RAND: SARB WARNS OF $-LIQUIDITY SHORTAGES

Tactical view:
We will use EURUSD 1.13 as an important level to gauge whether the rand can retrace some of its gains close to R14.00 or whether downside risks are building for the rand to weaken above R14.40.

Strategic view:
We believe tighter global financial conditions are negative for the carry trade, leaving downside risks to the rand intact.

- The **rand** retraced gains and has struggled to strengthen below the R14.00 mark. Other risk assets have also given back gains, despite market expectations that President Trump's unfavourable economic policies will likely be in gridlock after the Democrats claimed the House of Representatives in the US midterm elections. In our view, recent gains in risk assets are being **overshadowed** by **(1)** the US Federal Reserve reaffirming tighter monetary conditions (rate hikes and balance sheet normalisation in 2019), which is likely to stay as the outlook for the US economy remains positive, and **(2)** offshore financial conditions beginning to tighten, as reflected in the widening LIBOR-OIS and cross-currency basis spreads.

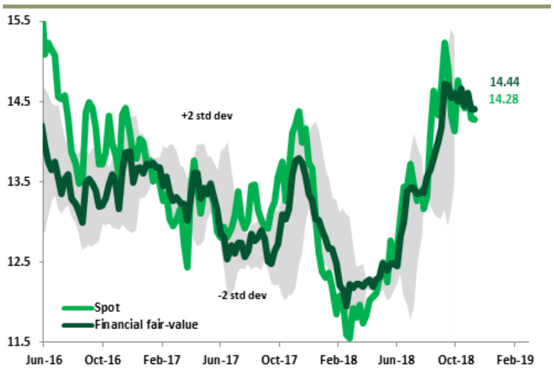
- **Locally**, the SARB published its bi-annual *Financial Stability Review* report, in which the report aims to identify risks to financial stability with a view of also mitigating any vulnerabilities through macro-prudential policies and monetary policy. **Four risks** were identified in the report: (1) weaker global growth and risks of escalating trade wars, (2) tighter financial conditions and $-liquidity shortages, (3) weak domestic growth, and (4) cybersecurity risks. Of particular interest to us, **"US dollar-liquidity shortages" were identified as having a 'medium' likelihood with a 'high' impact on the SARB's "risk assessment matrix" for the next 12 months.** We believe that these risks, and most notably $-liquidity shortages, will feed into the SARB's response function to some degree going forward. If the $-liquidity shortage becomes a 'high' likelihood, interest rate hikes may be more likely to restrict/contain foreign capital, severe bouts of currency volatility and upward pressure on inflation.

- **View:** We believe **global $-liquidity shortages** (both structural and seasonal) remain a key risk to the outlook for the **rand** because of the US Fed's tighter monetary policy and as demand for US dollars intensifies in the offshore US dollar banking system. As the year-end approaches, there are seasonal funding requirements (de-risking) for large European and Japanese banks stipulated by accounting regulations, which are likely to lead to a greater demand for US dollars than typically. **As a result: greater demand for US dollars and rising offshore funding US dollar costs,** accompanied by FX volatility, will likely not bode too well for the carry trade. The rand is one of the most liquid EM currencies, with daily forex turnover as a percentage of GDP at a staggering 18%, while SA's trade is only less than 1% of global trade volumes. **Therefore, we expect the rand to be volatile with a weakening bias towards the R14.50 area in the short term.**

- The structural $-liquidity shortage and the impact on financial markets remains core to our view. For more details on our assessment of global $-liquidity and its impact on SA, please refer to the following publications: Global $-Liquidity monthly *dashboard* assessment and *Rand: All about the L world- Liquidity, 19 June 2018*.

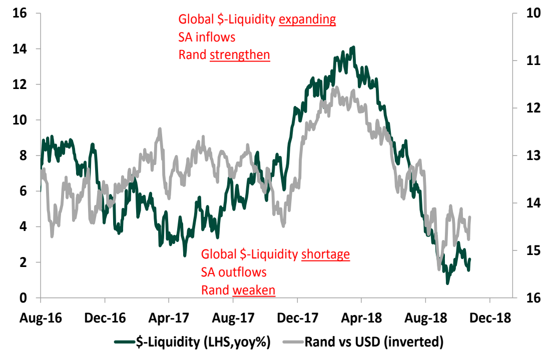
- From a technical perspective, we recommend keeping an eye on the USDZAR resistance level of R14.40 and the USDZAR support level of R14.00 (please see our latest technical strategy report *It is crucial for the risk-on phase that the EURUSD remain above 1.13* of 9 November 2018).

