Up? Down? Or Just Right?

Interest Rate Comment

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Executive Summary: Which Way Next for the Repo Rate?

Next week sees the South African Reserve Bank's Monetary Policy Committee (MPC) meet for the last time this year. The next time they meet will be in February 2006. The tone of October's MPC meeting led to heightened speculation that the repo rate would be raised – albeit modestly – at either the December or February meeting. Certainly, the bond market was of the view that rates were heading higher. However, recent economic developments paint a different picture than that of mid October.

More specifically, since the MPC's October meeting a number of economic factors have emerged that suggest that the pressure to raise rates is diminishing. For instance, the oil price has fallen significantly; interest rates in the United States and Europe have been hiked and, despite these rate increases, the Rand has remained relatively strong; the economy has attracted new foreign direct investment flows in the form of Vodafone's bid for Venfin's stake in Vodacom – a deal valued at R15 billion; money supply growth and growth in private sector credit extension have slowed; and inflation numbers at the consumer and producer level have surprised analysts by coming in lower than consensus. It is also apparent that the economy is growing at a rapid pace – far faster than previously thought – and government finances are in good shape to the extent that the 2006 fiscal year could produce a budget surplus.

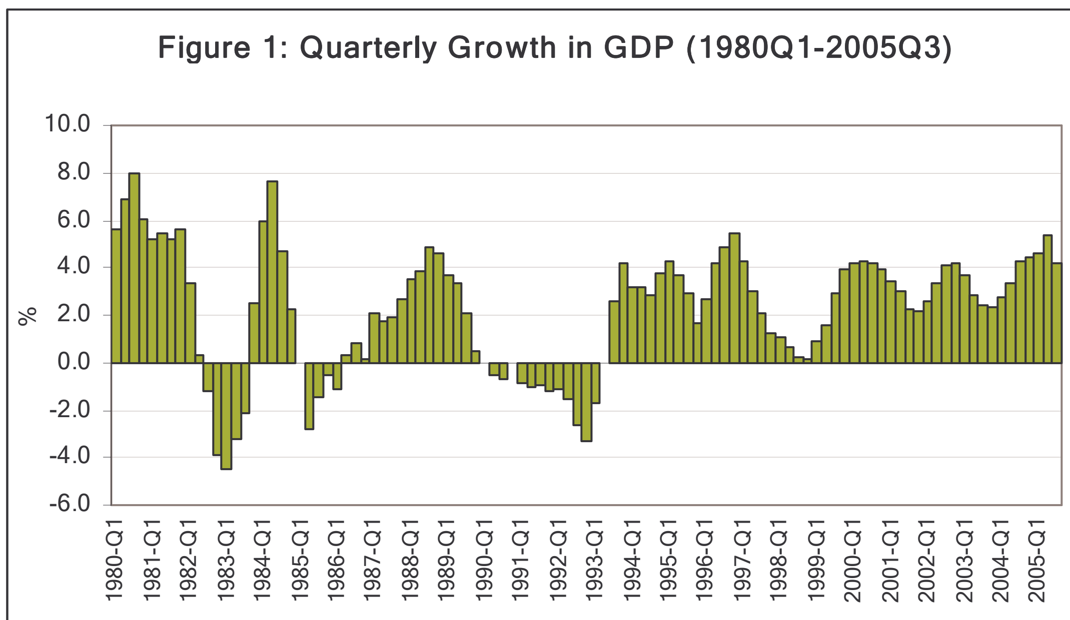
That said, factors that suggest a rate hike is in the offing linger. The economy continues to suffer from a savings shortage, which acts as a choke on investment growth; the trade and current accounts are recording large deficits; household debt remains at record high levels; and although growth in money supply and credit extension have slowed, the pace of expansion is still too high to believe that, at some stage, the monetary growth will not translate into price inflation.

When read in combination, we are of the view that the MPC will decide not to move the repo rate when it meets next week. However, in sharp contrast with our October assessment of the rate environment, if the extant economic conditions extend into 2006 then there is a distinct possibility that the next move in rates is down – and not up.

Comment on the Economy: Which Way Next for the Repo Rate?

An assessment of recent data releases and the extant economic environment suggest that the **pressure to raise the repo rate** that was evident in October of this year has **subsided substantially**. Below, we review some of the more important date that we think the South Africa Reserve Bank's MPC will consider when making their decision on the interest rate next week. We are of the view that the odds of a rate hike next week have almost dissipated and that the greatest likelihood is that next week's decision will be that rates are to remain on hold. However, looking beyond next week's meeting, it becomes evident that the reading of economic conditions has changed significantly since the MPC last met. Should this condition persist into 2006 then there is growing probability that **the next move in the repo rate could be down** and that this could happen as early as February 2006. We review the data and arguments below.

