INVESTMENT AND SOVEREIGN RESEARCH

***SOVEREIGN*: Jamaica** **September-28-2021**

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

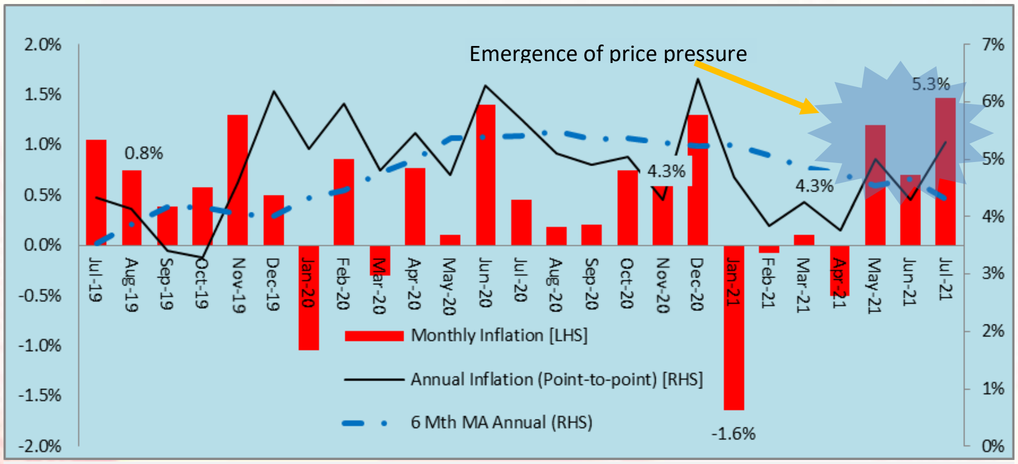
Summary

The Bank of Jamaica appears set to raise the policy rate despite inflation pressures arising from external price shocks. Advanced economies are facing higher than usual inflation but are likely to keep their policy rate fixed as a desire for robust and stable growth supersedes their desire to bring transitory inflation under control. Jamaica's economic growth is likely to remain robust in Q3:21 but will taper off in 2022 as the pace of economic recovery fades. With the fiscal accounts showing stronger than expected revenue inflows and increasing health and security costs, the government is set to table a supplementary budget. An increase in interest rates threaten to raise the cost of servicing government debt and lower medium and long-term economic growth.

Inflation

The Bank of Jamaica projected inflation to end the year within a band of 4%-6% by the end of FY 2021/22, which is relatively in line with the team of JMMB internal research. As of the end of July, the 12-month inflation rate was 5.4%, up from 4.3% in June. Information received from the Statistical Institute of Jamaica (STATIN) points to price pressure coming from increases in local agricultural produced–starch, vegetables, cooking bananas, plantains and pulse; electricity, water and sewage; and transportation. Domestic agriculture products account for roughly 35% of the consumption basket that STATIN uses to calculate headline inflation. Thus, supply shocks–weather-related or otherwise–have a profound effect on domestic inflation.

Figure 1: Inflation, point-to-point and monthly



Sources: STATIN and JMMBIR

Since the start of the fiscal year, there were at least two instances where heavy rainfall across the island damaged agriculture produce. This caused the price of some agricultural products to increase. However, as supply rises with more favourable weather, prices decline. As a result, the impact of agriculture prices on headline inflation reflects domestic supply conditions more often than not.

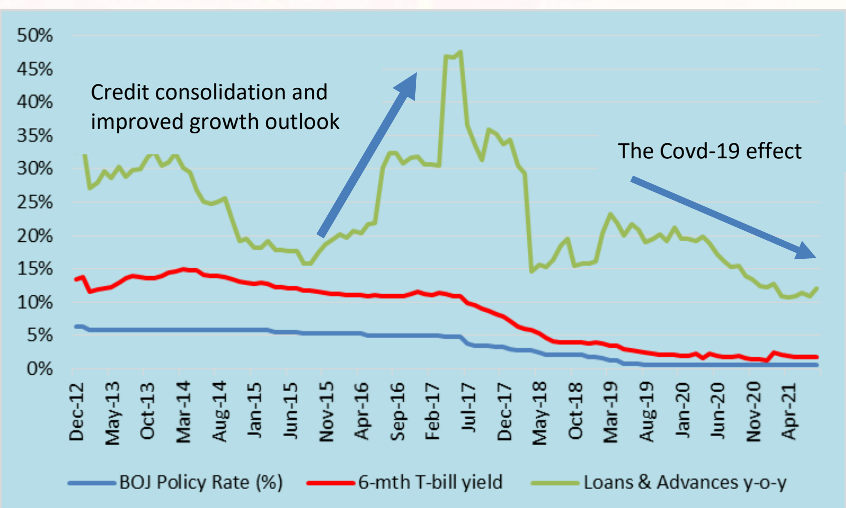
External conditions also affect local inflation. Towards this end, the price of imported commodities–crude oil/natural gas prices, chemicals and metal products, and food (grains, meat and starch) - also affect local inflation. The depreciation of the domestic currency further amplifies movements in external prices. With the COVID-19 pandemic, supply channels are affected in many countries because of restrictions on the movement of persons to help stem the rise in infection. Globally, we observe an increase in commodity prices because of this phenomenon, plus elevated shipping costs because of logistic challenges at several ports. An increase in commodity prices feeds into domestic inflation. Developed markets are experiencing elevated inflation owing to some factors outlined previously. In July, the average inflation rate across the Organization of Economic Cooperation and Development (OECD) countries was 4.2% compared to 1.4% in 2020. Inflation in the United States of America increased to 5.4% in July compared to 1.2% in 2020.

