



Headline inflation eased further in January, but upside risks remain

Highlights

- According to Statistics South Africa (Stats SA), headline inflation (CPI) in January 2023 eased to 6.9% year-on-year (y/y) from 7.2% y/y in December 2022. This was in line with the median Reuters consensus.
- The January y/y inflation rate was largely driven by food and non-alcoholic beverages (NAB), housing and utilities, transport and miscellaneous goods and services.
- On a month-on-month basis (m/m), CPI was deflationary for the first time since the peak of the pandemic.
- Lower international oil prices in December contributed positively to the lower rate of transport inflation in January. The average price of Brent crude oil was lower in December at US\$81/bbl.
- The price of petrol and diesel (inland) decreased by R2.06/l and R2.69/l, respectively in January. This represents the largest price cut dating back to 1996.
- Food inflation, on the other hand, accelerated more than in December despite the lower rate of increase in international food prices. This may be attributed to domestic challenges such as ongoing loadshedding and rand weakness.
- Core inflation remained unchanged at 4.9% y/y in January. The Reuters median consensus expected underlying inflation to increase slightly to 5%.
- While underlying pressures remain contained, we expect upward pressure in the coming months from housing costs and medical inflation, given that housing costs and medical inflation combined make up almost 50% of the services basket.
- The expected uptick in services inflation poses a risk to inflation expectations and wage settlements.
- At a headline level, risks stem from severe loadshedding, the re-opening of the Chinese economy, rand weakness, higher-than-expected electricity tariffs and adverse weather conditions.
- Despite these risks to the inflation outlook, the Monetary Policy Committee (MPC) is likely close to the end of the hiking cycle. We expect the MPC to respond to upside threats to inflation with one more 25-basis point increase in interest rates at the March meeting, which will result in the repo rate peaking at 7.5%.

Headline and core inflation broadly in line with expectations

Headline inflation eased from 7.2% y/y in December 2022 to 6.9% in January 2023, matching the Reuters consensus expectation. This is the lowest inflation rate since May 2022.

The main drivers of the annual increase were food and NAB (13.4% y/y, contributing 2.3%), transport (11.1% y/y, contributing 1.6%) housing and utilities (4.1% y/y, contributing 1%) and miscellaneous goods and services (4.8% y/y, contributing 0.7%). Food and NAB is the only category which recorded a higher rate of increase in January compared to the December outcome. Prices for housing and utilities were unchanged, while inflation for transport and miscellaneous goods and services was lower.

Headline inflation was disinflationary (negative 0.1%) m/m mainly due to transport inflation (negative 3.5% m/m). The previous occurrence of disinflation on a monthly basis was during the peak of the pandemic (April and May 2020).

Chart 1: Headline inflation dipped by 0.3%



Source: Global Insight, Momentum Investments

At an underlying level, inflation remained unchanged at 4.9% y/y in January and the m/m rate was also unchanged at 0.2%. Notably, the annual increase was lower than the market expectation of 5%.

International oil prices supportive of lower domestic inflation

Support for lower headline inflation stems from the continued decrease in international oil prices and the stronger domestic currency.

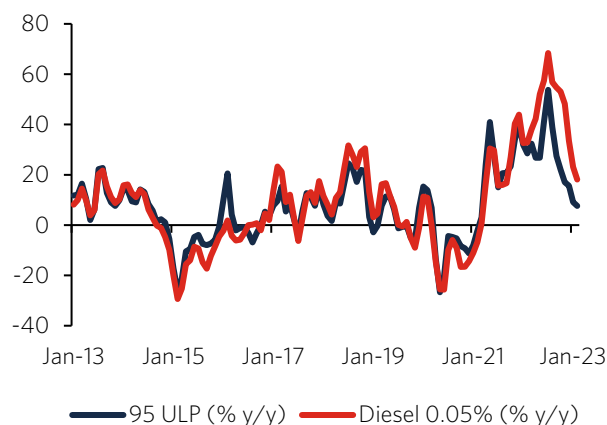
The price of Brent crude oil was down from an average of US\$91.4/bbl in November 2022 to US\$81/bbl in December 2022. Moreover, the domestic currency appreciated from R17.21 to R17.03 against the US dollar over the same period. This led to historically high cuts in the price of petrol and diesel in January 2023, given that fuel is purchased a month in advance.

According to the Central Energy Fund (CEF), the price of petrol (inland 95) decreased by R2.06/l to R21.4/l and diesel (inland) decreased by R2.69/l to R21.23/l in January. The y/y growth in petrol prices decelerated to 9.1%, the lowest level since March 2021, and diesel decelerated to 23.1% as illustrated in chart 2.

