momentum
investments

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in the moment

Repo rate unchanged at 8.25% with split preferences

Highlights

- The SARB has become increasingly concerned about the fiscal outlook. A fragile fiscus raises the country's risk premium, which ultimately influences short- and long-term interest rates. We are projecting a wider fiscal deficit at the upcoming Medium-Term Budget Policy Statement (MTBPS) relative to Treasury's February assumptions.
- The SARB markedly revised its economic projection for 2023 up to 0.7% (previously 0.4%) on a robust second-quarter growth figure. Revising growth upward while maintaining loadshedding assumptions points to the increasing resilience of the economy to power cuts. Overall risks to the domestic growth outlook were assessed as being balanced and expected growth for 2024 (1%) and 2025 (1.1%) was kept unchanged.
- Domestic inflation decelerated more rapidly than the SARB's projection for two consecutive quarters. Consequently, headline inflation was revised slightly down to 5.9% in 2023 (previously 6%). Core inflation saw a more significant downward revision to 4.9% in 2023 (previously 5.2%) and 4.7% in 2024 (previously 4.9%). Headline and core inflation metrics are expected to stabilise at 4.5% in 2025 (unchanged).
- Despite these downward revisions, risks to the inflation outlook are assessed as being to the upside. These risks include elevated global food prices, sticky core inflation globally, tighter oil markets, elevated domestic food inflation, an increased risk of El Niño, high electricity prices, potentially high average salaries and a depreciating rand.
- Fuel price inflation was revised markedly higher to 0.4% in 2023 (previously negative 3.1%) and is expected to accelerate to 5.8% in 2024.
- Food price inflation in 2023 was broadly unchanged at 10.4% (previously 10.3%).
- In line with expectations (Reuters, Bloomberg and our own), the Monetary Policy Committee (MPC) kept the repo rate constant at 8.25% for the second consecutive meeting. The split among analysts in the September Reuters survey was near unanimous with only three of the 20 analysts pencilling in a rate hike.
- Despite an unchanged stance in interest rates, the SARB retained a cautious tone, flagging 'serious' upside risks to the inflation outlook. The SARB governor warned that high inflation begets high interest rates and as such, the correct stance is to bring inflation down. This is particularly important given that higher inflation has eroded purchasing power for consumers as incomes have failed to keep pace with rising prices.
- The split of preferences on the Committee (three having a preference for no hike against two preferring another interest rate hike) speaks to the SARB's ongoing fears of a resurgence in or broadening out of inflation pressures.
- As such, we expect the SARB to maintain interest rates in restrictive territory into the second quarter of next year (a quarter later than the September Reuters consensus), at which point we expect the first interest rate cut to come through in line with a sustainable shift lower in inflation towards the midpoint of the target range.

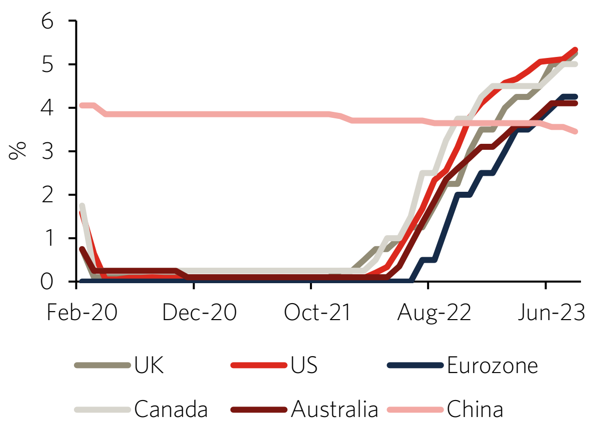
Global rates will be kept high for longer

One of the recurring themes during the SARB's Biennial conference held in September 2023 was that the majority of global central banks intend to keep interest rates "sufficiently high for sufficiently long". This sentiment is largely informed by persistent upside risks to the inflation outlook despite inflation being on a downward trajectory.

In its June 2023 report, the Bank for International Settlements (BIS) noted that the last mile of disinflation is always the hardest to achieve given that (1) base effects become less favourable, (2) real wages recover as nominal wages catch up and inflation falls as well as (3) political pressure to ease monetary policy creeps in as authorities fear a slowdown in aggregate demand.

As such, the threat of a revival in inflation should stave off interest rate cuts for some time.

