

RAND CONTAINS CONTAGION RISK

We expect the rand to correct closer to R12.23 against the USD in the short-term

However, global headwinds are likely to leave the rand vulnerable

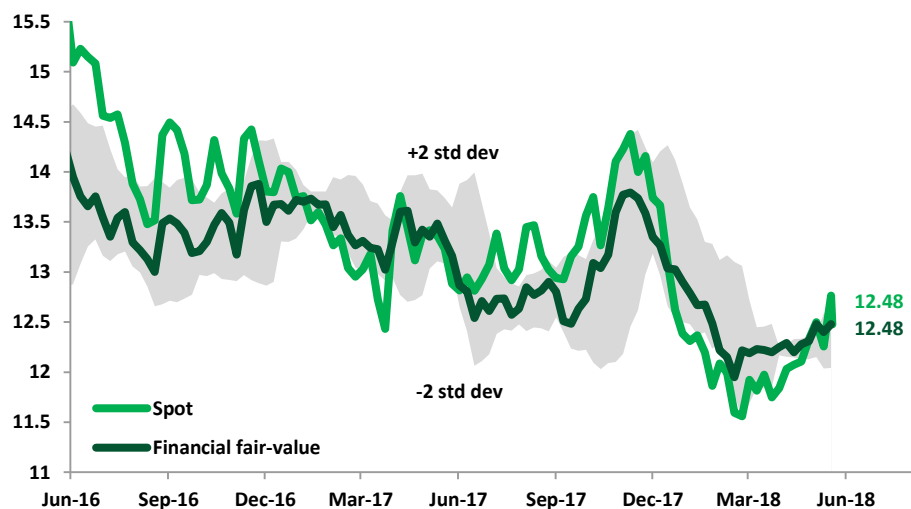
Our forecasts:

R12.40, 1H18

R13.10, 2H18

- Since the start of the year our view has been that the rand would gradually weaken (or rather that the dollar would strengthen) towards **the 12.50 level by mid-year**, and to around **13.00 by year-end**. We continue to hold this view.
- Should EM capital flows reverse, the risk is that the reversal results in major currency weakness. This could push the rand out beyond our target of 12.50 for mid-year and 13.00 for year-end. In fact, the SARB's May 2018 MPC statement highlighted this risk and started with the statement "higher US long-bond yields have led to sharply lower capital flows to emerging markets".
- That said, the rand has managed to contain contagion risk that has arisen in other struggling EMs (e.g. Turkey) relatively well, albeit with bouts of volatility. During Q&A at the MPC meeting, the governor indicated that the SARB does not think that current global developments will see a repeat of the 'Taper Tantrum' seen in 2013, providing some indication that the SARB remains comfortable that these upside risks will remain contained.
- As base case, we share the governor's view, and this is one reason why rand weakness (and our expectation of rand weakness into year-end) may seem moderate in the face of external headwinds.
- We believe two factors in particular should provide support for the rand in an otherwise increasingly hostile external environment (compared to, for example, 2013). **Firstly**, South Africa's long bond real yields better reflect the country's external vulnerability and **secondly** the slope of the yield curve is quite steep.
- **Short-term, we recommend keeping an eye on support at R12.23 and resistance at R12.93** (see our latest Technical Strategy note: "Rand correction phase unfolding, but not for long" of 24 May 2018 for a more detailed technical view on the currency).

Figure 1: Rand financial fair-value estimate



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

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WHERE DO WE LOOK FOR SUPPORT FOR THE RAND AS EM'S STRUGGLES?

Despite recent weakness we are not turning more bearish yet

Since the start of the year our view has been that the rand would gradually weaken (or rather that the dollar would strengthen) towards the 12.50 level by mid-year, and to around 13.00 by year-end. We continue to hold this view.

When EM capital flows reverse, the risk is that it results in major currency weakness, well beyond our target of 12.50 for mid-year and 13.00 for year-end, exists. In fact, the May MPC statement highlighted this risk and started with the statement that “higher US long-bond yields have led to sharply lower capital flows to emerging markets”.

