



Food inflation underpins negative inflation surprise yet again

Highlights

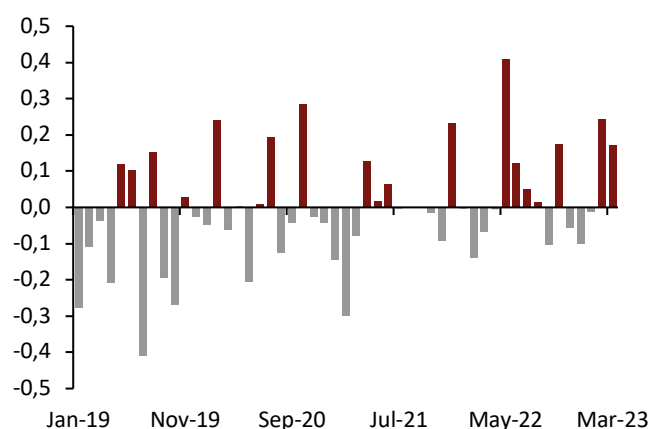
- Headline inflation rose to 7.1% year-on-year (y/y) in March 2023, against the market's expectation for an improvement to 6.9% y/y. The rise in food inflation as well as education costs drove the deviation.
- Core inflation was unchanged at 5.2% y/y in March, but this outcome exceeded the median Reuters expectation of 5.1% y/y.
- Rental inflation (16.49% of the basket) was subdued at c.2.5%, which reduces demand-pull inflationary pressures.
- Data from PayProp and the newly-released residential property price index (RPPI) by Statistics South Africa (Stats SA) suggests an uptick in rental and property prices in 2022. However, affordability concerns and weak economic growth prospects will likely restrict the rise of both indicators this year.
- Water and electricity inflation presents upward pressure on administered prices in the coming months. Most SA municipalities have tabled proposed municipal rate increases for 2023/24 in their respective draft budgets with the following un-weighted average increases: property rates (3.75%), water (10.11%), sewerage (7.78%), electricity (18.38%) and refuse removal (6.18%).
- Despite these proposed increases, municipal finances are in bad shape and basic service delivery has deteriorated. This has resulted in increased protest activity.
- Elevated food inflation is impeding a meaningful improvement in headline inflation. However, inflation in meat, as well as bread and cereals inflation has started decelerating and could drop more notably in the second half of the year.
- Producer price inflation (PPI) for live animals dropped substantially to 15.4% y/y in February. A weak rand is nevertheless keeping the price of bread and cereals high.
- The SA Reserve Bank (SARB) revised its estimate of average food inflation in 2023 to 9.9% (up from 7.3%). The Agriculture Business Chamber of SA (Agbiz) sees food inflation averaging lower (between 7% and 8%) on the back of sufficient agricultural supply and limited impact of weather condition changes.
- Notable upside surprises in headline inflation in the latest two readings, alongside measures of underlying inflation trending in the upper half of the inflation target, suggest an increased risk of additional monetary policy action at the May interest rate-setting meeting. Nonetheless, we maintain that on a forward-looking basis, real interest rates have moved into more restrictive territory, potentially capping prospects for significant tightening from here.

Upside inflation surprise a function of food and NAB, education and personal care

According to Stats SA, headline inflation was slightly higher at 7.1% y/y in March 2023 following an increase to 7% y/y in February. Moreover, the index increased by 1% on a month-on-month (m/m) basis compared to 0.7% last month. However, core inflation remained unchanged at 5.2% in March.

The March CPI print was higher than the Reuters and Bloomberg median consensus of 6.9% y/y.

