18 August 2014

Headline CPI: perhaps past its peak

FX

Local CPI data will be published on Wednesday. Consensus pegs the July print at 6.4% y/y, lower than the 6.6% y/y reading in June. Base effects are favourable and material, with a 1.1% m/m (sa) increase recorded in July 2013. SBGS economist Kim Silberman sees inflation easing by slightly more than consensus, to 6.3% y/y. The 29c m/m increase in the petrol price translates to a softening of petrol price inflation from 13.4% y/y to 8.3% y/y, given a much larger m/m increase in July 2013. In June, petrol contributed 0.76 percentage points (pps) to the headline figure; this time, it will contribute only 0.43 pps. Food inflation is seen falling from 9.2% y/y in June to 9.0% y/y. Partially offsetting the deceleration in petrol and food inflation, are likely increases in water supply services and funeral services inflation (both are surveyed in July). Upside risks are seen stemming from vehicle price inflation off the back of exchange rate pass-through. Electricity is expected to have increased 7.1% m/m in July – that is, equivalent to the increase in July 2013, leaving electricity inflation flat Y/Y. If we are right regarding a below consensus CPI result, this would be interest rate positive and thus currency market negative.

Notwithstanding a drop in the level of inflation, the SARB's anxieties will be running high so long as the rate remains above the target ceiling. The SARB's inflation profile anticipates a deceleration in the rate of inflation in Q3:14, before resuming an upward trend again to peak in Q4:14 (at a quarterly average of 6.6%). The Bank expects that headline inflation will remain outside the band for an extended period – until Q2:15, according to its July forecasts. The Bank might lower these forecasts to take into account the July hike. At the March meeting – that is, following the January hike of 50 bps - the Bank adjusted its 2015 inflation forecast moderately from 6.0% y/y to 5.8% y/y; it left the peak in Q4:14 and the duration of the target ceiling breach unaltered. The Bank also mentioned in its July Statement that, even when inflation does return to within the target, it expects it to "remain uncomfortably close to the upper end of the target range". In light of this and its view that inflation risks lie to the upside, the Bank is acutely aware that its credibility, and consequently its ability to ensure that inflation expectations remain well anchored, are in a precarious position. We expect CPI inflation to average 6.1%y/y in 2014 and 5.1%y/y in 2015, and – while also expecting a pick-up in Q4:14 – we think that the y/y change might have peaked in June.

Key financial market indicators

Spot		chg	Cross Rates		chg
USDZAR	10.59	0.40%	EURUSD	1.34	0.27%
EURZAR	14.20	0.68%	GBPUSD	1.67	0.04%
GBPZAR	17.68	0.47%	USDJPY	102.36	-0.09%
ZARJPY	9.67	-0.48%	AUDUSD	0.93	0.03%
USDZAR fwd		chg	Commodities		chg
1m	10.65	0.41%	Gold	1304.83	-0.67%
3m	10.76	0.41%	Platinum	1455.75	-0.73%
6m	10.93	0.40%	Copper	6870.00	0.66%
12m	11.29	0.39%	Brent	103.53	1.49%
Equities/Risk		chg	US Yields/spreads		chg (pps)
ALSI	51194	0.35%	US 10 yr	2.36	-0.06
VIX	13.15	5.88%	US 30 yr	3.13	-0.06
MSCI World	1714	-0.09%	EMBI	308.44	4.58
MSCI EM	1075	0.20%	SA CDS	183.47	2.46
Bonds		chg (pps)	Rates		chg (pps)
R 203	7.06	0.04	3m JIBAR	6.08	0.00
R 208	7.82	0.03	FRA 3x6	6.22	0.01
R 186	8.26	0.04	FRA 6x9	6.46	0.06
R 214	8.96	0.03	FRA 12x15	6.81	0.04

Source: Standard Bank Research, Bloomberg

The SA Daily

South Africa | FX & FI

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The exchange rate was mentioned as "remain[ing] a key factor" in its view that inflation risks remain to the upside. This heightens the sensitivity of policy decisions to exchange rate movements. With the targeted inflation measure likely to remain well above 6.0%, the Bank's 'implicit tolerance' for currency weakness will be running low. It is important to note also that the Bank has previously mentioned that it already sees "indications of some acceleration" in pass-through and, consequently, it might not take much of a push here for the Bank to become acutely concerned. Analysts expect core inflation to hold steady at 5.6% y/y in July. In June core inflation kicked up after remaining at 5.5% y/y for three consecutive months. We anticipate core inflation rose to 5.7%y/y in July as food inflation moderated.

