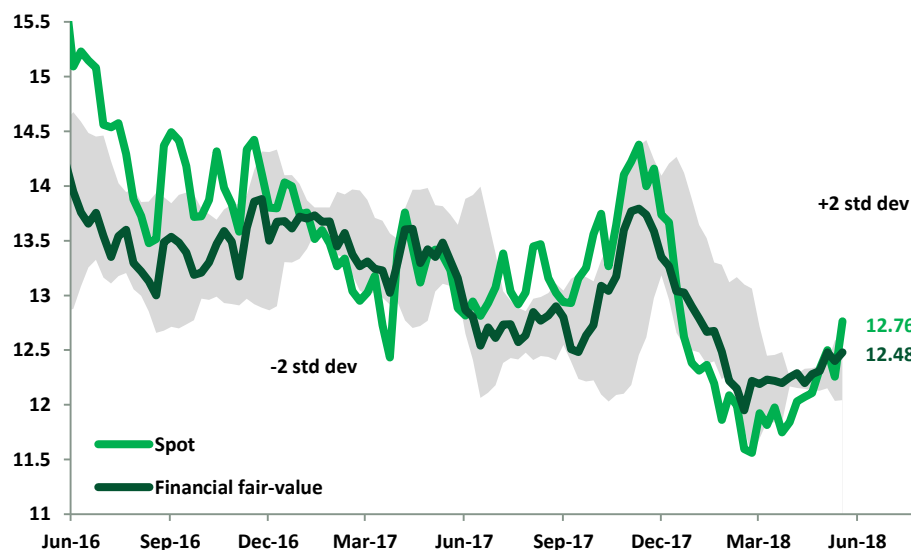


HEADACHE FOR THE RAND: STRONGER US DOLLAR

- **The stronger US dollar has rung alarm bells in financial markets** – the US Dollar has gained 5% since mid-February 2018 as the US Federal Reserve reverses quantitative easing and signals a series of staccato rate rises. The dramatic comeback in the US dollar has led to a slump in emerging market currencies, with the South African rand erasing its gains of the past three months.
- The US dollar is a barometer for the changing global liquidity environment. A stronger US dollar is a reflection of tighter global financial conditions, which is not conducive for risk-assets. On the flipside, a weaker US dollar is a reflection of easier global financial conditions and bodes well for the performance of risk-assets like the rand.
- **Our 1H18 and 2H18 forecasts for the rand are R12.45 and R13.00 respectively, which is more bearish than the Bloomberg consensus view (i.e. R12.22 for 1H18 and R12.09 for 2H18).**
- The reason for our ‘out-of-line’ forecast for the rand is due to our long-held view (i.e. since the start of 2018) that the US dollar would strengthen amid a number of global liquidity tailwinds that are losing momentum (which would dampen the outlook for risk-assets like the rand). Our view is now materializing, but we must admit that we are surprised by the speed at which it is taking place. We expect this trend to continue as the year progresses. Our target level on the US dollar index is 95 points, which is equivalent to €1.15/\$ – hence our bearish forecast for the rand.
- On the local front, we expect the SARB to leave interest rates unchanged, albeit with a hawkish statement (amid the rise in long-term US interest rates, higher rand-oil prices, and a more volatile emerging market environment). We believe that the rand will continue to trade in-line with the international environment. We leave open the possibility that the US dollar could consolidate in the near-term, in which case we could see the rand pull back to R12.30.
- **Short-term, we recommend keeping an eye on support at R12.23 and resistance at R12.93** (see our latest Technical Strategy note: [“Short-term Charts: Major Assets”](#) of 16 May 2018 for a more detailed technical view on the currency).

Figure 1: ZAR is moving in-line with the deteriorating international environment



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

EMERGING MARKETS BRACE AS THE US DOLLAR STRENGTHENS

Flows into the EM carry-trade are like a rising escalator, while outflows tend to be like a falling lift.

One of the most popular and most profitable investment strategies since the start of 2016 has been to purchase emerging market assets (bonds and equities) funded by the US dollar. This investment strategy is also known as the “carry-trade” whereby investors invest in high yielding assets (emerging market assets) funded by assets which have a low borrowing costs (US dollar or other low-interest rate instruments) [Chart 1](#).