Chart 1: Negative market surprises since February 2023



Source: Bloomberg median consensus, Global Insight and Momentum Investments

Greater than zero (>0) = negative surprise

Less than zero (<0) = positive surprise

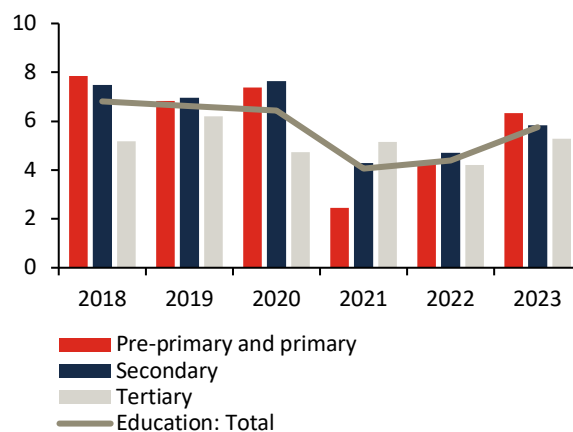
The pressure at a headline level largely stemmed from food and non-alcoholic beverages (NAB, 14% y/y) and the category's contribution to headline inflation increased from 2.3% to 2.4%. The other category that recorded a higher contribution in March relative to February was education (contribution of 0.2%, up from 0.1%).

Housing and utilities inflation remained unchanged at 4% y/y (contributing 1%), while transport inflation decelerated from 9.9% y/y to 8.9% y/y. The deceleration in transport inflation marks the eighth consecutive

decline supported by lower international oil prices and a high base effect.

March is a high survey month, with an additional 24.6% of the basket being surveyed apart from regular monthly surveys. However, this did not lead to a more significant jump in inflation because rental inflation (16.49% of the basket) remained contained. Of the additional items surveyed, education (2.62% of the basket) and domestic worker wages (2.53% of the basket) increased while the other items decelerated or remained the same. Education rose to 5.7% after two years of an average inflation rate of 4.2%, hence the bigger contribution from this category to headline CPI. However, this is still below the long-term average of 7.4%, reflecting the changes of fee-free education at a tertiary level.

Chart 2: Education inflation rises in 2023, % y/y



Source: Global Insight, Momentum Investments

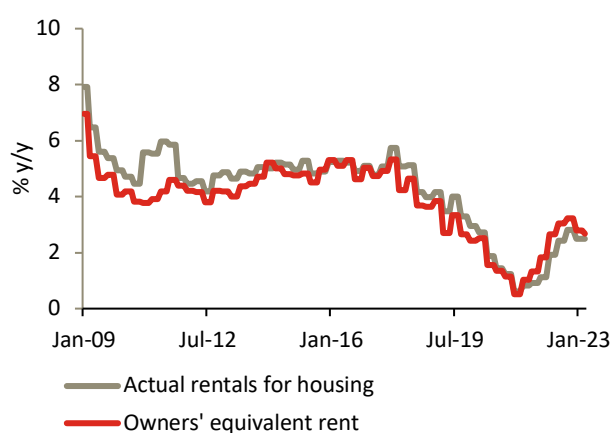
As illustrated in chart 2, the increase was recorded across all levels of education but the fees in pre-primary and primary increased the most.

Higher-than-expected inflation in March was also recorded for non-alcoholic beverages (10.3% y/y) and personal care (11.1% y/y).

Rental inflation remained contained in March 2023

Owners' equivalent rent (12.99% of the inflation basket) declined slightly to 2.7% y/y in March and actual rentals inflation (3.5% of the inflation basket) remained unchanged at 2.5% y/y. This follows a retreat in rental inflation from the December survey and implies that there are no significant demand pressures relative to available rental supply.

Chart 3: Rental inflation retreats



Source: Global Insight, Momentum Investments
Data until March 2023

Following the trough in May 2021, actual rentals and owners' equivalent rent have responded to the increase in interest rates as seen in chart 3. However, the increase in actual rentals is lower because the demand for rentals is still relatively weak which would not justify a higher increase in prices. Furthermore, this may also reflect an element of consideration from landlords given constrained consumer finances.

In the latest PayProp annual market report (fourth quarter of 2022), the company notes that rental growth rates and tenant arrears improved in 2022. This correlates with the improvement seen in vacancy rates. According to the report, rent increased by 3.4% y/y in the fourth quarter of 2022 and arrears decreased to 18.1% from pre-pandemic levels of 19.3%.

