INTEREST RATE BAROMETER

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EXECUTIVE SUMMARY

- Our Interest Rate Barometer considers the factors influencing the decision of the SARB Monetary Policy Committee's last meeting on 18 January 2018, as well as developments since the last meeting (which, in our view, could influence the MPC rate decision on 28 March 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, six support an unchanged stance, one factor favours a hike, while six factors support a cut. On a weighted basis, this implies a split probability of a 47% chance of a hold and a 47% chance of a cut at this week's MPC meeting; we believe that it will be a very close call between these two options.
- Based on our analysis, we are of the opinion that the repo rate will be reduced by 25bps this week. However, before Friday's rating action we thought a cut was more likely in May rather than at this week's MPC meeting. The "Stable" outlook assigned to South Africa's rating by Moody's now favours a first rate cut this week in our opinion. We maintain our base case (unchanged since the start of the year) that two cuts of 25 bps each are likely to materialise this year*. The SARB has maintained an inflation profile above consensus and we could now see marginal downward revisions to the SARB's inflation forecasts, while we expect its growth forecasts to be revised higher.
- Given the elimination of credit rating downgrade risks, the threat of imminent WGBI-related outflows has diminished in our opinion. As a result, the SARB could credibly adjust the Quarterly Projection Model (QPM) to reflect a flat interest rate path, as opposed to the hikes that were projected in January 2018. Given the elimination of significant upside risks that the SARB had previously been concerned about (particularly the rand), we see the risks to the inflation outlook as balanced over the medium-term.

Table 1:

	Factors	SARB outlook at the January 2018 policy meeting	Recent developments	Rate impact
GLOBAL ECONOMY (20%)	**Growth**	The global growth outlook remains positive and relatively synchronised, although uneven across regions. However, some moderation in growth is generally expected in 2019. Growth in the United States (US) is expected to be given a boost by the proposed tax reforms, but the extent of this is still unclear. The euro area recovery also appears to be sustained, with a persistent decline in the unemployment rate amid a broad-based firming of fixed capital formation. The recent positive momentum in Japanese growth is also expected to continue. These favourable conditions are expected to have a positive spill over effect on emerging markets in general, with upward growth revisions in most regions, although less so for Latin America and Africa.	Global growth is still expected to be 3.9% for 2018 and 2019 according to the IMF, and although the risks to the outlook are broadly balanced, there are some glaring risks which could derail the current recovery path: Any upset in the Chinese economic rebalancing process could subtract from private demand, the current boost from the US tax reforms are likely to wane by the end of 2019 implying global growth is likely to slow by then, and most recently the increase to the trade tariffs announced by the White House may pose a threat to global trade activity (which has remained the key underpin to global growth over the last two years).	HOLD→
	Inflation and interest rates	Global inflation trends, by contrast, remain subdued, although there are indications of emerging upside pressures, driven in part by higher energy prices. Core inflation pressures are also becoming evident in the US in particular, and are expected to intensify gradually should strong growth and labour market tightness persist. Monetary policies in the advanced economies, particularly in the US and the United Kingdom (UK), are expected to maintain a moderate tightening bias, while the pace of withdrawal of monetary accommodation in the euro area and Japan is expected to be slow. These trends should help sustain capital flows to emerging markets.	Developed market inflation trends have been mixed recently – while US headline inflation has surprised to the upside, the targeted core PCE measure remains below target levels. However the Fed remains steadfast in its monetary policy normalisation path for 2018, with two more rate hikes likely this year. In the UK, inflation has only recently moderated below 3%, but the BOE remains hawkish because CPI is unlikely to fall below the 2% target. In the Eurozone, inflationary pressures remain muted, despite better economic activity and a reduction of QE. The ECB has recently turned more constructive.	HOLD→
	Oil price	International oil prices have continued their upward trend to current levels of around US$70 per barrel for Brent crude oil. These increases are due to supply restrictions by some producers, as well as increased global demand. At this stage, it is unclear if these prices will settle at these elevated levels or if the trend will be reversed by increased US shale output in response to higher prices. The oil price assumptions in the QPM have been adjusted upwards to average US$62 per barrel in 2018 and 2019.	While the oil price has remained roughly unchanged since the last MPC meeting, it has trended within a wide trading range of between $62.5 and $70.5/bbl. The higher oil price is mainly due to sentiment around OPEC production cuts; the market seems highly confident that a high compliance rate will be achieved in 2018. The Brent crude price is 36% higher on an annualised basis and hence places some upside pressure on local fuel costs. However this needs to be evaluated in conjunction with the rand exchange rate.	HIKE↑