Despite the price rise, the Federal Reserve has not signalled to raise the policy rate, as economic growth remains fragile and headwinds from the COVID-19 pandemic persist. In most developed countries, their policy rate remains unchanged. We do not expect any change until at least the second half of 2022. There is even a signal that the European Union Central Bank may adopt a negative interest rate in the coming months. Closer to home, the Central Bank of the Dominican Republic (CBDR), which has an inflation targeting policy regime, has held its policy rate fixed at 3.5%. The bank reduced the policy rate by 100 basis points in March 2020. Despite inflation running above the upper band of its targeted rate, it has no intention of adjusting the rate upwards, at least not in the short run.

The rationale underlying the bank's action is twofold: i) to assist with the economic recovery that is on the way, and ii) higher than expected inflation is transitory, the price level is expected to normalise over Q4:21 into the first half of 2022. The DR's inflation rate is more susceptible to external price shocks than Jamaica, owing to the high energy component of their inflation basket.

Interest Rate

Figure 2: Loans & Loan Advances growth and Selected Interest Rates



Sources: BOJ and JMMBIR

Domestic interest rates could trend upwards because of the posture of the Bank of Jamaica (BOJ). After holding the policy rate fixed at 0.5% since August 2019, the governor signalled that the central bank might increase interest rates to attenuate the risk of inflation overshooting the upper band of its forecast target. While this may not come to fruition, the market is highly likely to price in the expectation of an increase in interest rates in the short run. Treasury bill (T-bill) yields have trended down over the past five years. The yield on the 6-months instrument in September was 1.66%, approximately 50 basis points higher than August. Before the governor's announcement, we expected T-bill yields to move closer to the policy rate of 0.5% by the end of the fiscal year. However, given the increased probability of upward adjustments in the policy rate, yields are likely to trend higher instead of downwards.

Capital Market & Equity Markets

Low-interest rates coupled with prudent fiscal policy have provided fuel to the local capital and equity markets. In the five years leading up to the Covid-19 pandemic in 2020, we witnessed strong growth in both markets. Despite the headwinds from the Covid-19 pandemic, capital market transactions remain buoyant as local corporates position themselves to take advantage of opportunistic growth and synergies. There are still projects in the pipeline with tremendous growth opportunities that offer a reasonable rate of return. Corporates will still carry out these projects despite a likely rise in interest rates. On the downside, some corporates may shelf marginal projects, as returns may not be sufficient. The rate change is likely to cause a reduction in investments. The quantum of the decline will depend on the pace and magnitude of the shift in domestic interest rates and the outlook on the economy.

Like the local capital market, low-interest rates have buoyed the equity market in part. Some corporates swap out high-cost debt for lower-cost debt and/or take on additional leverage to pursue activities that increase value added returns to shareholders. Driving this thrust was the positive outlook on the domestic economy and the low cost of debt financing. We have observed a noticeable improvement in the balance sheet of listed companies on the Jamaica Stock Exchange (JSE) and some private companies.

On the household side, using overall loans and advances (LAD) from commercial banks as a proxy for household credit, we see where LAD for the five years leading up to December 2013 increased at a compound annual growth rate (CAGR) of 9.5%. For the five years up to December 2019, LAD grew at a CAGR of 17.2%. Because of the economic slump in 2020, credit expansion slowed to 10.2%, while for the six months ending June 2021, credit growth slowed to a mere 5%. Economic contraction and job losses coupled with the already high debt burden for households influenced the reduction in credit growth, as liquidity levels remain relatively elevated. Given the prevailing headwinds from Covid-19, an increase in interest rates could further limit credit growth, lower aggregate demand and lengthen the timeline for nominal GDP to return to the level recorded in 2019.

Outlook on Growth

The Planning Institute of Jamaica estimated that the economy expanded by 12.9% in Q2:21 relative to the similar period in 2020. The positive outturn reflected robust growth in Tourism (330.7%), Other Services (50%), Construction (18.3%) and the Distributive Trade (13.2%). As a result of this performance, the BOJ expects the economy to expand by 5%-7% at the end of the fiscal year, up from 4% - 5%. With the third wave of Covid-19 infections now affecting the island and no movement days imposed by the government to minimise the spread of the disease, the pace of economic expansion is likely to slow in Q3. The vaccination rate is rising but remains well below the 75% -80% deemed appropriate to achieve herd immunity. While more extended lockdowns can help stem an increase in transmission of the disease, hospitalisation and even death, they will not do so over a long period without sufficient persons getting the vaccine. We are likely to see an increase in these variables if the vaccination rate remains low.

