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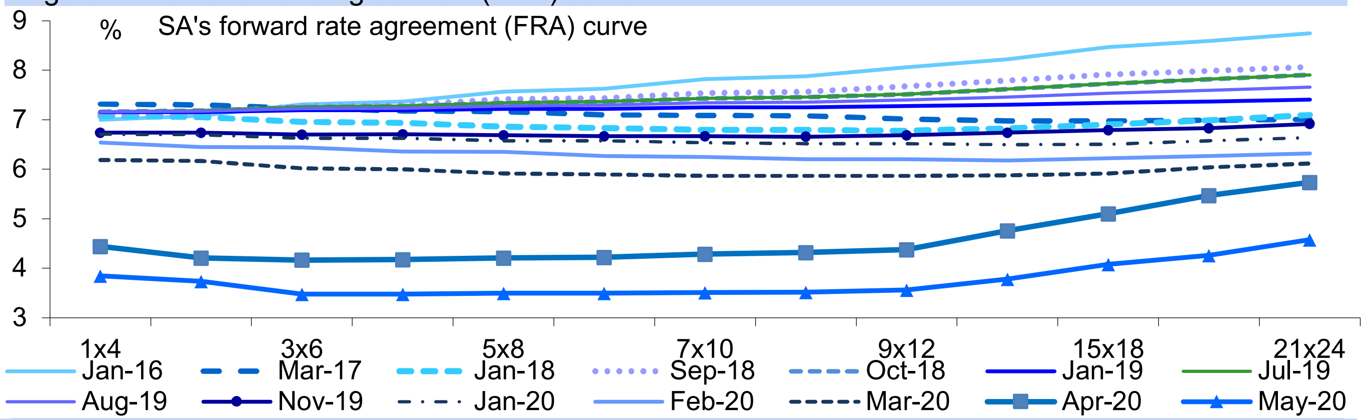
MPC preview: interest rates are likely to remain lower for longer in South Africa, at this week's MPC meeting a small rate cut is likely

Tuesday 19 May 2020

Figure 1: Forward Rate Agreement (FRA) curve



Source: Bloomberg

South Africa has seen a 2.25bp cut in interest rates this year, 200bp in direct response to the impact Covid-19 has had on the economy and financial markets, as the crisis deepened. The first cut, of 25bp in January, was in response to the recession SA had fallen into in the second half of last year, given that inflation was subdued into the target range close to the midpoint, and expected to remain there over the forecast period. Indeed, this year we expect CPI inflation will come out at 3.4% y/y, and at 4.1% y/y in 2021, although we believe the risks are for even lower outcomes. At the last MPC meeting, the emergency meeting in April, the MPC forecast CPI inflation at 3.6% y/y for this year and 4.5% y/y for next year, but we believe these forecasts will be lowered at their meeting this week, to closer to 3.4% y/y or below for this year, and to closer to 4.0% y/y for next year. This week's MPC meeting is likely to see a further downwards revision to the Reserve Bank's GDP outlook, particularly for 2021, as the lockdown is proving lengthy and severe. We expect however that the SARB (South African Reserve Bank) will not engage in another large (100bp) cut in the repo rate this week, preferring instead to preserve some room to implement further easing later in the year, should conditions worsen even further. The SARB has also introduced various other tools to assist the functioning of the markets and that of the financial system, and these also support the functioning of monetary policy, either directly or indirectly.

