



SARB slows hiking cycle after frontloading its fight against inflation

Highlights

- Evidence that inflation is cooling in the United States (US) has given the Federal Reserve (Fed) room to take a step back from its hawkish stance. Although macro uncertainty is still high and recession risks remain elevated, global growth expectations appear to have stabilised. These factors have driven investors out of US assets, including the dollar which is typically viewed as a safe-haven asset, into perceived riskier markets. Consequently, the dollar weakened and the rand, among other emerging market (EM) currencies, benefitted from this trend.
- Nonetheless, risks to the near-term outlook for the rand remain high with analysts forecasting a meaningful risk of recession, although earnings estimates do not yet fully reflect this. Should economic troubles deepen in the coming months, investors are likely to seek out safe-haven assets and pile back into the US dollar, leaving EM assets, including the rand, on the back foot before risk appetite is expected to reverse later in the year.
- Continued interest rate normalisation at a global level, albeit at a softer pace, and upside risks to inflation have prompted the South African Reserve Bank (SARB) Monetary Policy Committee (MPC) to raise interest rates by 25 basis points to 7.25%.
- The MPC's interest rate decision was in line with eight out of the 20 surveyed analysts (including ourselves) in the monthly Reuters Econometer poll for January 2023, while eleven analysts were expecting a larger rate increment of 50 basis points. One surveyed analyst expected no change in interest rates. The range of interest rate expectations by the end of next year remains wide in light of elevated uncertainty and a wide range in projected economic outcomes.
- The SARB left its headline inflation assumption of 5.4% for 2023 unchanged but lifted its view on 2024 from 4.5% to 4.8%. The SARB continues to flag the balance of risks to the outlook for inflation as being to the upside given stickier local food inflation, upside risks to administered tariffs and risks to salary adjustments to reflect higher food and fuel costs. Despite the international price of oil steadying in the past five months, the SARB continues to raise energy inflation as an upside threat to the local inflation trajectory given the ongoing war in Ukraine and the expected rebound in Chinese growth.
- Despite marked downward revisions to growth for 2023 in November 2022, the SARB shaved off a further 0.8% resulting in a below-consensus growth expectation of 0.3% for this year. Growth is expected to recover slightly to 0.7% in 2024 (from an estimated 1.4% in November 2022). After taking these steep revisions into account, the SARB sees risks to the growth outlook as being fairly balanced. The SARB calculates that loadshedding will erase

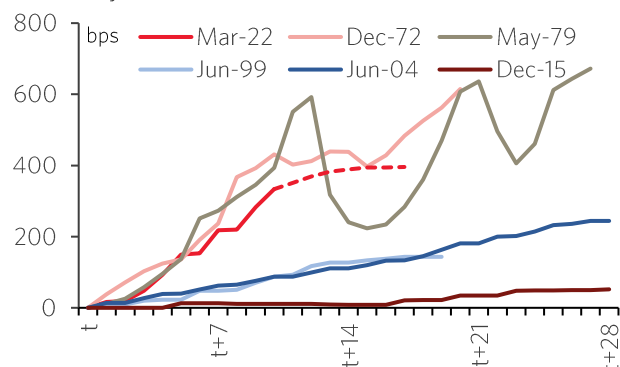
around 2% from expected growth this year, from a previous estimate of 0.6% given a higher projected intensity of loadshedding (250 days of loadshedding relative to a previously assumed 100 days in 2023).

- The SARB revealed that while at the November 2022 rate-setting meeting three members opted for a 75-basis point increase and two preferred a smaller hike of 50 basis points, this time only two members favoured a 50-basis point increase, while three presented an argument for a smaller hike of 25 basis points. None of the members expressed a preference for an unchanged stance on interest rates.
- The SARB is likely to maintain a firm tone in the near term as it acknowledges persistent upside risks to the inflation trajectory, continued interest rate normalisation, globally, and an uptick in longer-dated inflation expectations to 5.5%. We suspect the end of the rate hiking cycle is on the horizon and only anticipate one more interest rate hike of 25 basis points in March.