Chart 1: Interest rate plateau ahead

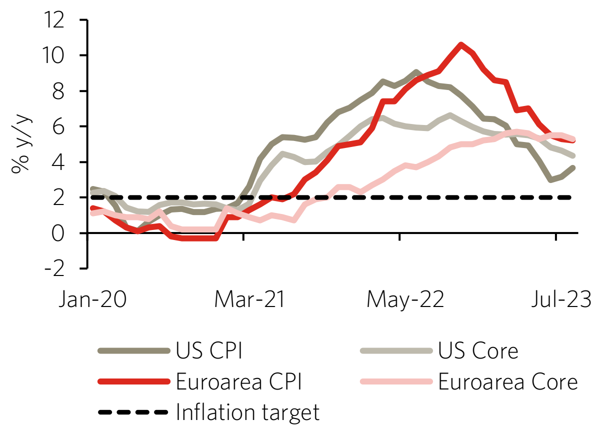


Source: Bloomberg, Momentum Investments

In July 2023, the United States (US) Federal Reserve Bank (Fed) resumed the hiking cycle by raising the federal funds target range by 25 basis points to 5.25% to 5.5%. The July statement released pointed to robust job gains, resilient economic growth and elevated inflation as some of the reasons underlying an 11th hike in this cycle. At the most recent meeting in September, the Fed decided to leave rates unchanged partly due to slightly lower jobs growth and a lower median projection of core inflation for 2023 (3.7% from 3.9% in June). The Federal Open Market Committee (FOMC) continued to sternly communicate their commitment to returning inflation to the 2% target. The unwavering commitment to achieve the Fed's inflation target echoed Fed Chairman Jerome Powell's address at the Jackson Hole Symposium hosted in August 2023, where he noted that getting inflation back to target will "require a period of below-trend economic growth and some softening in labour market conditions"". He closed off his address by stating that "we will keep at it until the job is done" which, to a certain extent, implies that the Fed will remain in restrictive territory until there is more evidence of inflation coming down to their 2% target.

The European Central Bank (ECB) raised rates by 25-basis points in August 2023. Similar to the Fed, the ECB communicated their intention to return inflation to the 2% target and noted that "interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target". This is an explicit declaration to keep rates restrictive for longer and hints that August could possibly be the end of the hiking cycle, particularly so given that the ECB acknowledged that previous rate hikes are increasingly dampening demand and leading it to revise its growth projections lower.

Chart 2: EU inflation further above target compared to US



Source: Bloomberg, Momentum Investments

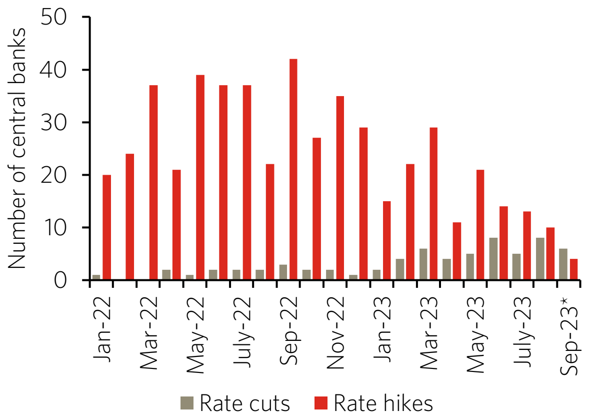
According to the Bloomberg median consensus, the Fed and ECB are expected to start cutting rates in the first quarter of 2024 with the Fed cutting more aggressively than the ECB. This is partly because the US started the hiking cycle first and hiked more aggressively. Furthermore, the EU still needs to cover more ground to get inflation back to target because both headline and core inflation is trending higher compared to the US (see chart 2).

The Bank of England (BOE) raised rates to 5.25% in August (25 basis point hike). The BOE's representative at the SARB Biennial conference indicated that raising rates further into mid-2024 and cutting thereafter has a similar impact on the inflation outlook as keeping rates constant for a longer period. His preference was toward the latter because it poses fewer risks to financial stability and it would be more effective in the real economy. He further noted that synchronised monetary policy tightening globally tempered with the country's transmission lag by extending it to the traditional 18-24 months as opposed to 10 months which supports the preference of keeping rates sufficiently high for longer.

