Investec

Week Ahead: 2018 Budget expected to outline fiscal consolidation measures in view of credit rating pressures

16th February 2018

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Figure 1: SA Monetary Policy Committee (MPC) meeting dates for 2018

Month	Date	Forecast
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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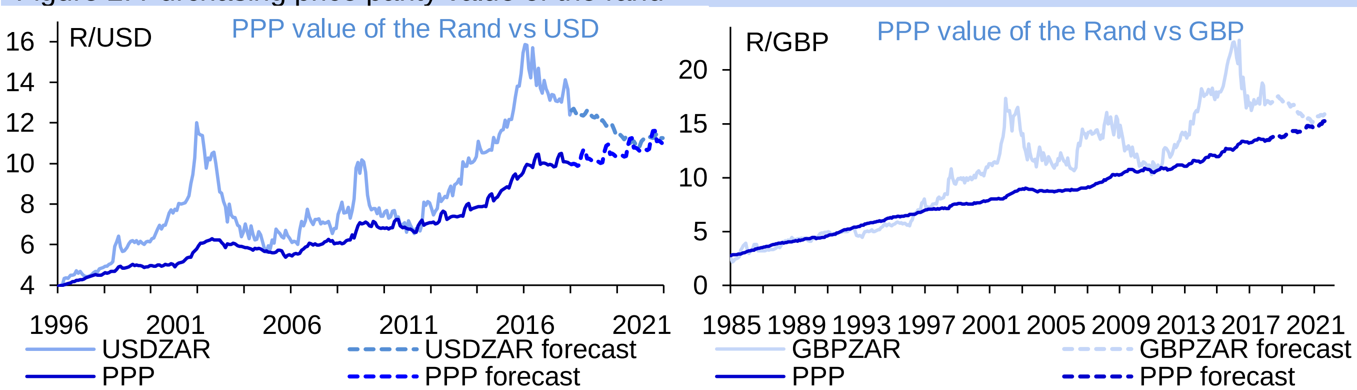
Currency outlook for the week ahead and foreign portfolio flows:

Figure 2: Purchasing price parity value of the rand



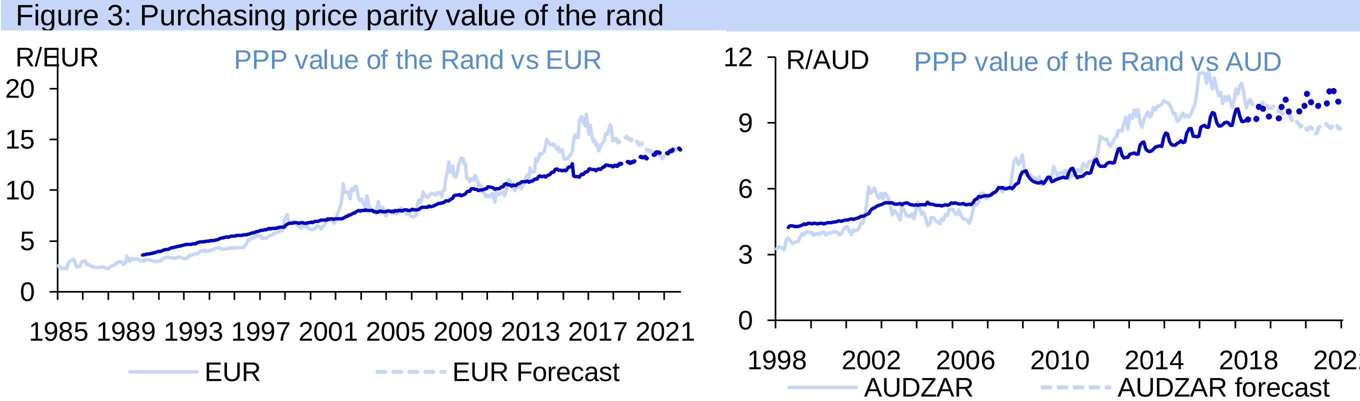
Source: Investec, IRESS

The rand strengthened by 3.1% over the last week to R11.65/USD currently. On a year to date basis, the rand has gained 6.4% to be the best performer amongst a basket of 24 emerging market currencies. These gains reflect the effects of the positive perceptions surrounding the recent domestic political developments. Aside from this, global risk appetite remains broadly intact which has had favourable effects for emerging market currencies. The risk appetite for higher-yielding assets has been a contributing factor to US$ depreciation of 1.7%, on a trade-weighted basis over the last week, to its lowest level since 2014.

