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NEDBANK CIB

Interest Rate Barometer

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Executive Summary

- The interest rate barometer ***considers the factors influencing the decision*** of the SARB's Monetary Policy Committee as stated in the statement accompanying the previous meeting's interest rate decision (19 May 2016) ***as well as developments since the previous meeting*** which could influence Thursday's MPC rate decision. The factors are rated on a stand-alone basis as a likely hike, hold or cut and are weighted into 3 broad categories: global economy (20%), domestic economy (40%) and major inflation drivers (40%) - as per Table 1.
- Of the 13 factors analysed, 2 support expectations for a hike (3 previous), 9 factors support an unchanged stance (8 previous) and 2 factors favour a cut (2 previous). On a weighted basis, this implies a 70% probability of a hold at this week's meeting. The shift indicates a short term reprieve but maintains a hawkish bias over the longer term.
- Based on our analysis, ***the Nedbank CIB view is for the repo rate to be left unchanged*** this week. We are expecting the SARB to revise their growth and CPI profiles lower. The SARB is likely to reiterate that this is a pause in a hiking cycle.
- The rand and the local socio-political risk premium remain key swing factors given their fluidity. Currently, global capital flows are proving supportive despite the bearish macro-fundamental backdrop.

Table 1

	Factors	SARB outlook at the May policy meeting	Recent developments	Rate impact
GLOBAL ECONOMY (20%)	**Growth**	"Global growth remains hesitant following a disappointing first quarter in the US and the UK in particular. The outlook for the UK is clouded by the possibility of an exit from the EU, while the prospects for the Japanese economy remain uncertain. By contrast, the growth outlook in the euro area is more promising, driven by improvements in Germany and France in particular, although there are concerns that the recent momentum may be fading. Divergent prospects are evident in the emerging markets. Russia and Brazil remain in recession, but there are signs of some stabilisation in China, as the economy appears to be responding to government policy initiatives. Of some concern is the persistent deterioration in growth forecasts for sub-Saharan Africa, which includes some of South Africa's important trading partners. The region is now expected to underperform the global economy in 2016, for the first time in 16 years, as the effects of lower commodity prices and drought take their toll."	The Q1 data globally has been soft. Q2 data looks to be reversing up for most regions, due to low base effects. Industrial activity in the US and Eurozone has improved, along with consumer spending. In the UK however, the Brexit vote has cast some uncertainty as to the trajectory of the economy. Although there has been a slew of growth forecast cuts by the IMF recently, the global growth forecast is unchanged at April's estimate of 3.2% for 2016. EMs' remain in a difficult space. Geopolitical tensions have risen, while commodity prices are expected to fall and flows remain volatile. These factors may hamper growth in coming months. The Chinese economy remains fragile. Q2 SA economic growth will likely rise off the low Q1 base.	**HOLD➔**
	Inflation and interest rates	"Global inflation pressures remain benign, with low energy prices still having an impact, although this effect is likely to dissipate with the recent upward trend in oil prices. As a result of these trends, asynchronous monetary policies persist. While policies are generally accommodative amid subdued growth, particularly in many advanced economies, a number of emerging markets have maintained a tightening bias in response to inflation pressures. The US Fed is expected to continue with its slow pace of policy rate normalisation but there is a high degree of uncertainty regarding the timing of the next increase."	Since the May meeting, global inflation has risen. The UK, US and Eurozone have seen slight upticks in prices. While there was some uptick from higher commodities and services prices, goods price inflation is still benign. Emerging market inflation metrics have stabilised following an improvement in currency and commodity metrics. The increase in uncertainty and market volatility has altered the outlook for interest rates this year. While the ECB and BOE seem to be firmly entrenched in the ultra-loose monetary policy camp, the Fed is still pondering a rate hike, although markets place a 44% probability of this materializing before the end of this year (up from 20% a week earlier).	**HOLD➔**

