FX AT A GLANCE

23 July 2018

NEDBANK CIB

RAND: VOLATILITY FROM THE EAST

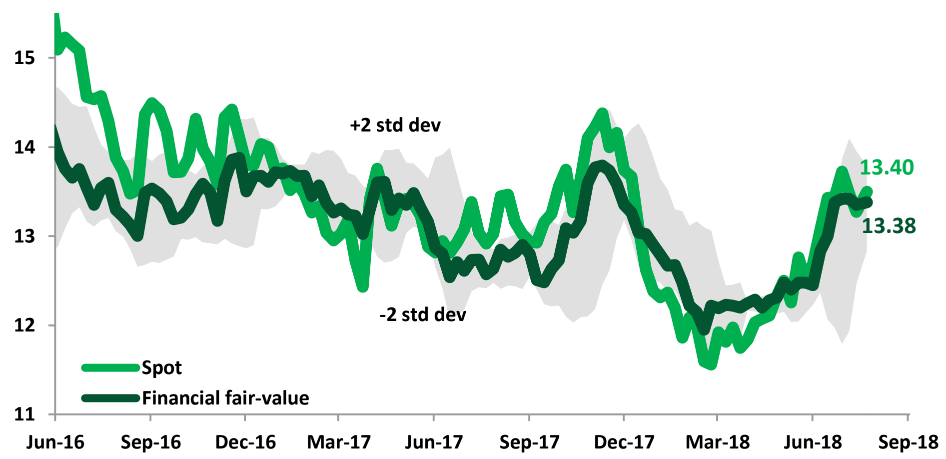
Tactical view:
We expect the Rand to correct to 13.50-13.20 in the short-term

Strategic view:
We believe that rising US Dollar borrowing costs and a US Dollar shortage will be negative for the carry-trade, leaving the rand vulnerable.

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

- The **"double whammy"** of a **stronger Dollar** and now the weaker **Chinese Yuan** is casting a shadow over financial markets; this has led to losses in the rand and other emerging market currencies. Evidence of this can be seen in the **increased sensitivity** between the moves in the USD/CNY and EM FX i.e. the beta (sensitivity) has climbed from 0.15 to 0.40.
- The currency of the world's 2nd largest economy **– the Chinese Yuan –** has slumped in recent weeks (YTD -4% vs. the USD), raising concerns that its over indebted economy (debt to GDP ratio currently at 257%) is slowing down which will pose a headwind for global growth, commodity prices and the outlook for emerging markets**. A slowdown in Chinese growth is likely to tighten global financial conditions, and this will not bode well for the rand and other EM FX** – Chart 1 and Chart 2 on the next page.
- In light of volatile external developments we believe the rand is likely to remain in the range between **13.50-13.20** for the following reasons 1) hawkish language from the SARB 2) our expectations that Chinese authorities will intervene to ease financial conditions in its economy and 3) the US Dollar is struggling to break out of a tight range between 94-95 index points on a sustainable basis.
- As mentioned, **the SARB last week delivered a hawkish MPC statement** despite keeping the repo rate unchanged. The MPC statement was more hawkish than we expected, not only in its language, but also via its forecasts. Our headline inflation forecast remains well below that of the SARB's and as a result we do not expect the SARB to hike rates this year. However, the hawkish statement should provide some support for the currency in the near term in a volatile external environment (see *Upping the ante in language and forecasts* of 19 July).
- **Longer-term** , we maintain our view which we have had since the start of the 2018:
  - **Tighter global financial conditions** will continue to dominate the outlook for the rand. We believe the longer term trend for the rand is weaker amid lingering trade-war risks, China credit cycle slowing down and as growth in $-Liquidity remains restrictive. As a result, we believe that the rand will end the year in the range of **13.00-14.00**, with a bias towards the upper end of this range.
- From a technical perspective, we recommend keeping an eye on the **$-Rand resistance** level of **R13.17** and **$-Rand support level of R13.37** (see our latest Technical Strategy note: *"The first part of the correction is complete"* dated 18 July 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 FINANCIAL CONDITIONS: MONITORING CLOSELY

We have highlighted in a numerous publications the importance of **global liquidity** and its impact on the rand. The rand is **very sensitive** to changes in the global environment due to the nature of our real economy (i.e. commodity exporter) and also because our financial markets are deeply integrated with the rest of the world's capital markets – hence we believe it is essential to understand both changes in the real economy and also changes in the external environment.

