Viewpoint: SARB decision may come back to haunt it

TreasuryONE Optimising Your Cash Flows

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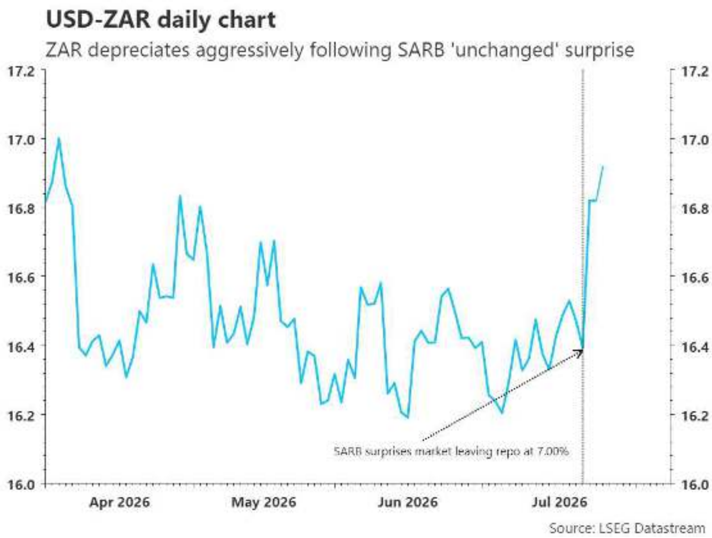
Key points

- The SARB's decision not to hike is questionable. It raises serious questions around the SARB's credibility and its commitment to reaching its 3% inflation target. Although the inflation shock is not demand-driven, it would be exacerbated by a sharp depreciation of the ZAR. The ZAR's response is exactly what the SARB did not want to see, and unfortunately, it will now play a key role in ensuring inflation remains elevated for longer.
- High inflation and a more volatile or weaker ZAR are synonymous. It is highly unlikely that you get the one without the other. Typically, when the ZAR is strong, inflation tends to be under control and price stability is enhanced. The opposite also holds true. Any decision that promotes currency volatility, therefore, tends to run counter to the SARB's mandate, and the motives behind it need to be questioned and debated.
- The argument that rate hikes would not stop an oil price shock or prevent the current bout of inflation misses the point completely. Monetary policy should not be focused solely on one aspect of prices, but rather on prices more generally, including, but not limited to, the value of the ZAR. In a world of rising risk perceptions where countries like SA face massive structural headwinds, foreign investors demand higher returns to part with their money. That will unfold one way or another. Prudent policy would've placed the SARB ahead of the curve, not reacting to it.

BASELINE VIEW: As is obvious, the ZAR is on the defensive and showing few signs of staging a recovery. The SARB did itself no favours and may have to respond with even more rate hikes down the line. Whether the introduction of new members of the MPC has turned the balance more dovish or not will not stop the rate adjustment from taking place. The SARB can either recognise the need for higher rates, or it will be imposed on it through a much weaker ZAR and higher bond yields, neither of which is in SA's best interests. For now, the ZAR remains vulnerable to depreciation.

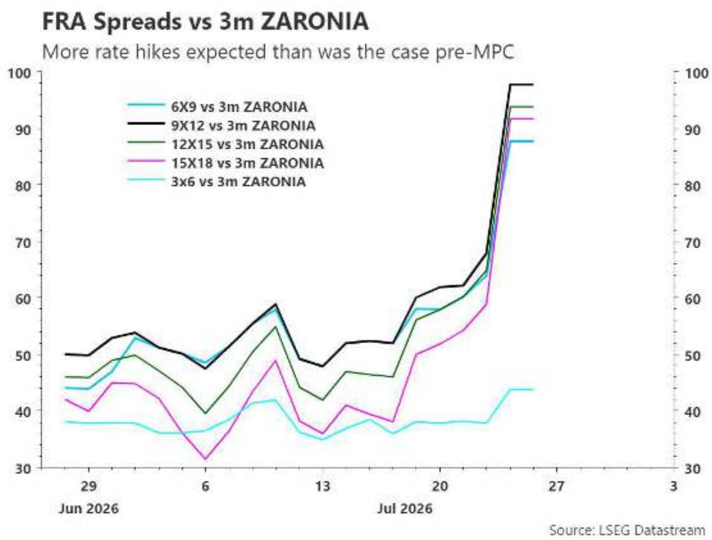
ZAR reaction is an unfiltered vote on the decision of the SARB



Last week's SARB decision did not go down well. The ZAR has capitulated. One could argue that it coincided with the USD appreciating and the VIX temporarily spiking, but that would not explain the full extent of the move. This was clearly a market reaction to a decision that the markets disagreed with. The result is a substantially weaker ZAR that is threatening to break back above the 17.0000/dlr and which ironically will accomplish exactly the opposite of the SARB's mandate to promote price stability.

Of course, the ultimate test will be whether the USD-ZAR sustains these levels and weakens further, but irrespective, it is not a risk the SARB should be taking. It has only just adopted a 3% inflation target, and it needed to build its credentials as an inflation fighter. Last week's decision was counterproductive and might force the SARB to do more than it might have done had it hiked.

