LOW INFLATION CONFIRMATION

Dave Mohr and Izak Odendaal, Old Mutual Multi-Managers

South Africans were left cursing in the dark during last week's stage four load shedding, which, if it continues, will damage economic growth and sentiment. However, local financial markets tend to take their cues from abroad, rather than domestically, and rolling blackouts were largely shrugged off by the rand and the JSE. For the former, the US interest rate decision (discussed below) mattered more, while the latter benefited from a rally in mining shares.

LOCAL INFLATION AS EXPECTED

The other notable local event was the release of monthly inflation data. According to Stats SA, the consumer price index (CPI) was 4.1% higher in February than a year ago. This was up slightly from 4% in January and in line with expectations. Food inflation, which accounts for 15% of the total CPI basket, remains subdued at 2.3%, but is likely to rise as the impact of higher maize and wheat prices filters through. Petrol inflation was marginally positive. However, a big 74c per litre petrol price hike in March followed by another sizable R1-plus expected increase in April will contribute to somewhat higher overall inflation since petrol accounts for 4.5% of the CPI. However, the exact impact will depend on whether companies pass on higher transport costs to consumers. In the current climate, they have limited room to do so.

Both food and fuel prices are volatile, being subject to commodity price and exchange rate movements. Consumers are price-takers of food and fuel, as there are few substitutes. Therefore, Stats SA calculates a 'core' price index that excludes these items. Core inflation was unchanged at 4.4% year-on-year. This is a better measure of underlying inflationary pressures, and remains subdued.

Overall inflation is being held up by administered service costs, such as water and electricity tariffs (6% of the basket) and insurance (10%). While the former is set by government and will likely continue to increase, particularly electricity tariffs, the latter is subject to market competition and, although still high at 6.8% year-on-year, has declined in recent years.

Goods prices are subject not just to local competition between retailers, but also global competition between producers. Retail sales growth numbers, also released last week, showed sales grew by 1.2% year-on-year in real terms in January (i.e. after inflation), and 3.6% in nominal terms. Both real and nominal growth rates are low, pointing to the tough trading environment, while the difference between real and nominal growth rates implies inflation at retail stores of slightly more than 2%. Retailers simply cannot push through meaningful price increases.

GRINDING LOWER

The biggest category in the CPI is implied and actual rents, together accounting for 16% of CPI. Implied or 'owners equivalent' rent is what homeowners would pay to rent their own properties. These rose by 4.2% and 3.8% respectively from a year ago, indicating weakness in the property market. However, since rents are typically long-term contracts, it also points to lower expected future inflation. The days of automatically escalating a rental contract by 6% seem to be over. This is of course what the South African Reserve Bank (SARB) wants to see. It does not just want inflation to be on its 4.5% inflation target (the midpoint between 3% and 6%), it also wants consumers to believe that inflation will stay there, and change their behaviour accordingly. The SARB therefore maintains high interest rates, despite the stumbling economy. Granted, it has had some success in bringing inflation and expected inflation down. Inflation averaged 10% in the 1990s, 6% in the 2000s, and 5.3% in the 2010s. Don't be surprised if it averages closer to 4% in the next decade, as local inflation continues to grind lower on a structural basis and converge on global inflation rates.

Why does the SARB have an inflation targeting mandate in the first place? High inflation tends to distort economic decision-making. If all prices are rising rapidly, it can be difficult for consumers to figure out appropriate prices for individual items. It also has distributional impacts as poorer people own fewer inflation-hedging assets like property or shares, and also because inflation erodes the value of debt (which is a fixed rand amount). High inflation therefore benefits borrowers and disadvantages lenders. Finally, lower and stable inflation implies lower and stable interest rates. Though interest rates are probably too high for the current economic conditions, they have come down meaningfully from the late 1990s, when the prime rate peaked at 25.5%.

