South Africa Central Bank Preview: September 2021

Details:

Monetary policy decision and release of Monetary Policy Report: 1400BST/1500CEST/0900ET, Thursday 23rd September 2021.

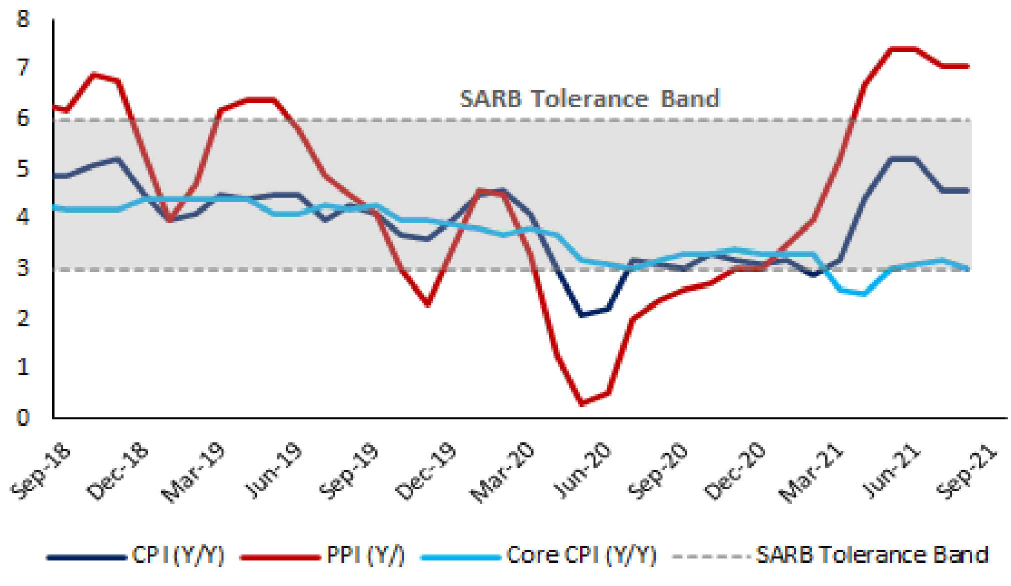
MNI Point of View

POV: SARB Seen on Hold at 3.5%, Inflation Vectors Still Contained

The SARB is expected to keep its key rate unchanged at 3.50% this week, with inflation still broadly contained within the 3-6% target range on both a near and medium-term basis. This, alongside a muted aggregate demand impulse, structurally high unemployment and a fragile recovery narrative, informs our base case for the SARB to remain on hold out to 1Q22 and potentially beyond. The more interesting component of the meeting will be the SARB's assessment of GDP following the recent rebasing, and discussion of a possible shift to a narrower 3-4% inflation target, which has been well-received by analysts thus far.

Although headline CPI is expected to rise to 4.9% y/y in August vs 4.6% in July, price pressures remain well-anchored within the SARB's 3-6% target range. Moreover, core inflation in August is expected to print flat at 3.0% y/y, complemented by a lower PPI reading in July (7.1% y/y) - reflecting broadly muted pricing and aggregate demand dynamics kept lower by acutely high unemployment. Despite considerable ZAR volatility in recent weeks, FX passthrough to inflation should be minimal at this meeting, given spot rates stand +0.71% above July 22 levels. Oil prices, however, have risen by 4.41% since then - adding upside risks to 2021/2022 assumptions at $67 & $65/bbl respectively.