**This represents the Nedbank CIB Markets Research view and may differ from the Nedbank Group House view*

Table 1 *(continued)*

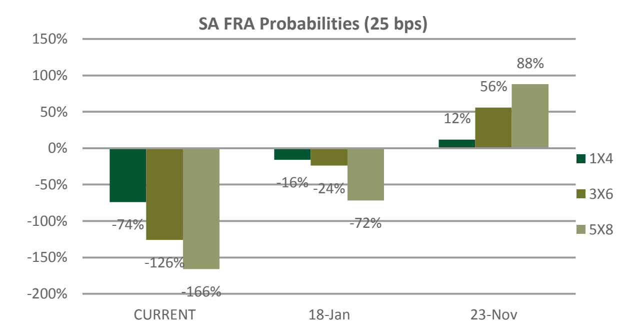
	Factors	SARB outlook at the January 2018 policy meeting	Recent developments	Rate impact
DOMESTIC ECONOMY (40%)	**SARB's GDP forecast**	The SARB has revised its forecast for gross domestic product (GDP) growth up from 0.7% to 0.9% for 2017, while forecasts for 2018 and 2019 have been adjusted to 1.4% and 1.6% respectively, up from 1.2% and 1.5% previously. This more favourable outlook is consistent with the further increase in the SARB's composite leading business cycle indicator of economic activity in October. The outlook is also likely to be impacted positively should the recent political developments lead to a sustained boost in business and consumer confidence.	SA GDP growth surprised sharply to the upside in 4Q17, at 3.1% qoq (SAAR) from 2.4% in the previous quarter, while the GDP profile was revised for all prior years going back to 2013. Unsurprisingly the agricultural sector was the key driver of growth in 4Q17. Due to the sharp positive surprise, Nedbank has revised its forecasted growth to 1.8% in 2018. This compares favourably to the SARB's forecast of 1.4%, which we believe could be adjusted higher. Potential growth may be revised higher, while the output gap may narrow.	**HOLD➔**
	Domestic supply	High-frequency data suggest that fourth-quarter growth is likely to be slower than in the previous quarter, but still positive. On a month-to-month basis, mining output increased in October but declined in November, while manufacturing output increased in both these months. However, the decline in the Absa Purchasing Managers' Index (PMI) to 44.9 index points in December is indicative of the continued challenges faced by the sector. More positively, the sub-index measuring expected business conditions in six months' time improved markedly.	Growth in mining production quickened to 2,4% yoy in January, from a 0,5% decline in December. Growth was bolstered by growth in iron ore production. Manufacturing production matched market expectations in January, contracting by a seasonally adjusted 1,6% mom but growing by 2,5% yoy, up from the 1,8% yoy increase recorded in December last year. The annual increase was mainly the result of the higher production of food and beverages, metals and machinery, as well as motor vehicles and other transport equipment.	**CUT↓**
	Domestic demand	Despite being relatively constrained, the outlook for household consumption expenditure has improved, with annual average real growth rates of around 1.3% expected over the forecast period. This category is expected to be the main driver of GDP growth in the short to medium term. Although consumers are likely to be adversely affected by possible further tax increases, expenditure is expected to be underpinned by lower inflation and positive real wage increases.	New vehicle sales rose by 1% mom, driven by sales of commercial vehicles, as consumer and business sentiment remains upbeat. Household credit impulse, by contrast, remains upbeat. It was prompted by higher disposable incomes, lower debt to disposable income, and lower debt servicing costs. Retail sales growth remains healthy, boosted by the abovementioned factors. Fiscal policy was tightened recently and this does pose a risk of derailing the progress made in domestic demand.	**CUT↓**
	Monetary conditions	Growth in bank credit extension to households remains weak but has trended slightly higher in recent months. Much of this increase reflects growth in instalment sale financing, consistent with improved motor vehicle sales. Growth in credit extension to the corporate sector, while more robust, has been on a downward trend for some time.	Private sector credit extension growth eased to 5.5% yoy and declined by 0.4% mom in January, mainly led by a slowdown in corporate credit growth. Credit growth is expected to improve gradually in 2018, on the back of better confidence levels.	**HOLD➔**
