GLOBAL MARKETS

Strategic Research | South Africa

20 November 2017

NEDBANK CIB

Interest Rate Barometer

Nedbank CIB Research

Reezwana Sumad
+27 11 294 1753
ReezwanaS@Nedbank.co.za

www.nedbank.co.za/researchportal

Executive Summary

- The interest rate barometer ***considers the factors influencing the decision*** of the SARB's Monetary Policy Committee's last meeting on 22 September 2017 ***as well as developments since the last meeting*** (which, in our view, could influence the MPC rate decision on 23 November 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%) (see Table 1).
- Of the 13 factors analysed, eight support an unchanged stance, two factors favour hikes, while three factors support a cut. On a weighted basis, this implies a 63% probability of a hold at this week's MPC meeting.
- Based on our analysis, ***we are of the opinion that the repo rate will be left unchanged at 6.75%*** this week. We are expecting the SARB to revise its inflation profile slightly higher for 2018, while its growth forecasts are expected to remain unchanged. We believe that the SARB is likely to reiterate the vulnerability of the rand exchange rate due to event risks on the horizon. Therefore, the tone this week may be relatively hawkish. Furthermore, possible upside risks from petrol costs, electricity tariffs and public sector wage negotiations may be highlighted.
- 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, possible credit rating downgrades and local political headlines, 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 September policy meeting	Recent developments	Rate impact
GLOBAL ECONOMY (20%)	Growth	Global conditions remain generally favourable despite some geopolitical risks. The upswing appears to be synchronised, with increased world trade volumes. Growth in the US is forecast to remain above potential in the short to medium term, with the devastation caused by the recent hurricanes expected to have only a limited and shortlived impact on growth. The improved growth performance in the euro area also appears to be sustained and region-wide, while the Japanese economy has MPC Statement September 21 st, 2017 Page 4 experienced moderate growth in the past few quarters. By contrast, growth in the UK has slowed, following weak investment in the face of the Brexit headwinds. The outlook for emerging markets is also relatively positive amid generally improving fundamentals.	The IMF recently raised its global growth forecast to 3.6% for 2017 and 3.7% for 2018, both raised by 10bps. The upbeat outlook is being led by a turnaround in the Eurozone economy, so much so that the IMF refers to the region as the 'engine of global trade'. Factors supporting the recovery in growth are investment, trade and industrial production, as well as upbeat business and consumer confidence. Most Emerging Market countries held up well in 3Q17. However, concerns over a long-term slowdown in Chinese growth have emerged after the conclusion of the recent policy conference.	HOLD→
	Inflation and interest rates	Despite the improved growth outlook, global inflation pressures remain benign, particularly in the advanced economies. These trends are likely to contribute to the persistence of accommodative monetary policy stances in Japan and the euro area, where the recent appreciation of the euro is likely to dampen inflation pressures further. As expected, the US Fed yesterday announced a gradual reduction of its balance sheet. The process had been communicated previously and was largely priced in by the financial markets. The pace of policy rate normalisation is also expected to remain measured, as inflation continues to surprise on the downside, despite tightening labour market conditions.	Inflation in Developed Markets has eased recently, with the UK, US and Eurozone headline rates falling, but core inflation showing some upside. In the US, the Fed's core PCE measure rose marginally, but remains below 2% since 2012. The UK headline inflation rate remains well above the BoE target of 2%, which prompted the BoE to raise interest rates in October 2017. The Fed maintained gradual monetary policy tightening, by reducing the size of its balance sheet and maintaining a slightly hawkish tone despite low inflation. The ECB announced the tapering of its asset purchase programme to begin in January 2018.	HOLD→
	Oil price	International oil prices have increased by about US$5 per barrel since the previous meeting, with Brent crude oil currently trading at around US$55 per barrel. Nevertheless, the MPC does not expect a further sustained acceleration in prices as the flexibility of US shale oil production is expected to provide a ceiling to prices.	The oil price trended higher since the last MPC meeting with Brent trading between a $55.6/bbl. and $64/bbl. Political instability in Saudi Arabia and reports of a 96% compliance rate achieved by OPEC in the recent cuts were some of the reasons for the higher oil price, along with a decline in output from Iraq, Algeria and Nigeria. Brent crude prices are 28% higher on an annualised basis and hence places some upside pressure on local fuel costs.	HIKE↑

