Investment reaction to MPC

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24 May 2020, Johannesburg – After a three-day policy meeting, the SARB’s monetary policy committee (MPC) on Thursday decided to cut the repo rate by a further 50 basis points (bps) leaving the South Africa’s prime lending rate at 7.25%. Unlike previous meetings, the agreed rate cut was not unanimous with 2 out of the 5 members voting for a 25-bps cut, meaning cuts higher than 25 bps may be harder to come by in future with parts of the economy slowly opening for business.

The immediate market reaction was quite muted with bond yields remaining stable, and the rand continuing to strengthen on the back of dollar weakness. The JSE closed the day lower – in-line with global markets. Interest rate cuts, do however, have an eventual impact on savings and investments.

Cash

For savers, the reduction in the repo rate will not be good news. Savings instruments linked to the prime lending rate will experience a reduction in interest earned on account of a lower variable interest rate. Savers with fixed instruments such as a fixed deposit will experience no immediate change to their saving returns, however savers looking to utilise a fixed vehicle post 22 May will see a reduction in the rates offered.
Bonds

On the back of a rate cut, bonds become more attractive to investors on account of the yield offered in comparison to other fixed instruments. The result is a decrease in the bond yield on account of the increased demand for these investment vehicles. Increase in demand increases the price of bonds and is positive for current bond holders.

Preference shares

Like cash investments, preference shareholders will not see the further rate cut as good news. As most preference share dividends are linked to the prime lending rate, a decrease in the rate results in less dividends received, decreasing the dividend yield as well as the price of the asset.

Property shares

Property companies will welcome the news of further rate cuts. Lower interest rates are positive for a sector that utilises debt heavily to acquire assets. The decrease in the rate will mean two things for property companies:

1. lower interest costs, increasing net property margins; and
2. an increase in the market value of properties on balance sheet due to a decrease in the discount rate.

Equities

Although a reduction in the rate was predicted by South African economists, the reduction will still be positive to certain South African equity stocks. Lower interest expenses, higher market value of assets as well as increased spending capacity on consumers results in combined positivity to certain equity sectors.
The impact of the rate cut on equities will not be as dramatic as previous cuts on account of reduced economic growth and job losses, however, will still have an effect.

**Retail and consumer facing shares**

These shares should benefit the most on account of the opening of all online trading with increased consumer spending capacity. The rate cut will mean lower monthly expenses to consumers, increasing spending capacity as well as access to debt at lower costs.

**Companies with high debt levels**

Companies will experience immediate relief in the form of lower interest costs on account of the rate cut. This should free up additional cash flow for these companies and present an opportunity to de–gear and begin reducing debt exposure.

To conclude, the Covid-19 outbreak has caused major challenges in forecasting domestic economic activity. The compilation of accurate economic statistics will remain severely challenged with many inputs still unknown.

Nonetheless, the large economic impact of the pandemic and the deep global recession will result in a sharp contraction in output in 2020. The SARB expects GDP in 2020 to contract by 7.0%, compared to the 6.1% contraction forecast in April. Easing of the lockdown will support growth in the near term and some high frequency activity indicators show a pickup in spending from extremely low levels. However, getting back to pre-pandemic activity levels will take time. This will mean income losses for households and businesses alike. The ensuing demand shocks suggest that inflation will likely remain low throughout the forecast horizon.

The local currency has depreciated substantially and will most likely remain relatively weak for the remainder of this year.
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Nevertheless, the exchange rate pass-through to inflation should remain relatively subdued, mainly due to the low demand levels. This means minimal upward pressure on inflation due to currency weakness.

These factors (deeper-than-expected GDP contraction and benign inflation outlook), combined with the zero policy rates in developed markets, have created further space for policy easing by the SARB and the Quarterly Projection Model (QPM) indicates two further possible cuts of 25 basis point each, into the next two quarters of 2020. It must be noted that the QPM serves as a policy guide and changes rapidly in response to data and risks.

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