Sanlam

Economic Overview for Business Owners

July 2016

Interest rates: relief in sight?

It's been a long, although not especially steep, grind higher in interest rates since early 2014, when the South African Reserve Bank implemented its first interest rate hike of the current cycle. Thus far, the Bank has increased its repo rate by a cumulative 200bp in response to sustained Rand weakness, which fuelled inflation expectations. The impact has been significant, especially since the effective debt servicing cost for a given level of the prime overdraft rate is materially higher after the global financial crisis, compared to the history before the crisis.

But if the Bank's inflation forecast turns out to be accurate, there is good reason to believe we have reached the end of the interest rate hiking cycle. Specifically, the forecast (published in July 2016) shows headline consumer price inflation increasing from 6.3 per cent in June 2016 to a peak of 7.1 per cent in 4Q16, before slowing to 5.5 per cent in 4Q17. Meanwhile, core CPI is expected to peak at 6.1 per cent in 4Q16, before slowing to 5.2 per cent by 4Q17. Assume the Bank leaves its repo rate unchanged at 7 per cent until December 2016. This implies a real repo rate in the vicinity of 1.5 per cent, if the nominal repo rate is adjusted for the headline inflation forecast for 4Q17. That seems sufficiently high, considering the palpably weak state of the South African economy.

In recent commentaries I have highlighted the nascent downturn in corporate profits in South Africa and its far-reaching implications. Businesses are likely to cut costs, including the wage bill. This is likely to constrain employment growth (or even result in outright declines in job growth) and, by extension, final consumption expenditure by households, which, indeed, fell 1.3 per cent annualised in real terms in 1Q2016.

At the same time, given declining profits and depressed business confidence, private sector fixed investment spending growth has turned down sharply, falling 4.4 per cent and 6.8 per cent annualised in 4Q15 and 1Q16 respectively. The return on capital is simply not sufficiently high to prompt businesses to lift investment growth meaningfully.

This is a lot of bad news, but it does augur well for the interest rate outlook. There are no demand pressures to speak of which could lift inflation.

Further, the positive flip-side of declining domestic final demand is the nascent improvement in our trade balance and, therefore, our current account balance. The improvement in the trade balance has been striking in recent months. The surplus of R18.7 billion recorded in May 2016 is the highest since the current data series for the trade account was first published in 2010.

Along with expected additional monetary policy easing in the UK, Japan and possibly the Euro area, as central banks respond in the aftermath of the decision of UK voters to leave the European Union, this should support the Rand exchange rate. This is important, because South Africa is a small, open economy and the currency plays a central role in the inflation process. A steady Rand would be most helpful in containing the expected increase in inflation through to the end of 2016.

Hence, the Reserve Bank should be comfortable with the current level of its repo rate and is likely to remain on hold for an extended periodprovided the economy rebalances (reflected in a material improvement in the current account balance), the Rand remains stable and the inflation forecast for the medium to longer term remains well below the upper limit of its inflation target range.

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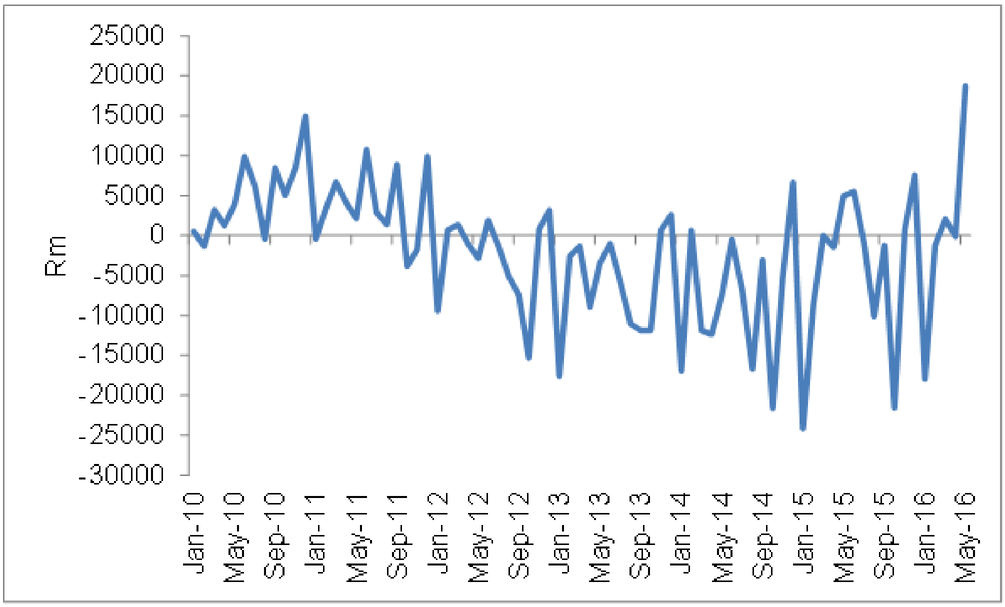
Trade surplus balloons in May 2016