But during Q&A at the MPC meeting, the governor indicated that the SARB does not think that current global developments will see a repeat of the ‘Taper Tantrum’, providing some indication that although it believes the risks to inflation have shifted to the upside, it remains comfortable that these upside risks will remain contained. As base case, we share the governor’s view and this is one reason why rand weakness may seem moderate in the face of external headwinds.

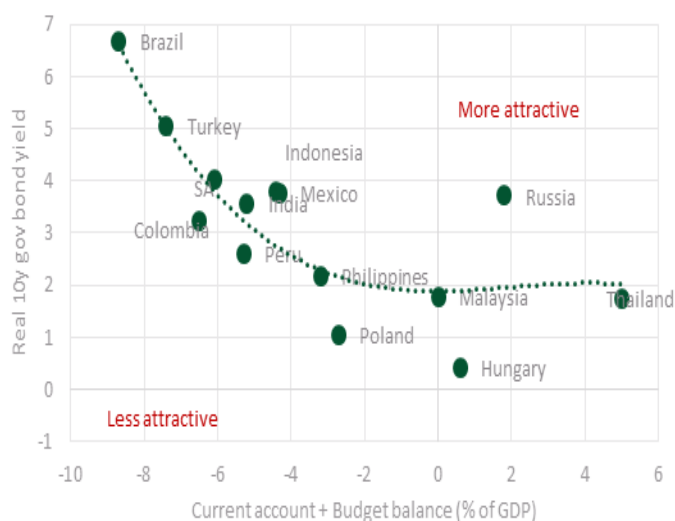
Two factors in particular should provide support for the rand in an otherwise increasingly hostile external environment than compared to eg 2013. Between the start of 2013 and January 2014 the rand depreciated by 34% against the dollar (from 8.50 to 11.40). Between the start of 2013 and January 2014 the rand depreciated by 34% against the dollar (from 8.50 to 11.40).

Firstly, South Africa’s long bond real yields better reflect the country’s external vulnerability (measured as the forward-looking current account and budget balance as a percentage of GDP) than in, for example, 2013. In fact, EMs in general are slightly better positioned from a real yield perspective (**Chart 1** and **Chart 2**) providing better real return given the external vulnerability.

Secondly, for South Africa specifically, the slope of the yield curve is quite steep which provides positive roll-return for any investor in government bonds. The steeper the yield curve, the more support it should provide to the currency. Currently, the spread between the 10y bond yield and the SARB’s repo rate is 220bps. In 2013, when the rand depreciated in the face of external headwinds, this spread hit a low of 118bps (in May of that year). Right now, the curve’s steepness is almost double of what was then. Of course, the curve can steepen even further, but this tends to be driven by local idiosyncratic events. For example, the spread between the 10y bond yield and the repo rate hit 408bps in December 2015 (when Finance Minister Nene was removed) but reversed quickly after that as the yield carry became very attractive.

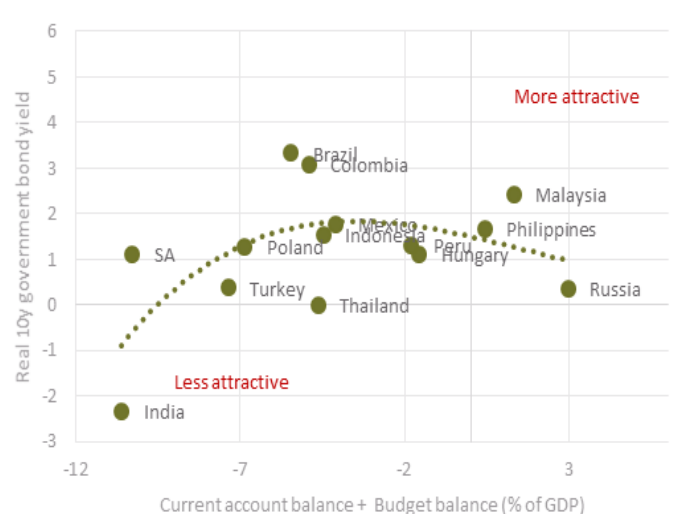
We expect the rand to trade close to R12.50-R13.00 against the US dollar as the year progresses

