momentum investments

in the moment

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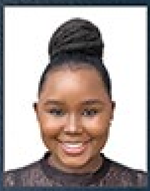


Monetary Policy Review: Restrictive for longer

Highlights

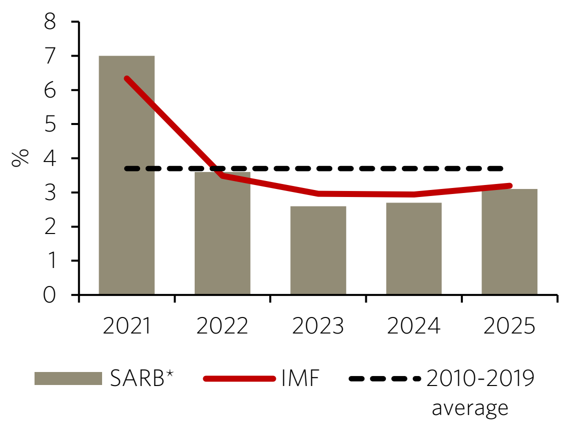
- Global recessionary risks have abated since the April Monetary Policy Review (MPR). Better-than-expected global growth (GDP) and an anticipated easing in inflation lends itself to a scenario of a soft landing. Global growth is supported by high consumption growth on the back of strong demand fuelled by high household savings and fiscal support.
- The global recovery is showing signs of divergence between advanced economies, or developed markets (DM), and emerging markets (EM). This can be partly attributed to geo-economic fragmentation which affects countries disproportionately.
- Headline inflation has eased globally while core inflation remains sticky, particularly in DM. This, combined with inflation remaining well above targets, calls for global rates staying high(er) for long(er).
- Domestically, growth has surprised positively, thanks to lower-than-anticipated loadshedding, but weak growth is projected for the second half of 2023. The estimated impact of loadshedding on growth has been reduced from a 2% cut to growth in 2023 to a lesser 1.8% detraction due to an assumption of less severe loadshedding and no economic costs attached to stages 1 and 2.
- Structural constraints (e.g. logistics, water, electricity) are hampering local growth and perpetuating the growth gap with EM.
- The South African (SA) inflation profile has moved in the right direction since the April MPR. The SA Reserve Bank (SARB) expects disinflation to continue toward the midpoint of the inflation target band but at a slower place.
- Risks to the inflation trajectory remain titled to the upside and include sticky core inflation, renewed international oil price risks, loadshedding, higher administered costs, a weak currency, and higher food inflation. Although El Niño poses a risk to the agricultural sector, the probability of a severe drought similar to the ones experienced in 1991-92 and 2015-16 is assumed to be very low.
- The SARB warns that the global real neutral level of interest may shift higher on a more prolonged basis which poses a risk to capital flows to EM given the potential reduction in carry trade benefits.
- The rise in government debt is largely responsible for the steepness in the yield curve. The SARB warns that as long bond yields rise on the back of adverse fiscal developments, they become less responsive to moves in monetary policy.
- According to the SARB, domestic policy rates were accommodative for the majority of the normalisation period and only turned restrictive in May 2023 and are expected to remain restrictive. This signals that rate cuts are not yet a consideration. We maintain our view of the first rate cut being in the second quarter of 2024, at the earliest. This is to counter fiscal dominance and lingering upside threats to inflation.

Resilient global growth amid global disinflation

Since the April MPR, global growth has proved resilient, recession risks have largely diminished, and disinflation has continued. What has transpired nevertheless, is a growing divergence between DM and EM. Outcomes within these country groups are also becoming increasingly divergent.

The SARB's 2023 growth estimate for SA's major trading partners was revised up to 2.6% (previously 2% in the April MPR) but is lower than the International Monetary Fund's (IMF) forecast of 3% global growth. As seen in chart 1, the SARB's projection for SA's major trading partners remains lower than the IMF's global forecast through to 2025, but both institutions are projecting a moderate pickup in economic activity, albeit below the average growth rate experienced between the global financial crisis and the pandemic. According to the SARB, below-trend growth reflects a slow recovery in investment and weak potential growth. Low potential growth complicates the task of monetary policy because a small uptick in growth may create an impression of an overheating economy (positive output gap).

