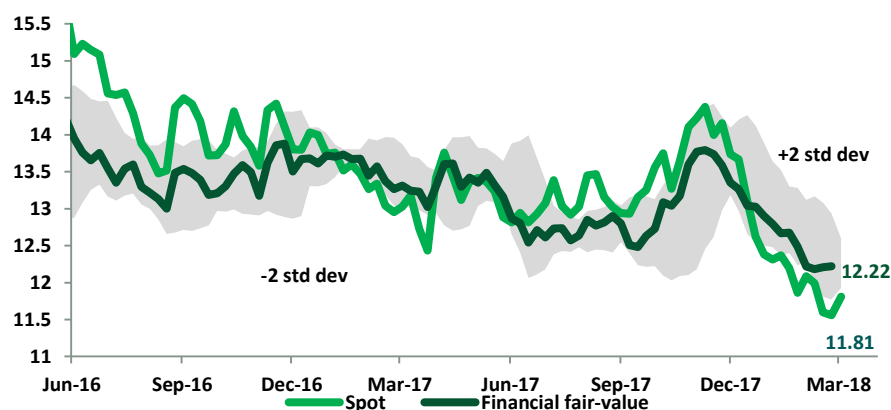


MOMENTUM IS FADING IN RAND STRENGTH; SEARCHING FOR A SHORT-TERM CATALYST

- **Positive momentum for the rand has been in place since December 2017 – but is now fading.** For the rand to appreciate further there needs to be a renewed positive local impetus in our opinion. At the same time, global developments (especially major central bank policy) are set to remain a headwind rather than a tailwind for the local currency.
- **What are the local catalysts needed for the rand to grind stronger in the face of a Fed that is set to run tighter monetary policy?**
 - During the course of the next month there are two key events that may add renewed short-term strength to the rand. **Firstly**, the rand should strengthen if Moody's keeps South Africa's local currency rating on the investment grade level this month (this is our base case). **Secondly**, if the SARB remains on hold at their MPC meeting of 28 March 2018 then the rand may find some support from an interest rate differential perspective (no cut this month is our base case – we expect a cut only in July). The above is why, from a rand perspective, we believe it is too soon to get bearish just yet. Local support could return, if only briefly, depending on the outcome of these events.
 - A rally in the currency over the next month on approach to **R11.65**, from a risk/return perspective, would likely be good news for importers looking to gain dollar exposure. On a six and 12 month view, we expect rand-strength below this level to fade. **Our six-month and 12-month target range for the USDZAR is R12.40 and R13.00 respectively.**
 - Worth noting that, in our view, extreme weakness (i.e. a rand at 13.00 within the next six months) is unsustainable, unless FX volatility dramatically climbs. On a six month view, any rand weakness beyond 12.50 would appear attractive from an export perspective. That is, on a six month view, we would fade weakness beyond 12.50.
 - **Keep an eye on support at R11.71 and resistance at R12.18** (see our latest technical strategy [report](#) for a more detailed technical view on the currency).

Figure 1: ZAR is expensive on our short-term valuation metrics



Source: Bloomberg, Nedbank CIB Research. Estimated using OLS regression method. Variable include DXY, Equity prices, US10yr, CDS spread, local-to-US 2y swap spread and oil price

WEAKNESS LIKELY TO BE DRIVEN FROM ABROAD AS POLICY TIGHTENS

This last week was a reminder that offshore forces remain a key driver of EM currencies

The rand has been on a strengthening path since early 2016, appreciating by 30% against the US dollar albeit with bouts of volatility (Chart 1). While much of the focus over the past 12 months has been on domestic developments, the impact of Fed policy on EM currencies was brought to the fore in recent days. The major driver of the rand weakness (and other EM currencies weakness) since last week was US Federal Reserve chairman Jerome Powell's testimony to congress. Some of his comments were interpreted as meaning that the Federal Reserve could hike interest rates more than three times this year (amid the upbeat outlook for the US economy). Currently, the market is pricing in only three hikes by the Fed this year.