This week sees the release of minutes of the 29 to 30 July FOMC meeting.
As anticipated, the FOMC did not announce any major changes to its policy path at this meeting. The Committee made a "further measured reduction" in its asset purchases, keeping it on track to wind down the programme completely by the 28 to 29 October meeting – asset purchases will then end in November. There were, however, some subtle changes to the July FOMC Statement. The Committee no longer described the unemployment rate as "elevated", merely stating that it had declined further. Nevertheless, most likely to avoid any inference that its view on the labour market had changed appreciably, the Committee added that "a range of labor market indicators suggests that there remains significant underutilization of labor resources."
The Committee also removed language describing "inflation persistently below its 2 percent objective" as "pos[ing] risks to economic performance". This time, the Committee described the likelihood of inflation running persistently below 2 per cent as having "diminished somewhat". This could be read as a slightly more hawkish tilt. The minutes will shed further light on the debates that led to these changes. There was no explicit indication in the July Statement regarding the policy normalisation measures that might follow the conclusion of the Fed's bond-buying programme. The minutes of the meeting might be more telling in this regard, particularly if they reveal differing opinions on the Committee as to the appropriate profile for tightening steps. Keep in mind that one Committee member, Philadelphia Fed President Charles Plosser, chose to dissent at the July meeting. He objected to the use of "a considerable time" in providing guidance regarding the appropriateness of keeping the fed funds rate at current levels after the asset purchase programme ends. Plosser felt that such "time dependent" language did "not reflect the considerable economic progress that has been made toward the Committee's goals".

Also this week is the Kansas City Fed's annual Jackson Hole symposium. For the first time as Fed Chair, Janet Yellen will address the conference on Friday. She is not expected to make any significant monetary policy pronouncements, but rather stick to this year's theme, "re-evaluating labour market dynamics". However, any insights into how she, and others at the Fed, might evaluate the current labour market situation could provide hints as to the intended policy normalisation path. It will also be interesting to see what other papers might be presented at the symposium, and if there are any opinions regarding the amount of slack in the labour market that might contradict the Fed's view.

Fed policy normalisation should translate to dollar strength, especially against the euro and yen, where further policy easing appears likely. Consensus pegs the first hike in the fed funds rate as occurring in Q3:15. Steve Barrow, our G10 FIC Strategist, agrees with this view. Pricing in the fed funds futures market appears to be discounting a slightly earlier "liftoff" in Q2:15.

The rand weakened against the US dollar on Friday after five consecutive days of strength, closing at USDZAR10.59, compared with Thursday's close of USDZAR10.55. The rand depreciated despite a weaker performance from the dollar against the major crosses. The local currency weakened into a mixed to stronger bias among commodity currencies and into a mixed to weaker bias among EM currencies we monitor for purposes of this report. The dollar weakened mildly against the pound, the euro and the yen, with the biggest move seen against the euro (0.3%). Three of the five commodity currencies we monitor – namely, the NOK, the CAD and the AUD – appreciated on the day. The exceptions were the NZD and the ZAR, both of which depreciated. All but three of the EM currencies we monitor depreciated on the day. The exceptions were the BRL and the IDR, both of which appreciated, as well as the INR, which was unchanged. The rand was the worst-performing commodity currency and ranked third last among EM peers (beating only the TRY and the RUB). The rand traded between a low of USDZAR10.5320 and a high of USDZAR10.6283 on Friday. Support from where the rand opened this morning sits at 10.5250, 10.4850, 10.4560 and 10.4000. Resistance levels sit at 10.6160, 10.7200 and 10.7700.

Turning to commodity prices, Brent and copper rose by 1.5% and 0.7% respectively. The recovery in Brent followed a move higher last week due to Ukrainian forces having attacked a military convoy from Russia. Platinum and gold meanwhile both fell by approximately 0.7%. The ALSI rose by 0.4% and the EM MSCI rose by 0.2% on the day. The EMBI spread widened by 5 bps and the SA CDS 5yr spread widened by 2 bps. The CBOE VIX index, a volatility proxy for global risk appetite/aversion, rose by 5.9%.