Chart 1: Spot vs our financial fair value model on the rand based on financial market variables



Source: BBG, Eviews Econometric model, Nedbank CIB Research

Chart 2: Global $-liquidity remains a key external risk to the rand via the carry trade



Source: BBG, Nedbank CIB Research

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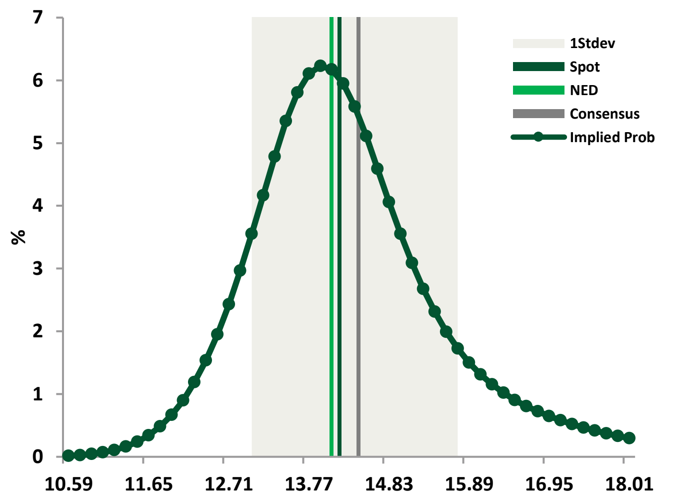
FX VOL CURVES – STABILISING

Implied volatility in the options market has stabilised, but relative to the previous two years, it remains elevated (see Chart 5). The volatility curve has moved closer to its three-year average amid the improvement in emerging-market and local investor sentiment. That said, the options market's forecast for the USDZAR remains more bearish than Bloomberg consensus expectations:

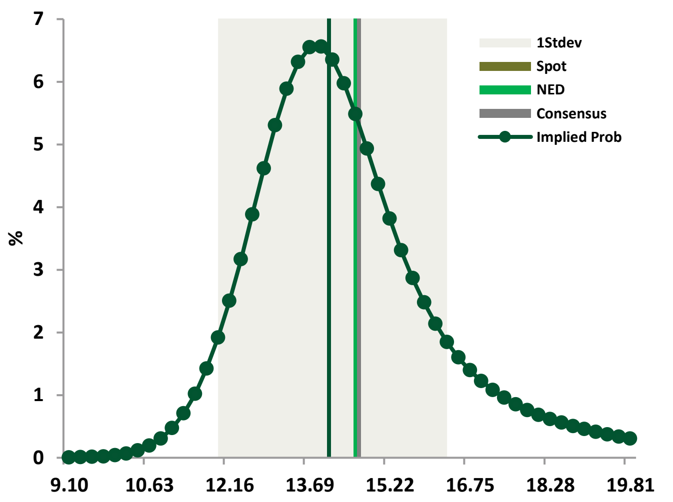
- On a three-month view, the options market suggests a one standard deviation trading range for the USDZAR of R13.02-15.93 (see Chart 3)
- On a six-month view, the probability is skewed towards weakness, as one would expect, with the implied probability distribution suggesting a one standard deviation range of R12.55-16.72 (see Chart 4).