Chart 1: 2018 EM external vulnerability vs real bond yields



Source: Nedbank CIB Markets Research

Chart 2: 2012 EM external vulnerability vs real bond yields



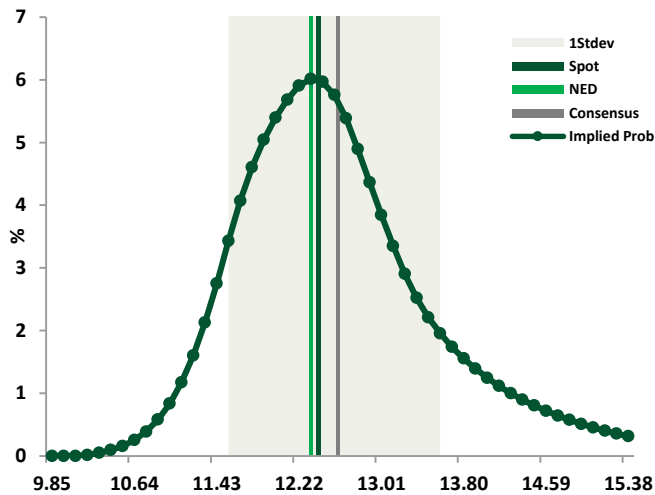
Source: Nedbank CIB Markets Research

FX VOL RISING BUT STILL BELOW THREE-YEAR AVERAGES

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

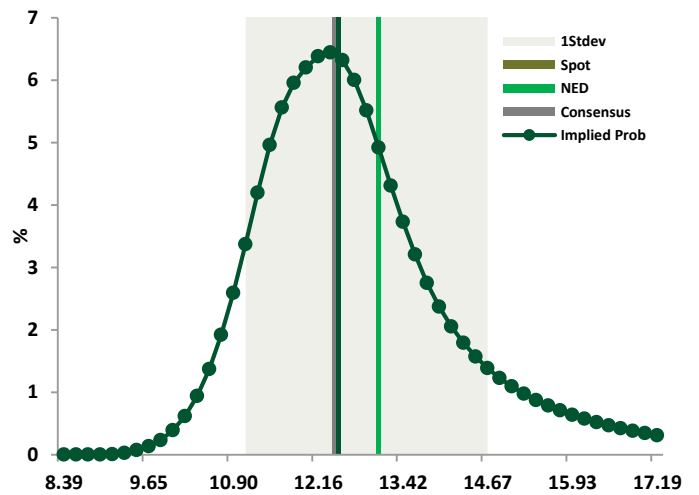
- On a three-month view, the option market suggests a one standard deviation trading range for the USDZAR of between 11.57 and 13.62 (see Chart 4).
- On a six-month view, the probability is skewed towards weakness, as one would expect, with the implied probability distribution suggesting a one standard deviation range of between 11.17 and 14.44 (see Chart 5).

Chart 3: 3m implied probability distribution vs forecast



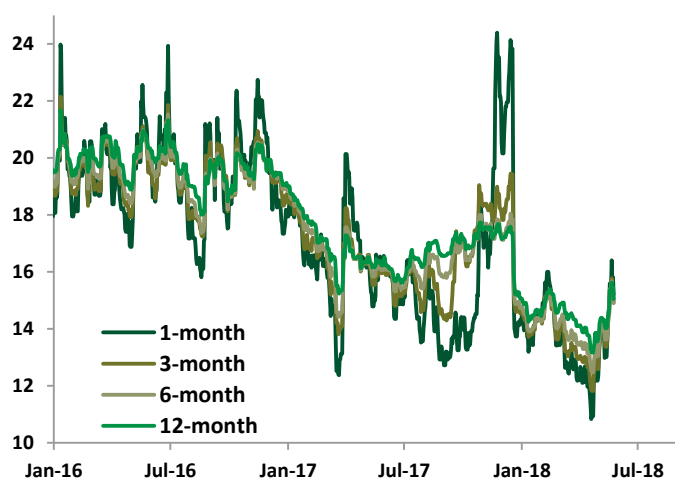
Source: IIF and Nedbank CIB Markets Research