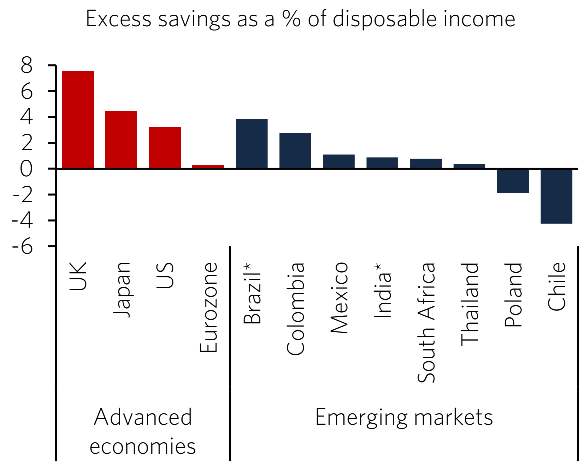
Chart 1: Global growth below historical average



Source: SARB, Momentum Investments
** Real GDP growth in SA's major-trading partner countries*

Global economic resilience partly stems from high consumption growth on the back of strong demand fuelled by high household savings and fiscal support. While household savings buffers have declined, chart 2 illustrates that savings remain positive across most DM and EM, signalling that household consumption growth will continue to support overall economic growth. However, savings buffers are larger in DM compared to EM, partly because these nations rolled out larger fiscal support during the pandemic and later the Russian incursion of Ukraine.

Chart 2: Excess savings still supportive of growth

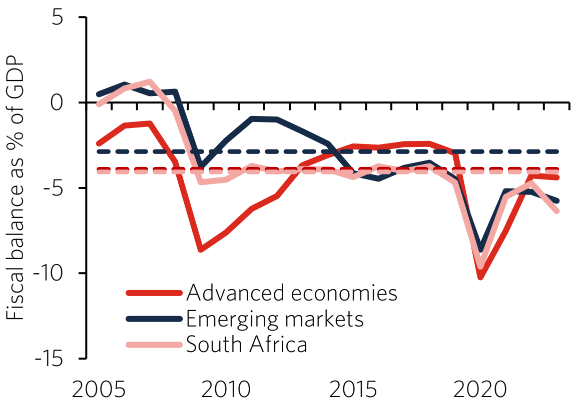


Source: SARB, Momentum Investments
** Data for Brazil and India show gross savings as a percentage of gross disposable income*

Fiscal support to cushion the impact of the pandemic and soaring energy prices have contributed to a deterioration in fiscal balances, as seen in chart 3. In its latest World Economic Outlook, the IMF warned that eroded fiscal buffer leaves countries vulnerable to crises and recommended that countries focus on rebuilding these buffers.

SA's fiscal deficit may widen by a further 1% over the medium-term framework relative to National Treasury's guidance in the February 2023 budget.

Chart 3: EM fiscal deficits much wider than pre-pandemic levels compared to DMs

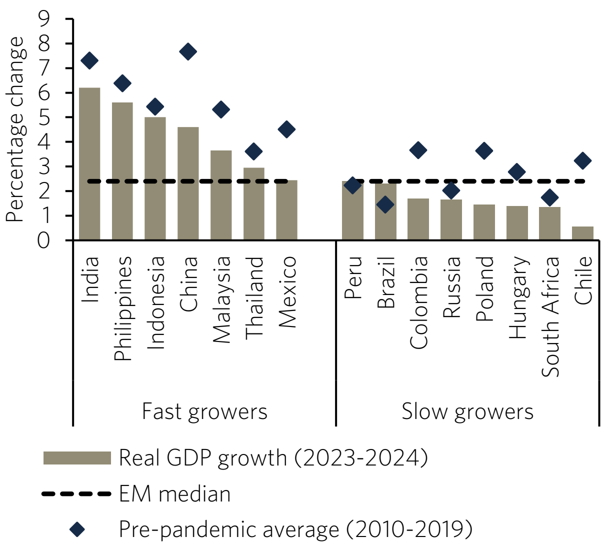


Source: SARB, Momentum Investments

** Dotted lines indicate averages between 2010 and 2019*

The IMF projects that DM will grow by 1.5% in 2023 and EM by 4% but growth is expected to be uneven within these country groups. Within DM, countries exhibiting resilience include the United States (US) and Japan, with the Eurozone exhibiting weak growth. However, divergent growth rates are also evident within the Eurozone as witnessed by services-dominant countries (France and Spain) performing better than manufacturing- and trade-dominant countries such as Germany. This trend is apparent in EM as well. As illustrated in chart 4, the range between the fastest growing economy (India at 6.2%) and the slowest economy (Chile at 0.6%) is significantly wide.