We expect that the MPC will deliver a modest cut of 25bp this week, but there is a possibility it chooses to keep interest rates unchanged, giving the immensity of the cuts at its last two meetings. Keeping its powder dry by leaving rates unchanged or providing only a small, 25bp cut, in the face of a potentially much larger contraction in GDP than is currently widely expected (the latest Reuters Econometer showed a contraction of -6.5% y/y for 2020) would allow for more support later. GDP risks contracting by closer to -10% y/y to -15% y/y this year due to the very slow reopening of the economy that is occurring, and the extreme

Figure 2: Forecasts

Period end rate %	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
Repo Rate	5.25	4.00	4.00	4.00	4.00	4.25	4.25	4.25
Prime Overdraft Rate	8.75	7.50	7.50	7.50	7.50	7.75	7.75	7.75

Source: Iress, Investec

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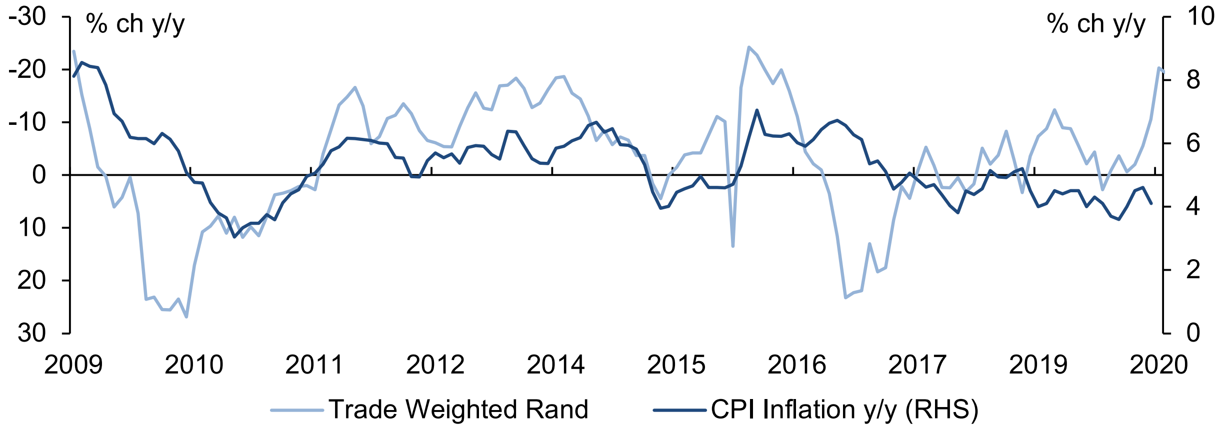
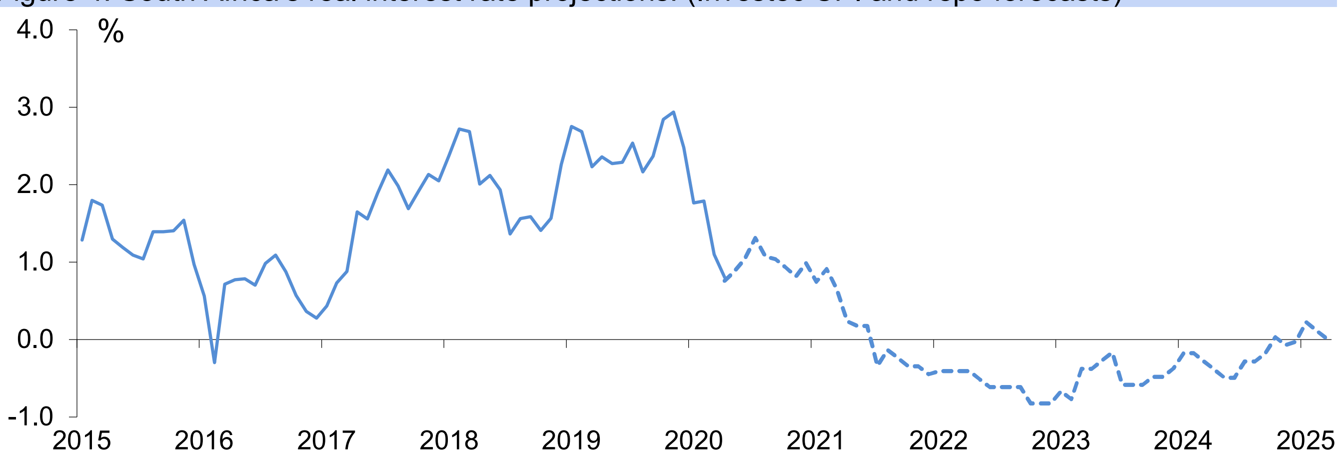
Figure 3: Trade weighted rand movements vs CPI inflation (both % change y/y)