Figure 1: Price Pressures Well-Contained, Core Inflation Remains Subdued



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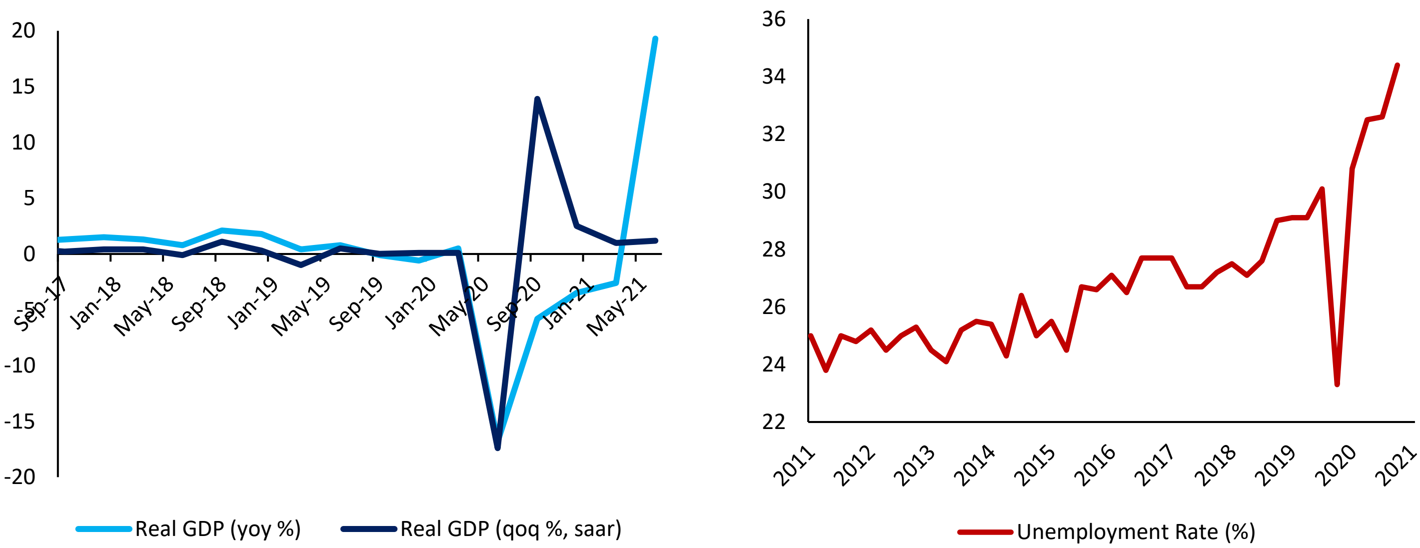
Overall, inflation pressures remain broadly balanced at this juncture, with Governor Kganyago likely to reiterate his focus on medium-term disinflationary factors and willingness to look through near-term transitory factors to support the fragile domestic recovery. In the prior statement, the SARB made dovish revisions to 2022 average inflation at 4.2% vs 4.4% prior, while forecasting end-2021 CPI at 4.3% vs 4.2% prior. Interestingly, sell-side analysts are undecided on the CPI trajectory with some (mostly international banks) highlighting upside risks resulting in a +25bps hike before year-end, while locals and GS favour a more moderate inflation path culminating in a lower likelihood of hikes out as far as the end of 2022.

Our base case aligns with the latter, given the fragility of the recovery as the economy continues to operate below pre-pandemic levels with a notable output gap and muted aggregate demand impulse. Moreover, Governor Kgangayo remains cognizant of the risks to growth emanating from a premature hiking cycle, with 3Q growth expected to contract in line with a substantial downturn in July economic activity metrics following widespread social unrest and rioting. While the statement may retain cautious phasing on short-term inflation risks being biased to the upside to avoid sounding too dovish, this should not impact the SARB's broadly accommodative stance. Hence, we continue to see little scope for policy tightening until 1Q22, and possibly out as the end of 2022 with medium-term pricing vectors forecast to remain well-anchored within the SARB's target range.

Figure 2: Unemployment Continues to Spiral, 3Q GDP Set to Contract



Nevertheless, beyond the mostly uneventful key rate decision at this meeting, markets will be keen to gauge the SARB's assessment of the recent GDP rebasing and discussion of the potential 3-4% inflation target. On the growth front, analysts expect the rebasing to result in an upside revision of the SARB's 4.2% FY21 forecast towards 5.0% or higher - but see no material reduction in the output gap. Additionally, while it's unlikely that the SARB will immediately implement its narrower inflation target, markets will be looking for more guidance on possible implementation timelines and appetite among the MPC.

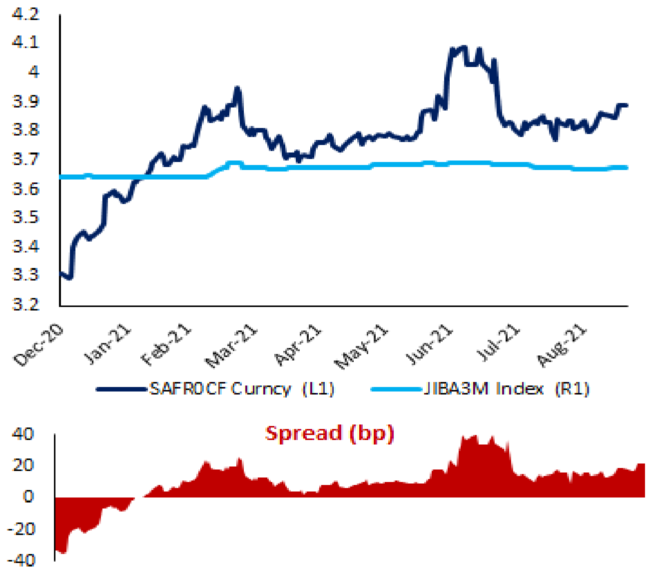
High SARB policy credibility has seen the concept extremely well-received by markets, with the aim of anchoring policy expectations lower resonating with investors. Here, a near-term implementation would likely be construed as a hawkish development by markets, but Kganyago will likely be conscious of that and provide well-telegraphed guidance towards its implementation at an appropriate time for policy.