Chart 4: Divergent growth within EM

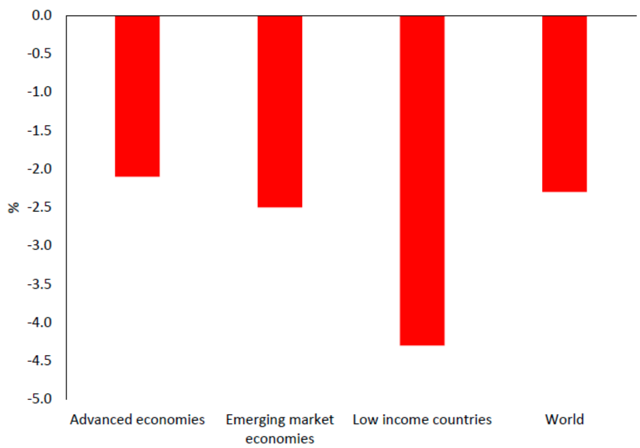


Source: SARB, Momentum Investments

While China remains categorised as a fast-growing economy, the forecasted growth rate of 4.6% in 2023/24 is well below the pre-pandemic average of 7.7%. Chinese economic growth continues to be constrained by the ailing property market and weak domestic demand.

The SARB notes that the divergence within EM reflects the different approaches implemented to address the pandemic, the differing impact of the pandemic, idiosyncratic factors, and geo-fragmentation. As seen in chart 5, geo-economic fragmentation could potentially detract almost 4.5% of real GDP in low-income countries and around 2.5% in EM.

Chart 5: Low-income countries disproportionately affected by geo-economic fragmentation (real GDP losses)

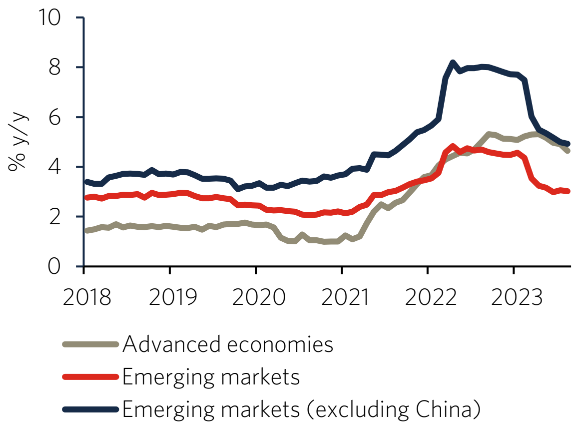


Source: SARB

Global headline inflation has encouragingly eased on the back of base effects, easing supply chain shocks, softer commodity prices and tighter monetary policy. The disinflationary process has been steeper in DM compared to EM, but DM are faced with more persistent core inflation (see chart 6)

Persistent DM core inflation is a product of tight labour markets and high services inflation driven by high rental inflation. The SARB notes that excluding housing from services inflation in the US results in a decline in services inflation (this does not hold in the United Kingdom). EM are not battling with persistent core inflation because these economies were ahead of the curve in terms of monetary policy tightening, savings buffers are not excessive, and currencies have largely strengthened against the US dollar.

Chart 6: Persistent core inflation in DM



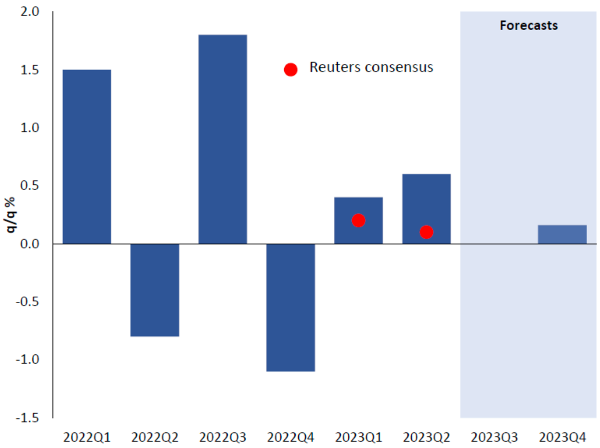
Source: SARB, Momentum Investments

Despite the downward trend in inflation, many countries are still far from their inflation targets. As such, the SARB echoes the general narrative of interest rates remaining high(er) for long(er). This is particularly prudent given upside risks to the inflation trajectory namely El Niño, climate change, sticky core inflation, currency volatility and high international oil prices.

