

Our expectations:

In the last couple of months, the drop in monthly prices was mainly due to a decrease in food prices, which is the largest contributor of the consumer price index (CPI). This puts the last 6 months' average monthly inflation at around 0.7%, which we believe is a stronger indicator of price stability than yearly figures. In its Article IV consultation and second program review, the International Monetary Fund (IMF) urges the CBE to focus on seasonally-adjusted monthly inflation trends, and consider gradual monetary easing only if inflation expectations and different key macroeconomic indicators suggest the absence of demand-pull pressures and second-round effects. The report added that private investment growth is key to a more sustainable GDP growth. Although we agree on the importance of price stability and stimulating private growth, we see the start of an easing cycle as the true catalyst to private investment growth at the current stage rather than further legislative reforms. While the IMF expects inflation to decelerate to 12% by July 2018, the report considers the premature easing of monetary policy as a foreseen risk. From our belief that policy rate movements should react to inflation expectations, and that the start of an easing cycle is a catalyst to growth, we expect the CBE to start cutting rates at its February MPC meeting. That said, we do not see the monetary easing as a pressing risk to capital flight nor currency devaluation. We base our belief on the strong reported external position figures and the rise of foreign holdings in local T-bills by around USD1bn since the beginning of the year, despite the drop of 1-year T-bills yield by c200 bps. The reported balance of payments for 1Q17/18 shows strengthening fundamentals, with the current account recording an annualized deficit of USD6.56bn, narrower than the annualized deficit of USD19.13bn for the same period a year earlier and an actual deficit of USD15.58bn in FY16/17. Additionally, 1Q17/18 foreign direct investments almost fully cover the current account deficit, implying strong external position fundamentals. Accordingly, we believe the MPC will likely cut policy rates by 100 bps at its upcoming meeting.