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SA Economics

FOMC Note

Thursday 1 August 2019

FOMC cuts by 25bp as expected, rand fails to strengthen as national treasury announces an increase in bond issuance per week in SA to support Eskom bailout, Moody's downgrade becomes more likely for South Africa

- The US Federal Open Market "Committee … (FOMC) … decided to lower the target range for the federal funds rate to 2 to 2-1/4 percent" as expected at its July 2019 meeting. Two committee members voted against the cut, preferring that the fed funds target rate was left unchanged instead.

- Specifically, the FOMC worried that "(a)lthough growth of household spending has picked up from earlier in the year, growth of business fixed investment has been soft. On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent."

- The FOMC in particular highlighted global growth concerns in its decision to cut interest rates, stating "(i)n light of the implications of global developments for the economic outlook as well as muted inflation pressures, the Committee decided to lower the target range for the federal funds rate."

- The rand had already priced in this 25bp US rate cut aleady in July (see "Bond note: rising expectations of a 25bp cut at the July FOMC meeting sees the rand drop through R14.00/USD, and the yield on the R186 through 8.00%, with the US yield curve maintaining inversion over the 10 year - 3 month period since May", 11th July 2019, website address below).

- Severe financial deterioration of South Africa's electricity utility, Eskom, has added to the pressure on SA's government finances. SA's Finance Ministry recently detailed a special appropriation bill for an additional R59bn for Eskom over two years, which will widen the budget deficit, with National Treasury announcing additional weekly bond issuance of around 27%.

- Moody's immediately responded that SA's "Government proposal to more than double support to Eskom is credit negative". Moody's is the last of the three key credit rating agencies to hold SA long-term debt on investment grade, Fitch also responded immediately, dropping SA rating outlook to negative, indicating that a credit rating downgrade is on the cards.

- As the supply of government bonds increases this will put upwards pressure on long term borrowing costs and substantially increase the chance of credit rating downgrades for SA. The rand has weakened to R14.43/USD, R15.94/EUR and R17.50/GBP from its close last night of R14.34/USD, R15.88/EUR and R17.44/GBP, also in reaction to the FOMC's tone.

- The FOMC ended its balance sheet normalisation a couple of months early, stating it "will conclude the reduction of its aggregate securities holdings in the System Open Market Account in August, two months earlier than previously indicated". This has been seen as somewhat hawkish, countering the dovish bent of last night's US 25bp rate cut to some degree.

- Additionally, Governor Powell strongly cautioned that the Fed is not necessarily embarking on an aggressive interest rate cut cycle, rather terming yesterday's 25bp easing as a "midcycle adjustment". In particular he signalled that the Fed is highly unlikely to begin a long rate cut cycle, as that would be more appropriate under continual marked slowing of economic growth.

- Markets took the FOMC commentary surrounding the 25bp cut in the fed funds target rate to be somewhat hawkish, when a far more dovish tone was expected. This also aided the rand weaker. However, we continue to believe a further 25bp cut could materialise in the current US interest rate cycle, and therefore SA could experience the same.

Please note we have changed the probabilities in the scenario table below to reflect an increased chance of a Moody's credit rating downgrade for SA: