

5 September 2011

Economic Commentary

Monthly Insight

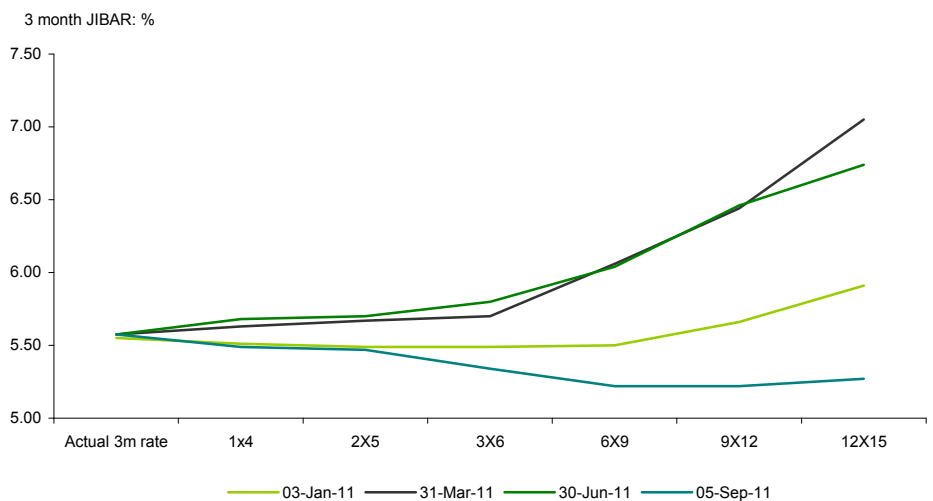
Interest rates expected to remain flat until July 2012

- Global growth prospects have deteriorated in recent months and the risk of a double-dip recession in the US and Europe has increased. Locally the picture has also worsened, growth for this year is now forecast to be a meagre 3,2%, down from 3,8% just two months ago.
- The market's current view of both local and global growth prospects has swung from being too positive to probably being too negative.
- Although recent economic data has not been encouraging, moderately improved growth combined with higher inflation is likely to resume later in the year.
- We believe that calls for an interest rate cut are premature. There would need to be strong evidence that the local economy is entering a recession before such a move would be warranted.
- Rather, we have opted to adjust our forecast slightly to reflect the more subdued economic outlook. As a result, we now anticipate that the first interest rate hike will come in July 2011, while acknowledging higher downside potential in the short term.

Comment

In last month's Monthly Insight we made the case for keeping interest rates lower for longer. We argued that demand-side pressure on inflation would stay subdued as households remained conservative, spending in line with income growth. We also highlighted the risk of an increasingly fragile global economy and how this might hurt domestic growth prospects.

Chart 1 :Forward rate curve moves lower



Source: BER

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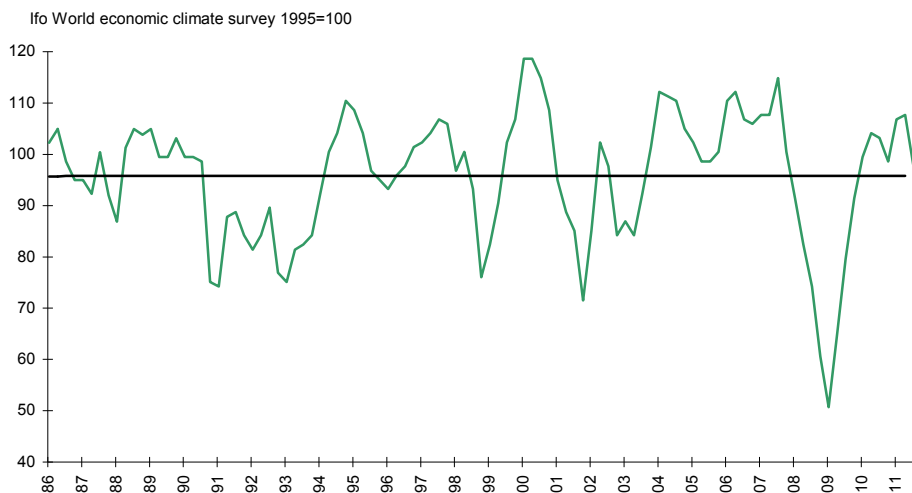
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Over the past month the market's view has turned decidedly more gloomy. The forward rate 5
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agreement (FRA) curve has moved sharply, reflecting this change in perception. At the beginning of August, the FRA curve were still pricing in a 50 basis point hike over the next 12 months. Now the market anticipates that rates could drop slightly. FRA curves have also moved in the US and Europe, reflecting a more pessimistic economic view. Interest rates in Europe are expected to fall over the next year, while in the US rates are now forecast to remain unchanged.

Chart 2 : Global economic climate deteriorates



Source: BER

What has prompted this shift in sentiment?

For much of the early part of this year, many were convinced that the policy actions taken by the US to support economic growth would be sufficient to help both the labour and housing markets out of the doldrums. In Europe, most hoped that the Eurozone's larger economies such as Italy and Spain would escape unscathed from the sovereign debt crisis that had gripped Ireland, Portugal and Greece for much of the previous two years. In late July, sentiment turned sharply negative. Economic data in the US and Europe, which had been weakening modestly in preceding months, suddenly caught the market's attention and caused many to adjust their growth forecasts lower, with talk of a possible double-dip recession re-entering the discourse. At the same time the market focused its attention on Italy and Spain, putting upward pressure on bond yields as policymakers and investors were forced to consider whether or not it would be possible to bail these countries out in the event that they ran into more serious trouble.

In response to increasingly fragile growth prospects and a higher risk of a double-dip recession, central banks, but particularly the US Federal Reserve, have adopted more dovish language. At the Fed's August meeting Chairman Ben Bernanke took the unprecedented step of publicly announcing an extended time frame for monetary policy. He said that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate at least through mid-2013". However, the statement did stress that this was not an "unconditional commitment" and the Committee would reassess if "economic conditions do not evolve as the Committee currently expects". At the annual Federal Reserve Bank of Kansas City's Jackson Hole economic policy symposium he gave some further clarity on the direction of monetary policy. Although he did not announce further quantitative easing as many in the market had hoped, he stressed that there was a range of further policy options available and that these would be discussed further at the September FOMC meeting.

There is also growing speculation that the European Central Bank will drop its hawkish language at its upcoming meeting, with recent economic indicators pointing to a marked slowdown in European growth, particularly in the manufacturing sector.

Locally the picture has also worsened, with growth forecasts being marked down to around 3% from 4% just two months ago. In the manufacturing sector growth will be contained by subdued export demand. In line with international trends, the Purchasing Managers' index has slipped in recent months and is now below the key 50 level that divides a contraction

from an expansion. Apart from a sluggish global economy, the ability of the local manufacturers to compete on the global markets will probably remain under pressure because of the leap in local electricity costs, rising labour costs, inadequate general infrastructure and a relatively strong rand. Consumer spending has benefited from strong growth in income over the past year, but modest credit growth, a weak labour market, high debt levels and the prospect of higher interest rates will keep spending in check.

The question is whether the market is now pricing in too much doom and gloom. It is probably too early to say with certainty, but it is quite possible that as the immediate dangers of debt default in Europe recedes and as Japanese activity normalises, growth will resume, albeit at moderate levels. If this is the case, annualised growth in excess of 3% in South Africa will resume later in the year and this, combined with the expected rise in headline inflation to over 6%, would support a neutral stance by the MPC.

Conclusion

The market's current view has probably swung from being too positive to being too negative about the current state of both the local and global economy. Although recent economic data has not been encouraging, moderately improved growth combined with higher inflation is likely to resume later in the year. As a result, we believe that calls for an interest rate cut are premature and that there would need to be decisive evidence that the local economy was entering a recession before such a move would be warranted. Rather, we have opted to adjust our forecast slightly to reflect the more subdued economic outlook. As a result, we now anticipate that the first interest rate hike will come in July 2011.

Table 1 : SARB checklist

Factor	SARB's most recent interpretation (MPC July)	Recent tendency
International economy		
Growth	"The global economic outlook has deteriorated. Events in the eurozone appear to have entered a new phase, with the focus moving from the peripheral countries to some of the larger economies in the region. The global systemic risks posed by any failure to overcome the sovereign debt crisis are enormous, and are exacerbated by the potential failure to resolve the debt ceiling crisis in the United States. These events are taking place against the backdrop of a slowdown in growth in many of the advanced economies."	Global growth has slowed over the past few months.
Inflation and interest rates	"Global headline inflation has increased, driven primarily by higher food and other commodity prices, particularly oil."	Rising on higher food and fuel inflation, has forced breaches in targets in both the UK and EU.
Oil	"The price of Brent crude oil, currently at around US\$117 per barrel. The price has experienced some volatility in recent weeks, particularly following the release of oil stocks by the International Energy Agency in June, when the price declined to US\$106 per barrel."	The price of Brent crude oil has remained below \$120 per barrel.
Food	"Food inflation has been one of the main contributors to headline inflation."	Food inflation at consumer level continued to rise higher.
Domestic economy		
Balance of Payments	Current account deficit widened to 3,1% of gdp in the first quarter, from 1% of gdp in first quarter of 2011.	A trade deficit of R3,9 billion was recorded in July.
Exchange rate (rand)	"The bouts of risk aversion relating to developments in the euro area have impacted on the volatility of the rand exchange rate. Since the previous MPC meeting, the rand has fluctuated within a range of R6,67 and R7,02 against the US dollar."	The rand remained strong against the weak dollar and is in sync with other emerging market currencies.
Labour markets (unit labour costs)	"According to Andrew Levy Employment Publications, the overall average wage settlement rate in collective bargaining agreements amounted to 8,2 per cent in the first quarter of 2011"	Wage demands have moderated slightly.
Administered prices	"The main risk to the inflation outlook remained administered prices, particularly electricity price increases."	Eskom proposal watered down to 25% pa over three years from original 45% pa.
Domestic demand and supply	"GDP growth now expected to average 3,6 per cent and 3,9 per cent in 2011 and 2012 respectively. These growth rates, while an improvement, are still too low to have a significant impact on the unemployment rate which measured 24,0 per cent in the fourth quarter of 2010."	Household spending is recovering but fixed investment remains weak. A more favourable outlook for the global economy should support domestic manufacturing.
Monetary conditions	"Underlying credit extension remains weak but there has been some improvement in the past months."	Households continue to drive the modest recovery in credit extension, while lending by corporates remains subdued.
Fiscal policy	"...the MPC does not foresee a possible conflict with monetary policy objectives."	Budget deficit is very large, but not an immediate threat to inflation unless public sector wages rise strongly again.
Indicators of inflationary expectations	"Average inflation expectations for both 2011 and 2012 have increased with inflation expected to average 5,1% in 2011 and 6% in 2012".	Rising headline inflation will push expectations up higher.

Source: Nedbank and SA Reserve Bank

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