Our **less-bullish stance** relative to the rest of the industry (Bloomberg consensus) continues to be based on the outlook for the external environment which will dominate. **Global headwinds** arising from 1) US Federal Reserve determined to continue with the path of raising interest rates and tapering of its balance sheet 2) The lingering risks from tit-for-trade policies between the US and its major trading partners 3) slowdown in China's credit cycle.

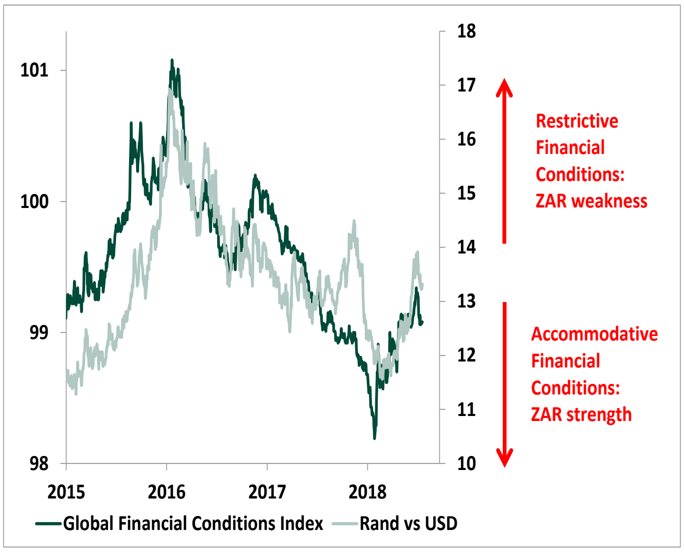
Restrictive global financial conditions will leave the rand vulnerable.

These factors will make it **difficult** for **global financial conditions** to become accommodative on a sustainable basis, leaving the rand and other emerging market currencies **vulnerable to the downside**: Chart 1.

According to our ***"Liquidity and credit cycle***" clock Chart 2, we believe that as we progress into 2H18, financial conditions will become restrictive which will not bode well for risk assets, currently we are not yet at 6 o'clock as the US Dollar has not accelerated out of the current consolidation and all our global $-Liquidity indicators have merely slowed down and are not in contractionary state yet.

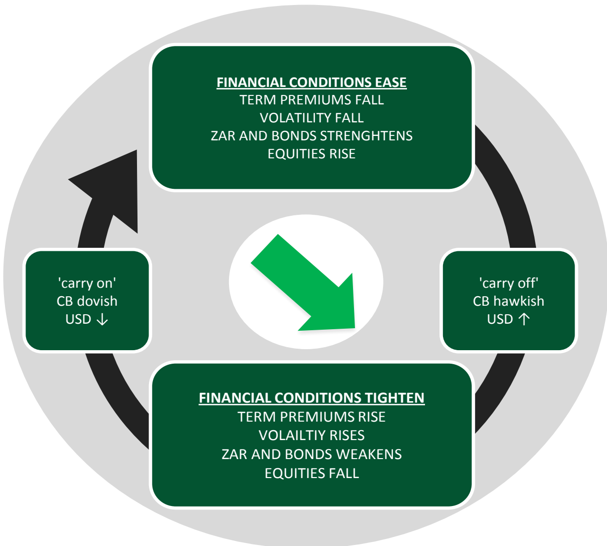
We expect the rand to trade between R13.00-R14.00 against the US dollar as the year progresses

Chart 1: Global headwinds will keep Global Financial Conditions restrictive; this will leave the ZAR vulnerable



Source: BBG, Nedbank CIB markets Research

Chart 2: Our "Liquidity and credit cycle" clock is not yet at 6 o'clock hence our tactical call of R13.50-R13.20