Non-residents were mild net sellers of local equities (-ZAR153 million) and were aggressive net sellers of local bonds (-ZAR1 482 million) yesterday. Selling of bonds was seen in the 12+ (-ZAR1 532 million) year bucket. Buying was meanwhile seen in the 3-7 (ZAR39 million) and 1-3 (ZAR11 million) year segments; net buying/selling in the 7-12 year segment was flat. Bond yields rose by between 3 bps (R208 and R214) and 4 bps (R203 and R186) on the day. The 3x6, 6x9 and 12x15 FRAs rose by 1 bp, 6 bps and 4 bps respectively.

By Bruce Donald, Marc Ground and Varushka Singh

FI

The main data print this week will be July CPI on Wednesday, the second of three that the SARB will see prior to their September MPC meeting. After May and June saw consecutive 6.6% y/y prints, Bloomberg consensus is for July to print at 6.4% y/y. SBGS' forecast is for a slightly lower 6.3% y/y, primarily "due to petrol price inflation, which fell from 13.4% y/y in June to 8.31% in July and will shave 0.29 ppts off the headline rate". We expect the bond market to trade fairly range-bound in the days prior to this print.

On Friday we published the SA FI Weekly, "SA Growth Cycles and Bond Market Performance", discussing the growth trajectory in South Africa and how assets have performed.

Friday was another quiet day, with only ZAR12.16bn traded in nominal SAGBs and a further ZAR2.24bn in inflation-linked debt. The R186 accounted for 31% of nominal turnover, due to offshore selling in the bond, while the R2048 accounted for 13% of turnover. The entire curve weakened on Friday, with yields ticking by 2 bps (the R2048) to 4.5 bps (the R2030). The yield on the R186 moved 3.5 bps higher. Over the course of the week, the curve steepened, with front-end rates, up to and including the R186 rallying, while bonds from the R2032 selling off slightly. FRAs ticked slightly higher on Friday, but remain considerably lower over the course of the week. The US Treasury curve flattened further on Friday, as USTs strengthened overall. The yield on the 2yr UST fell by the smallest increment, of 0.84 of a bp to 0.41%. The yield on the 5yr UST fell by 3.79 bps to 1.54%, and the 10yr UST fell by the largest increment, of 6.18 bps to 2.34%. At the longer-end, the yield on the 30yr note fell by 5.94 bps, to 3.13%.

Non-residents were net sellers of nominal SAGBs on Friday for a total of -ZAR1.48bn. This followed positive sentiment (on Thursday), in which foreigners purchased +ZAR589m of nominal SAGBs, after recording five preceding trading days of net selling. Friday's outflows were concentrated in the 12+ year segment, with -ZAR1.53bn sold in this category. Significant selling in this category was recorded in the R186 (-ZAR810m), R2048 (-ZAR315m), R213 (-ZAR331m), R2032 (-ZAR200m) and R2030 (-ZAR100m). Net buying in this extended maturity segment was meanwhile recorded in the R214 (+ZAR188m) and R209 (+ZAR107m), which partially offset the overall net selling. The only other notable transaction on the day was recorded in the R208, which recorded +ZAR142m of foreign buying.

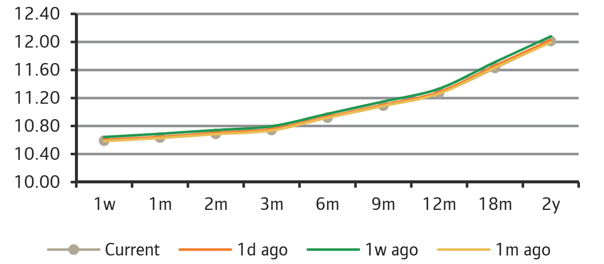
Friday's ILB auction of the I2038, R212 and I2046 saw good demand, with total bids improving substantially from the previous week's auction, in tandem with a pickup in investor participation at the offering. Auction bids increased to ZAR1.81bn from the prior week's ZAR1.07bn, recording an auction bid/cover ratio of 2.3x at Friday's auction (previous auction: 1.3x). Pricing was in line with Thursday's closing MTM levels, with the exception of the I2046, which priced 1.00 bp more competitively. Market participation improved to 22 participants on Friday compared with only 10 participants at the last offering. The I2038 and the I2046 attracted an almost equitable amount of investor interest, with the I2038 receiving 37% of bids, and the I2046, 36% of bids. The R212 received the remaining 27% of investor bids. The I2046 cleared at 1.93%, 1 bp stronger than Thursday's closing MTM yield of 1.94%. The I2038 cleared at 1.90% and the R212 priced at 1.63%, both in line with their respective MTM levels. The I2038 and the R212 were both auctioned at the previous week's ILB government offering, and compared with those clearing yields, the I2038 cleared in line with its prior auction level, while the R212 priced 2.00 bps higher.