Domestic growth resilience expected to fade in second half of 2023

Simar to global growth, SA's economic growth has shown resilience, especially as the country is grappling with the energy crisis, water shortages and logistics constraints. Growth in the first half of 2023 surprised positively against the SARB's and the Reuters median consensus but the SARB is still projecting weak growth for the third and fourth quarter (see chart 7).

Chart 7: Flat growth expected in the third quarter



Source: SARB

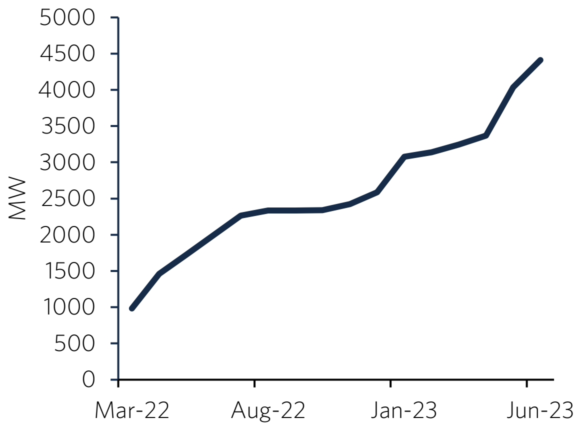
In the April MPR, the SARB revealed that loadshedding will likely shave off 2% from the growth rate in 2023, but this has subsequently been revised down to 1.8% in the October MPR. The downward revision was informed by an assumption of less intense loadshedding (but more frequent) and removing costs, which were previously attached to stage 1 and 2 loadshedding given the increased usage of alternative backup energy systems. Essentially, the SARB assumes that lower stages of loadshedding do not have severe economic cost implications. Loadshedding assumptions for the medium term were left unchanged relative to the April MPR and the growth estimates for 2024 (1%) and 2025 (1.1%) were consequently unchanged.

The sharp jump from the initial growth projection of 0.2% in 2023 at the time of the April MPR to 1% in 2024 built in an improvement in energy supply. Involvement of the private sector has resulted in great strides toward addressing the energy crisis. As seen in chart 8, the installation of rooftop solar has increased by almost five times from 983MW in March 2022 to 4 412MW in June 2023. The uptake in rooftop installations is partly being boosted by government's solar panel tax incentive. *News24* notes that the incentive is set to expire by end of February 2024 for households and run until 2025 for businesses.

The SARB expects renewable energy investment activity to contribute positively to total investment.

Total investment is projected to grow by 7.7% in 2023, contributing 1.1% to GDP.

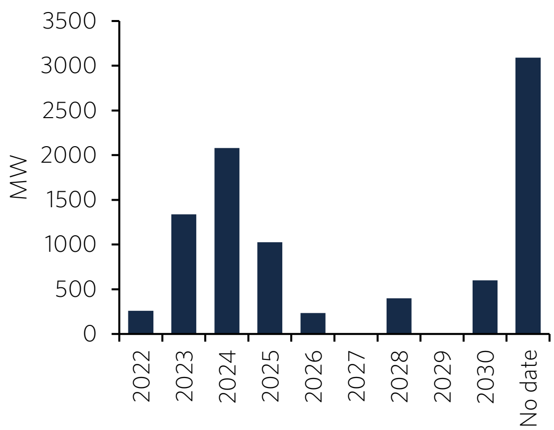
Chart 8: Rooftop solar installations have risen*



Source: SARB, Momentum Investments
** Estimated maximum*

Moreover, the pipeline of embedded generation projects suggests that the energy supply crisis should start alleviating from 2024 onwards.