Markets

Since the 22 July meeting, ZAR has traded in a wide 8.65% range vs the USD (14.00-15.40) due to its well-deserved high beta status - reacting abruptly to fluctuations in global risk sentiment and the hunt for yield. With one of the most attractive vol-adjusted carry profiles, ZAR outperformed in late August - early September on the back of globally low implied vol and unwinding taper fears before flipping to worst performing currency as concerns of an accelerated hiking timeline from the FOMC dented demand for risk assets last week.

While this SARB meeting is expected to see little impact on ZAR assets, the FOMC will likely be a key driver for near-term volatility emanating from the US Treasury market. Here, we see ZAR's cyclical and high-beta nature to be somewhat of a volatility magnet in the short-run as markets navigate taper and dot-plot announcements. However, with CPI expected to remain muted, fiscal conditions improving on rebased GDP and commodity super cycle-related tax windfalls, alongside robust external balances into 2023 - ZAR should be relatively well insulated against excessive weakness over the medium-term.

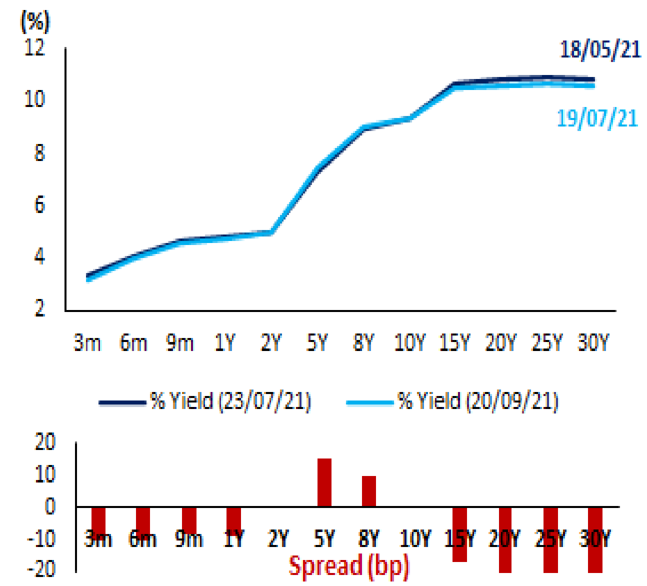
Figure 3: 3x6 FRA-Jibar Spreads Reflect +21.5bp of Hikes from 3Q21-1Q22



Going into this meeting, the broad consensus aligns with an uneventful meeting and limited post-announcement market reaction. The more interesting divergence comes in November where some international institutions expect a reactive +25bp hike from the SARB, against the majority of local institutions calling for a prolonged period of holding at 3.5%.

While this divergence is not as stark as the mis-pricing for a hike at the July meeting, it still creates scope for an unwind of relatively hawkish expectations, should inflationary pressures fail to materialise in Oct-Nov - as per our base case.

Figure 4: SAGB Term Structure Retains Some Bull Flattening gains



Since the 22 July meeting, SAGBs have also traded within a broad range, with strong gains in the late Aug - early Sept period almost fully pared in the recent Fed-induced risk unwind. With real yields among the widest in the EM space and our outlook still relatively dovish, we expect SAGBs to continue to trade in line with global risk sentiment around the FOMC taper and lift-off forecasts.

The SAGB curve also still remains among the steepest globally, offering some of the highest FX-hedged yields (expressed via 3m forwards) among major EM & DM markets. This, along with robust fundamentals, should continue to support demand in bouts of more favourable risk conditions and hunt for yield over the medium-term.