Chart 3: 3m implied probability distribution vs forecast



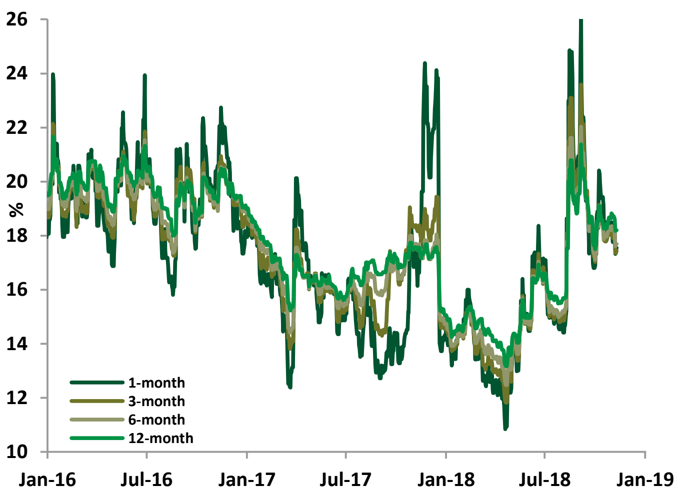
Source: Bloomberg, Nedbank CIB

Chart 4: 6m implied probability distribution vs forecast



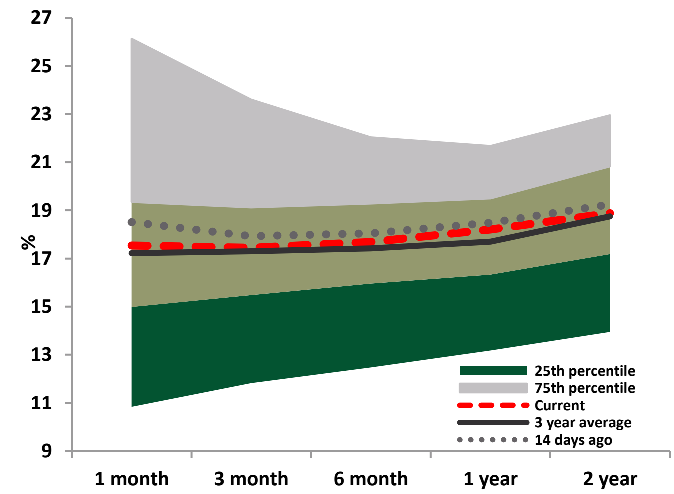
Source: Bloomberg, Nedbank CIB

Chart 5: USDZAR implied volatility



Source: Bloomberg, Nedbank CIB

Chart 6: ATM USDZAR implied volatility cone



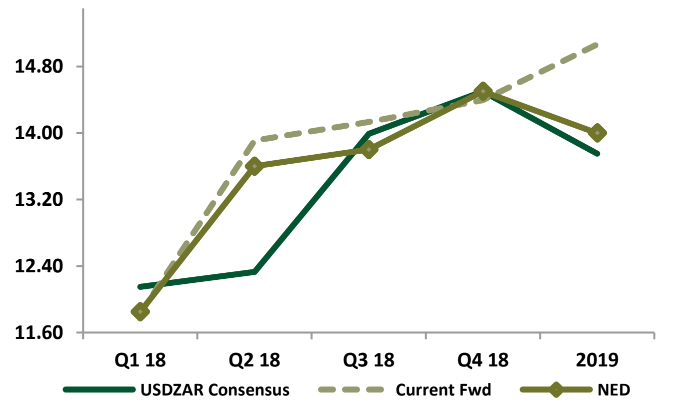
Source: Bloomberg, Nedbank CIB

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

	Current	Q2 18 Actual	Q3 Actual	Q4 18F	2019F
USDZAR	**14.28**	**13.72**	**14.14**		
Nedbank CIB Markets		13.60	13.80	14.50	14.00
Forward market		13.91	14.13	14.36	15.03
Consensus		12.33	13.99	14.50	13.75
EURZAR	**16.21**	**16.03**	**16.41**		
Nedbank CIB Markets		15.78	16.08	16.89	16.59
Forward market		16.13	16.40	16.38	17.75
Consensus		14.80	16.09	16.68	17.05
GBPZAR	**18.59**	**18.18**	**18.43**		
Nedbank CIB Markets		17.95	18.77	20.59	20.30
Forward market		18.25	18.42	18.75	19.99
Consensus		16.77	18.19	18.85	18.85
AUDZAR	**10.27**	**10.16**	**10.21**		
Nedbank CIB Markets		10.06	10.21	10.73	10.50
Forward market		10.17	10.36	10.41	10.97
Consensus		9.37	10.21	10.44	10.31

