Economic Update

1. SA Reserve Bank kept rates unchanged, as expected, but revised down its GDP growth forecasts and warned about some upside risks to inflation.

2. SA trade balance improved in February to +R4 billion, after a very substantial deficit of -R13 billion in January 2019. During the month exports of vehicles surged R8.5 billion while machinery imports declined by R4.2 billion.

3. SA petrol price will increase by a substantial R1.31/l on Wed 3 April 2019.

4. US confidence indicators have weakened further in early 2019, with the risks weighted to the downside.

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1. The South African Reserve Bank decided to leave the Repo rate (Repurchase Rate) unchanged at 6.75% at its MPC meeting last week. This was a unanimous decision and in line with market expectations. The Reserve Bank last adjusted interest rates in November 2018, when it hiked rate by 25bps. The Governor highlighted that the Bank has revised down its growth forecast for 2019 to 1.3% from 1.7%, and that electricity, petrol, water and food together with some rand weakness present upside risks to inflation. We expect SA interest rates will remain on hold for the remainder of 2019.

In terms of inflation the Reserve Bank highlighted the following:

- The medium-term outlook for inflation is impacted by higher energy tariffs and rising food and fuel prices.
- Headline inflation is expected to average 4.8% in 2019, before increasing to 5.3% in 2020 and moderating to 4.7% in 2021. Headline CPI is expected to peak at 5.7% in the first quarter of 2020.
- The assumptions for Brent crude oil in the Quarterly Projection Model (QPM) were revised up by US$2/barrel from $62 to $64 for 2019.
- Food price inflation is expected to bottom out in the first quarter of 2019 and peak at 5.9% in the second quarter of 2020.
- The assumption for electricity price inflation, which takes into account municipal price adjustments, has increased from 12% to 13% for 2019/20 and from 6% to 9% in 2020/21.
- Higher food, fuel and electricity prices are expected to lift inflation over the medium term.

In terms of the growth outlook, the Bank highlighted the following:

- Growth in household expenditure is expected to decline to 1% in 2019 and 1.4% in 2020 before increasing to 1.8% in 2021.
- The SARB now expects GDP growth for 2019 will average 1.3% (down from 1.7% in January). The forecast for 2020 is 1.8% (down from 2%), rising to 2% for 2021 (down from 2.2%).
- The Bank remains of the view that current challenges facing the economy are primarily structural in nature.
- The MPC believes the risks to the growth forecast will continue to be on the downside.

In terms of the rand exchange rate, the Bank highlighted the following:

- Since the January MPC, the rand has depreciated by 6.4% against the US dollar, by 5.2% against the euro, and by 6.1% on a trade-weighted basis.
- The implied starting point for the rand is R14 to the dollar, compared with R14.30 at the time of the previous meeting. At these levels, the QPM believes the rand to be less undervalued.

Lastly, the Governor indicated that the implied path of policy rates generated by the Bank's QPM is for one hike of 25 basis points, reaching 7% by the end of 2021.

In conclusion, although inflation has generally surprised on the downside in recent months, the sharp increase in electricity, water, and fuel prices will tend to push inflation higher over the coming months. At the same time the increased electricity constraints have resulted in a downward revision to SA growth in 2019, with risk to the downside. Once again the Bank acknowledged the weakness in the domestic economy is largely unrelated to interest rates. While the longer-term risks to the SA inflation forecast are still somewhat to the upside, the Bank can afford to keep rates on hold for an extended period while it watches international and local developments, including the path of international interest rates.

2. In February 2019, South Africa's trade balance recorded a surplus of R3.99 billion, which was mostly in line with market expectations for a surplus of R3.3 billion (Bloomberg). This compares with a deficit of –R13.1 billion in January and a surplus of R16.6 billion in December 2018. The monthly trade data is notoriously difficult to forecast accurately, especially since the data is not seasonally adjusted and prone to revisions.

For 2018 as a whole South Africa's trade surplus totalled R14.12 billion, which is well below the 2017 surplus of R76.63 billion. The improvement in the trade balance during 2017 helped to support the rand at the time, especially towards the end of 2017. In contrast, during 2018 the trade account started to systematically weaken, with the country recording a deficit in the first eleven months of the year. Correspondingly, the rand exchange rate remained under pressure during most of 2018.

In February 2019 exports increased by a substantial R9.5 billion (10.7%m/m), while imports declined by R7.6 billion (7.4%m/m). Unfortunately, in dollar terms, SA exports continued to decline in February, which is especially concerning since global trade has slowed appreciably in recent months (see chart attached and discussion below). A sustained moderation in SA export growth would significantly hurt the chances of the economy experiences an economic revival in 2019.

Looking back over the past few years, it seems fair to argue that the South African trade account benefited – at least to some extent – from the buoyancy in the world economy in 2016/2017, partly through an increase in exports. This was reflected in a sharp narrowing of South Africa's current account deficit to less than 3% of GDP (see charts attached). However, more recently a broader range of factors have shaped South Africa's trade performance. In particular, the rise of global trade protection has led to some moderation in global trade, making it a little more difficult for South Africa to grow its exports. At the same time the weakness in the domestic economy tended to dampen import demand in early 2018, but with inventory levels falling further in the first half of 2018 and the economy emerging from recession in Q3/Q4 2018, there has been a near-term acceleration in import demand.

Lastly, the volatility of the rand has been exacerbated the volatility of the trade data, with many companies spending an increased amount of time trying to actively manage their currency risk.