Heading into next week, market participants will digest the State of the Nation address, to be delivered after market close this evening, for policy markers under the new leadership of President Ramaphosa. An additional influence on the currency is likely to be the 2018 Budget on Wednesday 21st February owing to the implications for SA's sovereign credit rating. SA's credit rating with Moody's, which is presently one notch above non-investment grade, is on review for a downgrade. Moody's noted that this review would assess the "size and the composition of the 2018 budget."

In the week ahead, the rand is expected to trade in a range of R11.15/USD – R12.15/USD, R14.05/EUR - R15.05/EUR and R15.90/GBP - R16.90/GBP.

Figure 3: Purchasing price parity value of the rand



Source: Investec, IRESS

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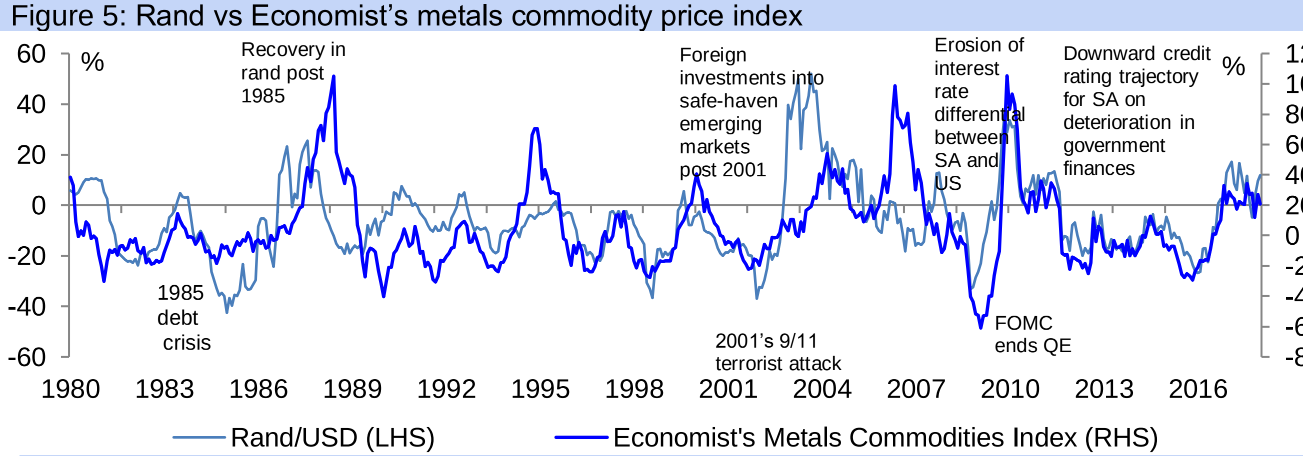
Figure 4: Net foreign portfolio flows for SA assets			
Week	Equities (Rbn)	Bonds (Rbn)	Total (Rbn)
5th February – 9th February 2018	3.7	-4.7	-1.0
29th January – 2nd February 2018	-2.8	-2.2	-5.0
22nd January – 26th January 2018	9.6	-5.3	4.3
15th January – 19th January 2018	5.9	-0.5	5.5
8th January – 12th January 2018	0.7	-0.1	0.7
2nd January – 5th January 2018	-0.6	-1.5	-2.1
27th December – 29th December 2017	2.6	-1.7	0.9
18th December – 22nd December 2017	16.9	9.1	26.0
11th December – 15th December 2017	5.2	-4.4	0.8
4th December – 8th December 2017	5.8	-5.8	0.1
Month			
January 2018	10.7	-7.0	3.7
December 2017	31.0	-4.6	26.4
November 2017	2.4	-14.3	-12.0
October 2017	9.1	-13.7	-4.6
September 2017	-24.7	17.8	-6.8
August 2017	-1.9	-2.4	-4.3
July 2017	10.8	8.1	18.9
June 2017	-19.1	-6.4	-25.5
May 2017	-9.1	9.2	0.1
April 2017	-2.9	14.4	11.5
March 2017	-12.8	18.6	5.7
February 2017	-9.6	3.7	-5.9
January 2017	-16.1	-6.5	-22.7
Note: data subject to frequent revisions			Source: IRESS