As pointed out above, we believe that further material gains in the rand (below the 11.50 level) are likely to be limited and possibly short-lived. Our rationale behind this stems from our view that foreign influences and developed market central bank policies will be the main drivers of the rand going forward. Portfolio flows into emerging markets like SA have been underpinned by the large-scale monetary accommodation from the global central banks (Chart 2). Since the global financial crisis in 2008/09, emerging markets have attracted \$2.8tn in portfolio flows (cumulative debt and equity), while SA has received \$30bn. The inflows came largely on the back of attractive yields that were on offer in emerging market economies (relative to the yields in their developed market counterparts).

As global growth improves (the World Bank forecasts world growth of 3.1% for 2018 vs 2.9% in 2017) and inflation picks up in the US and EU, major central banks look set to remain on, or return to, a tightening path. While the prospect of tighter monetary policy in the US and EU have not affected emerging market flows YTD, pressure is likely to build. A slowdown of portfolio flows into emerging markets, especially debt markets, becomes a growing possibility on the back of emerging market credit risk that seems to have compressed by a significant margin in recent years. Lower portfolio flows should make it more challenging for emerging markets like SA to fund their current account deficits.

Fortunately, South Africa's external vulnerability is lower than before

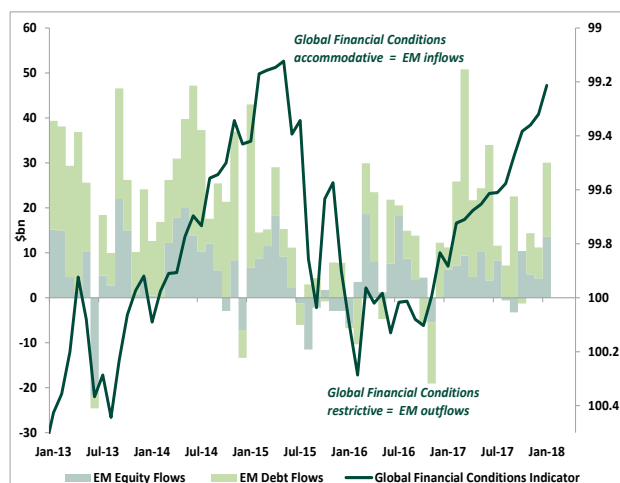
We expect South Africa's current account deficit to come in at 2.4% of GDP in 2018, below the average deficit of 3.5% of GDP seen since the financial crisis, and well below the 6% deficit seen in 2013. This implies that the local currency is less vulnerable to global flows now than, for example, in 2013 when the Fed first signalled its intention to embark on a tightening path. As pointed out above, our six-month and 12-month target range for the USDZAR is R12.40 and R13.00.