Magnitude and synchronous nature of policy tightening acts as a drag on global activity

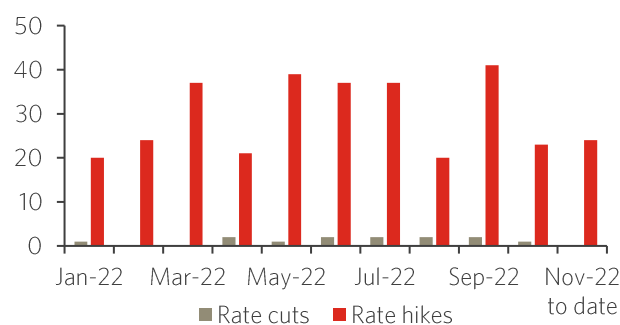
Major central banks tightened policy at the fastest pace in more than 40 years (see chart 1), to rein in decades-high inflation and to protect the credibility of their respective price stability mandates.

Chart 1: Fastest pace of policy tightening in more than 40 years



Source: World Bank, Momentum Investments, t=start of interest rate tightening cycle

Chart 2: Number of interest rate hikes has outweighed cuts, globally

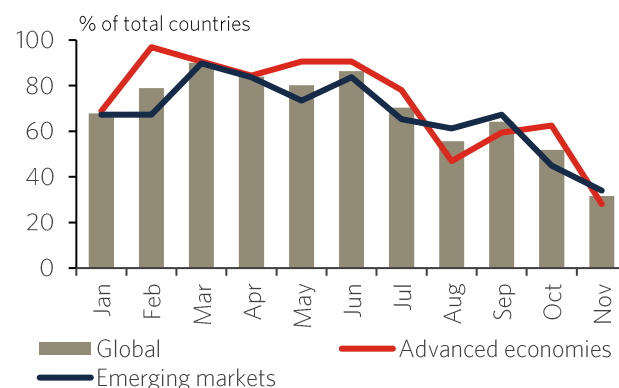


Source: cbrates.com, Momentum Investments

There were 365 rate hikes announced last year across the globe relative to only 16 rate cuts implemented (see

chart 2). The pace of interest rate hikes has nonetheless slowed in recent months with fewer economies experiencing an acceleration in inflation (see chart 3).

Chart 3: Fewer than a third of countries experienced accelerating inflation in November 2022



Source: World Bank, Momentum Investments

Several economic metrics are guiding toward a further reprieve in inflation in the US, including negative growth in the M2 money supply measure (cash and liquid deposits), an alleviation in global supply chain indices and weakening rental markets. After raising its benchmark interest rate by 425 basis points in 2022, the US Fed is expected to slow its pace of interest rate hikes, reaching a peak by the second quarter of this year. The Fed's rhetoric may nevertheless continue to take a hawkish tilt, given a strong jobs market.

Growth and interest rate differentials between the US and the Eurozone are expected to narrow further with the Reuters consensus expecting a higher peak in Eurozone short-term interest rates of around 3.25% in the second quarter of this year, which will be the

highest rate observed since late 2008. A continued streak higher in headline inflation in the Eurozone pushed the consensus view on the terminal interest rate up from an expected peak of 2.5% in the December Reuters poll.

Similarly, the Reuters consensus expects further hikes in the United Kingdom into the second quarter of the year (to an expected peak of 4.5%) to respond to high underlying inflation and strong wage growth.

Loadshedding remains the biggest downside risk to local growth

Although household consumption provided the main underpin for economic growth last year, higher borrowing costs for consumers and high inflation continue to suppress sentiment and point to a slowdown in growth in household consumption this year.

Although we expect some recovery in fixed investment in the second half of the year, investment outside of energy in the private sector may be set back by political turbulence in the run up to the national elections in 2024. Moreover, subdued demand and energy constraints could defer additional investment by the private sector. The SARB notes softer growth and weaker confidence is likely to prevent a faster acceleration in fixed investment spending.

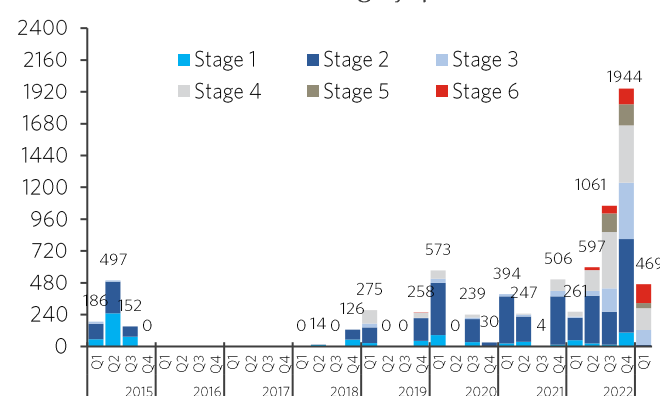
Based on data from EskomSePush, loadshedding escalated to a record 1 944 hours (6 108 GWh) in the fourth quarter of the year (see chart 4). On a quarter-to-date basis, we've experienced 469 hours and 2 059 GWh of loadshedding which underscores ongoing pressure on the economy.

