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MPC Preview

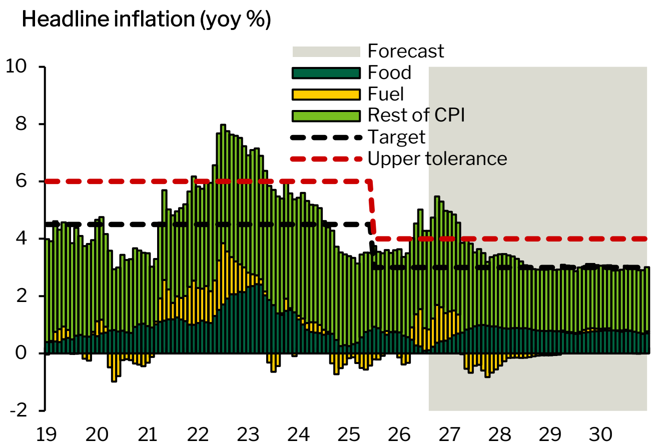
ECONOMICS | SOUTH AFRICA | MONETARY POLICY

NEDBANK

We expect a hike as the energy shock proves more persistent

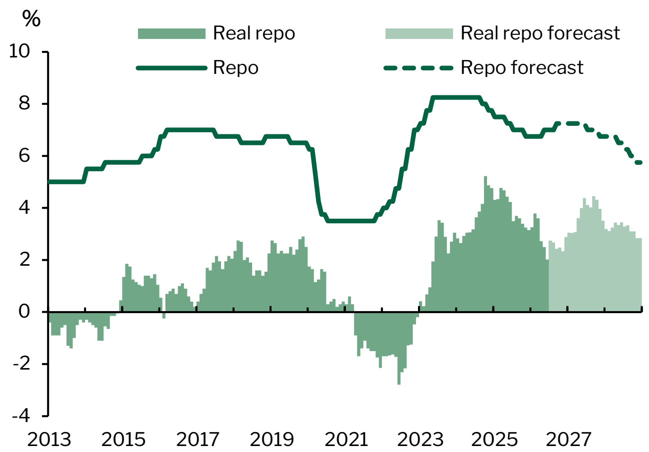
- The MPC's job is not getting any easier. When the MPC meets next week, the facts on the table will show that inflation softened over the past two months, inflation expectations stabilised in Q3, and the economy weakened over Q2. Despite these developments, the inflation outlook remains highly uncertain. The upside risks to the outlook have increased significantly since the last meeting. The Middle East conflict appears to be spreading, threatening alternative transport routes for Gulf oil exports, worsening the supply squeeze in the global energy markets and driving oil prices back above $100 per barrel. Recent oil price movements have already pushed local petrol prices up by an average of R1.34 per litre or 5.3% mom in September. Even more alarmingly, petrol looks set to increase by around R2 per litre or a scary 7% mom in October. Our calculations suggest the renewed petrol price surge alone will lift inflation above 5% yoy in October. Furthermore, the US Federal Reserve (Fed) under the new chair Kevin Warsh found the resolve to defy President Trump's wishes and to fight persistent above-target inflation, raising interest rates for the first time since 2023. As a result, the US dollar strengthened and the rand weakened. So far, the dollar's gain has been modest, but its recovery could gather momentum quickly if the Fed tightens monetary policy further in the months ahead. Considering these developments, we expect inflation to increase again from September onwards and to stay above the 4% tolerance limit for about 10 months, only returning to 3% around the middle of next year.
- For the MPC, the questions remain the same: Will the current oil price shock lead to significant and sustained second-round price effects and thereby set inflation expectations on an upward trajectory? Is monetary policy restrictive enough to contain inflation expectations through what is likely to remain a highly volatile period? The answers to these questions are not straightforward, which is why next week's meeting remains a close call between a hold or a hike for us.
- The case for a hold stems from the fact that there is little evidence of significant second-round effects. Firstly, price-setting behaviour remains mostly measured and contained. Given that domestic demand is weakening, and sales volumes are moderating, firms' ability to pass higher costs onto consumers will probably remain quite limited. Secondly, wage pressures appear subdued and will probably remain tame amid shrinking employment and fading union power. At this stage, the underlying inflation impulse appears relatively benign, and the mild Q3 inflation expectations survey partly reflects these realities.