Source: Stats SA, Iress

Figure 4: South Africa's real interest rate projections: (Investec CPI and repo forecasts)



Source: Investec, Iress

Figure 5: Inflation forecasts	2019	2020	2021	2022	2023	2024	2025
Consumer Inflation (Av: %)	4.1	3.4	4.1	5.1	5.4	5.5	5.5
Producer Inflation (Av: %)	4.6	3.2	4.0	5.1	5.3	5.3	5.3
Salary & wage increases (%)	4.0	2.1	3.3	5.2	5.4	6.2	6.6

Source: Investec

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Figure 6: Reuters May 2020 Econometer poll: Repo rate end period %									
Forecast period	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	2020	2021	2022
Median	3.75	3.75	3.75	3.75	3.75	4.00	3.75	4.00	4.50
Highest forecast	4.25	4.25	4.25	4.25	4.75	5.25	4.25	5.25	6.25
Lowest forecast	3.30	3.00	3.00	3.00	3.00	3.00	3.00	3.50	4.00
No. of forecasts	18	18	18	17	16	15	18	18	14
									Source: Reuters

nature of the lockdown. South Africa has seen one of the most severe economic lockdowns globally, and its lengthy duration (with level 3 now only expected by June) will likely see the domestic economy contract by closer to -10% y/y to -15% y/y this year. Moving to a lower level each month means Q3.20 would then still see restrictions to economic activity, of level 2 in July and level 1 in August, contributing to diminish much of the lift that was expected in that quarter, and lowering GDP growth for the year as a whole.

The lockdowns globally and domestically are unprecedented, and there is not really anything to benchmark the situation off. The closest may be a war situation, but without the capital stimulus from capex and defence expenditure of the economy, while South Africa has very little available for further fiscal stimulus. The contraction in GDP has also fed off itself, likely moving from a linear to a geometric progression. Companies are shutting down permanently (Stats SA shows a significant number already have) and no (or fewer) new comparable ones are being created, resulting in demand reducing for the production of the goods/services those companies sold, with fewer people earning incomes. This reduces the demand for purchasing goods and services, leading to demand diminishing in the economy, particularly if those that have jobs/are self-employed see their total renumeration levels cut. As demand diminishes those companies that are still in business see turnover negatively affected and look to cut costs (retrench staff, order less to sell, etc.). This creates a negative cycle, a downwards spiral lower and lower the longer the lockdown is imposed. While this does not apply to every company, many are still seeing demand for essential goods/services etc, but many of their customers are negatively affected and spend less, if at all, creating a knock on negative effect that escalates (happens more and more quickly) the longer a severe lockdown persists. Much also depends on the savings of businesses - if they have no turnover coming in and no, or low, savings their longevity is likely limited to less than 30 days. Most in a survey indicated in the second half of April to Statistics SA that they can only survive between one and three months with no turnover. The SARB forecasts GDP growth for South Africa this year at -6.1% y/y and in 2021 at 2.2% y/y at its April MPC meeting, and is likely to lower its forecasts this week.

Interest rates are likely to remain low for a lengthy period of time, as the economy will not recover in Q3.20,

Figure 7: Reuters May 2020 Econometer poll: SARB CPI, unadjusted % ch y/y, avg for period									
Forecast period	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	2020	2021	2022
Median	2.9	3.1	3.2	3.6	4.4	4.5	3.5	4.1	4.5
Highest forecast	3.8	3.9	4.2	4.6	5.1	5.6	4.7	5.3	5.1
Lowest forecast	2.0	2.1	2.1	2.4	3.7	4.1	2.0	3.5	2.7
No. of forecasts	15	14	14	13	14	12	24	24	14
									Source: Reuters