Moreover, robust export activity in 2022 is expected to taper off this year in line with slowing growth in many of SA's main trading partners. The SARB estimates that the output gap (the difference between actual and potential growth) in SA's main trading partners for 2023 is expected to widen from a projected negative 0.2% last year to negative 1.1% this year, with global growth estimated at 1.6% for this year (from a previous estimate of 1.9%). The SARB assumes that declining

Despite measures to allow the 10-year Japanese government bond yield to move 50 basis points on either side of its 0% target in December (from a previous allowance of 25 basis points), the Bank of Japan disappointed markets and did not expand the band of the yield further in January, maintaining its ultra-easy stance on monetary policy.

commodity prices will also detract from export growth this year.

Chart 4: Hours of loadshedding by quarter



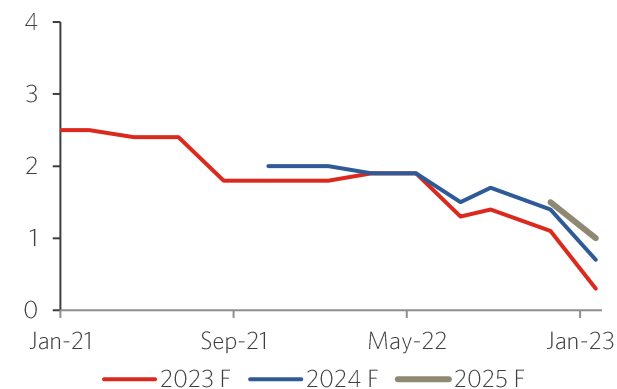
Source: EskomSePush, Momentum Investments
Q1 2023 = data up to 23 January 2023

The Reuters consensus for January 2023 estimates an economic contraction of 0.4% in quarter-on-quarter (q/q), seasonally adjusted (sa) terms for the fourth quarter of last year but anticipates a mild recovery of 0.1% q/q sa in the first quarter of this year. The SARB expects flat economic growth in the final quarter of 2022, leaving full-year growth at 2.5%.

Previously the SARB calculated that loadshedding would shave 0.6% off growth this year. However, given lower available energy capacity, the SARB has revised this figure to a 2% dent to growth. The SARB now expects 250 days of loadshedding in 2023 and 150 days for 2024 from previous estimates of 100 days and 40 days, respectively. An additional 100 days of loadshedding is assumed for 2025. The SARB uses a growth loss estimate of between R0 and R1.2 million for

stages 1 and 2 and up to between R204 million and R899 million for stages 3 to 6, when continued on a 24-hour basis on weekdays.

Chart 5: SARB's real growth revisions (%)



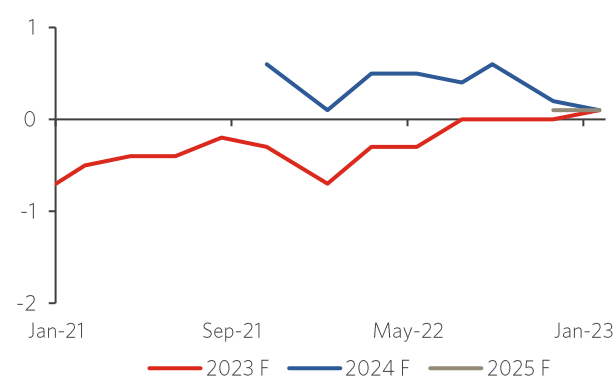
Source: SARB, Momentum Investments

The SARB now expects the economy to expand by 0.3% (from 1.1% previously) this year and to climb by 0.7% (previously 1.4%) in 2024 (see chart 5). These revised projections are markedly lower than the January 2023 Reuters consensus expectation of 1.2% for this year and 1.8% for next. The SARB's forecasts are also notably lower than our growth forecasts for 1.1% this year and 1.6% next year.

Even by 2025, the SARB anticipates a pedestrian outlook on growth and forecasts a figure of 1% (1.5% previously). After these major revisions, the SARB views risks to the growth outlook as being fairly balanced.