Chart 1: Oil price volatility continues as the war drags on



Source: Stats SA & Nedbank GEU

Chart 2: Our interest rate forecast



Source: SARB & Nedbank GEU

- The case for a hike rest on the persistent and rising upside risks to the inflation outlook against the backdrop of the SARB's commitment to anchor inflation expectations around the 3% target. Firstly, the Middle East war has already lasted longer than most expected at its onset, entering its 7th month, with no end in sight. Instead, the conflict has intensified and broadened throughout August and September. At the same time, talks between the warring parties have completely fallen apart, suggesting that the prospects of finding a mutually acceptable offramp looks dim. A prolonged conflict now seems likely, which implies global energy supplies will remain tight and prices will stay high. Under these circumstances, it becomes harder to describe the energy shock as 'temporary'. Secondly, there is already evidence of broader global price pressures and the beginnings of a synchronised tightening in monetary policy across the globe. The Fed finally joined the hawks on Wednesday. Analysts expect another hike early next year and the markets priced in two more hikes by March next year. Traders expect the Fed's rate-hiking cycle to lead to a stronger US dollar. There are good reasons to be sceptical of the upside for the dollar, but the risk of a more meaningful appreciation has undoubtedly increased. A stronger dollar would inevitably lead to a weaker rand, which together with generally higher global inflation, would not only amplify the impact of higher oil prices but also raise import costs of a broader range of goods. Thirdly, add to the mix the threat posed to food prices from the anticipated El Niño weather patten and the benign price- and wage-setting dynamics described above could become unhinged. And finally, there is the need to safeguard the credibility of the SARB's new 3% inflation target. Inflation looks set to remain above the target for some time, our forecast suggests another 10 months. This is long enough to undermine policy credibility and unsettle inflation expectations.

- Weighing the case for a hold against the case for a hike, we think the MPC will raise its inflation forecast, stress the mounting upside risks to the outlook and choose to hike interest rates by 25 bps to reinforce policy credibility in the face of a more persistent energy shock.

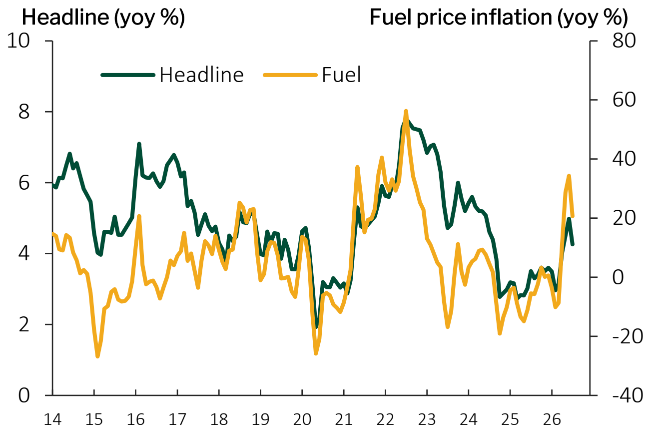
Recent inflation trends

Inflation outcomes have been volatile since the last MPC meeting, rising from 4.5% in May to 5% in June, before moderating to 4.3% in July. Fuel prices drove the acceleration in June and the deceleration in July. Petrol prices declined by an average of R1.98 per litre or 7.2% mom in July as global oil prices fell sharply after traffic through the Strait of Hormuz briefly picked up following extended ceasefire and signing of the short-lived 'memorandum of understanding' between the US and Iran. As a result, local fuel price inflation eased from 34% yoy in June to 20.6% in July.

Continued food price disinflation also helped. Food inflation declined further over the past two months, slowing from 1.6% in May to 1.4% in June and a modest 0.6% in July. Prices of most food products either contracted or rose at a slower pace. Meat prices decelerated significantly as the impact of foot-and-mouth disease faded, receding from 7.3% in May and 5.1% in June to just 1.5% in July, its lowest level since June 2010. Cereal, fruit and vegetable prices all declined further, still benefitting from good rains, healthy inventories, higher production and subdued global food prices.

