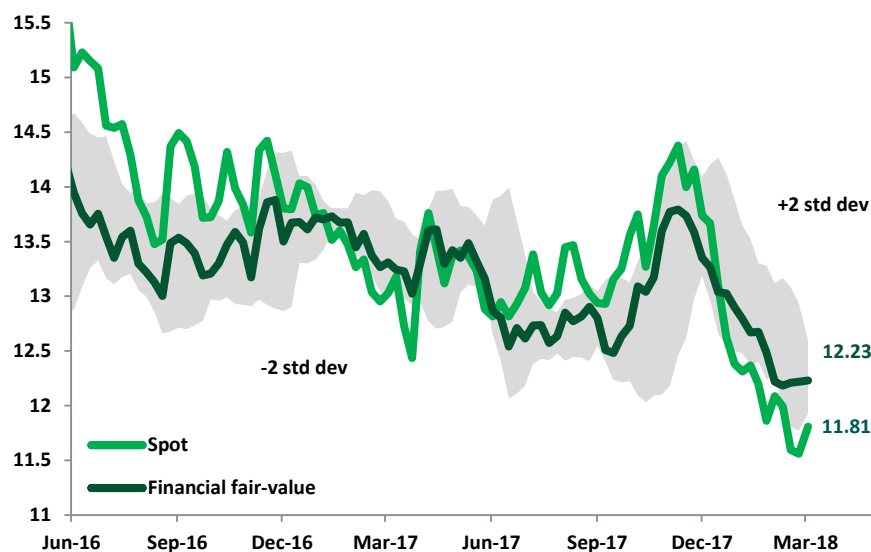


THE CURRENCY AND TRADE WARS: AN INNOCENT BYSTANDER

- The rand was on the **back foot** for most of last week, despite [GDP data surprising on the upside](#). This came amid fears over a looming trade war, following President Trump's plan to impose steel and aluminium tariffs. Concerns are that increased trade protection may derail the broad upsurge in global growth.
- At the same time concerns around land reform also contributed to the negative sentiment for the local currency, despite the positive momentum introduced by the 2018 Budget in late February. The local market is now keenly awaiting the rating review of Moody's on 23 March 2018.
- We expect Moody's to keep South Africa's local currency rating unchanged (investment grade) with a negative outlook (Baa3 negative outlook). Furthermore, we do not believe that the SARB will change the repo rate this month, but that it would very likely cut the repo rate either in May or July. A ratings reprieve, aided by favourable interest differentials (compared to our emerging market peers) should boost the local unit in the short-term. We would not be surprised to see the rand rally closer to **R11.65**.
- **Our six-month and 12-month target range for the USDZAR remains unchanged at R12.40 and R13.00 respectively.** We believe global factors will be the key driver of the currency this year.
- **Short term, keep an eye on support at R11.70 and resistance at R12.06** (see our latest technical strategy [note](#) 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

GLOBAL TRADE, PROTECTIONISM, AND THE RAND

Global trade underpinning the recovery in global growth

Global growth is projected to rise to 3.5% in 2017 and 3.7% in 2018 according to the OECD, with the upturn expected to be the most synchronized amongst nations since 2010 (this is assuming countries do not resort to protectionist policies that threaten global growth). South Africa has managed to achieve an overall growth number of 1.3% for 2017, from 0.6% in 2016. The domestic economic confidence environment has improved in recent months as President Cyril Ramaphosa has been swift to address the country's most pressing concerns (state-level corruption etc). In the past these local concerns have negatively impacted investor confidence, and as a result weakened investment spending and economic growth. We believe the domestic outlook remains more favourable than what was seen in 2017, with Nedbank projecting real GDP growth of 1.6% in 2018 and 1.8% in 2019.