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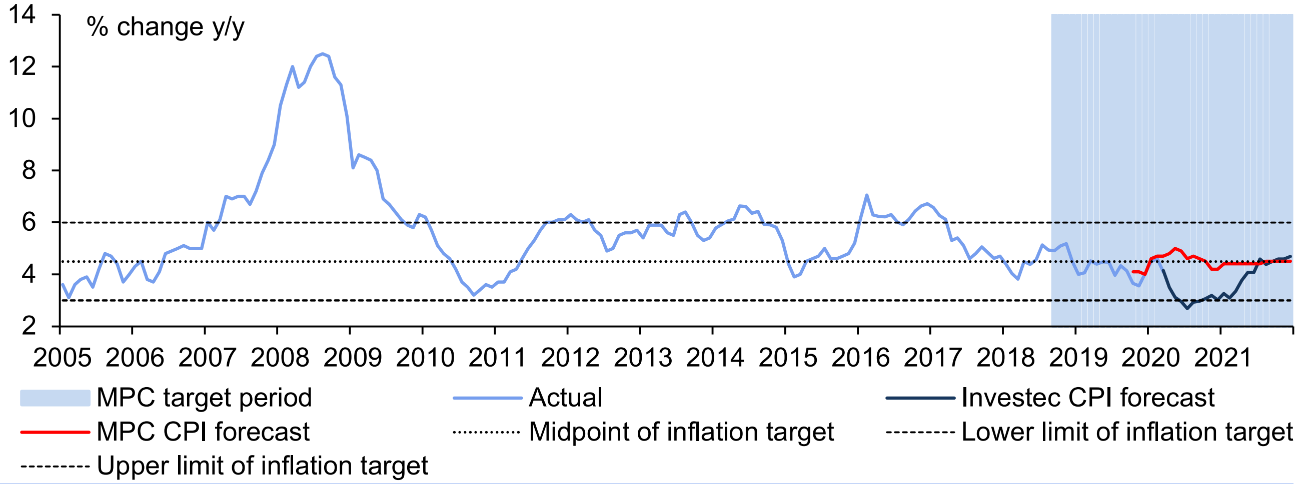
Figure 8: SA Consumer Inflation: history and forecasts



Source: Stats SA, SARB, Investec

Figure 9: Reuters May 2020 Foreign exchange rates poll: USDZAR

	1M	3M	6M	1Y
Release/Effective Date	29 May 2020	31 Jul 2020	30 Oct 2020	30 Apr 2020
Median	18.6100	18.1340	17.5600	16.8000
High	21.0000	20.0000	19.6700	20.0000
Low	17.9400	15.6700	15.2000	14.6700
No. of forecasts	19	26	26	25

Source: Reuters

Figure 10: SA Monetary Policy Committee (MPC) meeting dates for 2020

Month	Date	Forecast
May 2020	19th – 21st	4.00
July 2020	21st – 23rd	4.00
September 2020	15th – 17th	4.00
November 2020	17th – 19th	4.00

Source: SA Reserve Bank, Investec

Figure 11: Reuters May 2020: Econometer poll: SARB GDP end period

Forecast period	Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	2020	2021	2022
Median	-4.5	-36.2	20.9	4.7	2.6	2.7	2.3	-6.5	2.9	1.5
Highest forecast	-0.3	-10.0	46.7	25.0	10.6	12.0	10.6	-1.0	6.5	3.3
Lowest forecast	-10.0	-50.3	-8.0	-9.3	-0.5	-2.3	-1.5	-10.0	0.4	0.1
No. of forecasts	13	14	14	14	13	12	11	28	27	14