The report cautions against an expectation of continued rising rental rates in 2023 because of affordability concerns on the back of the higher cost of living. Further

risks to the market are cited as weak income growth, high unemployment, high interest rates, high inflation and increasing municipal charges. Nevertheless, rental rates may still increase due to higher demand for rentals as people shy away from purchasing property because of the high interest rate environment.

Stats SA's newly launched RPPI provides information on house prices in SA with a five-month lag.

Chart 4: Slow recovery in property prices



Source: Global Insight, Momentum Investments
Data until November 2022

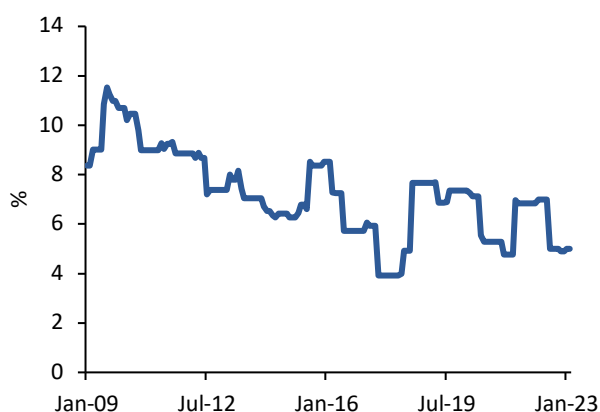
According to the index, the average growth in national property prices was lower in the first 11 months of 2022 (5.7%) compared to a 7.5% average growth rate over the same period in 2021. However, we note that base effects supported growth in 2021.

Growth in property prices bottomed out in June 2022, but the index is showing signs of a slow recovery. Property price inflation remained unchanged at 5.8% y/y in November 2022 from October. Notwithstanding the improvement, property price growth is still well below the recent peak of 8.6% y/y in March 2021. Elevated interest rates, higher uncertainty, unemployment and weak growth prospects are likely the reasons for the slow recovery.

Electricity and water tariffs pose upward pressure on administered price inflation

Regulated administered price inflation was 6.7% y/y in March, down from the peak of 24.7% y/y in July 2022. Administered prices, excluding fuel and paraffin, has been on a downward trend as depicted in chart 5.

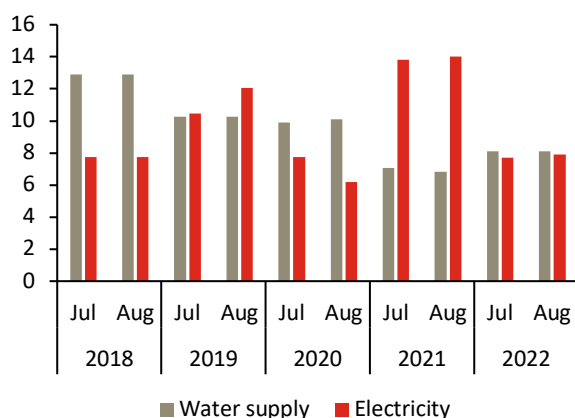
Chart 5: Administered prices excl. fuel and paraffin



Source: Global Insight, Momentum Investments

Administered prices dropped from around 7% y/y recorded in July 2021 to 5% y/y in July 2022. This is in line with the deceleration in electricity prices from 2021 to 2022 as illustrated in chart 6. Electricity price inflation dropped from 14% y/y recorded in August 2021 to 7.7% y/y in July 2022. Increases in water tariffs accelerated from 6.8% y/y to 8.1% y/y over the same period.

Chart 6: Electricity and water inflation expected to edge higher, % y/y



Sources: Global Insight, Momentum Investments

Electricity and water tariffs present upward pressure on administered price inflation in the near term. We expect water and electricity inflation to pick up in July and August 2023 when municipal charges are surveyed.