Since the start of 2018, emerging market currencies have been losing momentum amid rising geopolitical tensions in the Middle East. Furthermore, tit-for-tat trade policies between China and the US have stoked fears of trade wars escalating; wars which would threaten the prospects for global growth and trade. However, in recent weeks the resurgent US dollar and the rise of US short-term interest rates has increased the cost of funding emerging market FX carry-trades. As a result, emerging market currencies have come under pressure, leading to a sharp downturn in emerging market portfolio flows [Chart 2](#). We expect this trend to continue as the year progresses. Our target level for the US dollar index is 95 points, which is equivalent to €1.15/\$, hence our bearish forecast for the rand.

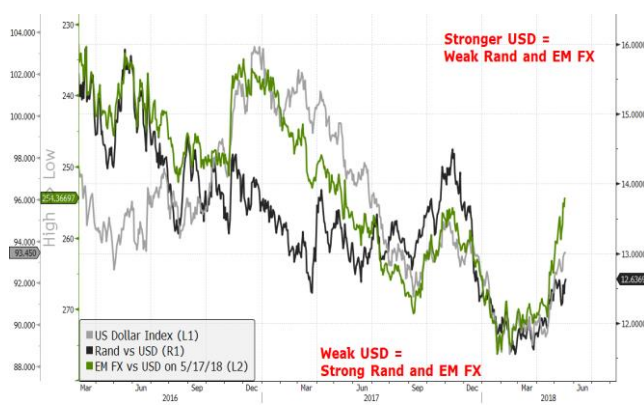
The weaker US dollar since 2017 has enabled emerging market investors to steadily profit from these strategies, somewhat like being on a slowly rising escalator. However, when the US dollar makes a comeback, carry-trade losses are normally sharp, somewhat like being in a falling lift [Chart 3](#).

Strong dollar trends tend to outweigh SA and EM fundamentals at times

SA’s external vulnerability measures, as reflected by the improvement in the narrowing of the current account deficit (2.4% of GDP estimated vs. 6% of GDP 5y average), imply that the local currency is less vulnerable to global flows. With that being said, South Africa has also received the largest amount of portfolio inflow as a percentage of GDP over the past six years (at 45% of GDP vs emerging market peers of 23%). Thus we do not rule out the possibility that the rand could come under severe/burdensome pressure should the carry-trade unwind. The outlook for the US dollar will be key to the performance of the rand and other emerging market currencies in our opinion.

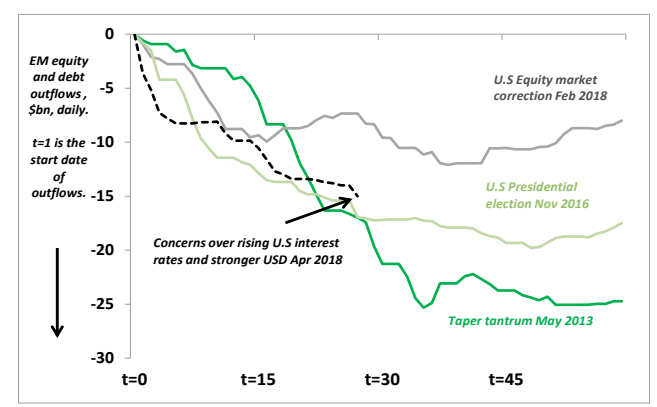
We expect the rand to trade closer to R12.50-R13.00 against the dollar over the coming months.

Chart 1: Strong US dollar has eroded gains from “Ramaphoria” and the EM carry-trade



Source: Bloomberg and Nedbank CIB markets Research

Chart 2: EMs are very vulnerable to the global environment, as reflected in the sharp downturn in EM portfolio flows



Source: IIF and Nedbank CIB Markets Research

Chart 3: EM FX gains are steady, like going up an escalator, but losses are like going down a lift