Source: Reuters

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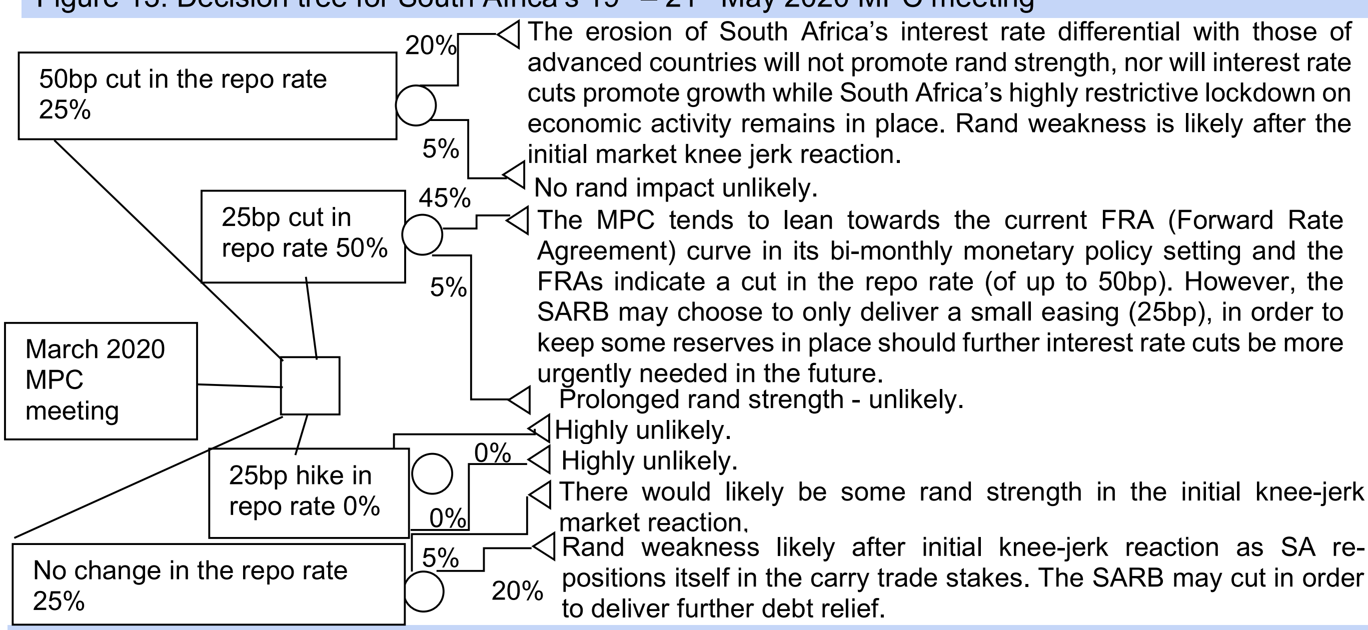
Figure 12: forecasts	2020	2021	2022	2023	2024	2025
Repo Rate	4.00	4.25	4.50	5.00	5.25	5.50
Prime Overdraft Rate	7.50	7.75	8.00	8.50	8.75	9.00
SA rand bond	10.70	10.60	9.50	9.50	9.30	9.10
US Fed funds rate	1.00-1.25	0.00-0.25	0.00-0.25	0.25-0.50	0.50-0.75	1.00-1.25
UK Bank rate	0.10	0.10	0.10	0.25	0.50	100

Note: forecasts are *% year-end.* Source: Investec, SARB, IRESS

nor will it recover in Q4.20, or in 2021. Many years of growth will have been wiped off GDP and it will be a slow lengthy process to rebuild. Unemployment risks rising to 50% next year.

From an inflation point of view, the SARB is in no rush to hike interest rates, recently communicating that when inflation rises again (which will likely be supported by base effects next year), it plans to see through (ignore) the immediate increase and wait for second round effects to see if there is a broad based price increase. Stats SA's various publications of price inflation has showed subdued inflation, but another one of its surveys, that of the impact of Covid-19 on businesses shows that the majority of businesses have seen prices increase by more than normal in the lockdown, and that most cannot get the materials and goods they need as inputs for their businesses. This will also have a negative impact on inflation, as shortages push prices up in these areas. Global supply chains have also been disrupted around the world, and this too delays recovery. The rand's weakness has yet to feed through materially into imports, with the collapse in the oil price having shielded much of the impact to date. The uncharted territory South Africa and the rest of the globe is in has created enormous uncertainty. In SA the government has warned that levels will be raised if necessary (the lockdown intensified) which would severely worsen the GDP outcome. Covid-19 has not yet peaked in SA, and it is quite a while before it is expected to do so.