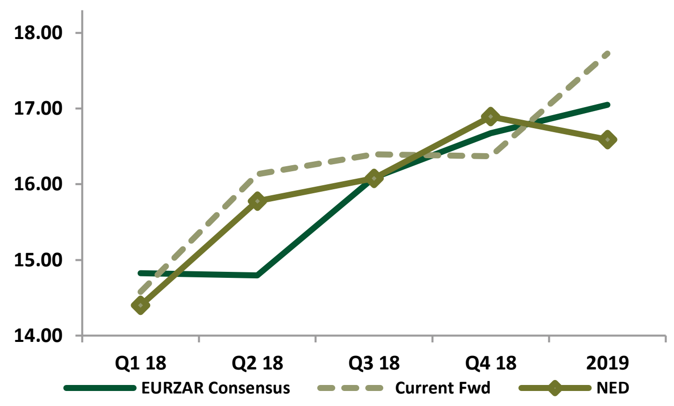
Source: Bloomberg, Nedbank CIB

Chart 8: USDZAR forecasts, consensus and forwards



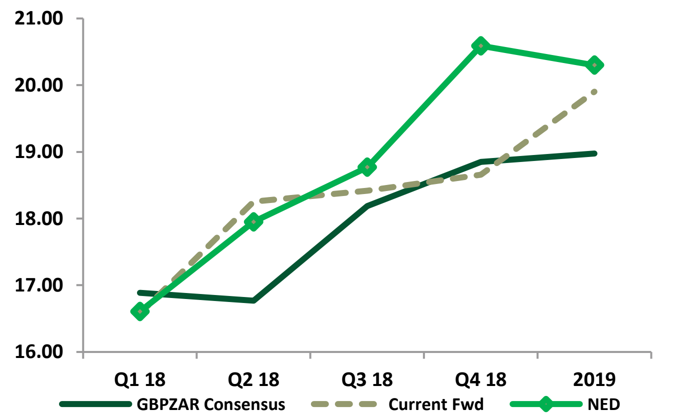
Source: Bloomberg, Nedbank CIB

Chart 9: EURZAR forecasts, consensus and forwards



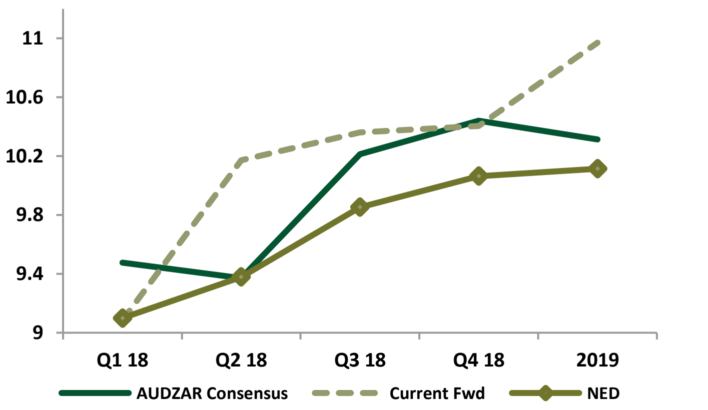
Source: Bloomberg, Nedbank CIB

Chart 10: GBPZAR forecasts, consensus and forwards



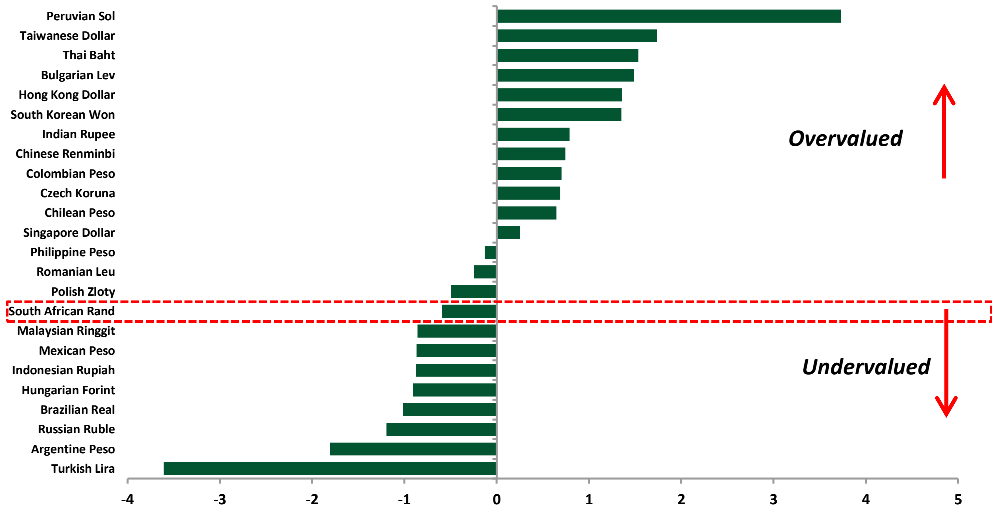
Source: Bloomberg, Nedbank CIB

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



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

Chart 13: EM currency performance vs USD

	CNY	JPY	KRW	TRY	MXN	RUB	THB	INR	AUD	BRL	GBP	EUR	CAD	ZAR	USD
CNY		-5.272	-0.845	35.413	-3.832	7.501	-4.757	7.766	1.779	5.402	-1.935	-0.999	-1.814	9.634	-5.537
JPY	5.561		-4.214	-30.491	-1.651	-11.401	-0.546	-12.087	-6.950	-10.264	-3.452	-4.357	-3.525	-13.610	0.284
KRW	0.000	4.668		-26.976	2.802	-7.485	4.061	-7.792	-2.832	-6.222	0.836	0.224	0.765	-9.795	5.184
TRY	-26.159	42.980	36.897		40.764	27.008	42.164	26.043	33.017	28.455	38.305	37.700	37.952	24.910	44.282
MXN	3.965	1.143	-2.710	-28.961		-10.003	1.159	-10.390	-5.473	-8.642	-1.826	-2.774	-1.933	-11.800	1.993
RUB	-6.411	12.829	8.084	-21.281	11.138		12.957	-0.831	5.158	1.406	9.677	8.443	8.913	-1.671	13.605
THB	4.955	0.544	-3.934	-29.679	-0.920	-10.919		-11.598	-6.424	-9.624	-2.794	-3.875	-2.970	-13.134	0.783
INR	-7.202	13.750	8.442	-20.704	11.645	0.444	13.116		5.870	1.837	9.893	8.742	9.844	-2.077	14.075
