

RAND REPRIEVE, BUT DOWNSIDE RISKS INTACT

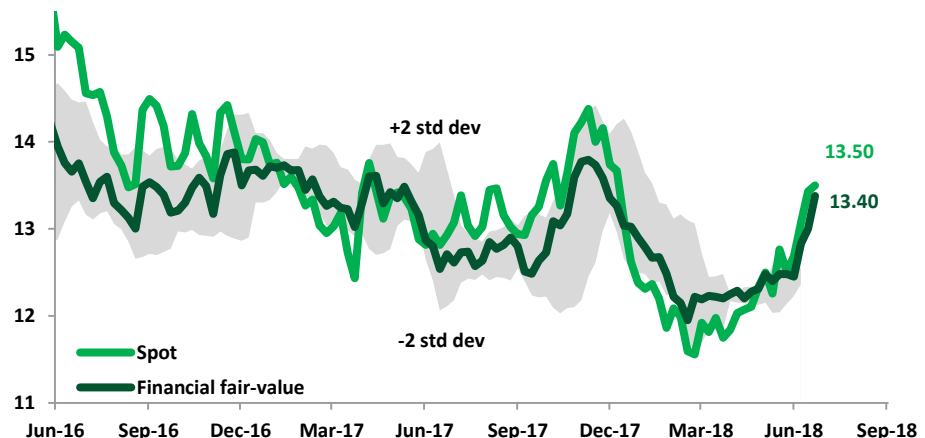
We expect the rand to correct to 13.40-13.30 in the short-term.

However, rising US borrowing cost and a dollar shortage will be negative for the carry-trade and will leave the rand vulnerable

Our forecasts:
R13.00, 3Q18
R13.10, 4Q18

- We believe that the rand (and EM currencies more broadly) are set to enter a **phase of consolidation and strength** after almost three consecutive weeks of rand weakness. However, on a multi-month view we believe that global headwinds are likely to persist. Our **tactical target** for the rand is **13.30**, with a secondary target of **13.10**.
- Our tactical expectations for some consolidation and strength in the rand is premised on a number of factors that we are monitoring closely. On the fundamental side, the decline in our global \$-Liquidity indicators have lost some momentum to the downside in recent weeks. This is supportive of a period of consolidation in currencies. Furthermore, expectations that the SARB will act by raising rates to counter inflation should the rand weaken too far, is adding additional support in our view (supported by comments by Deputy Governor Kuben Naidoo on [Bloomberg TV last week](#)). We believe that **technical support** is also aiding the rand as the US Dollar Index struggles to hold ground above 95.
- In our previous two reports we highlighted that South Africa's current account for 1Q18 is likely to disappoint, relative to market expectations. The current account balance came in at -4.8% of GDP. The print was wider than Bloomberg consensus of -3.9%. It was also wider than the -2.9% for 4Q17. While it highlights South Africa's external vulnerability, as base case we believe that the current account will narrow for the rest of 2018. As a result, **from a currency perspective, we would not be too concerned that the current widening of South Africa's external financing requirement is a trend that will persist.**
- In line with our tactical view, we maintain that the rand will end the year closer to 13.00 than 14.00, and as a result our **year-end target remains unchanged** at 13.10. However, with that being said we can only revise our forecast should our global \$-Liquidity measures move into contractionary state. Currently they have merely lost momentum.
- We keep an eye on **ominous signs** from the global equity market, in particular from the world's most importantly systemically financial institutions, which may swing the bias towards further weakness in the rand sooner than we anticipate (see next page for detail).
- From a technical perspective, we recommend keeping an eye on the **\$-rand resistance** level of **R13.52** and **support of R13.94** (see our latest Technical Strategy note: ["It is time for EM's to take a breather"](#) of 21 June 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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GLOBAL STOCK MARKET: DOWNSIDE RISKS FOR THE RAND.