EM FI markets strengthened on balance on Friday, skewed by moves recorded in Russia and Brazil. 5yr yields fell by 1.28 bps on average and 10yr yields fell by 2.64 bps on average. SA's FI market moved in the opposite direction to US Treasury yields on Friday, as SAGBs sold off. This saw the local market deliver a poor performance against the EMs we consider for the purposes of our reports, despite many of the EM FI markets we cover weakening on the day. SA was the worst performer in the 5yr space, with the yield rising by 2.70 bps, and was the second worst performer in the 10yr space, with the yield rising by 3.60 bps. Turkey was the worst performer in the 10yr space, with the yield rising by a relatively larger 11.00 bps, while recording the second-worst performance in the 5yr space, with the yield rising by 1.00 bp. FI markets in Indonesia, Poland and Hungary also weakened on Friday. In contrast, Russia's FI market recorded the best performance in the 5yr space, with the yield declining by 12.19 bps and the 10yr yield recorded the second best performance, declining by 11.08 bps. Brazil's 10yr yield recorded a sharp decline on the day, falling by 25.70 bps. FI markets in Mexico and Thailand also strengthened overall on Friday.

Most of the EM currencies we monitor depreciated on Friday. The rand depreciated by 0.40%, behind larger moves weaker in the Turkish lira (0.73%) and Russian ruble (0.69%). The Polish zloty depreciated by 0.38% and the Hungarian forint depreciated by 0.32%. The Brazilian real was the only EM currency we monitor, to appreciate notably on Friday, by 0.29%.

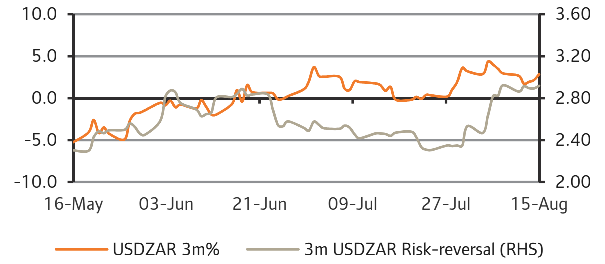
By Asher Lipson and Kuvasha Naidoo

Figure 1: USDZAR forwards



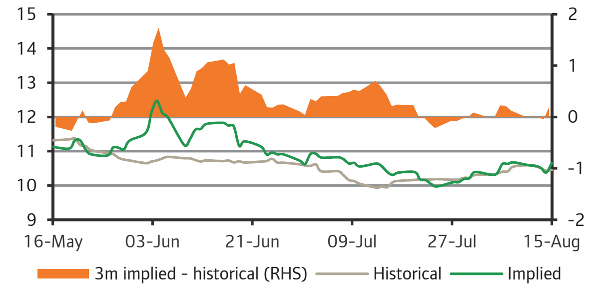
Source: Standard Bank Research, Bloomberg

Figure 2: USDZAR vs risk-reversal



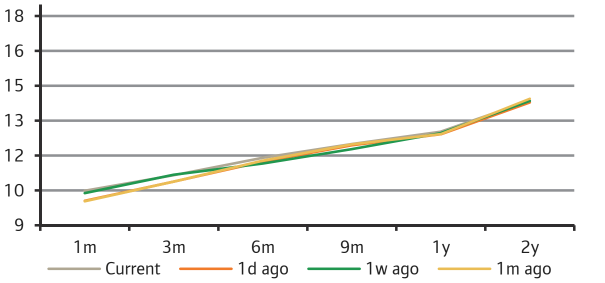
Source: Standard Bank Research, Bloomberg

