GLOBAL MARKETS

Market Commentary | South Africa

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MAKE THINGS HAPPEN

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 (21 July 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, two support expectations for a hike, nine factors support an unchanged stance and two factors favour a cut. On a weighted basis, this implies a 70% probability of a hold at this week's meeting.
- 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 CPI profile lower, taking into account the recent rand strength. The SARB is likely to reiterate that this is a pause in a hiking cycle in our view.
- The rand and the local socio-political risk premium remain key swing factors given their fluidity. Key event-risk in the form of a possible credit rating downgrade in December, combined with a Fed rate hike possibility will also have a bearing on local monetary policy decisions. Currently, global capital flows are proving supportive despite the bearish macro-fundamental backdrop.

Table 1:

	Factors	SARB outlook at the July policy meeting	Recent developments	Rate impact
GLOBAL ECONOMY (20%)	**Growth**	"The global economic outlook has been influenced by the outcome of the UK referendum. Nevertheless the longer term real impacts are expected to be negative for global growth, particularly for the UK and Europe, as investment decisions are put on hold during the transition period. A high degree of uncertainty is expected to persist for some time as the magnitude of this slowdown is still unclear and dependent on the nature and speed of the UK disengagement. Since the referendum, global growth forecasts have generally been revised down. The outlook for emerging markets has remained relatively subdued, with further downside risks in Turkey following the recent coup attempt and terrorist attacks. Recent outcomes in China indicate some improvement in the growth prospects in response to government stimulus packages, and this has underpinned a stabilisation and moderate upward trend in commodity prices."	In Q2 and early into Q3, GDP growth was mixed - firmer in some developed countries, with US and UK GDP growth rate rising, while that of the Eurozone slowed marginally. Japanese and Chinese growth also disappointed. Emerging market growth remained depressed, including fragile confidence levels and falling exports. Downbeat global demand, heightened political risk, falling commodity prices and retail sales, and rising debt levels have all driven the outlook for economic growth lower in emerging markets. This is expected to persist over the medium term.	**HOLD➔**
	Inflation and interest rates	"Inflation in the advanced economies remains low and still generally below target. The Brexit vote has also modified expectations regarding monetary policy in these economies. Although the Bank of England kept policy rates on hold at its most recent meeting, expectations are for a reduction in the policy rate in the near future, with the prospect of a resumption of quantitative easing. Markets are now expecting the US policy rate to remain unchanged for some time. At the same time, the highly accommodative monetary policy stances of the ECB and Bank of Japan are expected to persist, with the possibility of additional stimulus. Global uncertainties appear to have delayed monetary policy tightening in advanced economies."	Since the July meeting, global inflation has risen. The UK, US and Eurozone have seen slight upticks in prices. While there was some uptick from higher services prices, goods price inflation is still benign and inflation in Asia has edged lower. 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 50% probability of this materializing before the end of this year.	**HOLD➔**

