Fundamentals

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Macroeconomic update | Strategy | South Africa

South Africa is catching a cold

IN BRIEF

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- Monetary tightening decisions are currently a balancing act between combating record-high inflation and not triggering an economic recession i.e. soft landing. As the global economy is still in a tight spot, South Africa is at the centre of its cross-current of shocks.

- However, the country's large and diversified economy, effective monetary – and more recently fiscal-policy framework, and deep financial sector are buffers against these budding shocks – that include the direct exposure to the Russia-Ukraine conflict through higher inflation.

- Hence, the South African Reserve Bank (SARB) once again hiked the repurchase (repo) rate at its May meeting to 4.75%, from 4.25% so as to douse these inflationary flames.

- Although the inflation reading of 5.9% y/y for April is still within the SARB's target range, the outlook is tougher, as we expect price pressures to prove more challenging from mid-year.

- The SARB's policy decision reinforces the bank's hawkish stance on inflation, and its commitment to remain an attractive investment destination in the face of an unprecedented number of headwinds that will keep financing conditions tight and steepen the yield curve for rand-denominated bonds.

- Being a risk-sensitive currency, the rand will also actively respond to shifting global risk appetite that will be driven by interest rate trends in the United States (US), the residue of the Russia-Ukrainian conflict, and the China situation with renewed COVID-19 lockdowns and harbour lockdown measures.

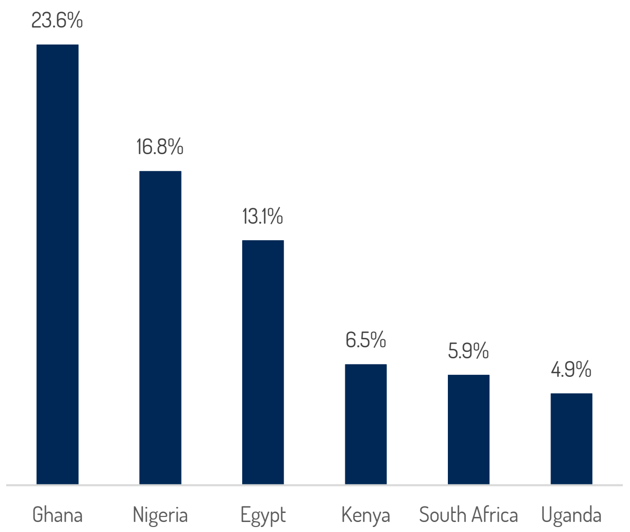
Against the global backdrop of more rapid policy normalisation, and the sustained upside risks to domestic inflation, the South African Reserve Bank (SARB) raised interest rates by the biggest margin (50basis points) in more than five years to 4.75%. The SARB's decision to deliver a bolder repurchase (repo) rate hike follows a global trend of interest rate hikes, as economies continue to suffer from the same broad troubles, including severe food and fuel price increases caused by the Russia-Ukraine conflict and ongoing supply-chain dislocations that emerged during the pandemic.

As inflationary pressures remain globalised, the most worrying implication for South Africa will be the rising curve in US interest rates that could squeeze liquidity from its financial markets and put pressure on the local currency. This will prompt further rate hikes from the SARB in the coming months so as to stem the pace of capital reversal, ease pressure on the rand, and preserve the appeal of rand-denominated assets.

Near-term inflation risks bias to the upside

Although South Africa's inflation is low relative to a number of African and non-African emerging economies, the near-term risks to South Africa's inflation trajectory are skewed to the upside - and a protracted breach of the SARB's 3% - 6% inflation threshold is envisaged.

