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in the **moment**

SARB hikes by 50 basis points in reaction to currency weakness aggravating inflation risks

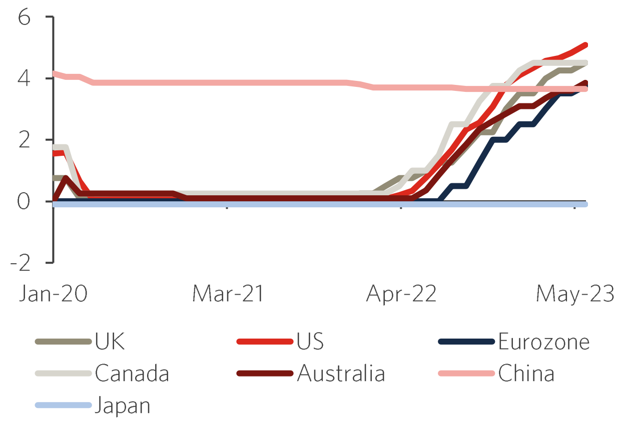
Highlights

- While the implementation of financial stability measures has stabilised the banking sector, they have also contributed to more restrictive credit conditions that will exert downward pressure on growth, employment and inflation.
- There is likely to be a considerable pause in global interest rates before possible monetary policy loosening comes into view given the risk of unwinding policy too early, allowing for inflation to flare up again.
- The South African Reserve Bank (SARB) maintained its view that loadshedding would detract 2% off growth this year but the market may be expecting a worse outcome given the expectation of higher stages of loadshedding as we enter winter. Despite the market's downward revisions to growth, the SARB now expects the economy to expand by 0.3% (from 0.2% previously) this year and to climb to an unchanged 1% in 2024.
- Following these revisions, the SARB views risks to the medium-term growth outlook as being fairly balanced.
- The SARB's expectation for headline inflation for this year was revised up to 6.2% from 6% in March on higher expectations for core goods inflation. For 2024, the SARB sees inflation higher at 5.1% (previously 4.9%).
- Aside from a weaker currency, the SARB noted additional upside risks to the inflation trajectory stemming from administered tariffs (including electricity) and stickier local food prices, particularly as weather conditions are set to change to a drier and hotter El Niño weather pattern.
- The MPC's interest rate decision to hike by 50 basis points (bps) to 8.25% was out of line with the Reuters consensus for May 2023. A majority of 11 from 20 surveyed analysts (including ourselves) expected interest rates to increase by 25 basis points, while six analysts were expecting a hike of 50 basis points. The remainder anticipated an unchanged stance on monetary policy.
- Despite the split in market views, the SARB revealed that the rate decision was unanimous among the MPC members.
- Today's interest rate meeting has not definitively closed the door on further interest rate hikes, particularly given the upward revision to core inflation and the unanimous call for a 50-basis point hike in this meeting. As such, we believe this leaves the door open to another possible hike in July. Thereafter, 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.

Recent banking failures have tightened global credit conditions

Jerome Powell, the Chairman of the Federal Reserve (Fed), acknowledged that while the implementation of financial stability measures has stabilised the banking sector, they have also contributed to more restrictive credit conditions that will exert downward pressure on growth, employment and inflation.

Chart 1: Central bank rates (%)



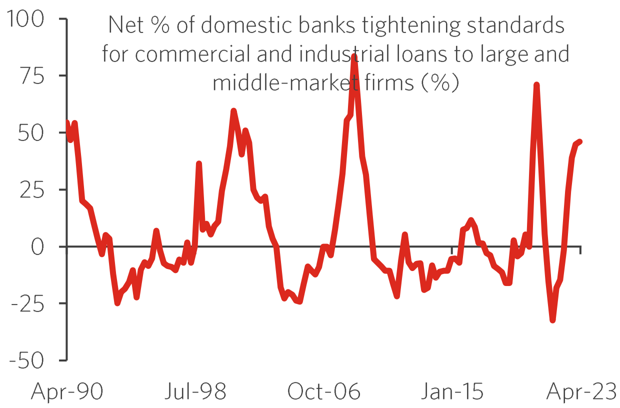
Source: Bloomberg, Momentum Investments

The United States (US) Fed has raised the benchmark rate of interest by 5% since March 2022 to a target range of between 5% and 5.25% (see chart 1). Financial market participants have interpreted the latest policy move and accompanying statement as a conditional pause in the interest rate hiking cycle. Powell acknowledged uncertainty around the effects of past monetary policy tightening on the US economy so far and to what extent much tighter credit conditions will affect growth (see chart 2).

Although market-implied policy rates are signalling an end to the current interest rate hiking cycle, should the rate of disinflation disappoint, hawks on the Federal Open Market Committee have indicated that interest rates could be lifted further as an "insurance policy" against inflation risks.

Across the Atlantic, the European Central Bank (ECB) raised interest rates by 25 basis points in May (a cumulative 375 basis points since the start of the cycle), shifting gears to smaller interest rate increments. Market participants continue to price in further interest rate tightening given ECB President Christine Lagarde's comments that "we are not pausing – that is very clear. We know that we have more ground to cover". Market implied policy rates are still anticipating the ECB's interest rate hiking cycle to draw to an end in two quarters' time.

Chart 2: Lending standards are tightening in the US

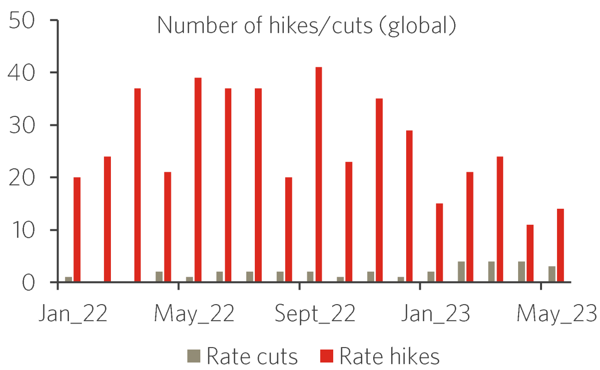


Source: Federal Reserve Bank of St. Louis, Momentum Investments

The pace of interest rate tightening across the globe appears to be decelerating. The world economy experienced 141 interest rate hikes between January and May of 2022, compared with 85 year to date (see chart 3).

That said, we expect a considerable pause in interest rates before possible monetary policy loosening comes into view given the risk of unwinding policy too early, allowing for inflation to flare up again.

Chart 3: Number of interest rate hikes slowing



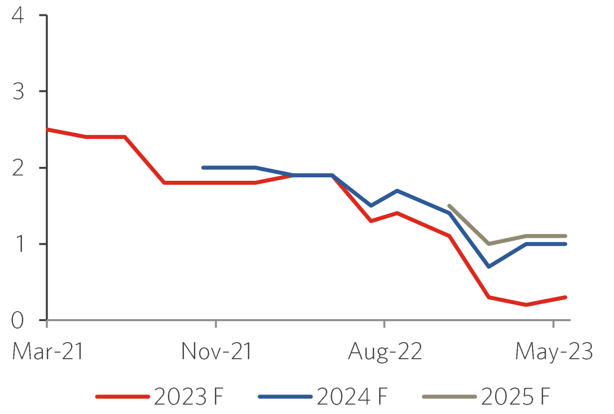
Source: cbrates.com, Momentum Investments, data up to May 2023 (month to date)

Economic activity at a standstill

The Reuters consensus for May 2023 estimates an economic expansion of 0.2% in quarter-on-quarter (q/q), seasonally adjusted (sa) terms for the first quarter of this year suggesting the economy will just about avoid a technical recession. This compares to the SARB's forecast of 0.4%.

Despite downward revisions to growth by the market, the SARB now expects the economy to expand by 0.3% (from 0.2% previously) this year and to climb to an unchanged 1% in 2024 (see chart 4), supported by a rise in real disposable income and investment by the private sector. The SARB maintained its view that loadshedding would detract 2% off growth this year but the market is likely pricing in a larger knock on the back of the expectation of higher stages of loadshedding as we enter winter. A switch from wetter La Niña weather conditions to hotter and drier El Niño has also been flagged as a potential risk to the agriculture sector.