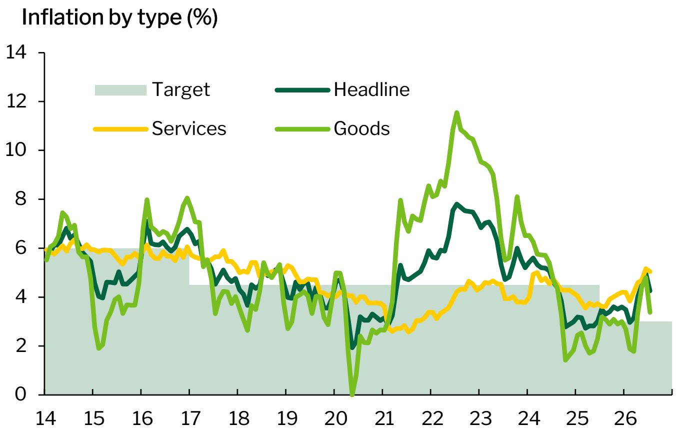
Despite the respite in fuel prices, there were some worrying developments in the July numbers. Services inflation remained elevated, easing only slightly from 5.2% to 5%. After climbing steadily over the past twelve months, owners' equivalent rent and actual rentals remained unchanged but elevated at 4% and 4.1%, respectively. Electricity tariffs rose by 8.3%. The ongoing pass through of earlier fuel price hikes drove taxi fares up and kept public transport costs at a high 11.8%. Insurance, dominated by health insurance, also remained well above target at 5.9% in July. At the same time, restaurant prices rose at a faster pace, climbing from 5.7% in June to 5.9% in July, probably also reflecting higher transport logistics costs. These pressures suggest that the impact of the global energy price shocks continued to filter through the broader economy. Consequently, core inflation, which excludes food and fuel, accelerated to a three-year high of 4.2% in July.

Chart 3: Inflation eased slightly on lower fuel costs



Source: Stats SA

Chart 4: Goods and services inflation also moderated



Source: Stats SA

Our inflation forecasts

Our inflation outlook has worsened since the last MPC meeting. We have upped our inflation forecast for the near term considerably. Predictably, the upward revisions stem from our assumption of a prolonged conflict in the Middle East, leading to repeated or persistent disruptions to transport routes, which will strain global energy supplies and keep oil prices at uncomfortably high levels. Consequently, fuel price inflation is expected to remain in double digits for the rest of 2026 and into early 2027, prolonging the direct and indirect inflationary effects of the energy shock.

Apart from these pressures, we also see food inflation reversing course, gradually rising from its current lows, driven by rising input costs due to higher fuel and fertiliser prices and more adverse weather conditions as El Niño lowers local and global production. At this stage, we forecast a mild upcycle in food inflation, climbing slowly from a low 0.6% in July to 2.6% by year-end before accelerating to a peak of around 5.9% in September next year. We expect the impact of the upcoming El Niño episode to be partly contained by healthy groundwater and reservoir levels and ample local and global food inventories. At this stage, leading meteorologists are confident that El Niño conditions will manifest in October and continue to February. If these predictions materialise, the ensuing drought will only affect the 2026/27 planting season, which suggests that the above buffers should be enough to prevent a more severe and prolonged rise in food inflation.

Beyond food and fuel, administered prices are expected to remain a persistent source of inflationary pressure. Increases in electricity and municipal water tariffs continue to raise production and operating costs, creating ongoing cost-push pressures. While the rand will likely lose some ground against a stronger US dollar, we still expect it to remain relatively resilient and act as a mild disinflationary force over the next 6 months. Finally, softer domestic demand will also dampen price pressures and contain second-round effects from the energy shock.

Turning to the numbers, the 2% mom reduction in average petrol prices will probably keep inflation steady at 4.3% in August. Thereafter, inflation will increase again. Petrol prices already rose by an average of R1.34 per litre or 5.3% mom in September and looks set to increase by about R2 per litre or 7% mom in October. Our calculations suggest the renewed petrol price surge will push inflation above 5% between October to November, before slowly receding over the next six months, with a more convincing step down towards 3% anticipated in the second half of the year. Some form of government relief such as cutting the fuel levy as they did in April would help to cushion the impact. Without relief, we forecast inflation to average to 4.3% in 2026, 3.5% in 2027 and 3% in 2028.

