The US inflation impulse: pressure on SA contained

The latest US inflation print may have increased doubts that South Africa can escape most of the inflationary pressures observed in the US. For one, it seems as if the FRA market believes South Africa will not be able to escape these pressures. The FRA market is currently pricing in 250 bps of hikes over the next two years, which, in our view, is consistent with inflation expectations closer to 6% by the end of next year. These inflationary pressures may arrive for South Africa, but our estimates suggest the US is unlikely to be the major source of such inflationary pressures.

US raises inflation fears; is the pressure on South Africa contained?

We estimate how much of the US's, the EU's and China's inflationary pressures are passed through to domestic inflation. These three economies are not only the largest economic blocs in the world but also South Africa's largest sources of imports. The US inflation impulse on South Africa's inflation settles just above 10% after six months. The impulse from China settles just above 20%, while that of the EU settles at 35%.

The US alone unlikely to be a key driver of South Africa inflation

Our estimates suggest that US inflationary pressures alone are unlikely to be the key driver of South Africa's inflation rate – the transmission of economic conditions affecting US inflation is too small and additional pressure would need to come from somewhere else. We still disagree with FRA pricing that suggests South Africa will see inflation expectations closer to 6% (see In lockstep – the MPC and the Fed spread).

South Africa's January headline CPI expected at 5,6% yoy; hike in March

We expect South Africa's headline CPI to come in at 5,6% yoy for January when it is released on Wednesday, down from 5,90% in December. The December print is likely to have been peak inflation within the current 12-month inflation cycle. We continue to expect a 25 bps hike from SARB in March, irrespective of whether the Fed increases the Fed funds rate by 25 bps or 50 bps - from a real policy rate perspective the SARB continues to be well positioned relative to the Fed. We expect another three hikes of 25 bps each this year by SARB, putting the repo rate at 4,75% by year-end (up from 4,50% in January).

Despite inflation, SAGBs rally as Budget expectations look up

Last week, we updated our expectations for the 2022 Budget. We expect the Budget's headline numbers to handsomely beat expectations set in the MTBPS. As before, the long-term expenditure pressures remain acute, but the cyclically strong revenue overshoot is dominating near-term expectations (see 2022 Budget – revenue boom persists).

But upside for bonds will most likely be priced in by the time the Budget is read

Our fair-value estimate for the 10-year bond yield (R2032) remains at 9,9%, and after the recent rally in SAGBs, much of the upside is likely to have been priced in by the time the Budget is read on 23 February. We would look for the flattener to fade (see Flattener is running out of legs).

We are looking to turning better buyers of USD

On the USDZAR, our view remains unchanged. We have a fair-value point estimate at 15,20, with a neutral range between 15,10 and 15,70. This range is skewed for some rand weakness that may be induced by higher oil prices (see Shifting our bias as oil rises). Should the rand drop to 15,00, we would be better buyers of USD.

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US raises inflation fears, but the pressure on South Africa is contained

South Africa's inflation rate has been rising steadily since it bottomed at 2,9% in February last year. However, domestic inflationary pressures have been muted compared to what we observed in the US where headline CPI surprised on the upside again in January, coming in at 7,5% yoy. This latest US inflation print may have increased doubts that South Africa can escape most of the inflationary pressures observed in the US. For one, it seems as if the FRA market believes South Africa will not be able to escape these pressures. The FRA market is currently pricing in 250 bps of hikes over the next two years, which, in our view, is consistent with inflation expectations closer to 6% by the end of next year (see In lockstep – the MPC and the Fed spread). We continue to believe this is wrong.

Inflationary pressures from the US are smaller than what the FRA market is pricing in

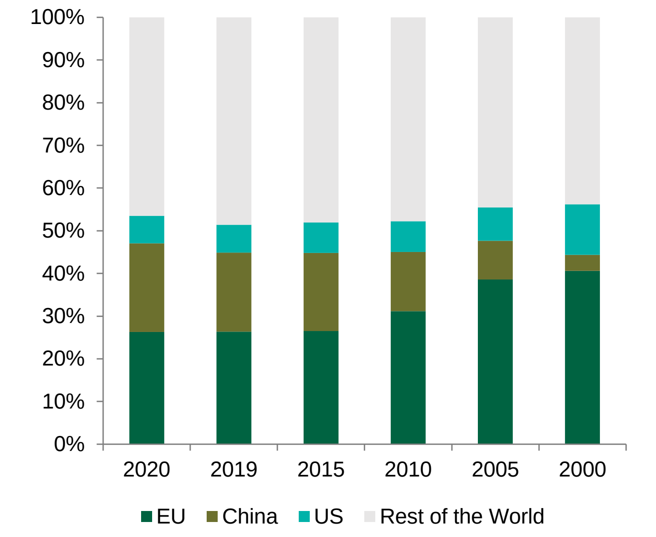
Our estimates suggest that if South Africa's inflation moves much higher than what we (or SARB, for that matter) expect, it will most likely not be because of the US.