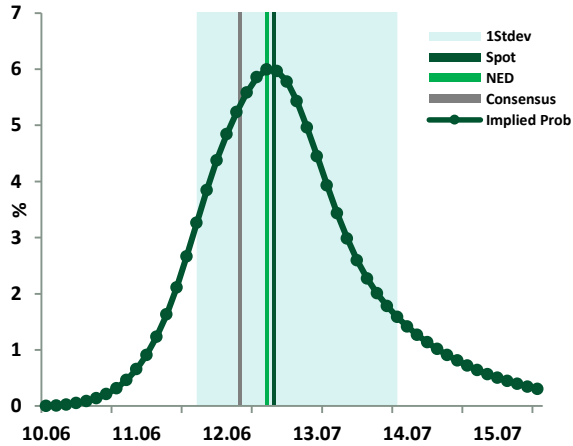
Source: Bloomberg and Nedbank CIB markets Research

FX VOL RISING AS EXTERNAL ENVIRONMENT WEIGHS ON THE RAND

The forecast from the option market for the USDZAR has shifted away from Bloomberg consensus in recent weeks:

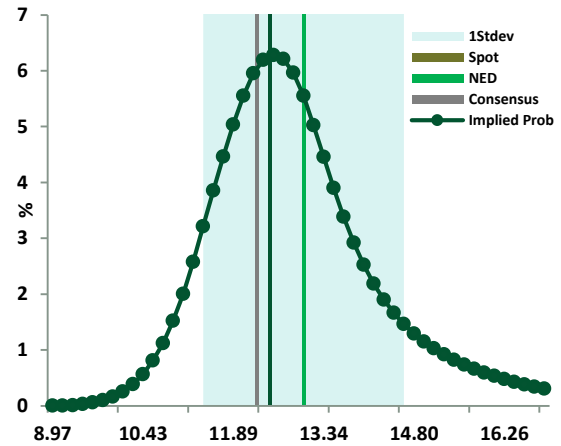
- On a three-month view, the option market suggests a one standard deviation trading range for the USDZAR of between 11.79 and 13.81 (see Chart 4).
- On a six-month view, the probability is skewed towards weakness, as one would expect, with the implied probability distribution suggesting a one standard deviation range of between 11.48 and 14.48 (see Chart 5).

