momentum

investments

in the
moment

Herman van Papendorp

Head of Investment Research & Asset Allocation

Sanisha Packirisamy

Economist

Tshiamo Masike

Economic Analyst

Headline inflation eases markedly in May 2023

Highlights

- According to Statistics South Africa (Stats SA), headline inflation (CPI) eased noticeably from 6.8% year-on-year (y/y) in April 2023 to 6.3% y/y in May and core (underlying) inflation dropped slightly to 5.2% y/y in May from 5.3% y/y.
- Disinflation in May was mainly due to lower food and non-alcoholic beverages (NAB) inflation (11.8% y/y, contributing 2.1% in May down from 2.4% in April) and lower transport inflation (7% y/y, contributing 1%).
- International food prices, measured by the Food and Agriculture Organisation's (FAO) food price index retreated in May following the slight rebound in April. Since the peak in March 2022, global food prices are down by 22.1%.
- The Crop Estimates Committee (CEC) estimates that 2023 total commercial field crops will be 6.4% larger than a year ago. The June 2023 floods in the Western Cape are estimated to have had a big impact on the province's agriculture sector but we do not anticipate this to significantly affect the country's production levels because the province's contribution to total maize production is minor.
- Domestic fuel prices are coming down in line with international oil prices. However, prices are still elevated and negatively affecting consumers. Meanwhile, the rand, which is depressed by global developments and idiosyncratic factors, is contributing to elevated fuel prices.
- According to the Central Energy Fund's (CEF) over and under recovery announced on 20 June 2023, we can expect a slight price drop in both grades of petrol and an increase in both grades of diesel in July.
- The agreement of additional oil supply cuts among members of the Organisation of Petroleum Exporting Countries Plus (OPEC+) brings about renewed upside risks to international oil prices and domestic transport inflation. This is exacerbated by the supply cut agreement being extended by one year to December 2024 and the International Energy Agency's (IEA) expectation of higher oil demand in the second half of 2023.
- In comparison to the average inflation rate of emerging and developing market economies (EM), SA's inflation rate has remained relatively contained and is instead trending more in line with the average inflation rate of developed markets (DM).
- The SA Reserve Bank's (SARB) enhanced Quarterly Projection Model (QPM) is said to produce better forecasts on key variables than the original version. The enhanced model estimates stronger spillover effects of food and fuel price changes on core inflation. On the other hand, spillovers from fuel to food inflation is softer than the original model but stronger than the effects of electricity price changes on food inflation.
- Despite May's better-than-expected inflation outcome and the possibility of inflation easing further in the coming months, inflation expectations are elevated and the value of the rand is weak and volatile. Going into the July interest rate setting meeting, we expect developments in inflation expectations and the sustainability of rand

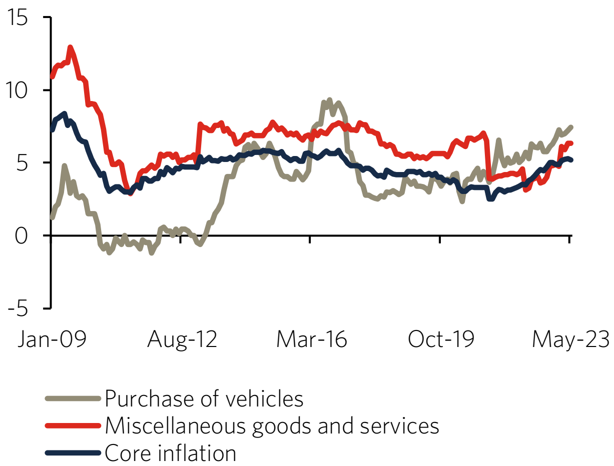
weakness to be top-of-mind matters for the Monetary Policy Committee (MPC). We continue to expect one more interest rate hike of 25 basis points in the current hiking cycle, leaving the peak at 8.5%.

Headline inflation dropped markedly

Stats SA reported headline inflation at 6.3% y/y in May 2023, notably lower than 6.8% y/y in April and better than the Reuters median consensus of 6.5% y/y. The lower CPI print is largely due to lower food and NAB inflation, which dropped from 13.9% y/y in April to 11.8% in May. Moreover, seven of the 12 main categories recorded lower inflation in May.

Core inflation was slightly lower at 5.2% y/y in May compared to 5.3% y/y in April on the back of lower household content and services inflation and a sizable drop in the price of spare parts and accessories. However, underlying inflation remains elevated due to miscellaneous goods and services (6.3% y/y, contributing 1.3%) and purchases of vehicles (7.5% y/y, contributing 0.6%). The higher inflation rate for miscellaneous goods and services is largely due to health insurance inflation.