	Forecast of inflation	The inflation forecast generated by the SARB's Quarterly Projection Model (QPM) shows some improvement since November. The average forecast for 2017 is unchanged at 5.3% but has been revised downwards for 2018 and 2019 to 4.9% and 5.4% respectively from 5.2% and 5.5% previously. Inflation is expected to average 5.5% in the final quarter of 2019. The lower turning point of the forecast is still expected in the first quarter of 2018 but has been revised down from 4.7% to 4.4%. The main drivers of the more favourable forecast were the stronger exchange rate and lower electricity price assumption, following the 5.23% electricity tariff increase granted to Eskom by the National Energy Regulator of South Africa (Nersa).	SA CPI slowed to 4% yoy in February, from 4.4% previously, better than consensus of 4.2%. Core inflation remained unchanged at 4.1% yoy. Goods inflation eased to 3.2% yoy (previously 3.7%), while services inflation fell to 4.9% yoy. The increase in the VAT rate, to 15%, from April 2018 will likely add between 30bps to 40bps to our average annual inflation estimate. However we still see inflation remaining below or close to 5% over the medium-term. Nedbank CIB forecasts the average inflation rate at 4.7% in 2018 and 4.9% in 2019 (inclusive of the impact of a VAT hike). We still believe the risks to the outlook are to the downside.	**CUT↓**
	Market expectations	The FRA market has capitulated yet again, given the stronger rand and perceived downside risks to inflation – the FRAs are currently showing an 86% probability of a 25bps cut in three months' time, with a cumulative 50bps priced in within the next year.	The FRA market is currently pricing in a 74% probability of a 25bps cut this week, and a cut with certainty at the next meeting on 24 May 2018.	**CUT↓**
INFLATION DRIVERS (40%)	**Food prices**	Food products price inflation moderated further to 0.9% due to strong base effects from lower agricultural prices. Meat price inflation, however, remains elevated, as the adverse effects of the recent drought continue to be felt. Food price inflation is now expected to average 5.2% and 6.0% in 2018 and 2019 respectively, up from 4.5% and 5.9% previously.	Since the last MPC meeting, the SA white maize price fell 3%. Stockpiles of maize and other crops remain ample; however the base effects of the sharp decline in agricultural prices over the past year may start to filter into headline food inflation. The white maize price is currently 6% lower on an annualised basis, versus -40% at the January MPC meeting. Fruit, bread, cereals, and oil prices are currently in deflation due to the better harvests. Meat prices have remained elevated; however this may ease as the effects of the 2016 drought are eliminated once herds are restocked. Furthermore, imported food prices remain in deflation, and with the current strong rand, imported food inflation is likely to remain low.	**CUT↓**
	Rand exchange rate	The rand exchange rate responded strongly to the outcome of the ANC elective conference, and since then has traded in a range of between R12.25 and R12.50 against the US dollar. This is in sharp contrast to the low of R14.47 a month earlier. Since the previous meeting of the Monetary Policy Committee (MPC), the rand has appreciated by 13.1% against the US dollar, by 9.6% against the euro, and by 10.6% on a trade-weighted basis. In the near term, the rand is expected to remain sensitive to sentiment generated by political developments. The favourable outlook for capital flows to emerging