

FIXED INCOME

FLASH NOTE

17 JANUARY 2019



SARB MPC: A RETURN TO THE (DOVISH) DRAWING BOARD

- In line with our expectations, the SARB unanimously kept the repo rate at 6.75%. We had expected a more dovish set of inflation forecasts by the SARB than the previous MPC. Indeed, the CPI projection was revised sharply lower, while the real GDP growth forecasts were adjusted marginally lower.
- However, in our view, the more important adjustment came in the SARB's Quarterly Projection Model (QPM), which now shows just one hike of 25bps, compared to three hikes of 25bps projected in November 2018 (or four hikes including the November hike).
- The QPM's repo rate forecast was more dovish than we expected and all else equal, we would read today's QPM repo rate forecast as marginally rand negative. A dovish SARB should also speak to a marginally steeper yield curve. That said, although the bias has clearly shifted towards a SARB that is likely to hike later rather than sooner, we note that the QPM still forecasts the one (and only) repo rate hike to be delivered this year.
- The MPC has become more dovish because of a few factors. Firstly, the SARB's oil price assumption was revised down to \$62/bbl. for 2019, from \$73/bbl. previously. Combined with this, the rand appreciated against the dollar and the euro, while fuel costs eased sharply. Because of this, the SARB's headline CPI forecasts dropped dramatically, to 4.8% in 2019 and 5.3% in 2020 (from 5.5% and 5.4% previously). The SARB now sees inflation peaking at 5.6% in 1Q20 (from 3Q19). With a view to achieving a 4.5% inflation rate, the SARB's QPM now shows one hike instead of four over the next two years. Furthermore, since the last MPC meeting, global central banks have become less hawkish, suggesting a slower pace of monetary policy normalisation and this probably influenced the SARB's own outlook. Lastly, the BER inflation expectations survey has shown a reduction in five-year inflation expectations to 5.3% from 5.5% previously. However, the MPC has highlighted that it would still like to see inflation expectations closer to the mid-point of 4.5%.
- Despite the positive developments from an inflation perspective, the SARB is still mindful that risks to the inflation outlook are assessed to be moderately on the upside. These risks emanate from the possibility of higher administered and utilities prices, upside risks to food inflation, volatile international oil prices and threats to risk sentiment and the effect on EMs.
- The SARB has tweaked its growth profile slightly higher for 2018 (0.7% vs 0.6% in November 2018), while the 2019 growth rate projection was revised down to 1.7% (from 1.9% previously), and 2020 forecasts were kept unchanged at 2%. Real GDP growth of 2.2% is forecast in 2021. Growth risks are still to the downside and are concentrated to electricity constraints, weak confidence levels and structural bottlenecks that impede investment growth. Despite the sharp reduction in the growth forecast for 2019, the SARB's output gap remained unchanged at -0.9%.
- Our headline inflation forecast is now well above that of the SARB's. We now believe that CPI risks are to the upside relative to the SARB's estimates given a volatile rand and oil price assumption. We see inflation averaging 5.3% in 2019, and 5.2% in 2020, with core inflation at 4.5% in both years. The SARB sees core inflation at 5% and 5.1% over the next two years, which we believe is too high in the absence of any demand-pull inflation.
- As such we believe the risk now lies that the SARB has capitulated too far in their inflation forecast. That is, they have moved from a headline inflation forecast that was too high to a forecast that is too low for 2019. While the FRA market now puts a 5% chance of a hike in the next six months and around a 30% chance of a hike in 2019, the risk is now that the market becomes too complacent (dovish). If this is the case, history would suggest that bonds underperform until such a time where a slightly more hawkish policy path is priced.