Revisiting the balance of risks to the inflation outlook

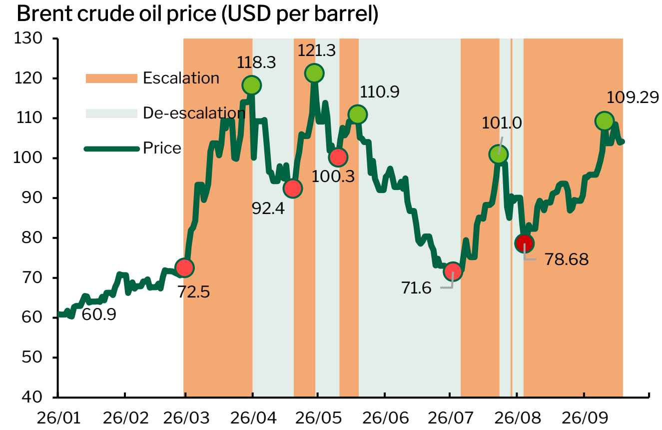
Risks to the inflation outlook remain firmly skewed to the upside. Since the last MPC meeting, the upside risks from the energy shock increased significantly amid yet another escalation in the Middle East conflict and the rand's prospects looks more subdued as tighter US monetary policy could boost the dollar and weigh on risk appetites. Beyond these immediate concerns, the threat of a 'super' El Niño also looms large in the background. In contrast, downside risks also emerged. Inflation expectations stabilised in Q3, and the economy contracted over Q2. Given the conflicting forces impacting inflation, we will take a closer look at how these risks are likely to evolve in the months ahead.

Global oil markets: How bad is it?

Underlying conditions in global oil markets look more precarious than at any time since the US-Iran war started in late February. Since the breakdown in the Memorandum of Understanding in July, the fighting has intensified and broadened. Iran attacked more ships in the Strait of Hormuz, reinforcing its chokehold over the critical waterway. In response, the US has maintained its blockade on Iranian ports. Iran's proxy in Yemen, the rebel Houthi group, also entered the conflict more aggressively, striking the East-West Pipeline in Saudi Arabia and capturing large tracks of land overlooking the Strait of Bab El-Mandeb, thereby threatening the most significant alternative transport route for Gulf exports through the Red Sea.

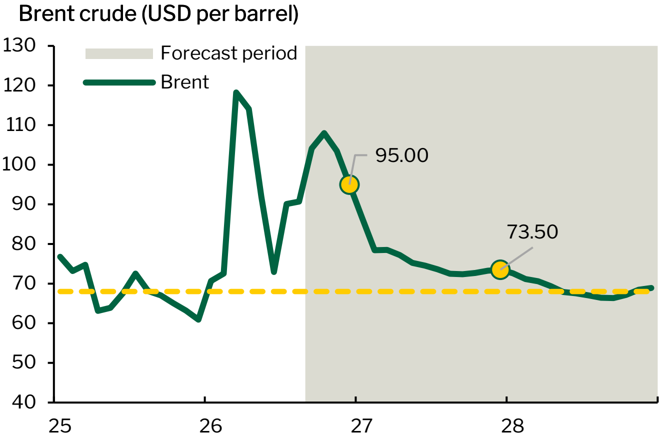
The latest escalation came as global oil and refined product inventories fell significantly. The US Energy Information Administration (EIA) estimates that global oil inventories declined by 400 million barrels so far this year and expected the drawdown to continue for the rest of the year. The market for refined petroleum products, especially diesel, is even tighter than that for crude oil. Bloomberg reports that China's diesel inventories have fallen to a 15-month low and that of petrol is at its lowest level since 2022. Across the globe, refineries are running near full capacity, struggling to compensate for loss of exports from two of the world's major fuel-processing hubs, the Middle East and Russia. As a result, prices of all energy products marched upwards towards their earlier highs. Brent crude surged from $71.08 on 1 July to $90.09 on 1 August, before breaching the $100 mark on 9 September.