Figure 5: Rand vs Economist's metals commodity price index



Source: IRESS, Investec

Data releases in the week ahead

Figure 6: Economic data releases for next week

Date	Country	Indicator	Month	Forecast	Previous
19/02/18	Eurozone	Current Account SA	Dec		32.5bn
		Current Account NSA	Dec		37.8bn
		Construction Output	Dec		0.5% m/m
		Construction Output	Dec		2.7% y/y
20/02/18	SA	Leading Indicator	Dec		105.4
	Eurozone	ZEW Survey Expectations	Feb		31.8
		Advance Consumer Confidence	Feb	1.1	1.3
21/02/18	SA	2018 Budget	2018		
		CPI	Jan	0.5% m/m	0.5% m/m
		CPI	Jan	4.6% y/y	4.7% y/y
		Core CPI	Jan		0.3% m/m
		Core CPI	Jan		4.2% y/y
	US	MBA Mortgage Applications	Jan		-4.1%
		Existing Home Sales	Jan	5.62mn	5.57mn
		Existing Home Sales	Jan	0.9% m/m	-3.6% m/m
		FOMC Meeting Minutes	Jan 31		
	Eurozone	Preliminary Manufacturing PMI	Feb	59.2	59.6
		Preliminary Services PMI	Feb	57.6	58.0
		Preliminary Composite PMI	Feb	58.4	58.8
22/02/18	US	Initial Jobless Claims	Feb 17	225k	230k
		Continuing Claims	Feb 10		1942k
		Leading Index	Jan	0.7%	0.6%
23/02/18	Eurozone	CPI	Jan	-0.9% m/m	0.4% m/m
		CPI	Jan	1.3% y/y	1.4% y/y
		Core CPI	Jan	1.0% y/y	1.0% y/y

Note: sa – seasonally adjusted, nsa – not seasonally adjusted   Source: Bloomberg

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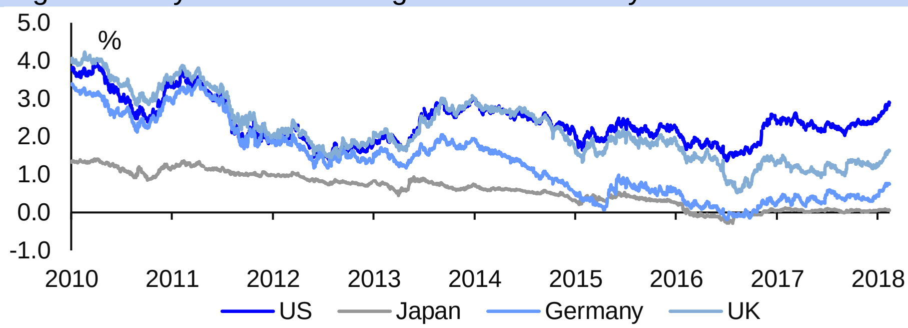
International section

written by Philip Shaw (PS)/ Victoria Clarke (VC)/ Ryan Djajasaputra (RD)/George Brown (GB).