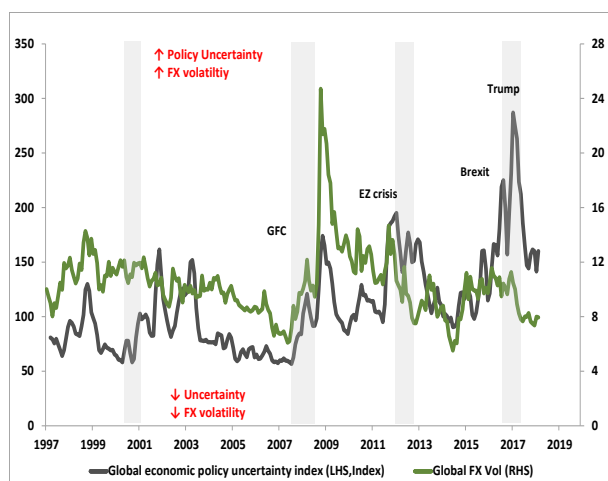
US President Trump last week reiterated his protectionist policies, and outlined plans to implement import tariffs on steel and aluminium. This move raised fears in financial markets that should certain countries retaliate (ie Canada, European nations, and China) a trade war could be sparked. Since international trade is the engine of global growth, a trade war is likely to damage confidence and curtail global growth. The environment in FX markets has been very calm, as reflected in the low FX volatility levels (Chart 1). This can be attributed to improving global economic fundamentals, as well as to central banks' extraordinary easy policies. However, for currency markets, the threat of retaliatory tariffs by nations is likely to result in higher levels of FX volatility as investors seek safety in 'less risky' currencies such as the yen, dollar, and Swiss franc and start de-risking away from 'risky' currencies such as the rand, real, and won.

SA external vulnerability has decreased in recent years, but risks have not vanished

South Africa has two main links to the rest of the world: Portfolio flows and the trade of goods and services. Stronger global growth improves demand for South African exports, while portfolio flows are attracted based on the outlook for the domestic economy and interest rate differentials (carry trade). These flows, both trade and portfolio, are captured in the country's balance of payments as well as in the current account balance. South Africa's external vulnerability, as measured by the current account, has improved significantly since 2014 and is expected to reach 2.4% of GDP in 2018 (from a deficit of 6% in 2013). As a result, external shocks via trade and portfolio flows are likely to be less severe now than what they were in, for example, 2013.

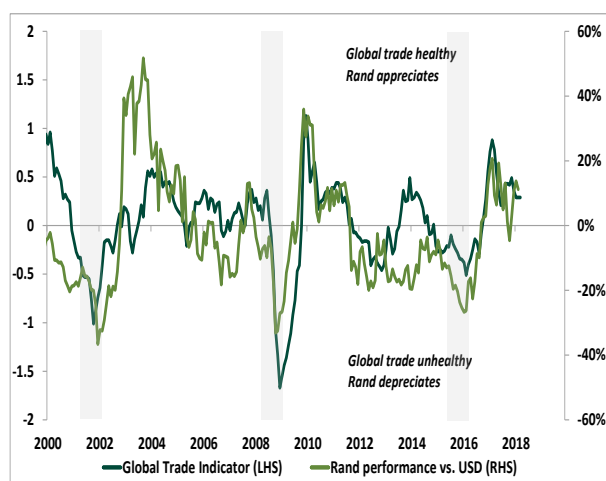
Reduced global output as a result of trade wars may result in not only lower demand for South African exports, but also in higher volatility in currency markets. This is likely to impact negatively on the carry trade on a risk-adjusted basis (Chart 2). It would also leave the local currency exposed to weakness. This of course is not unique to South Africa, seeing as a number of emerging markets have attracted substantial capital flows on the back of investors' search for yield amid the ultra-extraordinary policies of the major central banks. Although it is too early to say if the possibility of a trade war could disrupt the global growth outlook, we keep this risk on our radar going forward.