Table 1 ***(continued)***

	Factors	SARB outlook at the September policy meeting	Recent developments	Rate impact
DOMESTIC ECONOMY (40%)	**SARB's GDP forecast**	The domestic economic growth outlook remains constrained despite the higher-than expected growth outcome of 2.5% in the second quarter of this year. This broad-based improvement, while welcome, is not expected to have a significant impact on the annual growth outcome. The Bank's forecast for GDP growth for 2017 has been revised up marginally from 0.5% to 0.6%, while the forecasts for 2018 and 2019 have remained unchanged at 1.2% and 1.5%	SA GDP growth indicators reflect a cyclical recovery that is likely to persist into 4Q17. Due to a strong 2Q17 performance, Nedbank's GDP growth forecast was raised to 0.8% from 0.7% previously. However, this is well below potential growth of 1.5% and reflects a subdued recovery in 2018. The IMF, World Bank, SARB and Bloomberg consensus revised the 2017 full-year growth forecast to between 0.5% and 0.8%. Even 2018 growth will likely remain below potential.	**CUT**↓
	Domestic supply	All the major sectors, apart from construction, recorded positive growth in the second quarter, with a particularly strong performance in the agricultural sector. The recovery in the manufacturing sector followed three successive quarterly contractions, while the tertiary sector reversed its one quarter contraction. The limited monthly data for the third quarter present a mixed picture at this stage. Mining sector output contracted in July while manufacturing recorded positive growth. However, the Absa PMI has averaged 43.5 index points in the first two months of the quarter, suggesting continued headwinds for the sector	SA's mining production surprised sharply to the downside in September, contracting by 0.9% yoy, from 7.9% growth in August, worse than consensus of 6.7%. This is the biggest contraction since December 2016. Key drivers of the decline were PGMs, iron ore, and coal. SA's manufacturing sector also disappointed in our view, with the main contributors towards the decline being wood and paper production, petroleum and chemical production, and motor vehicles and parts.	**CUT**↓
	Domestic demand	Consumption expenditure by households rebounded strongly in the second quarter following the sizeable contraction in the previous quarter. Spending on all three major goods components recovered, but expenditure on services contracted. Despite the improved outcome, the outlook for consumption expenditure growth remains subdued, although positive, amid very low levels of consumer confidence.	New vehicle sales growth was positive for the fifth consecutive month in October 2017, with growth of 4.6% yoy recorded. Given better credit extension to households and lower inflation and interest rates, we may see this persist off a low base over the medium-term. Similarly, retail sales growth rose above its long-term average in August and September and indications are that this may persist over the next few months.	**HOLD**→
	Monetary conditions	Growth in credit extension to the private sector has declined steadily over the past few months, as corporate demand for mortgage finance and general loans in particular moderated. Growth in credit extension to households remains weak and negative in real terms. These trends are also reflected in continued household deleveraging, with household debt to disposable income declining further to 72.6% in the second quarter, its lowest level since the beginning of 2006.	Private sector credit extension (PSCE) growth moderated to 5.6% yoy in September 2017 and this was mainly buoyed by credit to corporates. Growth in credit to households also remains positive, with unsecured lending to both households and corporates rising sharply in September. However, credit conditions may tighten if confidence levels continue to deteriorate.	**HOLD**→
	Forecast of inflation	The Bank's forecast for headline CPI inflation is unchanged at an annual average of 5.3% in 2017, and revised up by 0.1 percentage point to 5.0% and 5.3% in 2018 and 2019. A lower turning point of 4.6% is still expected in the first quarter of 2018. The same pattern is observed in the forecast for core inflation which is unchanged at 4.8% for 2017, but adjusted up to 4.9% and 5.0% for the next two years.	SA CPI has surprised to the downside in seven out of the last nine prints. However in the last print, CPI surprised to the upside at 5.1% yoy, from 4.8% previously and 5% expected. CPI has fallen below the SARB's forecast in the first two quarters and is expected to fall below the SARB's forecast in the last quarter of the year. Nedbank currently forecasts an average CPI rate of 5.2% in 2017 and 4.8% in 2018, with upside risks in 2018. Currently, 81% of the CPI basket subcomponents fall below the 6% target.	**CUT**↓