Chart 1: Purchases of vehicles and miscellaneous goods and services drive core inflation

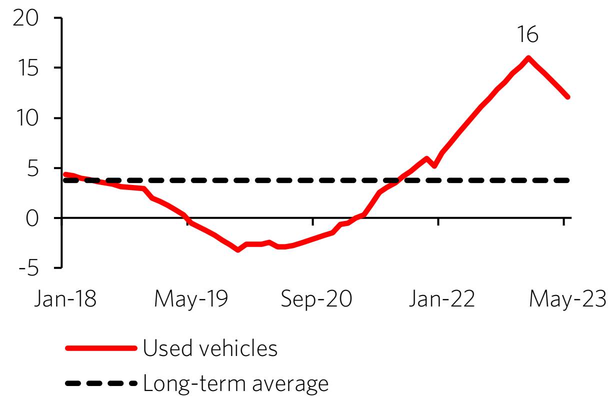


Source: Global Insight, Stats SA, Momentum Investments

Following the pandemic, used vehicle inflation accelerated to a peak of 16% y/y in December 2022. According to *BusinessTech*, this was partly due to the global shortage of semiconductors and microchips which led to a reduction in the supply of new vehicles.

However, used vehicle prices have decelerated for the fifth consecutive month to 12.1% y/y in May 2023. Still, inflation in this category remains significantly above the long-term average of 3.9% since 2009 as depicted in chart 2.

Chart 2: Used vehicle inflation cooling off



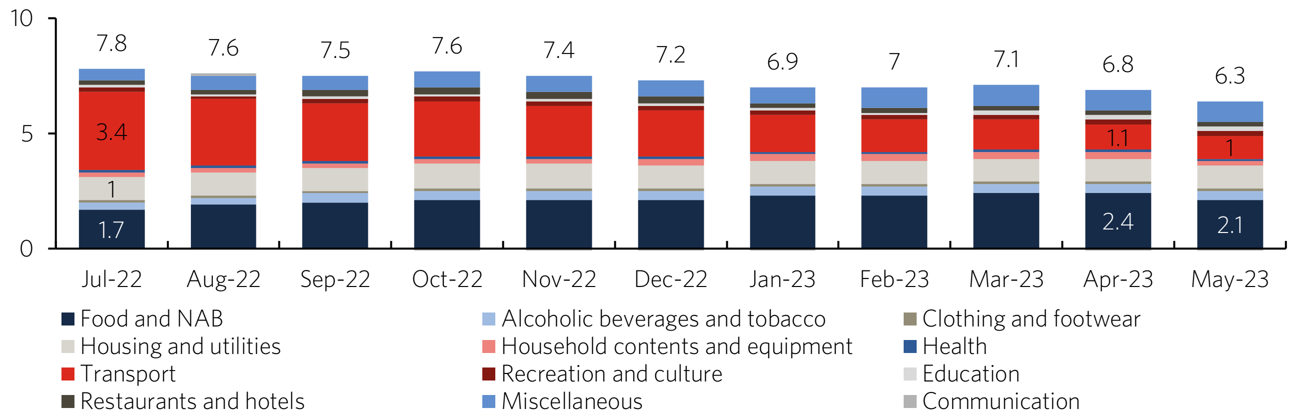
Source: Global Insight, Stats SA, Momentum Investments

The TransUnion vehicle price index report states that a lower number of used vehicles were financed in the first quarter of 2023 compared to the fourth quarter of 2022 which translated to a lower used-to-new ratio of 1.86 from 1.98. The report attributes this to the lower supply of quality used vehicles (a lingering impact from the effects of the pandemic). Furthermore, vehicle price increases outpaced wage growth which is making vehicles largely unaffordable for consumers. TransUnion expects the used-to-new ratio to remain stable in the coming quarters. This means that demand for used vehicles is unlikely to go up which will place downward pressure on prices.

Food inflation eases for the second consecutive month

The deceleration in transport inflation has played a significant role in easing inflationary pressures. As seen in chart 3, the contribution of transport inflation to headline inflation has significantly come down from the peak of 3.4% in July 2022 to 1% in May 2023.

