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SA Economics

FOMC Note

20th June 2019

Increasingly dovish tilt of the FOMC leaves door open for US interest rate cuts, rand strengthens to R14.23/USD, R16.06/EUR and R18.07/GBP, as the focus turns to 31st July FOMC meeting

- While the Fed decided "to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent" as expected at its June 2019 FOMC meeting, the committee's tone was decidedly more dovish than at its May meeting. With the statement released after SA market hours last night, the rand strengthened this morning to R14.23/USD, R16.06/EUR and R18.07/GBP in response.

- Specifically, the FOMC worried that while "(t)he Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but uncertainties about this outlook have increased."

- Additionally, the word patient (seen to imply a pause in the rate hike cycle) was removed, with the FOMC stating instead "(i)n light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective."

- The next FOMC meeting is on 30th to 31st July, followed by 17th to 18th September, 29th to 30th October and 10th to 11th December this year. Markets have factored in around a 66% chance of a 25bp cut in the fed funds rate in July, and the implied probabilities of further cuts could rise as markets digest the Fed's comments. One member of the committee voted for a cut.

- Since the last published dot plot graph almost half of the committee members assess that an appropriate level for the fed funds rate to fall to this year is 1-3/4 to 2 percent from its current 2-1/4 to 2-1/2 percent, a 50bp drop. Indeed, this significant shift was evidenced for 2020 as well, where a substantial proportion of FOMC members also felt the rate should be 1-3/4 to 2 percent.

- The FOMC outcome strengthens the likelihood that the SARB will cut interest rates by 25bp in July at its MPC meeting on the 18th (see "Rand note: rand strengthens ahead of FOMC meeting tonight as the FOMC's tone is expected to become increasingly dovish, but no cut in the federal funds rate is expected yet - instead markets are increasingly factoring in a 25bp drop for July", 19th June 2019, see website below).

- Should the SARB not cut interest rates at its July MPC meeting, possibly due to marked rand weakness at the time (not expected), the likelihood of a 25bp cut in SA interest rates could still prevail at the further two MPC meetings this year, on 19th September and 21st November.

- However, the SARB has made it extremely clear in its last MPC statement that there is a strong likelihood of lower interest rates due to the moderation in its inflation outlook, and it is likely to choose not to delay. South Africa's FRA curve is factoring in a 25bp cut in the repo rate by the end of this year.

Please note we have refreshed the exchange rate forecasts for the up and down cases in the scenario table below:

Economic Scenarios: (note updated Q2.19 forecasts, and some further dated forecasts)

Extreme Up case 1%		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
	Rand/USD (average)	14.00	14.20	11.00	10.30	9.50	8.60	7.90	7.60
	Repo rate (end rate)	6.75	6.25	6.00	6.00	5.75	5.75	5.50	5.50

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), Trump protectionism removed, SA export and domestic growth boom lifts employment and incomes to the degree that poverty is eliminated. Property rights strengthened, individuals obtain title deeds in EWC without disruption to economy. Fiscal consolidation, credit rating upgrades to A grade.

Up case 10%		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
	Rand/USD (average)	14.00	14.30	12.80	11.40	10.00	9.95	9.90	9.70
	Repo rate (end rate)	6.75	6.50	6.25	6.25	6.25	6.00	6.00	6.00

Persistent growth of 3.0 – 5.0%, higher probability of extreme up case. Better governance, growth creating reforms in line with global norms (structural constraints are overcome) and greater socio-economic stability, some strengthening in property rights, individuals obtain title deeds in EWC without disruption to economy. High business confidence and fixed investment growth, substantial FDI inflows, fiscal consolidation. Strong global growth and commodity cycle, 'trade war' subsides. Stabilisation of credit ratings, with ultimately credit rating upgrades.

Base case 47%		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
	Rand/USD (average)	14.00	14.40	14.30	13.90	13.40	13.70	13.90	13.30
	Repo rate (end rate)	6.75	6.75	6.50	6.50	6.50	6.50	6.50	6.50

Annual growth rate of 2.0% y/y reached by 2020, 3.0% y/y by 2024. Higher confidence and investment levels than past decade, limited impact of EWC/expropriation without compensation (to abandoned and unused land of government and agricultural sector – individuals are new owners and receive title deeds). Rand structurally stronger nears PPP by 2021. SA retains one investment grade (Moody's) rating on its local currency long-term sovereign debt in 2019. Sedate global monetary policy normalisation – avoid severe global risk-off environment, neutral to global risk-on. Modestly strengthening global demand.

Down case 37%		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
	Rand/USD (average)	14.00	14.65	15.80	17.00	18.50	18.90	17.50	16.50
	Repo rate (end rate)	6.75	7.00	7.50	8.00	8.50	8.50	8.50	8.50

Partial expropriation of (certain groups') private commercial sector property (including productive land) without compensation, plus wide scale land grabs, title deeds not transferred to individuals under semi-nationalisation. Confidence and investment depressed, marked rand weakness, significant strike action and widespread load shedding. SA sub-investment grade (loses Moody's rating), increased chance of further credit downgrades. Faster than expected global (US) monetary policy normalisation, general market risk-off, global sharp economic slowdown (commodity slump), marked escalation of US-China trade war, short global financial crisis (SA V shaped recession).

Extreme down case 5%		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
	Rand/USD (average)	14.00	15.00	17.00	19.00	22.00	24.00	25.50	26.00
	Repo rate (end rate)	6.75	7.75	10.00	14.00	16.50	18.00	21.00	21.50

Wide scale expropriation of private sector property (assets and land) rights without compensation with state as custodian - nationalisation. Credit ratings junk & sovereign debt default - state bankruptcy/failed state. Partial to no payment of public sector employees' wages and social grants, persistent government services outages and rolling mass strike action, civil unrest/war. Global economy falls into recession, severe global trade war, severe lengthy global financial crisis, SA economic depression.

Note: Event risk begins Q2.19. Source: Investec

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