markets as well as the positive trade account balances is expected to be supportive of the rand. The latter is a reflection of the favourable terms of trade and import compression from lower growth. However, the lingering prospect of a credit ratings downgrade to sub-investment grade by Moody's continues to weigh on the longer-term outlook for the rand. Such an event would trigger the exclusion of South African government bonds from the World Government Bond Index, and is likely to precipitate significant capital outflows. The extent of the impact on the exchange rate remains uncertain.	Since the last MPC meeting, the rand strengthened marginally, by 2.8% against the USD. It is currently 6% stronger on an annualised basis. The trade-weighted rand is currently 3% stronger (since the last MPC meeting). This was one of the major upside risks to the inflation outlook which the SARB had been concerned about, but which we believe has subsided in the near-term. The MPC started the year with a USDZAR forecast of R12.90/$ – this will probably need to be revised lower, given the decline in fair-value valuations, coupled with the recent stronger trend in the rand exchange rate. Moodys: Moodys kept the sovereign credit rating unchanged at Baa3 but raised the outlook to 'Stable' from 'Negative'. This has been a key factor influencing the SARB's uncertainty with regards to the rand and portfolio outflows. This may mean that the SARB now perceives the rand as less of an upside risk to the inflation outlook. This would imply that South African policy makers would now in all likelihood be more comfortable that portfolio outflows associated with a WGBI exclusion will not materialise this year.	**CUT↓**
	Administered prices	Domestic petrol prices increased by 71 cents per litre in December but were reduced by 34 cents per litre (for 95 octane) in January as a result of the stronger exchange rate. The current over-recovery on the petrol price points to a further price reduction in February, should current trends persist.	Since the January 2018 policy meeting, the local petrol price declined by 66c/litre (-4.6%). The current under-recovery in the petrol price stands at 7c/litre, probably implying a small cut to the fuel price next month. Transport inflation has been a key disinflationary driver in recent months and is the main reason for the decline in administered prices. An upside risk to administered prices was electricity costs. This has now receded given the lower-than-expected tariff that Nersa granted to Eskom in December 2017. However, this could re-emerge as a risk if NERSA allows for RCA adjustments by Eskom.	**HOLD➔**
	Wage settlements	Wage pressures are expected to continue contributing to inflation persistence. Growth over four quarters in nominal remuneration per worker in the formal non-agricultural sector increased from 6.3% in the second quarter of 2017 to 6.8% in the third quarter. However, adjusting for labour productivity, growth in nominal unit labour costs declined from 6.1% to 5.5%. Average nominal remuneration increases are expected to remain above 6% over the forecast period.	According to the latest Quarterly Bulletin, public sector remuneration growth per worker (including election-related outliers) accelerated from 9.1% in the second quarter of 2017 to 13.6% in the third quarter. By contrast, private sector remuneration growth per worker moderated from 5.4% in the second quarter of 2017 to 4.7% in the third quarter. According to Andrew Levy Employment Publications, the average wage settlement rate in collective bargaining agreements amounted to 7.6% in 2017, marginally up from 7.5% in 2016. Hence above-inflation wage settlements will remain inflationary unless inflation expectations are lowered or productivity rises sharply.	**HOLD➔**