Chart 1: USDZAR-driven local and international developments



Source: Nedbank CIB markets Research

Chart 2: Global financial conditions and EM market flows

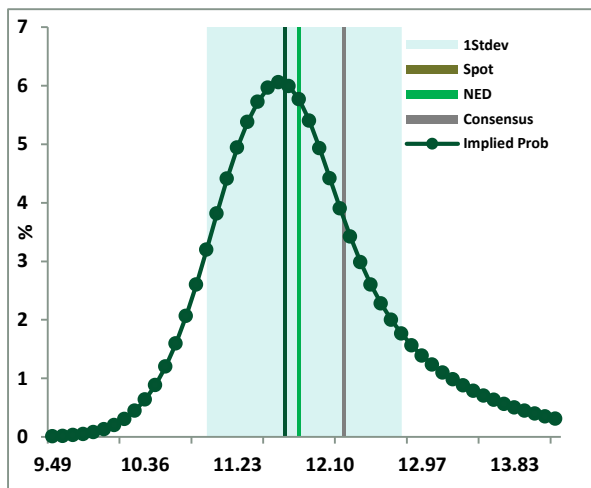


Source: Nedbank CIB Markets Research

OPTIONS MARKET – VOLS ARE LOW AS LOCAL RISK RECEDES

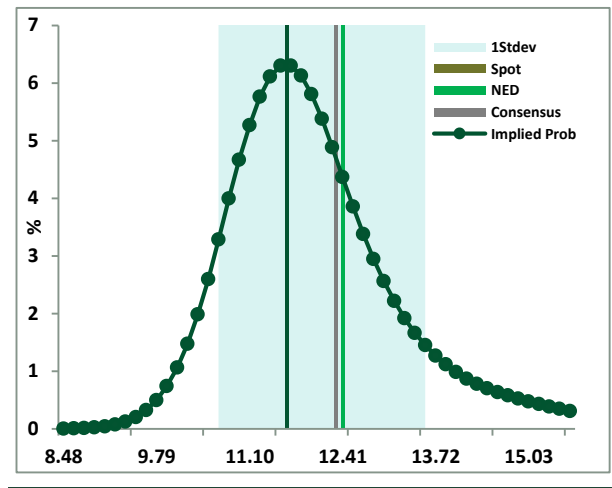
- On a three month view, the option market suggests a 1 standard deviation trading range for the USDZAR, of between 11.00 and 12.70 (Chart 4).
- On a six month view, the probability is skewed towards weakness, as one would expect, with the implied probability distribution suggesting a 1 standard deviation range of between 10.66 and 13.43 (Chart 5).
- Overall implied volatility has declined substantially for the USDZAR since December 2017, making option pricing, in general, cheaper (Chart 6).
- We note that volatility is now trading in the lowest 25th percentile up to two years out (Chart 7).

Chart 4: 3m implied probability distribution vs forecast



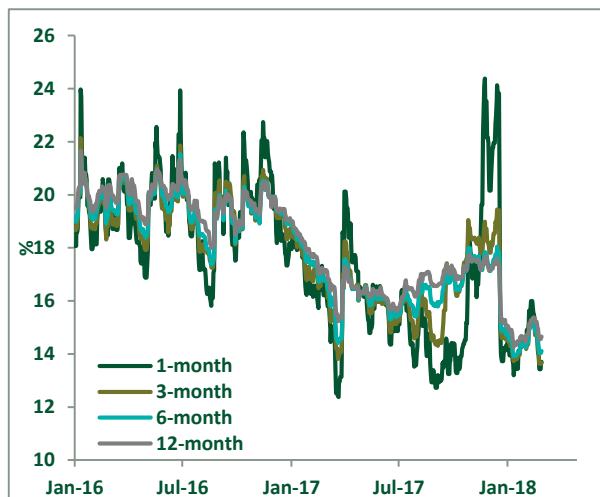
Source: Bloomberg

Chart 5: 6m implied probability distribution vs forecast



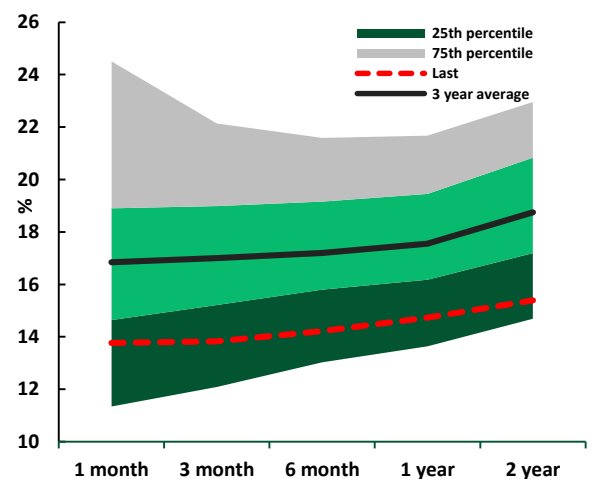
Source: Bloomberg

Chart 6: USDZAR implied volatility



Source: Bloomberg

Chart 7: ATM USDZAR implied volatility cone



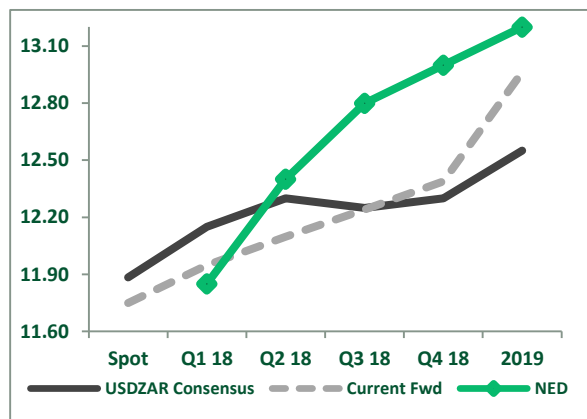
Source: Bloomberg

Table 1: Rand currency forecast table vs consensus and forwards (period end)