Figure 3: Implied vs. actual USDZAR volatility



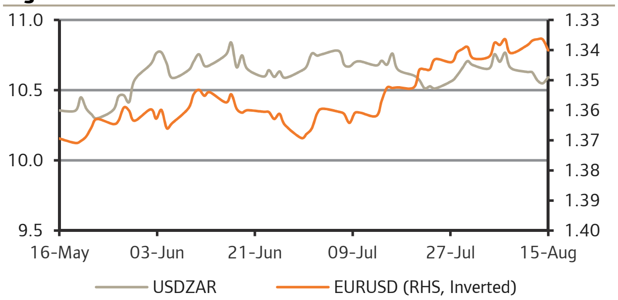
Source: Standard Bank Research, Bloomberg

Figure 4: USDZAR volatility curves



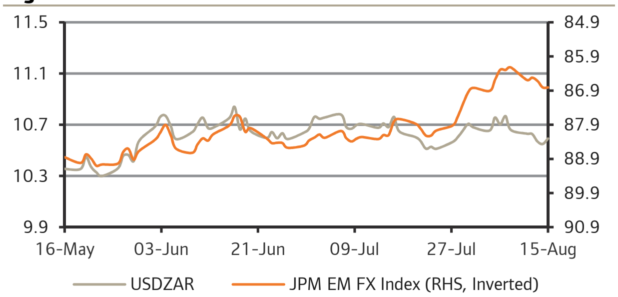
Source: Standard Bank Research, Bloomberg

Figure 5: USDZAR vs. EURUSD



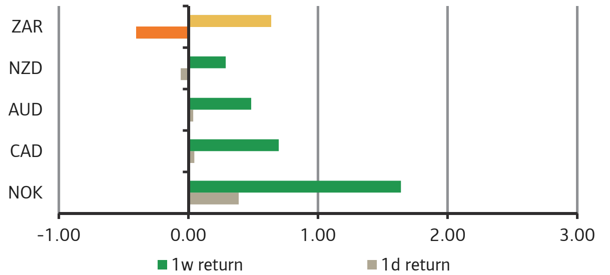
Source: Standard Bank Research, Bloomberg

Figure 6: USDZAR vs. EM FX index



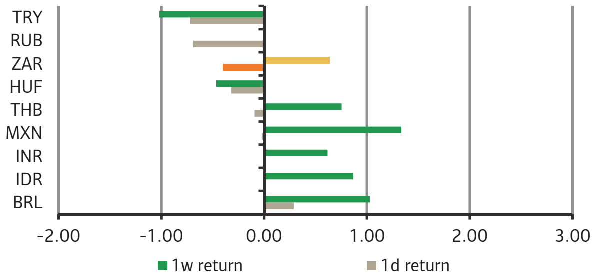
Source: Standard Bank Research, Bloomberg

Figure 7: USDZAR vs. commodity currency performance



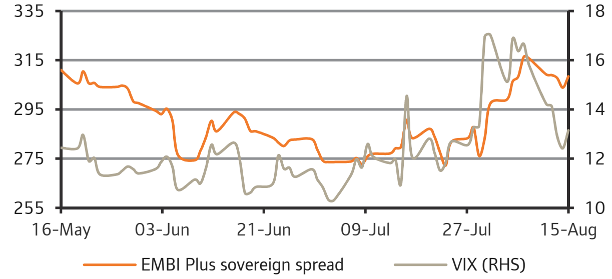
Source: Standard Bank Research, Bloomberg

Figure 8: USDZAR vs. EM currency performance



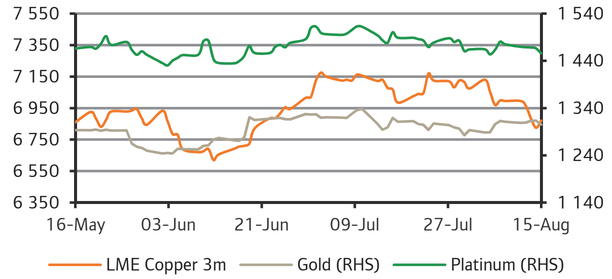
Source: Standard Bank Research, Bloomberg