China remains an anomaly in the current global environment. The People's Bank of China (PBoC) cut the one-year Loan Prime Rate for the second consecutive time to 3.45% in August as economic growth momentum seems to be fading. The Chinese economy temporarily dipped into deflation in July 2023 (negative 0.3% year-on-year (y/y)) which was not a good signal for economic growth, but deflationary pressures eased in August as consumer prices rose 0.1% y/y. Nevertheless, the ailing property sector remains a drag in the Chinese economy and this will potentially spillover into the SA economy because weak activity in the Chinese real estate market results in softer commodity prices related to construction.

Globally, the number of central banks hiking rates has decreased significantly (see chart 3) to only four central banks recorded in September so far. On the other hand, more central banks have started to cut rates with six banks cutting rates in September so far. The number of rate cuts exceeded rate hikes in September (so far) for the first time since November 2020. Rate cuts may be increasing while the number of rate hikes decrease but the number of central banks making any changes to the policy rates is much lower (see chart 3) implying that most global central banks are keeping rates constant.

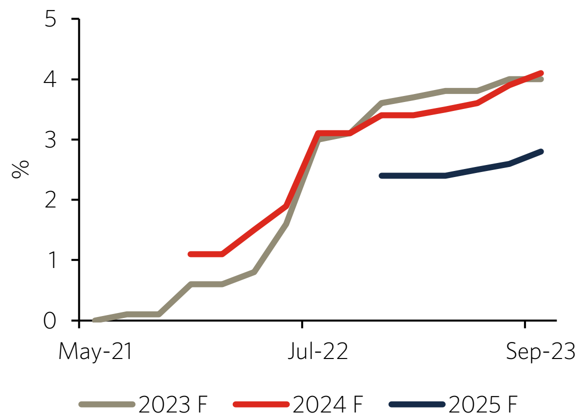
Chart 3: Number of global interest rate changes down significantly



Source: CB rates, Momentum Investments
** Month-to-date (1 to 20 September)*

The SARB expects international policy rates to remain elevated in 2024 and only meaningfully come down by 2025 (see chart 4).

Chart 4: SARB's international policy interest rates revisions



Source: SARB, Momentum Investments

Central banks are navigating unchartered waters. Consequently, some central banks have communicated that they remain highly data dependent and will continue to observe economic developments to inform their decisions from meeting to meeting with the common objective of returning inflation to their respective targets.

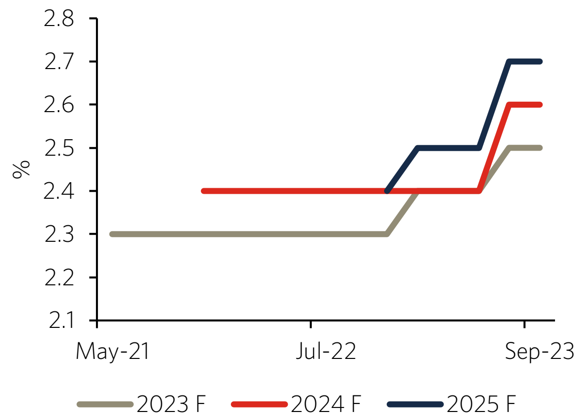
Fiscal trajectory complicates monetary policy

The SARB has increasingly expressed concerns about the fragility of the fiscal environment and its impact on monetary policy.

SA government finances are becoming progressively tighter due to slowing government revenue, on the back of softer commodity prices, and rising expenditure commitments driven by the public sector wage bill, the extension of the social relief of distress grant and transfers to underperforming state-owned entities. The inevitable fiscal slippage will likely result in a wider fiscal deficit projection at the upcoming MTBPS scheduled for 1 November 2023. A National Treasury representative at the SARB's Biennial Conference acknowledged the difficulty of retracting fiscal stimulus which signals that fiscal pressures will continue to mount. This is exacerbated by the upcoming 2024 elections.

Fiscal pressures are raising the sovereign risk premium which is what the SARB is most concerned about. According to the SARB, a higher risk premium is factored in when estimating the neutral rate (rate at which monetary policy is neither stimulating nor restricting the economy) and this has a bearing on short-term and long-term interest rates.

