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Looking under the hood at SA Inflation

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As fixed income managers, inflation (current and future) is a critical input into our investment process. Our job is to build portfolios that beat inflation for our investors over time – but how would one have a view of whether nominal fixed rate SA bond yields at, say 9%, 10% or 13% have value if you don't have a view on expected inflation, and therefore implied real yields, over the long term? Also, SA interest rates are set by the Reserve Bank, which has an inflation-targeting mandate. They set interest rates with the aim of keeping inflation within a 3% - 6% target range, as set by the National Treasury. The midpoint of this range is 4.5%, and this is the de-facto target – if the SARB does not have confidence that inflation will fall to 4.5% over their forecast period, SA rates will be held at a tight or restrictive level with the aim of driving inflation down. The interest rate cycle is a key input into all investment processes and market prices (including the shape and changes in the yield curve), so understanding what the SARB is thinking and how they are likely to set interest rates over time is therefore crucial for all investment teams.

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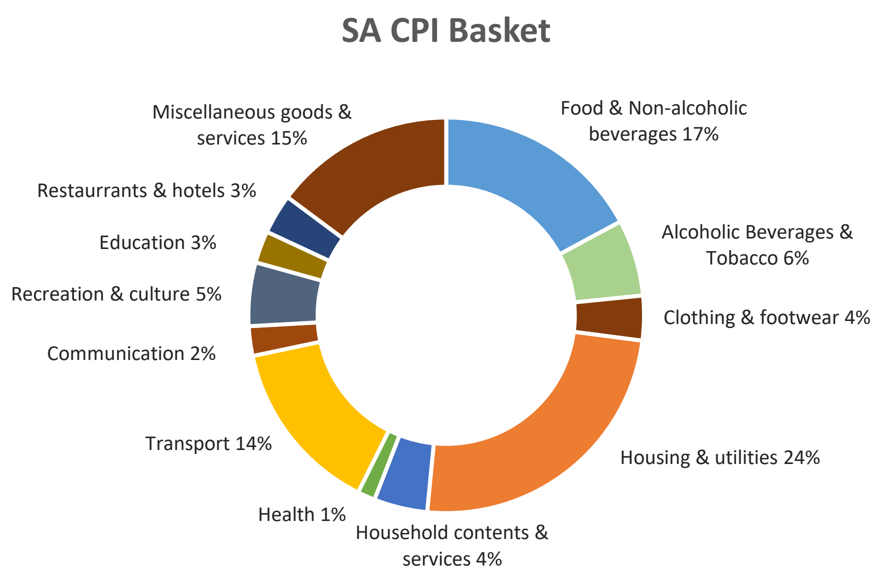
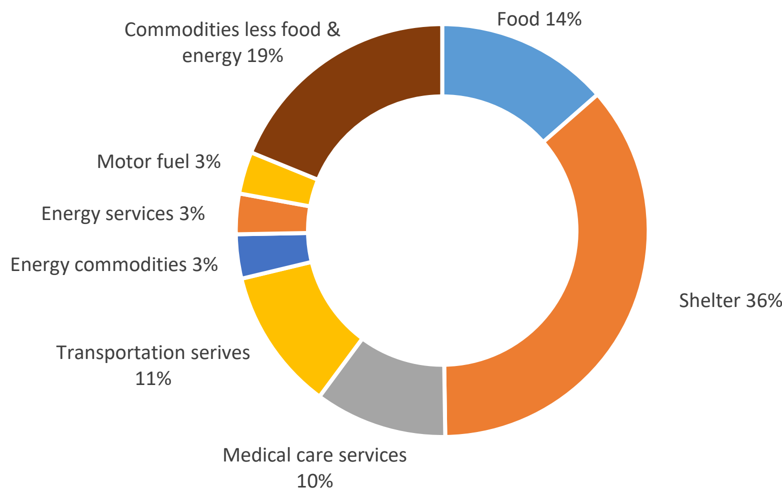
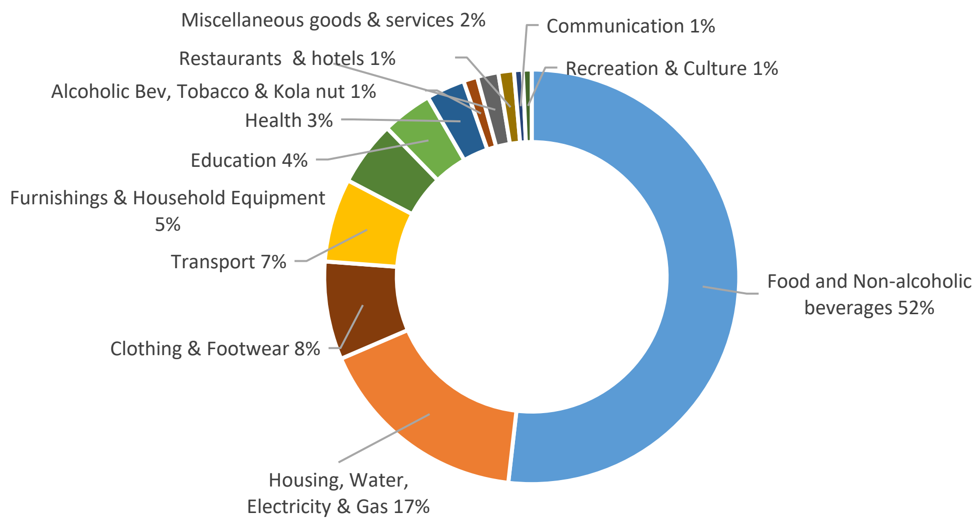
So, what do we then think about when determining how we expect inflation to move over time? To answer that, we need to understand the details of how inflation is actually measured - what prices are more important than others? A consumer price index (CPI) measures the price change of a typical basket of consumer goods and services, representing consumer spending patterns. The change in the price of this basket represents the rate of inflation (or change in the cost of living) which is experienced by a country's consumers as a whole. This representative basket will differ from country to country, can vary quite considerably across countries, and is updated regularly (every few years) to take into account changes in spending patterns over time. For example, when StatsSA last updated the basket in 2022, fourteen new items were added (including gin and cappuccino sachets), while two were removed (DVD players and satellite dishes - postage stamps were removed in 2016). A recent update to the UK basket saw vinyl records (!), air fryers and gluten-free bread being added, with hand sanitiser falling out.