Chart 5: Oil price volatility continues as the war drags on



Source: LSEG

Chart 6: Our oil price assumptions



Source: LSEG & Nedbank GEU

To make matters worse, the chances of finding a quick offramp from the war looks slim as neither the US nor Iran appears willing to negotiate. Yesterday, Saudi Arabia offered a glimmer of hope, announcing that they have managed to recover about half of the capacity of its East-West Pipeline within days from the attack, and expect a return to full operation within roughly six weeks. Meanwhile, Saudi Arabia is rerouting more crude exports in an elaborate process to avoid Iranian detection along the Omani coastline of the Strait of Hormuz. These so-called dark transits appear to have increased and likely prevented an even sharper rise in energy prices.

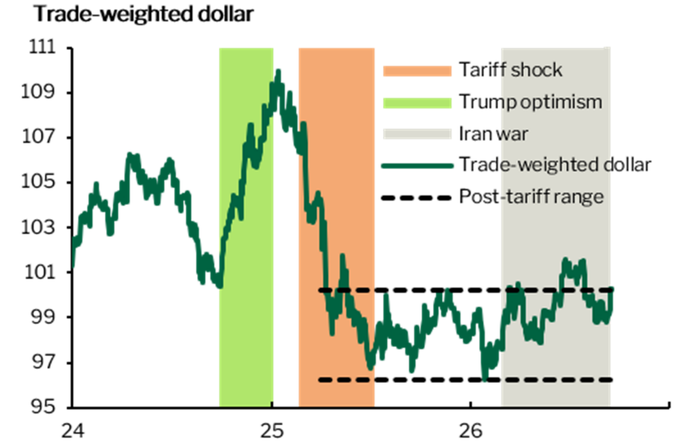
While the search for alternative transport routes will intensify and probably become a strategic imperative over the longer term, a sustainable normalisation in global energy supply remains highly dependent on the restoration of traffic through the straits of Hormuz and Bab El-Mandeb over the medium term. If these bottlenecks persist, inventories will fall further, the risk of more widespread physical shortages will increase, and prices will have to rise even more to reduce demand sufficiently to restore market balance. Under these circumstances, the direct and indirect effects of higher energy prices would be much higher, elevating the risks of a broad-based acceleration in global price pressures and more persistent second-round effects.

We still think the world will scrape through on the innovative rerouting of Gulf exports, higher output from oil-producers outside the conflict zone, and softer demand conditions. But it is difficult to see a clear path out of this conundrum without material compromises by the warring parties.

The rand: Still resilient, but more vulnerable

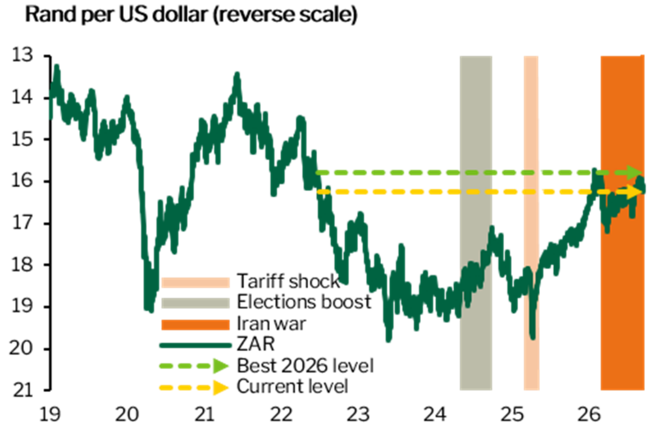
The downside risks for the rand have increased. The pressure will come from two fronts: The increased probability of a more prolonged energy shock and the strong likelihood of further hikes in US interest rates. A prolonged energy crisis would lead to a general increase in risk-off sentiment among international investors. Emerging markets will bear the brunt of fading risk appetites as their growth and inflation prospects become more adversely affected than those of the US and other advanced countries. Tightening US monetary policy, if significant, will amply the risk aversion, and erode the interest rate margin to the US dollar. With the US Fed raising interest rate by 25 bps this week, it has not only partly restored its credibility but raised expectations of more hikes in the months ahead. Analysts expect another hike early next year and the markets priced in two more hikes by March next year. Traders expect the Fed's rate-hiking cycle to lead to a stronger US dollar. There are good reasons to be sceptical of the upside for the dollar, but the risk of a more meaningful appreciation has undoubtedly increased. A stronger dollar would inevitably lead to a weaker rand. So far, the rand's depreciation has been modest. After the Fed hike, the rand depreciated briefly to R16.37 against the dollar, but quickly returned to R16.23, where it traded before the Fed's move. We still expect the rand to hold relatively steady around R16.20 level, underpinned by the country's improved fiscal outlook, ongoing structural reforms, monetary policy credibility and improved credit ratings. Consequently, we expect the rand to remain a source of mild disinflationary pressure for the rest of this year.