Chart 5: SARB's neutral real interest rate revisions



Source: SARB, Momentum Investments

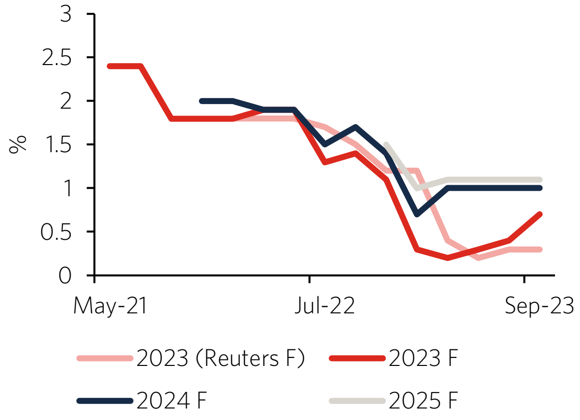
Concerns about the fiscal trajectory and the interplay between fiscal and monetary policy is not unique to SA. The recent cycle of synchronised interest rate hikes globally unveiled fiscal pressures, particularly in advanced economies, because fiscal authorities had been accustomed to the prolonged period of low interest rates.

An article published by the International Monetary Fund (IMF) notes that the effectiveness of monetary policy to a certain extent depends on central bank independence. A distinction is made between legal independence (de jure) and practical independence (de facto). The latter involves central banks making interest rate decisions without worrying about the impact on government indebtedness or default risk. However, because public debt has increased over the years, more so during the pandemic when governments issued fiscal support, maintaining de facto independence has become increasingly difficult because any increase in interest rates lifts debt-service costs. "Central banks can retain independence only if they promise not to accede to any government desires to monetise excessive debt, which would then force authorities to cut spending or increase taxes, or both (fiscal consolidation)," according to the IMF.

Evidence of economic resilience warrants upward growth revisions

Domestic economic growth surprised positively in the second quarter of 2023 despite more loadshedding in the quarter. Quarterly growth of 0.6% published by Statistics SA was higher than the Reuters median consensus (0.1% q/q) and the SARB's projection of 0.4% q/q. On account of a better-than-anticipated economic expansion in the second quarter, the SARB substantially revised expected economic growth for 2023 up for the third time this year to 0.7% (previously 0.4%) as seen in chart 6. This is higher than the September 2023 Reuters median consensus of 0.3% (unchanged).

Chart 6: SARB's real growth revisions

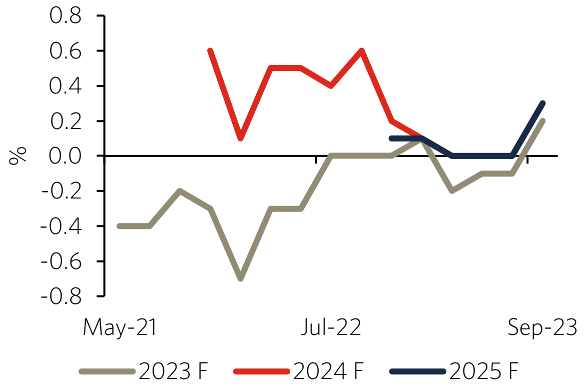


Source: SARB, Momentum Investments

Risks to the medium-term growth outlook were assessed to be balanced and growth expectations for 2024 and 2025 remained unchanged at 1% and 1.1%, respectively.

Potential growth for 2023 was revised up to 0% (previously negative 0.1%). The upward revision in potential growth from negative forecasts over the past three meetings speaks to the economy becoming more resilient to loadshedding. The output gap was revised into positive territory for the medium term to 0.2% in 2023 and 0.3% in 2024 and 2025 (see chart 7). Despite the upward revision, the estimates are still around 0%, implying little positive or negative impact on inflation from an expected improvement in growth.

Chart 7: SARB's output gap revisions



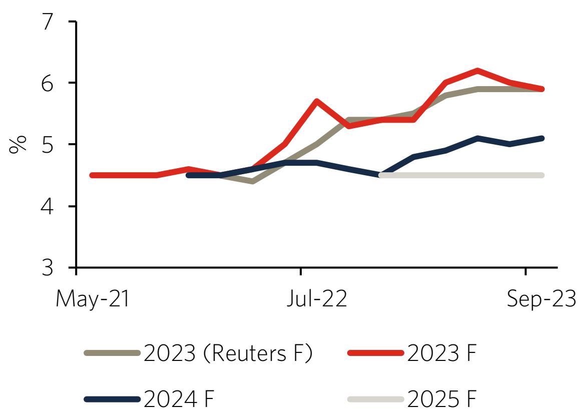
Source: SARB, Momentum Investments

The SARB noted that addressing logistics constraints and improving the energy crisis could significantly improve domestic growth.