Chart 4: 6m implied probability distribution vs forecast



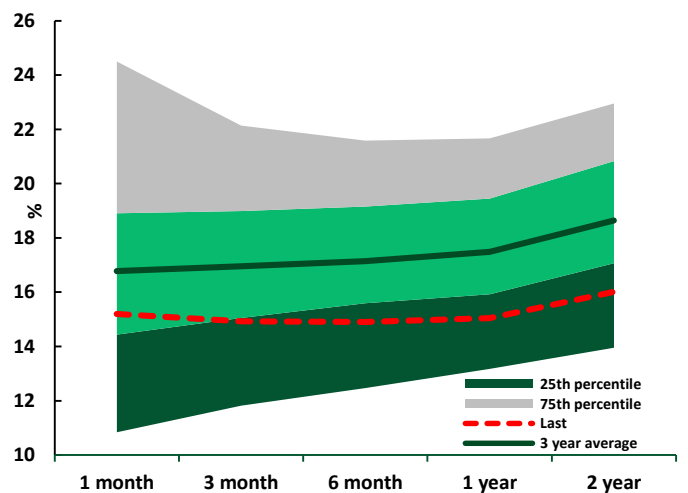
Source: IIF and Nedbank CIB Markets Research

Chart 5: USDZAR implied volatility



Source: IIF and Nedbank CIB Markets Research

Chart 6: ATM USDZAR implied volatility cone



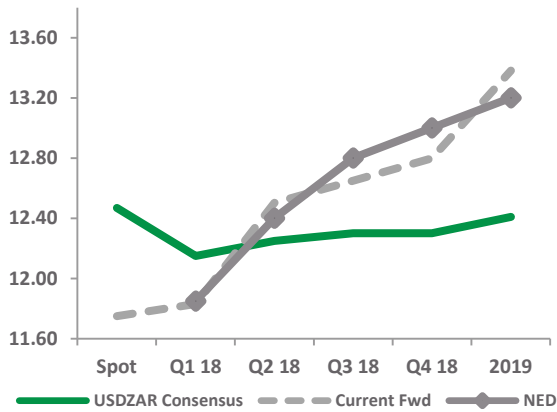
Source: IIF and Nedbank CIB Markets Research

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 | 12.49 | 11.85 | 12.40 | 12.80 | 13.00 | 13.20 |
| Current Fwd | 12.49 | 11.83 | 12.54 | 12.69 | 12.85 | 13.44 |
| Consensus | 12.49 | 12.15 | 12.33 | 12.28 | 12.40 | 12.21 |
| EURZAR | | | | | | |
| Nedbank | 14.58 | 14.40 | 14.88 | 15.23 | 15.15 | 15.64 |
| Current Fwd | 14.58 | 14.58 | 14.67 | 14.96 | 15.26 | 16.50 |
| Consensus | 14.58 | 14.82 | 14.92 | 15.10 | 15.50 | 15.87 |
| GBPZAR | | | | | | |
| Nedbank | 16.68 | 16.47 | 17.36 | 17.92 | 18.46 | 19.14 |
| Current Fwd | 16.68 | 16.58 | 16.77 | 17.04 | 17.33 | 18.48 |
| Consensus | 16.68 | 16.89 | 17.02 | 17.07 | 17.36 | 17.36 |
| AUDZAR | | | | | | |
| Nedbank | 9.45 | 9.24 | 9.67 | 10.50 | 10.66 | 10.96 |
| Current Fwd | 9.45 | 9.08 | 9.49 | 9.61 | 9.73 | 10.22 |
| Consensus | 9.45 | 9.48 | 9.37 | 9.46 | 9.55 | 9.77 |