	Current Spot	Q1 18	Q2 18	Q3 18	Q4 18	2019
USDZAR						
Nedbank	11.88	11.85	12.40	12.80	13.00	13.20
Current Fwd	11.88	11.93	12.08	12.23	12.37	12.95
Consensus	11.88	12.15	12.30	12.25	12.30	12.55
EURZAR						
Nedbank	14.63	14.40	14.88	15.23	15.15	15.64
Current Fwd	14.63	14.72	15.00	15.29	15.59	16.81
Consensus	14.63	14.82	15.13	15.31	15.50	16.32
GBPZAR						
Nedbank	16.39	16.47	17.36	17.92	18.46	19.14
Current Fwd	16.39	16.48	16.74	17.01	17.28	18.38
Consensus	16.39	16.89	17.22	17.15	17.47	17.47
AUDZAR						
Nedbank	9.22	9.24	9.67	10.50	10.66	10.96
Current Fwd	9.22	9.27	9.38	9.50	9.62	10.10
Consensus	9.22	9.48	9.59	9.56	9.84	10.29

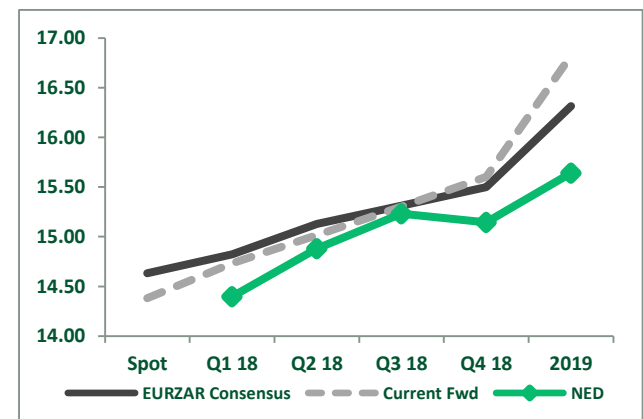
Source: Bloomberg, Nedbank CIB

Chart 8: USDZAR forecasts, consensus, and fwds



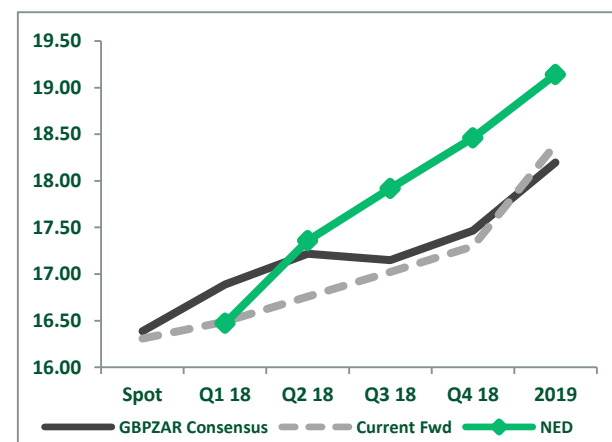
Source: Bloomberg, Nedbank CIB

Chart 9: EURZAR forecasts, consensus, and fwds



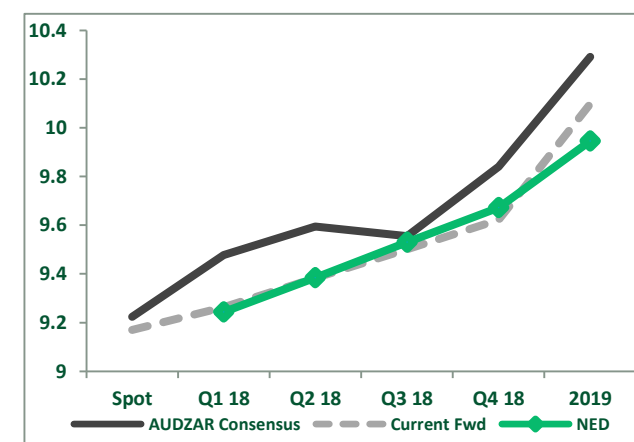
Source: Bloomberg, Nedbank CIB

Chart 10: GBPZAR forecasts, consensus, and fwds



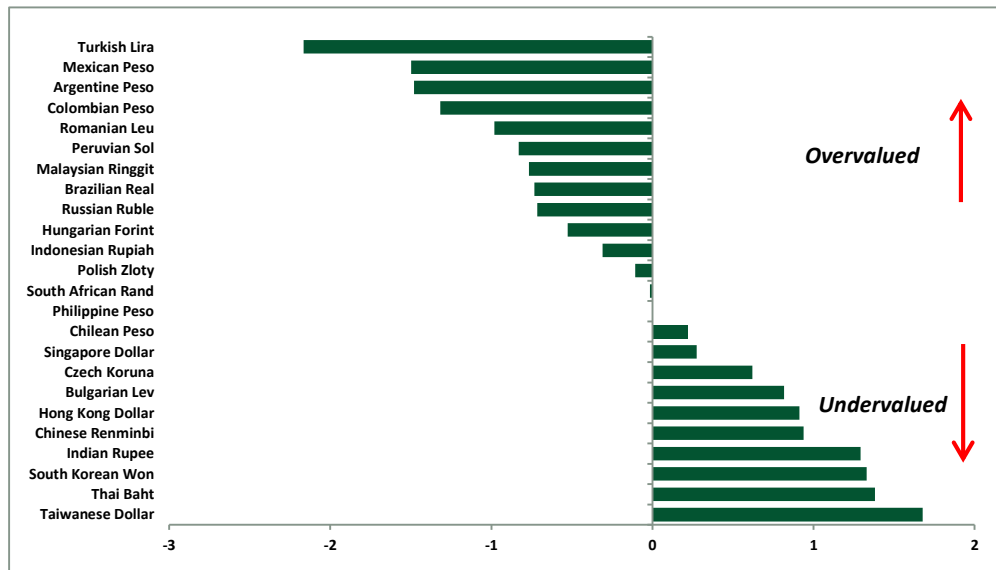
Source: Bloomberg, Nedbank CIB

Chart 11: AUDZAR forecasts, consensus, and fwds



Source: Bloomberg, Nedbank CIB

Figure 2: EM currencies overvalued vs undervalued (z-scores)



Source: Bloomberg and BIS. A larger value indicates the spot rate has a larger deviation from the PPP rate to the