Chart 1: FX volatility driven by uncertainty in economic policies



Source: DS, Nedbank CIB markets Research

Chart 2: Rand's performance linked via global trade channel

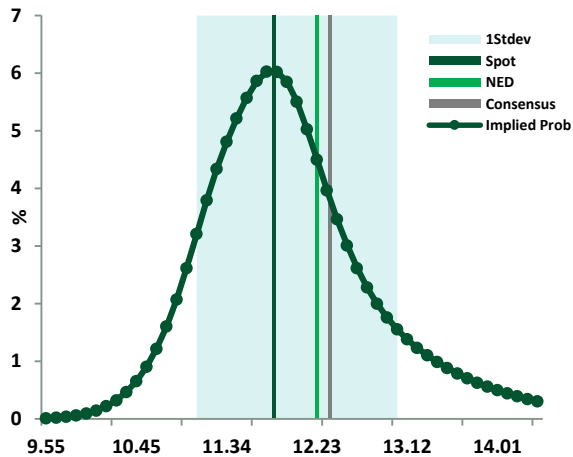


Source: DS, Nedbank CIB Markets Research

OPTIONS MARKET – VOLS REMAIN LOW

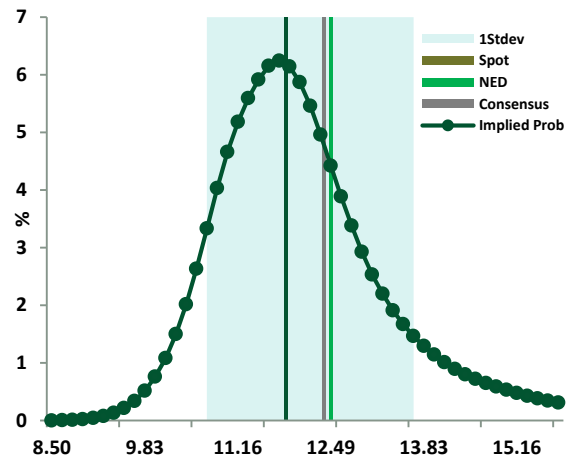
- On a three-month view, the option market suggests a 1 standard deviation trading range for the USDZAR, of between 11.00 and 12.90 (Chart 3).
- On a six-month view, the probability is skewed towards weakness, as one would expect, with the implied probability distribution suggesting a 1 standard deviation range of between 10.70 and 13.50 (Chart 4).
- Overall, implied volatility has declined substantially for the USDZAR since December 2017, making option pricing, in general, cheaper (Chart 5).
- We note that volatility is still trading in the lowest 25th percentile up to two years out (Chart 6).