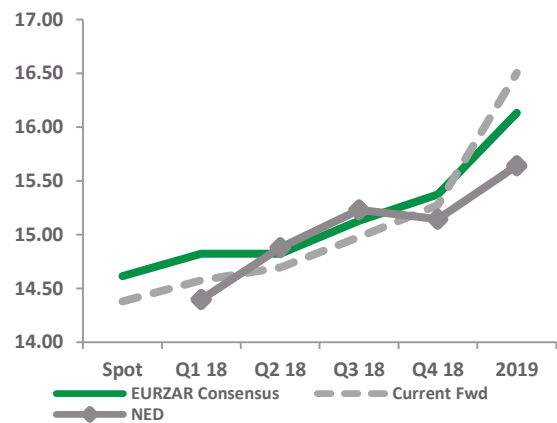
Source: Bloomberg, Nedbank CIB

Chart 8: USDZAR forecasts, consensus, and forwards



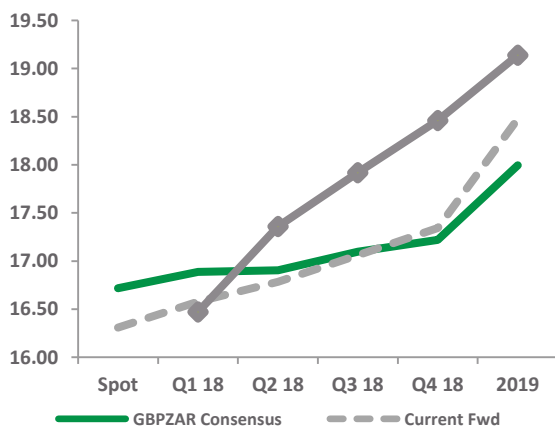
Source: Bloomberg, Nedbank CIB

Chart 9: EURZAR forecasts, consensus, and forwards



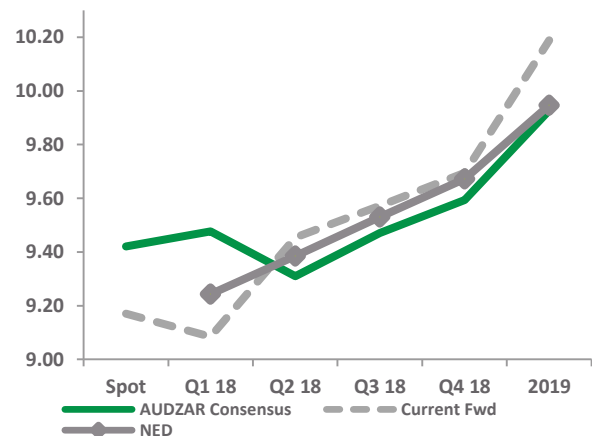
Source: Bloomberg, Nedbank CIB

Chart 10: GBPZAR forecasts, consensus, and forwards



Source: Bloomberg, Nedbank CIB

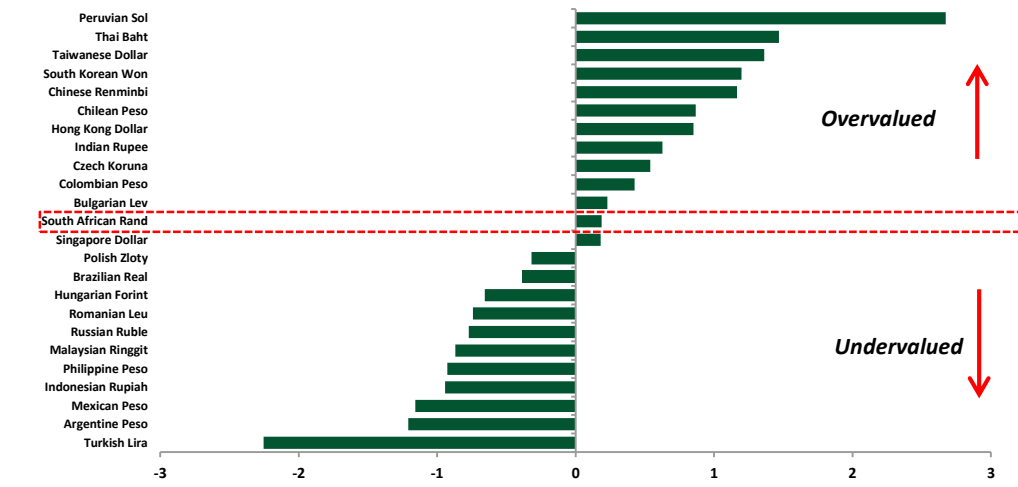
Chart 11: AUDZAR forecasts, consensus, and forwards