We expect economic growth to improve in Q4, assuming the number of Covid-19 infections remains subdued. Overall growth in 2021 will reflect recovery, as output is likely to remain below the 2019 level. Although we expect the economy to continue to improve in 2022, lower year-on-year growth is envisaged compared to 2021. The outlook reflects a high rate of vaccination and improvement in the domestic supply channel. Depending on the monetary/interest rate policy of the BOJ and developments in the international economy, the equity market could experience more robust growth than in the pre-pandemic period.

Supply-side challenges could persist longer than expected because of the slow vaccination rate in commodity-dependent developing countries, an increase in Covid-19 infections/deaths, and an increase in global interest rates which would dampen inflation expectation in developed countries but lead to other challenges. All three forces could amplify existing problems, causing global growth to slow. For Jamaica, this could harm remittance flows, tourism, and economic growth.

Synopsis of GOJ Fiscal Operations and Growth

Resulting from the third wave of coronavirus infections and increased spending on healthcare and security, the Government of Jamaica (GOJ) has given notice to table a supplementary budget to account for the shift in expenditure. For the period April–July, central government operations generated a primary surplus of $38.2 billion. When compared to budget, this was $26.4 billion or 223.2% better. The performance reflected higher than budgeted revenue intake of $17.3 billion (8.3%) and lower spending of $7.3 billion (3.1%). A breakdown of revenue figures shows above budget performance for Income and Profit, Production and Consumption and international Trade of $1 billion (2.3%), $4.7 billion (7.8%) and $11.3 billion (20.7%) respectively. International trade accounts for over 66% of the higher than expected flows. We expect the outlay on budgeted items to speed up over the rest of the fiscal period to close the gap on overall expenditure relative to planned spending.

Stronger than programmed economic growth could continue to fuel a revenue increase. However, the lockdown will slow the pace of growth in Q3, which could persist into mid-2021 if Covid-19 infections remain stubbornly elevated. Based on the numbers, the GOJ has room to increase spending by at least $10 billion without breaching the primary balance target set at the start of the fiscal year. Given that better than programmed revenue is likely to fund the increase in expenditure, we do not expect loan intake to depart from budget. Despite the uncertainty about a rise in interest rates, this is good news for the local capital market.

Conclusion

We believe that inflation will probably rise above the BOJ's upper band of the forecast towards the end of the year into Q1:21. However, the pressure source will manifest from the global price rise, and that is outside the central bank's control. **We also believe that elevated inflation is transitory and will revert to the mid-point of the forecast range**. As the global supply chain challenges abate and the pace of economic expansion normalises in larger economies, international prices are likely to fall. Jamaica is on the path to economic recovery. Real GDP remains well below 2019 despite record growth during the second half of 2021. We do not expect nominal GDP to return to 2019 levels until 2023. An increase in interest rate could extend that recovery period, as it could unwind capital expansion and stall marginal projects. **The DR experience has shown that the markets are not quick to punish policymakers when external shocks force prices beyond the target, especially if the rise in prices is transitory.**

While the probability has increased that the BOJ governor will raise the policy rate, there is no certainty that he will do so and when. With the expectation of an interest rate increase, the market will react. Therefore, we expect to see this in the pricing of financial products and Treasury bill yields. **All the sectors in the economy are likely to feel the effect likewise the possibility of increased costs for financial products, including mortgages, credit card debts and personal loans. Even the central government will not escape a rate hike as 34% of the domestic debt is variable-rate debt.** The market will demand higher coupons for future issuances. The economy is likely to experience lower aggregate demand and slower growth over the medium term. However, we expect growth to remain buoyant and corporates across all sectors to report improved financial performance in the short run.

If there is a marginal, one off, rate increase, it will have a negligible impact on debt servicing costs this fiscal year. It will also not hinder the robust revenue performance relative to budget. As noted, we think the GOJ has at least $10 billion at its discretion, which can be used on increased outlay for health and security without breaching the primary balance target. The lockdown has shown a critical need for food for school children and the vulnerable and the need for children engaged in online learning to have internet access and tablets/laptops. The better than programmed resources available to the GOJ allow additional spending to meet these needs in the short run. However, over the long run, smarter spending and higher economic growth are needed to help reduce unemployment and poverty and increase income levels.

Sources: Bloomberg and Fitch Connect

APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

PLEASE NOTE THAT NO INDIVIDUAL ASSET IN YOUR PORTFOLIO SHOULD HAVE A WEIGHTING GREATER THAN 5% UNLESS OTHERWISE RECOMMENDED BY YOUR PORTFOLIO MANAGER OR A SPECIFIC JMMB RESEARCH REPORT. CONSEQUENTLY THE FOLLOWING **DEFINITIONS** ARE PROVIDED FOR CLARITY.

UNDERWEIGHT—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

HOLD/MARKETWEIGHT—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

VERWEIGHT/BUY—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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