Figure 13: Decision tree for South Africa's 19th – 21st May 2020 MPC meeting



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

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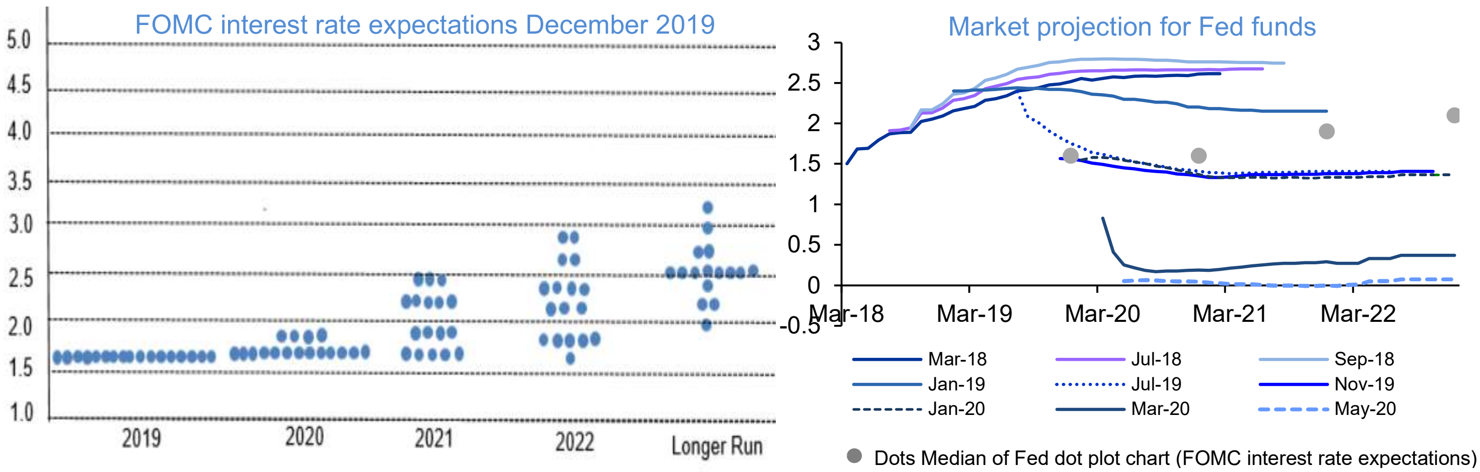
Figure 14: US interest rate projections



Source: FOMC, Bloomberg

Note: in left graph each circle/dot is individual's judgement of appropriate fed funds rate per period

Figure 15: FOMC 2020 Meeting Schedule

July	28th – 29th
September	15th-16th*
November	4th – 5th
December	15th – 16th*

Source: Federal Reserve Bank

*Meeting associated with a Summary of Economic Projections

Figure 16: Forecast of international interest rates (%, end quarter)

	US Fed funds	Euro zone Refi rate	Euro zone deposit rate	UK Bank Rate
Current	0.00-0.25	0.00	-0.50	0.10
Q1.20	0.00-0.25	0.00	-0.50	0.10
Q2.20	0.00-0.25	0.00	-0.60	0.10
Q3.20	0.00-0.25	0.00	-0.60	0.10
Q4.20	0.00-0.25	0.00	-0.60	0.10
Q1.21	0.00-0.25	0.00	-0.60	0.10
Q2.21	0.00-0.25	0.00	-0.60	0.10
Q3.21	0.00-0.25	0.00	-0.60	0.10
Q4.21	0.00-0.25	0.00	-0.60	0.10

Source: Macrobond, Investec

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Figure 17: Interest rate forecast end rates

