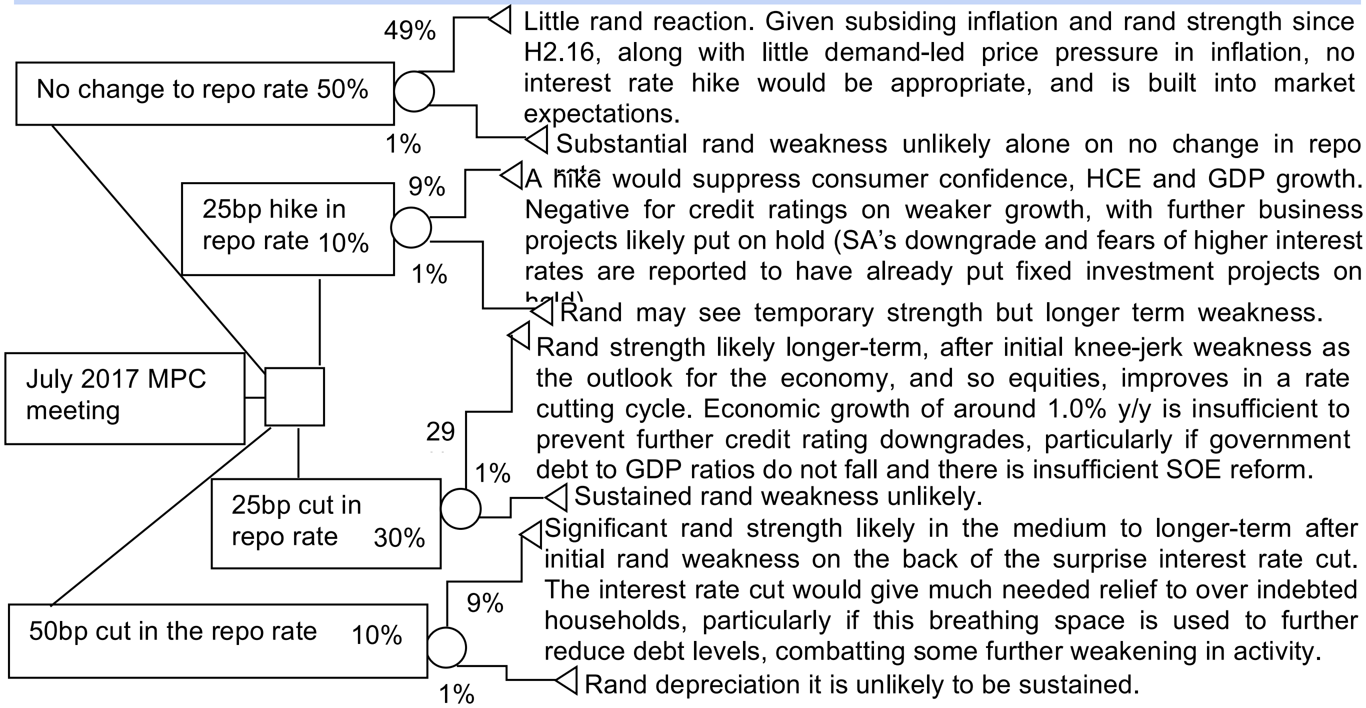
Figure 22: Decision tree for South Africa's July 18th to 20th 2017 MPC meeting



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

performance and fiscal health of EMs and low income economies. World growth is expected to lift to 2.7% this year, from 2.3% last year, and reach 3.0% by 2018 as US economic activity underpins activity. The risk-on environment in financial markets for EM local currency debt has seen the domestic currency strengthen to R12.56/USD, R14.15/EUR and R16.06/GBP by mid-June, aided by SA's remaining two investment grade ratings on its local currency long-term sovereign debt.

Risk-on faded slightly at the start of Q3.17 (after bolstering the rand in H1.17), with the rand weakening as developed economies' Central Banks suggested a shift towards a tightening bias, causing global bond yields to lift. A faster normalisation of global interest rates than currently expected would erode the global risk-on sentiment, likely to the point of risk-off, which could see rand weakness. Additionally, threats to SARB independence and inflation targeting saw the local currency depreciate, although a subsequent less hawkish tone from the FOMC, and government communication that inflation targeting is not under threat, then saw the domestic currency recover somewhat. The domestic currency is likely to remain volatile, with the risk of a weakening bias, which will likely cause the SARB to be cautious.