Table 1 *(continued)*

	Factors	SARB outlook at the July policy meeting	Recent developments	Rate impact
GLOBAL ECONOMY (20%) (Cont.)	**Oil price**	"Brent crude oil has mostly traded within a band of US$45 and US$50 since the previous meeting of the MPC. The Bank's model assumes a very moderate upward trend in oil prices over the forecast period, but there may be a degree of downside risk in the short term, with some upside risk in the outer period as global demand recovers. The domestic petrol price increased by a cumulative 60 cents per litre in the past two months, due to both the exchange rate and international prices. However, the recent appreciation of the rand coupled with a lower average oil price has resulted in a substantial over-recovery in the petrol price, and a sizeable reduction in retail prices is expected in August"	Oil prices have remained roughly unchanged since the last MPC meeting, and maintained a wide trading range of between $41/bbl. and $51/bbl. However, the supply glut remains entrenched. US inventories remain close to historical highs, Saudi Arabia is actively competing with Iran for market share, even as OPEC is set to convene talks around a possible production freeze. A sustained uplift in oil prices remains a key upside risk to our inflation views over the medium term. Our base range over the medium term is between $40-$50/bbl.	**HOLD →**
DOMESTIC ECONOMY (40%)	**SARB's GDP forecast**	"The Bank's latest forecast is for zero percent growth in 2016, compared with 0.6% previously. Growth rates of 1.1% and 1.5% are forecast for the next two years, down from 1.3% and 1.7% previously. The Bank's estimate of potential output has been revised down marginally to 1.4% in 2016, rising to 1.7% in 2018. This growth outlook is corroborated by the persistent negative trend in the Bank's leading indicator of economic activity."	The 3.3% q/q growth rate in GDP in Q2 is likely a normalisation from the very low base in Q1. The recent deterioration in mining and manufacturing data, along with retail spending may keep H2 growth subdued. As a result, Nedbanks full-year forecast stands at 0.2% for this year, rising to 0.9% next year. The growth outlook is impeded by subdued global and local demand, very low confidence levels, and on-going labour woes.	**HOLD →**
	Domestic supply	"Recent economic data suggest that positive growth was recorded in the second quarter, with the mining and manufacturing sectors expected to add positively to growth. The more positive trend in manufacturing is consistent with the Barclays PMI which has been above the neutral 50 level since March. The BER manufacturing confidence index also improved, but still remains at low levels. Underlying the negative performance of the economy during the first quarter was the sharp contraction in growth in gross fixed capital formation for the second consecutive quarter, by both the private sector and general government."	Mining production slumped by 5.4% y/y in July, from -3.0% in June, significantly worse than forecasts of -1.4%. SA manufacturing production growth fell sharply in July, to 0.4% y/y, from 4.7% growth in June, significantly worse than forecasts of 3.4%. The outlook for the sector remains dire. Even though exports have remained upbeat for most of this year, this is expected to change going forward, as demand dwindles. Local and global demand is downbeat, hence this is unlikely to boost mining or manufacturing production growth over the next few months.	**CUT ↓**
	Domestic demand	"Growth in consumption expenditure by households also contracted in the first quarter, with a sharp slowdown in expenditure on durable goods in particular. The FNB/BER consumer confidence index declined in the second quarter to low levels, following a moderate improvement in the previous quarter. The BER retail confidence index also declined sharply in the second quarter. While new vehicle sales remained weak, vehicle exports recorded strong growth in the second quarter. Despite the surprise increase in retail and wholesale trade sales in May, consumption expenditure by households is expected to remain subdued given the low consumer confidence, high debt levels, rising costs of debt servicing, and slow employment growth."	The annual rate of contraction in total vehicle sales moderated to 9.6% in August from 17.1% in July. In contrast, vehicle exports rebounded strongly, rising by 22.7% m/m and 26.7% y/y. The outlook for vehicle sales remains poor due to weak economic growth, low confidence, fragile household finances and higher borrowing costs. Annual growth in retail sales slowed to 0.8% in July, from 1.4% in June and lower than market expectations for a 1.9% increase. As we do not see the current situation reversing in the medium term, retail sales growth will continue to remain benign for the next few months.	**CUT ↓**