Chart 7: The dollar's gain has been modest



Source: LSEG

Chart 8: The rand is softer, but still resilient

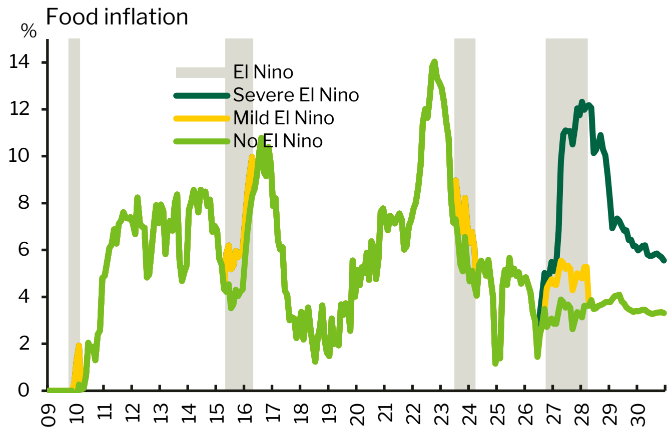


Source: LSEG

Food prices: El Niño could put food inflation back on the boil

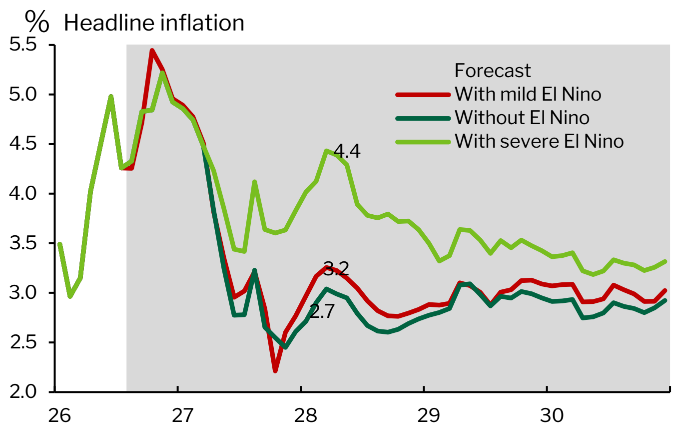
Meteorologists currently expect the upcoming El Niño cycle to be among the strongest on record. Such conditions pose significant risks to agricultural production, livestock farming and transport infrastructure, threatening food security and potentially generating supply shortages that place upward pressure on food prices. The impact is not uniform across countries and regions. Several regions are already experiencing above-normal temperatures and below-average rainfall. For South Africa, the effects are expected to emerge during the summer rainfall season, beginning in the final quarter of 2026 and extending into 2027. Given the lagged transmission from agricultural production to retail food prices, the full inflationary impact could persist well beyond the initial weather shock and extend into 2028. Maize, fruit and vegetable production are particularly vulnerable owing to their sensitivity to rainfall patterns and temperature extremes.

Chart 9: Food inflation scenarios



Source: Stats SA & Nedbank GEU

Chart 10: El Nino is likely to have a mild impact on inflation



Source: Stats SA & Nedbank GEU

Our baseline forecast assumes a relatively moderate El Niño impact as several factors are expected to cushion domestic agricultural production from the worst effects of adverse weather conditions. South Africa enters the 2026/27 production season from a relatively strong position following above-average rainfall during late 2025 and early 2026, which resulted in improved dam levels and favourable soil moisture conditions. These factors should provide some resilience, particularly in rain-fed agricultural regions, reducing the immediate impact of lower rainfall during the early stages of the El Niño cycle.

