

SA RESERVE BANK FACES STAGFLATION DILEMMA

14 Apr 2016

WIKUS FURSTENBERG | PORTFOLIO MANAGER AT FUTUREGROWTH

Recent policy actions by the European Central Bank (ECB) and Bank of Japan (BOJ) are prime examples of unconventional monetary policies as central banks in most parts of the developed world run out of conventional options in the ongoing fight to get their economies back on a path of sustained growth. Weak global growth also continued to slow the progress of the US Federal Reserve's own policy normalisation process. This, despite the fact that US inflation is finally heading closer to the illusive 2% target, while the unemployment rate seems to have stabilised around the 5.0% level.

Back home, the South African Reserve Bank (SARB) remains entangled in a very different policy dilemma of stagflation. The speed of inflation's acceleration at both producer (8.1%) and consumer (7.0%) levels has surprised many, while economic growth remains anaemic. In addition, the particularly precarious balance of payment position, both in absolute and relative terms, necessitates a higher real repo rate. To the SARB's credit, it continues to focus on its mandate of maintaining price stability and, for that reason, raised the repo rate by another 75 basis points (bps) during the past quarter. As a result, the repo rate has now increased by 2% from the cycle low.

THE BALANCING ACT

On the fiscal side, our view is that the Minister of Finance delivered a realistic and balanced National Budget in February. Somehow the market expected bolder announcements, including large tax increases in light of the fear of sovereign credit rating downgrades. This ignored the very complex backdrop of anaemic local economic growth and complicated socio-economic realities. As a matter of fact, we are of the opinion that the focus on reining in expenditure is the more appropriate and sustainable approach. The seemingly growing conflict between the "reformists" (those focused on assuring economic stability and general good governance) and those threatened by prudent fiscal management continued to serve as a catalyst for continued market volatility.

The yield of the benchmark R186 government bond traded in a wide range of 9.02% to 9.95% during the first quarter of this year. A Yellen-induced emerging market currency and bond bull rally saw the market end the quarter at 9.10% – or 66bps lower than the close of 9.76% at the end of December 2015. Inflation-linked bond yields drifted lower in response to rising inflation and concerns about additional upside risk to the future rate of inflation.

During the quarter, the JSE ASSA All Bond Index rendered a return of 6.55%, recovering fourth quarter 2015 losses. The JSE ASSA Government Inflation-linked Index returned 2.12%, followed by the STeFI Call Deposit Index (as a proxy for cash) return of 1.53%.

LOW GLOBAL GROWTH WEIGHS ON SA

The global growth recovery remains fragile and patchy, which sets the scene for a more modest future inflation profile as well as significant monetary policy divergence. It also implies a steady

and shallow tightening cycle for the few economies that are in a position to normalise monetary policy, especially the US. This should cap global bond yields, especially as inflation pressures in developed markets remain subdued. On the negative side, the continued uncertainty about the Chinese growth outlook remains a risk, especially for emerging market commodity producers with a weak external position, like South Africa.

TAKING A CAUTIOUS APPROACH

Locally, investors face a worsening inflation outlook on the back of rising food prices, the risk posed by sustained rand weakness and the likely increase in inflation expectations. Although the Minister of Finance is clearly determined to rectify the damage to fiscal policy credibility and, by implication, a sovereign credit downgrade to non-investment status, the jury is still out on actual delivery. Besides South African idiosyncratic factors, we also expect global risk appetite to remain volatile. As a result, we will approach the market with caution and focus on increasing our holding of low duration inflation-linked bonds and longer-dated money market assets that are offered at higher yields, but with limited market risk. Moreover, the SARB will need to raise the repo rate again, a move already anticipated by both the money and bond markets.