We estimate how much of the US's inflationary pressure is passed through to domestic inflation. We also estimate the same for the EU and China. These three economies are not only the largest economic blocs in the world but are also South Africa's largest sources of imports, with 26% of imports coming from the EU in 2019 (pre-pandemic), 17,3% from China and 6,1% from the US (Exhibit 1). Furthermore, with the USD being the reserve currency of the world and China the largest commodity consumer, these three economies should account for a large part of South Africa's externally induced inflation.

US inflationary pressures on South Africa are 10% and smaller than those of the EU or China

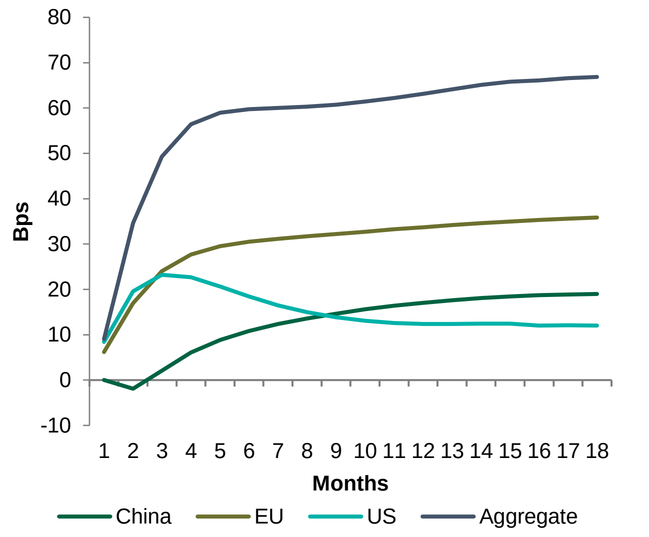
Exhibit 2 shows the impulse of a 100 bps rise in inflation in the US, EU and China on South Africa's inflation. Note that our estimates in Exhibit 2 are broader than simply import inflation. Our estimate reflects the effect of broader economic conditions that emanate from these large economies to South Africa's inflation, such as the fiscal and monetary policy stance of, for example, the US that may affect SARB's policy stance or financial conditions in South Africa, wage pressures, global aggregate demand and commodity prices. Imported goods and services would only be a sub-set of the effect we estimate.

Exhibit 1: The major sources of South Africa's imports



Source: Bloomberg, Nedbank CIB Markets Research

Exhibit 2: The impact of inflationary pressures on SA inflation



Source: Nedbank CIB Markets Research

The US inflation impulse rises initially to around 20% but settles just above 10% after six months. This implies that the economic conditions that push US inflation up by 100 bps are likely to push South Africa's inflation higher, on average, by 10 bps. China's inflation impulse is slower to transmit to South Africa but ends up settling around 20% after 12 months.

China's impulse, in our view, is slow to impact South Africa because it is transmitted mainly via real flows and commodity prices, whereas the US impact would largely be via portfolio flows in financial markets. Lastly, the EU's impulse has the largest impact on South Africa's inflation, settling at 35% after six months. The size and speed of the EU's impulse, in our view, reflects both the size of the import trade link and the financial market or portfolio flows.

Of course, it is possible that South Africa experiences an inflation impulse from all three economies at once. In such a scenario, about 65% of South Africa's inflation would be sourced from economic conditions generated by these three economies. Currently, the US is a source of a potential inflation impulse for South Africa, while the EU is increasingly looking like one, too. The aggregate impulse of these two economics adds up to 45% after 12 months. China, however, continues to have a very muted inflation outlook.