Chart 4: SARB's real growth revisions (%)



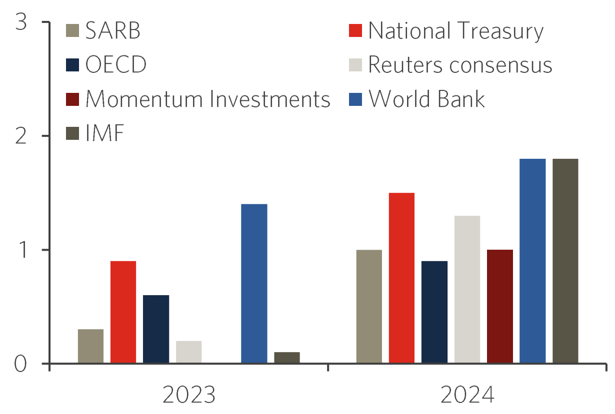
Source: SARB, Momentum Investments

These revised projections are lower than the May 2023 Reuters consensus expectation of 0.2% for this year and 1.3% for next (see chart 5). The SARB's forecasts are above our downwardly-revised growth forecasts of 0% for this year but in line with our expectation of 1% for next year.

The SARB's Monetary Policy Review for April noted that the Reuters median quarterly 2022 GDP forecasts outperformed the SARB's with a mean absolute percentage error of 0.81 relative to the SARB's 0.94.

The SARB anticipates the tepid outlook on growth to extend to 2025 and forecasts an (unchanged) figure of 1.1%, relative to the Reuters' and our projection of 1.5% and 1.6%, respectively. Following these revisions, the SARB views risks to the medium-term growth outlook as being fairly balanced.

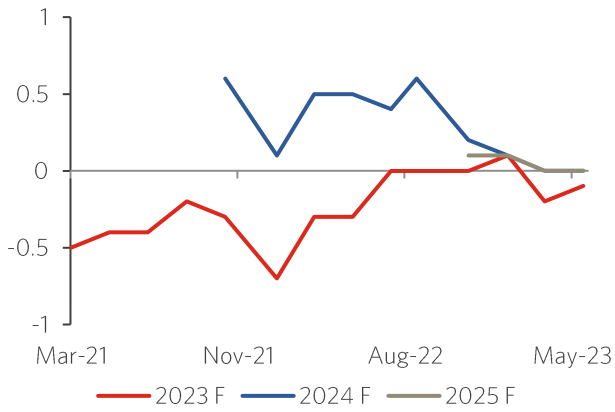
Chart 5: Comparative growth forecasts (%)



Source: SARB, Treasury, International Monetary Fund (IMF), World Bank, Reuters, Organisation for Economic Cooperation and Development (OECD), Momentum Investments

The SARB expects the output gap to close next year from an estimated negative 0.6% last year (see chart 6). The SARB's potential growth estimate for this year was revised lower to negative 0.1% and remained at 0% for next year. The 0% output gap is expected to persist into 2025.

Chart 6: SARB's output gap revisions (%)