- Data released this week show that the South African economy continues to grow at a **rapid pace**. More than that, however, the expansion recorded by the economy over the past decade is nearly **devoid of the boom-and-bust feature** that characterised growth over the 1980s and first part of the 1990s (see Figure 1). In itself, this provides sound evidence of the structural adjustments that the economy has undergone since 1994. This changed nature of the economy gives us confidence that the **benign** inflation and interest rate environments of the recent past increasingly will become **engrained features** of the local landscape.



Source: Adapted from South African Reserve Bank and Statistics South Africa

- More specifically, the data released this week show that gross domestic product (GDP) grew by 4.2 percent in the third quarter of 2005. This represents the 28th consecutive quarter of growth, meaning that the South African economy has **not experienced a production downturn since the late 1990s**.

- Equally, it is noteworthy that this week's GDP data released saw Statistics South Africa revise previously reported growth figures upwards (in most places quite sharply). This was not out of line with expectations, but the result indicates that the economy is growing at a pace that is much **closer to government's six percent growth** target than previous data releases indicated (see Table 1).

Table 1: GDP Growth Data (2004-2005)

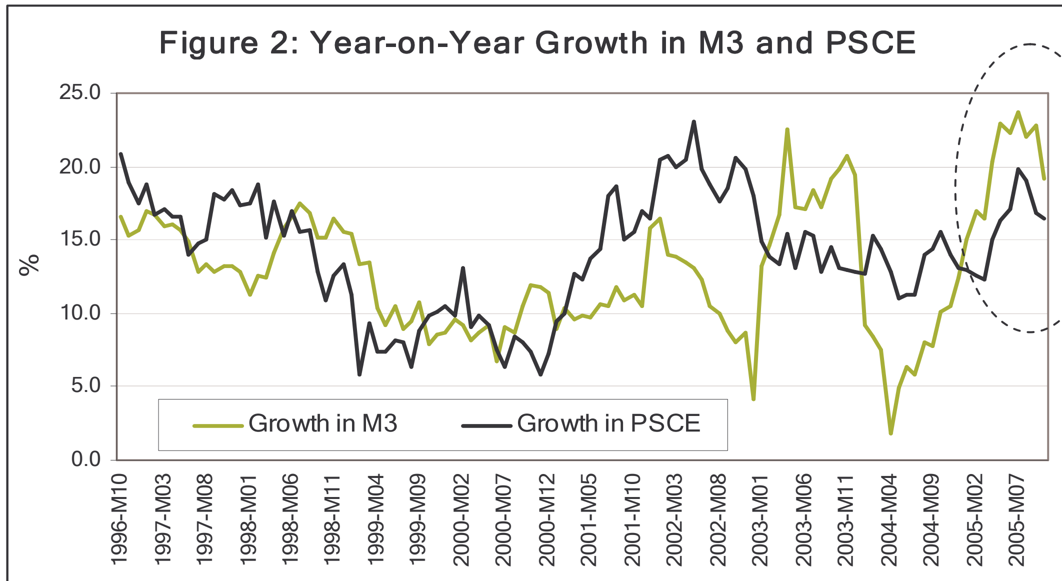
Period	GDP Growth (%) Previous	GDP Growth (%) Revised
2004	3.7	4.5
2005Q1	3.5	4.6
2005Q2	4.8	5.4
2005Q3	NA	4.2

