SARB MPC PREVIEW

16 NOVEMBER 2018

NEDBANK CIB

SARB HAWKS EXPECTED TO MULL (AND WIN) RATE HIKE

- **We expect the repo rate to be hiked by 25bps to 6.75% next week. It will be a close call**. **We have identified six factors in which material developments have taken place since the last MPC meeting** (Table 1); these could be adjusted or accounted for differently, not only in the SARB's QPM but also by MPC members.
- **We do highlight the fact that these factors present somewhat of a mixed outlook for inflation over the medium term**, and that as such, the upcoming MPC decision will, to a large degree, depend on how keen the MPC is to anchor inflation expectations closer to the mid-point of the target band. South Africa is facing higher administered prices, rising inflation expectations, the threat of an El Niño event on the horizon and tighter global financial conditions and, by implication, a weaker rand. All these factors point to upward inflationary pressures. However, at the same time, we expect food inflation to remain subdued, and believe there is a clear lack of demand-pull inflation and a resultant weak exchange rate pass-through to inflation.
- **Our baseline inflation estimates are 4.7%, 5.6% and 5.2% for 2018, 2019 and 2020, respectively.** The SARB has maintained an inflation profile slightly above our forecasts – we do not expect this to change. In fact, the SARB may well adjust its inflation outlook marginally higher if only because of the NERSA's RCA clawback ruling. We expect the SARB to maintain a hawkish tone to anchor inflation expectations closer to the mid-point of the 3-6% target range.

SUMMARY OF KEY DEVELOPMENTS SINCE THE LAST MPC MEETING

Table 1: Discussion points likely to feature in the MPC statement

Global/Local	Factors	SARB Sept 2018 MPC meeting	Recent developments
GLOBAL ECONOMY	**Geopolitical developments**	"While the global economic outlook is expected to remain broadly favourable over the short term, medium term risks are tilted to the downside due to elevated policy uncertainty. This uncertainty arises from escalating trade tensions and tightening global financial conditions."	The IMF revised its global growth forecasts lower. The IMF projects growth of 3.7% (on average) from 2018-20 (prev.: 3.9%) and 3.6% over the following three years. However, rising trade tensions could reduce global growth by 1% over the next two years. The Citi Surprise Index for EMs showed a negative economic surprise for emerging markets, indicating that, on balance, EM fundamentals have deteriorated. Given tighter monetary policy and a slowdown in the global economy in Q3 due to trade uncertainty, we expect EM economic activity to slow down as well. In the UK, there are increased fears of a 'no-deal' Brexit, heightening uncertainty among businesses. Global trade conditions remain subdued, threatening to hamper global growth eventually. Recently, US sanctions on Iran took full effect, however the White House exempted eight countries that are coincidentally Iran's biggest export destinations for oil. As a result, the oil price fell sharply, to \$65/bbl. currently. Trade tensions between the US and China have subsided recently, with China conceding that it is willing to improve trade relations with its key trading partners. However, the full effect of the higher US import tariffs on Chinese products will only kick in in January 2019, which may heighten geopolitical tensions then.