	Market expectations	The FRA market has been driven by investor complacency in recent months. The FRAs have capitulated to price in interest rate cuts since March 2017. The FRA market is currently pricing in an 81% probability of a rate cut at the SARB's meeting next week and a 133% probability of a cut by November 2017.	The FRA market has capitulated given the recent hawkishness by SARB MPC members – the FRAs are currently showing a 66% probability of a 25bps hike in three months' time, with a cumulative 75bps priced in within the next two years.	**HOLD**→
INFLATION DRIVERS (40%)	**Food prices**	Food and non-alcoholic beverage inflation surprised on the downside, moderating from 6.8% to 5.7%. Meat prices continued to accelerate in August, having measured 15.0%, but the lower cereal prices contributed to the slowing momentum. Year-on-year producer price inflation for final manufactured goods declined from 4.0% in June to 3.6% in July.	Food inflation eased to 5.5% yoy in September 2017, due to lower maize and grain prices. Meat inflation will likely remain elevated through 2017 as farmers have started restocking their herds. However, this is expected to be more than offset by lower grain prices. The SA white maize price has, however, risen by 9.4% since the last MPC meeting, but is still 52% lower on an annualised basis. Hence this may ease food inflation further in coming months. Fruit, veg, bread, cereals and oil prices are currently in deflation due to the better harvests and weather conditions.	**HOLD**→
	Rand exchange rate	The rand remains a key upside risk to the inflation outlook. Furthermore, some of the event risks, particularly those of a political nature, are now more imminent but with no greater degree of clarity regarding the outcome. The prospect of a further ratings downgrade persists, particularly given the increased fiscal challenges and political uncertainty. The narrower current account deficit and the global environment remain supportive of the rand.	Since the last MPC meeting, the rand weakened by almost 6% against the dollar, maintaining a range of between R13.25-14.50/$. The USDZAR is 1.5% stronger on an annualised basis, while the trade-weighted rand is 4.3% weaker. Given the strong probability of further credit rating downgrades and heightened political risks, the rand may remain volatile and possibly poised for further weakness.	**HIKE**↑
	Administered prices	A further upside risk relates to the possibility of a large electricity tariff increase than is currently assumed in our forecast from July next year. A tariff increase of 20% could raise the headline inflation forecast by between 0.2 and 0.3 percentage points, and the MPC will continue to assess the possible second round effects of these increases.	Since the September 2017 policy meeting, the local petrol price rose by 33c/litre (2.4%). The current under recovery in the petrol price stands at a staggering 73c/litre, implying a further petrol price hike in the coming month in our view. Transport inflation has risen from the low of 1% recorded in July 2017, to the current 5.6% yoy (September 2017). This has been the main reason for administered price inflation rising above 6% in September 2017 in our view. We believe this may rise further, given impending petrol price hikes. We believe that another key upside risk to administered prices over the next 18 months comes from utilities costs as Eskom applied to NERSA for a 19.9% tariff hike for 2018.	**HOLD**→
	Wage settlements	The MPC remains concerned that inflation expectations of business people and trade unions remains above or close to 6% for the next two years even though our own forecast and those of most analysts expect inflation to be much closer to 5%. Lower inflation expectations among key price setters are an important element in reducing inflation in the future, thus enabling lower nominal interest rates.	The BER's average five-year inflation expectation fell to 5.6% in 3Q17, from 5.9% previously – this is the lowest since the survey began. According to the latest Quarterly Bulletin, real wage growth per worker accelerated from -0.5% in the fourth quarter of 2016, to 1.0% in the first quarter of 2017, as nominal wage growth accelerated while consumer price inflation slowed somewhat. Public sector remuneration growth per worker accelerated from 8.5% in the fourth quarter of 2016 to 10.7% in the first quarter of 2017. Remuneration growth per worker in the private sector accelerated somewhat from 4.4% in the fourth quarter of 2016 to 5.2% in the first quarter of 2017. Real wage growth is expected to average around 1.4% over the medium-term, with downside risks. The implementation of the National Minimum Wage should pose some upside pressure on wage settlements when it is implemented. Upcoming public sector wage negotiations in 1Q18 could also pose as an upside risk to wage inflation and to headline CPI over the next three years.	**HOLD**→