This basket of goods is divided into broad categories that are common across countries, such as food, transport, clothing, healthcare, etc with weightings reflecting how much of an average household budget is spent on those goods and services. Typical households in different countries spend their budgets in different ways, influenced by several factors such as cultural preferences and levels of economic development. A common rule of thumb is that the lower the GDP per capita of a country, the greater the percentage of the budget is spent on food - this is clearly evidenced across Africa, where food typically represents somewhere between 30%-50% of a consumer's spend. The split between goods and services is somewhat different in the US, reflecting its higher level of economic development, with only a 13.5% basket weighting in food. South Africa is somewhere in between around 17% of the basket is comprised of food.

Chart 1: CPI basket weightings across different countries







Source: SA basket – sourced from StatsSA; Nigeria basket – sourced from National Bureau of Statistics; US basket – sourced from Bureau of Labor

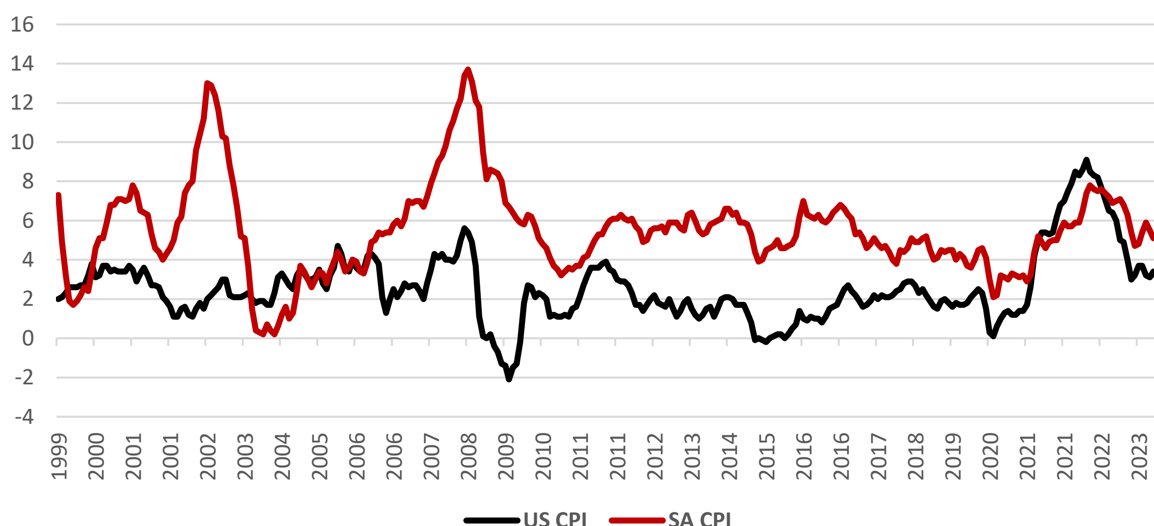
After years of relatively low inflation, countries around the world experienced a surge post 2020. The US inflation rate climbed to the highest level in 40 years, and SA's inflation rate spiked above the upper end of the SARB's target range, peaking at 7.8% year on year from an average of 3.3% in 2020 (many other countries experienced inflation rate peaks at double-digit levels).

There were several features that were interesting when comparing these different experiences. The first is that US inflation hasn't been higher than SA's since 2006; the US peak at 9.1%, higher than SA's 7.8% peak, was certainly unusual (see Chart 2). The second interesting feature was that the drivers of the inflation surge in both countries were markedly different - mainly due to the different composition of their respective baskets. Let's step back to examine the dynamics that played out over this period. The initial spread of the COVID

pandemic that enforced hard lockdowns across the globe fractured supply chains at a time when fiscal policy was generously deployed across developed counties, leading to demand for physical goods soaring and overwhelming broken supply chains crippled with physical bottlenecks. This episode of pandemic-related excess goods demand chasing limited supply was merely the first of a series of rolling shocks to strike the global economy. Supply chains have largely normalised since this event. Still, a large amount of pent-up demand for services was unleashed as economies re-opened fully over time, as evidenced by elevated and sticky services inflation currently experienced across many developed markets, including the US.

The second global inflation shock was when Russia invaded Ukraine in February 2022, resulting in a significant spike in global energy and food prices. These pricing dynamics materially impacted the rate of global inflation, but the translation of the shocks into actual inflation rates across individual countries was dependent on the nuances of each country's inflation basket - the first dynamic had a greater impact on developed markets. In contrast, those countries with a higher proportion of their basket impacted by food and fuel prices (such as South Africa and other peers on the Continent) saw a greater impact from the second shock.

Chart 2: US and SA inflation rates (year on year %)