Source: SARB, Nedbank CIB Market Research

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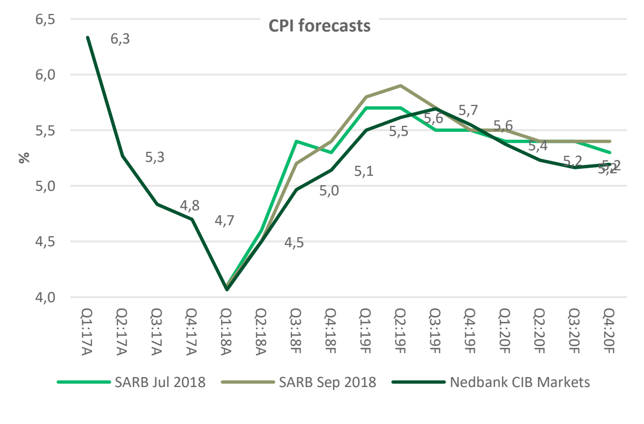
Global/Local	Factors	SARB Sept 2018 MPC meeting	Recent developments
LOCAL ECONOMY	**GDP growth and the output gap**	"The SARB now forecasts growth in 2018 to average 0.7% (down from 1.2% in July). The forecast for 2019 and 2020 is unchanged at 1.9% and 2.0% respectively. At these growth rates, the negative output gap is wider in the near term but is still expected to close by the end of 2020 as GDP growth rates exceed potential growth. The MPC assesses the risks to the growth forecast to be moderately on the downside. The Committee continues to be of the view that current challenges facing the economy are primarily structural in nature and cannot be solved by monetary policy alone."	SA's real economy has presented mixed signals in Q3 but is likely to see the low base effect from Q2 improve the GDP data in Q3 – while the mining industry is likely to contribute negatively towards Q3 growth, the positive impact from the manufacturing industry inventory rebuild may more than offset this. Retail activity picked up modestly in Q3, which may see household spending driving GDE growth. Since the last MPC meeting, the announcement of a fiscal stimulus package was followed by a disappointing MTBPS, which was then followed by an investment and jobs conference that attracted R290bn worth of investment pledges. The growth outlook remains benign and the output gap negative, with further downside risks over the medium term, unless investment activity picks up.
	Inflation, inflation forecasts, inflation expectations	"Despite remaining within the inflation target range throughout the forecast period, the SARB's model projects an increase in headline inflation, peaking at levels closer to the upper end of the target range. Headline inflation is now expected to remain at an average of 4.8% in 2018, before increasing to 5.7% in 2019 (up from 5.6%) and moderating to 5.4% in 2020. Headline CPI inflation is expected to peak at around 5.9% in the second quarter of 2019. The forecast for core inflation is 4.4% in 2018 (down from 4.6%), 5.6% in 2019 (up from 5.5%) and 5.5% in 2020 (up from 5.3%). The MPC assesses the risks to the inflation outlook to be on the upside. The MPC noted the rising inflation trajectory which, while remaining within the target range, is moving further away from the mid-point of the target range. However, the MPC remains concerned about the deteriorating inflation outlook, driven mainly by multiple supply-side factors. The approach of the Committee continues to be to look through the first-round effects and focus on the possible second-round effects. With risks and uncertainties at higher levels, the MPC will continue to be vigilant and will not hesitate to act should it become necessary."	SA's CPI disappointed consensus in September, remaining unchanged at 4.9% y/y. Core inflation was left at 4.2%, goods price inflation declined by 20bps, while services inflation saw a similar rise. While we still believe the SARB remains quite hawkish, particularly given its core CPI forecast of 5.5% for 2019, we could see a further upward revision to its inflation estimates, and to stress that inflation risks remain to the upside. In contrast, we believe risks to CPI forecasts are to the downside in the absence of any exogenous shock. However, CPI pressures have emanated from supply-side factors (a weaker rand and higher food costs/bad weather) rather than demand-driven factors. The SARB has also recently warned that markets should not discount the probability of CPI breaching the 6% level and that the SARB may raise rates in that event. Inflation expectations are set to rise again in Q4, as a result of elevated wage settlements – the Labour Research Service (LRS) shows that the median wage increase for the YTD is at 7%, and average salary increases for the year across all occupations is 9.6%.
	Market expectations	The FRA market was predicting four rate hikes of 25bps each over the next two years.	The FRA curve flattened since the last MPC meeting, as front-end yields rose sharply. The market is now seeing 3.8 hikes of 25bps each over the next two years
LOCAL ECONOMY	**Rand exchange rate**	"Since the July MPC, the rand has depreciated by 7.3% against the US dollar, by 8.1% against the euro, and by 7.1% on a trade-weighted basis. At current levels, the SARB's model assesses the rand to be undervalued. The implied starting point for the rand is R14.20 against the US dollar, compared with R13.40 at the time of the previous meeting. Tighter global financial conditions and the change in investor sentiment towards emerging markets remain key external risks to the rand, and it is likely that the rand, along with other emerging market currencies, will remain volatile. However, the pace of monetary policy normalisation in the advanced economies continues to be gradual"	Since the last MPC meeting, the rand has strengthened by 0.8% against the USD, by 4.4% against a very weak EUR, and by 4% against the pound. Therefore, the trade-weighted rand strengthened by 3.7% in the same period. Rand weakness has been well contained since the last MPC meeting, but the currency remains highly volatile. The 2-month implied volatility is the highest in the world after the Turkish Lira. Nedbank CIB continues to forecast a USDZAR exchange rate range of R14.00-R15.00 by year-end. While we do not rule out the possibility of a break out of this range, we do believe that if the EURUSD continues to weaken, this would reduce upside risks to the rand, i.e., the rand would continue to weaken.
	Administered prices	"Elevated international oil prices will contribute to fuel price inflation. Other administered prices are expected to increase at rates above the upper end of the inflation target range, as water and electricity tariffs rise, alongside rates and taxes in major metros."	Eskom recently applied to NERSA for a 15% MYPD increase from July 2019. NERSA is currently deliberating and will make a decision by March 2019. Administered prices are expected to remain elevated, in the face of elevated utilities costs. Transport costs have become increasingly difficult to forecast given government intervention in September and November in first providing relief, and then preventing a fuel price cut. Since the last MPC meeting, the rand price of Brent has *fallen* by 20%, and the over recovery in the petrol price is currently close to 154-cents/litre. This implies that if the oil price remains at current low levels, while the rand remains stable (and there is no government intervention), then a similar cut is anticipated in December. In our last MPC Preview, the rand price of Brent had *risen* by 20% since the prior MPC meeting. The local petrol price has risen by R2.32/litre since the start of the year and has been a key driver of higher headline CPI since the low of 3.8% in March. Should a large fuel price cut materialise in December, this may well undo a bulk of that pressure.