April 2022 annual headline inflation of selected African countries



Source: Bloomberg

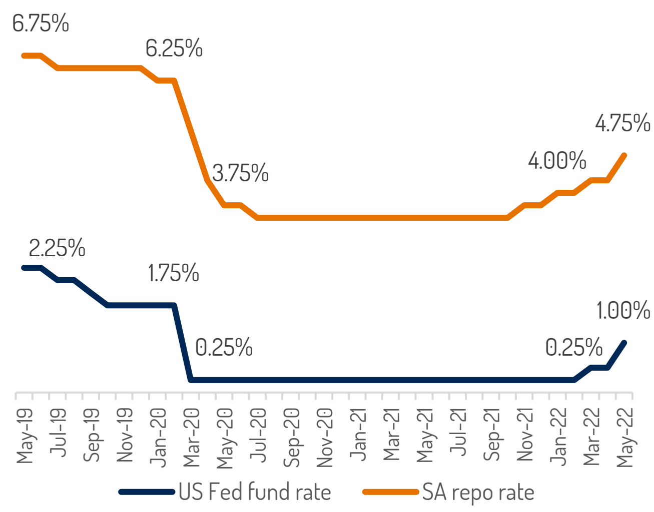
The looming expiration of the ZAR 1.50/litre fuel levy reprieve breeds uncertainty about the future path of the country's fuel inflation - as global oil prices are poised to remain elevated - and the continued spillover into food prices. In April, South Africa's finance minister - Enoch Godongwana - announced a temporary reduction in the general fuel levy by ZAR 1.50/litre for April and May, to ease the pinch from rising fuel costs. Also, threats from new coronavirus lockdowns, weaker rand prospects on risk-off bias, and wage indexation could keep up the near-term pressure on consumer prices.

Seeking the interest rate sweet spot

Our expectations from the SARB are on the hawkish side as a means to keep up with the accelerated pace of global monetary policy normalisation, stem capital outflows, and ensure foreign participation in the local bond markets.

Given a 96% correlation probability between South Africa's repo rate and the US federal fund rate over a three-year horizon, subsequent policy actions from the SARB are likely to be paced to US Fed policy rate decisions. This is required to not only check domestic inflation in South Africa but also to support the rand by attracting foreign investment flows.

United States vs South Africa interest rates (%)



Source: Bloomberg

Being an emerging market, South Africa went ahead of the global tightening cycle – hiking its repo rate ahead of rate hikes in the US and UK. In our opinion, it needs to maintain that position to continue to attract investment amid the increasingly volatile global economic scenario.

Also, the SARB has a history of strong credibility and is highly attentive to inflation risks. Therefore, the anticipated confluence of price shocks (from higher commodities pricing and weakening rand prospects) to the South African economy in the near term will prompt further rate hikes in the coming months, as the focus right now is on anchoring inflation and inflation expectations.

The rand is on shaky ground as the dollar flex continues

Being a popular tradeable currency in the global financial market, the rand is poised to remain on the back foot against the dollar due to more volatile economic and financial conditions in the near term. Concerns over slowing economic growth globally, rising interest rates, and war risks, will lead to increased market volatility, denting the appeal of rand-denominated assets. A further risk to the rand is the recent increase in South Africa's offshore investment limits, which could lead to more capital outflows over time. On the domestic front, concerns over load shedding, and floods in KwaZulu-Natal, may also be pulling the rand lower.

Conclusion

Thanks to global financial and geopolitical conditions, there is little realistic expectation that interest rates will be doing anything other than rising in the near future. The upside risks to inflation are a significant concern, both in South Africa and elsewhere. As a result, the US Federal Reserve Bank is likely to raise its policy rate by 50 basis points at its June and July meetings. This is an indication of the magnitude of rate increases that we expect from the SARB in the coming months as they face a number of near-term risks if they do too little.

Given South Africa's improved economic outlook – following its GDP rebasing exercise and better-than-expected fiscal performance – a stronger majority of the five-member monetary policy committee (4:1) will continue to vote in favour of frontloading rate hikes over the next couple of meetings, as the SARB looks to build buffers to allow for policy manoeuvre in a highly uncertain global environment. Hiking more aggressively at this time, when the economy and asset prices are stronger to withstand a slightly faster pace of tightening, will prevent steep interest rate hikes in the future if global growth concerns intensify into 2023.

Also, the rand is likely to remain under some pressure as a result of global monetary policy tightening and concomitant growth and commodity price concerns, but the SARB will be matching the pace of global rate increases to safeguard the yield advantage of holding assets denominated in rand, and contain inflation that might come through a weaker exchange rate.

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