FRA market implies inflation expectations at 6%; this is to high

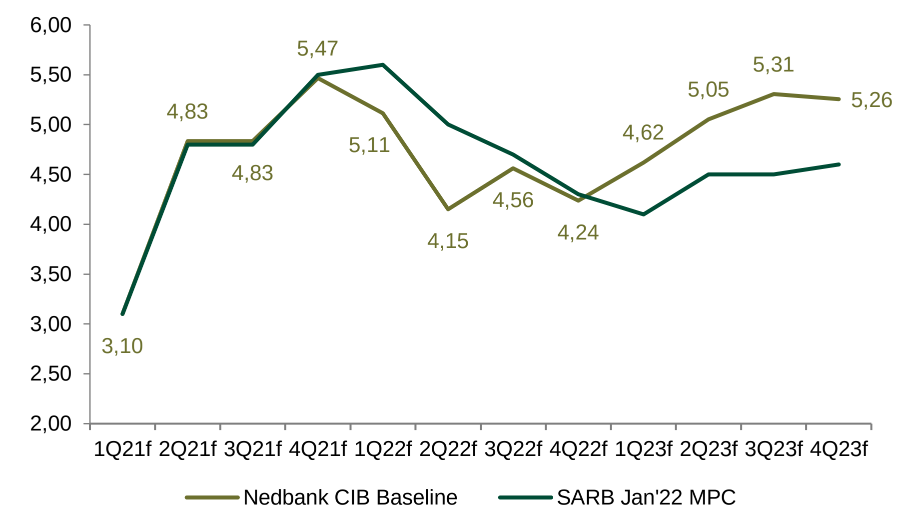
Our estimates suggest that US inflationary pressures alone are unlikely to be the key driver of South Africa's inflation rate – the transmission of economic conditions affecting US inflation is too small. EU inflationary conditions are likely to add upward pressure but remain more muted than the US's. Fortunately, by all accounts, it appears as if China's inflationary pressure remains well anchored around 2%. We would agree with SARB that upside risks to inflation remain in place if only from external conditions. But we still disagree with FRA pricing that suggests South Africa will see inflation expectations closer to 6%.

South Africa's January headline CPI expected at 5,6% yoy

We expect South Africa's headline CPI to come in at 5,6% yoy in January when it is released on Wednesday, down from 5,9% in December. We also expect the December print to have been peak inflation within the current 12-month inflation cycle. A key driver of CPI in January will still be transport inflation expected at 13% yoy. However, like headline inflation, transport inflation would have decelerated from 16,80% in December. We expect food inflation at 6% yoy and average 5,8% in 2022.

From here, we expect inflation to steadily decline towards 4,2% in 2Q22 and then steadily rise to end the year near the midpoint of the target band. We expect inflation to average 4,5% in 2022.

Exhibit 3: Our inflation expectations over the next 24 months



Source: Nedbank CIB Markets Research, SARB

We continue to expect a hike of 25 bps in March, irrespective of whether the Fed hikes by 50 bps or 25 bps

We believe SARB will hike by another 25 bps in March, irrespective of whether the Fed increases the Fed funds rate by 25 bps or 50 bps. In total, we expect SARB to hike the repo rate 100 bps this year (up from 75 bps previously). As such, we expect another three hikes of 25 bps each, putting the repo rate at 4,75% by year-end. Our view remains unchanged that SARB's policy stance is well positioned relative to the Fed's increasingly hawkish policy stance (see In lockstep – the MPC and the Fed spread) and that matching a Fed that is now expected to hike at least six times (25 bps each) in 2022 is unlikely.

Exhibit 4: Summary of our core macroeconomic and market views

Growth	We expect GDP growth of 5,0% yoy in 2021 and 2,0% yoy in 2022.
Currency	Our neutral range for the USDZAR is between 15,10 and 15,70, with a year-end target at 16,00. As such, we remain better buyers of USD when the rand strengthens below this range.
Inflation	We believe inflation will likely remain muted for some time. However, we expect inflation to rise sharply in the near term, due to higher administered prices, before settling back to SARB's midpoint target of 4,5%. We forecast CPI (average) at 4,5% in 2022 and 5,0% in 2023.
SARB	We expect SARB to hike by 25 bps in March. We forecast another 75 bps worth of hikes in 2022, taking the repo rate to 4,75% by year-end. We have a repo rate ending 2023 at 5,25%, compared to SARB's 5,84%.
Bond yields	Global factors, including a tighter monetary policy stance, higher global inflation rates and a higher risk-free rate (UST yields) have raised fair-value yields since our last update. Our fair-value estimate for the 10-year yield is 9,9% (R2032). We adjust our fair-value range for the R2048 50 bps higher to 10,50-11,00%.
Rating action	The recent GDP rebasing positively affected the sovereign's near-term debt burden metrics, and the revenue overshoot has helped narrow the primary budget deficit compared to what was expected earlier in the year. However, what induced the last cycle of downgrades was the pace at which debt was accumulating, rather than the absolute stock level of debt. While the pace of accumulation should slow in the coming years, rating agencies remain cautious, as long-run risks to GDP growth and fiscal stability still weigh on the credit outlook. The agencies still worry about commodity price reversals, the impact of global rate increases on emerging-market risk sentiment and the impact of local socio-political pressures on expenditure ceilings. Eskom and other SOE bailouts continue to cloud the fiscal outlook, while reforms are only taking shape slowly. Fitch rates South Africa "BB-/Stable", Moody's "Ba2/Neg." and S&P "BB-/Stable".

Source: Nedbank CIB Markets Research