Source: SARB, Nedbank CIB Market Research

INFLATION DYNAMICS AND RISK FACTORS

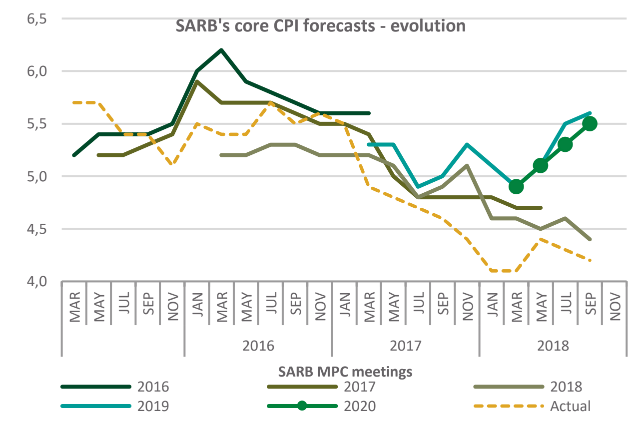
- **Our baseline inflation estimates for 2018, 2019 and 2020 are 4.7%, 5.6% and 5.2%, respectively** (**Chart 1 and Table 3**). However, we believe risks to these estimates are tilted to the downside in the absence of strong domestic demand.
- Two risks to inflation have materialised recently – the NERSA finalising its RCA implementation plan for Eskom and the hike in fuel prices in October (**Table 2**).
- **With regard to Eskom and electricity tariffs:**
    - The NERSA allowed the recently approved RCA clawback to be made up over a four-year period, which would imply a 4.4% additional tariff over and above the usual multi-year price determination (MYPD) adjustment. Since we had expected it to be rolled out over two years, **this development eases our headline inflation estimate by about 7bps between 2019 and 2020**.
    - Separately, we forecast a baseline 8% electricity tariff hike from July 2019, related to the MYPD application. Eskom recently applied for a 15% tariff hike for each of the next three years in its MYPD application to the NERSA. **If the NERSA approves a tariff hike that is closer to 5% per annum, our headline CPI forecast falls by 10bps in 2019 and 2020.**
    - Alternatively, **if Eskom manages to obtain the 15% it has applied for, then CPI rises by 10bps in 2019 (to 5.7%) and by 30bps in 2020 (to 5.5%).** Importantly, if this materialises, then CPI may touch 6% y/y in September 2019 as administered prices rise. This is not our base case. The NERSA will announce an MYPD adjustment on/by 1 March 2019.