	Monetary conditions	"Consumption expenditure has been further constrained by the absence of significant wealth effects owing to the weak performance of asset markets, particularly the housing market. Credit extension to households also remains weak, with negative real rates of growth."	Growth in private sector credit extension (PSCE) accelerated to 7.3% y/y, beating the market's forecast of 7.0% from 6.6% in May, driven mainly by credit to companies. Credit growth is likely to remain subdued in the short term. In such a low growth environment, both corporates and consumers are likely to be cautious of borrowing.	**HOLD →**
	Forecast of inflation	"Inflation is still expected to accelerate further this year and is only expected to return to within the target range of 3-6% during the third quarter of 2017. Inflation is now expected to average 6.6% in 2016 and 6.0% in 2017, compared with 6.7% and 6.2% previously. In 2018 inflation is expected to average 5.5%, marginally up from the previous forecast. The expected peak, at 7.1% in the fourth quarter of 2016, is down from 7.3%."	Nedbank forecasts inflation to average 6.2% in 2016 before coming back to 5.7% in 2017 (both revised lower), compared to the SARB's forecast of 6.6% and 6.0% respectively. Nedbank forecasts a peak of 6.2% in Q4, down from 6.8% previously, and below the SARB's forecast of 7.1%. CPI eased by 0.3% y/y in July (currently at 6.0%). We expect the SARB to revise their forecast of the CPI profile and peak marginally lower on the back of the stronger rand recently.	**HIKE ↑**
	Market expectations	Forward rate agreements are pricing in a 12% hike of 25bps, 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.	Forward rate agreements are pricing in a 13% probability of a hike of 25bps, at this week's meeting, and a 33% probability of a 25bps hike in three months' time. The risk of a hike this year will rise should the rand weaken and credit ratings agencies threaten with a downgrade.	**HOLD →**
INFLATION DRIVERS (40%)	**Food prices**	"There are as yet no clear signs of a recovery in the agricultural sector, and food price inflation is expected to remain elevated for some time. The Bank expects food price inflation to peak at 12.6% during the final quarter of this year. There are some encouraging signs of moderation in some food categories at both the producer and consumer price levels, and futures prices of grains have declined markedly. Food prices remain an upside risk in the near term. There could however be a sharp decline in agricultural prices next year should favourable weather patterns transpire as forecast. "	Only one-third of the CPI subcomponents are now above the 6% mark, after peaking at 88% at the February print. Food inflation remained elevated, at 11.3% y/y in July. 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 12.1% since the last MPC meeting, however it is still 25% higher compared to a year ago and therefore will add upside pressures to headline CPI.	**HIKE ↑**
	Rand exchange rate	"The impact of the more appreciated rand exchange rate on the inflation outlook will depend to a large extent on whether the exchange rate is sustained at these stronger levels. Current exchange rate levels are stronger than those implicit in the forecast, providing some buffer to the projections. The rand remains sensitive to both domestic and external developments, and the recent trends can be quickly reversed."	Since the last MPC meeting, the rand strengthened by 1.95% against the dollar, maintaining a wide range between R13.28-R14.72/$. The outlook for the rand remains highly uncertain. Given the strong probability of further political turmoil and persistent worries about further possible downgrades to South Africa's sovereign risk rating, we expect a weaker trend later in the year.	**HOLD →**
	Administered prices	"The downward revisions (to inflation) are due in part to lower administered price inflation (mainly petrol), despite a small upward adjustment in the international oil price assumption. The domestic petrol price increased by a cumulative 60 cents per litre in the past two months, due to both the exchange rate and international prices. A combination of a stronger exchange rate and subdued international oil prices would have a favourable impact on domestic petrol prices in the coming months. 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. There are as yet no clear signs of a recovery in the agricultural sector, and food price inflation is expected to remain elevated for some time."	Since the July policy meeting, the local petrol price fell by R1.17/litre (-8.73%) despite the four consecutive months of increases since March, which was quickly reversed given a falling oil price and a stronger rand exchange rate. 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	"Average wage growth has remained relatively stable, but there are risks of increases in excess of inflation and productivity gains."	Recently, Numsa announced a breakdown in wage talks between employers and workers in the tyre manufacturing industry. Strikes may arise as a result. Any work stoppages will impact the vehicle manufacturing and export sectors.	**HOLD →**