Sequence of events: All about the US Dollar: While timing is always difficult, we believe that the volatility and weakness in EM currencies was largely predictable. Global \$-Liquidity has tightened since March 2018 and led to US Dollar strength and unwinding of some carry trades. In contrast, international and local equity markets have been rather resilient to tighter global financial conditions compared to other asset classes such as EM currency and EM debt markets. **The risk, in our view, is that equity markets also slump.**

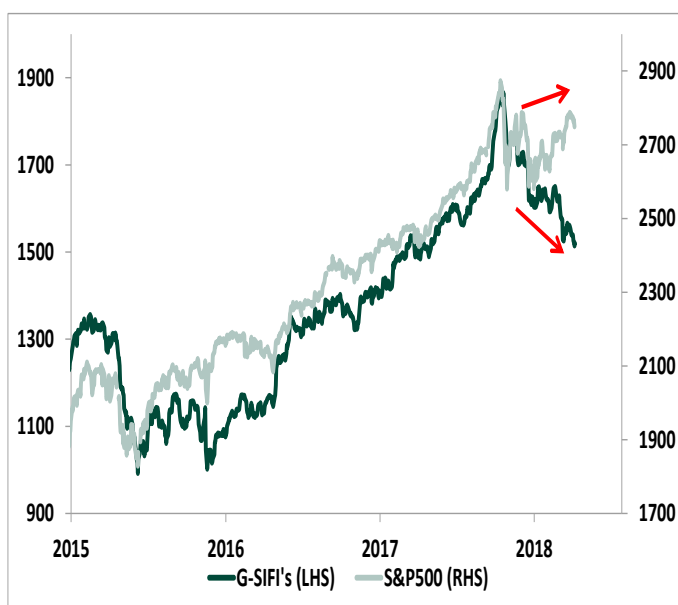
Why do global equity markets matter for the rand and other emerging market currencies? The stock market performance, alongside the world's large financial institutions, play an important role in global capital flows. We believe that the **FSB's list of Global Systemically Important Financial Institutions (G-SIFI's)** is a good proxy of these financial institutions (and the forces in capital flow which they represent).

If the G-SIFI's are performing well, it would imply that the health of the global economy is good and that movement of capital into emerging markets is positive. However, if the G-SIFI's are underperforming, it would imply that expectations of the health of the global economy is fading and even turning negative. If expectations of global growth declines it is also likely to result in capital avoiding more risk and growth sensitive assets, such as emerging market debt and EM currencies, including the rand.

Since the beginning of 2018, the **G-SIFI's have lost 18% or \$850bn of its market cap. More important, it has decoupled from broader stock market and we believe that this is not sustainable Chart 1.** We have been sceptical of 'global synchronized growth' narrative in the market for a quite some time. In our opinion, the recovery has been credit fuelled and with the financial conditions tightening beneath the surface the strains are being reflected in the performance of these financial institutions, as they are key to the performance of the global economy, after all they lend credit to facilitate demand and growth.

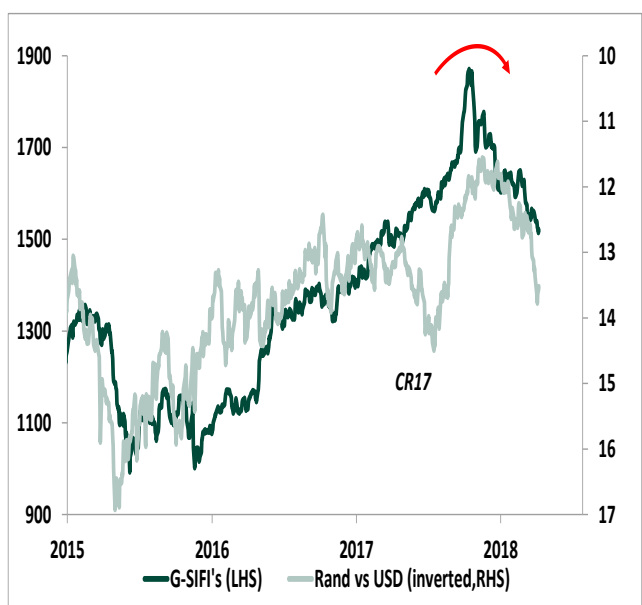
Given the above, one would expect that there be a relationship between the performances in the rand vs the performance of the G-SIFI (Chart 2). If the G-SIFI's continue to underperform, we believe that any correction in the rand will not be sustained. **Looking at these indicators, downside risks to our forecasts remain.** However, we will only revise our forecasts once all our global \$-Liquidity measures move into contractionary state as currently they have merely lost momentum.

