GLOBAL MARKETS

Strategic Research | South Africa

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NEDBANK CIB

Interest Rate Barometer

Nedbank CIB Strategic Research

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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 (24 November 2016) ***as well as developments since the previous meeting,*** which, in our view, could influence the MPC rate decision on 24 January 2017. 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, seven factors support an unchanged stance and four factors favour a cut. On a weighted basis, this implies a 54% probability of a hold at next week's MPC meeting.
- Based on our analysis, ***the Nedbank CIB view is for the repo rate to be left unchanged*** next week. We are expecting the SARB to revise their CPI profile lower, taking into account possibly lower food inflation and a stronger rand this year. The SARB is likely to reiterate that we are at 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-risks in the form of geopolitical tensions, combined with a Fed rate hike profile will also have a bearing on local monetary policy decisions, in our opinion.

Table 1:

	Factors	SARB outlook at the November policy meeting	Recent developments	Rate impact
GLOBAL ECONOMY (20%)	Growth	"The global outlook has become increasingly uncertain during the year following the UK decision to leave the European Union, and the outcome of the US presidential election. While the new policy direction in the US is still unclear, the markets have interpreted the outcome as being positive for US growth in the short run A further concern for emerging markets is the potential change of trade policies that may impact on existing trade treaties, as well as unilateral increases in tariff protection in the US. The outlook for emerging markets has therefore become more uncertain. The lingering concerns about the sustainability of the recovery in the Chinese economy have been revived by the possibility of tariff increases on Chinese exports."	The IMF updated its World Economic Outlook report, in which the global growth forecast was left unchanged at 3.4% and 3.6% over the next two years, from 3.1% expected in 2016. Both emerging and developed market economic activity is expected to rise this year (from 2016), but policy uncertainty in the US remains a key risk in our view. The outlook for developed markets has improved on the back of possible fiscal stimulus from the US, while growth prospects for EMs have deteriorated marginally due to tighter financial conditions. Due to expectations for fiscal stimulus from the Trump administration, US GDP growth forecast was raised by a cumulative 50bps over the next two years. The IMF has stressed the uncertain nature of this forecast given policy uncertainty. While the risk to the outlook is to the downside, near-term policy uncertainty means that if global activity rises due to greater fiscal spending from the US and if Chinese stimulus rises, growth risks may be tilted to the upside in the near term.	HOLD→
	Inflation and interest rates	"Global inflation remains generally benign and since the previous meeting of the MPC a number of countries have loosened monetary policy. Expansionary policies are expected to persist in the Eurozone, Japan and the UK, despite emerging inflation pressures in the latter. By contrast, a persistence of significant outflows from emerging markets in response to the possibility of a tighter US monetary policy stance could pose challenges for monetary policies in a number of these economies."	Developed market inflation rates have risen close to central bank targets, this as energy prices have risen sharply recently. The PCE in the US is at 1.4%, the UK inflation rate is 1.6%, while Eurozone CPI is 1.1%. Upside inflationary pressures are still evident. CPI within EMs is more nuanced, with easing pressures in some, offset by rising pressures in others. Monetary policy is still divergent, with rising rates in the US and easy monetary policy in Europe and most of Asia. Again, in EMs, monetary policy remains mixed with a bias for easing. Fed rate hike path represents a potential upside risk.	HOLD→