Table 1 ***(continued)***

	Factors	SARB outlook at the May policy meeting	Recent developments	Rate impact
GLOBAL ECONOMY (20%) (Contd)	**Oil price**	"The international oil price assumptions in the forecasting model have been increased, with the price of Brent crude oil remaining firmly above the US$40 per barrel level since the second week of April. Demand has surprised on the upside, and, despite an increase in supply from Iran, output has declined in a number of countries. This upward price trend may, however, be contained by high levels of inventories. Domestic petrol prices have increased by a cumulative R1,00 per litre since March, mainly due to higher international prices and an increase in the fuel levy. Should current exchange rate and international oil price trends persist, a further significant increase can be expected in June."	Oil prices have fallen by 2.3% since the last MPC meeting, and maintained a conservative trading range of between $46/bbl and $53/bbl. However, the supply glut remains entrenched despite an uptick in demand. Even though economic activity may improve in coming quarters, supplies remain ample, hence we are likely to see a range-bound trend, unless geopolitical tensions arise. Inventories are still high, but production losses and cuts have eased some overhang in the market. A sustained uplift in oil prices remains a key upside risk to our inflation views over the medium term despite our view that the near term rally is not sustainable.	**HOLD→**
DOMESTIC ECONOMY (40%)	**SARB's GDP forecast**	"The domestic economic growth outlook remains weak, with the Bank's GDP growth forecast for 2016 revised down from 0,8 per cent to 0,6 per cent. While a recovery is still expected in the next two years, the forecasts for both these years have been revised down by 0,1 percentage point to 1,3 per cent and 1,7 per cent. With the estimates of potential output unchanged, the output gap is expected to widen over the forecast period."	Given the contraction in GDP in the first quarter, strong and sustained growth in each of the next three quarters is required to produce even a marginally positive outcome for 2016 as a whole. Consequently, we now expect the economy to contract by 0.1% in 2016 (down from our previous forecast of 0.2% growth), before recovering at a slightly faster pace of 1% in 2017 (previously 0.9%).We expect the SARB to revise their GDP forecasts lower this week.	**CUT↓**
	Domestic supply	"…the favourable developments in the Barclays PMI which has recovered fairly strongly, to above the neutral 50-level for the past two months. However, while the recent modest recovery in commodity prices may impact positively on mining output, prices remain low and the sector remains beset by higher input costs and regulatory uncertainty. The continuing drought is also expected to put further strain on the agricultural sector."	SA Manufacturing production growth surprised to the upside in both April and May, off low bases in Q1. As a result, we may see a positive contribution towards Q2 GDP growth, however risk factors still remain in the form of wage negotiations, political event risk and the (now) stronger rand limiting export demand. SA mining production rebounded in April and May, but still remained in contraction on an annualised basis. Over the month however, positive growth rates were recorded. Low base effects may provide a positive contribution towards Q2 GDP growth, after the -18.1% contribution in Q1.	**HOLD→**
	Domestic demand	"Household consumption expenditure also remains subdued, with low growth in retail sales in the first quarter. New vehicle sales also continue to decline. The FNB/BER consumer confidence index recovered to some extent in the first quarter of the year, although it still remains at depressed levels, and indicates a low willingness to spend and utilise credit among consumers."	Naamsa Vehicle sales continued to decline, falling by 10.3% y/y and 10.6% y/y in May and June respectively. Quarterly vehicle sales is currently at the lowest level in 5 years, indicating consumer spending remains sluggish. Retail sales growth for March, April and May remained resilient, at 2.8%, 1.5%, and 4.5% y/y respectively. This is a concern because households may enter financial distress in coming months, which will likely bode negatively for economic activity.	**CUT↓**
	Monetary conditions	"The constrained outlook for household consumption expenditure is indicative of the absence of demand pressures in the economy. This is also confirmed in the weak wealth effects and the continued slow pace of credit extension to households. Growth in credit extension to corporates remains strong, but moderated in March."	Growth in private sector credit extension (PSCE) slowed to 6.6 % y/y against the consensus forecast of 7.0 % from 7.1 %, mainly pushed down by slower growth in credit to companies. Credit growth is expected to remain weak in the short term as both consumer and business confidence is unlikely to improve significantly on the back of a poor economic outlook. Credit growth will remain volatile in the months ahead, but the general trend is likely to be weak as interest rates are likely to still rise and economic activity will be subdued.	**HOLD→**