On a trend basis, South Africa's trade balance remains in surplus (see chart attached), but the extent of the surplus has narrowed significantly over the past year. Should the performance of the economy gain some momentum in the second half of 2019, and at the same time the level of global trade protection remain problematic, export growth would most likely struggle to gain traction, while import demand could accelerate. This combination would lead to a worsening of South Africa's current account deficit during 2019/2020. A larger current surplus would not be ideal, given the current increased vulnerability of emerging market currencies and the unpredictability of capital flows to emerging markets. All of this means the rand remains, fundamentally, at risk, although the recent bout of currency weakness suggests the rand could stabilise if Moody's decides to leave South Africa's credit rating unchanged, when they eventually publish their credit review of SA.

3. The Department of Energy announced that the petrol price (95 ULP and 93 ULP) will increase by R1.31/l and R1.34 respectively, with effect from Wednesday, 3 April 2019. The latest announcement means that the price of 95 Octane (LRP, Gauteng) will now cost R16.13 a litre, still below the peak petrol price of R17.08 in October and November 2018. The price of diesel (0.05% sulphur) will increase by 81c/l while diesel (0.005% sulphur) will rise by 82c/l. The cost of paraffin will increase by 65c/l (retail price), while the gas price will increase by a substantial R171/kg.

April is a significant month in the fuel price calendar since there is a revision in the road and pipeline tariffs as well as the Fuel and Road Accident Fund levies which are implemented into the price structures of petrol, diesel and illuminating paraffin. Their total contributions to the fuel price increase are about 26c/l in Gauteng. The average international product prices of petrol, diesel and illuminating paraffin increased during the period under review. The rand depreciated against the dollar during the period under review on average, when compared to the previous period. The average rand/dollar exchange rate for the period 1 March 2019 to 28 March 2019 was R4.38 compared with R13.80 during the previous period. The international factors amounted to R1.06c/l on petrol and 56c/l on diesel and illuminating paraffin.

The petrol price rose by a considerable 74c/l last month and, with the latest hike in the petrol price this month, will contribute considerably to the rise in the monthly inflation rate. We continue to expect SA consumer inflation will remain under control within the next few months but will in all likelihood move above 5.5% in early 2020. The Reserve Bank should nevertheless keep interest rates on hold for the remainder of this year.

Lastly, while SA consumer spending has been the key underpin to SA's economic growth in recent years, a couple of factors have dampened the outlook for consumer activity in 2019. These include the latest increases in the petrol price, the ongoing weakness in domestic economic activity, a further slowdown in wage growth as the private sector continues to cut costs, and dwindling bonus payments as corporate earnings take strain. There are also hikes in electricity tariffs awarded to Eskom by NERSA which also come into effect in April. Hopefully, after the National Election on 8 May, sentiment will start to tick up, resulting in some economic improvement.

4. In early 2017 we introduced an economic research product that scores a range of US confidence indicators on a monthly basis. This has been done as part of our ongoing evaluation of the effectiveness of US economic policy initiatives (especially since the election of President Trump), and the relative strength of the US economy. Attached is the US confidence report for March 2019. **Overall, the mix of confidence indicators have weakened noticeably in the past couple of months and, collectively, are at their lowest level since President Trump was elected. At this stage the confidence levels are not indicative of an imminent recession, but are signaling a meaningful slowdown in economic activity, with risk to the downside.**

It is clear that the initial boost in US business confidence in late 2016 and early 2017 was linked to Trump's promises regarding tax cuts, less business regulation, greater trade protection and increased spend on economic infrastructure. After that business confidence levels increased further, achieving a number of record levels in August/September 2018, including the highest overall level of confidence ever recorded, surpassing the previous high set in July 1983. Other record levels include job creation plans, job openings, and the intention to expand. This was a very impressive set of business confidence indicators.

However, most confidence indicators have weakened in the past three to five months. These include the ISM manufacturing index, the outlook for small business over the next six months, and various aspects of consumer confidence. Unsurprisingly, the US leading economic indicator has also slowed appreciably and the 10-year/2-year yield gap has narrowed significantly further.

The fall-off in confidence appears to relate to a variety of factors including the escalation of trade tensions between the US and China (as well as between the US and a range of other countries), the recent and prolonged US government shutdown, the systematic increase in US interest rates (in 2018 the US Federal Reserve increased rates four times and by 25bps on each occasions), the rapid increase in US government debt that has become much more noticeable more recently, and a loss of economic momentum in other key areas of the global economy, especially the Euro area and China.

There is a strong and positive correlation between US confidence and economic growth. Hence a sustained weakening of various confidence indices would signal a slowdown in economic activity, which would undermine corporate earning's expectations and market valuations.

The consensus US GDP growth estimate for 2019 is currently 2.4%, which is down from 2.9% in 2018, but marginally above the average growth rate the US has experienced since the global financial market crisis in 2008/2009, which is 2.3%. The risk to US economic growth in 2019 is, unfortunately, to the downside. At this stage the weakness in the US economy is more pronounced in areas such as manufacturing, housing and exports. However, there is some evidence to suggest that household spending is softening. A sustained weakening of household income and spending would signal that the US slowdown has become more significant.

The confidence indicators we have chosen to monitor each month include the following:

- ISM manufacturing index
- ISM non-manufacturing index
- NFIB Business Confidence
- NFIB Hiring Plans
- Wells Fargo Small Business Confidence
- US consumer confidence (Conference Board)
- US prospective home buyers
- US leading indicator

Each of the above indicators is scored (subjectively) on a scale of 1 to 10, with 10 being extremely high confidence. Currently (end-March 2019), **the average of all eight indicators scored a more subdued 6.6 out of 10, which is still reasonably high, but well off the peak achieved in late 2018**.

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