Chart 1: Our headline CPI forecast vs the SARB's



Source: Nedbank CIB Market Research

Chart 2: Core CPI forecasts have risen due to a weaker ZAR



Source: Nedbank CIB Market Research

- **With regard to fuel prices:**
    - Consumers were entitled to a 20-cent reduction in petrol prices in November based on the calculated over-recovery. However, this was not provided, as the government's intervention in September had to be paid for eventually. **Currently, the over-recovery in the petrol price is at 154 cents/litre,** which means that if the USDZAR exchange rate remains stable at current levels, along with the oil price, consumers may enjoy a similar cut in December. This is contingent on any further government intervention since politicians have taken an active interest in the price-settling mechanism of **the fuel price, which has been predictable in the past, but has become increasingly clouded by political intervention recently**. It is impossible to forecast such interventions that may make monetary policy decisions difficult **as the economy's natural price discovery mechanism is hampered.**
    - For every USD5/bbl increase in the profile of the oil price, our headline CPI estimate rises by about 10bps.

Table 2: Risk factors and their impact on our headline CPI estimates

Risks	*Impact on average CPI projection*	
Food inflation is 20% higher than baseline	⬆ 10bps (2019)	⬆ 20bps (2020)
Brent crude profile is $5/bbl. higher	⬆ 10bps	
NERSA approves 5% MYPD adjustment	⬇ 10bps	
NERSA approves 15% MYPD adjustment	⬆ 10bps (2019)	⬆ 30bps (2020)
USDZAR 10% stronger than baseline	⬇ 30bps (2019)	⬇ 10bps (2020)
USDZAR 10% weaker than baseline	⬆ 10bps (2019)	⬆ 30bps (2020)

Source: Nedbank CIB Market Research

The SARB's position

- While we do not expect CPI to breach the 6% upper target level over the medium term, the SARB might.
- The latest SARB CPI forecast did not **include the NERSA's RCA clawback in its electricity inflation forecast**. This will now be included in its forecasts to be presented next week. **We believe that the RCA clawback alone may raise the SARB's CPI profile for 2019 and 2020 by about 10bps (to 5.8% and 5.5%, respectively).**
- The SARB has had to raise the starting point for its USDZAR exchange rate forecast at each of its last three meetings. The current starting point is R14.20/USD, which could be revised slightly higher (to R14.35/USD) (**Table 4**). This is unlikely to impact the SARB's inflation profile materially.
- The SARB has an oil price forecast of USD72/bbl for 2018 and USD70/bbl for 2019 and 2020. We do not expect significant changes to these estimates, despite the recent slump in the oil price.
- Of significance is the SARB's projected path for the currency – **Table 4** shows the changes relating to the currency projections at each SARB MPC meeting this year and how we expect this to evolve at its meeting next week.
- Notably, to achieve the SARB's implied USDZAR average for 2018 (its September forecast), we estimate that the USDZAR would need to rise to R19.00/USD towards year-end, which seems unlikely. We could see a revision of its implied USDZAR average for 2018 next week.