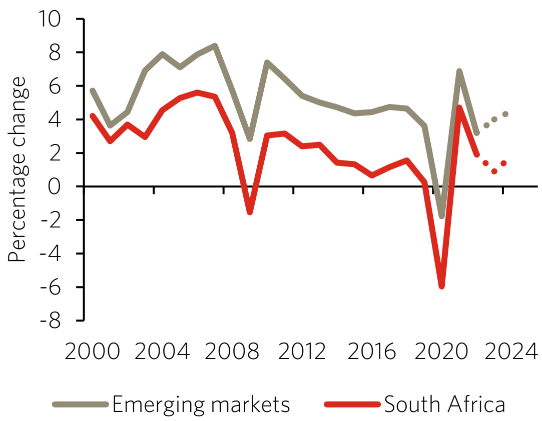
Chart 9: Embedded generation projects*



Source: SARB, Momentum Investments

Relative to other EM, SA's economic growth has consistently underperformed as illustrated in chart 10. The long-term average growth gap between SA and EM is 2.8% and is projected to increase to 2.9% by 2024.This does not bode well for SA's competitive advantage and could make it difficult to attract foreign capital inflows which is needed given the fiscal challenges.

Chart 10: SA growth consistently below EM*



Source: SARB, Momentum Investments
** Dotted line indicates forecasts*

This gap may be partly explained by structural constraints (deteriorating logistics and energy supply constraints) and addressing these constraints has the potential to close this gap.

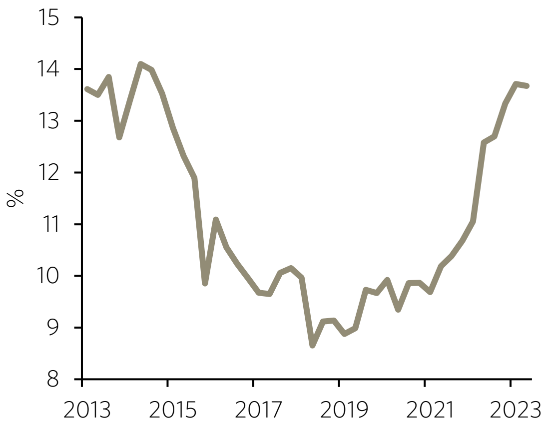
Risks to the domestic inflation outlook tilted to the upside

Since the April MPR, inflation has moderated to within the inflation target band largely due to disinflation in fuel and food inflation, base effects, and tighter monetary policy. Going forward, the SARB expects the move toward the midpoint of the target range to be slow due to fading base effects, sticky core inflation and elevated inflation expectations.

Pressure on core inflation has, over the past year, stemmed from core goods (not services). Core goods inflation was mostly driven by a weaker exchange rate which translated to a higher exchange rate pass-through (higher imported inflation) as seen in chart 11 and a higher demand for alcoholic beverages and tobacco. Core goods inflation is expected to average

6.3% in 2023, almost double its five-year average of 3.2%, and moderate to 5.2% in 2024.

Chart 11: Higher exchange rate pass-through*



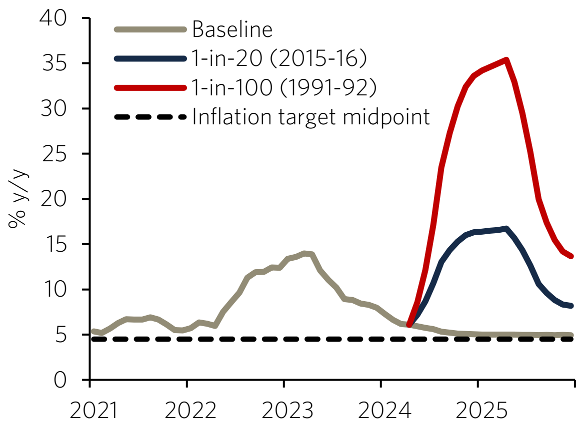
Source: SARB, Momentum Investments
** Estimated pass-through*

CPI is expected to average 5.9% in 2023 and stabilise at 4.5% in the second quarter of 2025. Risks to the trajectory are detailed as higher international oil prices, a weaker currency, higher food prices and high administered prices.