Figure 7: 10 year benchmark government bond yields

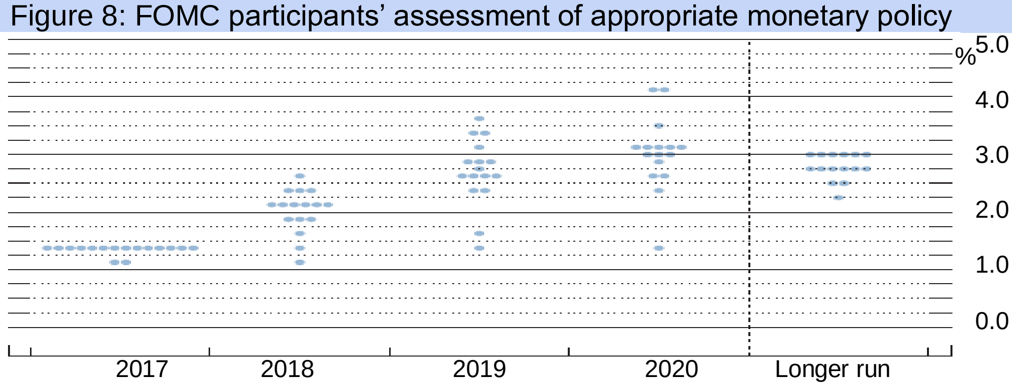


Sources: Bloomberg

(VC) A more positive tone has returned to global equity markets, with most major equities indices up over the week so far. Indeed, at the time of writing, the S&P 500 is 1% up over the year to date having stood 3.5% down on the year opening level a week ago. Equity markets quickly shrugged off any concerns that rising US inflation might lead to a faster pace of monetary policy normalisation following firmer than expected US CPI inflation figures released mid-week. The US dollar reaction was also not what one might have had expected following the CPI figures, with the USD having broadly weakened since. However, bond markets have appeared less relaxed about the prospect of more aggressive Fed tightening, with 10-year US Treasury yields rising to 2.93% in the aftermath of Wednesday's inflation data, their highest standing since January 2014.

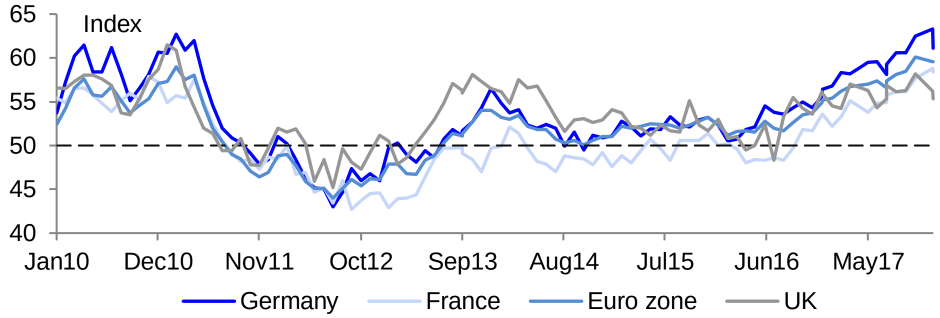
As we look to next week, one focal point for markets will be the publication of the January FOMC minutes. These will be from Dr Yellen's last meeting at the helm of the Fed. They will no doubt reinforce expectations that the Fed is firmly on track to raise rates again under its new Chief Jerome Powell on the 21 March. However, with bond markets in particular jittery about Fed normalisation plans, any further hints that the Fed might be considering moving more aggressively than the Fed's 'dot plot' (3 hikes in 2018) implies could set off another wave of nervousness. In this respect the tone of broader US economic releases also remains important for global sentiment, although we note that the US data calendar is thinner next week, with the week curtailed by Monday's Presidents' Day holiday.