Chart 3: Food and NAB category remains the biggest contributor to elevated inflation

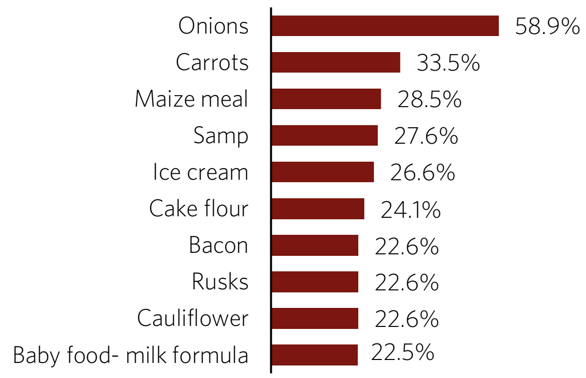


Source: Global Insight, Stats SA, Momentum Investments

Conversely, the food and NAB category has been the main source of upward pressure as illustrated by the larger contribution of 2.1% in May 2023 compared to 1.7% in July 2022. Food and NAB inflation has generally been accelerating since May 2022 with the exception of a slight deceleration in December 2022 and most recently in April and May 2023. The marked drop in food and NAB inflation in May translated to a lower contribution of 2.1% from 2.4% in April. The lower rate of growth was inevitable given the deceleration in global food prices. The FAO nominal food price index was down 22.1% in May 2023 from the peak in March 2022. A key risk to the downward trajectory in this category is the anticipated further weaking of the rand against the United States dollar (US$).

The drop in food and NAB inflation was broad-based with eight of the nine food categories recording lower inflation rates as well as hot beverages. The prices of oils and fats as well as fruits declined by 2.4% y/y and 3.3% y/y, respectively. A notable deceleration was recorded in breads and cereals, meat, fish and vegetables. Despite the deceleration in vegetable inflation, prices are still 20.8% higher than a year ago. Vegetable products (onions and carrots) accounted for the biggest price increases in May 2023 compared to a year ago (see chart 4). Food inflation rose by 0.3% on a month-on-month (m/m) basis in May compared to 0.6% m/m in April.

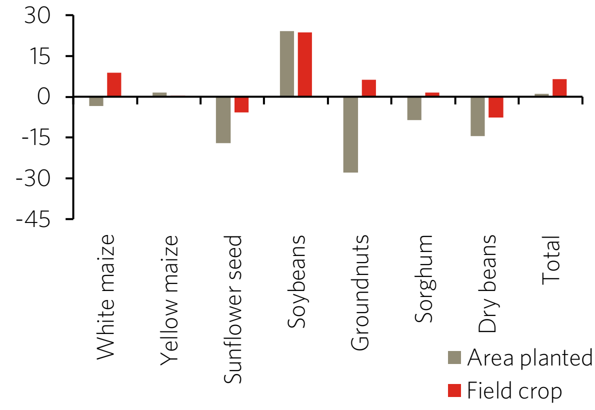
Chart 4: Top 10 price increases in May 2023 (% y/y)



Source: Stats SA, Momentum Investments

In the fourth production forecast for summer crops, the CEC estimates that the total area planted for commercial crops in 2023 will be 1.1% more than in 2022 and the harvest will be 6.4% larger over the same period as seen in chart 5. Higher production will be beneficial for alleviating pressure on domestic food inflation in the near term.

Chart 5: Total area planted and field crop estimated to be higher in 2023 (% y/y)



Source: CEC, Momentum Investments

The largest increase in the planted area estimate and size of the crop is soybeans, increasing by 24.1% y/y and 23.6% y/y, respectively. Agrimark consulting noted that farmers are switching from maize to soy because soy has lower input costs and is more weather resistant which is an important consideration with the upcoming El Niño season. Nevertheless, maize makes up the bulk of total commercial field crops in 2023 (81.2%, down from 82.5% in 2022).

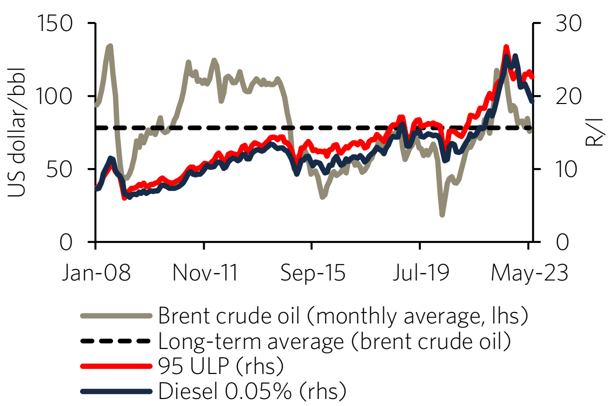
Sunflower seed and dry beans are estimated to be planted on less land and yield less compared to 2023. On the other hand, groundnuts are estimated to be planted on less land but produce a higher harvest.