The SARB forecasts administered price inflation excluding the basic fuel price (a better measure of administered fuel inflation) to average 6.5% over the medium term and the trend of above-inflation electricity price increases are expected to continue over the medium term. Electricity prices are projected to increase by 13.4% in 2024 and 10.9% in 2024. According to the September MPC, average CPI was forecasted at 5.1% for 2024 and 4.5% for 2025. There is a possibility of a negative surprise to electricity prices because Eskom may need to recoup the cost of running diesel generators above the National Energy Regulator of South Africa (NERSA) -approved load factor.

Risks to food prices are detailed as stemming from geopolitical tensions, El Niño, grain export restrictions from major global producers and loadshedding. El Niño is estimated to have begun in May 2023 and there is a 95% chance that it may persist until the end of 2023. However, the impact on food inflation is expected from April 2024. The degree of impact will depend on the severity of the drought. A drought similar to 2015-16 could add up to 10% to food inflation (occurs once every 20 years) and a more severe drought similar to 1991-92 could add up to 28% to food inflation, but this type of drought typically occurs only once every 100 years. The SARB has not included El Niño risks to its food and non-alcoholic beverages (NAB) inflation forecast of 10.4% in 2023 and 5.2% in 2024. Therefore, there is a risk of negative surprises.

Chart 12: Low probability of a El Niño impact on food and NAB



Source: SARB, Momentum Investments

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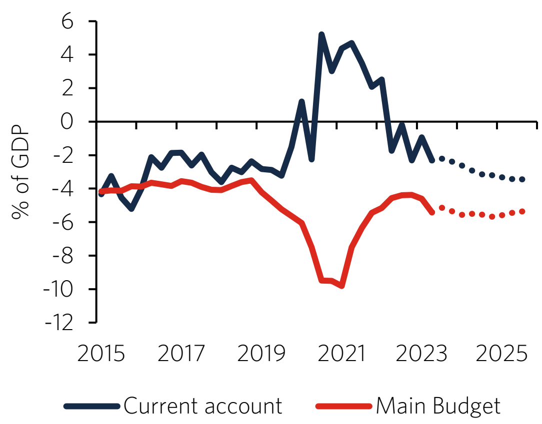
SA's vulnerability to a reduction in capital inflows

With the global economic environment becoming more adverse due to unexpected persistence in core inflation and rising geopolitical shifts, the SARB warns that the global real neutral level of interest may shift higher on a more prolonged basis.

As such, this poses a risk to capital flows to EM given the potential reduction in carry trade benefits. The SARB warns that capital flows are harder to attract in the current environment and investors are increasingly discriminating among sovereigns based on better macro fundamentals. Against this backdrop, SA looks particularly vulnerable given its expansionary fiscal policy and wider projected external deficit (see chart 13).

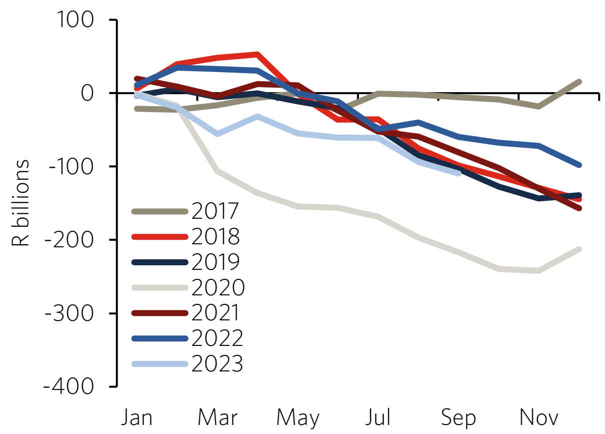
Chart 13: Macro imbalances leave SA vulnerable



Source: SARB, Momentum Investments
** Dotted line indicate forecasts*

Geopolitical factors and intensified loadshedding led to significant non-resident capital outflows in SA's equity market in the first half of the year (see chart 14). As such pressure has remained on the rand.