	Forecast of inflation	"Inflation is now expected to average 6,7 per cent in 2016 compared with 6,6 per cent previously. In 2017 and 2018 inflation is expected to average 6,2 per cent and 5,4 per cent, marginally down from the previous forecast. The expected peak, at 7,3 per cent in the fourth quarter of 2016, is unchanged. The downward revisions are due in part to the higher interest rate assumption, a slightly less depreciated exchange rate assumption, a wider output gap and a lower electricity price assumption."	Nedbank forecasts inflation to average 6.5% in 2016 before coming back to 6% in 2017 (revised lower), compared to the SARB's forecast of 6.7% and 6.2% respectively. Nedbank forecasts a peak of 6.8% in Q4, down from 7.5% previously, and below the SARB's forecast of 7.3%. CPI eased by 0.1% y/y in both April and May (currently at 6.1%). The next print us due later this week and consensus expects 6.3% y/y as a result of higher food and utilities inflation. We expect the SARB to revise their forecast of the CPI profile and peak marginally lower.	**HIKE↑**
	Market expectations	Forward rate agreements when compared to 3m JIBAR are currently pricing in a 44% probability of a 25bps rate hike at this meeting and a 104% chance of a 25bps rate hike in 3 months' time, softer than prior (greater than 100% implies larger or more frequent hikes).	Forward rate agreements are pricing in a 12% hike of 25 bps, at this week's meeting, a 36% probability of a 25 bp hike in 3 months' time, and a 68% probability of a hike in 5 months.	**HOLD→**
INFLATION DRIVERS (40%)	**Food prices**	"Food prices remain a significant risk to the inflation outlook in the face of persistent drought and exchange rate weakness. The recent increases have surprised on the upside, and more aggressive food price increases are now forecast for the near term. The Bank now expects food price inflation to peak at around 12 per cent in the final quarter of this year. Futures prices suggest that both maize and wheat prices are expected to remain elevated for the rest of the year, reinforced by a sizeable increase in the domestic wheat import tariff."	Only one-third of the CPI subcomponents is now above the 6% mark after peaking at 88% at the February print. Food inflation eased to 10.8% y/y, from 11.3% in April. Protein, vegetable, and grain price inflation remain in double-digits and are upside risk factors to our inflation outlook. The SA white maize price has declined by 11.6% since the last MPC meeting, however it is still 53% higher compared to a year ago and therefore will add upside pressures to headline CPI.	**HIKE↑**
	Rand exchange rate	"The rand exchange rate has remained volatile, and following a few weeks of relative strength, has resumed a weakening path and continues to pose an upside risk to the inflation outlook. Since the previous meeting of the MPC, the rand has traded in a range between R14,20 and R15,90 against the US dollar, and has depreciated by 1,5 per cent against the dollar, by 0,9 per cent against the euro, and by 1,2 per cent on a trade-weighted basis.	Despite the interim strength in the rand over the last 2 months, risks to the downside remain in the form of political risk as well as global risk from Brexit woes. Sharp foreign inflows may reverse should there be any negative developments in the local context, as well as within emerging markets as a whole.	**HOLD→**
	Administered prices	"Domestic petrol prices have increased by a cumulative R1,00 per litre since March, mainly due to higher international prices and an increase in the fuel levy. Should current exchange rate and international oil price trends persist, a further significant increase can be expected in June. Since the March policy meeting, the local petrol price rose by 31c/litre (+2.5%) despite a brief reprieve of 69c at the end of March which was quickly reversed given a rising oil price and an increase in the fuel levy of 30c/litre from April.The lower than expected increase granted to Eskom by NERSA (9.4% vs 16.6% requested) softens the inflation profile marginally. However, this remains above the inflation target band."	Since the March policy meeting, the local petrol price rose by 60c/litre (+4.7%) despite a brief reprieve of 69c at the end of March which was quickly reversed given a rising oil price and an increase in the fuel levy of 30c/litre from April. The lower than expected increase granted to Eskom by NERSA (9.4% vs 16.6% requested) softens the inflation profile marginally. However, this remains above the inflation target band.	**HOLD→**
	Wage settlements	"Wage growth appears to be moderating, with growth in nominal remuneration per worker in the formal non-agricultural sector declining to below 6 per cent in the fourth quarter of 2015, mainly due to lower private sector remuneration growth. Once adjusting for labour productivity, growth in unit labour costs remained unchanged at 5,0 per cent in that quarter."	An impending negotiation in the mining sector will be watched closely for any dislocations in the medium term. Positive rhetoric from trade unions recently regarding softened wage demands are an encouraging development	**HOLD→**