The expected uptick in electricity inflation stems from the Nersa-approved 18.65% electricity tariff for financial year 2023/24. *Moneyweb* notes that eThekweni is proposing a tariff increase of 21.9%, higher than the approved rate hike. The intended rate hike for Tshwane and Mangaung is not yet known and the other five metros have tabled an increase in line with 18.65% or lower as detailed in table 1. However, Nersa is proposing that municipalities increase electricity tariffs by 15.1% from July which will reduce electricity price pressures if the metros apply it.

Table 1: Municipal rate increases for 2023/24, %

Residential*	Rates	Water	Sewerage	Electricity**	Refuse removal
City of Joburg	5.3** *	9.3	9.3	18.65	7
eThekweni	8.9	14.9	11.9	21.91	8
City of Cape Town	-1.1	8.6	8.6	17.6	5.5
Ekurhuleni	4.4	12	5.3	15*** *	5.3
Nelson Mandela Bay	5	6	6	18.49	6
Buffalo City	0	9.86	5.3	18.65	5.3
Average	3.75	10.11	7.78	18.38	6.18

Sources: Moneyweb, Momentum Investments

*Tshwane and Mangaung are excluded

**Pending finalisation of the Nersa tariff guideline

***Plus increase from valuation roll which, in total, is 12% higher

****Planned increase prior to Nersa announcement

In terms of water prices, eThekweni is proposing the highest rate increase of 14.9%, above the 10.11%

average increase. With the higher rate increases in eThekweni, it is estimated that a homeowner of a R1 million property in the metro pays over 100% more than a homeowner in Johannesburg and almost 200% more than an owner in Cape Town.

Apart from upward pressure on administered prices, these proposed municipal rates increases may undermine the recovery in the property sector due to higher costs.

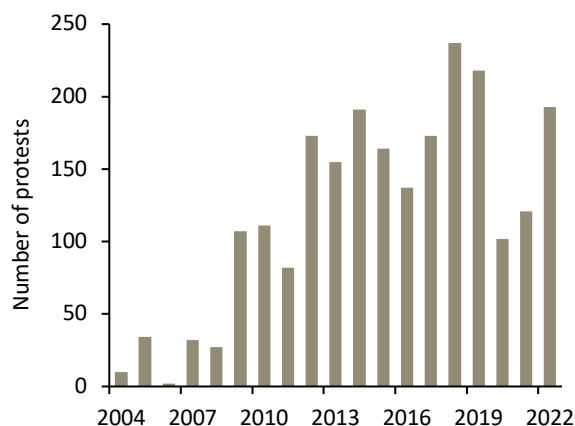
Municipal arrears to Eskom are growing at an unsustainable rate (R56.3 billion as at December 2022) despite rate hikes which negatively affects Eskom's recovery and addressing the energy crisis. In the latest consolidated general report on local government audit outcomes, only 41 out of 257 municipalities (16%) were awarded a clean audit in 2020/21. The majority of the municipalities had audit outcomes that were unqualified with findings (38%) and qualified with findings (30%).

Lastly, municipal rates are increasing but there is little value for money given that service delivery continues to deteriorate in some metros. This increases the likelihood of service delivery protests.

As reported by Municipal IQ, the number of major service delivery protests increased to 193 in 2022

following the drop caused by COVID-19 restrictions in 2020 and 2021 as seen in chart 7.

Chart 7: Major service delivery protests up in 2022



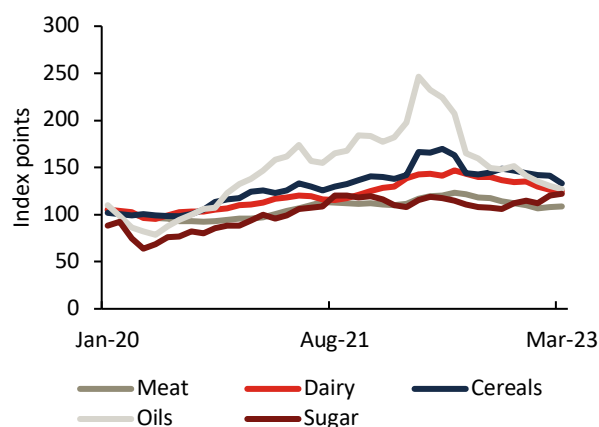
Source: Municipal IQ, Momentum Investments