The SARB expects the output gap to close this year from an estimated negative 0.3% last year (see chart 6). The SARB's potential growth estimate for this year was revised lower to 0% and 0.6% for next year, from 0.5% and 1.1% previously. The 1.5% predicted for 2025 has been downwardly adjusted to 1%.

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



Source: SARB, Momentum Investments

Food, oil, electricity and wages still pose upside risks to the inflation outlook

Sticky food inflation, a tight balance in international oil markets, an ongoing war in Ukraine, upside risks to local electricity prices and risks to salary adjustments underpin the SARB's assessment of inflation risks as being to the upside in the near term.

The SARB expects local food inflation to average 7.3% (previously 6.2%) this year and 4.4% next year (from 4.2%), relative to our forecasts of 8.9% and 4.2%, respectively. Despite good soil moisture and favourable weather conditions, loadshedding is likely to put upward pressure on crops which rely on irrigation as well as on poultry and egg prices, as facilities producing these agricultural outputs also rely on electricity.

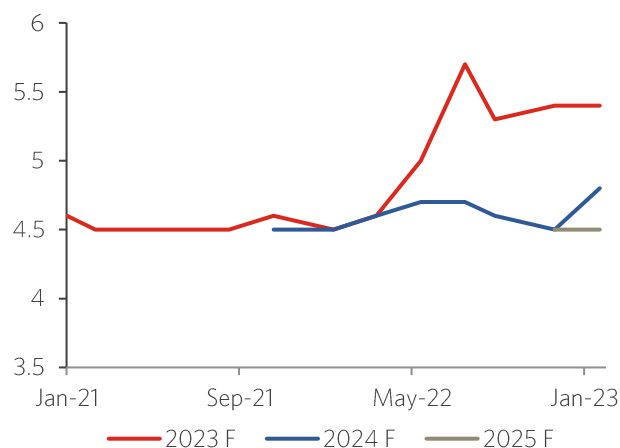
The US Energy Information Administration's (EIA) Short-term Energy Outlook for January 2023 indicated that it expected international oil prices to average at a lower US\$83/bbl in 2023 from an average of

US\$101/bbl last year on weaker global growth and an expected increase in supply. Oil prices are expected to drop further to US\$78/bbl, on average next year, on a projected rise in oil inventories.

Relative stability in the oil price in the last five months allowed for a marginal revision to the SARB's forecasted average oil price for this year to US\$89/bbl (previously US\$92/bbl). It kept its forecasts of US\$85/bbl for next year and US\$80/bbl for 2025 intact.

The SARB's expectation for headline inflation for this year remained at 5.4%. This is lower than our forecast of 5.8% and the January 2023 Reuters consensus of 5.5%. For 2024, the SARB sees inflation higher at 4.8% (previously 4.5%). This estimate is broadly in line with the Reuter's and our projection of 4.7% (see chart 7). The SARB expects headline inflation to fall to 4.5% (unchanged) in 2025.

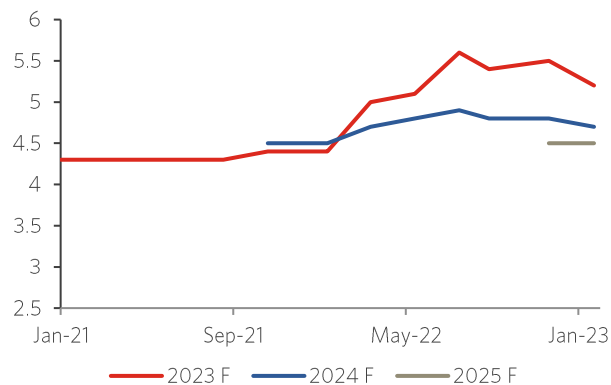
Chart 7: SARB's headline inflation forecasts (%)



Source: SARB, Momentum Investments

The SARB lowered its core or underlying inflation projections (excluding food and fuel prices) from 5.4% to 5.2% for this year (see chart 8). Core inflation is expected to average at a marginally lower 4.7% in 2024 before declining to a projected (and unchanged) 4.5% in 2025. The SARB attributes its downward adjustments to core inflation to lower rental inflation.