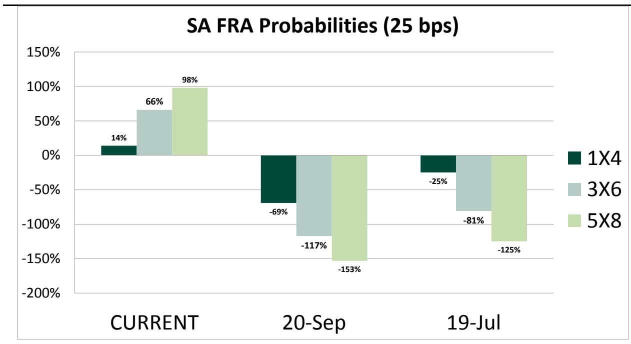
Source: SARB, Nedbank

Table 2: Probability of outcomes

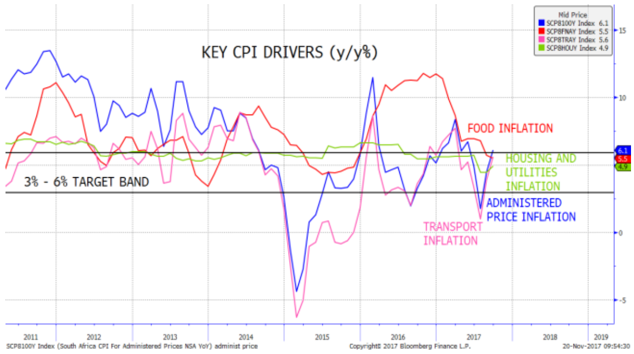
	Impact	Unweighted Probabilities	Weighted probabilities
Global economy (20%)	Cut	0%	0%
	Hold	67%	13%
	Hike	33%	7%
Domestic (40%)	Cut	50%	20%
	Hold	50%	20%
	Hike	0%	0%
Inflation drivers (40%)	Cut	0%	0%
	Hold	75%	30%
	Hike	25%	10%
Final Result	**Cut** ↓	23%	20%
	Hold →	62%	63%
	Hike ↑	15%	17%

Source: Nedbank

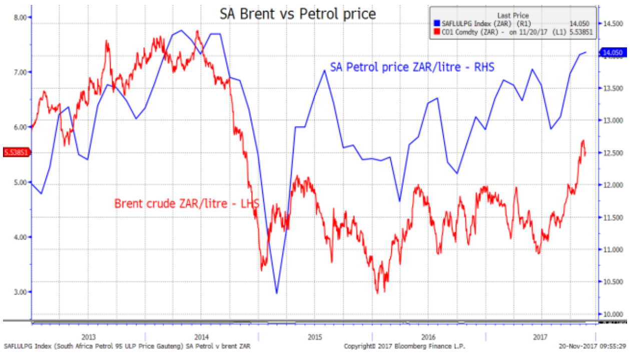
FRA Market now certain of a rate hike by June 2018



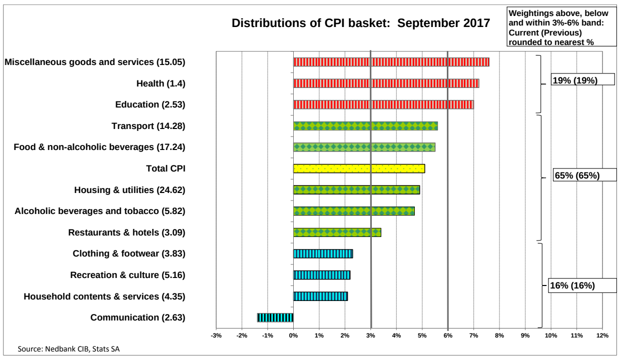
Administered price inflation now above 6%



