momentum investments

in the moment

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Headline inflation surprises positively, dropping to 6.8% y/y

Highlights

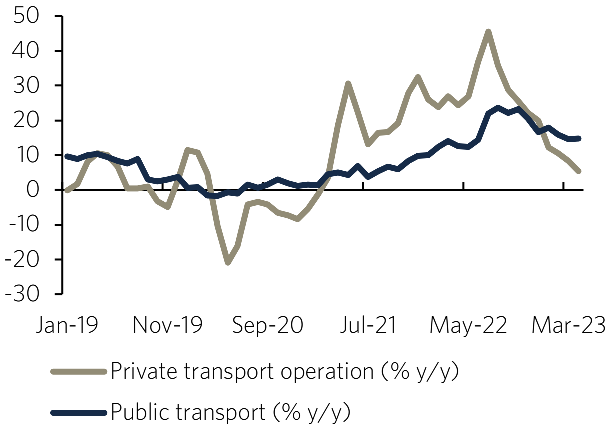
- The April 2023 inflation print of 6.8% year-on-year (y/y) starts the second quarter with a better-than-expected outcome. According to the median Reuters consensus, the market anticipated an inflation rate of 7% y/y.
- The deceleration in transport inflation is largely due to private transport while public transport remains sticky and continues to place pressure on the lowest 30% of spenders in South Africa (SA).
- Core inflation ticked up to 5.3% y/y (in line with market expectations) from 5.2% y/y in March. This is on the back of higher health insurance inflation (8.3% y/y from 7.5% y/y since the previous survey in February 2023).
- Local food inflation eased to 14.3% y/y in April (partly a reason behind the positive surprise against market consensus of headline inflation). Although food inflation is likely to remain elevated in the near term due to currency weakness and loadshedding, today's figure could signal the peak in food inflation.
- Processed food has been the main driver of food inflation. However, unprocessed food inflation is sturdily gaining momentum.
- The global food price index and international oil prices have indicated a decelerating trend despite a slight rebound in April. The International Energy Agency (IEA) warns of upward pressure on oil prices in the second half of 2023 due to anticipated supply shortages from productions cuts to be implemented by the Organisation of the Petroleum Exporting Countries Plus (OPEC+).
- According to the over-recovery reported by the Central Energy Fund (CEF) for petrol and diesel (inland), we can expect a decrease in fuel prices in June 2023 estimated at 94 c/l for petrol and 106 c/l for diesel.
- The tightening of monetary policy by the SA Reserve Bank (SARB) and the tax and expenditure plans proposed in the *2023 Budget Review* by the National Treasury indicate that monetary and fiscal policy are working toward the common goal of containing inflation. However, there are fiscal concerns (wage bill, softer commodity prices which are less conducive for terms of trade, loadshedding impact and the social relief of distress (SRD) grant) which may undermine fiscal consolidation efforts.
- The refining of the Quarterly Projection Model (QPM) is said to produce improved forecasts by the July Monetary Policy Committee (MPC) sitting and we believe this will have a positive impact on inflation expectations which have shifted above the midpoint of the inflation target.
- In light of currency weakness, sticky food inflation, renewed risks of higher international oil prices, rate hikes from major central banks and vulnerable global financial conditions, we expect a further interest rate hike in the upcoming May interest rate-setting meeting. Risks to a larger 50-basis point increment have grown relative to our initial expectation given the extent of currency depreciation and the additional upside threat it poses to inflation expectations.

Headline inflation eases despite an uptick in core inflation

The inflation rate in April 2023 was 6.8% y/y, down from 7.1% y/y in March and better than the Reuters median consensus of 7% y/y. This was largely driven by transport inflation decelerating from 8.9% y/y in March (1.3% contribution) to 7.6% y/y in April (1.1% contribution).