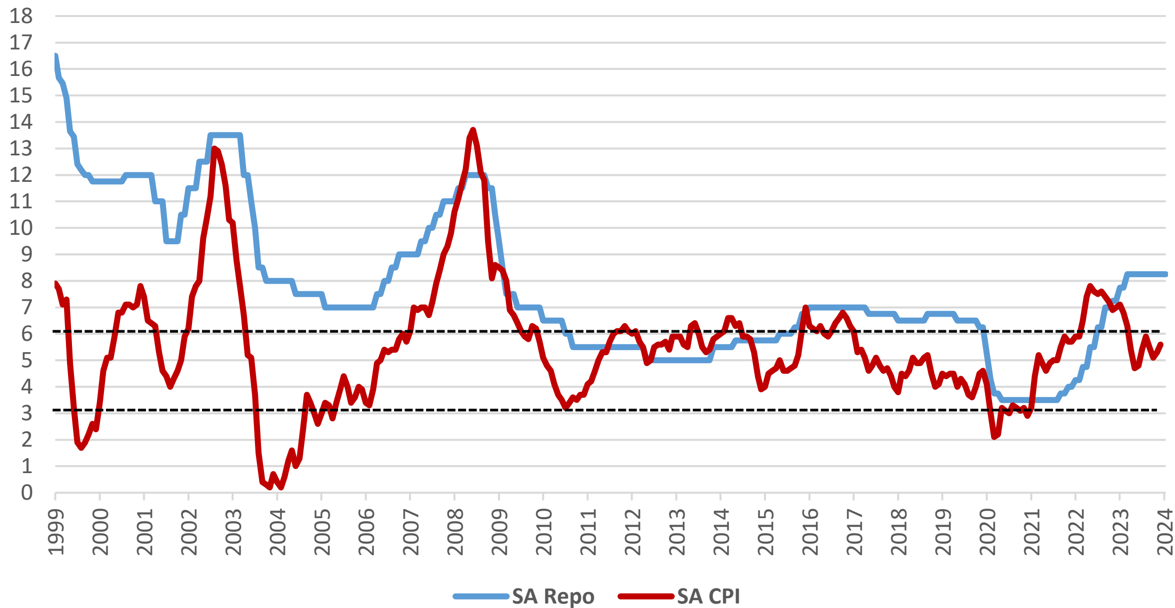
Source: Bloomberg

So, what is the inflation outlook now, and what is the prognosis for the future? SA's inflation rate is decelerating in a bumpy fashion back towards the midpoint of the target range (see Chart 3 below). The path towards 4.5% does, unfortunately, carry upside risks, primarily emanating from food prices due to El Niño related hot and dry weather conditions in maize growing regions as well as a weaker exchange rate. The MPC (Monetary Policy Committee – the panel that sets the official interest rate at the SARB) is conservative when considering these risks and likely to err on the side of caution. Hence, it is unlikely to reduce SA interest rates until these upside risks have lessened.

Regardless of the weight in the basket, central banks across all countries do pay particular attention to food and oil price shocks given that they are very visible and tangible - consumers acutely notice these price

increases every time they go grocery shopping or fill up their cars, and they receive widespread media attention with 'cost-of-living crisis' headlines. As the anchoring of inflation expectations is so critical to the credibility of central banks, they consider these risks carefully, and this explains the sensitivity of the SARB to these particular upside risks to the outlook.

Chart 3: SA inflation and interest rates



Source: Bloomberg