Table 1 *(continued)*

	Factors	SARB outlook at the November policy meeting	Recent developments	Rate impact
GLOBAL ECONOMY (20%) (Cont.)	**Oil price**	"Brent crude oil prices reached a year high of US$52 per barrel in early October following the OPEC agreement to curtail production. Since then, prices have declined following doubts about the prospects for an agreement on the distribution of production cuts across the cartel. Some price volatility is expected in the short run as negotiations on production cuts continue. The Bank's forecast maintains the assumption of a moderate upward trajectory of international oil prices over the forecast period."	The oil price has risen since the last MPC meeting, and trended within a wide $46 - 57/bbl. trading range. OPEC members managed to gain support from some non-OPEC oil producers to put a deal together for a 1.6mbpd production cut. As a result, the oil price accelerated towards the abovementioned high and remains elevated currently. Brent is expected to remain between $50-- $60/bbl. over the medium term until US shale oil production comes on-stream later this year, posing some downside risk in the latter part of 2017.	**HIKE**↑
DOMESTIC ECONOMY (40%)	**SARB's GDP forecast**	"The domestic economic growth outlook remains subdued, although the low point of the cycle appears to be behind us. The Bank's forecast remains unchanged at 0,4% for 2016, and 1,2% and 1,6% for the next two years. While the estimate for potential GDP growth was revised down marginally to 1,3%, and rising to 1,5% by 2018, the output gap is expected to remain negative over the forecast period."	SA GDP eased sharply in 3Q16, off a high base in 2Q16, due to weakness in agriculture, manufacturing, utilities and trade. 4Q16 may see a similar subdued pace of growth, emanating from weak mining, manufacturing, agriculture, and utilities growth. While 2017 growth will likely improve off a low base, it is still expected to remain below potential, with a negative output gap.	**CUT**↓
	Domestic supply	"The mining sector contributed positively to GDP growth in the quarter. The physical volume of manufacturing output declined, despite a positive month-to-month outcome in September. The Barclays Purchasing Managers' Index (PMI), which declined further in October, has remained below the neutral 50 index point level for three consecutive months. The weak trends in manufacturing are consistent with the continued low levels of business confidence, despite a moderate improvement in the third quarter."	SA mining production contracted by 4.2% yoy in November, from -2.6% previously, worse than expectations of -0.9%. The sharply lower production levels were led by deep contractions in gold, iron ore, PGM, nickel and coal production. Manufacturing production growth surprised sharply to the upside, at 1.9% yoy in November, from -2.7% in October, better than expectations of 0.3%. The uptick in November may be reflective of seasonal demand trends and new export orders	**CUT**↓
	Domestic demand	"Consumption expenditure by households remains subdued, with declining retail trade sales, and static wholesale trade sales in the third quarter of this year. Although new motor vehicle sales increased sharply on a month-to-month basis in October, a sizeable proportion of this is attributed to car rental companies, and challenging conditions in the new vehicle sector persist."	New vehicle sales contracted by 15.3% yoy in December, from -9.6% in November, worse than the -8.8% expected. Both passenger and commercial vehicle sales contracted sharply. Only local sales of busses increased sharply. Despite December being a seasonally better period for vehicles sales, vehicle sales continues to decline, and is reflective of a benign consumer sector, with consumers unwilling and unable to buy a new vehicle. SA retail sales data surprised sharply to the upside in November, due to seasonal influences. Retail sales growth was +3.8% yoy in November, from -0.2% previously, better than expectations of -0.4%. The trend is still subdued, reflective of weak demand and low household savings rates. The long term average sales growth is close to 5%, so even November's print, despite surprising to the upside, remains below trend.	**CUT**↓
	Monetary conditions	"Consumers continue to face a number of constraints. Employment growth is particularly weak; household debt levels, while moderating, are still elevated; and wealth effects are muted amid stagnant equity and residential property markets. Furthermore, growth in credit extension to households remains subdued."	Private sector credit extension (PSCE) growth moderated to 6.3% yoy, lower than the market's forecast of 6.9% from 7.2% yoy in September, with most of the major categories recording slower annual growth. Annual credit growth to both companies and households decelerated in October. Credit growth is likely to remain weak in the short-term given slow economic activity and the poor outlook.	**CUT**↓