GLOBAL INFLATION MISSING IN ACTION

The interesting post-crisis phenomenon globally has been that many central banks tried to raise inflation, rather than lower it. To do this, some have resorted to previously unthinkable tactics such as negative interest rates and large-scale purchases of financial assets (commonly known as quantitative easing or QE).

If high inflation is a problem, surely low inflation is good? Not if inflation is too low. In developed countries, the ideal inflation rate is considered to be 2%. Lower than that causes three problems. Firstly, one person's inflation is another's income. If I spend 2% more at the shop, the shopkeeper's income rises by the same amount. This is why owning company shares is such a good long-term hedge against inflation. But if there is low inflation and low income growth, the incentive to take risks and expand economic activity can be reduced. Secondly, just as high inflation erodes the real value of debt, negative inflation increases the real debt burden. Some inflation is good to keep debt manageable. Finally, and this is a bit technical, central banks want firepower to fight the next recession, whenever that might be. With low inflation, they are not able to raise interest rates by much, and therefore do not have much room to cut. For instance, the US Federal Reserve (the Fed) has cut around 5% in previous downturns, but its policy interest rate range is only at 2.25% to 2.5% at the moment.

DOVES IN FULL FLIGHT

The Fed kept this rate unchanged last week, which was expected. Rather, the market focus was on clues on the future path of interest rates since the Fed called halt on its hiking cycle at its January monetary policy meeting.

Chairman Jerome Powell was at pains to emphasise that his colleagues would follow a patient approach, focusing on the incoming data, rather than following a predetermined plan.

The so-called dot-plot, a summary of individual Fed officials' own views, suggest no further hikes this year, with only one more pencilled in for 2020. The Fed will also stop the shrinking of its balance sheet by September, ending up with a portfolio of $3.5 trillion bonds, much more than initially expected.

All in all, the Fed is now in full dovish mode. While the initial market response cheered this outcome, investors soon became concerned over what it might signal for the health of the US economy. Long bond yields declined, reflecting lower growth and interest expectations, and some actually dipped below short-term yields. Such an 'inversion' of the yield curve is seen by many as a harbinger of recession, leading to an equity sell-off on Friday, but historically the lags between inversion and the onset of a downturn can be anything from a few months to three years. No other US recession signal is flashing red.

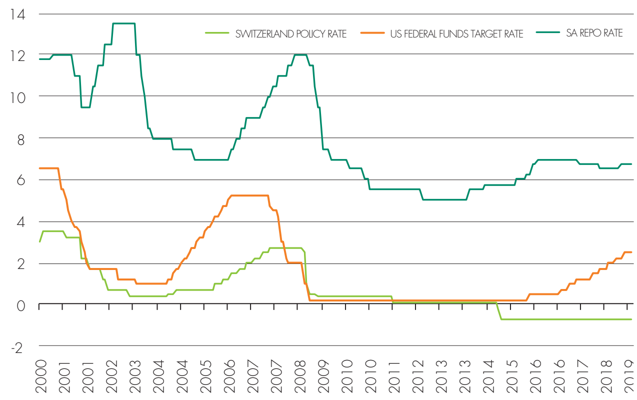
Switzerland's central bank, the Swiss National Bank, also had a policy meeting last week. It is an interesting case of a central bank really throwing the kitchen sink at the problem of low to negative inflation. This includes negative interest rates (-0.75%), fixing the currency at certain points and QE. Switzerland explains a common misunderstanding around inflation. Inflation is not whether something is cheap or expensive; it measures how quickly prices change. Something can have a high inflation rate but still be cheap. Switzerland is a famously expensive country to live in, but there is no inflation (core inflation is barely half a percent). Due to its safe-haven status, foreign capital tends to flood in during periods of uncertainty, pushing the currency up and imported inflation down.