Whilst we can discern the MPC's likely reaction function in the near term, how does this help us in determining what inflation will be five, ten or fifteen years in the future? The answer is the same - by focusing on the MPC's reaction function. If price setters in the economy have confidence that the SARB will do whatever is necessary to drive inflation back to the target range over time, they can look through near term shocks when thinking about inflation on a longer-term view. This is relevant for both price setters in the economy (such as companies looking to set prices for their goods and services and workers when negotiating multi-year wage agreements) as well as investors in long-term assets who need to determine their expected real returns over time. When a central bank has this confidence from participants in the economy, they are said to have credibility, and this credibility is critical in anchoring long-term inflation expectations within a desirable target range.

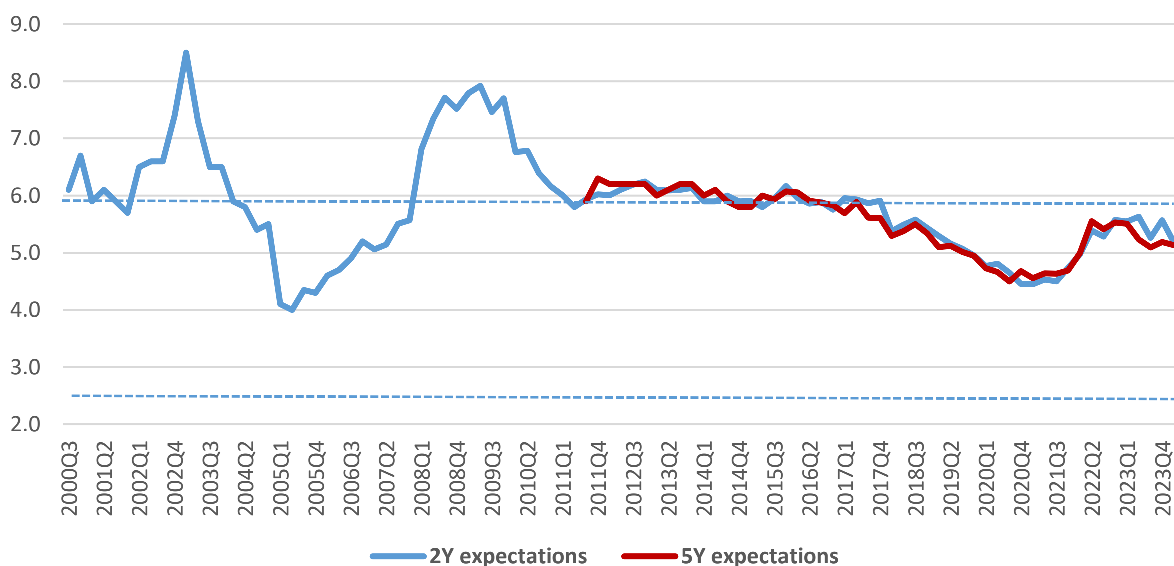
Thinking of how inflation (and inflation expectations) may be different in the future, any possible changes to the actual inflation target range would, of course, need to be considered carefully when making investment decisions. For SA investors, it is well known that the SARB would prefer a lower target than the current 3-6% range, a key aspiration of the current SARB Governor and supported by his broader team. In fact, when inflation targeting was introduced in SA in 2000, the target was always intended to move from the 3-6% range to 3-5% (in 2004 and 2005) and then lower over time – this goal was delayed as currency pressure raised questions around the achievement of a lower target at that time and has not officially been revisited since.