Chart 4: 3m implied probability distribution vs forecast



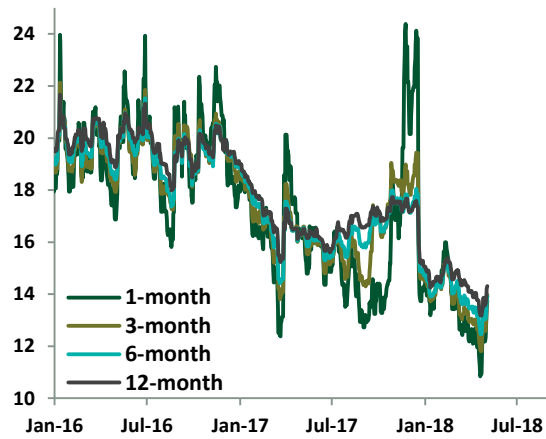
Source: Bloomberg

Chart 5: 6m implied probability distribution vs forecast



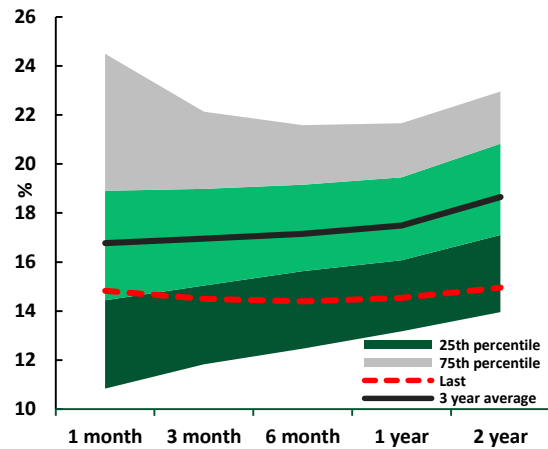
Source: Bloomberg

Chart 6: USDZAR implied volatility



Source: Bloomberg

Chart 7: ATM USDZAR implied volatility cone



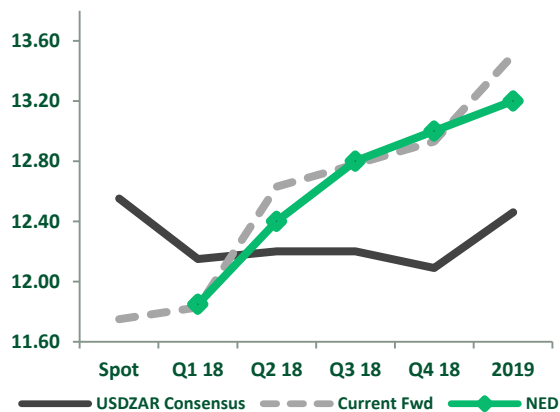
Source: Nedbank CIB Research; Bloomberg

Chart 8: Rand currency forecast table vs. consensus and forwards (period end)

	Current Spot	Q1 18	Q2 18	Q3 18	Q4 18	2019
USDZAR						
Nedbank	12.78	11.85	12.40	12.80	13.00	13.20
Current Fwd	12.78	11.83	12.84	13.00	13.15	13.75
Consensus	12.78	12.15	12.23	12.23	12.15	12.41
EURZAR						
Nedbank	15.01	14.40	14.88	15.23	15.15	15.64
Current Fwd	15.01	14.58	15.13	15.42	15.73	17.01
Consensus	15.01	14.82	14.80	15.04	15.19	16.13
GBPZAR						
Nedbank	17.17	16.47	17.36	17.92	18.46	19.14
Current Fwd	17.17	16.58	17.28	17.56	17.86	19.04
Consensus	17.17	16.89	16.88	17.12	17.13	17.13
AUDZAR						
Nedbank	9.61	9.24	9.67	10.50	10.66	10.96
Current Fwd	9.61	9.08	9.66	9.78	9.91	10.42
Consensus	9.61	9.48	9.29	9.42	9.48	9.93