The report cites electricity as the biggest reason for protests in 2022. Another reason for unhappy communities was access to clean water. Most of the protests in 2022 were concentrated in Gauteng (27%) but the report notes that protests in KwaZulu-Natal are increasing (22%). The higher municipal rate increases in eThekweni may spark a further increase in protests in the province.

Food inflation still a risk despite disinflation in the largest weights of the food basket

International food prices, measured by the Food and Agriculture Organisation (FAO) food price index, decelerated for the 12th consecutive month in March 2023. Since the peak in March 2022, the index has decreased by 34.2 points. A breakdown of the index shows that all the sub-indices (meat, dairy, cereals, oils) are lower than a year ago except for sugar prices as seen in chart 8. The index measuring oil prices has decreased the most by 119.7 points between March 2022 and March 2023. On the other hand, the sugar price index was 122.1 in March 2023, the highest level since February 2017. According to the World Bank, an acceleration in sugar prices is due to lower estimated production in India.

Chart 8: Sugar and meat prices accelerated in March

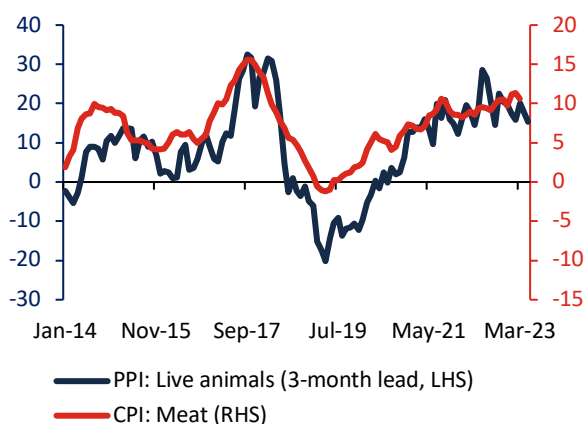


Sources: FAO, Momentum Investments

Domestic food inflation accelerated to 14.4% y/y in March from 14% y/y in February. This was largely driven by milk, eggs and cheese (13.6%) and vegetables (20.5%). Inflation in a larger portion of the food basket, meat as well as bread and cereals, decelerated.

Meat inflation (35.4% of the food basket at a consumer level) declined to 10.6% y/y in March from 11.4% y/y in February. PPI of live animals came down from 21.6% y/y in January 2023 to 15.4% y/y in February. Most of the meat consumed in SA is produced domestically hence the strong correlation between these two series as depicted in chart 9. As such, meat prices could continue to come down in the near term.

Chart 9: Producer inflation signals meat disinflation, % y/y

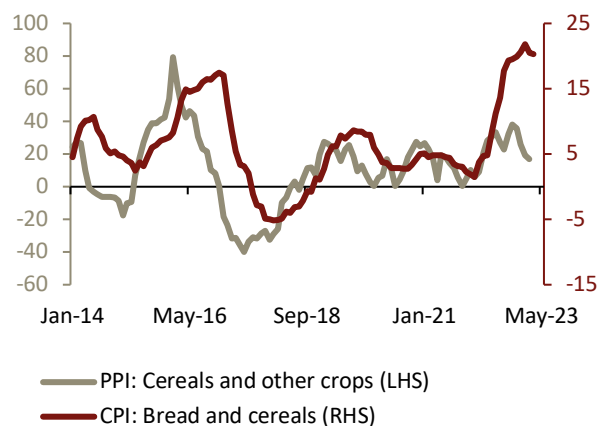


Source: Global Insight, Momentum Investments

Agbiz indicates that downward pressure on meat prices stems from lower carcass prices. Moreover, downtrading from red meat is expected to place further downward pressure on meat prices as consumers continue to try and make ends meet with a constrained budget. However, upside risks to other meat types remain.