Table 4: SARB MPC's USDZAR starting point: Evolution in 2018

MPC Meeting	*USDZAR implied start*	*2018 performance**	*2018 implied USDZAR avg*	*2019 performance**
Jan	12,90	0,6%	13,05	-3,4%
Mar	11,97	7,5%	12,31	-4,1%
May	12,37	4,4%	12,72	-3,3%
Jul	13,40	-0,8%	13,41	-4,6%
Sep	14,20	-3,2%	13,74	-4,9%
Nov**	14,35	-0,5%	13,38	

* negative values imply rand weakness; **estimate

'Performance' is the SARB's nominal effective exchange rate (NEER) y/y performance forecast based on the annual average NEER; Source: SARB, Nedbank CIB Market Research

Table 3: Nedbank CIB Market Research baseline forecasts and assumptions

Nedbank CIB Market Research estimates						
Avg	CPI	Core	Food	Oil	USDZAR	Electricity
2017A	5,3	4,8	7,0	55,7	13,3	4,8
2018F	4,7	4,3	3,7	73,3	13,3	5,2
2019F	5,6	4,6	7,4	72,9	14,7	11,3
2020F	5,2	4,6	6,3	71,0	14,6	12,4
Q1:17A	6,3	5,2	10,2	54,7	13,3	7,4
Q2:17A	5,3	4,8	6,9	50,0	13,2	7,4
Q3:17A	4,8	4,6	6,0	54,2	13,3	2,1
Q4:17A	4,7	4,4	5,1	63,9	13,4	2,2
Q1:18A	4,1	4,1	4,1	68,4	11,8	2,2
Q2:18A	4,5	4,4	3,3	77,4	13,0	3,1
Q3:18F	5,0	4,2	3,1	78,1	14,0	7,8
Q4:18F	5,1	4,4	4,5	69,2	14,6	7,8
Q1:19F	5,5	4,5	6,2	73,1	14,6	7,8
Q2:19F	5,6	4,6	7,7	73,1	15,0	12,4
Q3:19F	5,7	4,6	8,2	72,6	14,8	12,4
Q4:19F	5,6	4,7	7,7	72,4	14,5	12,4
Q1:20F	5,4	4,7	6,8	71,9	14,4	12,4
Q2:20F	5,2	4,6	6,2	71,3	14,5	12,4
Q3:20F	5,2	4,6	6,0	70,7	14,7	12,4
Q4:20F	5,2	4,6	6,2	70,1	14,8	12,4
Q1:21F	5,2	4,6	6,5	69,5	14,5	12,4
Q2:21F	5,2	4,5	6,8	68,9	14,5	12,4
Q3:21F	5,2	4,5	6,9	68,4	14,5	14,5
Q4:21F	5,2	4,5	6,8	67,7	14,5	14,5

Source: Nedbank CIB Market Research

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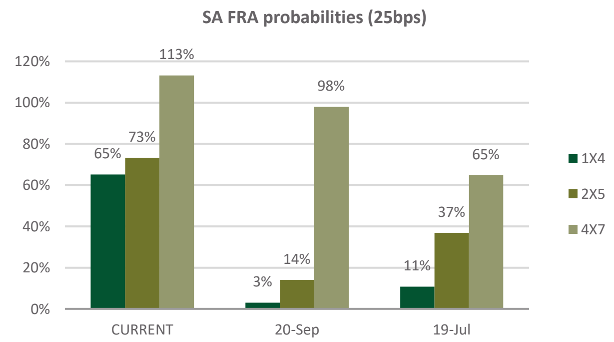
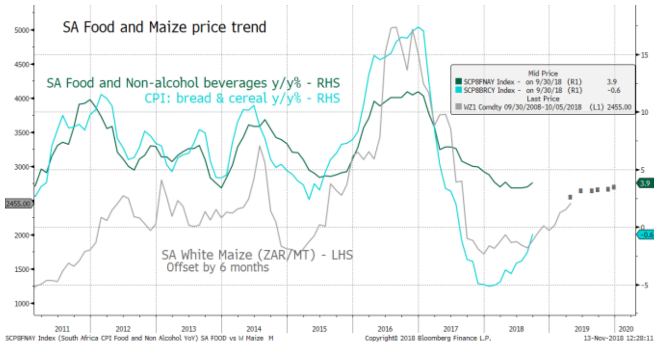
DATA INFORMING OUR VIEW

