

Downward pressure on inflation gains momentum

by Mark le Roux

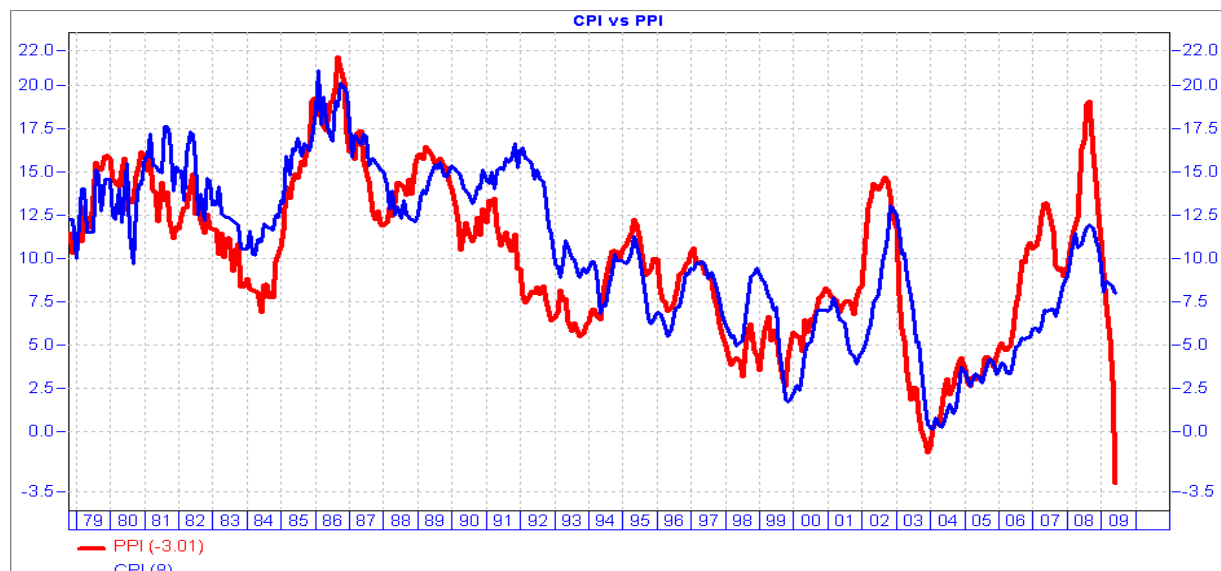
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Inflation data, while gradually moving downward, has continued to disappoint throughout the second quarter of this year, consistently coming in above consensus expectations. However, there are reasons to believe that the 'sticky' pace of decline is unlikely to continue and that the inflation story will be tilted back on a positive path. CPI should be back within its target range of 3%-6% by early 2010.

The three drivers tilting inflation on this course are food prices, producer price inflation and the rand.

Firstly, maize and wheat prices, which are a reasonable proxy for what is happening to food prices, are running in excess of 30% down on a year-on-year basis. While this has not yet reached the consumer in terms of lower retail food prices, it has already fed through to falling agricultural producer inflation and slowing manufacturing food inflation. Given the relatively large weighting of food prices in the overall CPI, the impact of this is likely to make a material difference.

The second positive contributor is producer price inflation (PPI). PPI tends to lead CPI with approximately a four-month lag, and the gap between these two measures is now at 11%. If the long-term relationship holds (see figure below), PPI is likely to exert downward pressure on CPI in the near future.

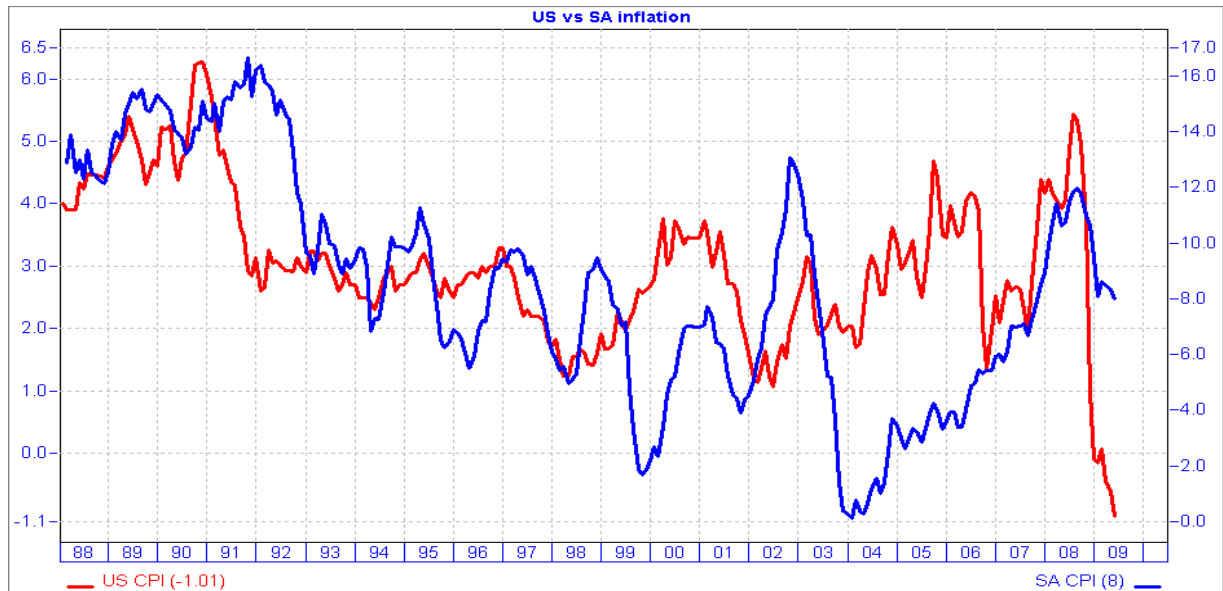


Source: I-Net Bridge

Thirdly, a key reason for the 'sticky' inflation experienced in the latter part of 2008 and early part of this year was the weakness in the local currency last year. The rand, however, has appreciated some 27% by end June from its lows in early March 2009, and this is likely to have a

significant dampening effect on inflation in the second half of the year - provided it holds these levels.

A further encouraging signal is global inflation. CPI in the US has continued to navigate lower (see figure below) since peaking in July last year. Lower global inflation should provide support for the direction of local CPI.



Source: I-Net Bridge

Added to these positive developments is the strong message from the Monetary Policy Committee in leaving rates unchanged at their June meeting. This demonstrates their willingness to continue wrestling inflation back into the target range.

While the local bond market has been weighed down by an overload of government and state-owned enterprise (SOE) issuance, the more positive inflation outlook bodes well for bonds over the longer term. The deluge of supply may well continue to weigh the market down, especially given that the budget deficit looks set to surprise on the upside and the exact composition of the revised funding requirements remains unknown. A positive argument can however be made from the likely trends in inflation, and the fact that the market may have underestimated the effect of the stronger rand in pulling inflation down from its current levels.

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