	Forecast of inflation	"The latest inflation forecast of the Bank is broadly unchanged over the forecast period, despite a moderate upward adjustment to the food price forecast in the later quarters. The annual averages are unchanged at 6,4% for 2016, and 5,8% and 5,5% in the coming two years. Inflation is expected to peak at 6,6% in the fourth quarter of this year, marginally lower than in the previous forecast, with a sustained return to within the target range still expected to occur during the second quarter of 2017. The higher food price assumption is offset by a slightly more appreciated exchange rate assumption"	Nedbank forecasts inflation to average 5.4% in 2017, compared to the SARB's forecast of 5.8%. Nedbank forecasts inflation to fall below 6% sometime in 1Q17. A low of 5.4% is expected in the middle of the year, and remaining range-bound into year-end. Despite the near-term outlook of inflation remaining close to 6%, monetary policy is forward looking six to nine months out, with inflation expected to moderate.	**HOLD**→
	Market expectations	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.	Forward rate agreements are pricing in a 5% probability of a hike of 25bps, at this week's meeting, and a 13% 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 the Fed hike aggressively. The FRA curve remains flat, therefore market expectations are benign.	**HOLD**→
INFLATION DRIVERS (40%)	**Food prices**	"Food price inflation remains a significant driver of inflation, and is sensitive to the continuing drought. While food price inflation is still expected to moderate from early 2017, the pace of decline is expected to be slower than previously forecast. This has led to an upward revision to the food price assumption in the forecast during the outer quarters in particular. The change is mainly due to the delayed impact of meat prices which are now expected to peak only in early 2018, as farmers rebuild their herds during 2017."	Only about 38% of the CPI subcomponents are now above the 6% mark, while about two-thirds are within the target band. Food inflation remained elevated, at 11.7% yoy in December, against our expectation of some deceleration. Protein, vegetable and grain price inflation remain in double-digits. However, the SA white maize price has declined by 18% since the last MPC meeting and is now 34% lower on an annualised basis. Hence this may ease food inflation in coming months.	**HIKE**↑
	Rand exchange rate	"The rand appreciated steadily from the middle of October in response to some positive domestic developments, as well as inflows from a large M&A transaction. The currency was trading at around R13,20 against the US dollar just before the elections. It then reached its weakest point of R14,60 against the US dollar in the wake of the surprise outcome, before recovering somewhat. Domestic long bond yields (R186) initially spiked by about 60 basis points, but the increase has since moderated to about 25 basis points. Since the previous meeting of the MPC, the rand has depreciated by about 5,7% against the US dollar, and by about 1,1% on a trade-weighted basis.	Since the last MPC meeting, the rand strengthened by 4.3% against the dollar, maintaining a range of between R13.44-14.15/$. The USDZAR is 19% stronger on an annualised basis, while the trade-weighted rand is 25% stronger, albeit off a very weak base. The outlook for the rand remains highly uncertain, in our view. Given the strong probability of local and geopolitical risks, 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.	**HOLD**→
	Administered prices	"The domestic price of 93 octane petrol increased by a cumulative 88 cents per litre in October and November, with almost all of the increase due to higher international product prices. The current over-recovery indicates that should current trends persist, about half of that increase could be reversed in December.	Since the November 2016 policy meeting, the local petrol price rose by 28-cents/litre (2.2%). Transport inflation is a key upside risk to our CPI forecast over the medium-term. The current under-recovery in the petrol price stands at 35cents, indicating a petrol price hike next month. The lower than expected increase granted to Eskom by NERSA last year (9.4% vs 16.6% requested) softens the inflation profile marginally, but remains above the inflation target band. An Eskom tariff hike this year and a possible fuel levy hike pose upside threats to administered price inflation.	**HOLD**→
	Wage settlements	"Slow growth in household disposable incomes is also reflected in a gradual decline in wage growth, with growth in nominal remuneration per worker declining to 5,8% in the second quarter. When an adjustment is made for the increase in labour productivity, growth over four quarters in nominal unit labour costs measured 5,1% in the second quarter. The Andrew Levy Employment Publications Survey reports an average wage settlement rate in collective bargaining agreements of 7,5% in the first three quarters of the year, and 7,1% in the third quarter. This may be indicative of wage settlements becoming more sensitive to the persistently high unemployment rates.	While inflation expectations have been declining, it currently remains anchored at 6%. Wage growth has declined recently and this may be reflective of expectations for inflation to ease in 2017. The implementation of the National Minimum wage should pose some upside pressure on wage settlements when it does materialise.	**HOLD**→