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



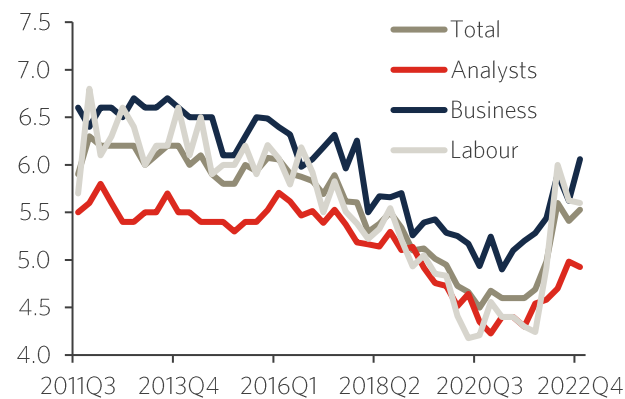
Source: SARB, Momentum Investments

The SARB highlighted its assumptions on electricity price inflation was upwardly revised from 9% to 12.9% for this year, from 10% to 14.5% for next year and from 10% to 10.9% for 2025.

Despite minor revisions to inflation, the SARB assesses the risks to its inflation outlook as remaining to the upside. These risks stem from a tight balance in international oil markets, sticky local food inflation, high administered prices, and cost-reflective salary adjustments.

Average five-year inflation expectations in five years' time, as measured by the Bureau of Economic Research (BER), ticked higher to 5.5% in the fourth quarter of the year, driven by business' expectations (chart 9). However, services inflation (which closely correlates with longer-dated inflation expectations) fell for a second consecutive month in December boding well for the containment of inflation expectations.

Chart 9: Uptick in longer-dated* inflation expectations (%)



Source: SARB, Momentum Investments, *average five-year expectations in five years' time

A less hawkish MPC

Today's interest rate meeting revealed that three MPC members favoured an interest rate hike of 25 basis points, while two preferred a larger increase of 50 basis points (see table 1).

Going into today's interest rate decision, eight of the 20 surveyed analysts in the January 2023 Reuters

Econometer poll (including ourselves) were expecting interest rates to increase by 25 basis points. Eleven analysts forecasted a larger change of 50 basis points, while one expected an unchanged stance. According to the MPC, the QPM indicated marginal changes relative to the November 2022 meeting. It calculates interest rates at 7.1% by the end of this year and 6.9% by the end of next year.

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

Number of committee members	Favoured a 25-basis point cut	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
19 November 2020	2	3	-	-	-	-
21 January 2021	2	3	-	-	-	-
25 March 2021	-	5	-	-	-	-
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	-	-

Source: SARB, Momentum Investments

Closing in on the end of the hiking cycle

The SARB noted its decision to hike interest rates to 7.25% was based on its desire to firmly anchor inflation expectations closer to the midpoint of the target and to increase market and household confidence in its ability to sustainably bring inflation back to target. By doing so, the SARB hopes to lower the economic costs of high inflation on businesses and households and prevent higher interest rates in the future.

The SARB is likely to maintain a firm stance as it responds to persistent upside risks to the inflation trajectory, continued interest rate normalisation, globally (albeit at a softer pace), and longer-dated inflation expectations which are tracking above the midpoint of the target band at 5.5%.

As such, we expect the SARB to follow with a 25-basis point hike at the March 2023 meeting. We see additional interest rate tightening beyond this point as too onerous for economic growth (through tighter financial conditions). Moreover, more aggressive policy moves may not be as effective as the initial interest rate hikes in the cycle given the reduced effectiveness of the

monetary policy transmission mechanism against exogenous factors and administered price inflation.

Using the latest adjustment in interest rates and the median Reuters consensus forecast for headline inflation in the first quarter of 2024, real interest rates are 2.25%. Nevertheless, in the question-and-answer session, the governor warned that although interest rates are in positive territory in real terms using forward-looking inflation, they are still seen to be below neutral, suggesting today's interest rate decision may not be the last move in the cycle. The governor further noted in a response to another question that if risks to inflation were viewed as being to the upside, "doing nothing was not an option".

While previously the forward-rate agreement (FRA) market forecasted a steeper and more aggressive response in monetary policy, it has pared back its expectations, which now look more or less in line with the Reuters consensus expectation. The FRA market is discounting the first interest rate cut by the third quarter of this year.

The QPM projects nominal interest rates to end this year at 7.1% (lower than the Reuters forecast of 7.25%) and 6.9% at the end of 2024 (relative to the Reuters prediction of 7%).

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