The Macro Research Desk

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February 2018 headline inflation surprises positively

Highlights

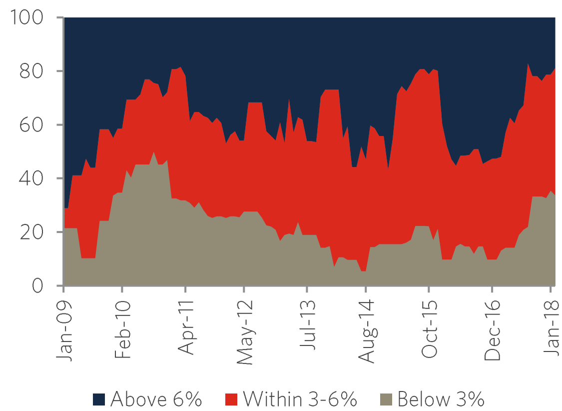
- Broad-based inflation reprieve, with a near-record share of the inflation basket tracking below the 6% upper band of the 3% to 6% inflation target.
- Increased slaughtering rates and cheaper feed input costs should drive meat inflation even lower in upcoming months.
- Tax increases, announced in the national budget, are likely to affect inflation in the short term.
- Encouraging downward shift in services inflation.
- Core inflation remained contained.
- Lower-income earners benefiting from lower inflation.
- A favourable inflation trajectory leaves room for modest monetary policy easing in upcoming months.

Near-record share of inflation basket tracking below 6%

Consumer price inflation (CPI) dipped to 4.0% in year-on-year (y/y) terms in February 2018 from 4.4% y/y in January. This print was slightly lower than Momentum Investments' estimate of 4.1% y/y. February is a relatively low survey month with only 8% of the consumer basket being surveyed (mainly medical aid contributions), in addition to the usual monthly surveys. Relative to Momentum Investments' forecasts, monthly price changes for food (flat), clothing (0.2%), furnishings (negative 0.9%), personal care (0.3%) and insurance (6.1%) came in lower than anticipated. Meanwhile, price increases for alcoholic beverages (0.6%), maintenance (1.1%), public transport (1.3%) and hotels (1.1%) surprised to the upside.

A broad-based inflation reprieve remains prominent in SA's consumer basket. Price increases for more than 80% of the items in the basket (using a weighted approach) came in below the 6% upper end of the inflation target band (see chart 1), which compared favourably to historic data starting in 2009.

Chart 1: Portion of inflation basket trading below, within and above the target band (%)



Source: Global Insight, Momentum Investments, data to February 2018

Meat price pressures eased in February 2018

Overall food inflation dropped further in February 2018 to 4.0% y/y from a 12% y/y peak in October 2016. Although meat inflation remained above the 6% upper target band for the 15th month in a row, price pressures eased from 15.6% y/y in September 2017 to 11.4% y/y in February 2018.

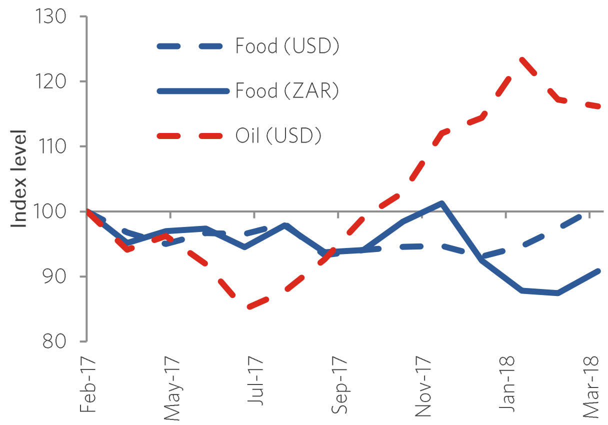
In Momentum Investments' opinion, a further normalisation in slaughtering rates should increase meat supplies and moderate price increases in this category in upcoming months. In addition, cheaper yellow maize should benefit feedstock input costs for livestock producers, allowing meat inflation to ease further.

Meanwhile, deflation in bread and cereal products continued for the seventh consecutive month. In monthly terms, prices fell a further 0.2% in February 2018.

Even after factoring in the Western Cape drought effect on fruit and vegetable prices, Momentum Investments anticipates food inflation to remain benign in upcoming months, given the expectation of lower meat inflation and well-behaved bread and cereal inflation.

International food prices are around 1% higher than they were a year ago. However, after taking into account the effect of the rand's favourable movement for the past year, food prices are nearly 10% lower in rand terms (see chart 2).