Chart 1: There are ominous signs from the world's most important financial institutions (creators of money)



Source: Nedbank CIB markets Research

Chart 2: Decent relationship between G-SIFI's and rand since they play an important role in the carry-trade



Source: Nedbank CIB markets Research

FX VOL RISING - THE VOL CURVE INVERTS

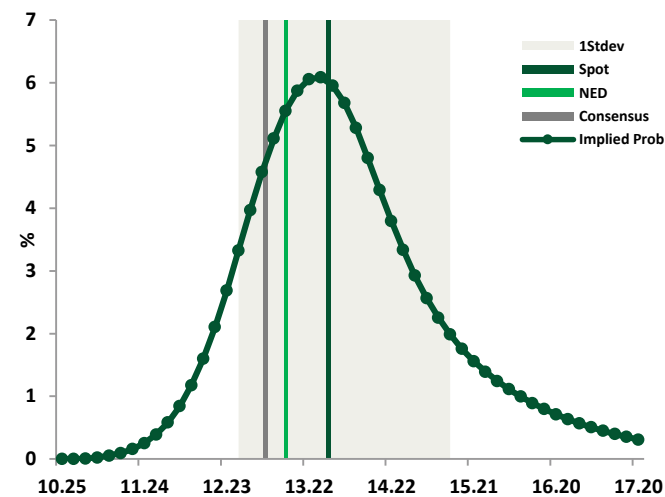
We highlight the rise in nearby USDZAR ATM implied volatility (vol), while longer dated ATM vol remains largely unchanged and at relatively low levels ([Chart 6](#)).

In our view, the rise in shorter-dated vol relative to that of longer dated vol signals market expectations that the current uneasiness with global developments may blow over. As pointed out above, we believe that the current headwinds may linger for longer than current market expectations.

The forecast from the option market for the USDZAR remains more bearish than the Bloomberg consensus expectations:

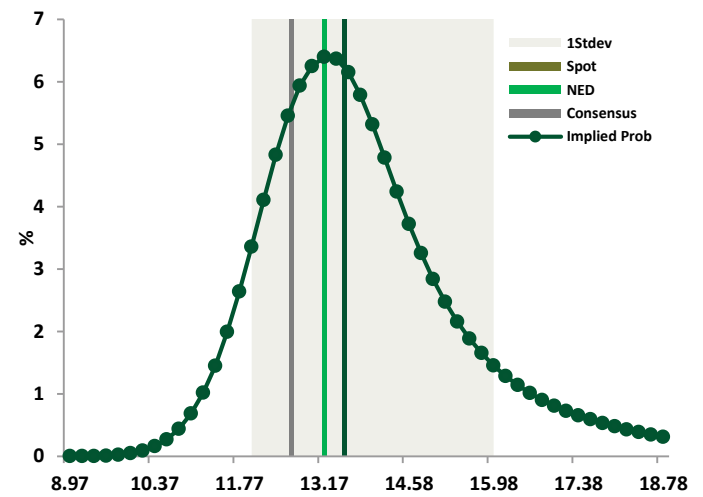
- On a three-month view, the option market suggests a one standard deviation trading range for the USDZAR of between 12.40 and 14.80 (see [Chart 4](#)).
- On a six-month view, the probability is skewed towards weakness, as one would expect, with the implied probability distribution suggesting a one standard deviation range of between 12.00 and 15.80 (see [Chart 5](#)).

Chart 3: 3m implied probability distribution vs forecast



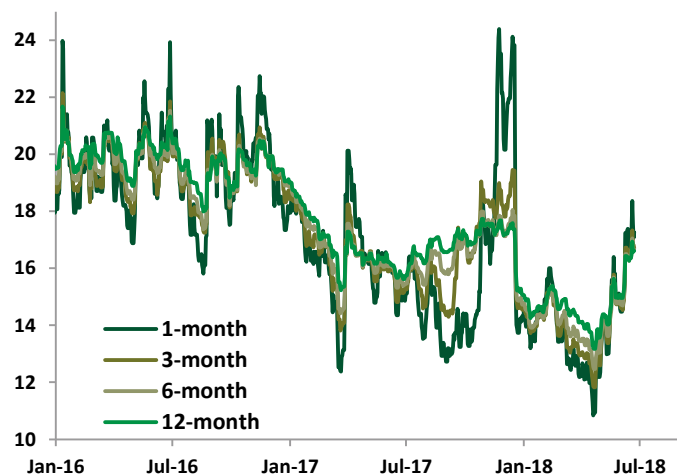
Source: IIF and Nedbank CIB Markets Research