According to the CEC, the three biggest maize producing provinces are Free State (44%), Mpumalanga (22%) and North West (17), cumulatively producing 83% of total maize in 2023. The Western Cape produces the least maize (estimated at 0.2% in 2023). As such, the recent flooding in the Western Cape in June 2023 is unlikely to have a big negative impact on the country's agricultural output. *Eyewitness News* does, however, report that the Western Cape government has conducted an initial damage assessment which estimates damage of between R750 million and R1 billion for the province's agricultural sector.

Brent crude oil prices slid to below the long-term average

The average price of Brent crude oil came down notably by 9.1% m/m to US$75.6/bbl in May 2023. This is the lowest average price since December 2021. Moreover, the average price level fell slightly below the long-term average of US$78.2/bbl as depicted in chart 6. The IEA attributes this to weaker sentiment due to concerns about global economic conditions and oil demand prospects.

Chart 6: Price of brent crude oil slightly lower than the long-term average since 2008



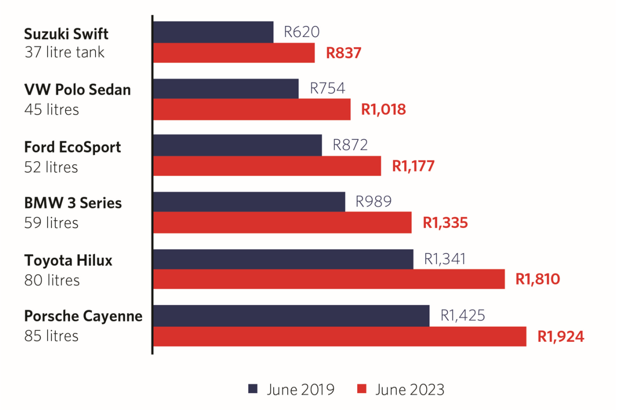
Source: Iress, Momentum Investments

While lower brent crude oil prices have a negative impact on export revenues of net oil exporting countries, it will provide further relief to SA consumers who have been feeling the pinch of high fuel prices. As seen in chart 6, the price of inland petrol and diesel mimics the movement of average brent crude oil prices with a one-month lag. According to the CEF, inland petrol (93 and 95) and diesel (0.05%) prices decreased by 71 c/l and 84 c/l, respectively in June 2023 which indicates that we can expect further downward pressure from transport inflation in the June CPI print. The drop in the average price of brent crude oil in May was a contributing factor to the decrease in fuel prices in June. However, the weak exchange rate dampened the benefit of markedly lower international oil prices. The rand was weaker at R19.45 against the US dollar at the end of May compared to R18.29 in April. This was largely due to the perception of SA's geopolitical alliance and the worsening energy crisis. The rand has since strengthened and was trading at around R18.39 against the US dollar on 21 June 2023 which will help relieve inflationary pressures. However, the SARB still flags further currency weakness as a risk.

The CEF estimates an over recovery of 8 c/l and 16.4 c/l for inland petrol 95 and 93, respectively and an under recovery of 15.7 c/l and 10.5 c/l for inland diesel 0.05% and 0.005%, respectively as at 20 June 2023. Therefore, we could see a slight price drop in both grades of petrol and an increase in both grades of diesel in July.

Despite lower domestic fuel prices in recent months, fuel prices are still elevated compared to 2019 as seen in chart 6. *The Outlier* provided a comparison of how much a full tank costs on selected cars in June 2023 compared to pre-pandemic (see chart 7). This comparison contextualises the immense impact of fuel increases and the current elevated levels on consumer spending and disposable income.