The greater risk may stem from the external environment. Severe drought conditions in major global food-producing regions could lead to higher international food prices and increase the cost of imported food products and agricultural inputs. Nevertheless, the pass-through to domestic inflation is expected to be contained by the relatively firm exchange rate assumed in the baseline forecast. In this scenario, food inflation is projected to rise gradually, peaking at around 6% in the third quarter of 2027 and remaining elevated between 3.5% and 4.5% through much of 2028. Despite this acceleration, headline inflation is expected to remain relatively contained, at an average of 4.7% in the first quarter of 2027 before moderating to 3% by year-end and hover around 3% throughout most of 2028. On an annual basis, this will result in inflation average of 3.3% for 2027 and 3% for 2028. Although inflation would broadly remain within the 4% and 2% tolerance band, the persistence of elevated food price pressures would slow the pace of disinflation and increase the risk of second-round effects, particularly if households and firms begin revising their inflation expectations upwards.

In a more severe scenario, adverse weather conditions persist for longer than currently anticipated (persisting at various degrees throughout 2027). A more prolonged weather shock could deplete dam levels, reduce soil moisture reserves and further constrain agricultural output, leading to food inflation outcomes that are materially higher and more persistent than currently assumed in the baseline forecast. This would result in a substantial deterioration in both domestic and global food supply conditions. Under this scenario, global food inflation reaches around 30% by March 2028 while domestic producer food prices rise steadily to around 18% by the fourth quarter of 2028. Assuming fuel prices and the exchange rate remain unchanged from the baseline, consumer food inflation would increase to 12% by the third quarter of 2027 and remain in double digits throughout 2028. The broader inflation outcome of this scenario would be material. However, even so, headline inflation would peak at around 5.2% in November 2026. However, inflation would average higher at 4% in 2027 and 2028. In this scenario, food price pressures would delay inflation's return to the 3% target to 2029 as more significant second-round effects would emerge.

In conclusion, if the El Niño event proves truly severe, inflation will likely remain above target for the next two years.

Will rising cost pressures subdue domestic demand enough to tame inflation and inflation expectations?

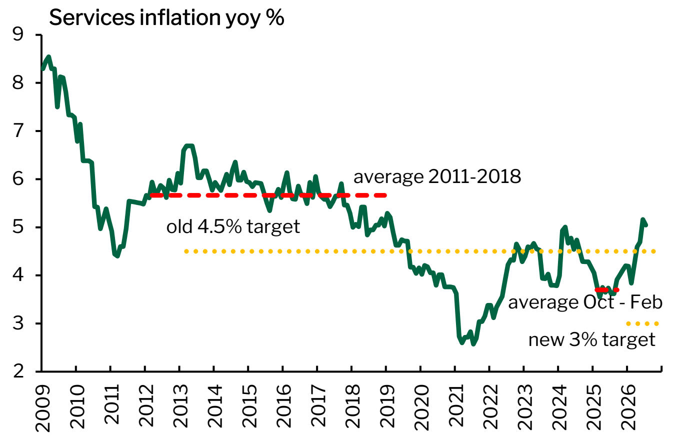
GDP contracted by 0.2% over Q2. However, the drag came from net exports and not from domestic demand. Instead, domestic demand picked up moderately in Q2 after slowing in Q1. Even so, demand conditions have softened relative to last year. The weakest has been most visible in consumer demand for goods, which has prompted firms to increase discounting and promotional activity. But these normal demand-side adjustments do not extend to services. Demand for services recovered in Q2 and service inflation remained elevated at 5%. Services inflation started trending upwards long before the energy shock emerged. Health insurance and owners' equivalent rent rose gradually throughout 2025 and early 2026, exerting persistent upward pressure on inflation. The fuel price shock added a new layer. Airfares jumped from almost no contribution to services inflation to 33.8% yoy in April and increased at average pace of 28.2% between April and July. Minibus taxi fares rose 13.1% yoy in both June and July, making them the third-largest contributor.