Figure 8: FOMC participants' assessment of appropriate monetary policy



Sources: US Federal Reserve

Figure 9: Eurozone manufacturing PMIs



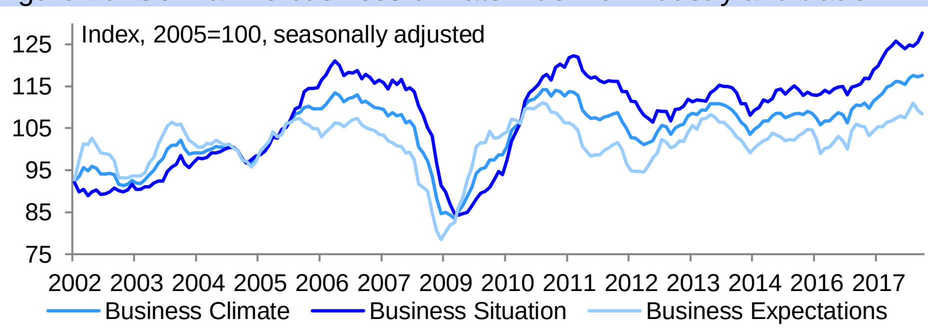
Sources: Markit

UK focused investors will continue to closely track Brexit related news. Faced with widespread criticism that the government's plans for the next phase of Brexit talks are, at best, unclear, PM May and several ministers are set to deliver a series of speeches seeking to clarify the government's position, demonstrate that the Cabinet is unified and provide some impetus to allow PM May to move forward with transitional phase talks with Brussels. Theresa May is set to speak this Saturday in Munich, although the focus is likely to be on security. However we can expect a more substantial speech from May and other key Brexit ministers, probably following the planned gathering of the Cabinet at Chequers. For sterling and UK focused investors more broadly, that speech will be key in shaping sentiment amidst rapidly waning optimism that the UK will be able to reach a transitional arrangement deal over the coming weeks or even months.

In the Eurozone, we are into the final run up to the 4 March Italian election. It looks highly likely that the outcome will be a hung parliament, raising the prospect that Italy may once again be faced with the prospect of a technocratic government if a 'grand coalition' fails to come together. Markets remain relaxed about this however, given that this is unlikely to lead Italy down the path of holding its own referendum on leaving the EU. Turning to data releases, the Euro area calendar includes the 'flash' PMIs for February alongside the German IfO survey. Finally, the Euro area week ahead will include a discussion of the long-term EU Budget (technically the Multiannual Financial Framework), which may well carry repercussions for Brexit discussions. Indeed, it may strengthen the UK's hand, if it leaves the EU even keener to get its hands on any UK financial contribution to help fund its spending goals.

Finally, note that the broader global calendar is relatively quiet with China's Lunar New Year holiday spanning the first three days of the week. Over in Japan, it is widely reported that the nominees for the Bank of Japan Governor position and deputies will be passed to its parliament today; news reports have suggested incumbent Governor Haruhiko Kuroda will be reappointed.

Figure 10: German ifo business climate index for industry and trade



Sources: ifo institute

Global forecasts

Figure 11: 10-year government bond yields (%, end-quarter):			
	US	Germany	UK
Current	2.71	0.66	1.46
2018			
Q2	2.60	0.75	1.50
Q4	2.75	1.00	1.75
2019			
Q2	2.75	1.00	1.75
Q4	3.00	1.25	2.00
			Source: Reuters, Investec

Figure 12: Key official interest rates (%, end quarter)					
	US Fed funds	Eurozone refi rate	Eurozone deposit rate	UK Bank rate	Australia cash rate
Current	1.25-1.50	0.00	-0.40	0.50	1.50
2018					
Q1	1.50-1.75	0.00	-0.40	0.50	1.50
Q2	1.50-1.75	0.00	-0.40	0.75	1.50
Q3	1.75-2.00	0.00	-0.40	0.75	1.75
Q4	1.75-2.00	0.00	-0.40	1.00	2.00
2019					
Q1	1.75-2.00	0.00	-0.40	1.00	2.25
Q2	2.00-2.25	0.00	-0.20	1.25	2.50
Q3	2.00-2.25	0.25	0.00	1.25	2.50
Q4	2.00-2.25	0.50	0.25	1.25	2.75
End year 2020	2.50	1.00	0.75	1.50	3.00
					Source: Reuters, Investec