Source: Adapted from Statistics South Africa

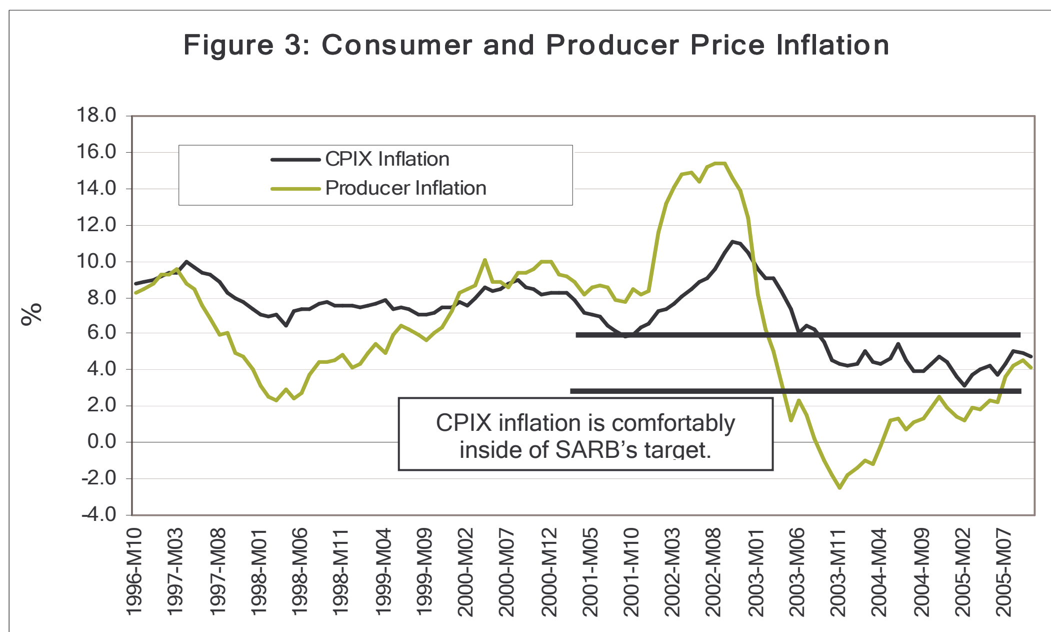
- Considering the outlook for interest rates, up until a few weeks ago it was almost self evident that the MPC would be **obliged to hike the repo rate** when it meets next week or, if not next week, then almost certainly at the first meeting of 2006 which will be held in February. The pressure to raise the domestic repo rate has various sources, including the rate hiking activity that has taken place elsewhere in the world, led by the United States (US); rapid expansion in the domestic money supply (as measured by growth in M3), which in turn has been led by rapid growth in private sector credit extension (PSCE); and incipient consumer price inflation sparked by the recent oil price spike.

- Figure 2 shows the record of growth in money supply and PSCE over the past decade. Our interest, of course, is with the most recent data. On this score, it must be recognised that the average rate of growth in money supply over the past year of 15.5 percent is substantially higher than growth in nominal GDP and, unless checked, it is only a matter of time before this level of expansion in the monetary base of the economy will translate into price inflation. Thus, it is encouraging that October showed a **sharp slowdown in the rate of expansion in money supply and PSCE**. In the case of money supply the rate of growth fell from 16.9 percent to 16.4 percent between September and October. PSCE growth slowed from 22.8 percent in September to 19.1 percent in October.

- In the same breath, a welcome feature of the inflationary environment is that there is still **little evidence of so-called second-round inflation** which might have materialised out of the first-round inflationary pressures caused by the oil price spike. Indeed, despite the inflationary agitation caused by higher oil prices, data released by Statistics South Africa last week show that consumer price inflation (as measured by CPIX, the object of the South African Reserve Bank's inflation target) fell from 4.7 percent in September to 4.4 percent in October. Producer price inflation also eased, falling from 4.6 percent in September to 4.2 percent in October (see Figure 3).



Source: Adapted from South African Reserve Bank



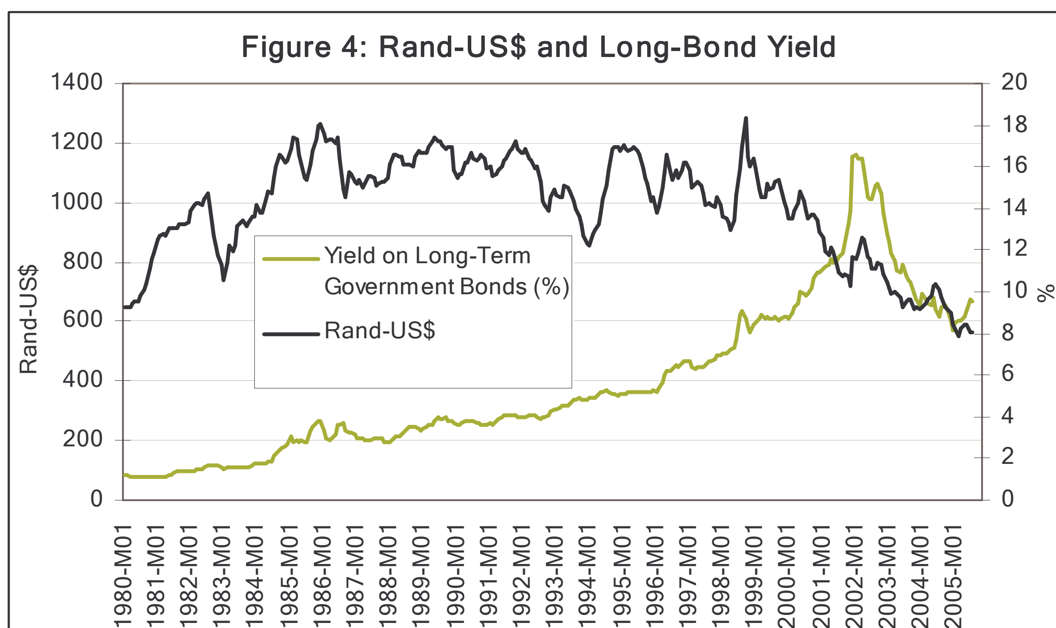
Source: Adapted from South African Reserve Bank