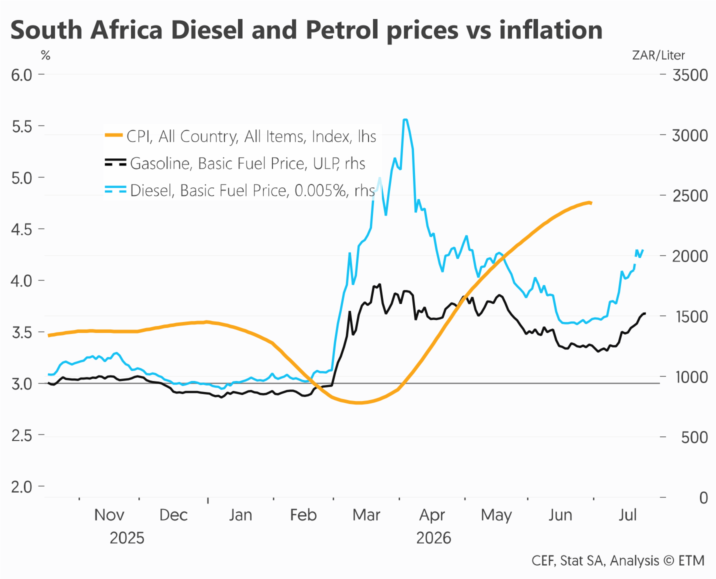
FRA rates jump higher, signalling much more monetary tightening to come



If the ZAR's reaction does not convince readers that the market viewed this as a possible policy error, perhaps the FRA curve will do a better job. Prior to the SARB's MPC meeting, the FRA curve was pricing in two 25bp rate hikes, with the risk of a third. Following the decision to hold, the market now expects the SARB to do more.

The misconception is that so long as it doesn't affect households, the impact will be limited. However, that does not take into account the corporate borrowing that will be affected by last week's decision, as rates and bond yields have surged higher in response. Companies will naturally turn more, rather than less conservative, in their borrowing, and that does nothing for South Africa's economic dynamism. If the objective was to encourage stability, the result has achieved the opposite, and that will be evident at the petrol pumps.

Household debt relief, will be eaten away by inflation and fuel prices



The ZAR plays an important role in determining petrol and diesel prices. The weaker the ZAR, the higher the fuel prices. The resulting depreciation in the ZAR has therefore directly impacted the fuel price, which then feeds directly into inflation, as the accompanying chart shows. Prioritising household financial pressures above broad-based currency and price stability is not a good idea, and that is now becoming extremely evident.

In economics, the term there is no such thing as a free lunch applies. What might appear to be relief for households at a rates level, might be more than offset by the depreciation of the ZAR, higher import prices and inflation that eats away at the very disposable income that the SARB might've tried to support.

At best, the relief that they have offered households will be short-lived. At worst, they have simply encouraged inflationary pressures to become more embedded.

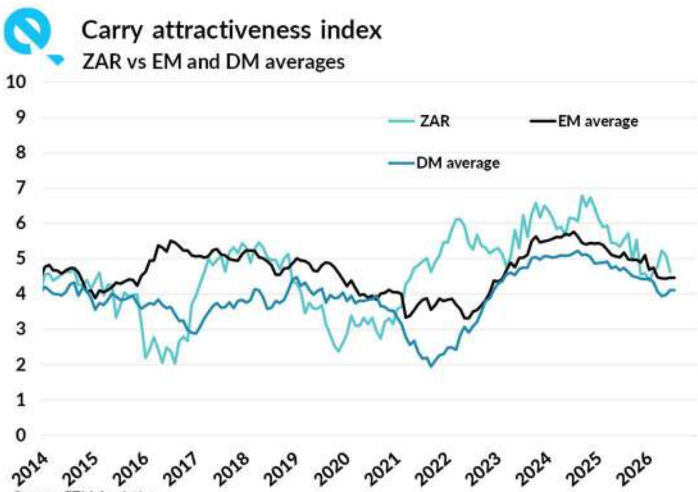
ZAR no longer stands out in carry attractiveness

Source: ETM Analytics

Furthermore, it is worth noting that prior to this interest rate decision, the ZAR did not sit particularly high up ETM's carry attractiveness index. Although it is still in the top half of the table, the ZAR does not stand out as a currency worth paying much attention to. On the contrary, it is grouped together with other key trading partners, such as the US with the USD and the UK with the GBP. In other words, based on this metric, there is no obvious reason to speculate constructively on the ZAR against these two majors.

The saving grace for emerging markets more broadly is that the JPY remains on the defensive for its own domestic considerations and retains its status as the world's favoured funding currency. Were this to reverse due to a global equity rout, for instance, emerging markets and the ZAR in particular would find themselves on the defensive. It is therefore fair to say that on the basis of the Carry Attractiveness Index, the ZAR is vulnerable.

Reflected in timeseries format, the ZAR is trading only marginally above the EM (Emerging Market) average. It does not stand out as a speculative play in any way, and the result is that the ZAR will remain more vulnerable to external shocks than if it ranked far above the EM average and stood out as a currency to back. The decision not to hike, therefore, affects far more than just household finances. It affects SA's currency, it affects its standing amongst other emerging markets, it does nothing to contain inflation and if anything has elevated the degree of volatility the ZAR will now be subjected to. Unless the ZAR makes a strong recovery to justify this decision, it could well go down as a mistake, and which places the SARB



Source: ETM Analytics

behind the curve, especially if developments in the Middle East escalate further and oil prices remain elevated.