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Chart 1: SARB inflation estimates revised sharply lower

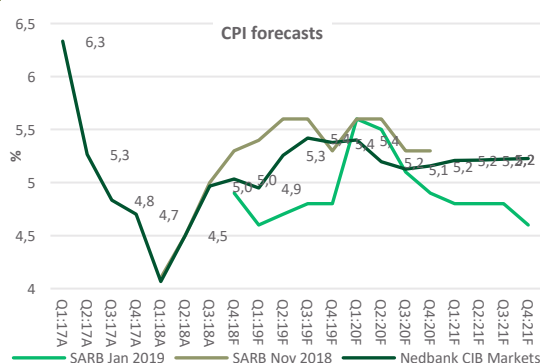


Chart 2: SARB pleased with reduction in expectations

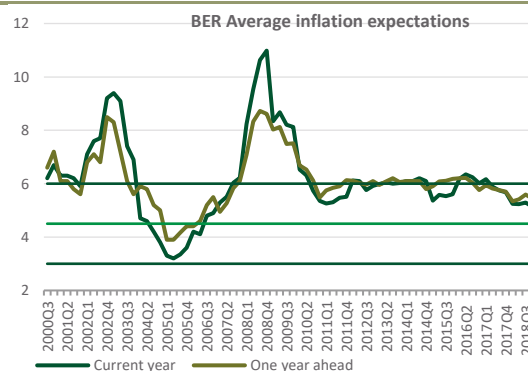


Table 1: Changes since the previous MPC meeting (major changes/similarities highlighted in grey)