SARB cautiously optimistic about the inflation trajectory

Domestic inflation surprised favourably against the SARB's quarterly projection of 6.4% (outcome: 6.2%) in the second quarter and again in the third quarter (5.4%, outcome: 4.7%). The better-than-expected outcome in the second quarter was despite a slight uptick in September's headline inflation (4.8% y/y from 4.7% y/y in August). The SARB revised its headline inflation expectation for 2023 slightly down to 5.9% (previously 6%), bringing the forecast in line with the Reuters median consensus (see chart 8). This may be a marginal revision, but it is notable because it means average annual inflation for 2023 is expected to be within the inflation target range, following the 6.9% rate recorded in 2022. Headline inflation was revised slightly higher to 5.1% in 2024 (previously 5%) but it is still expected to stabilise at 4.5% in 2025.

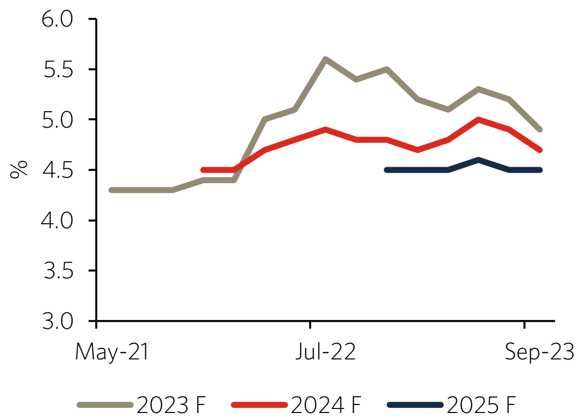
Chart 8: SARB's headline inflation revisions



Source: SARB, Momentum Investments

Core inflation was revised markedly lower to 4.9% in 2023 (previously 5.2%), 4.7% in 2024 (previously 4.9%) and is expected to stabilise at 4.5% in 2025 (unchanged) as seen in chart 9. The 2023 downward revision is due to lower public transport inflation dragging services inflation down to 4.4% in 2023 (previously 4.8%). Core goods inflation in 2023 was revised slightly up to 6.3% from 6.2%.

Chart 9: SARB's core inflation revisions

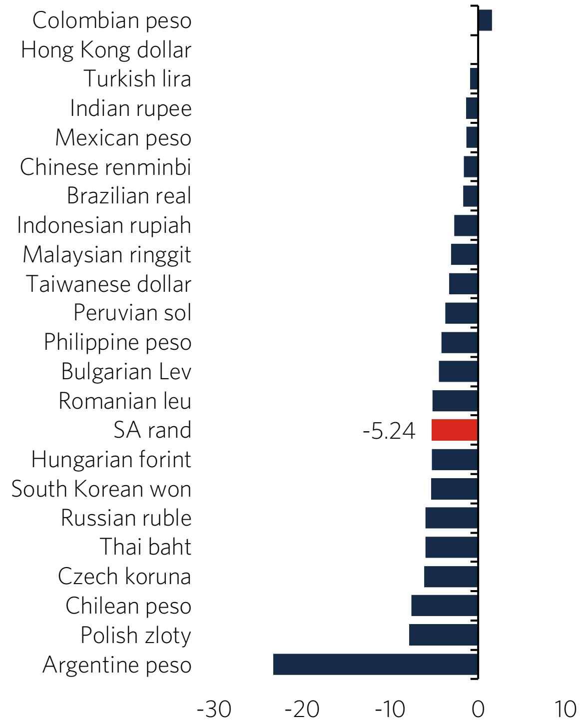


Source: SARB, Momentum Investments

Despite these downward revisions, the SARB notes that risks to the inflation outlook are assessed to the upside and include elevated global food prices, sticky core inflation globally, tighter oil markets, elevated domestic food inflation, an increased risk of El Niño, high electricity prices, potentially high average salaries, and a weakening rand.