INVESTMENT IMPLICATION

What does this inflation picture mean for asset class outlooks? Low inflation and low interest rates have tended to be good for financial assets, but not under all circumstances. Global equities have done well in the low inflation environment of the past decade, partly since low inflation means investors are prepared to pay up for earnings growth (i.e. higher price:earnings multiples). However, falling inflation in South Africa is largely a sign of a weak economy, and therefore limited top-line growth. Companies have responded by cutting costs to maintain margins. It means that one day when the economy picks up, local companies will be lean and mean and make fat profits. But for now, all this cost-cutting just adds to slow growth. However, remember that this only applies to the portion of JSE listed companies' earnings that are generated domestically. This is less than half of the total. The overall outlook for local equities is still very much dependent on what happens abroad and rolling blackouts does not change this.

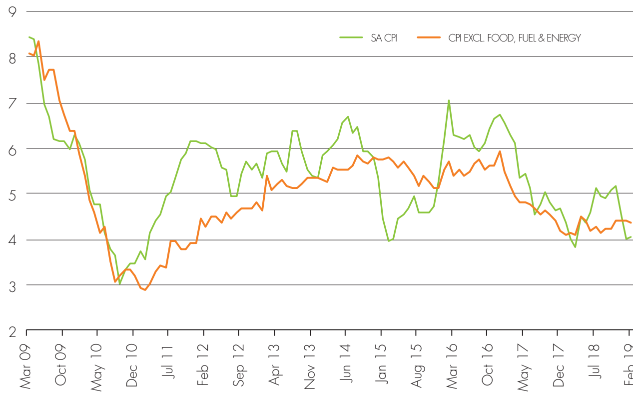
For fixed income assets, low inflation is good. As the name suggests, these assets pay out a fixed income whose real value can be eroded by unexpected higher inflation. But the real value increases when inflation is lower. The combination of high interest rates and low inflation means domestic fixed income assets are very attractive to investors, even if it is bad news for economic growth. In contrast, in most developed countries, interest rates do not even compensate for what little inflation there is, and with the Fed in patient mode, this picture is not likely to change.

CHART 1: US AND SOUTH AFRICAN POLICY INTEREST RATES %



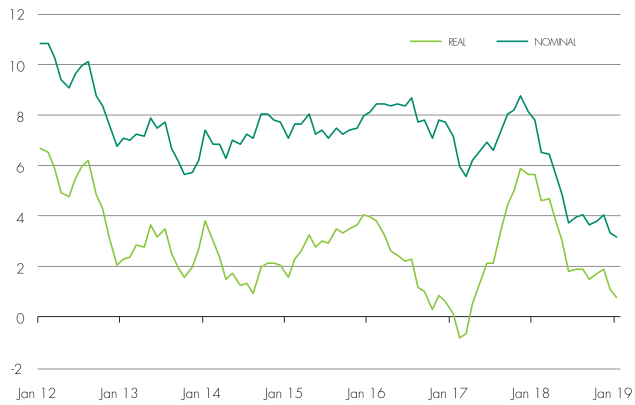
Source: Refinitiv

CHART 2: LOCAL INFLATION, %



Source: Refinitiv

CHART 3: LOCAL RETAIL SALES GROWTH %



Source: Refinitiv

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 095,0	-0,66%	0,43%	11,20%	1,06%
United States	S&P 500	US$	2 801,0	-0,74%	0,61%	11,73%	5,98%
Europe	MSCI Europe	US$	1 631,0	-1,69%	-0,06%	9,76%	-6,43%
Britain	FTSE 100	US$	9 521,0	-0,92%	1,47%	10,90%	-2,85%
Germany	DAX	US$	1 213,0	-2,65%	-1,54%	-1,51%	-13,85%
Japan	Nikkei 225	US$	196,8	2,29%	2,51%	0,87%	-4,03%
Emerging Markets	MSCI Emerging Markets	US$	1 060,0	0,28%	0,86%	9,73%	-11,45%
Brazil	MSCI Brazil	US$	2 044,0	-7,30%	-5,68%	5,14%	-8,91%
China	MSCI China	US$	82,3	0,11%	1,77%	16,92%	-11,95%
India	MSCI India	US$	589,9	0,36%	8,05%	5,72%	3,86%
South Africa	MSCI South Africa	US$	458,0	-0,43%	-2,97%	2,92%	-24,30%