However, the deceleration in transport stems more from private transport operations as opposed to public transport as seen in chart 1. Private transport inflation has seen a sharp deceleration from a peak of 45.5% y/y in July 2022 to 5.4% y/y in April 2023. Public transport inflation is, however, stickier at double digits and accelerated to 14.8% y/y in April from 14.6% y/y in March. This partly explains the higher inflation rate experienced by the lower expenditure deciles (average of 10.4% y/y for the first three deciles) compared to an average of 6.7% y/y for deciles eight to 10.

Chart 1: Public transport inflation remains sticky

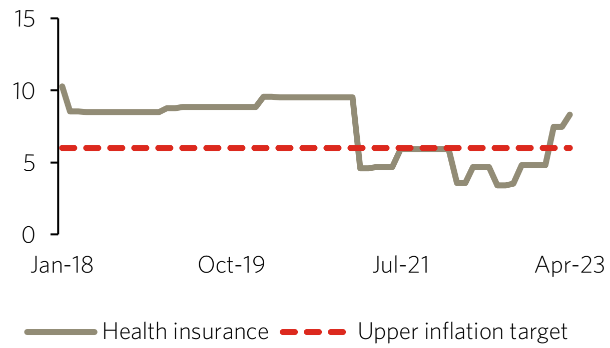


Source: Global Insight, Momentum Investments
Data until April 2023

Core inflation was slightly higher at 5.3% y/y in April (in line with market expectations) but eased slightly to 0.5% on a month-on-month (m/m) basis from 0.8 m/m in March. Slighter higher core inflation was due to an uptick in services inflation (4.7% y/y from 4.5% y/y in March). This is on the back of higher health insurance costs.

Medical insurance (the second largest component in the services basket) is surveyed biannually in February and April when medical aid increases are implemented. In the February survey, medical aid inflation shot up to 7.5% y/y, above the upper inflation target of 6%, and escalated further to 8.3% y/y in April. Increases by the three largest medical schemes (Discovery, Bonitas and Momentum) came into effect in April which puts additional strain to consumer finances. However, medical inflation is still below the pre-COVID average of 9%.

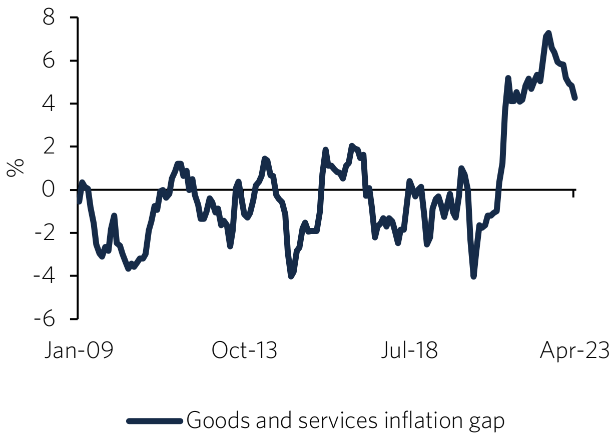
Chart 2: Health insurance up to 8.3% y/y



Source: Global Insight, Momentum Investments

In terms of the other additional surveyed items, funeral expenses and gravestone costs decelerated to 0.8% y/y and funeral policies stayed constant. On the other hand, inflation rose for recreational and sporting services (3.6% y/y), television subscription fees (7.3% y/y) and medical services (5.8% y/y).

Chart 3: Goods and services inflation gap narrows further as goods inflation decelerates



Source: Global Insight, Momentum Investments

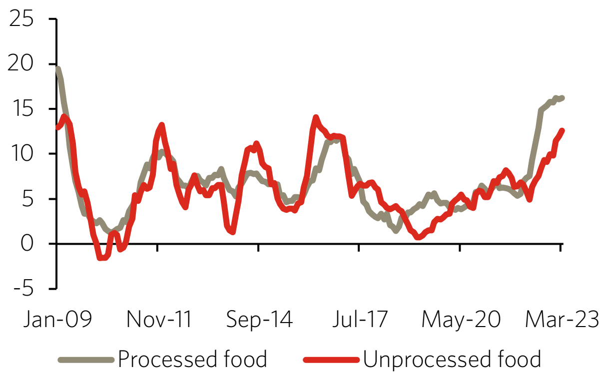
Overall, lower goods inflation in April (9% y/y) and marginally higher services inflation resulted in a narrower gap between the two indices as illustrated in chart 3. Unlike the steep uptick in services inflation globally, services inflation has only ticked up slightly in SA.