The rand has been volatile over the past couple of months and this instability complicates the task of monetary authorities because it creates room for unforeseen deviations in forecasts. The rand has shifted across the spectrum of best and worst performing currency among emerging markets over the observation periods between each MPC meeting. The local currency shifted from being one of the top two currencies to strengthen against the dollar in the period between the May and July MPC meeting to being the 9th worst performing currency at the moment (relative to the July meeting) as seen in chart 10. Current rand weakness is reflective of growing concerns about China's property market and the resurgence of stage 6 loadshedding in September.

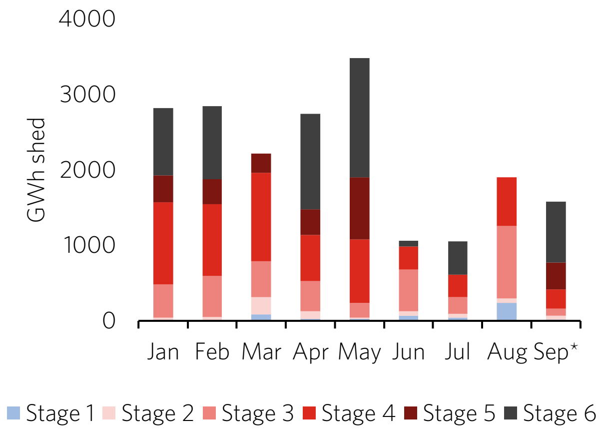
Chart 10: Broad-based currency depreciation across emerging markets since the July MPC* (%)



Source: Bloomberg, Momentum Investments
** 20 July to 21 September 2023*
Positive = appreciation, negative = depreciation

Eskom announced the return of stage 6 loadshedding in September following a maximum of stage 4 loadshedding in August and mild loadshedding during June and July (see chart 11). According to *BusinessTech*, the need for higher stages of loadshedding is due to increased generation capacity loss from many big units not being operational, increased planned maintenance (expected in summer), higher than normal demand and pumped storage losses. More intense loadshedding means businesses equipped with generators need to run the generators for more hours in a day and thus burn more diesel in an environment of higher fuel costs. Large food retailers in SA have expressed increased pressure from diesel costs which poses an upside risk to food inflation.

Chart 11: SA returned to stage 6 loadshedding



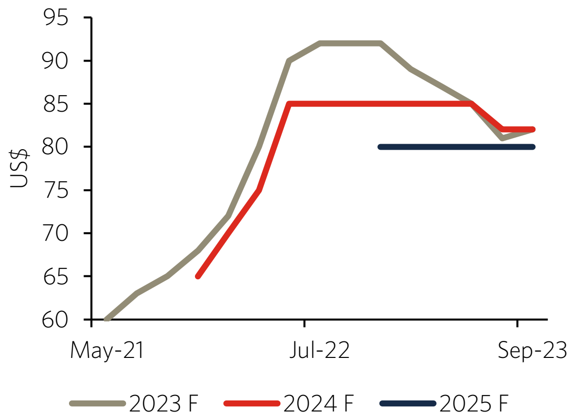
Source: EskomSePush, Momentum Investments
** Month-to-date (3 to 19 September 2023)*

The return of Kusile Unit 4 from 17 September will provide some reprieve. According to the Minister of Electricity, the Unit returned after being off for the 20-day planned maintenance routine. This increases generation capacity by 800MW (almost 1 stage of loadshedding). Kusile Units 1 to 3 are expected to return to service sooner than previously expected, between mid-October and the end of November (initially December). The return of these three units will mark a meaningful milestone in addressing the energy crisis because they will add an additional 2 400MW in generation capacity.

Higher international oil prices, in conjunction with a weaker rand, is a concern for the inflation trajectory because it introduces upward pressure on transport inflation. Fuel price inflation was revised markedly higher to 0.4% in 2023 (previously negative 3.1%) and is expected to accelerate to 5.8% in 2024. The SARB has previously warned that higher fuel and transport costs could have second-round effects and lead to higher food inflation.

In the September Short-Term Energy Outlook, the US Energy Information Administration (EIA) revised their average Brent crude oil price up for 2023 (US$ 84.46 bbl from US$ 79/bbl in July) and for 2024 (US$ 88.22/bbl from US$ 84/bbl). The SARB only revised their oil price assumption up in 2023 to US$ 82/bbl (previously US$ 81/bbl) and 2024 and 2025 was left unchanged at US$ 82/bbl and US$ 80/bbl, respectively (see chart 12). The SARB's forecasts remain below the EIA's projections.