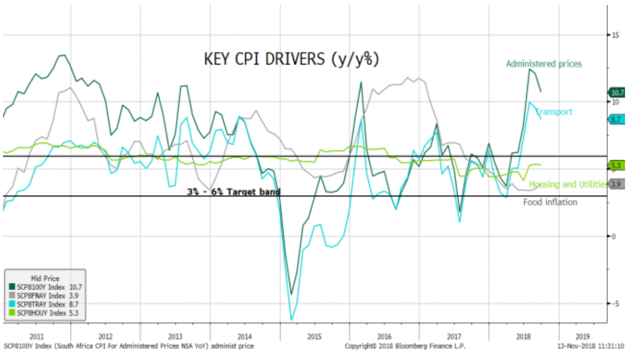
FRA market expects a hike next week



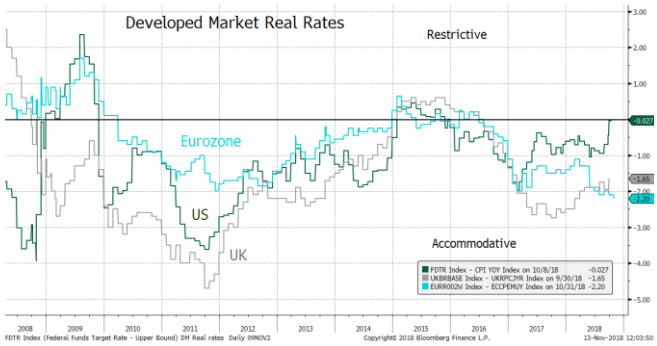
Food remains a disinflationary driver, but base effects fade



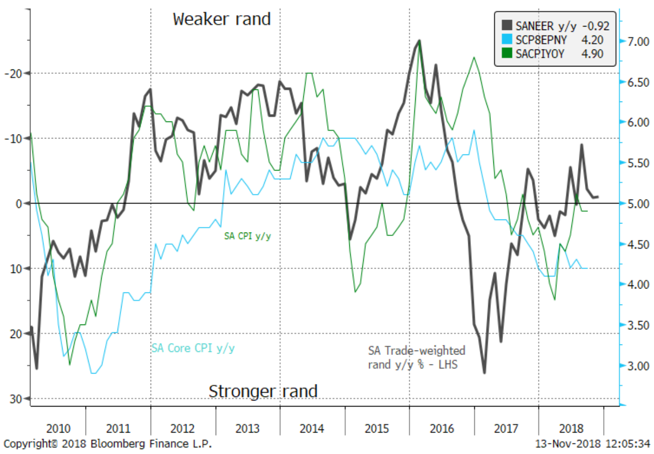
Administered prices: Upside risks materialise



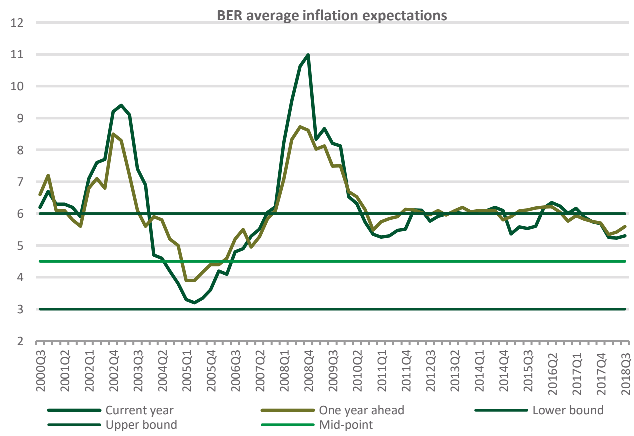
Hawkish DM central banks heighten risk of curtailing portfolio flows into EMs



Rand remains vulnerable to further exogenous shocks



Expectations remain a key concern for the SARB



Source: Bloomberg, Stats SA, BER, Nedbank CIB Market Research

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