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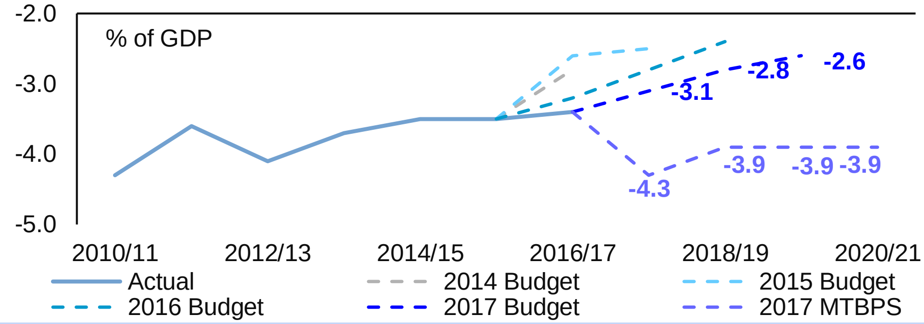
South Africa section

Figure 13: Consolidated budget deficit actuals and National Treasury forecasts



Source: 2017 MTBPS National Treasury

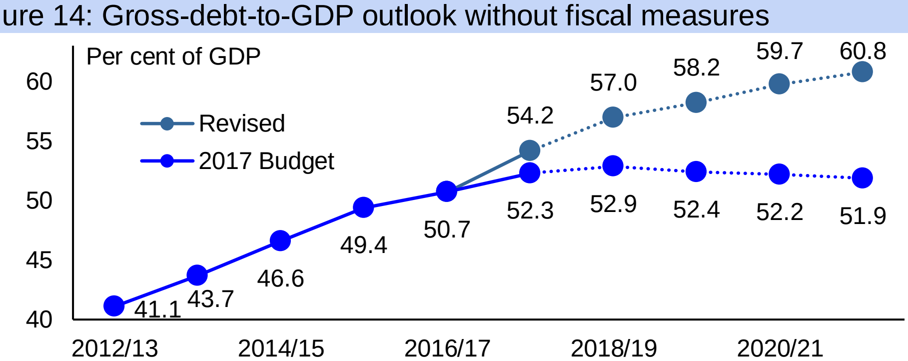
The 2017 Medium Term Budget Policy Statement (MTBPS) outlined that in the absence of a fiscal adjustment package, the consolidated budget deficit would rise to 4.3% of GDP in 2017/18 from 3.4% in 2016/17 and would remain at 3.9% over the medium term framework period of 2018/19 to 2020/21. The postponement of fiscal consolidation in the MTBPS, and the absence of a stabilisation of debt ratios, was viewed as credit negative by the rating agencies.

To avoid further credit rating downgrades, the 2018 Budget will need to implement material revenue and, particularly, expenditure side adjustments to achieve fiscal consolidation over the medium-term. A degree of fiscal consolidation was already expected to be presented in the 2018 Budget based on a statement from the National Treasury in November 2017 that "(t)he 2018 Budget will outline decisive and specific policy measures to strengthen the fiscal framework".

We project the revenue and expenditure side measures, along with slower CPI inflation and slightly higher nominal GDP growth, will yield a consolidated budget deficit of 4.0% of GDP in 2018/19. The deficit is then forecast to compress to 3.4% of GDP in 2019/20 and 2020/21 on fiscal consolidation.

The tightening of fiscal levers (adjustments to revenue and expenditure projections) is a key component of rebuilding confidence and avoiding further credit rating downgrades. Beyond this, the 2018 Budget will need to elaborate on the other "short-term confidence-boosting measures" outlined in the 2017 MTBPS. These include further detail on managing "fiscal and economic risks associated with state-owned entities"; and creating "policy certainty by finalising key legislative and policy processes".