Chart 4: 6m implied probability distribution vs forecast



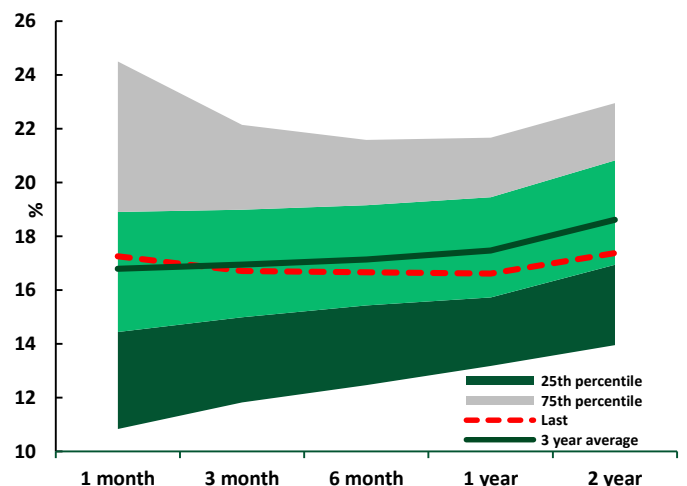
Source: IIF and Nedbank CIB Markets Research

Chart 5: USDZAR implied volatility



Source: IIF and Nedbank CIB Markets Research

Chart 6: ATM USDZAR implied volatility cone



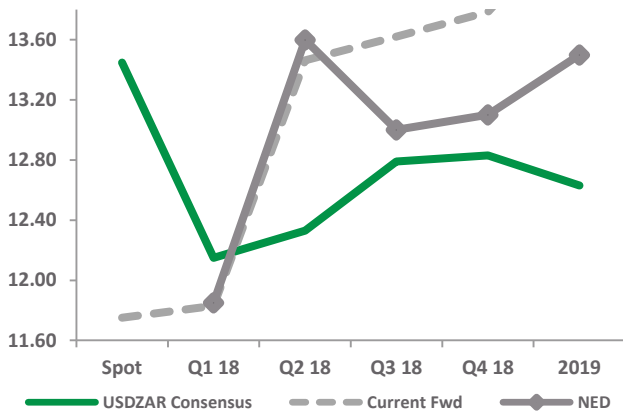
Source: IIF and Nedbank CIB Markets Research

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

	Current Spot	Q2 18	Q3 18	Q4 18	2019
USDZAR					
Nedbank CIB Markets	13.45	13.60	13.00	13.10	13.50
Current Fwd	13.45	13.46	13.62	13.78	14.45
Consensus	13.45	12.33	12.79	12.83	12.63
EURZAR					
Nedbank CIB Markets	15.66	15.78	15.15	15.26	16.00
Current Fwd	15.66	15.69	15.98	16.30	17.67
Consensus	15.66	14.80	15.22	15.40	15.91
GBPZAR					
Nedbank CIB Markets	17.86	17.95	17.68	18.60	19.58
Current Fwd	17.86	17.88	18.16	18.46	19.73
Consensus	17.86	16.77	17.14	17.45	17.45
AUDZAR					
Nedbank CIB Markets	9.99	10.06	9.62	9.69	10.13
Current Fwd	9.99	10.00	10.12	10.25	10.81
Consensus	9.99	9.37	9.72	9.88	9.98