Source: SARB, Nedbank

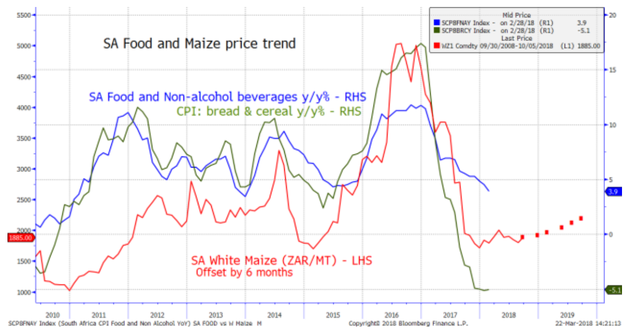
Table 2: Probability of outcomes

	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	50%	20%
	Hold	50%	20%
	Hike	0%	0%
Final Result	**Cut**	38.5%	46.7%
	Hold	53.8%	46.7%
	Hike	7.7%	6.7%

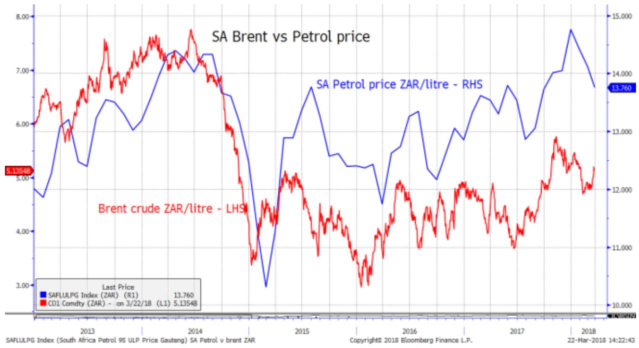
FRA Market now certain of a rate cut by May 2018



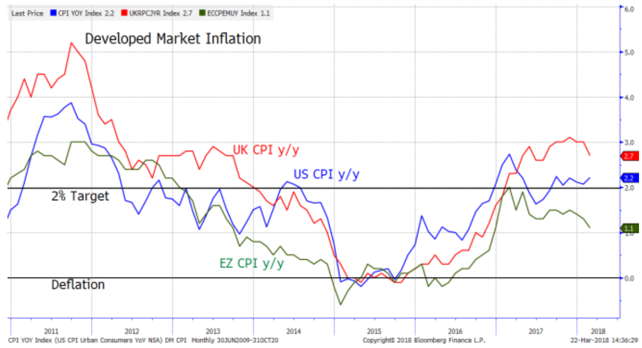
Food remains a disinflationary driver, but base effects fade



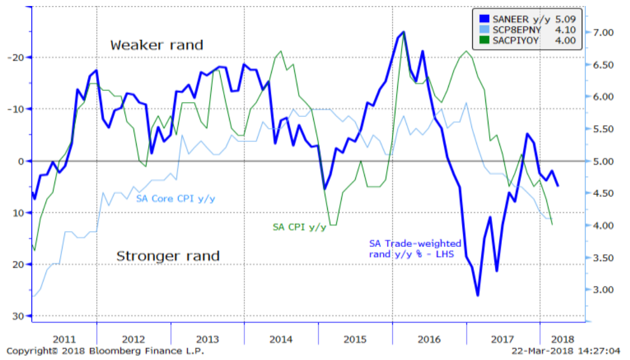
Strong rand anchors oil price, petrol price is lowered



Despite lower DM inflation, central banks remain hawkish



Rand strengthens further since the last MPC meeting



Moody's review provides some certainty for the rand and portfolio flows in the interim

Moody's		S&P		Fitch		
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa		AAA		AAA		Prime
Aa1		AA+	A-1+	AA+	F1+	High grade
Aa2	P-1	AA		AA		
Aa3		AA-		AA-		
A1		A+	A-1	A+	F1	Upper medium grade
A2		A		A		
A3	P-2	A-	A-2	A-	F2	
Baa1		BBB+		BBB+		Lower medium grade
Baa2	P-3	BBB	A-3	BBB	F3	
Baa3 (stable) FC+LC		BBB-		BBB-		
Ba1		BB+ (stable) LC		BB+ (stable) FC+LC		Non-investment grade speculative
Ba2		BB (stable) FC		BB		
Ba3		BB-	B	BB-	B	
B1		B+		B+		Highly speculative
B2		B		B		
B3		B-		B-		

Source: Bloomberg, Stats SA, Ratings agencies, Nedbank CIB Markets

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