Date	Prime forecast	Prime less Inflation	Repo	Repo less Inflation
Jan 2019	10.25	6.3	6.75	2.8
Feb 2019	10.25	6.2	6.75	2.7
Mar 2019	10.25	5.7	6.75	2.2
Apr 2019	10.25	5.9	6.75	2.4
May 2019	10.25	5.8	6.75	2.3
Jun 2019	10.25	5.8	6.75	2.3
Jul 2019	10.00	6.0	6.50	2.5
Aug 2019	10.00	5.7	6.50	2.2
Sep 2019	10.00	5.9	6.50	2.4
Oct 2019	10.00	6.3	6.50	2.8
Nov 2019	10.00	6.4	6.50	2.9
Dec 2019	10.00	6.0	6.50	2.5
Jan 2020	9.75	5.3	6.25	1.8
Feb 2020	9.75	5.1	6.25	1.6
Mar 2020	8.75	4.6	5.25	1.1
Apr 2020	7.75	4.3	4.25	0.8
May 2020	7.50	4.4	4.00	0.9
Jun 2020	7.50	4.6	4.00	1.1
Jul 2020	7.50	4.8	4.00	1.3
Aug 2020	7.50	4.6	4.00	1.1
Sep 2020	7.50	4.5	4.00	1.0
Oct 2020	7.50	4.4	4.00	0.9
Nov 2020	7.50	4.3	4.00	0.8
Dec 2020	7.50	4.5	4.00	1.0
Jan 2021	7.50	4.2	4.00	0.7
Feb 2021	7.50	4.4	4.00	0.9
Mar 2021	7.50	4.2	4.00	0.7
Apr 2021	7.50	3.7	4.00	0.2
May 2021	7.75	3.7	4.25	0.2
Jun 2021	7.75	3.7	4.25	0.2
Jul 2021	7.75	3.2	4.25	-0.3
Aug 2021	7.75	3.4	4.25	-0.1
Sep 2021	7.75	3.3	4.25	-0.2
Oct 2021	7.75	3.2	4.25	-0.3
Nov 2021	7.75	3.2	4.25	-0.3
Dec 2021	7.75	3.1	4.25	-0.4

Source: IRESS, Investec

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Figure 18: CPI forecast averages

Date	Index Base 2016	Annual y/y	Monthly m/m	Quarterly y/y	Calendar year y/y	
Jan 2019	109.2	4.0	-0.2			
Feb 2019	110.1	4.1	0.8			
Mar 2019	111.0	4.5	0.8	4.2		
Apr 2019	111.7	4.4	0.6			
May 2019	112.0	4.5	0.3			
Jun 2019	112.4	4.5	0.4	4.4		
Jul 2019	112.8	4.0	0.4			
Aug 2019	113.1	4.3	0.3			
Sep 2019	113.4	4.1	0.3	4.1		
Oct 2019	113.4	3.7	0.0			
Nov 2019	113.5	3.6	0.1			
Dec 2019	113.8	4.0	0.3	3.7	2019	4.1
Jan 2020	114.1	4.5	0.3			
Feb 2020	115.2	4.6	1.0			
Mar 2020	115.6	4.1	0.3	4.4		
Apr 2020	115.6	3.5	0.0			
May 2020	115.5	3.1	-0.1			
Jun 2020	115.7	2.9	0.2	3.2		
Jul 2020	115.8	2.7	0.1			
Aug 2020	116.4	2.9	0.5			
Sep 2020	116.8	3.0	0.3	2.9		
Oct 2020	116.9	3.1	0.1			
Nov 2020	117.1	3.2	0.2			
Dec 2020	117.2	3.0	0.1	3.1	2020	3.4
Jan 2021	117.8	3.3	0.5			
Feb 2021	118.8	3.1	0.8			
Mar 2021	119.5	3.3	0.6	3.2		
Apr 2021	119.9	3.8	0.4			
May 2021	120.2	4.1	0.2			
Jun 2021	120.4	4.1	0.2	4.0		
Jul 2021	121.1	4.6	0.6			
Aug 2021	121.5	4.4	0.3			
Sep 2021	122.0	4.5	0.4	4.5		
Oct 2021	122.2	4.6	0.2			
Nov 2021	122.5	4.6	0.2			
Dec 2021	122.7	4.7	0.2	4.6	2021	4.1