The MPC's deliberate targeting of the 4.5% mid-point was a successful move in this regard (before this, inflation expectations were anchored at a much higher 6% level, the upper end of the target range – see Chart 4 below), but an official reduction in the inflation mandate would allow an even lower level to be targeted. The reasons for this aspiration are straightforward: such a move would likely bring greater currency stability and lower long-term borrowing costs, spurring stronger growth and investment and improving welfare for all SA households.

The ultimate preference is for a point target of 3%, in line with other major emerging markets. Although a noble and admirable goal, the key challenge to achieving a lower inflation rate in South Africa is the high influence of administered prices on our inflation basket (comprising more than 15% of CPI), such as rates and taxes and water and electricity prices. These prices are set by the government or regulators and are largely insensitive to usual supply and demand dynamics or influenced by moral suasion that attempts to push inflation expectations lower. These components have increased well above the inflation target rate for many years. The unfortunate reality is that were the target range moved lower under these conditions, the remainder of the basket would then be required to increase at an even lower rate to 'subsidise' these components – potentially requiring even higher levels of interest rates for a longer period of time than would have been the case absent this dynamic.

This would clearly be suboptimal and is one of the reasons why broader political buy-in of a lower desired inflation regime would be a critical stepping stone along the way to achieving this outcome. Electricity, in particular, is also a key input across the production value chain in both manufacturing and agriculture, carrying a much higher impact than the primary weighting alone in the inflation basket would imply through these 'second round' effects. Where are we on the timing of any potential change to the target? National Treasury recently signalled in its debut Macro-Economic Policy Review that technical work is underway on what a more appropriate target level or range might be but has not yet provided any guidelines around timing.

Chart 4: SA BER inflation expectations survey results (5 years forward)



Source: BER (Bureau for Economic Research)

Understanding the drivers and nuances of our inflation basket and how SA differs from its peers in both the developed and emerging worlds is a key component in our analysis of the central bank reaction function - what they are expected to do both now and, in the future, to deliver successfully on their mandate. One of our greatest assets when crystal ball gazing into the future is a credible central bank and well anchored inflation expectations.

Glacier Research would like to thank Melanie Stockigt for contributing to this week's *Funds on Friday.*

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Melanie joined Laurium in December 2020. Prior to that she was a founding member of Tantalum Capital where she was Head of Fixed Interest and the portfolio manager for the fixed income portfolios. From 2002 to 2005 Melanie was at Coronation Fund Managers where she was head of the fixed interest team, managing fixed interest institutional and retail portfolios as well as the Strategic Income Fund. Melanie started her career in 1997 at Standard Corporate & Merchant Bank. Initially, she focused on interest rate and liquidity management before she moved to the Treasury Sales and Structuring Desk where she gained significant experience in structuring and marketing fixed income, credit and securitised products to institutional investors.