Figure 9: VIX global risk appetite proxy vs. EMBI



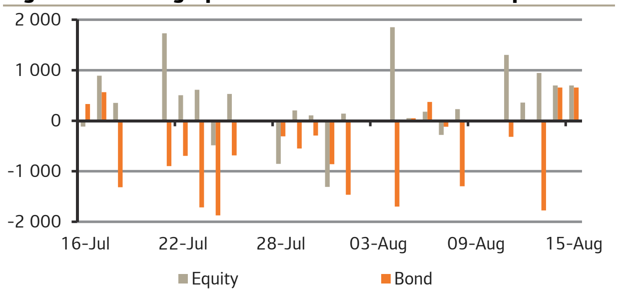
Source: Standard Bank Research, Bloomberg

Figure 10: Commodity prices



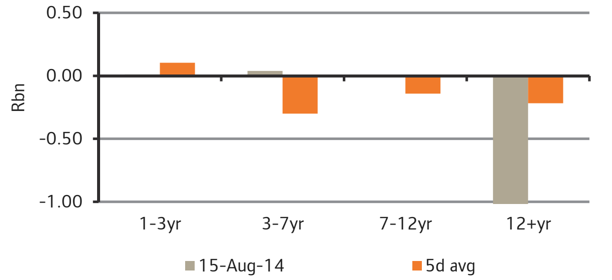
Source: Standard Bank Research, Bloomberg

Figure 11: Foreign purchases of SA bonds and equities



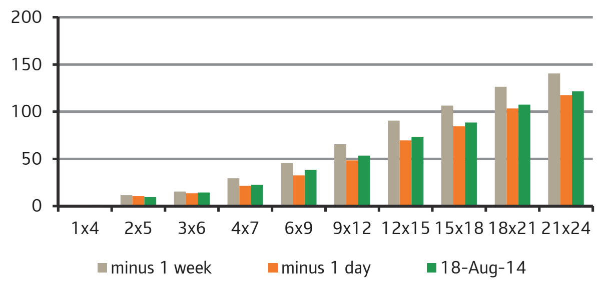
Source: Standard Bank Research, Bloomberg

Figure 12: Foreign purchases of SA bonds by maturity



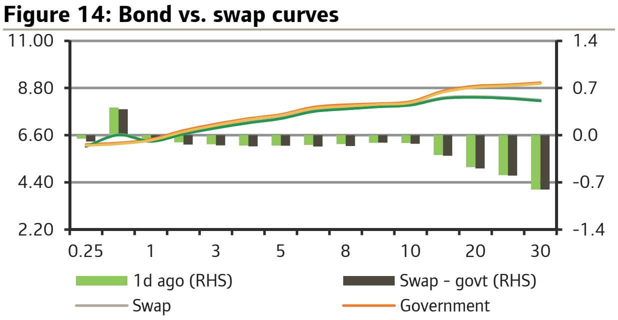
Source: Standard Bank Research, JSE

Figure 13: FRAs less JIBAR



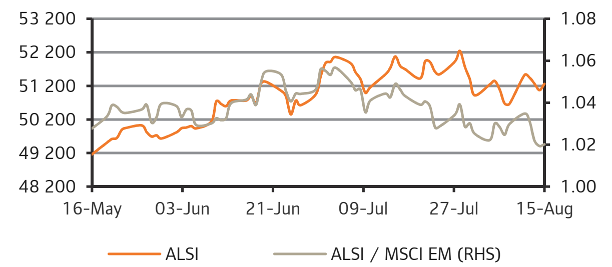
Source: Standard Bank Research, Bloomberg

Figure 14: Bond vs. swap curves



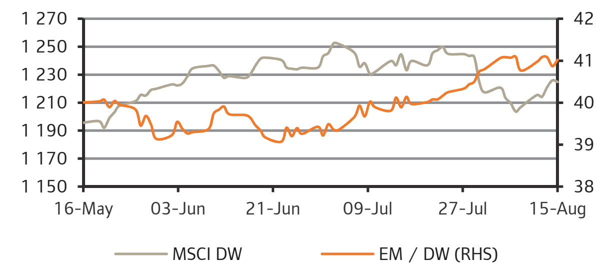
Source: Standard Bank Research, Bloomberg

Figure 15: ALSI vs. ALSI/MSCI EM relative



Source: Standard Bank Research, Bloomberg

Figure 16: MSCI EM vs. MSCI EM/DW relative



Source: Standard Bank Research, Bloomberg

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