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South Africa Central Bank Watch

MNI SARB Data Watch List

Inflation		Current	3m ago	3m Chg	6m ago	6m Chg	2Y History	Hit / Miss	Vs Trend	Surprise Index	Z-Score
CPI YoY	% y/y	4.6	4.4	↑	3.2	↑					1.16
Core CPI YoY	% y/y	3.0	3.0	→	3.3	↓					0.00
PPI YoY	% y/y	7.1	6.7	↑	3.5	↑					0.81
Economic Activity		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
Trade Balance Rand	ZARbn	37.0	51.3	↓	12.4	↑					0.54
Manufacturing Prod YoY	% y/y	-4.1	88.3	↓	-4.3	↑					-0.65
Absa Manufacturing PMI	Index	57.9	57.8	↑	53.0	↑					0.72
SACCI Business Confidence	Index	93.2	94.7	↓	94.5	↓					-1.28
Monetary Analysis		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
Money Supply M3 YoY	% y/y	1.93	2.02	↓	9.15	↓					-1.67
Private Sector Credit YoY	% y/y	0.61	-1.76	↑	3.26	↓					-0.05
Total Loans and Advances	ZAR bn	3635	3591	↑	3587	↑					1.82
Net Reserves	$bn	55.67	52.24	↑	51.58	↑					2.38
Consumer / Labour Market		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
Retail Sales YoY	% y/y	-0.8	95.1	↓	-3.9	↑					-0.09
BER Consumer Confidence	Index	-10.0	-13.0	↑	-9.0	↓					0.50
Unemployment	%	34.4	32.6	↑	32.5	↑					1.24
Non-farm payrolls QoQ	%q/q	-0.1	0.9	↓	0.6	↓					0.25
Markets		**Current**	**3m ago**	**3m Chg**	**6m ago**	**6m Chg**	**2Y History**	**Hit / Miss**	**Vs Trend**	**Surprise Index**	**Z-Score**
Equity (FTSE/Jse Top 40)	Index	54924	61783	↓	60754	↓					1.29
SA 10-Year Yield	%	9.35	9.29	↑	9.06	↑					-0.30
SA 2-Year Yield	bps	434	428	↑	378	↑					0.15
Effective Exchange Rate	Index	58.68	58.30	↑	55.41	↑					-0.11

Note: For quarterly data the 3m ago column will display the previous data point and the 6m ago column will display the data point prior to that.
Source: MNI, Bloomberg

Sell-Side View

Barclays: SARB to Hold at 3.5%, Reduced Inflation Target to Expedite Nomalisation

- SARB expected to hold rates steady and take advantage of this meeting to provide more clarity on recent communication that it would prefer to target the country's inflation floor after having successfully harnessed inflation expectations around the midpoint of the target band in recent years.
- An imminent implementation of such an ambition would support its call for policy normalization to begin as early as November.
- However, based on the conflicting signals on the pace of recovery given by upbeat PMI and disappointing business confidence data, Barclays see risks that the SARB may want to wait for actual 3Q 21 GDP outcomes before embarking on the normalization path.

Goldman Sachs: SARB Unanimously on Hold at 3.5%, Rates on Hold to End-2022

- In line with consensus, GS expects the policy rate to remain on hold at 3.5%, most likely in a unanimous decision among MPC members (as has been the case in the prior three MPC meetings).
- Inflation developments have been mixed since the last MPC meeting, with an upside surprise to the June inflation print but a downside surprise in July (surprises to both headline and core, for both months). Meanwhile, the Rand has been close to flat on a moving-average basis from the ZAR 14.40 vs. the USD assumed at the July MPC meeting, but the oil price has continued to rise on the same basis (implying some upside risk to the US$67/bbl and US$65/bbl assumptions for 2021 and 2022, respectively).
- Although inflation may be tracking marginally higher than the SARB's 4.6% forecast for Q3 2021 (GS estimates point to 4.7%), this likely does not constitute a material upside surprise to the SARB's forecasts and Q2 inflation realised 0.1pp below the standing forecast.
- From a forward-looking perspective, recent guidance from the Council for Medical Schemes suggests that health insurance inflation in 2022 may once again remain subdued, a factor that could imply downside risks to the SARB's 2022 inflation forecast.
- Additionally, expectations for a good agricultural harvest and the local government wage deal are likely to keep a lid on food and wage inflation, respectively. Put together, GS thinks this combination of factors is

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unlikely to entail hawkish forecast revisions to inflation. In fact, GS sees some possibility that the MPC could remove its assessment of near-term upside risks to inflation (although it may feel that it is somewhat premature to do so), a development that would be viewed as dovish.

- On the activity side, GDP growth in Q2 surprised materially to the upside and showed a significant acceleration in growth on the quarter (after a backward revision to the series and following the recent GDP rebasing exercise).
- However, recent high-frequency data for the month of July have surprised significantly to the downside, likely reflecting the unrest that took place as well as the Covid-related lockdown measures. GS has maintained its forecast for GDP growth for 2021 at 5.0% (with risks tilted to the upside) and thinks that the SARB may upgrade its standing forecast of 4.2% somewhat given the strength of the Q2 GDP print. Nonetheless, output remains well below pre-Covid levels and GS doubts that any GDP forecast revisions would imply a material erosion of the output gap that would affect the MPC's assessment of there currently being an absence of demand-side price pressures.
- Given the inflation and growth outlook, GS thinks the SARB is likely to remain comfortably on hold at this juncture. With the GS inflation forecast for 2022 (3.6%) materially more benign than the SARB's (4.2%) or consensus (4.5%), GS expects rates to remain on hold through end-2022.