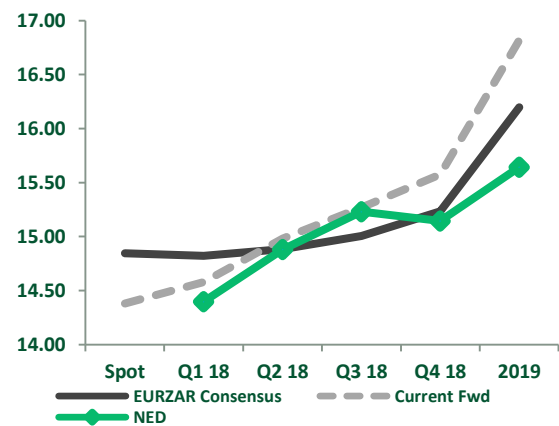
Source: Bloomberg, Nedbank CIB

Chart 9: USDZAR forecasts, consensus and forwards



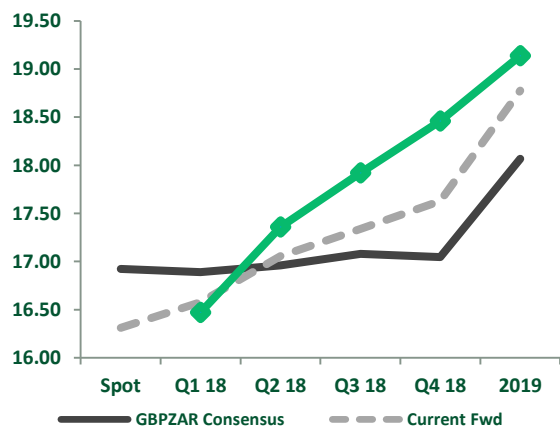
Source: Bloomberg, Nedbank CIB

Chart 10: EURZAR forecasts, consensus and forwards



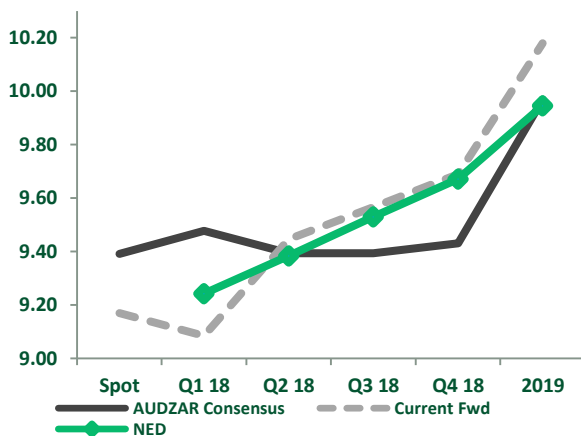
Source: Bloomberg, Nedbank CIB

Chart 11: GBPZAR forecasts, consensus and forwards



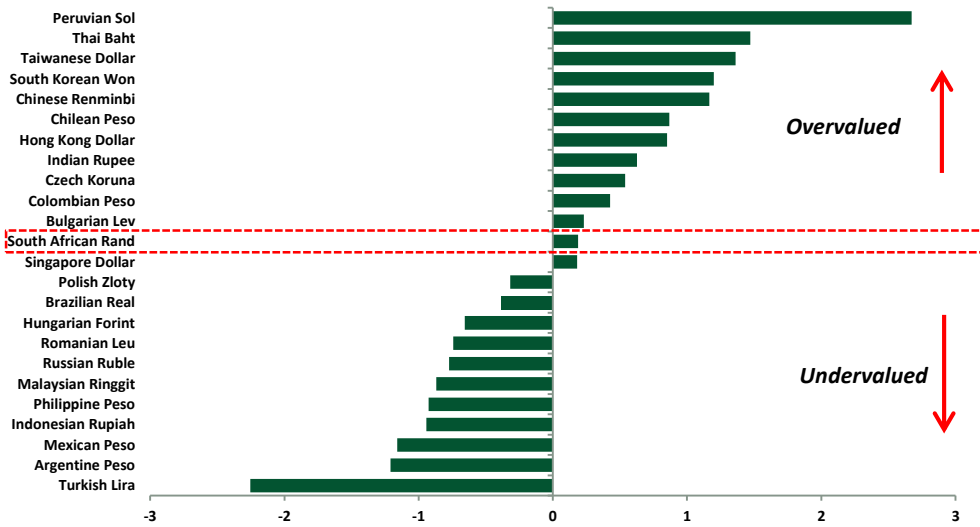
Source: Bloomberg, Nedbank CIB

Chart 12: AUDZAR forecasts, consensus, and forwards



Source: Bloomberg, Nedbank CIB

Chart 13: EM currencies overvalued vs undervalued (z-scores)
 Rand in fair value territory according to PPP metrics



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

Chart 14: EM currency performance

	CNY	JPY	KRW	TRY	MXN	RUB	THB	INR	AUD	BRL	GBP	EUR	CAD	ZAR	USD
CNY		-0.935	3.487	13.006	-0.793	13.062	-0.384	7.184	6.504	9.252	1.935	2.700	5.078	4.427	2.407
JPY	0.940		-4.025	-12.797	-0.175	-11.046	-0.327	-7.453	-6.653	-9.210	-2.700	-3.203	-5.322	-5.022	-3.133
KRW	-3.279	4.211		-8.539	4.145	-7.314	3.857	-3.608	-2.706	-5.409	1.409	0.711	-1.325	-1.029	0.898
TRY	-11.508	13.909	9.322		13.837	1.503	13.543	5.676	6.369	3.388	11.074	11.042	7.858	9.456	11.021
MXN	0.787	0.000	-4.011	-12.189		-11.003	-0.166	-7.143	-6.588	-9.063	-2.522	-3.080	-5.197	-4.465	-2.952
RUB	-10.330	12.422	7.890	-1.493	12.355		12.329	5.991	5.082	2.059	10.124	9.319	6.479	7.730	9.329
THB	0.350	0.315	-3.607	-11.937	0.351	-10.759		-7.119	-6.315	-8.910	-2.267	-2.935	-4.999	-4.749	-2.867
INR	-6.703	7.592	3.735	-5.337	7.749	-4.108	7.677		0.930	-2.127	5.204	4.463	2.475	2.378	4.664
AUD	-6.128	7.091	2.833	-5.981	6.912	-4.525	6.731	-0.995		-2.768	4.234	3.655	1.662	2.126	3.748
BRL	-8.486	10.136	5.711	-3.312	9.727	-2.020	9.790	2.159	2.869		7.381	6.294	4.339	4.540	6.482
GBP	-1.926	2.835	-1.385	-9.866	2.660	-8.594	2.255	-5.172	-4.053	-6.759		-0.522	-2.667	-2.174	-0.446
EUR	-2.715	3.352	-0.782	-9.897	3.066	-8.333	3.009	-4.138	-3.400	-5.962	0.559		-1.904	-1.486	0.144
CAD	-4.826	5.352	1.342	-7.890	5.477	-6.081	5.227	-2.031	-1.387	-4.139	2.774	2.152		0.591	2.219
ZAR	-5.056	4.823	1.876	-8.664	6.083	-7.216	4.910	-2.279	-2.108	-3.596	2.410	1.882	-0.559		1.546
USD	-2.353	3.234	-0.928	-9.330	3.047	-8.164	2.908	-4.240	-3.599	-6.294	0.511	-0.100	-2.175	-1.234	