Figure 14: Gross-debt-to-GDP outlook without fiscal measures



Source: 2017 MTBPS National Treasury

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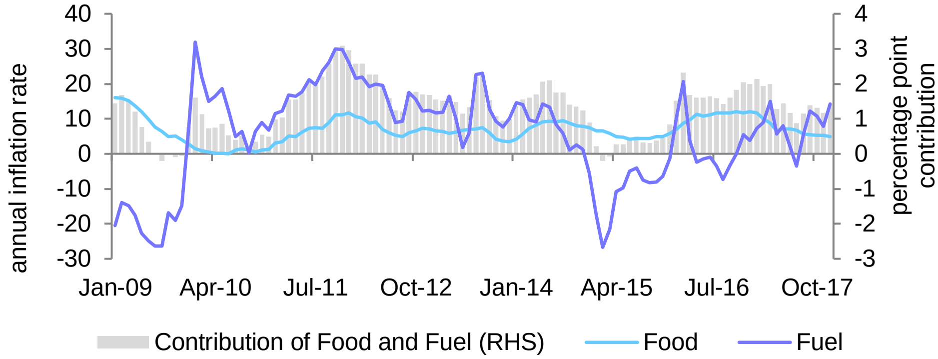
Figure 15: Contributions of good and petrol to annual CPI inflation



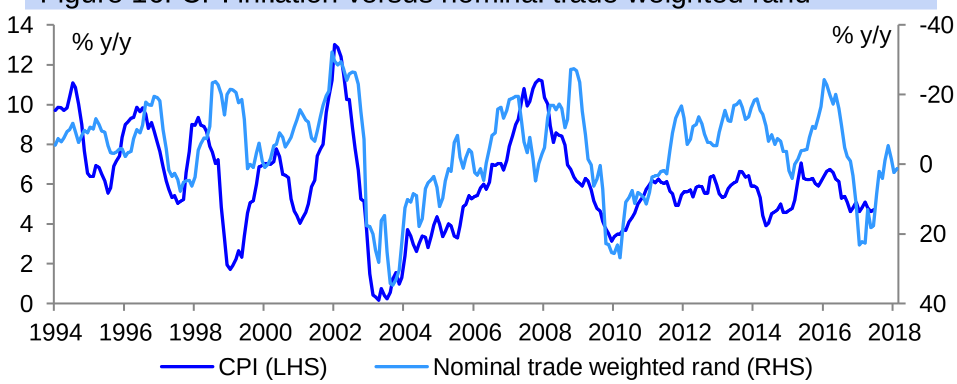
Sources: Stats SA, Investec

CPI inflation is forecast to have moderated slightly to 4.6% y/y in January 2018 from 4.7% y/y in December 2017, mainly on account of decreased price pressures stemming from the fuel component. In January, petrol and diesel prices declined by 34 and 22c/litre respectively.

We project CPI inflation to ease to an average 4.7% y/y in 2018 from 5.3% y/y in 2017, on the assumption that the rand will remain resilient and demand led inflationary pressures muted as only a relatively mild pick-up in economic growth is forecast. Moreover, the electricity tariff increase, of 5.23% granted by NERSA was well below the 19.9% requested by Eskom.

The SARB's current inflation forecast is closer to 5.5% over the twelve to 24 month forecast horizon, which constrains the room to cut interest rates. However, should the rand strengthen notably further on a sustained basis, the SARB may consider an interest rate cut on expected lower inflation.

