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 (22 September 2016) ***as well as developments since the previous meeting,*** which, in our view, 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 three 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 67% 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 possibly lower food inflation and a stronger rand next year. The SARB is likely to reiterate that we are close to the peak of the current hiking cycle, in our view.

- We believe that the rand and the local socio-political risk premium remain key swing factors given their fluidity. Key event-risk in the form of credit rating reviews in the next few weeks, combined with a possible Fed rate hike will also have a bearing on local monetary policy decisions, in our opinion.

Table 1:

	Factors	SARB outlook at the September policy meeting	Recent developments	Rate impact
GLOBAL ECONOMY (20%)	**Growth**	"The global growth outlook remains subdued, amid slowing growth in the advanced economies and a general downward revision to forecasts. Although prospects for the US economy remain relatively favourable, outcomes have not been consistently positive. Although the short term impacts of Brexit on the UK economy have not been as negative as initially feared, growth forecasts have been revised down as concerns remain regarding the longer term investment outlook. The euro area recovery remains steady but subdued. The Japanese economy remains caught in a deflation and low growth bind, following a weak second quarter. Indications are that the negative growth cycles in both Russia and Brazil have turned, and both countries are expected to record positive, but weak rates of growth in the near term. The Chinese economy appears to have stabilised following concerns about a slowdown earlier in the year, but concerns regarding the financial sector persist."	Over 3Q, preliminary GDP data shows a modest expansion in developed market growth, with the US leading the gains at a 2.9% annualised growth rate, while Japan and the UK posted marginal increases in 3Q growth, while that of the Eurozone remained unchanged. 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. The recent rise in global geopolitical risks are clouding the near term outlook for global growth.	**HOLD**➔
	Inflation and interest rates	"Given the broadly benign global inflation environment, apart from in some emerging markets, monetary policies have generally remained accommodative, with further loosening or a loosening bias in a number of the advanced economies. A notable exception is the United States where the bias remains for a resumption of interest rate normalisation, but the timing remains uncertain. The US policy rate trajectory is still expected to be moderate."	Most major economies experienced higher inflation since the last MPC meeting, due to higher services inflation and higher energy costs. Chinese, US and UK inflation surged closer toward the set targets, due to higher commodity and energy prices. In contrast, Japan remained firmly in deflation, while Eurozone inflation remains well below the 2% target. We believe that the increase in uncertainty and market volatility has altered the outlook for interest rates this year. While the ECB and BoJ seem to be firmly entrenched in the ultra-loose monetary policy camp, the Fed will likely hike rates next month, while the BoE rhetoric has changed completely – the BoE now expects higher interest rates due to the higher CPI forecast, compared to cuts previously expected. The probability of a December 2016 Fed rate hike rose from 50% in September, to almost 100% currently. The SARB is unlikely to pre-empt a Fed rate hike and will likely assess the impact of a Fed hike before adjusting their policy stance.	**HOLD**➔

