

SARB MPC: UPPING THE ANTE IN LANGUAGE AND FORECASTS

- We expected a hawkish statement and the MPC delivered exactly that.** In fact, the MPC statement was more hawkish than we expected, not only in its language, but also via its forecasts.
- The SARB now sees inflation at 5.6% in 2019 (up from 5.2% in May) and 5.4% in 2020 (up from 5.2%).** The SARB's Quarterly Projection Model (QPM) now forecasts 5 hikes between now and 2020 (up from 4 previously). At the same time the MPC assess the risks to inflation to remain on the upside. The hawkish tone, and higher inflation estimate, comes despite a weaker GDP growth forecast for 2018 (now seen at 1.2%, down from 1.7%). But the focus in our view has clearly shifted to 2019 where GDP growth is expected at 1.9% (up from 1.7% previously). The output gap is still expected to close in 2020.
- The deteriorating inflation outlook is "driven mainly by supply-side factors" while demand pressures "are not assessed to pose a risk to the inflation outlook".** The upside risks to the inflation outlook that the SARB has previously warned about, **have begun to materialise**, resulting in increased hawkishness by the MPC. These risks are not new; a possibly weaker rand (although we agree with the SARB's assessment that the rand is somewhat undervalued at current levels.), higher oil prices, electricity prices and elevated wage settlements (around the 7% level). While the latter risk could increase demand-side pressures to inflation, the former three risks are all supply-side factors. These supply side risks must deliver on second round inflationary effects before the SARB will act to curb their inflationary pressures. In this regard, during Q&A, MPC member Rashaad Cassim did indicate that these second round effects are explicitly modelled and accounted for in the forecast already.
- Our headline inflation forecast remains well below that of the SARB's even after accounting for electricity tariff increases following NERSA's ruling on Eskom's application for the RCA claw back.** We expect inflation to remain much closer to 5% over the forecast horizon than what the SARB is forecasting (Graph 1).
- The BER surveyed 1-year ahead inflation expectations, as well as the long-term (5-year) inflation expectations for Q2:18, rose marginally to 5.4%, up from 5.3% in Q1:18 (Graph 2). This too, should be of concern to an MPC that would prefer to have expectations anchored closer to the mid-point of the target band.
- As far as the market is concerned, the hawkish statement should provide some support for the currency in a volatile external environment.** Given our inflation forecast, we do not believe the SARB will deliver any hikes this year. If we are wrong, and hikes arrive sooner, the magnitude of hikes in our view, will end up less than what otherwise would be the case or implied by the QPM for that matter. The 2y IRS is trading at 7.30 (80bps above repo). At the same time the 5y IRS is around 7.75% (125bps above repo). As a result, we do believe for example that the 2y5y portion of the swap curve is likely to flatten. We continue to believe that longer-dated local bond yields provide 'decent' real yield pick-up, and that today's stance by the SARB should aid this view. **Overall we still favour a flatter yield curve, rather than a steeper one.**

Chart 1: SARB inflation estimates revised sharply higher

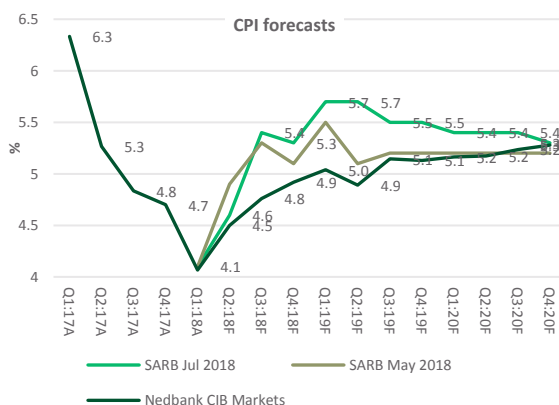
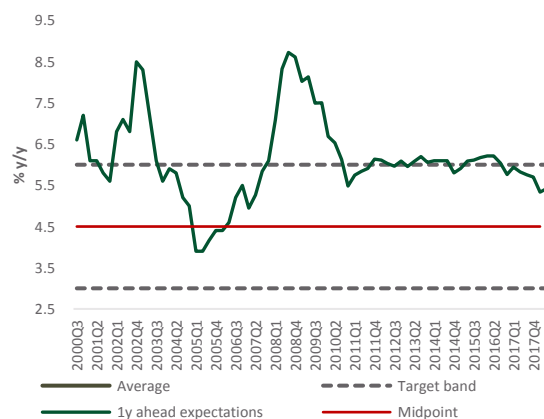