Source: Bloomberg

Chart 15: Correlation matrix – markets vs FX

	VIX	SPX	US	US	SA	TOP40	EM FX	DM FX	MXN	AUD	CAD	ZAR
VIX		-80%	-48%	-36%	13%	-33%	-25%	-5%	21%	-18%	21%	22%
SPX	-80%		36%	25%	-20%	42%	38%	11%	-35%	40%	-33%	-34%
US	-48%	36%		91%	10%	14%	-3%	-4%	3%	-12%	4%	9%
US	-36%	25%	91%		12%	8%	-12%	-8%	9%	-18%	14%	17%
SA	13%	-20%	10%	12%		-29%	-42%	-7%	33%	-24%	24%	56%
TOP40	-33%	42%	14%	8%	-29%		24%	-5%	-13%	23%	-24%	-12%
EM FX	-25%	38%	-3%	-12%	-42%	24%		-26%	-76%	70%	-52%	-71%
DM FX	-5%	11%	-4%	-8%	-7%	-5%	-26%		6%	-4%	-2%	3%
MXN	21%	-35%	3%	9%	33%	-13%	-76%	6%		-57%	55%	53%
AUD	-18%	40%	-12%	-18%	-24%	23%	70%	-4%	-57%		-64%	-60%
CAD	21%	-33%	4%	14%	24%	-24%	-52%	-2%	55%	-64%		49%
ZAR	22%	-34%	9%	17%	56%	-12%	-71%	3%	53%	-60%	49%	

Source: Bloomberg, YTD

Chart 16: Correlation matrix – commodities vs currencies

	Gold	Plat	Pall	Ironor	Coppe	T-Coal	Brent	BRL	AUD	CAD	ZAR	EM FX
Gold		69%	37%	4%	-6%	2%	23%	-52%	57%	-41%	-52%	59%
Plat	69%		52%	-4%	-1%	22%	32%	-43%	56%	-39%	-46%	56%
Pall	37%	52%		-14%	-9%	10%	40%	-26%	41%	-27%	-30%	40%
Ironor	4%	-4%	-14%		4%	-1%	-18%	9%	-3%	-4%	-8%	-4%
Coppe	-6%	-1%	-9%	4%		17%	5%	1%	-4%	1%	-6%	-5%
T-Coal	2%	22%	10%	-1%	17%		8%	-14%	6%	1%	-13%	7%
Brent	23%	32%	40%	-18%	5%	8%		-24%	30%	-35%	-28%	31%
BRL	-52%	-43%	-26%	9%	1%	-14%	-24%		-49%	31%	48%	-66%
AUD	57%	56%	41%	-3%	-4%	6%	30%	-49%		-64%	-60%	70%
CAD	-41%	-39%	-27%	-4%	1%	1%	-35%	31%	-64%		49%	-52%
ZAR	-52%	-46%	-30%	-8%	-6%	-13%	-28%	48%	-60%	49%		-71%
EM FX	59%	56%	40%	-4%	-5%	7%	31%	-66%	70%	-52%	-71%	

Source: Bloomberg, YTD

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