Emerging Insight

South Africa: all change – not done hiking

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Global

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Key takeaways

- Due to higher CPI risks from oil, food and ZAR, we are now calling for 25bp SARB hike on November 23.
- We now expect headline CPI to average 5.6% in 4Q 23, year end 5.5% and average 5.3% in 2024.
- Strategy: long EURZAR - rising oil prices, higher for longer rates narrative and fiscal risks weaken EM FX including ZAR

By Tatonga Rusike and Mikhail Liluashvili

Higher CPI risks + higher global rates for longer

We are making a new call: we now think SARB is likely to hike at the November MPC before initiating cuts in 2H 24. The near-term inflation outlook has weakened. New risks have emerged: higher oil prices + an outbreak of bird flu, leading to shortages of poultry products and a likely rise in food prices near-term. Oil prices are close to $90 per barrel, while USDZAR is weakening near-term. A strong USD to year-end means a weaker ZAR as global interest rates are set to stay higher for longer. Near-term fiscal risks are likely concerning for the SARB too. We estimate headline CPI reaching 5.2% in September, 5.7% in October, and averaging 5.6% in 4Q 23. We now expect CPI of 5.5% at year-end 2023 compared to 5% in our previous baseline associated with a dovish outlook for monetary policy.

New baseline: 25bp hike in Nov, cuts in 2H 24

We now expect the SARB to hike 25bp on November 23, taking the policy rate to 8.5%, and thereafter remaining flat until the end of 1H 24. We are further pushing our first cut expectation to July 2024 (previously May 2024), after the Fed's expected June cut. This means cumulative cuts of 50bp in 2024 and 100bp in 2025. We now see inflation returning to 4.5% only in 2025. CPI is likely to average 5.3% in 2024.

Strategy: long EURZAR

A combination of rising oil prices, a higher-for-longer rates narrative and fiscal risks in EM are likely to weaken EM FX further. The rand is closely correlated with the broader dollar and EM FX; hence the stronger dollar should continue to weaken the ZAR, in our view. We opened a long EURZAR trade at 20.15 (current: 20.5, target: 21.15). The risk is significant fiscal stimulus in China that will drive the rand stronger (see EM Alpha: More pain for EM: long EURZAR 02 October 2023).

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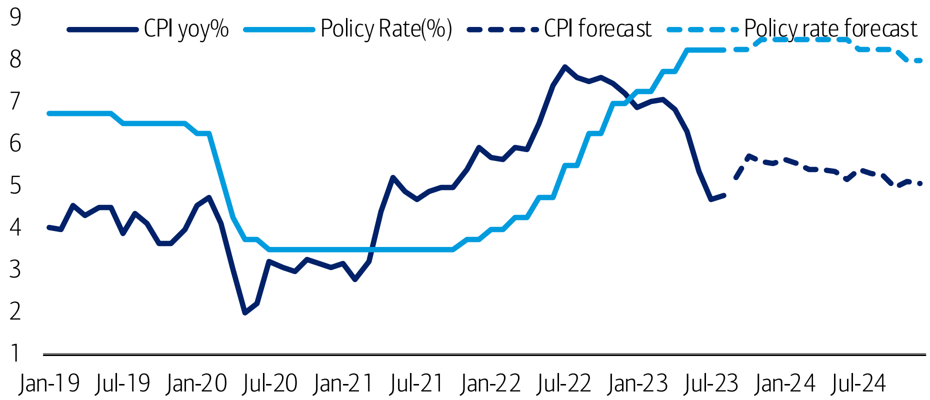
Higher CPI could prompt a SARB hike

Exhibit 1: Inflation and Monetary Policy History and Outlook
We are now forecasting a 25bp hike in November, before cuts in July 2024



Source: Haver, BofA Global Research

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Hawkish SARB likely to act

The July and September MPC decisions to hold the policy rate unchanged were rather too hawkish in our view. The inflation trend had continued a deceleration trend, with inflation falling back into the target range of 3-6%.

At the September monetary policy committee, members voted to hold with a narrow majority of 3 to 2 members. The minority voters for a hike argued that currency weakness, higher oil prices and fiscal risks had materialised since the July MPC. The voters who prevailed with the hold argument said substantial tightening had already taken place, including the 50bp hikes in each of March and May 2023, with the policy stance already restrictive, core inflation well behaved and less risk of second-round effects.