Table 2: EM currency performance vs USD – YTD (%)

	CNY	JPY	KRW	SGD	MYR	IDR	THB	INR	AUD	BRL	GBP	EUR	CAD	ZAR
CNY		-1.410	-0.069	0.716	0.842	1.069	0.551	0.354	1.399	2.037	1.677	1.321	1.060	0.460
JPY	1.435		-1.593	-1.731	-1.506	-1.807	-1.611	-1.923	-2.429	-2.826	-2.471	-2.466	-1.788	-0.357
KRW	0.000	1.099		-0.629	-0.675	-0.994	-0.532	-0.184	-1.585	-1.901	-1.576	-1.326	-0.869	-0.385
SGD	-0.666	1.809	0.660		-0.591	-0.092	0.239	0.243	-0.746	-1.229	-0.751	-0.775	-0.076	0.457
MYR	-0.837	2.092	0.681	-0.037		0.208	0.458	0.493	-0.895	-0.599	-0.176	-0.533	-0.478	0.927
IDR	-0.623	1.340	0.967	-0.186	-0.212		0.246	0.290	-1.074	-0.994	-0.334	-0.687	-0.620	0.561
THB	-0.551	2.298	0.000	-0.099	-0.481	-0.244		0.041	-0.827	-1.270	-0.932	-0.881	-0.207	0.302
INR	-0.346	1.252	0.187	-0.508	-0.497	-0.295	-0.039		-1.353	-1.451	-1.016	-1.211	-0.957	0.090
AUD	-1.365	2.510	1.638	0.742	0.402	1.075	0.855	1.015		-0.385	-0.051	-0.031	0.663	1.908
BRL	-1.969	3.630	1.983	1.098	0.601	1.042	1.264	1.481	0.269		0.345	0.117	1.456	1.560
GBP	-1.446	2.562	1.634	0.759	0.438	0.568	0.925	0.901	0.055	-0.364		0.075	0.736	1.858
EUR	-1.333	2.516	1.111	0.771	0.242	0.503	0.862	1.115	0.047	-0.097	-0.018		0.698	1.946
CAD	-1.056	1.835	0.906	0.063	-0.250	-0.108	0.235	0.513	-0.637	-1.013	-0.691	-0.693		1.157
ZAR	-0.459	0.731	0.407	-0.445	-0.926	-0.545	-0.288	-0.106	-1.851	-1.497	-1.815	-1.848	-1.137	