Source: BBG, Nedbank CIB markets Research

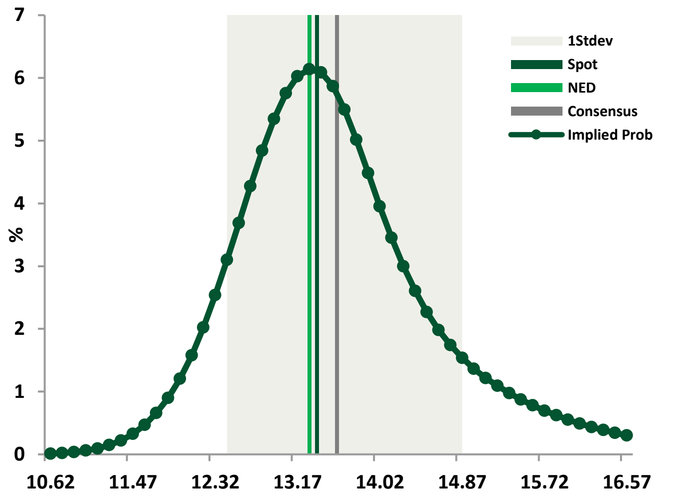
FX VOL CURVES MOVES FROM INVERTED TO NORMAL

After weeks of rising short-dated USDZAR at-the-money implied volatility and a weaker Rand (on the back of escalating global trade wars, EM outflows, US Fed hiking interest rates), calm has returned to the FX options market, with volatility skew reverting to normal from inverted (see Chart 6).

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

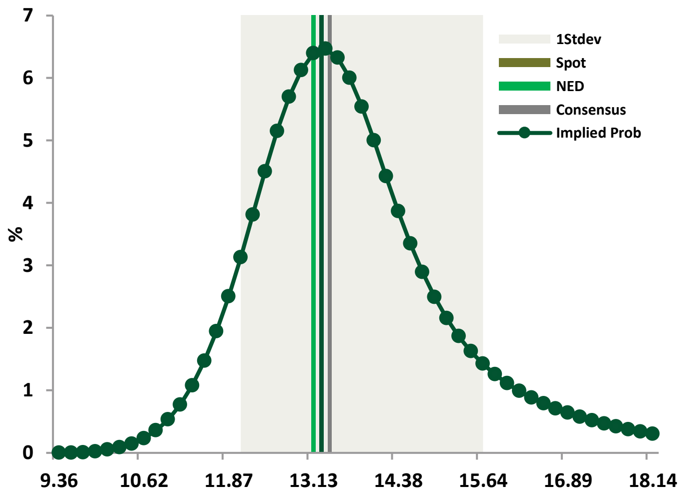
- On a three month view, the option market suggests a one standard deviation trading range for the USDZAR of between 12.40 and 14.75 (see Chart 4).
- On a six month view, the probability is skewed towards weakness, as one would expect, with the implied probability distribution suggesting a one standard deviation range of between 12.08 and 15.60 (see Chart 5).