The inflation outlook since the August 2023 print of 4.8%, has weakened largely on higher oil prices, a bird flu outbreak, and a weaker ZAR. Going into the November MPC meeting, we think the members will be more worried about the likely upcoming prints for September and October, which will shape their final decision. While SARB expects the inflation outlook to deteriorate, we estimate the magnitude of deterioration to be higher than SARB's baseline. For instance, in 4Q, SARB expects headline inflation to average 5.4%, while we estimate around 5.6%. While the oil risk may have been factored into the forecast, the likely higher food prices stemming from the bird flu-affected poultry sector may not yet be fully accounted for. USDZAR has weakened further: spot levels have stayed largely above 19 compared to SARB's starting point at the September MPC of 18.45, or 18.13 at the July MPC.

Higher oil and food prices risk CPI close to 6% target

Rising oil prices have reignited higher inflation risks in South Africa. Year-on-year inflation had reduced to 4.8% in August, near the central bank's 4.5% mid-point target. Following the increase in international oil prices, local fuel prices have increased month on month by 7.5% and 4.7% in September and October, respectively. Largely driven by higher oil prices, we now expect inflation to reach 5.2% in September, then 5.7% in October, close to the 6% upper end of the target.

Other factors could push the October inflation print close to the 6% upper end of the inflation target. The bird flu outbreak is causing shortages of poultry products – chickens and eggs – that could push up poultry prices. We estimate food prices could increase by close to 2% month on month in October.

January medical inflation another upside factor

Medical inflation is likely to spike in January 2024, causing an overall increase in CPI year on year. Usually, medical insurers raise prices in February, but they have moved 2024 price adjustments a month earlier. Various medical insurers have announced average increases of around 7% starting in January. For instance, medical schemes weighted average increases are 7.5% for Discovery Health, 6.9% for Bonitas and 6.9% for Momentum, among other health insurance providers. The proposed increases are in line with the guidance from the regulator – the Council for Medical Schemes provided guidance on price increases of 5% plus a utilisation estimate of 3.2-3.8%.

Impact of El Nino not yet a near-term risk

The impact of El Nino is a quarter or two away. Delayed rains could result in lower harvests around March/April 2024, pushing food prices higher. The rainy season falls around November to March. South Africa has been experiencing La Nina, the opposite phenomenon, over the past three years – in effect, above-average rainfall. So that can help mitigate the El Nino phenomenon given some reserves are already in the system. The last El Nino was in the 2015/16 rainy season and largely resulted in higher food prices and inflation exceeding the upper end of the 6% target, from around 5%.

Higher oil to weaken near-term ZAR outlook

The oil supply shock is negative for emerging markets FX, including ZAR, as the dollar is likely to remain strong till year-end. USD-ZAR is likely to be weaker to year end, at 19 per USD compared to our previous estimate of 18.5. We maintain our view that dollar weakness will bring ZAR strength into 2024. Effectively, we push our constructive view on ZAR further into 2024 driven principally by our expectation of USD weakness as the Fed stops hiking in November 2023 and pivots towards cutting in mid-2024. A dovish Fed and global central banks generally support a weaker USD and favour EM currencies including the ZAR. We now forecast USD/ZAR at 18 in mid-2024.

Exhibit 2: USD-ZAR forecasts
Bearish short-term ZAR on strong dollar, bullish 12month view as dollar weakens

USD-ZAR	Q4 23	Q1 24	Q2 24	Q3 24	Q4 24	Q1 25
New	19.0	18.5	18.0	17.0	17.5	17.8
Old	18.5	18.1	18	17	17.5	17.8

Source: BofA Global Research

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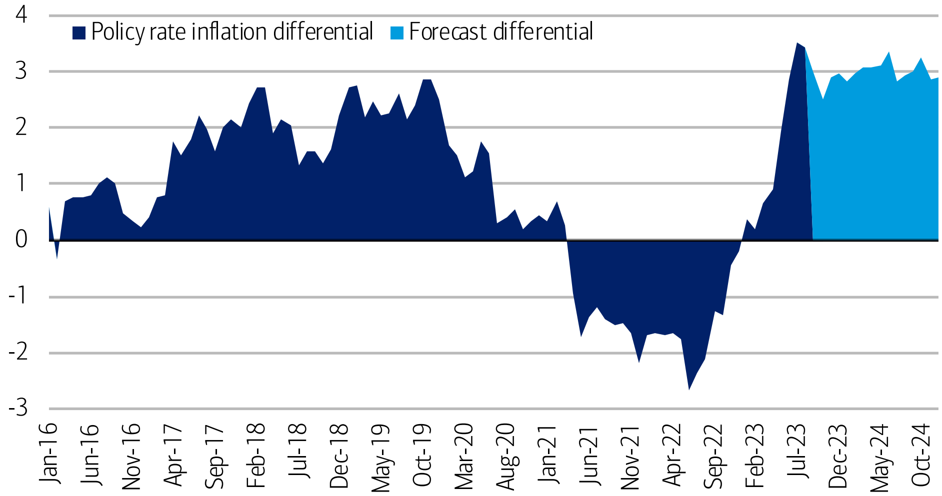
Optimal positive real rate