The SARB sees services as the main channel for second-round effects, through wages, expectations and transport. The logic is straightforward. Services are labour-intensive, so wages feed into prices more directly than for goods. Services prices are also reset annually and by reference to expected inflation, so rentals, medical scheme premiums, school fees and insurance premiums embed expectations for a full year. Transport is the fastest most direct channel, converting higher fuel costs into services prices within months. Because fuel is excluded from core inflation, but taxi and air fares are not, the shock moves into underlying inflation (the shock crosses from non-core to core inflation). Since monetary policy works with long and variable lags and cannot prevent the first-round effect of higher fuel prices, the SARB must act before second-round effects appear in the data. So far, pass-through is evident in transport costs but not in wages. The BER's Q3 inflation expectations survey shows average expectations for 2026 remaining at 4.4%, unchanged from Q2. Expectations for 2027 eased from 4.2% to 4%, and five-year expectations dipped from 4.1% to 4%. The trade union results matter most for the wage question. In July, the SARB noted that trade unions recorded the biggest increase in inflation expectations in the Q2 survey. That has since reversed. Union expectations for 2027 fell from 4.4% to 4.1%, and their five-year expectations fell from 4.7% to 4.3%.

Even so, services inflation tends to settle around a level and stay there, and that level has consistently been above the inflation target. Between 2011 and 2018, it hovered closer to 6%, the top of the old 3–6% target range, before edging lower from March 2019. With the target now at 3%, services inflation is probably still finding a new resting point. Its average of about 3.7% between February and September 2025, offers a clue that even in a benign environment, services settled well above 3%. That upward bias is not accidental. The SARB has highlighted structural drivers, notably medical scheme premiums that consistently outpace headline inflation and administered costs that rise faster than general prices. These pressures do not fade when fuel prices fall. So, even once the energy shock passes, services inflation is likely to settle at a level above target. This implies that anchoring overall inflation at 3% could take longer than the SARB's forecasts suggest.

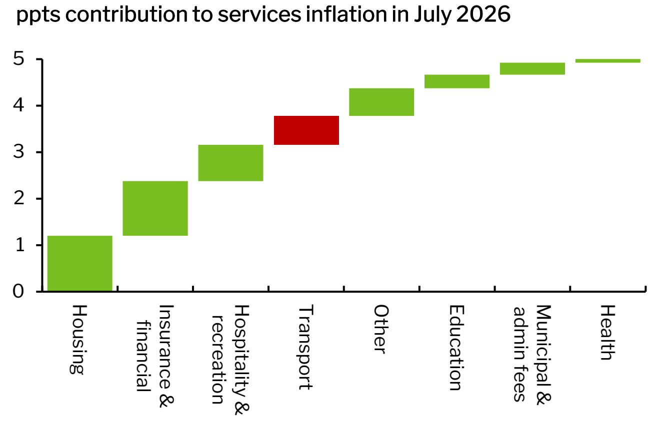
The SARB's tone has hardened this year. In January it described services inflation as still above 4% and needing to move closer to 3%. By July it was calling services inflation "problematic", with most components well above 3%. In our view, services inflation is a near-term upside risk that will be closely watched at next week's meeting. It is also a longer-term risk, and because its causes are structural, interest rates may need to stay elevated for longer to ensure it settles at a level much closer to the 3% target.

Chart 11: Inflation hovered close to 6% between 2011-2018



Source: Stats SA

Chart 12: Housing contributed the most to services inflation



Source: Stats SA & Nedbank GEU

Monetary policy implications

We acknowledge the current combination of weaker growth and rising inflation complicates the monetary policy decision. We expect the SARB to hike by 25 bps not because we see demand pressure on prices, but because the energy shock looks set to persist for longer and inflation appears likely to remain above target for an extended period, which would erode the credibility of the 3% target. The longer inflation stays above target the greater the risk that households and firms begin to view higher inflation as persistent rather than temporary and start to adjust their wage and price-setting behaviour, accordingly, allowing inflationary pressures to persist even as economic activity weakens.

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