Chart 3: 3m implied probability distribution vs forecast



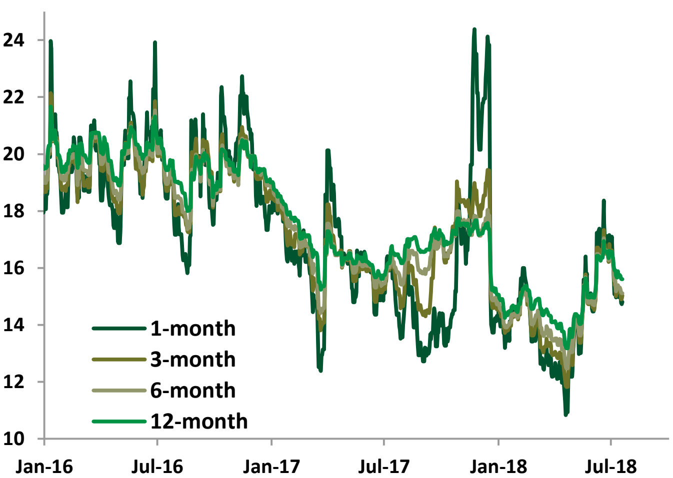
Source: Bloomberg, Nedbank CIB

Chart 4: 6m implied probability distribution vs forecast



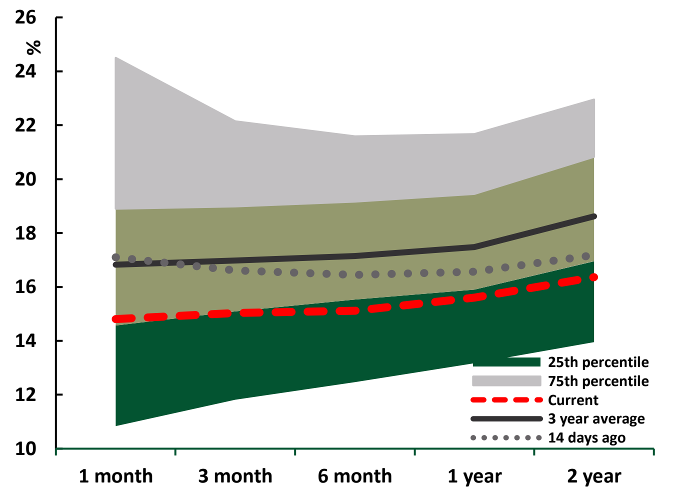
Source: Bloomberg, Nedbank CIB

Chart 5: USDZAR implied volatility



Source: Bloomberg, Nedbank CIB

Chart 6: ATM USDZAR implied volatility cone



Source: Bloomberg, Nedbank CIB

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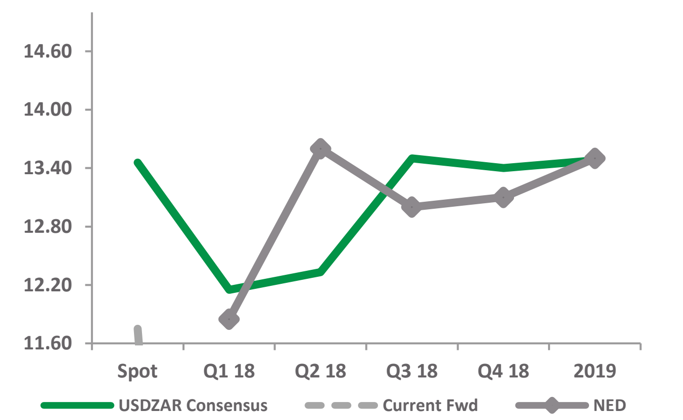
Chart 7: Rand currency forecast table vs consensus and forwards (period end)

	Current Spot	Q2 18	Q3 18	Q4 18	2019
USDZAR					
Nedbank CIB Markets	13.46	13.60	13.00	13.10	13.50
Current Fwd	13.46	13.91	13.57	13.74	14.40
Consensus	13.46	12.33	13.50	13.40	13.48
EURZAR					
Nedbank CIB Markets	15.72	15.78	15.15	15.26	16.00
Current Fwd	15.72	16.13	15.92	16.24	17.59
Consensus	15.72	14.80	15.80	15.81	16.85
GBPZAR					
Nedbank CIB Markets	17.57	17.95	17.68	18.60	19.58
Current Fwd	17.57	18.25	17.77	18.07	19.29
Consensus	17.57	16.77	17.96	17.96	17.96
AUDZAR					
Nedbank CIB Markets	9.94	10.06	9.62	9.69	10.13
Current Fwd	9.94	10.17	10.02	10.15	10.69
Consensus	9.94	9.37	9.99	10.05	10.38