Chart 2: International food and oil prices



Source: Stats SA, Global Insight, IRESS, Momentum Investments

Tax increases announced in the national budget to affect inflation in the short term

The Department of Energy announced a 30c/l cut in petrol prices in February 2018 (due to a drop in the international price of oil and an appreciation in the local currency), which contributed to the 1.4% decline in transport prices in the month. While the March 2018 inflation print is likely to see further relief in fuel prices (reflecting an additional 36c/l cut), fuel inflation should increase in April 2018 based on the 52c/l increase in fuel levies announced in the February 2018 national budget.

According to Stats SA, around 44% of the headline CPI basket compromised zero-rated and VAT-exempt items to protect poorer households (see table 1).

Table 1: Zero-rated and VAT-exempt items

Product group	Weight
Food and non-alcoholic beverages	5.5
Bread and cereals	1.7
Fish (tinned)	0.2
Milk, cheese and eggs	1.9
Cooking oil	0.3
Fruits and vegetables	1.4
Housing and utilities	18.9
Actual rentals	3.5
Imputed rentals	13.3
Assessment rates	1.3
Levies	0.8
Household contents and services (domestic worker wages)	2.5
Transport	6.3
Paraffin	0.1

Product group	Weight
Unleaded petrol	3.3
Diesel	1.3
Train fares	0.1
Bus (local) fares	0.0
Taxi fares	1.5
Bus (long distance) fares	0.0
Education	2.9
Pre-primary and primary	0.8
Secondary	0.8
Tertiary	1.0
Creche	0.4
Miscellaneous goods and services (health insurance)	7.5
Total	43.6

Source: Stats SA, Momentum Investments (items in blue font are goods, items in black font are services)

Momentum Investments expects international oil prices to average around US$62/barrel (bbl) in 2018 and US$63/bbl in 2019, broadly in line with the SA Reserve Bank's assumptions set out in its January 2018 monetary policy meeting assumptions document.

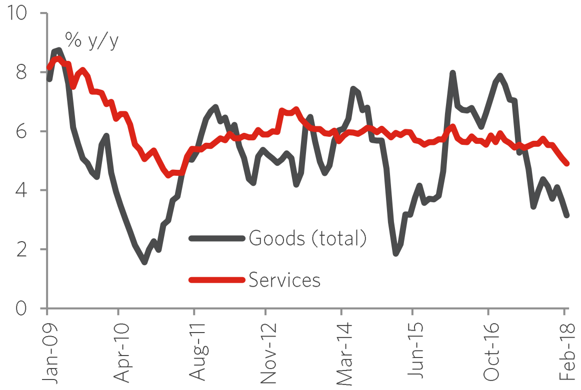
Stats SA announced it would undertake additional surveys in April and May 2018 to capture the effect of the value-added tax (VAT) rate increase from 14% to 15%. It noted automatic adjustments would be made to municipal tariffs to account for the increase in VAT, while short-term insurance would be surveyed in April and May 2018. Private medical practitioners and hospital costs are expected to be surveyed between April and October 2018, while the survey for toll fees would be delayed from March to either April or May 2018.

Encouraging downward shift in services inflation

Goods inflation, which averaged 5.1% since 2009, declined further to 3.2% y/y in February 2018, from 7.9% y/y in December 2016, largely attributable to minimal inflation pressures in durable (vehicles, furniture and appliances) and semi-durable (clothing) products.

During the same period, inflation pressures were higher among services (6%), which accounted for 51.3% of the inflation basket. Services inflation tracked in a narrow channel for the best part of three and a half years, but the recent four months have shown consistently lower inflation prints for this category. Services inflation registered at 4.9% y/y in February 2018, from 5.8% y/y in September 2017.

Chart 3: Encouraging move lower in services inflation



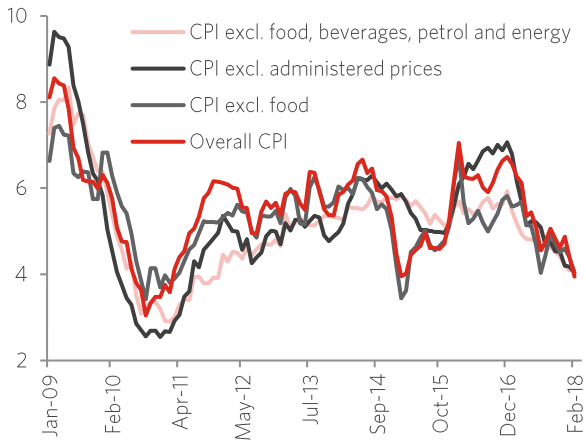
Source: Stats SA, Global Insight, Momentum Investments

Core inflation remained contained

Underlying measures of inflation steadied in the February 2018 print. Core inflation (headline excluding food, non-alcoholic beverages and petrol) tracked sideways at 4.1% y/y, but is significantly lower than the 5.8% y/y peak print published for August 2016 (see chart 4). Disinflation in core goods has largely been responsible for the downward trend in overall core inflation, while core services inflation, until very recently, has persisted at higher levels.