Source: Bloomberg, Nedbank CIB

Chart 12: 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 13: EM currency performance

| | CNY | JPY | KRW | TRY | MXN | RUB | THB | INR | AUD | BRL | GBP | EUR | CAD | ZAR | USD |
|-----|---------|--------|--------|---------|--------|--------|--------|--------|--------|---------|--------|--------|--------|--------|--------|
| CNY | | -0.918 | 3.055 | 26.644 | 1.883 | 8.896 | 0.266 | 9.401 | 5.285 | 12.257 | 2.727 | 4.229 | 4.560 | 2.923 | 1.926 |
| JPY | 0.923 | | -3.807 | -22.258 | -2.916 | -8.471 | -1.202 | -9.431 | -5.905 | -11.764 | -3.611 | -4.986 | -5.231 | -3.682 | -2.787 |
| KRW | -3.279 | 4.050 | | -18.656 | 1.032 | -4.853 | 2.752 | -5.706 | -2.152 | -8.260 | 0.224 | -1.302 | -1.456 | 0.126 | 1.212 |
| TRY | -21.060 | 27.773 | 22.914 | | 24.157 | 17.185 | 26.235 | 16.027 | 20.266 | 12.807 | 23.426 | 22.295 | 21.207 | 24.519 | 24.978 |
| MXN | -1.877 | 2.857 | -1.030 | -19.490 | | -5.855 | 1.656 | -6.494 | -3.162 | -9.114 | -0.709 | -2.155 | -2.405 | -0.384 | 0.164 |
| RUB | -7.569 | 9.274 | 5.113 | -14.672 | 6.179 | | 8.661 | -0.695 | 2.938 | -3.561 | 6.039 | 4.308 | 3.600 | 6.141 | 6.652 |
| THB | -0.300 | 1.221 | -2.623 | -20.779 | -1.543 | -7.363 | | -8.312 | -4.730 | -10.667 | -2.267 | -3.845 | -4.052 | -2.507 | -1.639 |
| INR | -8.602 | 10.193 | 6.047 | -13.851 | 7.019 | 0.771 | 9.070 | | 3.881 | -2.810 | 6.432 | 4.814 | 4.867 | 6.004 | 7.336 |
| AUD | -5.032 | 6.247 | 2.250 | -16.826 | 3.226 | -2.715 | 4.957 | -3.980 | | -6.234 | 2.438 | 0.946 | 0.954 | 2.609 | 3.295 |
| BRL | -10.930 | 13.299 | 9.004 | -11.309 | 9.964 | 3.700 | 11.942 | 2.892 | 6.677 | | 9.448 | 7.581 | 7.434 | 9.081 | 10.180 |
| GBP | -2.512 | 3.796 | -0.216 | -18.938 | 0.798 | -5.469 | 2.294 | -6.035 | -2.372 | -8.460 | | -1.426 | -1.648 | 0.167 | 0.852 |
| EUR | -4.140 | 5.282 | 1.105 | -18.240 | 2.123 | -3.472 | 3.986 | -4.444 | -0.815 | -7.055 | 1.482 | | 0.030 | 1.783 | 2.377 |
| CAD | -4.382 | 5.244 | 1.469 | -17.957 | 2.347 | -3.481 | 4.182 | -4.569 | -0.693 | -6.908 | 1.714 | 0.180 | | 1.870 | 2.490 |
| ZAR | -3.628 | 3.367 | 0.742 | -19.717 | 1.754 | -5.819 | 2.561 | -5.697 | -2.652 | -7.593 | 0.056 | -1.352 | -1.819 | | 0.519 |
| USD | -1.892 | 2.862 | -1.056 | -19.528 | -0.177 | -5.906 | 1.615 | -6.603 | -3.189 | -9.242 | -0.792 | -2.283 | -2.426 | -0.229 | |