	Factors	SARB outlook at the November 2018 policy meeting	SARB outlook at the January 2019 policy meeting
GLOBAL ECONOMY	Growth	The global economic outlook is expected to remain broadly favourable over the short term. However, medium term risks are tilted to the downside due to less synchronised global growth. This is amplified by elevated policy uncertainty emanating from escalating trade tensions, tightening global financial conditions and rising geo-political risks.	Global growth is expected to remain broadly favourable over the near term, but to moderate over the medium term while risks are tilted to the downside. The negative effects of tariff increases are becoming more visible in economic data and uncertainty arising from trade tensions remains. Other risks include geo-political developments and excessive financial market volatility.
	Inflation and interest rates	The global inflation trajectory remains on a moderate upward path as key advanced economies continue to grow above their potential. The pace of monetary policy normalisation in the advanced economies continues to be gradual. Policy tightening by the US Fed is expected to follow a measured path in the absence of significant inflation or growth surprises, while the European Central Bank (ECB) is expected to start a rate hiking cycle in late-2019. This means that monetary policies in some advanced economies will likely be tightening throughout the forecast period.	Recent communication from major central banks suggests a slower pace of monetary policy normalisation in advanced economies. In December, the US Fed signalled a more gradual pace of rate hikes. Although the European Central Bank (ECB) ended its asset purchase programme in December, it has indicated that monetary policy would remain largely accommodative.
	Oil price	Following persistent increases in oil prices since February, the assumptions for Brent crude oil in the QPM were revised upwards by US\$3 per barrel to US\$73 for 2019 and 2020.	Following a significant decline in oil prices since November, the assumptions for Brent crude oil in the QPM were revised down by around US\$10 per barrel from US\$73 to US\$62 for 2019 and US\$65 for 2020 and 2021.
DOMESTIC ECONOMY	SARB's GDP forecast	The SARB now forecasts growth in 2018 to average 0.6% (down from 0.7% in September). 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 than at the time of the previous MPC meeting. The output gap will narrow but will not close by the end of 2020, as previously expected. The MPC assesses the risks to the growth forecast to be moderately on the downside. As previously highlighted the Committee remains of the view that current challenges facing the economy are primarily structural in nature and cannot be solved by monetary policy alone.	The SARB now expects growth in 2018 to have averaged 0.7% (up from 0.6% in November). The growth forecast for 2019 is 1.7% (down from 1.9%), it is unchanged at 2.0% for 2020 and increases to 2.2% in 2021. At these growth rates, the negative output gap is expected to close in the first quarter of 2021. The MPC assesses the risks to the growth forecast to be on the downside. Weak business and consumer confidence continue to weigh on fixed capital formation. This could be exacerbated by the possibility of protracted electricity supply constraints. Furthermore, the Committee remains of the view that current challenges facing the economy are primarily structural in nature.
	Forecast of inflation	The inflation forecast has improved marginally since the previous MPC. While remaining within the inflation target range throughout the forecast period, the SARB's model projects an increase in headline inflation, albeit slightly lower than the September projection. Headline inflation is now expected to average 4.7% in 2018 (down from 4.8%), before increasing to 5.5% in 2019 (down from 5.7%) and moderating to an unchanged 5.4% in 2020. Headline CPI inflation is now expected to peak at around 5.6%, in the third quarter of 2019. The forecast for core inflation is 4.3% in 2018 (down from 4.4%), 5.3% in 2019 (down from 5.6%) and 5.5% in 2020. These inflation projections are based on an interest rate path generated by the SARB's Quarterly Projection Model (QPM). The MPC continues to assess the risks to the longer-term inflation outlook to be on the upside. The MPC noted the rising inflation trajectory which, while remaining within the target range, continues to deviate from the mid-point of the target range. The approach of the MPC is to look through the first-round effects and focus on the possible second-round effects of supply side shocks. However, shocks of a persistent nature such as extended periods of currency depreciation, elevated oil prices and multi-year electricity price increases make it difficult to disentangle these first and second round effects.	The near-term inflation forecast generated by the SARB's Quarterly Projection Model (QPM) has improved significantly since the previous MPC. Headline inflation is now expected to average 4.6% in 2018 (down from 4.7%) and 4.8% in 2019 (down from 5.5%), before increasing to 5.3% in 2020 (down from 5.4%) and moderating to 4.8% in 2021. Headline CPI inflation is now expected to peak at around 5.6%, in the first quarter of 2020. Core inflation is expected remain unchanged at 4.3% in 2018 and forecast to average 5.0% in 2019 (down from 5.3%), 5.1% in 2020 (down from 5.5%) and 4.8% in 2021. These inflation projections are based on an interest rate path generated by the QPM. The MPC has taken note of the improved inflation outlook, especially in the near-term. Over the forecast period, inflation is expected to remain within the inflation target range, averaging 5.3% in 2020 and 4.8% in 2021. The overall risks to the inflation outlook are assessed to be moderately on the upside. The approach of the MPC is to look through the first-round effects and focus on the possible second-round effects of supply side shocks. As previously indicated, any future policy adjustments will be data dependent.
INFLATION DRIVERS	Food prices	(No mention)	Lower food price inflation also contributed to lower consumer price inflation. Food price inflation is expected to have bottomed out in the fourth quarter of 2018 and to rise to 4.6% in 2021.
	Rand exchange rate	Since the September MPC, the rand has appreciated by 3.8% against the US dollar, by 6.6% against the euro, and by 5.2% on a trade-weighted basis. The implied starting point for the rand is R14.50 against the US dollar, compared with R14.20 at the time of the previous meeting. At these levels, the QPM assesses the rand to still be undervalued. Tighter global financial conditions, financial market volatility and the change in investor sentiment towards emerging markets remain key external risks to the rand. Over the medium term, it is likely that the rand, along with other emerging market currencies, will remain volatile.	Since the November MPC, the rand has appreciated by 1.4% against the US dollar, by 1.5% against the euro, and by 0.5% on a trade-weighted basis. The implied starting point for the rand is R14.30 against the US dollar, compared with R14.50 at the time of the previous meeting. At these levels, the QPM assesses the rand to be less undervalued. Emerging market currencies, including the rand, have recently benefited from a weaker US dollar and indications of continued accommodative monetary policy in advanced economies, but they remain vulnerable to changes in investor sentiment. The rand also remains sensitive to domestic growth prospects, political developments and policy settings.
	Administered prices	Administered prices, including fuel, electricity and water tariffs, are expected to increase at rates above the upper end of the inflation target range.	The overall risks to the inflation outlook are assessed to be moderately on the upside. The risks include administered prices such as electricity and water tariffs, rising domestic food prices in the outer years, changing investor sentiment towards emerging markets, moderation in global growth and volatile international oil prices.
	Wage settlements	These risks include tighter global financial conditions, a weaker exchange rate, higher wage growth, international oil prices and rising electricity and water tariffs. However, demand pressures are still not assessed to pose a significant risk to the inflation outlook.	(No mention)

Source: SARB, Nedbank CIB

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