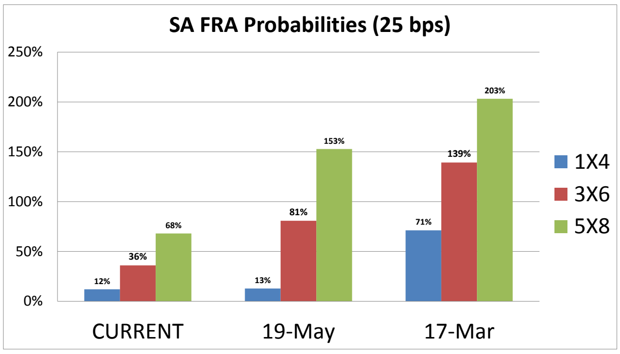
Source: SARB, Nedbank

Table 2: Probability of outcomes

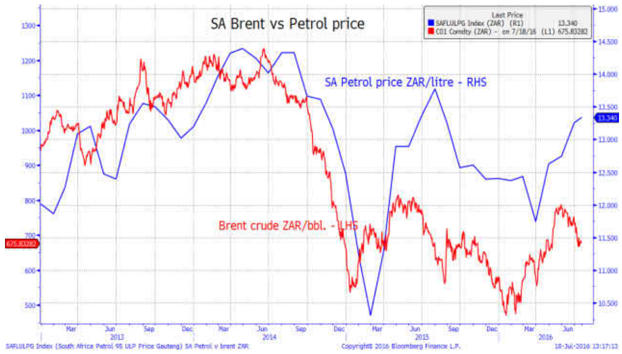
	Impact	Unweighted Probabilities	Weighted probabilities
Global economy (20%)	Cut	0%	0%
	Hold	100%	20%
	Hike	0%	0%
Domestic (40%)	Cut	33%	13%
	Hold	50%	20%
	Hike	17%	7%
Inflation drivers (40%)	Cut	0%	0%
	Hold	75%	30%
	Hike	25%	10%
Final Result	**Cut**	15%	13%
	Hold	69%	70%
	Hike	15%	17%

Source: Nedbank

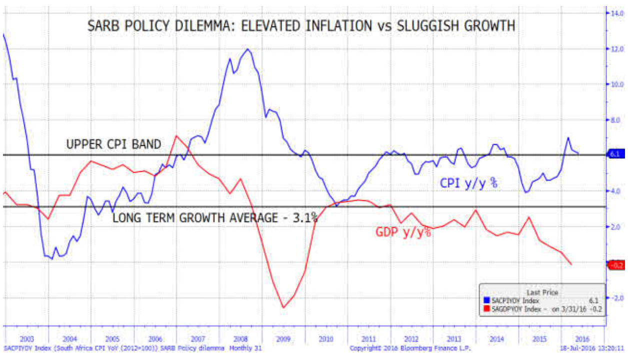
Market expectations remain soft



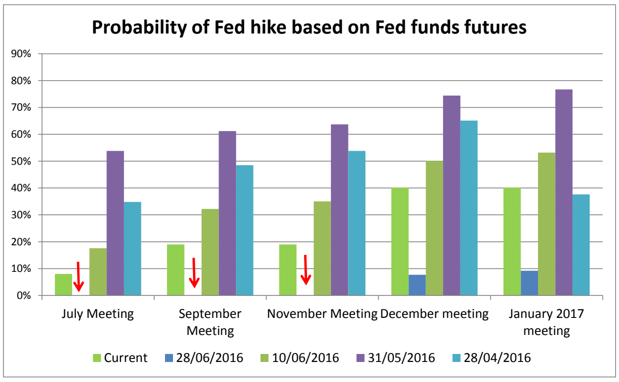
Petrol price likely to decline in the short term



Growth in the doldrums as stagflation remains

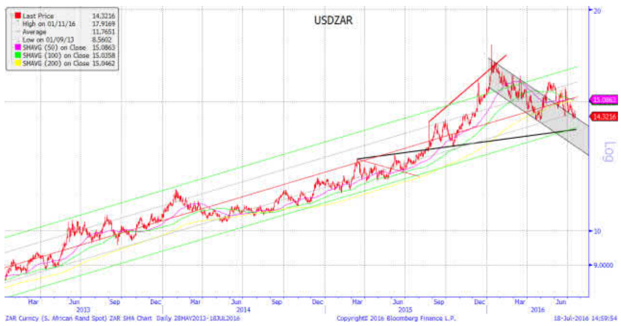


Probability of Fed hike rises after post-Brexit low (red arrows)



Global food price resumes uptick

Rand consolidation persists, impetus for lower CPI profile



Source: Bloomberg, Nedbank

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