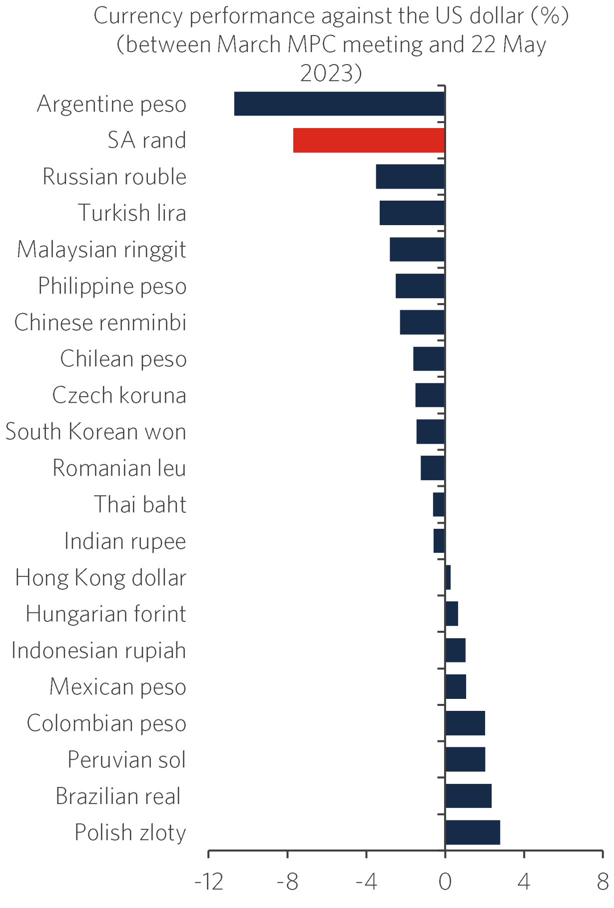


Source: SARB, Momentum Investments

Inflation risks stemming from the currency, administered tariffs and local food prices

Since the March 2023 SARB MPC meeting, the SA rand has had the second worst currency performance against the US dollar, following the Argentine peso (see chart 7).

Chart 7: Rand underperformance (%)



Source: Bloomberg, Momentum Investments

In addition to growth woes and power outages, the latest bout of currency weakness was triggered by a diplomatic row with the US after a claim by US Ambassador Rueben Brigety that SA had supplied weapons and ammunition to a Russian vessel in December last year. A visit by the Commander of the US army to Russian military forces has further stained SA's claim of nonalignment and neutrality over Russia's war in Ukraine and threatens to sour SA's stance on international relations further.

Aside from a weaker currency, the SARB noted additional upside risks to the inflation trajectory stemming from administered tariffs (including electricity) and stickier local food prices, particularly as weather conditions are set to change to a drier and hotter El Niño weather pattern.

Despite international oil prices shifting lower in April and May on concerns over the health of the global economy, the International Energy Agency warns that demand is expected to outstrip supply by 2 mb/d in the second half of the year.

In the April 2023 Monetary Policy Review, the SARB indicated that loadshedding is expected to add 0.5% to headline inflation in 2023 given the costs of back-up energy solutions and the extent to which these are passed onto consumers.

The SARB expects local food inflation to average 10.8% (previously 9.9%) this year and 5% (previously 4.5%) next year. This is higher than the 2023 forecast of between 7% and 8% projected by the Agricultural Business Chamber (Agbiz), which expects a drop off in food inflation in the second half of this year due to the Black Sea trade deal, higher Brazilian production of soybean and corn, good harvest expectations in the US and slower global demand (including slower Chinese import demand).

Agbiz notes that there is a three-to-five-month lag between farm and retail prices of some agricultural products. Fruit and vegetable inflation could remain elevated in the near term given the disruption to production from unfavourable weather conditions, but prices should soften thereafter. Agbiz also flags the drop in red meat prices at farm level which should filter through into lower meat prices at the retail level.

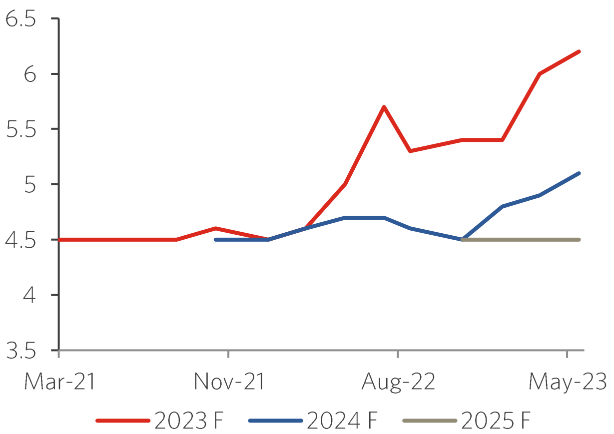
The balance between demand and supply should tighten in international oil markets in the second half of the year. The US Energy Information Administration's (EIA) Short-term Energy Outlook for May 2023 indicated that it expected international oil prices to average at US$79/bbl in 2023 from an average of US$101/bbl last year. Oil prices are expected to drop further to US$75/bbl, on average next year. The EIA notes that voluntary production cuts, disruptions to crude oil exports in Iraq and force majeure declared on crude oil loadings from multiple terminals in Nigeria should cap supply in the second half of the year.

The SARB's forecasted average oil price for this year dropped to US$85/bbl (previously US$87/bbl). It left its forecasts of US$85/bbl for next year and US$80/bbl for 2025 largely intact.