EQUITIES - SOUTH AFRICA (TR UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	56 107,0	0,12%	0,19%	6,39%	-1,95%
All Share	All Share (Total Return)	Rand	8 280,0	0,23%	0,75%	7,12%	1,23%
TOP 40/Large Caps	Top 40	Rand	7 324,0	0,30%	0,81%	7,25%	1,61%
Mid Caps	Mid Cap	Rand	15 998,0	-0,47%	-0,26%	4,40%	-3,52%
Small Companies	Small Cap	Rand	17 540,0	-0,82%	-1,60%	-2,31%	-15,12%
Resources	Resource 20	Rand	3 112,0	2,37%	4,08%	15,59%	40,20%
Industrials	Industrial 25	Rand	13 365,0	0,78%	2,40%	7,65%	-7,60%
Financials	Financial 15	Rand	9 124,0	-3,28%	-6,27%	-1,99%	-6,99%
Listed Property	SA Listed Property	Rand	1 870,8	-0,85%	-1,33%	1,62%	-8,56%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	490,1	0,95%	1,39%	2,34%	-0,13%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	Index Value	Week	Month-to-date	Year-to-date	1 Year
All Bond	BESA ALBI	Rand	649,2	-0,58%	0,08%	2,53%	2,57%
Government Bonds	BESA GOVI	Rand	642,6	-0,62%	0,07%	2,55%	2,09%
Corporate Bonds	SB JSE Credit Indices	Rand	99,7	-3,10%	-3,09%	-2,19%	-20,26%
Inflation Linked Bonds	BESA CILI	Rand	256,0	-0,07%	-0,29%	0,98%	-0,61%
Cash	STEFI Composite	Rand	417,4	0,14%	0,43%	1,59%	7,26%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	66,9	-0,10%	1,39%	23,93%	-3,01%
Gold	Gold Spot	US$	1 313,0	0,84%	-0,83%	2,50%	-1,43%
Platinum	Platinum Spot	US$	844,0	1,81%	-3,21%	6,43%	-11,90%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14,49	-0,67%	-2,77%	-0,95%	-18,13%
ZAR/Pound	ZAR/GBP	Rand	19,14	0,05%	-2,40%	-4,28%	-12,70%
ZAR/Euro	ZAR/EUR	Rand	16,38	-0,41%	-2,18%	0,57%	-10,97%
Dollar/Euro	USD/EUR	US$	1,13	0,00%	0,62%	1,50%	8,85%
Dollar/Pound	USD/GBP	US$	1,32	0,64%	0,69%	-3,10%	6,75%
Dollar/Yen	USD/JPY	US$	0,01	-1,43%	-1,34%	0,26%	4,37%

Source: I-Net, figures as at 22 March 2019

OLDMUTUAL

HELPLINE +27 21 524 4430 | **FACSIMILE** +27 21 441 1199 | **EMAIL** ommmclientquery@ommm.co.za | **INTERNET** www.ommultimanagers.co.za

ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- SA Reserve Bank Monetary Policy Committee meeting
- Producer inflation
- Credit growth
- Trade balance

US

- Building permits and housing starts
- House prices
- Trade balance

EUROPE

- Eurozone economic sentiment
- Loan growth

CHINA

- Industrial profits

OLDMUTUAL

HELPLINE +27 21 524 4430 | **FACSIMILE** +27 21 441 1199 | **EMAIL** ommmclientquery@ommm.co.za | **INTERNET** www.ommultimanagers.co.za

Old Mutual Multi Managers ("OM m|m") is a business unit of Old Mutual Life Assurance Company (South Africa) Limited ("OMLACSA"), a licenced Financial Services Provider, Reg. No: 1999/004643/06. OM m|m is authorised to provide financial services on the OMLACSA license, FSP 703.