Table 1 ***(continued)***

	Factors	SARB outlook at the September policy meeting	Recent developments	Rate impact
GLOBAL ECONOMY (20%) (Cont.)	**Oil price**	"International oil prices have fluctuated between US$40-US$50 per barrel for the past six months, amid uncertainty relating to a possible supply freeze by OPEC. The assumption for Brent crude oil in the Bank's forecasting model is unchanged, and assumes a moderate increase over the forecast period. After two consecutive months of price declines totalling R1,17 per litre, the domestic petrol price is expected to increase in October, due to adverse movements in the both the exchange rate and international product prices."	Oil prices have remained roughly unchanged since the last MPC meeting, and maintained a wide trading range of between $44/bbl. and $53/bbl. However, the supply glut remains entrenched. US inventories remain close to historical highs, Saudi Arabia and some other OPEC heavyweights are rumoured to opt not to support the production cut, details of which are set to be announced next week. A sustained uplift in oil prices remains a key upside risk to our inflation views over the medium-term. Our base range over the near term is between $40-$50/bbl.	**HOLD**→
DOMESTIC ECONOMY (40%)	**SARB's GDP forecast**	"Bank's forecast for economic growth for 2016 has been revised upward from zero per cent to 0,4 per cent. The forecasts for the next two years have been increased marginally by 0,1 percentage points, to 1,2 per cent and 1,6 per cent respectively. Estimates of potential output growth are unchanged, implying a persistence of below-potential growth. The trend in the Bank's composite leading indicator of economic activity remains indicative of subdued growth."	The 3.3% q/q growth rate in GDP in 2Q is likely a normalisation from the very low base in 1Q. Mining and manufacturing production have contracted on a net basis in 3Q, and may keep 2H16 growth subdued. As a result, Nedbank's full-year forecast stands at 0.3% for this year, rising to 1.0% 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	"Both the mining and manufacturing sectors recorded negative month-to-month growth rates in July, and the Barclays PMI declined sharply in August following five consecutive months above the neutral 50-point mark. Stresses are also evident in the construction sector with a further sharp decline in building plans passed during July."	SA mining production growth rose to 3.4% y/y in September, from 0.1% growth in August, well ahead of forecasts of 1%. SA manufacturing production growth fell to 0% y/y in September, from 2.2% previously, worse than forecasts of 0.5%. Between mining and manufacturing production in the third quarter, the cumulative contribution to 3Q GDP will likely be negative due to the larger weighting of the manufacturing sector on GDP. Both the mining and manufacturing sectors will probably continue to face subdued local and international demand in the near term, but over the medium and longer term, should fiscal stimulus from the US materialise, this may be supportive of commodity prices, and may be a possible upside tail-risk to the local mining and manufacturing sector growth.	**CUT**↓
	Domestic demand	"Consumption expenditure by households remains weak, despite a return to positive growth following the first quarter contraction. The annualised growth of 1,0 per cent suggests that consumers remain under pressure. In July, retail trade sales declined further, in contrast to positive wholesale trade sales. Domestic new vehicle sales continued their negative trend in July and August, while exports of motor vehicles have remained robust. The outlook for consumption expenditure growth is expected to remain constrained, given the unfavourable employment outlook, the absence of significant positive wealth effects, and the slow pace of growth of real disposable income of households."	Total vehicle sales dropped by another 10.1% y/y in October. The outlook for vehicle sales remains poor due to weak economic growth, low confidence, fragile household finances and higher borrowing costs, in our view. SA retail sales growth surged to 1.4% y/y in September, from no growth in August, better than expectations of 0.9%. Retail sales growth remains well below the long-term average of 5% y/y, and will likely remain depressed as consumer demand is very weak and consumer headwinds in the form of high prices, rising debt-service costs, elevated joblessness and debt levels and depressed consumer confidence continue to persist.	**CUT**↓
	Monetary conditions	"Credit extension to households continues to contract in real terms, likely driven by both the supply and demand side considerations. However, there has been a moderate increase in mortgage credit extension. As before, growth in credit extension to the corporate sector has been more resilient, but below its recent peaks."	Private sector credit extension (PSCE) growth accelerated to 7.2% y/y, beating the consensus forecast of 6.0% from 6.2% in August, pushed up mainly by the volatile investments and bills category, which rose by 4.7% over the month. Credit growth to companies remained firm while that to households was weak. Credit growth is likely to remain weak in the short-term given slow economic activity and the poor outlook.	**HOLD**→