Source: Bloomberg

Table 3: Correlation matrix – markets vs FX

	VIX	SPX	US	US	SA	TOP40	EM FX	DM FX	MXN	AUD	CAD	ZAR
VIX		-83%	-56%	-45%	20%	-35%	-33%	-1%	21%	-18%	28%	31%
SPX	-83%		32%	17%	-29%	44%	52%	8%	-38%	46%	-45%	-47%
US	-56%	32%		91%	-3%	13%	3%	6%	-9%	-14%	-5%	-3%
US	-45%	17%	91%		7%	2%	-12%	4%	3%	-22%	10%	10%
SA	20%	-29%	-3%	7%		-41%	-39%	-4%	21%	-8%	21%	51%
TOP40	-35%	44%	13%	2%	-41%		33%	-21%	-22%	15%	-39%	-15%
EM FX	-33%	52%	3%	-12%	-39%	33%		-50%	-72%	71%	-64%	-66%
DM FX	-1%	8%	6%	4%	-4%	-21%	-50%		31%	-23%	34%	2%
MXN	21%	-38%	-9%	3%	21%	-22%	-72%	31%		-59%	65%	48%
AUD	-18%	46%	-14%	-22%	-8%	15%	71%	-23%	-59%		-60%	-43%
CAD	28%	-45%	-5%	10%	21%	-39%	-64%	34%	65%	-60%		44%
ZAR	31%	-47%	-3%	10%	51%	-15%	-66%	2%	48%	-43%	44%	

Source: Bloomberg, YTD

Table 4: Correlation matrix – commodities vs currencies

	Gold	Plat	Pall	Ironor	Coppe	T-Coal	Brent	BRL	AUD	CAD	ZAR	EM FX
Gold		77%	41%	-4%	-2%	4%	48%	-62%	61%	-52%	-37%	77%
Plat	77%		44%	-11%	14%	19%	48%	-61%	54%	-37%	-28%	66%
Pall	41%	44%		-23%	-7%	4%	31%	-39%	37%	-21%	-12%	41%
Ironor	-4%	-11%	-23%		-7%	-11%	-23%	7%	-1%	-9%	-15%	1%
Coppe	-2%	14%	-7%	-7%		32%	26%	6%	-5%	1%	-17%	8%
T-Coal	4%	19%	4%	-11%	32%		26%	-25%	14%	-17%	-26%	13%
Brent	48%	48%	31%	-23%	26%	26%		-47%	39%	-34%	-31%	48%
BRL	-62%	-61%	-39%	7%	6%	-25%	-47%		-62%	51%	47%	-70%
AUD	61%	54%	37%	-1%	-5%	14%	39%	-62%		-60%	-43%	71%
CAD	-52%	-37%	-21%	-9%	1%	-17%	-34%	51%	-60%		44%	-64%
ZAR	-37%	-28%	-12%	-15%	-17%	-26%	-31%	47%	-43%	44%		-66%
EM FX	77%	66%	41%	1%	8%	13%	48%	-70%	71%	-64%	-66%	

Source: Bloomberg, YTD

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