Chart 3: 3m implied probability distribution vs forecast



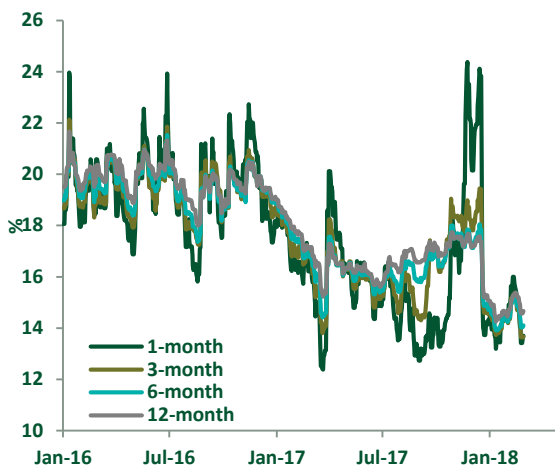
Source: Bloomberg

Chart 4: 6m implied probability distribution vs forecast



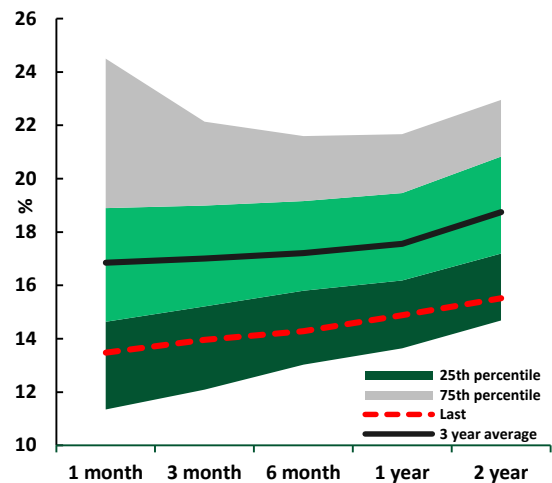
Source: Bloomberg

Chart 5: USDZAR implied volatility



Source: Bloomberg

Chart 6: ATM USDZAR implied volatility cone



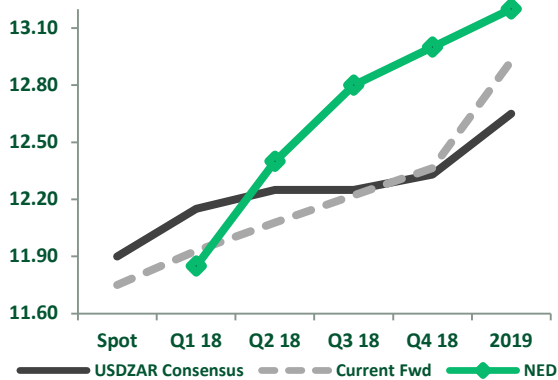
Source: Bloomberg

Chart 7: Rand currency forecast table vs consensus and forwards (period end)

	Current Spot	Q1 18	Q2 18	Q3 18	Q4 18	2019
USDZAR						
Nedbank	11.83	11.85	12.40	12.80	13.00	13.20
Current Fwd	11.83	11.86	12.00	12.14	12.29	12.85
Consensus	11.83	12.15	12.25	12.25	12.33	12.65
EURZAR						
Nedbank	14.57	14.40	14.88	15.23	15.15	15.64
Current Fwd	14.57	14.63	14.91	15.20	15.49	16.73
Consensus	14.57	14.82	15.07	15.19	15.54	16.45
GBPZAR						
Nedbank	16.39	16.47	17.36	17.92	18.46	19.14
Current Fwd	16.39	16.44	16.71	16.98	17.25	18.35
Consensus	16.39	16.89	17.03	17.15	17.51	17.51
AUDZAR						
Nedbank	9.31	9.24	9.67	10.50	10.66	10.96
Current Fwd	9.31	9.33	9.45	9.57	9.69	10.17
Consensus	9.31	9.48	9.68	9.68	9.86	10.37