Momentum Investments expects core inflation to average 5.2% for 2018 and 2019. It remains to be seen whether recent currency strength will be passed through to the consumer in full by retailers, to support market share, or whether an expected revival in consumer confidence (driven by positive political developments and higher growth in disposable incomes) will allow for a lower rate of pass-through.

Chart 4: Measures of core inflation (% y/y)



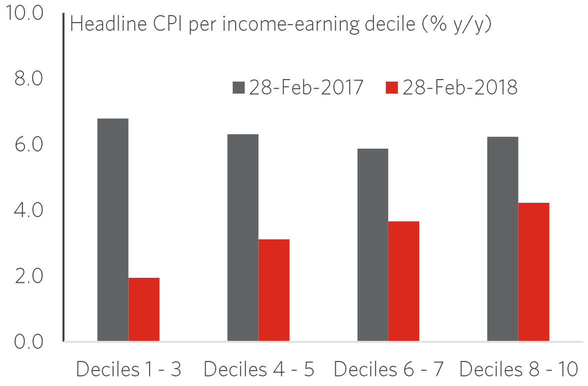
Source: Stats SA, Global Insight, Momentum Investments

Low-income earners benefiting from lower inflation

Lower-income earners tend to spend a larger portion of their income on food. With food inflation dropping sharply from 10% y/y a year ago to 4% y/y in February 2018, overall rates of inflation for lower-income earners declined faster than that for higher-income earners (who tend to spend more on rental, insurance and transportation costs).

Headline inflation registered at 1.9% y/y for the three-lowest income-earning deciles in February 2018 and 4.2% y/y for the three-highest income-earning deciles (see chart 5). As such, real wage gains for lower-income earners has improved.

Chart 5: Poorer households are experiencing lower rates of headline inflation



Source: Stats SA, Global Insight, Momentum Investments

Government attempted to shelter the lower-income earning groups from the increase in VAT by allowing for VAT exemptions on a number of items as well as by ensuring real increases in social grants.

Favourable inflation trajectory leaves room for further modest monetary policy easing

After factoring in the taxes announced in the February 2018 national budget, Momentum Investments expects headline inflation to moderate to 4.8% in 2018 from 5.3% in 2017, before rising to 5.4% in 2019 and 2020.

Comparatively, in its January 2018 interest-rate-setting meeting, the South African Reserve Bank (SARB) updated its headline inflation assumption for 2018 to 4.9% (from a prior estimate of 5.2%) and from 5.5% to 5.4% for 2019.

In Momentum Investments' opinion, inflation and growth risks have abated since the January 2018 meeting. International oil price pressures have receded and the probability of a sovereign ratings downgrade by Moody's rating agency has likely reduced significantly, given a number of positive political developments (appointment of credible ministers in key ministries, SA Revenue Services leadership and management issues being addressed, state capture investigation underway and a brighter, but credible, fiscal outlook announced in February 2018) and higher-than-expected growth data for 2017.

Given that the output gap is likely smaller based on the recent upward revisions to domestic growth, the argument for more aggressive easing has been weakened. Moreover, a decline in policy uncertainty has led to an improvement in sentiment and, as such, it is possible interest rate cuts may have a more positive effect on growth this time around.

Although the volatility of inflation expectations has reduced significantly in recent years and, despite the downward drift in longer-dated inflation expectations (as surveyed by the Bureau of Economic Research), the SARB has expressed its preference for expectations to settle closer to the midpoint of the 3% to 6% inflation target band to reflect a higher degree of monetary policy credibility. This would also allow the central bank to operate with more headroom, in the event of adverse supply-side shocks, which could shift inflation meaningfully higher for a protracted period.

As such, Momentum Investments sees space for one interest rate decrease of 25 basis points at the March 2018 interest-rate-setting meeting, with the possibility of a further 25 basis point cut in May 2018, should conditions remain favourable. The upcoming public sector wage settlement continues to pose upside pressure to inflation, while uncertainty around land reform could result in a weaker currency trajectory.