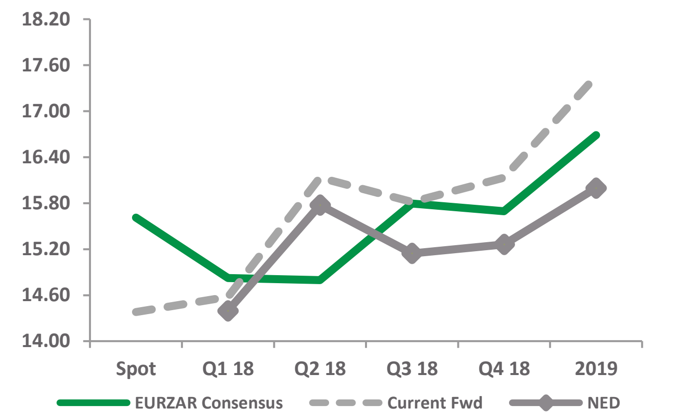
Source: Bloomberg, Nedbank CIB

Chart 8: USDZAR forecasts, consensus and forwards



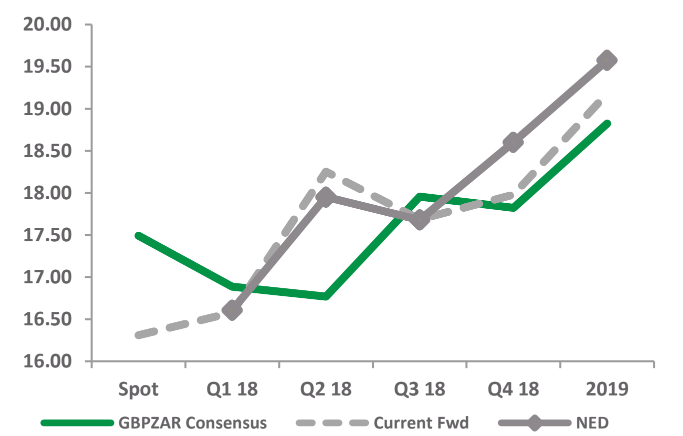
Source: Bloomberg, Nedbank CIB

Chart 9: EURZAR forecasts, consensus and forwards



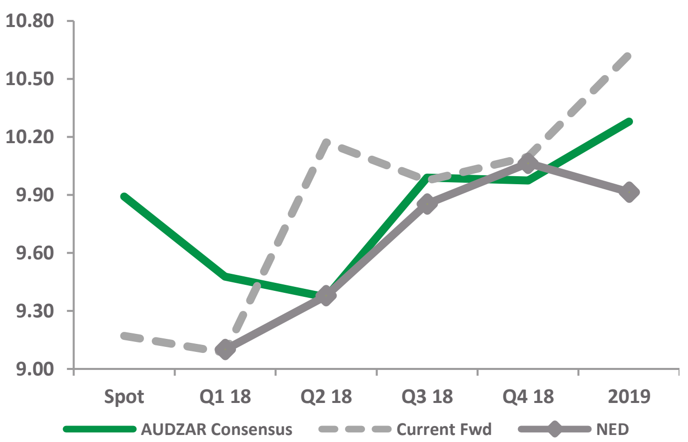
Source: Bloomberg, Nedbank CIB

Chart 10: GBPZAR forecasts, consensus and forwards



Source: Bloomberg, Nedbank CIB

Chart 11: AUDZAR forecasts, consensus and forwards



Source: Bloomberg, Nedbank CIB

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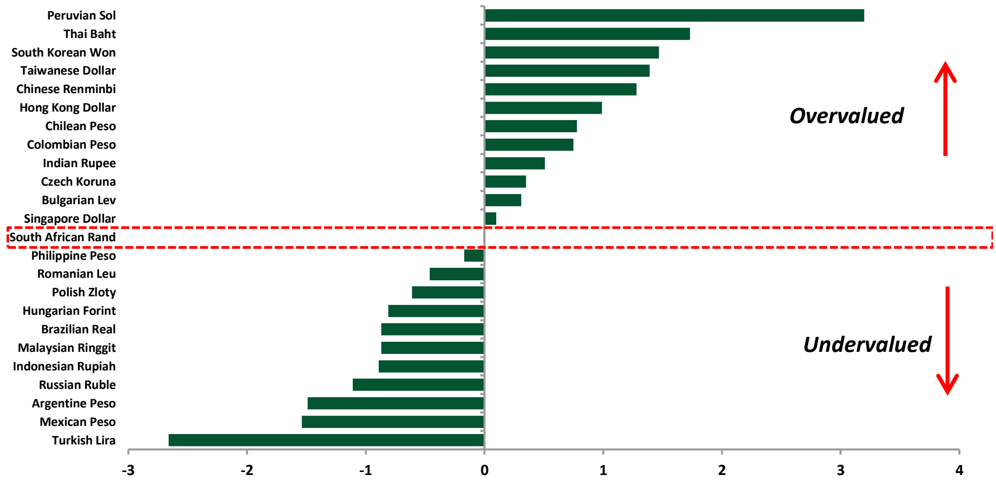
Chart 12: EM currencies overvalued vs undervalued (z-scores)
Rand in fair value territory according to PPP metrics