Domestic food inflation eased signalling a potential peak

Domestic food prices increased by 14.3% y/y in April, lower than 14.4% y/y in the previous month. This can be attributed to the further decline in meat inflation (9.5% y/y in April from 10.6% y/y in March). Oils and fats were also meaningfully lower at 9.9% y/y from 16% y/y in March. Bread and cereals (20.8% y/y), milk, eggs and cheese (14.5% y/y) and vegetables (23.1% y/y) placed upward pressure on food inflation during April.

The surge in food inflation from May 2022 was to a large extent driven by increases in the price of processed food as seen in chart 4. However, the rate of increase has stabilised somewhat since the third quarter of last year and is down to 15.9% y/y. On the other hand, price increases of unprocessed foods remain steep.

Chart 4: Upside risks for unprocessed food inflation



Source: Global Insight, Momentum Investments
Data until April 2023

The Avian flu outbreak at poultry farms in the Western Cape toward the end of April could stall the downward trajectory in meat inflation. Agbiz notes that animal diseases are a risk to agricultural production and they note that the risk will intensify with climate change. Animal diseases and weather changes (shift from La Niña to El Niño) pose a higher risk to unprocessed food inflation.

While the food category carries a lot of uncertainty, the SARB is predicting that food inflation peaked in the first quarter of the year. However, we maintain that food prices will remain sticky in the near term due to a weaker currency and more severe loadshedding.

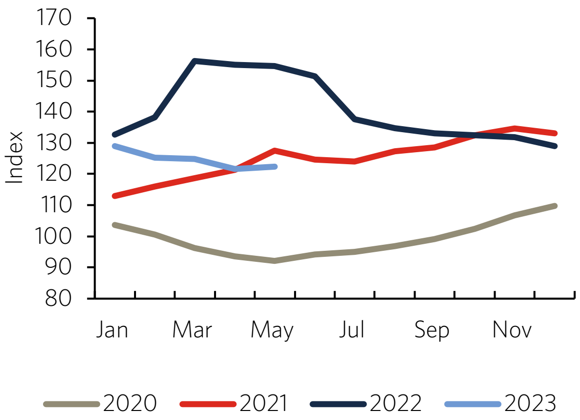
The rand has depreciated by around 13% year to date. This has been driven by a confluence of factors including concerns about the domestic economy given the ongoing loadshedding, major central banks' policy decisions, geopolitical issues, politics, and tighter global financial conditions, amongst others. These factors are an ongoing concern and may continue to influence the rand. Loadshedding has increased in intensity and duration compared to last year, major central banks are still far from their inflation targets and there is growing concern about SA's foreign policy stance.

International oil prices and global food prices ticked up in April

The nominal international food price index, measured by the Food and Agriculture Organisation (FAO), was slightly higher at 127.2 points in April 2023 (up 0.8 points from March). The marginal rebound follows 12 consecutive months of deceleration in the index and was driven by a sharp increase in the sugar price index (up 22.4 points on a m/m basis). The FAO attributes the increase in sugar prices to concerns over production levels for 2022/23 (actual and projected) from specific regions, higher crude oil prices and a stronger Brazilian currency against the US dollar.

Nevertheless, the April food price index is well below the elevated level reached last year this time and is now also below the 2021 reading which, if the rand strengthens, will be beneficial for domestic food inflation.

Chart 5: Global food price index lower than April 2021



Source: FAO, Momentum Investments

The average price of Brent crude oil also rebounded in April to US$84.7 bbl, the highest level since November 2022 from a 15-month low of US$78.4 bbl. According to the IEA, the rebound in April was due to surprise production cuts from the major oil exporting countries (OPEC+) in addition to the announcement of lower output from Russia since March until December 2023. Higher international oil prices in April correspond with the increase in the price of petrol (inland, 93 and 95) in May. However, diesel went down by 73.54 c/l in May due to lower international diesel prices according to the CEF. The CEF estimates an over-recovery of 93.5 c/l for petrol and 105.9 c/l for diesel (as at 23 May 2023) which means we can expect a decrease in the price of petrol and diesel in June.