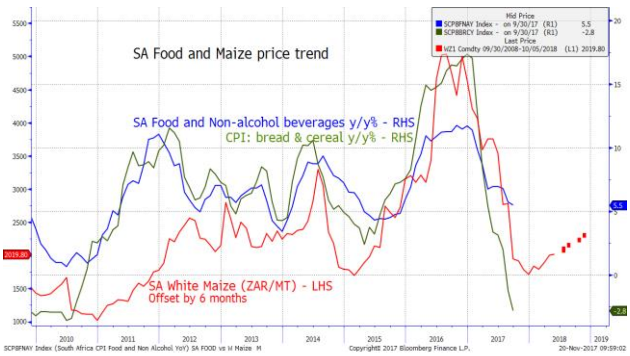
Higher international oil price pushes up local petrol price



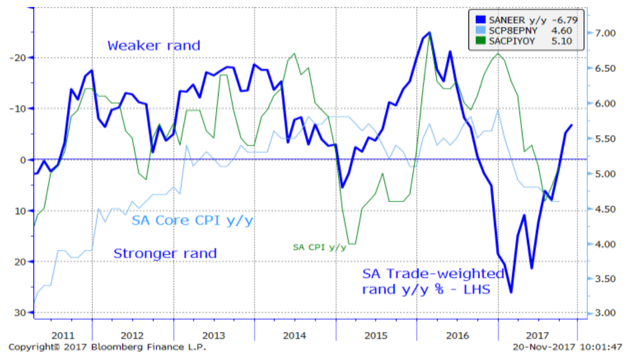
81% of the CPI subcomponents lie below 6% upper band



Lower food inflation expected to ease headline CPI



Trade-weighted rand loses ground since March 2017



Source: Bloomberg, Stats SA, Nedbank

Disclaimer

The information furnished in this report, brochure, document, material, or communication ("the Commentary"), has been prepared by Nedbank Limited (acting through its Nedbank Corporate and Investment Banking division), a registered bank in the Republic of South Africa, with registration number: 1951/000009/06 and having its registered office at 135 Rivonia Road, Sandton, Johannesburg ("Nedbank"). The information contained herein may include facts relating to current events or prevailing market conditions as at the date of this Commentary, which conditions may change and Nedbank shall be under no obligation to notify the recipient thereof or modify or amend this Commentary. The information included herein has been obtained from various sources believed by Nedbank to be reliable and expressed in good faith, however, Nedbank does not guarantee the accuracy and/or completeness thereof and accepts no liability in relation thereto.

Nedbank does not expressly, or by implication represent, recommend or propose that any securities and/or financial or investment products or services referred to in this Commentary are appropriate and or/or suitable for the recipient's particular investment objectives or financial situation. This Commentary should not be construed as "advice" as contemplated in the Financial Advisory and Intermediary Services Act, 37 of 2002 in relation to the specified products. The recipient must obtain its own advice prior to making any decision or taking any action whatsoever.

This Commentary is neither an offer to sell nor a solicitation of an offer to buy any of the products mentioned herein. Any offer to purchase or sell would be subject to Nedbank's internal approvals and agreement between the recipient and Nedbank. Any prices or levels contained herein are preliminary and indicative only and do not represent bids or offers and may not be considered to be binding on Nedbank. All risks associated with any products mentioned herein may not be disclosed to any third party and the recipient is obliged to ascertain all such risks prior to investing or transacting in the product or services. Products may involve a high degree of risk including but not limited to a low or no investment return, capital loss, counterparty risk, or issuer default, adverse or unanticipated financial markets fluctuations, inflation and currency exchange. As a result of these risks, the value of the product may fluctuate. Nedbank cannot predict actual results, performance or actual returns and no guarantee, assurance or warranties are given in this regard. Any information relating to past financial performance is not an indication of future performance.

Nedbank does not warrant or guarantee merchantability, non-infringement or third party rights or fitness for a particular purpose. Nedbank, its affiliates and individuals associated with them may have positions or may deal in securities or financial products or investments identical or similar to the products.

This Commentary is available to persons in the Republic of South Africa, financial services providers as defined in the FAIS Act, as well as to other investment and financial professionals who have experience in financial and investment matters.

Nedbank Limited is a licensed Financial Services Provider and a Registered Credit Provider (FSP License Number 9363 and National Credit Provider License Number NCRCP 16).