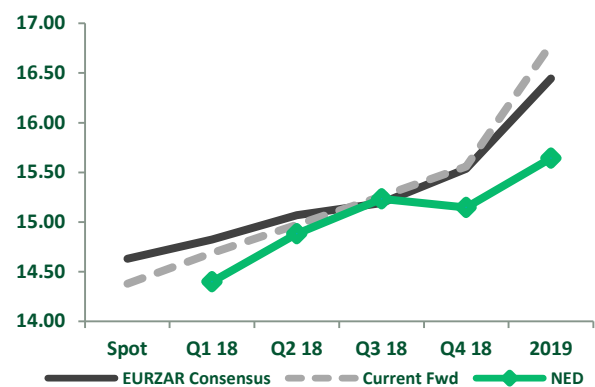
Source: Bloomberg, Nedbank CIB

Chart 8: USDZAR forecasts, consensus, and fwds



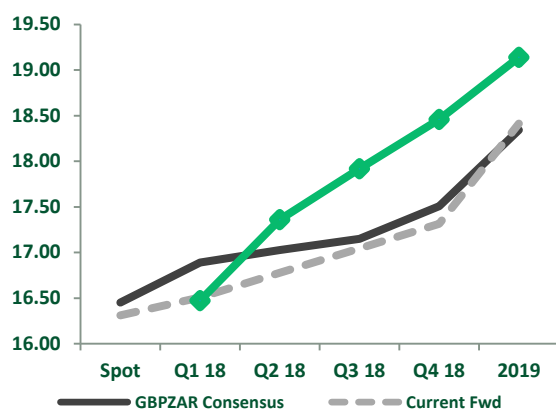
Source: Bloomberg, Nedbank CIB

Chart 9: EURZAR forecasts, consensus, and fwds



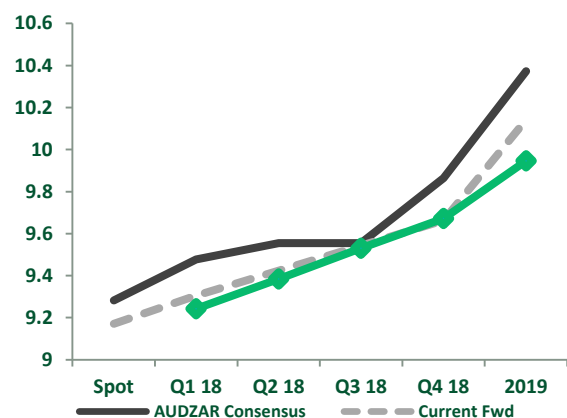
Source: Bloomberg, Nedbank CIB

Chart 10: GBPZAR forecasts, consensus, and fwds



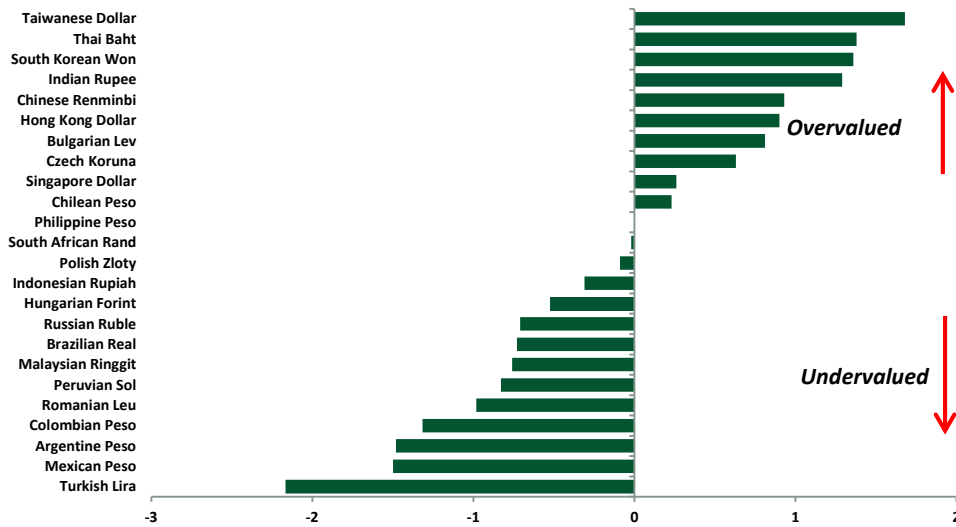
Source: Bloomberg, Nedbank CIB

Chart 11: AUDZAR forecasts, consensus, and fwds



Source: Bloomberg, Nedbank CIB

Chart 12: 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

Chart 13: EM currency performance vs USD – YTD (%)

	CNY	JPY	KRW	SGD	MYR	IDR	THB	INR	AUD	BRL	GBP	EUR	CAD	ZAR
CNY		-3.309	2.929	0.874	-0.719	4.384	-1.157	4.936	2.642	0.727	0.000	-0.585	5.596	-1.293
JPY	3.419		-6.013	-4.341	-2.253	-7.336	-2.191	-7.843	-5.788	-3.996	-3.334	-2.781	-8.403	-2.028
KRW	-3.279	6.426		1.826	3.663	-1.525	4.070	-1.919	0.277	2.146	2.873	3.468	-2.508	4.250
SGD	-1.132	4.869	-1.756		2.249	-3.225	2.190	-3.345	-1.522	0.496	1.079	1.576	-4.164	1.647
MYR	0.721	2.656	-3.535	-1.918		-4.992	0.400	-5.354	-3.293	-1.802	-0.699	-0.198	-6.160	0.182
IDR	-4.292	7.821	1.530	3.557	5.251		5.664	-0.415	1.846	3.485	4.788	5.048	-0.827	6.483
THB	1.151	2.235	-3.934	-2.190	-0.397	-5.359		-5.770	-3.653	-1.827	-1.009	-0.638	-6.330	0.182
INR	-4.707	8.512	1.943	3.694	5.692	0.426	6.116		2.252	3.881	4.952	5.491	-0.511	6.000
AUD	-2.562	6.115	-0.250	1.546	3.349	-1.064	3.772	-1.990		1.914	2.605	3.156	-2.547	4.348
BRL	-0.743	4.150	-2.100	-0.412	1.839	-3.363	1.868	-3.740	-1.848		0.888	1.199	-4.555	2.010
GBP	0.187	3.506	-2.784	-1.138	0.711	-4.220	0.993	-4.310	-2.530	-0.761		0.573	-5.215	1.672
EUR	0.505	2.895	-3.338	-1.683	0.585	-4.568	0.625	-4.904	-2.939	-1.209	-0.533		-5.515	1.189
CAD	-5.293	8.884	2.565	4.075	6.212	1.189	6.717	0.508	2.876	4.772	5.542	6.053		7.185
ZAR	0.489	1.638	-3.280	-2.442	-0.240	-5.339	-0.185	-5.748	-4.216	-1.221	-1.358	-0.771	-6.725	