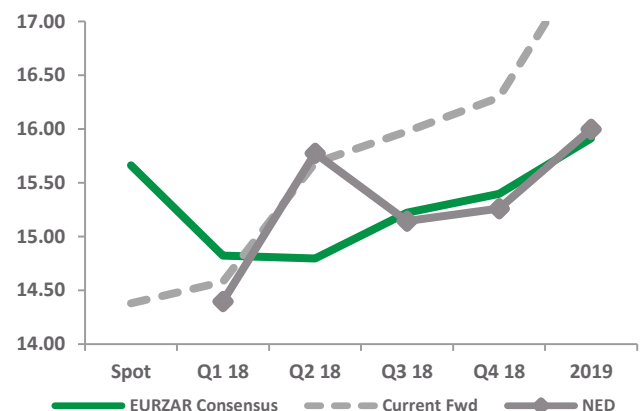
Source: Bloomberg, Nedbank CIB

Chart 8: USDZAR forecasts, consensus and forwards



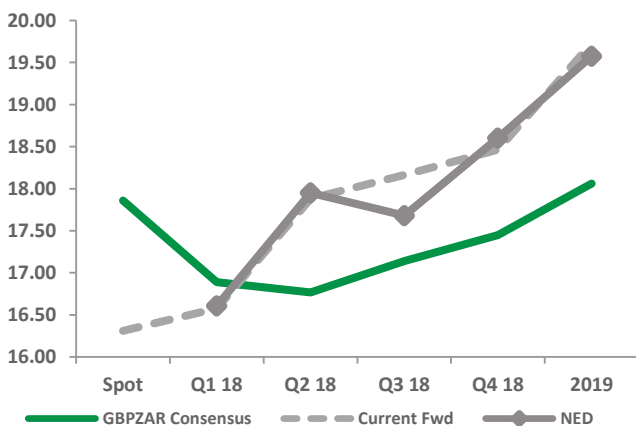
Source: Bloomberg, Nedbank CIB

Chart 9: EURZAR forecasts, consensus and forwards



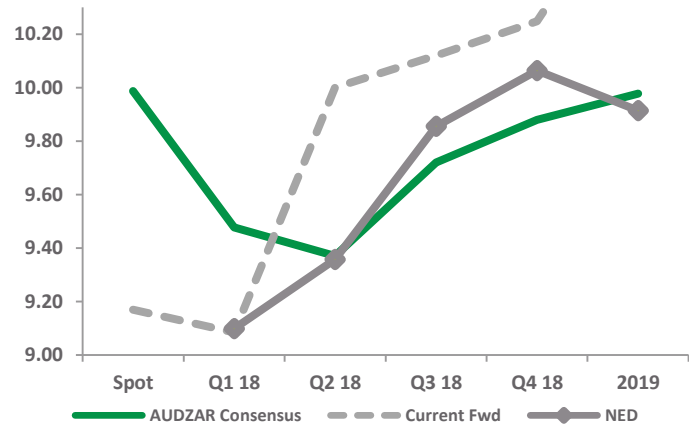
Source: Bloomberg, Nedbank CIB

Chart 10: GBPZAR forecasts, consensus and forwards



Source: Bloomberg, Nedbank CIB

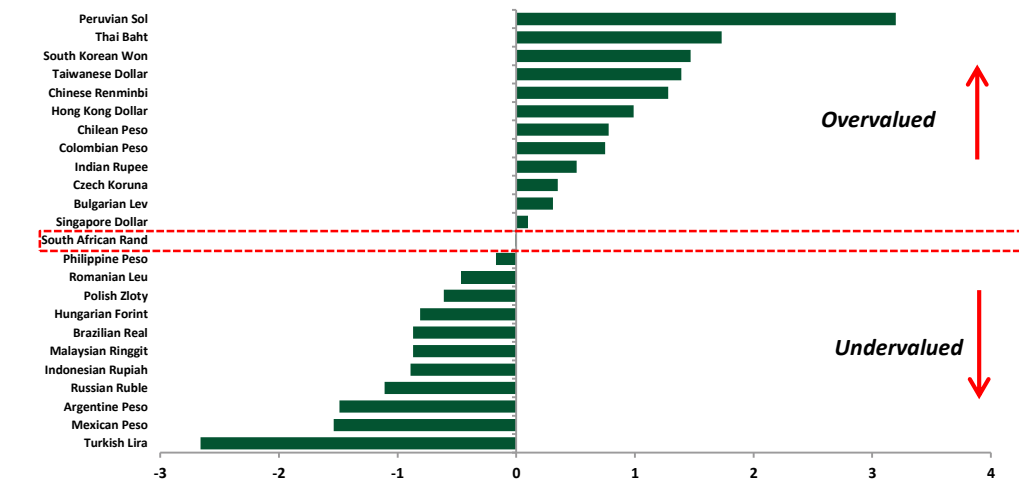
Chart 11: AUDZAR forecasts, consensus and forwards