	Forecast of inflation	"Inflation is expected to peak at 6,7 per cent in the fourth quarter of this year, compared with 7,1 per cent previously, with an earlier sustained return to within the target range now forecast to occur during the second quarter of 2017. Inflation is expected to average 6,4 per cent in 2016 and 5,8 per cent in 2017, compared with 6,6 per cent and 6,0 per cent previously. The forecast for 2018 is unchanged at an average of 5,5 per cent. The downward revisions are due in part to a lower starting point, lower administered price inflation assumptions (including petrol, electricity and rates and taxes inflation), as well as a less depreciated exchange rate assumption."	Nedbank forecasts inflation to average 6.3% in 2016 before coming back to 5.7% in 2017 (both revised lower), compared to the SARB's forecast of 6.4% and 5.8% respectively. Nedbank forecasts a peak of 6.4% in 4Q, down from 6.8% forecast earlier in the year and below the SARB's forecast of 6.7%. We expect the SARB to revise their forecast of the CPI profile and peak marginally lower due to expectations of lower agricultural prices next year. Despite the near-term outlook of inflation remaining close to 6%, monetary policy is forward looking six to nine months out, hence a possible pause by the SARB this week.	**HOLD**→
	Market expectations	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.	Forward rate agreements are pricing in a 13% probability of a hike of 25bps, at this week's meeting, and a 45% probability of a 25bps hike in three months' time. The risk of one more rate hike in the current cycle will rise should the rand weaken and credit ratings agencies downgrade our sovereign credit rating. The short-term volatility in the FRA's have been mainly as a result of a recent risk in global geopolitical risks.	**HOLD**→
INFLATION DRIVERS (40%)	**Food prices**	"Food prices remain a significant driver of inflation given the persistent drought, although long-range weather forecasts suggest improved rainfall prospects in the coming months. Food price inflation is still expected to reach a peak in the fourth quarter of this year, at around 12,3 per cent, slightly lower than in the previous forecast. Spot and futures prices of wheat and maize have declined in recent weeks, but meat prices are expected to rise further as farmers restock their herds. Global food price inflation has increased, mainly due to an acceleration in the price of sugar."	Only about 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 September. 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 risen by 1.7% since the last MPC meeting and is still 20% higher compared to a year ago and, therefore, we believe it should add upside pressures to headline CPI.	**HIKE**↑
	Rand exchange rate	"Since the previous meeting of the MPC, the rand traded in a range of R14,73 and R13,28 against the US dollar and has appreciated by 6,3 per cent against the US dollar, by 4,3 per cent against the euro, and by 5,2 per cent on a trade-weighted basis. The marked appreciation of the rand during the past few days appears to be driven by expectations of unchanged US monetary policy, as well as to speculation regarding possible purchases of rand related to a major M&A transaction. The rand, however, remains vulnerable to future changes in the US monetary policy stance, domestic political developments as well as to a risk of a possible ratings downgrade later in the year. Nevertheless, the upside risk to inflation from the exchange rate appears to have moderated somewhat."	Since the last MPC meeting, the rand weakened by 5.8% against the dollar, maintaining a wide range between R13.28-14.42/$. The USDZAR is 1.2% weaker on an annualised basis, while the trade-weighted rand is 0.28% stronger on a year-on-year basis. The outlook for the rand remains highly uncertain, in our view. Given the strong probability of further political turmoil and persistent worries around SA's sovereign credit rating, the rand may remain volatile. Should these risks not materialise, this may keep the rand along the current strengthening (consolidation) trend over the medium term. However, this is highly dependent on a volatile dollar and foreign investor flows into our local market.	**HOLD**→
	Administered prices	"The downward revisions (to inflation) are due in part to a lower starting point, lower administered price inflation assumptions (including petrol, electricity and rates and taxes inflation), as well as a less depreciated exchange rate assumption."	Since the September policy meeting, the local petrol price rose by 88-cents/litre (7.2%) after two consecutive monthly declines. Transport inflation is a key upside risk to our CPI forecast over the medium-term. However, the current over recovery in the petrol price stands at 45 cents, indicating a price cut next week. The lower than expected increase granted to Eskom by NERSA earlier in the year (9.4% vs 16.6% requested) softens the inflation profile marginally, but remains above the inflation target band.	**HIKE**↑
	Wage settlements	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.	A new national minimum wage of R3,500 p/m was proposed, after discussions between COSATU and the government. This is below the R4,500 p/m rate requested by the union and may result in further negotiations. If the new minimum wage is adopted, this may result in some demand-pull inflation, as the lowest income groups have the highest propensities to spend. The Andrew Levy wage settlement rate was 7.7% in 1H16.	**HOLD**→