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		-3.736	2.238	21.311	-7.202	5.800	-1.426	4.036	1.982	11.550	-0.176	-0.788	1.140	4.727	-4.054
JPY	3.876		-6.174	-21.172	3.572	-8.435	-2.350	-7.453	-5.625	-13.633	-3.586	-3.025	-4.808	-8.095	0.337
KRW	-1.639	6.222		-15.388	10.535	-2.443	3.689	-2.021	0.618	-8.008	2.734	2.929	1.439	-2.009	6.237
TRY	-17.559	25.948	18.225		30.599	15.561	22.998	16.861	18.902	8.682	21.755	23.122	19.916	17.150	27.208
MXN	7.748	-4.000	-9.485	-23.446		-11.709	-5.795	-10.390	-8.969	-16.678	-6.912	-6.392	-8.130	-10.906	-3.102
RUB	-4.898	9.222	2.514	-13.474	13.269		7.342	1.820	3.214	-5.738	6.008	6.408	3.988	1.291	10.018
THB	1.452	2.391	-3.279	-18.706	6.280	-6.242		-5.202	-3.326	-11.592	-1.088	-0.721	-2.501	-5.840	2.707
INR	-3.885	8.052	2.060	-14.454	11.744	-1.333	5.496		2.002	-7.001	4.248	4.813	2.960	-0.977	8.424
AUD	-1.964	5.930	-0.583	-15.901	9.831	-3.167	3.419	-1.990		-8.510	2.160	2.726	1.101	-2.319	6.301
BRL	-10.380	15.850	8.756	-8.020	20.819	6.085	13.122	7.500	9.345		11.929	12.593	10.324	6.476	16.178
GBP	0.358	3.765	-2.654	-17.750	7.447	-5.469	1.090	-4.310	-2.107	-10.519		0.587	-1.240	-4.348	4.070
EUR	0.701	3.139	-2.601	-18.728	6.840	-5.556	0.703	-4.291	-2.539	-11.215	-0.550		-1.572	-4.755	3.529
CAD	-1.148	4.772	-1.469	-17.171	8.764	-3.854	2.527	-2.538	-0.836	-9.359	1.290	1.799		-3.248	5.314
ZAR	-5.301	8.371	2.896	-14.680	13.727	-1.304	6.204	0.932	2.262	-5.351	4.868	5.513	3.325		8.721
USD	4.220	-0.349	-6.455	-20.881	3.204	-8.744	-2.667	-7.504	-5.917	-13.978	-3.856	-3.367	-5.041	-7.709	

Source: Bloomberg

Chart 14: Correlation matrix – markets vs FX

	VIX	SPX	US	US	SA	TOP40	EM FX	DM FX	MXN	AUD	CAD	ZAR
VIX		-81%	-47%	-37%	14%	-32%	-28%	-7%	20%	-20%	21%	25%
SPX	-81%		38%	28%	-18%	38%	40%	14%	-29%	38%	-32%	-34%
US	-47%	38%		92%	-3%	22%	10%	-8%	-4%	5%	-12%	-11%
US	-37%	28%	92%		1%	15%	3%	-10%	-1%	-2%	-4%	-4%
SA	14%	-18%	-3%	1%		-31%	-49%	-4%	35%	-31%	26%	62%
TOP40	-32%	38%	22%	15%	-31%		28%	-4%	-9%	32%	-28%	-18%
EM FX	-28%	40%	10%	3%	-49%	28%		-16%	-72%	72%	-56%	-78%
DM FX	-7%	14%	-8%	-10%	-4%	-4%	-16%		1%	-1%	3%	-5%
MXN	20%	-29%	-4%	-1%	35%	-9%	-72%	1%		-49%	50%	58%
AUD	-20%	38%	5%	-2%	-31%	32%	72%	-1%	-49%		-67%	-64%
CAD	21%	-32%	-12%	-4%	26%	-28%	-56%	3%	50%	-67%		50%
ZAR	25%	-34%	-11%	-4%	62%	-18%	-78%	-5%	58%	-64%	50%	

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		66%	35%	10%	-1%	2%	26%	-24%	52%	-38%	-41%	54%
Plat	66%		50%	0%	3%	16%	34%	-24%	58%	-41%	-48%	57%
Pall	35%	50%		-13%	-4%	9%	33%	-11%	42%	-30%	-29%	38%
Ironor	10%	0%	-13%		-4%	-1%	-12%	10%	-1%	-13%	-4%	-1%
Coppe	-1%	3%	-4%	-4%		13%	18%	0%	2%	6%	2%	-5%
T-Coal	2%	16%	9%	-1%	13%		6%	-8%	5%	1%	-10%	5%
Brent	26%	34%	33%	-12%	18%	6%		-11%	36%	-36%	-24%	28%
BRL	-24%	-24%	-11%	10%	0%	-8%	-11%		-32%	24%	31%	-48%
AUD	52%	58%	42%	-1%	2%	5%	36%	-32%		-67%	-64%	72%
CAD	-38%	-41%	-30%	-13%	6%	1%	-36%	24%	-67%		50%	-56%
ZAR	-41%	-48%	-29%	-4%	2%	-10%	-24%	31%	-64%	50%		-78%
EM FX	54%	57%	38%	-1%	-5%	5%	28%	-48%	72%	-56%	-78%	

Source: Bloomberg, YTD

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