The January price cuts were slightly reversed in February. The CEF announced an increase of 28c/l in

the petrol price (inland 95) and a smaller increase of 9.16c/l in the price of diesel (inland) for February. However, diesel is still relatively higher because of the limited supply and strong demand.

Chart 2: Substantial fuel price cuts in January 2023



Source: IRESS, Momentum Investments

As a result of lower fuel prices, transport inflation was meaningfully lower at 11.1% y/y in January from 13.9% y/y in December. The deceleration in transport inflation

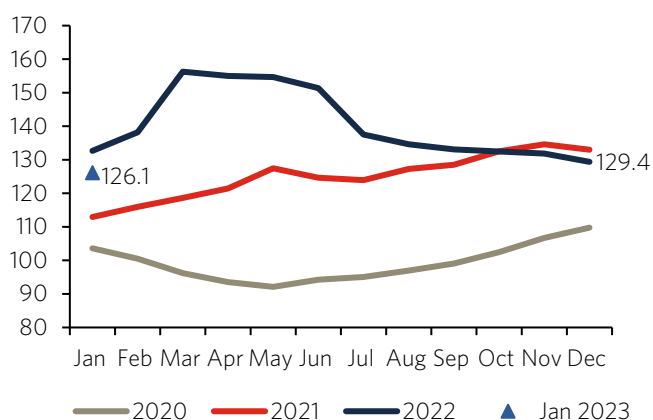
outpaced the acceleration in food inflation resulting in lower headline inflation overall.

Food inflation unexpectedly high, likely as a result of domestic challenges

The surge in food inflation in January 2023 (13.8% y/y) was unexpected given the encouraging outcome of 12.7% in December 2022 and the lower rate of increase in international food prices.

The Food and Agriculture Organisation (FAO) of the United Nations Food Price Index was 126.1 points in January, down from 129.4 points in December as illustrated in chart 3. While the index is lower than the same period a year ago, it remains elevated. The FAO attributes the drop in the index in January to a decrease in the price indices of vegetable oils, dairy and sugar. The index for cereals and meat was largely unchanged.

Chart 3: Food price index dropped in January 2023



Source: FAO of the United Nations, Momentum Investments

On the local front, higher food inflation was broad-based across the food categories, but the largest contribution stemmed from higher meat prices (11.2% y/y from 9.7% y/y) and bread and cereals (21% y/y from 20.6% y/y). Fruits and vegetables also accelerated meaningfully in January compared to December (3.6% y/y from 1.6% y/y and 14.3% y/y

from 12.5% y/y, respectively) although their weight to food inflation is relatively low.

According to Agrimark Consulting, global fertiliser prices remain elevated, but they are coming down. SA is expected to benefit from the decreasing trend in prices, particularly given that we import the bulk of our annual fertiliser consumption. Furthermore, the price of sunflower seed is decreasing which will lead to lower retail sunflower oil prices. This will be beneficial to constrained consumers given that sunflower oil (750ml) was on average 35.5% more in 2022 than in 2021 (second largest price increase from all inflation components last year). Moreover, wheat prices are coming down which will lead to lower bread prices and lower global shipping costs could in addition be beneficial.

However, Agrimark Consulting notes that there are a lot of developments in the agriculture sector which point to a stickier deceleration in food inflation. Globally, grain stock levels are declining which could push prices up and the third consecutive year of La Niña is not conducive for the US. Locally, loadshedding has a significant impact on agriculture because it leads to irrigation and ventilation disruptions which affect production and lowers supply. Around 25% of food production in summer and almost 40% in winter relies on sufficient irrigation. This indicates that supply reductions will likely be intensified in the coming months. The ventilation disruptions are known to have adversely affected poultry houses. As a result, the prices of vegetables, fruits, eggs, dairy products and chicken have become more expensive. This trend will likely continue as loadshedding persists.

Services inflation expected to edge higher

Following the rally of goods inflation from 0% in May 2020 to a peak of 11.5% in July 2022, goods inflation decelerated for the sixth consecutive month to 9.5% in

January 2023. On the other hand, services inflation has been on a general upward trajectory since March 2021, when COVID-19 lockdown restrictions were eased.