- It is said that in politics a week is a long time – the same might be said in the case of economic analysis. A constantly changing environment makes the task of forecasting a difficult one. However, when read together, the recent data releases alluded to above suggest that earlier fears of a rate hike in the first week of December may have been premature. If anything, these recent data releases suggest that the **interest rate pendulum may have reversed its recent bias towards**

tightening and, if anything has swung back through its low point so that the pressure on rates could now be downwards. This argument is returned to below.

- But whilst the buoyant growth environment and subdued inflationary setting are to be welcomed, it does not follow that the rest of the economy is doing as well. More to the point, the evidence of the economy's ability to create jobs in the extant setting is mixed. Investec's Purchasing Managers' Index (PMI) - a reliable barometer of industrial activity - fell sharply in November to 50.0 points from 54.1 points in October. Thus the PMI locates real activity in the economy at a 'neutral' point. More concerning, though is that the employment component of the index declined sharply to 45.0 points in November from 53.4 in the previous month, pointing to job-shedding. This anecdotal reading of employment data is in conflict with data released by other economic commentators and data agencies, and which has been brought into question elsewhere.

- The trade account numbers released earlier this week also are of concern. Although it is dangerous to place too great an emphasis on a single month's figures, it is concerning that exports fell by a sharp 11.0 percent in October, versus a more modest decline of 4.5 percent in imports. The net result was a trade account deficit of R5.5 billion for the month, which is the third largest deficit on record.



Source: Adapted from South African Reserve Bank

- When read in combination, the above evidence hints that the 'stronger for longer' Rand is helping to contain inflation, and that spending in the economy remains resilient (witness the on-going rapid expansion in PSCE and the firm rate of growth in GDP). However, not all parts of the economy are coping as well, and manufacturing - an important provider of jobs - is clearly under pressure. In turn,

this could prompt the MPC to consider the potential benefit that a rate cut might have by helping the Rand move lower, which would serve to promote struggling components of the economy, such as the manufacturing industry.

- The case for a rate cut is strengthened by the fact that inflation remains subdued and credit demand is slowing. Certainly, it is much harder to find a case for a rate increase than it was a month ago.

- Whilst our reading of the environment suggests that a rate cut is more likely than a rate increase, the most likely immediate outcome is that the MPC will keep rates on hold in December but will continue to warn about the risks of over borrowing and continue to remind us that rate hikes are a possibility (lest we have forgotten the experience of the late 1990s when interest rate hikes brought the economy to its knees). However, a careful reading of recent economic data suggests that a rate cut is a distinct possibility. As things stand, such a move would catch capital markets by surprise, and could lead to an upward move in asset prices, including the prices of bonds, property stocks and shares.

- Based on current multiples we think that medium-dated gilts and some of the parastatal stocks would show the greatest short-term gains in the case of bonds.

- In equities immediate beneficiaries of such a 'surprise' move in the repo rate would be the rate-sensitive counters located in the financial sector and spending-sensitive stocks, such as the cyclical retailers. Should a rate cut spur Rand weakness then it follows that the Rand-hedges would also benefit.

- Of course, the above comments apply almost exclusively to near term gains – which are not the substance of long-term wealth management. On this score, from a longer-term stance we continue to favour domestic equities and cash over bonds and property. Our views on the different domestic asset classes are detailed in our *Investors' Alidade: Cannon Asset Managers' Tactical Asset Allocation Toolkit* (December 2005).

The most recent forecasts of Cannon Asset Managers' economic model are attached, with commentary provided below. The forecasts are relevant for the period to end 2008.

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