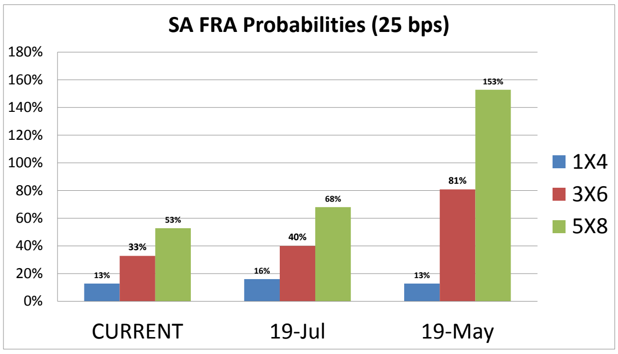
Source: SARB, Nedbank

Table 2: Probability of outcomes

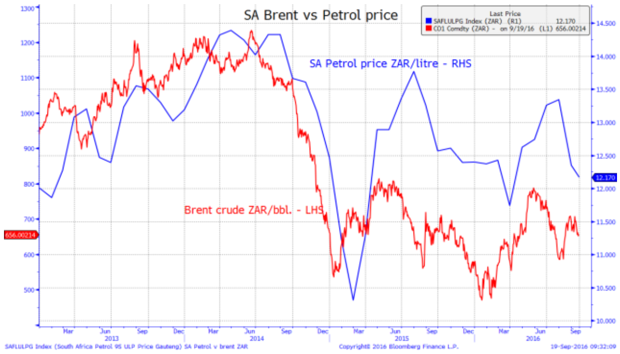
	Impact	Unweighted Probabilities	Weighted probabilities
Global economy (20%)	Cut	0%	0%
	Hold	100%	20%
	Hike	0%	0%
Domestic (40%)	Cut	33%	13%
	Hold	50%	20%
	Hike	17%	7%
Inflation drivers (40%)	Cut	0%	0%
	Hold	75%	30%
	Hike	25%	10%
Final Result	**Cut** ↓	15%	13%
	Hold →	69%	70%
	Hike ↑	15%	17%

Source: Nedbank

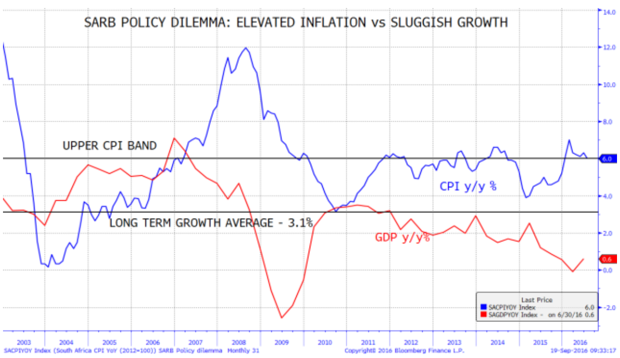
Market expectations remain soft



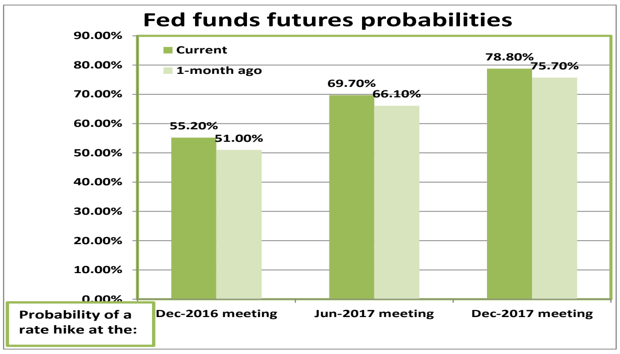
Recent petrol price decline may ease inflation



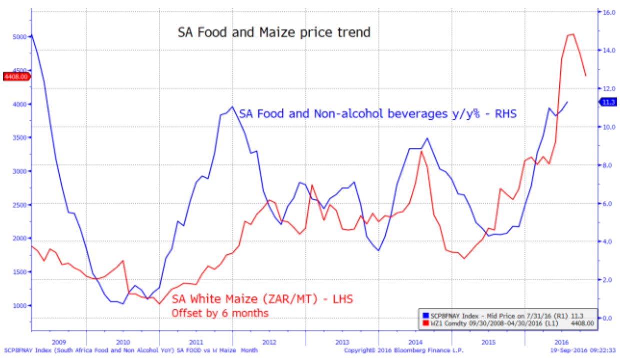
Growth in the doldrums as stagflation remains



Probability of Fed hike rises on the back of hawkish Fed



Local food inflation follows maize price with a 6 month lag



Trade-weighted rand holds below L/T depreciating trend line

Source: Bloomberg, Nedbank

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