The IEA warns that OPEC+ production cuts increase the risk of an anticipated supply shortage in the second half of the year largely because of higher demand from China's reopening. A supply deficit is anticipated despite weaker demand from lower industrial activity in the world's biggest economies and production growth in regions outside of OPEC+. Furthermore, the IEA cautions that these developments will add pressure to oil prices in the second half of the year, which adds to inflationary pressures.

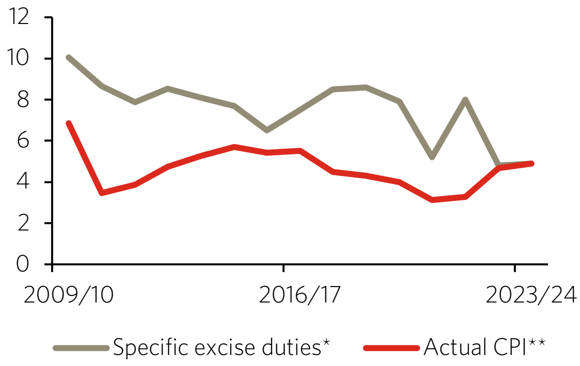
Risks to fiscal and monetary policy cooperatively trying to fight inflation

In the April 2023 World Economic Outlook, the International Monetary Fund (IMF) noted that one of the measures to contain inflation involved fiscal policy that is supportive of monetary policy. The tax and expenditure proposals tabled in the February *2023 Budget Review* (effective 1 April 2023) are broadly in line with the objective of containing inflation. However, there are potential developments which threaten government's fiscal consolidation strategy and may aggravate inflation pressures.

The budget proposed no changes to the general fuel levy which is beneficial in reducing upward pressure on fuel prices increase and thus transport inflation. The health promotion levy (sugar tax) was also left unchanged which will be favourable for food and non-alcoholic beverages (NAB) inflation.

Furthermore, the government recognises the grave impact of loadshedding on inflation which the SARB has estimated to be 0.5% in 2023 in the April Monetary Policy Review (MPR). To address inflationary pressures due to loadshedding, National Treasury extended the diesel fuel levy refund intended for manufacturers of foodstuff for two years which will help limit cost push inflation. Moreover, an incentive is provided in the form of a tax relief to businesses and households to install solar panels and other renewable sources of energy. An uptake of this incentive is expected to alleviate some demand pressure on the grid so that loadshedding can be reduced and businesses and production can resume without major disruptions and additional costs.

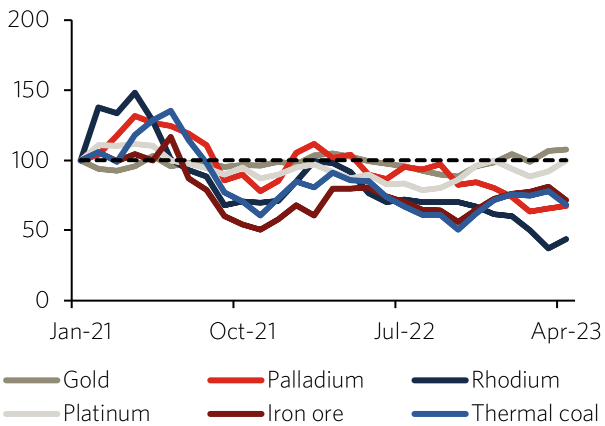
Chart 6: Excise duty increases historically above CPI



Source: Global Insight, Momentum Investments
** Average nominal % increase*
***Fiscal year and 2023/24 is a forecast*

Lastly, excise duties for alcohol and tobacco were increased by the expected inflation rate of 4.9% for fiscal year 2023/24. This category has historically been increased by more than what the Treasury forecasts inflation to be (approximately 2.3% higher on average since 2009/10).