Chart 14: Significant outflows in H1 2023

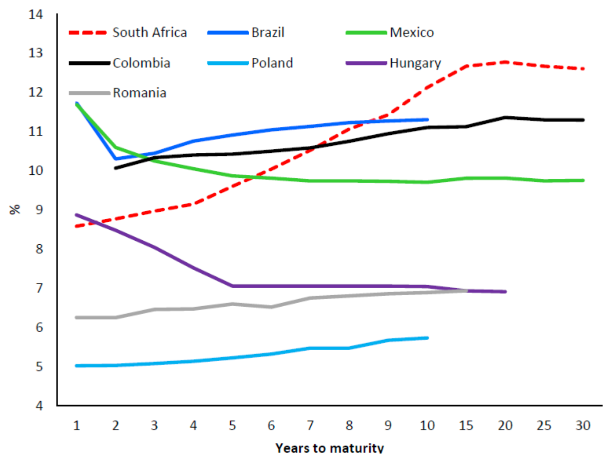


Source: SARB, Momentum Investments

The SARB projects a neutral real interest rate of between 2.4% and 2.5% between 2023 and 2025, up from 2% in 2020 and 2021.

In fixed income markets, SA's yield curve has steepened sharply over the last ten years, despite a reduction in inflation over this period (see chart 15). The SARB points to the rise in government debt largely being responsible for the steepness in the yield curve, which reflects rising debt sustainability concerns with lenders demanding a higher risk premium for holding longer-dated government bonds.

Chart 15: Steep SA yield curve compared to EM's



Source: SARB

Statistical analysis by the SARB, involving a Bayesian vector autoregression, estimates that for every percentage point increase in the fiscal deficit, long bond yields (maturities ranging between 10 and 30 years) rise between nine and 12 basis points. Moreover, an increase in the debt ratio slows growth, which worsens the fiscal position.

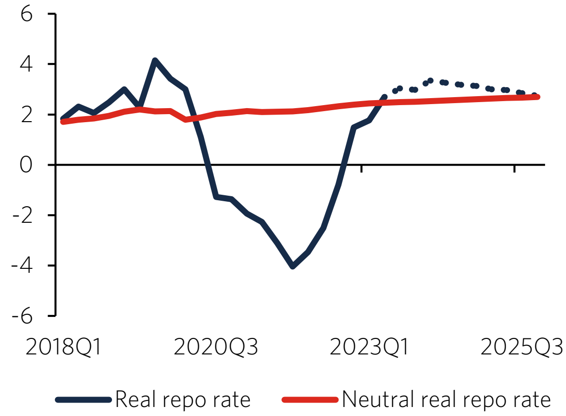
The SARB warns that as long bond yields rise on the back of adverse fiscal developments, they become less responsive to moves in monetary policy. Rising short-term interest rates and declining inflation should technically flatten the yield curve by lowering the long end. However, the SARB notes that this has not happened in SA and has flagged the importance of bringing down government debt to more sustainable levels, which can help to lower the cost of capital, reduce debt-service costs, and moderate inflation.

Only one rate hike since the April MPR

Globally, monetary policy has switched from being highly synchronised to more divergent. Some EM (Brazil and Chile) have started cutting rates given their more rapid disinflation profile, while some economies are either considering further (moderate) rate hikes or adopting a wait-and-see approach (constant rates). Nevertheless, the SARB is of the view that a few economies cutting will not lead to a deviation from the theme of higher rates for longer.

According to the SARB, domestic policy rates were accommodative for the majority of the normalisation period and only turned restrictive with the 50-basis point hike implemented in May 2023 (only hike since the previous MPR as seen in table 1). Since then, policy rates have remained restrictive rates as rates were kept unchanged and the expectation is to maintain a restrictive environment until the end of 2025 as seen in chart 16. This is in line with the global narrative of keeping rates sufficiently high for sufficiently long to ensure that inflation and inflation expectations are well anchored and to avoid premature easing.

Chart 16: Policy rates in restrictive territory



Source: SARB, Momentum Investments
** Dotted line indicates forecasts*

This supports our view that the SARB is likely either at the end of the current hiking cycle or very close to the end, but rates are expected to stay high for longer to counter fiscal dominance and lingering upside threats to inflation. We expect the SARB to only start cutting rates in the second quarter of 2024, at the earliest.

Table 1: Shift in MPC member preferences year-to-date

Number of committee members	Favoured no move	Favoured a 25-basis point hike	Favoured a 50-basis point hike	Favoured a 75-basis point hike	Favoured a 100-basis point hike
26 January 2023	-	3	2	-	-
30 March 2023	-	2	3	-	-
25 May 2023	-	-	5	-	-
20 July 2023	3	2	-	-	-
21 September 2023	3	2	-	-	-

Source: SARB, Momentum Investments