Chart 7: Full tank in 2023 still costs way more than in 2019



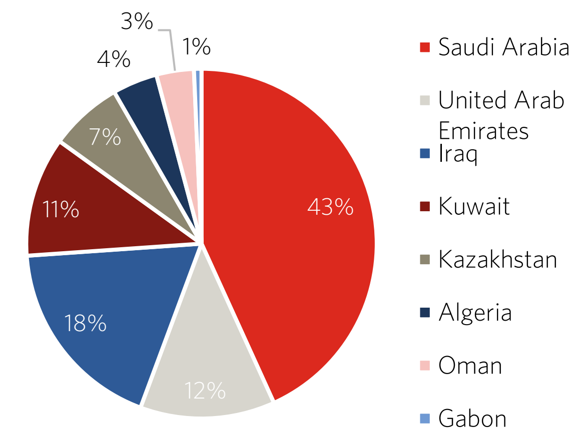
Source: The Outlier, Momentum Investments

In the May 2023 Oil Market Report, the IEA reiterates the risk of upward pressure on international oil prices in the second half of 2023. The agency expects demand to surpass supply due to China's reopening and the growth recovery in Organisation for Economic Co-operation and Development (OECD) countries driving demand with lower supply stemming from further supply cuts announced by OPEC+.

According to the World Population Review, OPEC+ comprises of 13 OPEC member countries, namely, Algeria, Angola, Equatorial Guinea, Gabon, Iran, Iraq, Kuwait, Libya, Nigeria, Republic of Congo, Saudi Arabia, United Arab Emirates and Venezuela, as well as 11 unofficial members, namely, Azerbaijan, Bahrain, Brunei, Kazakhstan, Malaysia, Mexico, Oman, Philippines, Russia, South Sudan and Sudan. The Energy Information Administration (EIA) indicates that the biggest producer of crude oil including lease condensate in 2022 was the US and the second and third largest producers were OPEC+ member countries (Saudi Arabia and Russia, respectively). According to *Reuters*, OPEC+ countries produce around 40% of the world's crude oil, which means that the group has a significant influence on oil prices.

As reported by *Reuters*, eight OPEC+ member countries (see chart 8) announced an agreement to reduce oil supply by a further 1.16 million barrels per day in April 2023, effective May 2023. Saudi Arabia committed to the lion's share of the additional 1.16 million barrels per day reduction (43%).

Chart 8: Proportion of additional oil cuts based on barrels per day



Source: Reuters, Momentum Investments

Reuters states that the additional supply cuts announcement brought the total supply cuts by OPEC+ countries to 3.66 million barrels per day (approximately 3.6% of global demand). The initial agreement and additional cuts were planned for the period ending December 2023; however, in June 2023, the group extended the agreement to the end of 2024. This introduces renewed upside risks to international oil prices and further prolongs the risk of elevated prices.

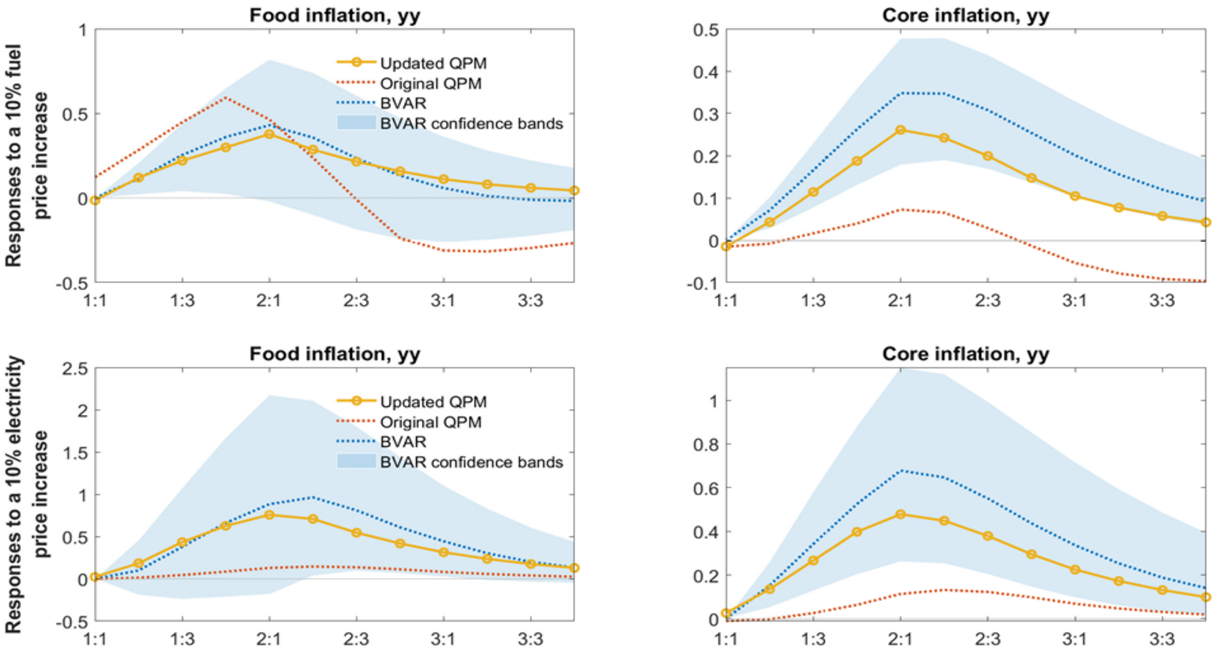
Enhanced QPM estimates stronger spillover effects on core inflation from fuel and food