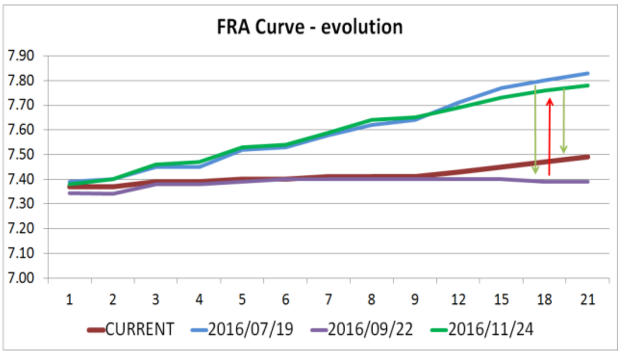
Source: SARB, Nedbank

Table 2: Probability of outcomes

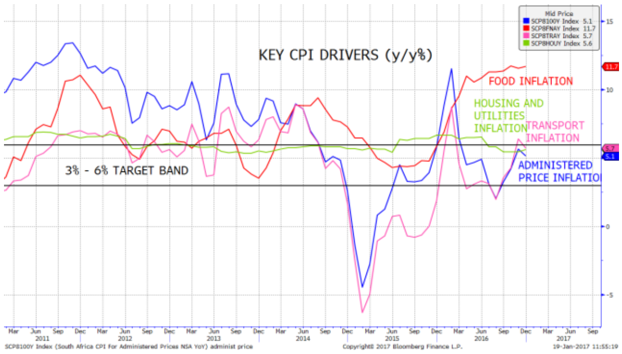
	Impact	Unweighted Probabilities	Weighted probabilities
Global economy (20%)	Cut	0%	0%
	Hold	67%	13%
	Hike	33%	7%
Domestic (40%)	Cut	67%	27%
	Hold	33%	13%
	Hike	0%	0%
Inflation drivers (40%)	Cut	0%	0%
	Hold	75%	30%
	Hike	25%	10%
Final Result	**Cut** ↓	31%	27%
	Hold →	54%	57%
	Hike ↑	15%	17%

Source: Nedbank

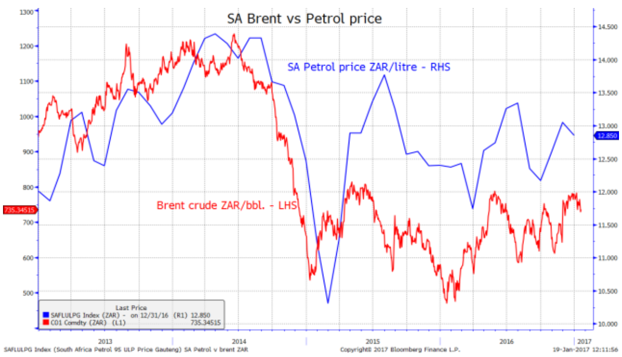
FRA Market expectations are exceptionally flat



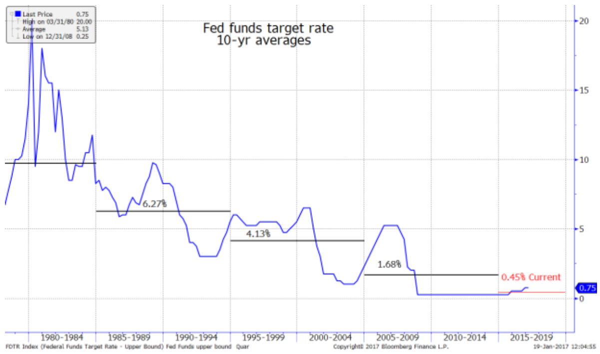
Administered prices represents key upside risk to CPI



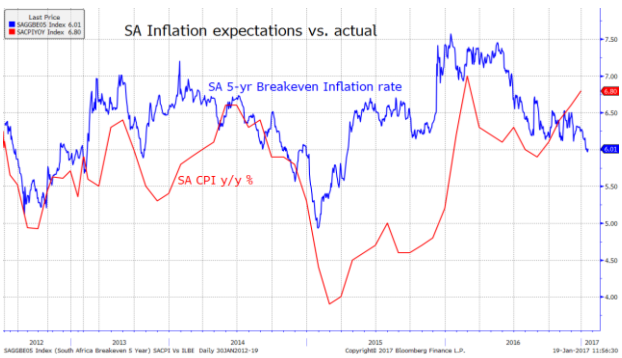
Higher transport inflation expected due to low base effect



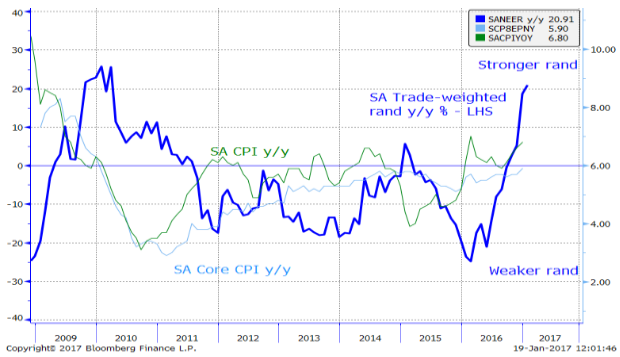
Upside risk for rates if Fed hikes aggressively



Inflation expectations declined consistently in H2/16



Trade-weighted rand maintains stronger trend



Source: Bloomberg, Nedbank

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