Chart 7: Commodity prices no longer as robust (Jan-21 = 100)



Source: Bloomberg, Momentum Investments

The fiscal concerns that pose a risk to the inflation outlook include the wage bill and the finalisation of the SRD grant especially with elections coming up in 2024. Moreover, the fiscal deficit for fiscal year 2023/24 is likely to be wider than the 3.9% of GDP originally budgeted due to pressure on government revenue from the softening commodity prices (see chart 7) and the loadshedding impact on economic activity. J.P. Morgan forecasts a fiscal deficit of 6% of GDP or 5.8% if revenue collections are not affected as much as anticipated during winter this year.

In terms of monetary policy, the SARB has been steadfast in increasing the repo rate to bring down inflation. Since November 2021, the MPC has increased the repo rate by a cumulative 425 basis points to 7.75% as at March 2023. The April MPR signalled a more hawkish tone given persistent domestic inflation and domestic risk factors (weaker rand, more severe loadshedding and higher inflation expectations by price setters). Moreover, global inflation will likely remain higher for longer due to the tight labour markets, a strong US dollar, fiscal support in the European Union and above-target inflation expectations.

The SARB remains committed to fighting inflation despite the downbeat growth projections of 0.2% for 2023 and the less accommodative policy trajectory.

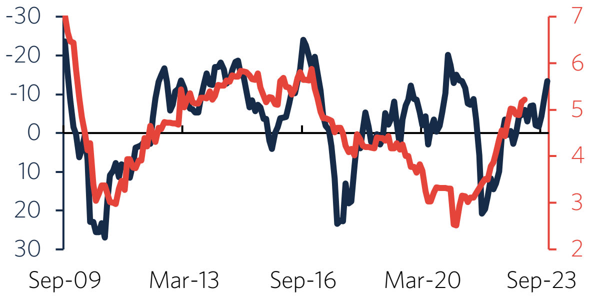
The MPC adopts a forward-thinking stance when approaching monetary policy, keeping in mind the 18-to-24-month transmission lag from policy decisions into the real economy. As such, inflation forecasts need to be as accurate as possible, and the SARB has embarked on enhancing their forecasting model (the QPM) to produce better forecasts. The results from the enhanced model will be published from the July MPC. This may also have a positive impact on inflation expectations because the QPM is also used as a tool to inform the public of the MPC's monetary policy projections.

Elevated risk of a larger rate hike at the May interest rate meeting

In light of currency weakness, sticky food inflation, renewed risks of higher international oil prices, rate hikes from major central banks and vulnerable global financial conditions, we expect a further interest rate hike in the upcoming May interest rate-setting meeting. Risks to a larger 50-basis point increment have grown relative to our initial expectation given the extent of currency depreciation and the additional upside threat it poses to inflation expectations.

As seen in chart 8, the rand weakness against SA's major trading partners (trade-weighted index) will likely keep core inflation elevated over the coming months.

Chart 8: Rand weakness an upside inflation risk



Trade-weighted index (%y/y, 8 month lead - inverted axis)
Core inflation (% y/y, RHS)

Source: SARB, Momentum Investments

The SARB's April 2023 MPR noted that "with most countries experiencing stagflationary conditions and real interest rates already in the neutral region, the outlook for monetary policy remains uncertain." Higher interest rate policy has dented purchasing power of upper-middle and high-income earners in SA who are exposed to prime-linked debt. However, the SARB has noted the distributional consequences of inflation, highlighting that the poor and those living on fixed incomes are the most adversely affected by higher rates. As such, to protect the economic wellbeing of all citizens, we expect the SARB to risk hiking by too much rather than by not hiking enough to arrest the cost-of-living crisis facing many South Africans.

Beyond the end of the current hiking cycle, monetary policy is likely to stay in restrictive mode for some time to assuage the upside threats to the inflation trajectory. We expect the first interest rate cut in the cycle to only be implemented by the end of the first quarter in 2024 at the earliest.