Source: Bloomberg

Chart 14: Correlation matrix – markets vs FX

| | VIX | SPX | US | US | SA | TOP40 | EM FX | DM FX | MXN | AUD | CAD | ZAR |
|-------|------|------|------|------|------|-------|-------|-------|------|------|------|------|
| VIX | | -80% | -46% | -35% | 12% | -32% | -25% | -6% | 21% | -18% | 20% | 21% |
| SPX | -80% | | 35% | 24% | -18% | 40% | 38% | 12% | -35% | 40% | -33% | -33% |
| US | -46% | 35% | | 92% | 8% | 17% | -5% | -6% | 1% | -9% | -2% | 7% |
| US | -35% | 24% | 92% | | 10% | 11% | -13% | -10% | 7% | -15% | 8% | 15% |
| SA | 12% | -18% | 8% | 10% | | -29% | -50% | -5% | 37% | -21% | 24% | 59% |
| TOP40 | -32% | 40% | 17% | 11% | -29% | | 29% | -5% | -13% | 25% | -28% | -15% |
| EM FX | -25% | 38% | -5% | -13% | -50% | 29% | | -25% | -76% | 70% | -54% | -76% |
| DM FX | -6% | 12% | -6% | -10% | -5% | -5% | -25% | | 6% | -2% | -1% | 2% |
| MXN | 21% | -35% | 1% | 7% | 37% | -13% | -76% | 6% | | -55% | 55% | 55% |
| AUD | -18% | 40% | -9% | -15% | -21% | 25% | 70% | -2% | -55% | | -64% | -57% |
| CAD | 20% | -33% | -2% | 8% | 24% | -28% | -54% | -1% | 55% | -64% | | 49% |
| ZAR | 21% | -33% | 7% | 15% | 59% | -15% | -76% | 2% | 55% | -57% | 49% | |

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 | | 68% | 35% | 4% | -7% | 2% | 21% | -48% | 56% | -39% | -49% | 64% |
| Plat | 68% | | 52% | -6% | -2% | 21% | 30% | -43% | 55% | -40% | -44% | 59% |
| Pall | 35% | 52% | | -14% | -9% | 9% | 40% | -29% | 43% | -30% | -29% | 39% |
| Ironor | 4% | -6% | -14% | | 4% | -1% | -16% | 11% | -2% | -4% | -9% | -2% |
| Coppe | -7% | -2% | -9% | 4% | | 17% | 6% | -2% | -5% | 3% | -5% | -5% |
| T-Coal | 2% | 21% | 9% | -1% | 17% | | 8% | -13% | 6% | 1% | -13% | 6% |
| Brent | 21% | 30% | 40% | -16% | 6% | 8% | | -26% | 30% | -36% | -29% | 29% |
| BRL | -48% | -43% | -29% | 11% | -2% | -13% | -26% | | -47% | 31% | 49% | -64% |
| AUD | 56% | 55% | 43% | -2% | -5% | 6% | 30% | -47% | | -64% | -57% | 70% |
| CAD | -39% | -40% | -30% | -4% | 3% | 1% | -36% | 31% | -64% | | 49% | -54% |
| ZAR | -49% | -44% | -29% | -9% | -5% | -13% | -29% | 49% | -57% | 49% | | -76% |
| EM FX | 64% | 59% | 39% | -2% | -5% | 6% | 29% | -64% | 70% | -54% | -76% | |

Source: Bloomberg, YTD

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