The SARB has released a working paper on enhancing the QPM (the SARB's forecasting model used to inform monetary policy). The SARB indicates that the changes (grouped into eight blocks) implemented on the model will result in better forecasts on key variables than the original version of the model.

One of the blocks speaks to the model's ability to 'explicitly account for spillover effects from fuel and electricity price changes to core and food inflation'. This is particularly important given the volatility of fuel inflation and the ongoing energy crisis.

According to the SARB, the enhanced model estimates softer spillovers from fuel to food inflation relative to the original model. However, this relationship is stronger than that of electricity price changes and food prices. On the other hand, the net effect of 'spillovers onto core inflation from relative fuel and food price movements are roughly three times stronger than in the original model and are also symmetric'. See chart 9 for illustrations of the spillovers from increases in the price of fuel and electricity.

Chart 9: Spillover effects from fuel and electricity price changes on core and food inflation



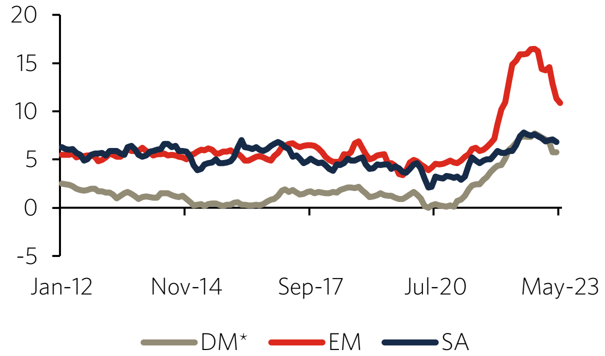
Source: SARB

Furthermore, the effect of world food inflation on domestic food inflation is estimated to be stronger with a one-quarter lag as opposed to the immediate impact from the original model.

SA inflation pales in comparison to EM inflation

One of the major consequences of the pandemic was rising global inflation. As seen in chart 10, DM, EM and SA inflation rallied post pandemic. Average DM inflation surged to a peak of 7.7% in October 2022 following a prolonged period of generally muted inflation. Average EM inflation rose to a significantly higher peak of 16.5% in October and SA inflation peaked earlier at 7.8% in July 2022.

Chart 10: SA inflation tracking closer to DM average CPI



Source: Bloomberg, IMF, Momentum Investments
DM and EM = average equal weighted inflation for the top 10 DMs and top 10 EMs according to GDP current prices (purchasing power parity, international dollars)
**DM data until April 2023*

The divergence in EM inflation was largely driven by double-digit inflation in Türkiye, Egypt and Poland.

Furthermore, EMs were disproportionately affected by supply chain disruptions through much higher food and fuel prices. This was exacerbated by the depreciating currencies due to higher interest rates in the US that resulted in capital outflows from EMs. However, SA's inflation is around the same level as average DM inflation.

Since the respective peaks, inflation has generally been coming back down and the decline has been more rapid in EMs compared to SA and DM. This is partly supported by base effects.

The International Monetary Fund (IMF) notes that inflation is still well above countries' respective inflation targets and there is a concern for more persistent core inflation, which is evident in SA's sticky core inflation over the past few months.

SARB likely nearing the end of the hiking cycle

May's headline CPI, core inflation and meaningful drop in food and NAB inflation surprised positively. We can expect inflation to ease further on the back of elevated inflation last year (base effects).

Despite today's better-than-expected CPI print and the likelihood of further relief from transport inflation and food inflation, inflation expectations are still elevated. As such, the Bureau for Economic Research's Inflation Expectations survey outcome in July will be a key consideration for the MPC. Moreover, exchange rate movements and the sustainability of rand weakness will be another top-of-mind matter for the SARB. Notably, July's interest decision meeting will be based on more accurate forecasts from the enhanced QPM model.

We continue to expect one more interest rate hike of 25 basis points in the cycle, leaving the peak of interest rates at 8.5%, with interest rate cuts only commencing towards the middle of next year.