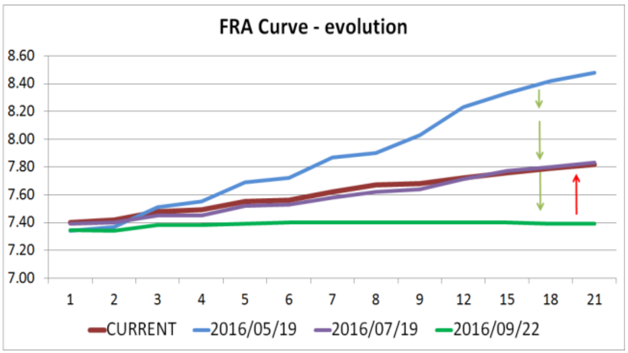
Source: SARB, Nedbank

Table 2: Probability of outcomes

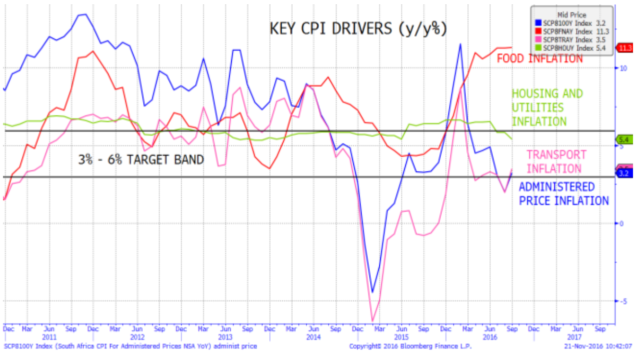
	Impact	Unweighted Probabilities	Weighted probabilities
Global economy (20%)	Cut	0%	0%
	Hold	100%	20%
	Hike	0%	0%
Domestic (40%)	Cut	33%	13%
	Hold	67%	27%
	Hike	0%	0%
Inflation drivers (40%)	Cut	0%	0%
	Hold	50%	20%
	Hike	50%	20%
Final Result	**Cut** ↓	15%	13%
	Hold →	69%	67%
	Hike ↑	15%	20%

Source: Nedbank

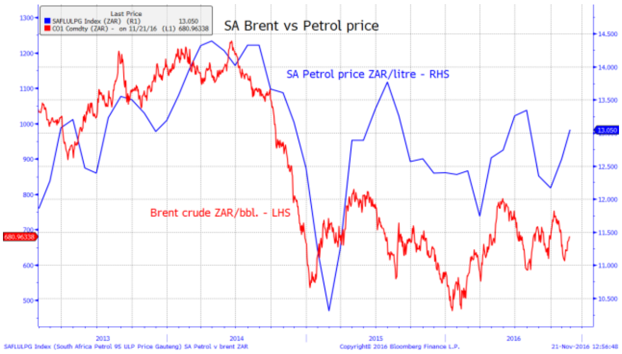
Market expectations of a rate hike rises recently



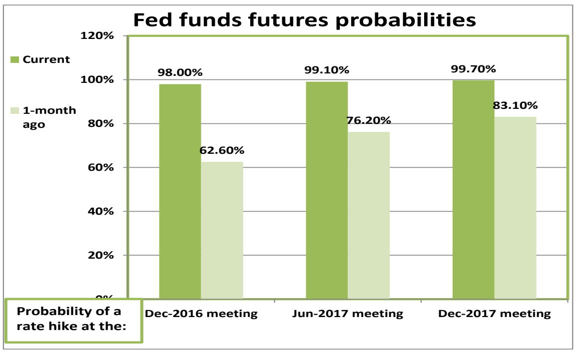
Administered prices represents key upside risk to CPI



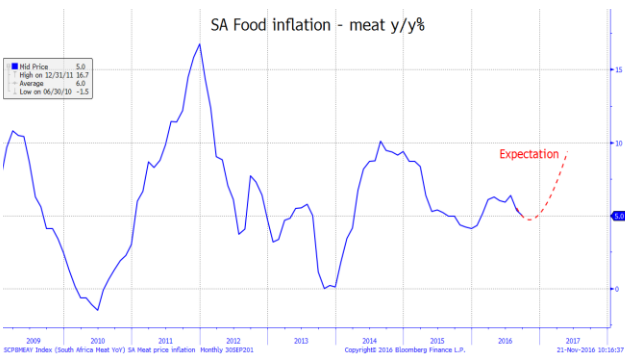
Higher transport inflation expected due to low base effect



Probability of Fed hike rises due to upbeat economic data



Local meat inflation may rise next year



Trade-weighted rand maintains stronger trend for the YTD

Source: Bloomberg, Nedbank

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