The SARB's expectation for headline inflation for this year was revised higher to 6.2% from 6% in March on higher expectations for core goods inflation. This is higher than our and the May 2023 Reuters consensus forecast of 5.8% and 5.9%, respectively. For 2024, the SARB sees inflation higher at 5.1% (previously 4.9%). This estimate is broadly in line with the Reuters projection but marginally higher than our projection of 4.7% (see chart 8). The SARB expects headline inflation to fall to an unchanged estimate of 4.5% in 2025. The MPC highlighted that inflation is likely to fall below 6% by the third quarter of this year and only sustainably dip to the midpoint of the target by the second quarter of 2025.

Sticky food prices at a local level (due to currency weakness and loadshedding affecting agricultural output), a tight balance in international oil markets and upside risks to local electricity prices continue to underpin the SARB's assessment of inflation risks as being to the upside in the near term.

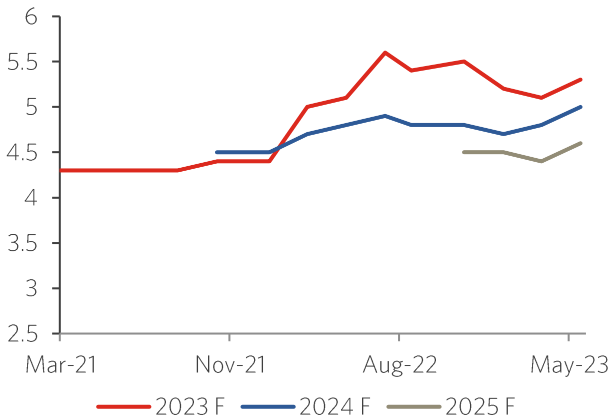
Chart 8: SARB's headline inflation forecasts (%)



Source: SARB, Momentum Investments

The SARB raised its core or underlying inflation projections (excluding food and fuel prices) from 5.1% to 5.3% for this year (see chart 9), relative to our estimate of 4.6%. Core inflation is expected to average at a marginally higher 5% in 2024 (relative to our 4.3%) before declining to a projected (upwardly revised) 4.6% (compared with our 4.3%) in 2025. The SARB attributes its upward adjustments to core inflation to core goods inflation.

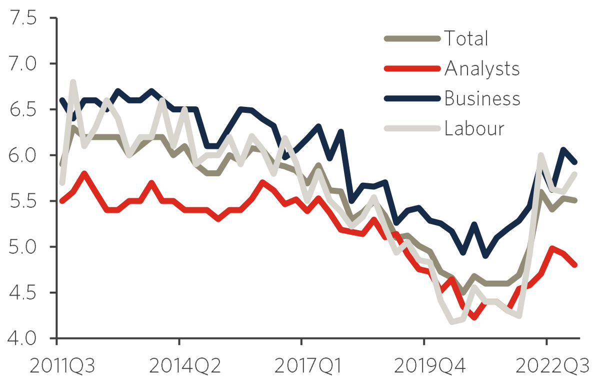
Chart 9: SARB's core inflation forecasts (%)



Source: SARB, Momentum Investments

Average five-year inflation expectations in five years' time, as measured by the Bureau of Economic Research (BER), recorded at 5.5% in the first quarter of the year (see chart 10). However, the SARB previously highlighted the sharp move over the past year and noted the importance of reining in expectations to shelter lower-income earners from the cost-of-living crisis.

Chart 10: Aggregate longer-dated* inflation expectations stabilised (%)



*Source: SARB, Momentum Investments, *average five-year expectations in five years' time, data up to Q1 2023*

Shorter-dated inflation expectations (two years' ahead) for businesses in particular picked up from 6% in the fourth quarter to 6.2% in the first quarter. Higher costs associated with alternative energy sources are likely contributing to a higher cost base for businesses posing a risk to higher retail costs. The SARB is concerned that the inflation expectations of businesses are becoming de-anchored.

Unanimous decision to hike by 50bps

Today's interest rate meeting revealed that all five MPC members favoured an interest rate hike of 50 basis points (see table 1).