While the SARB has communicated that the rate hike cycle is likely at an end, it has not yet come out in favour of interest rate cuts, although we do expect an increasingly dovish tone from H2.17. The SARB is unlikely to be pushed into a rate cutting cycle by South African politics, and has instead been following a careful path, which is unlikely to change materially.

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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	102.4	5.3	0.1					
	May 2017	102.7	5.4	0.3					
	Jun 2017	102.9	5.1	0.2	5.3				
	Jul 2017	103.5	4.9	0.6					
	Aug 2017	103.7	5.2	0.2					
	Sep 2017	104.0	5.3	0.3	5.1				
	Oct 2017	104.4	5.1	0.3					
	Nov 2017	104.6	5.0	0.2					
	Dec 2017	104.8	4.8	0.2	5.0	2017	5.4		
	Jan 2018	105.5	4.9	0.7					
	Feb 2018	105.9	4.2	0.4					
	Mar 2018	107.2	4.8	1.2	4.6			Mar 2017/18	5.0
	Apr 2018	107.6	5.1	0.4					
	May 2018	108.0	5.1	0.3					
	Jun 2018	108.3	5.2	0.3	5.1				
	Jul 2018	109.0	5.3	0.7					
	Aug 2018	109.5	5.5	0.4					
	Sep 2018	109.8	5.5	0.3	5.5				
	Oct 2018	110.2	5.6	0.4					
	Nov 2018	110.6	5.7	0.3					
	Dec 2018	110.9	5.8	0.3	5.7	2018	5.2		
	Jan 2019	111.7	5.8	0.7					
	Feb 2019	111.9	5.6	0.2					
	Mar 2019	113.0	5.4	1.0	5.6			Mar 2018/19	5.5
	Apr 2019	113.2	5.2	0.2					
	May 2019	113.5	5.1	0.2					
	Jun 2019	113.7	5.0	0.2	5.1				
	Jul 2019	114.6	5.1	0.8					
	Aug 2019	115.3	5.3	0.6					
	Sep 2019	115.6	5.3	0.3	5.3				
	Oct 2019	116.2	5.4	0.5					
	Nov 2019	116.6	5.4	0.3					
	Dec 2019	116.9	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	5.2	7.00	1.7
May 2017	10.50	5.1	7.00	1.6
Jun 2017	10.50	5.4	7.00	1.9
Jul 2017	10.50	5.6	7.00	2.1
Aug 2017	10.50	5.3	7.00	1.8
Sep 2017	10.50	5.2	7.00	1.7
Oct 2017	10.50	5.4	7.00	1.9
Nov 2017	10.50	5.5	7.00	2.0
Dec 2017	10.50	5.7	7.00	2.2
Jan 2018	10.50	5.6	7.00	2.1
Feb 2018	10.50	6.3	7.00	2.8
Mar 2018	10.50	5.7	7.00	2.2
Apr 2018	10.50	5.4	7.00	1.9
May 2018	10.50	5.4	7.00	1.9
Jun 2018	10.50	5.3	7.00	1.8
Jul 2018	10.50	5.2	7.00	1.7
Aug 2018	10.50	5.0	7.00	1.5
Sep 2018	10.50	5.0	7.00	1.5
Oct 2018	10.50	4.9	7.00	1.4
Nov 2018	10.50	4.8	7.00	1.5
Dec 2018	10.50	4.7	7.00	1.4
Jan 2019	10.50	4.7	7.00	1.4
Feb 2019	10.50	4.9	7.00	1.6
Mar 2019	10.50	5.1	7.00	1.8
Apr 2019	10.50	5.3	7.00	2.0
May 2019	10.50	5.4	7.00	2.1
Jun 2019	10.50	5.5	7.00	2.2
Jul 2019	10.50	5.4	7.00	2.1
Aug 2019	10.50	5.2	7.00	1.9
Sep 2019	10.50	5.2	7.00	1.9
Oct 2019	10.50	5.1	7.00	1.8
Nov 2019	10.50	5.1	7.00	1.8
Dec 2019	10.50	5.1	7.00	1.8

Source: IRESS, Investec

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