JPM: SARB to boost GDP, CPI Projections – Sees Frist +25bp Hike in November

- MPC to remain on hold, yet the statement likely will adopt a more neutral tone after a dovish bias in July. JPM think the combination of recent substantive GDP revisions and the periodic refresh of potential growth estimates could materially alter economic projections.
- Expect the SARB to mark up its 2021 growth forecast to 5%-5.2% (from 4.2%) and narrow the output gap estimate for 2020 (from -5.9% to -5.3%), 2021 (from -3.2% to -2.4%) and 2022 (from -1.8% to -1.4%).
- However, the SARB is not likely to follow a purely mechanical approach in its output gap estimate, and it is also uncertain whether revisions have already taken place in time for the September MPC meeting.
- At the same time, inflation projections could be tweaked higher by 0.2%-0.3%-pts over the next three quarters given lesser economic slack and pressures from administered prices, raising the inflation forecast somewhat to 4.4% (from 4.2%; JPMe: 4.7%) in 2022.
- The combined impact of a potentially narrower output gap and marginally higher inflation projections could raise the QPM-projected repo rate by 12bp to 3.9% by end-2021 and 22bp to 5.1% by end-2022.
- While the SARB is unlikely to be in a hurry to begin the normalization cycle this month amid a likely 3Q GDP drop, a muted investment recovery, and soft 2Q GDP details, JPM believe the case for near-term tightening is building and they expect a first 25bp rate hike in November to take the policy rate to 3.75%.

Morgan Stanley: SARB on Hold at 3.5%, Vote Distribution Could Turn More Hawkish

- This SARB meeting could be an inflection point for monetary policy, but MS don't see a significant impact on asset prices from an idiosyncratic point of view.
- This is mainly due to the Fed meeting on September 22, which its rates strategists expect to stir the market by coming out more hawkish, mainly through the dot plot.
- Expectations are that the central bank will keep the policy rate unchanged but MS economists flags that the vote distribution can turn out more hawkish.

Natwest: SARB Unchanged at 3.5%, Markets Pricing a Hike Before Year-End

- SARB to keep rates unchanged at 3.50%, in line with the consensus. Inflation remains steady around the SARB's midpoint target of 4.5%, and the outlook broadly balanced.
- The SARB's short-term inflation forecasts have been revised up, and rates markets are pricing a hike before year end – Natwest watches their guidance on the balance of risks and any signalling and continue to maintain a bearish bias in ZAR vs COP and BRL.
- Persistent bullish action in ZAR has been a significant challenge to Natwest's view, but they believe that much of this has been driven by positioning (and less so bond or trade flows) and could be ripe for correction.

TD Securities: SARB On Hold at 3.5%, No Hikes In 2021

- The upcoming SARB meeting on 23 September should be fairly uneventful, with no hikes expected in 2021. As the prospects of a full economic recovery in SA remain bleak, there is a long list of reasons why the SARB should hold rates for now:

- the unemployment rate stands at 34.6%, the low vaccination rate of 13% and a lack of demand-price pressures. July core inflation was 3.0% y/y, which is close to the bottom of the 3-6% target range. As such, TD doesn't think the SARB will be changing its dovish stance anytime soon.
- FX: The strength exhibited by the rand since the 2020 shock is nothing short of extraordinary. In the April 2020 to date period, USDZAR dropped around 24%.
- In TD's view, the main two factors behind this ZAR rally have been 1) positive global risk sentiment and 2) South Africa's large current account surplus. The latter is a direct result of the pandemic suppressing domestic demand and causing imports to collapse.
- At the same time, the global commodity cycle boomed, positively impacting South Africa's value of exports and terms of trade. As a result, over the past few quarters South Africa has been running its largest current account surplus on record, up to a whopping 5.6% of GDP in Q2 2021.
- However, going forward, TD sees risks for the rand. While the commodity boom may continue to provide support, and the steep local rates curve could prevent major rand weakness by attracting or retaining portfolio inflows, the market may start to set its eyes elsewhere.
- EM currencies from countries that are already tightening monetary policy and experiencing a much faster recovery (i.e. Russia and Mexico) may look more attractive. Furthermore, as domestic demand picks up and imports increase, support provided by the current account surplus should start to fade.