Going into today's interest rate decision, six of the 20 surveyed analysts in the May 2023 Reuters survey expected interest rates to increase by 50 basis points. Eleven analysts (including ourselves) forecasted a hike of 25 basis points and the rest were looking for no change. According to the MPC, the Quarterly Projection Model (QPM) indicated marginal changes relative to the March 2023 meeting. It calculates interest rates at 7.16% by the end of next year and 6.99% by the end of 2025.

Table 1: Shift in MPC member preferences at the scheduled May 2023 meeting

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
20 May 2021	5	-	-	-	-
22 July 2021	5	-	-	-	-
23 September 2021	5	-	-	-	-
18 November 2021	2	3	-	-	-
27 January 2022	1	4	-	-	-
24 March 2022	-	3	2	-	-
19 May 2022	-	1	4	-	-
21 July 2022	-	-	1	3	1
22 September 2022	-	-	-	3	2
24 November 2022	-	-	2	3	-
26 January 2023	-	3	2	-	-
30 March 2023	-	2	3	-	-
25 May 2023	-	-	5	-	-

Source: SARB, Momentum Investments

Revamped QPM

The QPM was first introduced in 2017 but will be undergoing notable changes this year to enhance the forecasting capability of the model. The SARB notes that the changes will reduce judgement applied to the model, which reduces bias in the formulation of its forecasts.

In the April Monetary Policy Review, the SARB announced that it would be introducing an updated QPM at the July MPC meeting. The changes include:

- Accounting for fiscal policy actions: Previously, the QPM used off-model analyses to incorporate the effect of rising public debt on country risk. This will be captured more directly going forward. Moreover, the effect of fiscal consolidation on economic activity will also be considered under the revised model.

- Distinction made between public and private wages to take account of public sector wages being more backward-looking in nature.
- The inclusion of both the nominal unit labour costs and the current real unit labour cost gap for Phillips curve calculations.
- The updated model will better account for spillover effects of fuel and electricity prices into core and food inflation.
- A higher weighting is attributed to the inflation target relative to past inflation outcomes to reflect better anchored inflation expectations.
- Adjusting the Taylor rule to focus on three-quarters-ahead inflation forecasts to reduce distorting base effects.
- Including a growth gap (relative growth dynamics) along with the output gap (level of activity)

Back-testing revealed that these changes improved the forecasting accuracy of the SARB for headline inflation, core inflation and growth. As such, the revamped QPM should allow the SARB to make better repo rate decisions going forward.

"Short-term pain for medium-to-longer term gain"

The SARB's April 2023 Monetary Policy Review noted that "with most countries experiencing stagflationary conditions and real interest rates already in the neutral region, the outlook for monetary policy remains uncertain".

Several developments in the international and local economy have kept inflation risks tilted to the upside. In a recent speech by the governor at the University of Johannesburg, the SARB previously noted the difficulty in maintaining price stability particularly where "many of the drivers of both inflation and growth are outside of our control". The governor alluded to the trickiness of setting monetary policy in a stagflation environment noting that "fighting inflation is much harder when the economy is already underperforming, as tighter financial conditions have the effect of cooling economic activity more broadly". In the question-and-answer session, the governor reiterated that these interest rate decisions, while inflicting shorter term pain, would be beneficial for all in the longer run given an appropriate setting of monetary policy.

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. In the public speech noted above, the governor reiterated the mandate of the SARB, ensuring that "we can continue to work towards improving and advancing the economic well-being of all South Africans".

Even though we do think the SARB is running out of road to use interest rate hikes as an instrument to combat higher inflation, given that the risks to inflation largely arise from exogenous factors, monetary policy may have to compensate for fiscal policy which is moving away from its consolidation path in a low growth environment and against a backdrop of a large public sector wage bill and rising social demands on the fiscus.

Today's interest rate meeting has not definitively closed the door on further interest rate hikes, particularly given the unanimous call for a 50-basis point hike in this meeting. As such, we believe this leaves the door open to another hike in July. Thereafter, 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.

Standard Bank noted that in the run up to today's meeting, the forward-rate agreement (FRA) market anticipated a cumulative 100 basis points of hikes before the end of the year, with the first interest rate cut only pencilled in by around the middle of next year.