Chart 12: SARB's Brent crude (US$/barrel) revisions



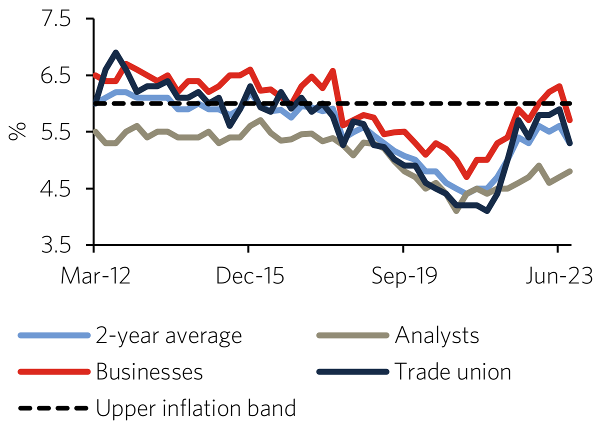
Source: SARB, Momentum Investments

Apart from higher fuel costs potentially spilling over into food inflation, an additional upside risk to food inflation stems from intensifying El Niño conditions. However, both these elements are not viewed as immediate risks to food prices. The expectation for food price inflation in 2023 was broadly unchanged at 10.4% (previously 10.3%). The Agriculture Business Chamber of SA (Agbiz) is more optimistic with their expectation of food inflation averaging between 9.5% and 9.9% in 2023.

Inflation expectations published by the Bureau for Economic Research (BER) retreated across all the different forecasted horizons in the third quarter survey results with shorter-dated average inflation expectations dropping by more than longer-dated expectations. Inflation expectations for 2023 and 2024 dropped by 0.4% to 6.1% and 5.5%, respectively. Average two-year and five-year expectations dropped by 0.3% and 0.1%, respectively to 5.3% and 5.1%. Businesses and trade unions (price setters) were responsible for the retreat in expectations across all the different forecast periods.

Average two-year expectations for businesses and trade unions dropped markedly by 0.6% to 5.7% and 5.3%, respectively. Analysts are more optimistic (see chart 13) despite a slight increase in expectations from 4.7% to 4.8%.

Chart 13: Businesses 2-year average inflation expectations fall below 6%



Source: BER, Momentum Investments

The SARB expressed that they "prefer to see expectations anchored at the mid-point of the target band".

Split preferences highlight inflation concerns

As expected, the SARB decided to keep the repo rate unchanged at 8.25%. Three members preferred the announced decision while two members thought it necessary to increase rates by 25-basis points.

The split of the MPC members was more hawkish than the analysts surveyed in the September 2023 Reuters survey. 17 of the 20 surveyed analysts expected the rate pause and the remaining three expected a rate hike (two expected a 25-basis point hike and one was more hawkish with a 50-basis point expectation).

The preference of a rate hike by some of the MPC members reflects concerns about upside inflationary pressures (fuel costs, volatile currency, loadshedding, higher administered prices and El Niño) and signals that the door for another rate hike is still open but a cut is not yet a consideration.

Table 1: Shift in MPC member preferences at the scheduled September 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
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	-	-
20 July 2023	3	2	-	-	-
21 September 2023	3	2			

Source: SARB, Momentum Investments

Extended pause before expected cuts

Despite an unchanged stance in interest rates, the SARB retained a cautious tone, flagging "serious" upside risks to the inflation outlook and noting that they stand ready to act if these risks materialise. The SARB governor warned that high inflation begets high interest rates and as such, the correct stance is to bring inflation down. This is particularly important given that higher inflation has eroded purchasing power for consumers as incomes have failed to keep pace with rising prices.

The SARB expressed satisfaction about the direction on inflation but noted concern about the pace of deceleration. Furthermore, the MPC reiterated that further evidence of inflation coming down is needed to ensure that inflation will continue to fall sustainably toward the midpoint of the target range. In the governor's words, "the arrival of a one swallow does not mean summer is here. You need to see more swallows in the sky".

As such, we expect the SARB to maintain interest rates in restrictive territory into the second quarter of next year (a quarter later than the September Reuters consensus), at which point we expect the first interest rate cut to come through in line with a sustainable shift lower in inflation towards the midpoint of the target range.