



Platform

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SARB'S CONUNDRUM - INFLATION TARGETING OR GROWTH?

Independent Insight in an Uncertain World

PIEXUS

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The latest CPI figure of 6% released by Stats SA last week, came in slightly above market expectations of 5,9%. Although the figure did not come as a big surprise, some interesting action took place in the fixed-interest market environment.

The yield on the locally traded R157, with a maturity of roughly four years (matures on 2015/09/15), shot up by 18 basis points from 6,9% on Tuesday, 22 November (the day before the release) to 7,08% on Friday 25 November's close. Although this might seem small, in the fixed interest rate environment it is quite a substantial move. And it came off a low of 6,36% as at 8 November, which was coincidentally the high point of the equity market before the recent drop.

Better still, and maybe more insightful, was the action on the Forward Rate Agreement (FRA) curve. This curve is an indication of where the market expects the very short end of the interest rate curve, i.e. the repo rate as issued by the South African Reserve Bank (SARB), to be at a couple of months out.

The accompanying graph shows how the market's expectations regarding interest rates have changed over the past few months. Despite the fact that the CPI figures released of late have kept on creeping higher, the market's expectations of future interest rate movements have been all over the place. The dark blue line indicates the most recent expectation, where the possibility of an interest rate hike is expected nine months out at least, meaning only at the end of August next year. This compares to end of June's expectation (purple line), when the market was still pricing in that the Reserve Bank might start increasing rates six months out from that point, meaning the end of this year or early 2012. However, at the end of September 2011 (brown line), amidst the doom and gloom of the Eurozone's debt crisis and declining business and consumer confidence across the globe, the market was pricing in the possibility of a decrease in interest rates.

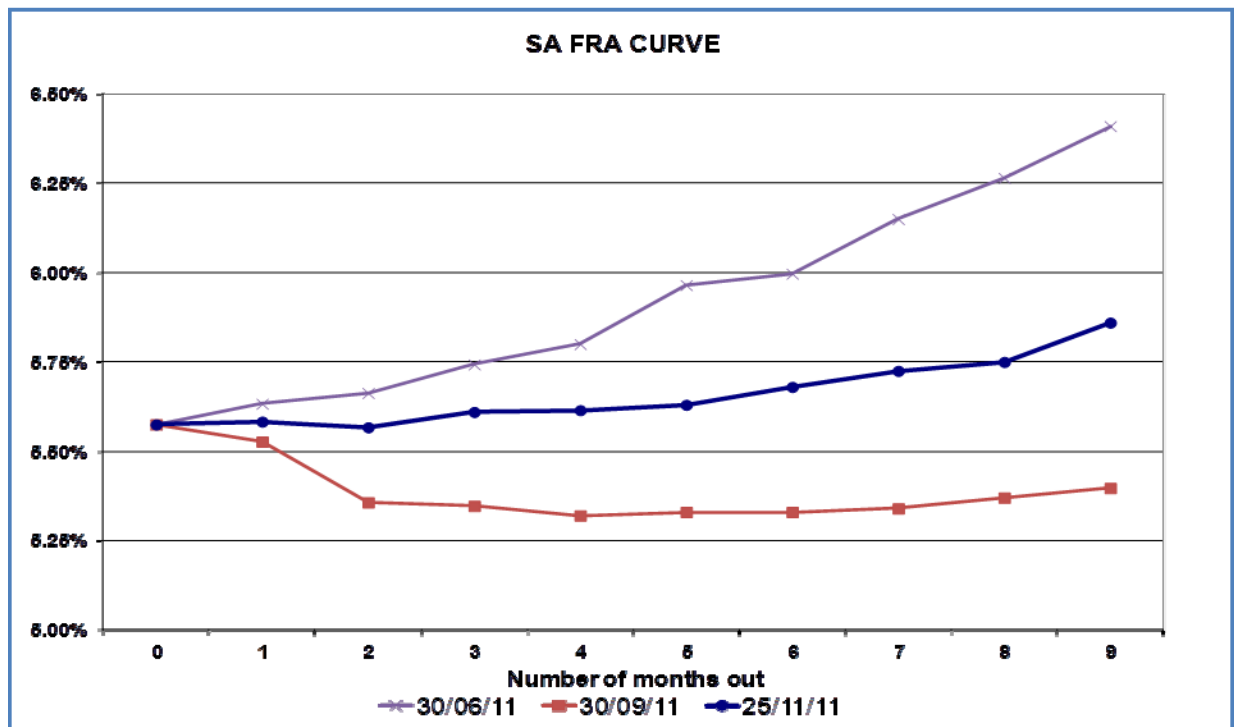
So, what happened over this short space of time for this vicious action to have taken place? There are currently factors in play over which the SARB has no control. We have the Eurozone's debt crisis that is affecting not only European economic growth, but also global growth. That of course means that the South African economy is also being hit as international demand starts to dry up and emerging markets are being shunned. Worse still, the European nations have not managed to come together and find a workable solution to address their problem as yet, which is sending markets into renewed sell-offs at any hint of difficulty.

Because of this crisis we believe there has been a perceptible shift in the SARB's focus from solely inflation targeting to also looking at the growth aspect of the local economy. Now the SARB needs to weigh the implications of a higher interest rate with the effect this may have on the local economy, and the dire need for more robust growth going forward.

Recent GDP numbers have been slightly disappointing despite a low interest rate environment that still is failing to stimulate growth. The poor GDP figures could keep pressure on the Reserve Bank to maintain the current low interest rate environment. Currently the local economy seems more dependent on the global recovery than domestic demand.

The expectation is thus for the SARB to keep rates steady at the moment, focusing more on the growth aspect of the local economy in order to give the economy a bit of breathing space to expand under these difficult conditions. This is portrayed by the current FRA curve under the current economic conditions as the market expects the next interest rate hike to come into play only nine months from now.

A low interest rate environment tends to favour equities under normal circumstances. The problem, however, is across the water, with the world's attention now squarely focused on Europe. With Italian and Spanish bond yields spiking higher, indicating the serious problems they have, the Eurozone needs to get its house in order, and quickly at that. Hopefully a solution to the crisis will come sooner rather than later, giving us all a most welcome present just in time for Christmas.



Source: I-Net Bridge