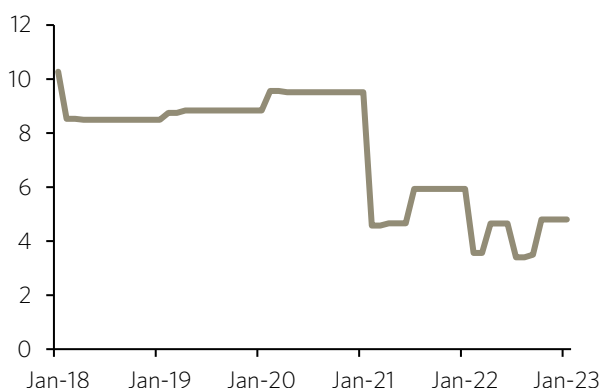
In January, services inflation remained unchanged at 4.3%. Eight out of the 34 services in the services basket recorded inflation of above 6% compared to only four items in March 2021.

The upward trend in services inflation over the past months may largely be attributed to the increase in housing costs (actual rentals and owners' equivalent rent) which account for 32% of the services basket. Owners' equivalent rent had gone down to 0.5% in March 2021, increased to the 3% mark in June 2022 and decelerated to 2.8% in December 2022. However, as indicated in the January CPI note, we expect housing costs to rise in the coming quarters which pose an upside risk to core inflation.

Inflation for passenger transport by air and road recorded double-digit growth of 18.2% and 21.9% in January, respectively, for more than 12 consecutive months.

Moreover, services inflation may be lifted by the increase in medical health insurance rates (second largest item (13.9%) in the services basket).

Chart 4: Medical insurance inflation expected to be higher (% y/y)



Source: Global Insight, Momentum Investments

Risks to the inflation outlook remain

Factors such as persistent loadshedding, a quick re-opening of the Chinese economy, the local exchange rate, high electricity tariffs and adverse weather conditions pose upside risks to the inflation outlook.

According to the SA Reserve Bank (SARB), medical health insurance has been lower because medical schemes had accumulated large surpluses during the pandemic (see chart 4). As such, medical schemes implemented smaller rate increases to relieve pressure on consumers. This trend continued into 2022 as the cost-of-living crisis gained momentum. In January 2023, medical insurance remained low at 4.8%, significantly below the pre-pandemic¹ average of 9%. However, this is expected to edge higher over the coming months due to higher rate increases. According to *Daily Maverick*, a few medical schemes have announced average rate increases which are above the Council of Medical Schemes' recommendation of a maximum increase of 5.7%.

Chart 5: Goods and services inflation gap narrowing



Source: Global Insight, Momentum Investments

While the gap between goods and services inflation remains wide as illustrated in chart 5, it has been closing at the margin. We expect a further fall in goods inflation to drive the gap smaller in the coming months.

¹ January 2018 to December 2020

sector. This places upward pressure on food prices. Moreover, businesses have invested in back-up power sources to mitigate the effect of loadshedding. This investment in conjunction with the cost of running back-up power (e.g. purchasing diesel) is eroding business margins. Should businesses decide to shift some of these costs to consumers, Nedbank estimates that prices would need to increase by between 2% and 4% in addition to periodic price adjustments.

The re-opening of China is anticipated to be inflationary due to pent-up demand. According to Bloomberg, the expectation of higher demand has already lifted commodity prices. In January 2023, copper prices increased to a high of US\$9 435/ton. However, the anticipated demand may be more gradual particularly if China's recovery stalls as indicated in the January 2023 World Economic Outlook.

The rand strengthened between November 2022 and December 2022 on dollar weakness, but local issues

weighed on the currency lately despite continued weakness in the dollar. If projected global growth slumps further and domestic risks, such as the potential greylisting, materialise, the rand may continue to depreciate in the near term, which will result in higher import prices.

As indicated in the January CPI note, the above-inflation electricity tariff increases of 18.65% for financial year 2023/24 and 12.74% for financial year 2024/25 is expected to put upward pressure on inflation in the coming months when electricity is surveyed (July).

Lastly, SA declared a national state of disaster because of floods in early February. The widespread flooding in seven of the nine provinces in SA due to the La Niña phenomenon has the potential of being inflationary.

SARB is likely close to the peak of the hiking cycle

Notwithstanding the above detailed risks, we believe that the MPC is near the end of the hiking cycle. Inflation has migrated lower largely due to lower food and fuel inflation and services inflation has not responded in the way services surged globally. Inflation may be further dampened by lower shipping costs and projected weaker global growth.

Moreover, the transmission of monetary policy takes around six to 18 months which implies that we are still

yet to see the impact of some of the rate increases from the second half of 2022.

We anticipate one more hike of 25-basis points in the March MPC (likely with a split vote between hiking and holding rates constant) because of the looming risks and higher longer-dated inflation expectations of 5.5% (1% more than the midpoint target of 4.5%) in the January 2023 survey.

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