The monetary policy stance is considered neutral – neither restrictive nor accommodative – when the real rate is at 2.5%. An uncertain global environment with higher rates for longer, and rising domestic fiscal risks, means the SARB may have to consider higher real rates above neutral for monetary policy to be restrictive.

The central bank's forecasting model, the quarterly projection model (QPM), suggests no further changes to the policy rate to year-end, with cuts of 67bp in 2024 and 26bp in 2025. Combining policy rate forecasts with SARB inflation projections, we see their estimates suggesting positive real rates of 2.5% in 2024 and 3.3% in 2025. However, we think that the landing scenario is likely to be in between the two rates. The QPM has been dovish in forecasting rate hikes and is likely more conservative on the cuts too. Our baseline sees real positive rates likely staying close to 3% over the next 12 months. The scenario accommodates our November 25bp hike, and 50bp cuts in 2024. See Exhibit 3 below.

Exhibit 3: Policy rate-inflation rate differential (%)

SARB has a neutral interest rate estimate of 2.5%, while we think that real rates are likely to be close to 3% over the next 12 months due to higher global rates for longer, rising domestic inflation and fiscal risks



Source: BofA Global Research

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Fed is nearing the end of its hiking cycle

Our US economics team views the surge in energy prices as unlikely to move the needle on rate hikes as long as inflation in the rest of the consumer basket moves in the right direction. The risk is that persistently higher energy prices negatively impact inflation expectations and the Fed stays higher for longer. The Fed is likely to hike 25bp one last time in November, for a terminal Fed funds rate of 5.5-5.75%. Our economists also believe the Fed will deliver 75bp of cuts next year, starting in June 2024 and proceeding at a quarterly pace.

Exhibit 4: South Africa macroeconomic forecasts

We now see a 25bp hike in November, taking the policy rate to 8.5% at year-end, and 50bp cuts in 2024

	2019	2020	2021	2022	2023e	2024f
Real GDP growth (%yoy)	0.3	-6.0	4.7	1.9	0.7	1.5
CPI average (%yoy)	4.1	3.3	4.6	6.9	5.9	5.3
Policy rate (%, end of period)	6.5	3.5	3.8	7.0	8.5	8.0
Fiscal Bal (% of GDP)	-6.1	-9.8	-5.1	-4.5	-6.1	-5.9
Primary Bal (% of GDP)	-2.5	-5.7	-0.8	0.1	-1.5	-1.2
Debt (% of GDP)	59.2	70.2	68.1	71.1	75.1	75.5
Current Account Deficit % of GDP	-2.6	1.9	3.7	-0.5	-2.3	-2.7
Exchange rate (USD/ZAR end period)	14.0	14.7	15.9	17.0	19.0	17.5
Exchange rate (USD/ZAR avg)	14.5	16.5	15.0	16.5	19.0	17.8

Source: Haver, BofA Global Research

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Strategy: long EURZAR

EM FX is still pricing a narrow soft-landing path, in our view. However, a combination of rising oil prices, a higher-for-longer rates narrative and fiscal risks in EM are likely to weaken EM currencies further. The rand is closely correlated with the broader dollar and EM FX; hence the stronger dollar should continue to weaken the ZAR, in our view. We prefer to express our bearish view on the rand against the EUR in order to diversify our longs away from the dollar and because the entry point looks attractive for EURZAR. We opened the trade at 20.15 (current: 20.5, target: 21.15, stop: 19.6). The risk is significant fiscal stimulus in China that will drive the rand stronger. For the original trading idea, please see EM Alpha: More pain for EM: long EURZAR 02 October 2023.

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