Figure 16: CPI inflation versus nominal trade weighted rand



Sources: Stats SA, Investec

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Figure 17: CPI forecast averages

Date	Index Base 2010	Annual y/y	Monthly m/m	Quarterly y/y	Calendar year 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		
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	105.2	4.6	0.5			
Feb 2018	106.0	4.2	0.7			
Mar 2018	106.8	4.4	0.8	4.4		
Apr 2018	107.1	4.6	0.3			
May 2018	107.2	4.4	0.1			
Jun 2018	107.6	4.5	0.3	4.5		
Jul 2018	108.2	4.8	0.6			
Aug 2018	108.4	5.0	0.2			
Sep 2018	108.7	4.8	0.3	4.9		
Oct 2018	109.1	4.8	0.3			
Nov 2018	109.4	5.0	0.3			
Dec 2018	109.7	4.8	0.3	4.9	2018	4.7
Jan 2019	110.3	4.8	0.5			
Feb 2019	111.3	5.0	0.9			
Mar 2019	112.3	5.1	0.9	5.0		
Apr 2019	112.5	5.0	0.2			
May 2019	112.7	5.1	0.2			
Jun 2019	112.9	5.0	0.2	5.0		
Jul 2019	113.7	5.1	0.7			
Aug 2019	114.3	5.4	0.5			
Sep 2019	114.9	5.7	0.6	5.4		
Oct 2019	115.4	5.8	0.5			
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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Figure 17: CPI forecast averages

Date	Index Base 2010	Annual y/y	Monthly m/m	Quarterly y/y	Calendar year y/y	
Jan 2020	116.8	6.0	0.5			
Feb 2020	117.9	6.0	0.9			
Mar 2020	118.4	5.4	0.4	5.8		
Apr 2020	118.6	5.4	0.2			
May 2020	119.1	5.6	0.4			
Jun 2020	119.4	5.7	0.3	5.6		
Jul 2020	120.3	5.7	0.7			
Aug 2020	120.5	5.4	0.2			
Sep 2020	121.0	5.3	0.4	5.5		
Oct 2020	121.2	5.0	0.2			
Nov 2020	121.7	5.0	0.4			
Dec 2020	122.1	5.0	0.3	5.0	2020	5.5
Jan 2021	122.8	5.1	0.6			
Feb 2021	124.0	5.2	1.0			
Mar 2021	124.5	5.2	0.4	5.1		
Apr 2021	124.8	5.3	0.3			
May 2021	125.3	5.3	0.4			
Jun 2021	125.6	5.2	0.2	5.2		
Jul 2021	126.6	5.3	0.8			
Aug 2021	127.4	5.7	0.6			
Sep 2021	127.9	5.7	0.4	5.6		
Oct 2021	128.3	5.8	0.3			
Nov 2021	128.5	5.6	0.2			
Dec 2021	128.9	5.6	0.3	5.7	2021	5.4

Source: Stats SA, Investec

Figure 18: 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	10.25	5.7	6.75	2.2
Aug 2017	10.25	5.5	6.75	2.0
Sep 2017	10.25	5.2	6.75	1.7
Oct 2017	10.25	5.4	6.75	1.9
Nov 2017	10.25	5.6	6.75	2.1
Dec 2017	10.25	5.5	6.75	2.0
Jan 2018	10.25	5.7	6.75	2.2
Feb 2018	10.25	6.1	6.75	2.6
Mar 2018	10.25	5.8	6.75	2.3
Apr 2018	10.25	5.6	6.75	2.1
May 2018	10.25	5.8	6.75	2.3
Jun 2018	10.25	5.7	6.75	2.2
Jul 2018	10.25	5.4	6.75	1.9
Aug 2018	10.25	5.3	6.75	1.8
Sep 2018	10.25	5.5	6.75	2.0
Oct 2018	10.25	5.5	6.75	2.0
Nov 2018	10.25	5.3	6.75	1.8
Dec 2018	10.25	5.4	6.75	1.9
Jan 2019	10.25	5.4	6.75	1.9
Feb 2019	10.25	5.2	6.75	1.7
Mar 2019	10.25	5.1	6.75	1.6
Apr 2019	10.25	5.2	6.75	1.7
May 2019	10.25	5.1	6.75	1.6
Jun 2019	10.25	5.2	6.75	1.7
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	4.4	6.75	0.9
Nov 2019	10.50	4.5	7.00	1.0
Dec 2019	10.50	4.5	7.00	1.0

Source: IRESS, Investec

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