Chart 2: BER inflation expectations 1y ahead marginally higher



Source: SARB, BER, Nedbank CIB Markets Research

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

	Factors	SARB outlook at the May 2018 policy meeting	SARB outlook at the July 2018 policy meeting
GLOBAL ECONOMY	Growth	The global economic backdrop has become more challenging amid continuing trade policy tensions between the US and China as well as other geopolitical risks. Although the economic growth outlook in the advanced economies generally remains positive, there are signs that the momentum may be slowing	While the global economic outlook has remained broadly favourable, expectations are that world growth will begin to slow in the third quarter of 2018. In addition, escalating trade tensions are contributing to uncertainty around global trade. World trade volumes contracted sharply in April 2018 – the worst performance since May 2015.
	Inflation and interest rates	Global inflation remains on a moderate upward trend, but still at low levels. However, the rising international oil prices could derail the relatively benign global inflation prognosis.	The global inflation outlook remains benign but is on a moderate upward path, largely due to the rising oil prices. The prices of most other commodities have been retreating.
	Oil price	Following persistent increases in international oil prices since February, the assumptions for Brent crude oil in the SARB's Quarterly Projection Model were revised upwards by US\$7 per barrel to US\$70 for 2018 and by US\$5 per barrel, to US\$67, for the next two years. Both the futures markets and the consensus forecasts indicate some moderation of prices over the next two years.	None (The SARB did revise its forecast of Brent to \$72/bbl. in 2018 and \$70/bbl. over the next two years, from \$70/bbl and \$67/bbl. respectively previously.)
DOMESTIC ECONOMY	SARB's GDP forecast	The domestic growth outlook remains challenging, although growth is still expected to outperform recent year outcomes. The SARB's forecast for GDP growth is unchanged at 1.7% for 2018, but has been revised up from 1.5% to 1.7% for 2019. The forecast for 2020 is unchanged at 2.0%. The forecast remains consistent with a closing of the negative output gap by 2020, but at a slightly faster pace than before. The risks to the forecast remain on the upside, but slightly less so than at the previous MPC meeting.	The growth forecast has deteriorated, and the outlook remains constrained. The domestic economic growth outlook for this year is weaker than we had expected in May. Following the broad-based contraction of 2.2% in the first quarter and early indications of modest growth in the second quarter, the SARB's forecast now indicates a growth rate of 1.2% for 2018 compared with 1.7% previously. The forecast for 2019 is 1.9%, marginally higher than the previous forecast of 1.7%, while the forecast for 2020 is unchanged at 2.0%. At these growth rates, the negative output gap is wider in the near term but is still expected to close in 2020. The MPC assesses the risks to the growth forecast to be more or less balanced.
	Forecast of inflation	The MPC noted the relative stability of the inflation forecast, despite changes in a number of the key assumptions. The forecasts for 2018 and 2019 are unchanged at 4.9% and 5.2% respectively, while the forecast for 2020 is marginally higher at 5.2% compared with 5.1% previously. The peak of 5.5% is still expected in the first quarter of 2019 before the impact of the VAT increase largely dissipates. In contrast with the previous meeting, the MPC assesses the risks to the inflation forecast to have moved to the upside. This change is mainly due to global developments. The upside risks identified above are supply-side shocks.	Despite remaining within the target band 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. The weaker rand exchange rate and the higher oil price assumptions result in a more elevated inflation trajectory. Headline inflation is now expected to average 4.8% in 2018 (down from 4.9%) before increasing to 5.6% in 2019 and decreasing again to 5.4% in 2020 (up from 5.2% in both years). Headline CPI inflation is expected to peak at around 5.7% in the first and second quarters of 2019 before declining to 5.3% at the end of 2020. The forecast for core inflation is 4.6% in 2018 (up from 4.5%), 5.5% in 2019 and 5.3% in 2020 (up from 5.1% in both years). The MPC assesses the risks to the inflation forecast to be on the upside. Several risks to the inflation outlook have begun to materialise
INFLATION DRIVERS	Food prices	The impact of these adjustments on the inflation forecast was offset in part by a lower food price forecast and a lower starting point. Food prices, by contrast, are expected to increase by 4.9% in 2018 and by 5.5% in 2019, lower than in the previous forecast.	The impact on headline inflation is somewhat moderated by lower food price inflation. Annual food price inflation is expected to remain within the target range over the forecast period, and is not seen as a major risk to the inflation outlook. This is largely driven by an adequate supply of grains over the near term, alongside moderating meat price increases.
	Rand exchange rate	Since the previous meeting of the MPC, the rand has depreciated significantly, against the US dollar in particular, reversing much of the overvaluation seen at that time. The rand has depreciated by 6.0% against the US dollar, by 0.7% against the euro, and by 2.8% on a trade-weighted basis. The implied starting point for the rand in the forecast is R12.37 against the US dollar compared with R11.97 at the time of the previous MPC meeting. In the near term, the rand is expected to remain volatile, with movements dominated by the changing assessment of these global trends.	Since the previous meeting of the MPC, the rand has depreciated by 7.2% against the US dollar, by 6.2% against the euro, and by 4.9% on a trade-weighted basis. At current levels, the SARB's model assesses the rand to be undervalued. It is likely that the local currency, along with other emerging market currencies, will remain volatile. The implied starting point for the rand is R13.40 against the US dollar compared with R12.37 at the time of the previous MPC meeting. A key external risk to the rand remains the possibility of tighter global financial conditions. However, the pace of monetary policy normalisation in the advanced economies continues to be gradual.
	Administered prices	Greater clarity with regard to electricity tariffs is expected in June when Nersa7 is scheduled to respond to Eskom's application for an increase in the order of 30%. The SARB's current assumptions are for an 8.0% increase from mid-2019 and a further similar increase in mid-2020. The possibility of an increase in excess of these assumptions poses an upside risk to our inflation forecast.	Electricity prices continue to pose a further upside risk. Higher international oil prices will contribute to petrol price inflation in 2018.
	Wage settlements	Nominal wage growth trends remain more or less unchanged, and upward pressure on inflation from this source is therefore expected to persist. Nominal average wage growth is expected to be sticky around the 7.0% level over the forecast period. Real wage increases are expected to remain positive and in excess of productivity growth. The outcome of the public-sector wage negotiations is still unclear	Average wage growth is expected to remain elevated at around 7% over the forecast period. This is particularly a concern if labour productivity growth continues to decline. Much of the upward pressure on wage inflation arises from the public sector wage settlement, which is at levels above headline inflation.

Source: SARB, Nedbank CIB

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