Source: Stats SA, Investec

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Figure 19: Economic Scenarios: note updated forecasts

		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
Extreme	USD/Rand (average)	15.38	15.00	14.00	13.00	12.00	11.00	10.00	9.00
Up case	Repo rate (end rate)	5.25	3.50	3.50	3.50	3.50	3.50	3.50	3.50

1% Impact of Covid-19 pandemic very rapidly resolved - economic growth of 3–5%, then 5-7% for SA. Good governance, growth-creating reforms (structural constraints overcome), strengthening of property rights - individuals obtain title deeds in EWC – no nationalisation. High business confidence and fixed investment growth, substantial FDI inflows, strong fiscal consolidation (government debt falls back to low ratios of 2000s). Strong global growth, commodity boom. Stabilisation of credit ratings, then credit rating upgrades.

		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
Up case **4%**	USD/Rand (average)	15.38	16.00	15.00	14.00	13.50	12.00	11.50	11.00
	Repo rate (end rate)	5.25	3.75	3.75	3.75	3.75	3.75	3.75	3.75

Quick rebound from Covid-19 pandemic, rising confidence and investment levels - structural problems worked down. No further credit rating downgrades, rating outlooks move to stable and eventually positive, strong fiscal consolidation (government debt projections fall substantially). Global risk-on, global demand quickly returns to trend growth. Limited impact of expropriation without compensation) to abandoned, unused, labour tenants'' and government land (individuals are new owners and receive title deeds) does not have a negative effect on economy - no nationalisation.

		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
Base	USD/Rand (average)	15.38	18.00	17.50	16.50	15.75	15.50	15.50	15.00
case	Repo rate (end rate)	5.25	4.00	4.00	4.00	4.00	4.25	4.25	4.25

43% Temporary sharp global slowdown and global financial turmoil from Covid-19 pandemic (severe currency depreciation, low interest rates) – eventually sufficient global and domestic monetary and other policy supports to growth and financial markets occur and risk sentiment stabilises. South Africa exits recession in Q3.20. Market unfriendly policies like expropriation of private sector property put on hold in the crisis. SA remains BB+ rating from Moody's - government debt projections stabilise.

		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
Lite	USD/Rand (average)	15.38	19.50	22.00	20.00	18.50	17.00	16.50	16.00
(domestic)	Repo rate (end rate)	5.25	4.25	4.25	4.50	4.75	4.75	4.75	5.00

Down case **42%** The international risk sentiment environment is that of the base case. South Africa continues to fail to see its debt projections stabilise and loses its BB+ rating from Moody's and falls towards B ratings from all three rating agencies. More severe recession in SA over 2020 than in the expected case. Expropriation of some private commercial sector property without compensation, with some negative impact on the economy. Business confidence depressed even further, significant rand weakness, significant load shedding and weak investment growth until substantial fiscal repair ultimately effected.

		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
Severe	USD/Rand (average)	15.38	22.00	24.00	21.00	20.00	19.00	18.00	16.50
down	Repo rate (end rate)	5.25	4.50	4.75	5.00	5.50	6.00	6.50	7.00

case **10%** Lengthy global recession on impact of Covid-19 – global financial crisis – insufficient monetary and other policy supports to growth domestically and internationally. Depression in SA, unprecedented rand weakness. Nationalisation of private sector property (title deeds not transferred to individuals). SA rated single B from all three key agencies, with further rating downgrades occurring into C grade as government finances deteriorate (debt projections elevate even further - fail to ever stabilise. Government borrows from increasingly wider sources as it sinks deeper into a debt trap), eventually include widespread services load shedding, strike action and civil unrest.

Note: Event risk begins Q2.20. Source: Investec

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