Source: Bloomberg

Chart 14: Correlation matrix – markets vs FX

	VIX	SPX	US	US	SA	TOP40	EM FX	DM FX	MXN	AUD	CAD	ZAR
VIX		-82%	-57%	-46%	17%	-34%	-33%	2%	22%	-20%	25%	31%
SPX	-82%		37%	22%	-27%	45%	52%	5%	-38%	47%	-40%	-50%
US	-57%	37%		91%	0%	14%	8%	-1%	-12%	-4%	-8%	-8%
US	-46%	22%	91%		6%	6%	-4%	1%	-1%	-11%	4%	3%
SA	17%	-27%	0%	6%		-43%	-39%	-11%	22%	-13%	24%	51%
TOP40	-34%	45%	14%	6%	-43%		40%	-14%	-26%	26%	-42%	-21%
EM FX	-33%	52%	8%	-4%	-39%	40%		-44%	-73%	72%	-62%	-67%
DM FX	2%	5%	-1%	1%	-11%	-14%	-44%		27%	-18%	26%	0%
MXN	22%	-38%	-12%	-1%	22%	-26%	-73%	27%		-62%	67%	49%
AUD	-20%	47%	-4%	-11%	-13%	26%	72%	-18%	-62%		-63%	-47%
CAD	25%	-40%	-8%	4%	24%	-42%	-62%	26%	67%	-63%		44%
ZAR	31%	-50%	-8%	3%	51%	-21%	-67%	0%	49%	-47%	44%	

Source: Bloomberg, YTD

Chart 15: Correlation matrix – commodities vs currencies

	Gold	Plat	Pall	Ironor	Coppe	T-Coal	Brent	BRL	AUD	CAD	ZAR	EM FX
Gold		77%	45%	-2%	2%	4%	49%	-61%	64%	-53%	-38%	76%
Plat	77%		58%	-4%	15%	23%	56%	-57%	57%	-41%	-34%	63%
Pall	45%	58%		-14%	-1%	11%	42%	-35%	43%	-27%	-20%	40%
Ironor	-2%	-4%	-14%		-7%	-8%	-16%	7%	3%	-13%	-16%	2%
Coppe	2%	15%	-1%	-7%		31%	26%	5%	2%	-4%	-19%	12%
T-Coal	4%	23%	11%	-8%	31%		26%	-23%	14%	-20%	-27%	11%
Brent	49%	56%	42%	-16%	26%	26%		-47%	45%	-34%	-40%	51%
BRL	-61%	-57%	-35%	7%	5%	-23%	-47%		-61%	49%	49%	-71%
AUD	64%	57%	43%	3%	2%	14%	45%	-61%		-63%	-47%	72%
CAD	-53%	-41%	-27%	-13%	-4%	-20%	-34%	49%	-63%		44%	-62%
ZAR	-38%	-34%	-20%	-16%	-19%	-27%	-40%	49%	-47%	44%		-67%
EM FX	76%	63%	40%	2%	12%	11%	51%	-71%	72%	-62%	-67%	

Source: Bloomberg, YTD

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