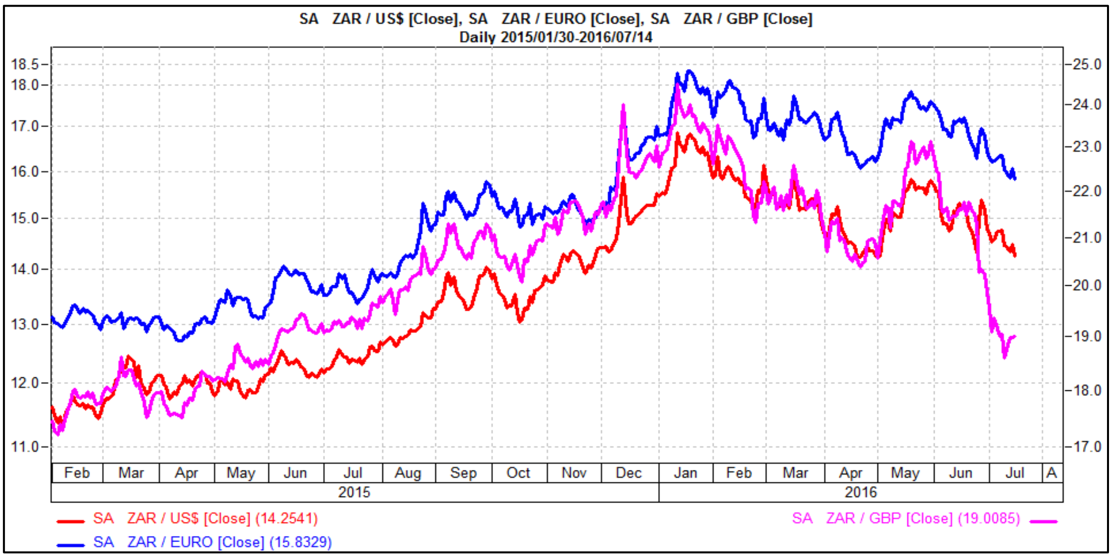


Source: SA Customs and Excise

What could go wrong? One risk is more aggressive interest rate hikes by the US Federal Reserve than currently priced into financial markets. Another risk is a potential downgrade of South Africa's foreign currency sovereign debt rating. If this translates into expectations of further ratings downgrades, additional downward pressure on the Rand, and hence upward pressure on inflation, is possible.

At least, South Africa's domestic currency debt ratings (which are relevant for 90 per cent of total government debt) are higher than the foreign currency ratings (with the admittedly worrying exception of Fitch Ratings), while the Rand, in my view, remains substantially undervalued against the US$. Also, should foreign capital inflows be constrained following a downgrade, domestic final demand is likely to remain weak. This would help to contain some of the upward pressure on prices. Hence, whereas the Reserve Bank will probably need to respond in this scenario, it is not altogether clear it would need to adopt a heavy-handed approach. That said, however, a downgrade would be a material risk to the interest rate outlook if the initial policy response, including fiscal policy and general economic reform is inadequate.

Brexit vote sparks Rand appreciation



Source: I Net

On balance, given the current information, it seems the Reserve Bank is at, close to the end of its interest rate hiking cycle. Accordingly, my base case scenario reflects no change in the Bank's repo rate through to the end of 2017. But, this outcome is only possible if we manage to avoid additional shocks, which raise inflation expectations or lift the Bank's inflation forecast meaningfully.

Written by Arthur Kamp, Investment Economist, Sanlam Investment Management