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		-2.269	3.991	24.074	3.172	10.418	1.077	6.571	5.742	13.887	2.023	3.215	6.010	10.040	0.124
JPY	2.317		-5.966	-21.693	-5.424	-10.974	-3.323	-8.295	-7.559	-14.187	-4.190	-5.355	-7.813	-11.207	-2.378
KRW	-3.279	6.387		-16.263	0.692	-5.307	2.815	-2.431	-1.657	-8.744	1.924	0.746	-1.920	-5.571	3.861
TRY	-19.409	26.995	19.286		20.243	13.223	22.743	16.695	17.361	8.959	21.826	20.963	17.103	13.955	24.688
MXN	-3.087	5.714	-0.705	-16.788		-6.002	2.152	-2.922	-2.343	-9.232	1.310	0.046	-2.550	-5.730	3.244
RUB	-8.905	12.329	5.606	-11.688	6.356		9.270	3.526	3.985	-3.628	8.344	6.834	3.575	0.603	10.092
THB	-1.101	3.431	-2.623	-18.558	-1.984	-7.914		-5.105	-4.347	-11.218	-0.738	-2.131	-4.623	-8.143	0.927
INR	-6.165	9.043	2.479	-14.369	2.935	-3.219	5.390		0.813	-6.712	4.529	3.163	0.608	-3.485	6.437
AUD	-5.414	8.147	1.667	-14.854	2.304	-3.620	4.533	-0.498		-7.165	3.645	2.351	-0.039	-3.672	5.567
BRL	-12.207	16.531	9.574	-8.251	10.024	3.747	12.630	7.191	7.733		11.815	9.911	7.460	3.424	13.754
GBP	-1.757	4.421	-1.875	-17.884	-1.330	-7.031	0.699	-4.310	-3.508	-10.519		-1.215	-3.754	-7.023	1.866
EUR	-3.198	5.693	-0.658	-17.283	0.000	-6.250	2.188	-2.835	-2.185	-9.040	1.269		-2.312	-5.795	3.205
CAD	-5.704	8.193	1.970	-15.175	2.504	-3.467	4.797	-0.508	0.296	-6.960	3.940	2.586		-3.445	5.791
ZAR	-9.906	12.193	6.761	-12.282	7.499	-0.652	8.844	3.573	3.704	-2.554	7.872	6.584	3.576		9.485
USD	-0.126	2.434	-3.681	-19.311	-3.145	-8.859	-0.967	-5.773	-5.277	-12.090	-1.791	-3.067	-5.481	-8.365	

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%	-48%	-38%	13%	-33%	-26%	-4%	21%	-19%	21%	22%
SPX	-80%		38%	28%	-16%	40%	39%	10%	-33%	39%	-34%	-32%
US	-48%	38%		93%	-3%	24%	10%	-8%	-9%	6%	-14%	-10%
US	-38%	28%	93%		0%	17%	2%	-11%	-6%	0%	-6%	-3%
SA	13%	-16%	-3%	0%		-28%	-46%	-6%	36%	-25%	22%	64%
TOP40	-33%	40%	24%	17%	-28%		27%	-7%	-10%	27%	-25%	-16%
EM FX	-26%	39%	10%	2%	-46%	27%		-21%	-73%	70%	-57%	-75%
DM FX	-4%	10%	-8%	-11%	-6%	-7%	-21%		1%	-3%	0%	-2%
MXN	21%	-33%	-9%	-6%	36%	-10%	-73%	1%		-47%	51%	54%
AUD	-19%	39%	6%	0%	-25%	27%	70%	-3%	-47%		-66%	-60%
CAD	21%	-34%	-14%	-6%	22%	-25%	-57%	0%	51%	-66%		51%
ZAR	22%	-32%	-10%	-3%	64%	-16%	-75%	-2%	54%	-60%	51%	

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		67%	34%	15%	-4%	2%	24%	-26%	50%	-36%	-40%	55%
Plat	67%		52%	5%	0%	19%	30%	-26%	51%	-40%	-42%	54%
Pall	34%	52%		-11%	-1%	9%	35%	-15%	42%	-30%	-27%	39%
Ironor	15%	5%	-11%		3%	-1%	-1%	9%	4%	-14%	-11%	3%
Coppe	-4%	0%	-1%	3%		15%	7%	7%	-1%	4%	2%	-8%
T-Coal	2%	19%	9%	-1%	15%		7%	-9%	5%	1%	-11%	6%
Brent	24%	30%	35%	-1%	7%	7%		-8%	28%	-38%	-20%	24%
BRL	-26%	-26%	-15%	9%	7%	-9%	-8%		-31%	27%	31%	-50%
AUD	50%	51%	42%	4%	-1%	5%	28%	-31%		-66%	-60%	70%
CAD	-36%	-40%	-30%	-14%	4%	1%	-38%	27%	-66%		51%	-57%
ZAR	-40%	-42%	-27%	-11%	2%	-11%	-20%	31%	-60%	51%		-75%
EM FX	55%	54%	39%	3%	-8%	6%	24%	-50%	70%	-57%	-75%	

Source: Bloomberg, YTD

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