The correlation between bread and cereals inflation and PPI for cereals and other crops is weaker due to the higher reliance on imports. The divergence between these two series (illustrated in chart 10) has been driven by limited supply and the weaker rand. As such, we assess the movement in the prices of bread and cereals with a greater emphasis on international trends and exchange rate movements.

Chart 10: Deviation between producer and consumer prices amid higher global uncertainty, % y/y



Source: Global Insight, Momentum Investments

The international cereal price index decreased for the fifth consecutive month to 133 points in March 2023. Local bread and cereals inflation (20.7% of the food basket) was also slightly lower at 20.3% y/y March.

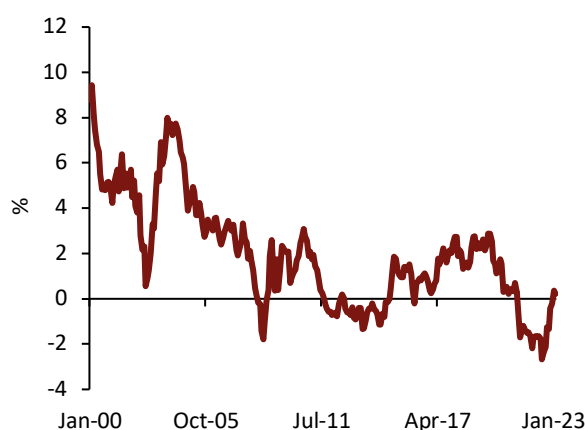
Despite the deceleration in global food prices and the expected deceleration in 56% of the food basket, we expect food inflation to remain elevated due to rand weakness. The exchange rate averaged R17.85 against the dollar in the first quarter of 2023 compared to R16.46 in 2022. The SARB has revised its estimate for average food inflation in 2023 to 9.9% from 7.3% at the March interest rate meeting. The revised estimate is higher than the average of 9.5% recorded in 2022. The reasons provided for the significant upward revision included the lagged impact of the weaker domestic currency and the higher risk of the El Niño season.

Agbiz is of the view that food inflation will moderate to between 7% and 8% in 2023, lower than the SARB's forecast. This view is informed by an expectation of lower prices for grains, cereal and meat towards the end of the first half of this year. Furthermore, Agbiz expects inflation in a third of the (weighted) items in the food basket to decelerate sharply in the second half of 2023. Additionally, they do not think the impact of the El Niño season will be significant this year and next year because of good soil conditions.

Less accommodative repo rate balanced with continued upside risks to inflation

Following the negative surprise in the February inflation print, higher perceived risks to the inflation outlook (sticky food inflation, currency weakness and administered prices) and increased global financial stability risks, the SARB surprised markets with a 50-basis point hike in March 2023. This move took the repo rate to 7.75% which means real interest rates have been lifted further into positive territory as illustrated in chart 11.

Chart 11: Real interest rates back in positive territory



Source: IRESS, Momentum Investments

Using realised inflation

Data until March 2023

Further significant increases in the repo rate will likely be harmful to already-downbeat growth prospects. In the latest World Economic Outlook, the International Monetary Fund revised SA's economic growth to 0.1% for 2023, significantly lower than its estimate of 1.1% in the January update and closer to the SARB's forecast of 0.2% (down from 0.3%).

In light of the above points, we expect the SARB to keep the repo rate constant at the May MPC meeting and we do not anticipate repo rate cuts in the coming months because of persistent upside risks to the inflation outlook.

However, notable upside surprises in headline inflation in the latest two readings, alongside measures of underlying inflation trending in the upper half of the inflation target, suggest an increased risk of additional monetary policy action at the May interest rate-setting meeting. Nonetheless, we maintain that on a forward-looking basis, real interest rates have moved into more restrictive territory, potentially capping prospects for significant tightening from here.

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