AUD	-1.773	7.443	2.917	-24.861	5.684	-4.525	6.838	-5.473		-3.052	3.760	2.753	3.923	-6.860	7.738
BRL	-5.147	11.259	6.588	-22.167	8.897	-1.406	10.645	-1.851	3.642		7.625	6.158	7.392	-3.833	11.753
GBP	2.134	3.628	-0.808	-27.632	1.862	-8.594	2.813	-8.621	-3.617	-6.983		-0.939	-0.051	-10.201	3.867
EUR	0.920	4.598	-0.298	-27.340	2.830	-7.639	4.025	-7.740	-2.569	-5.834	0.985		1.164	-9.213	4.922
CAD	1.800	3.385	-0.739	-28.023	1.878	-8.187	3.032	-8.629	-3.528	-6.881	0.082	-0.940		-10.236	3.850
ZAR	-9.568	15.287	11.768	-19.977	14.886	1.676	15.074	2.175	7.287	4.885	11.727	10.702	11.399		15.597
USD	5.852	-0.282	-4.503	-30.246	-1.946	-11.639	-0.824	-12.057	-7.185	-10.401	-3.663	-4.650	-3.708	-13.218	

Source: Bloomberg

Chart 14: Correlation matrix – markets vs FX

	VIX	SPX	US	US TIPS	SA 10yr	TOP40	EM FX	DM FX	MXN	AUD	CAD	ZAR
VIX		-81%	-44%	-35%	20%	-35%	-27%	-7%	22%	-18%	20%	26%
SPX	-81%		38%	31%	-21%	42%	32%	12%	-27%	31%	-26%	-30%
US 10yr	-44%	38%		92%	-6%	19%	13%	-11%	-8%	0%	-12%	-11%
US TIPS	-35%	31%	92%		-2%	14%	8%	-12%	-5%	-6%	-3%	-6%
SA 10yr	20%	-21%	-6%	-2%		-27%	-59%	-4%	38%	-33%	27%	69%
TOP40	-35%	42%	19%	14%	-27%		18%	-3%	-8%	27%	-24%	-22%
EM FX	-27%	32%	13%	8%	-59%	18%		-7%	-68%	64%	-48%	-81%
DM FX	-7%	12%	-11%	-12%	-4%	-3%	-7%		2%	6%	0%	-4%
MXN	22%	-27%	-8%	-5%	38%	-8%	-68%	2%		-44%	47%	57%
AUD	-18%	31%	0%	-6%	-33%	27%	64%	6%	-44%		-60%	-58%
CAD	20%	-26%	-12%	-3%	27%	-24%	-48%	0%	47%	-60%		47%
ZAR	26%	-30%	-11%	-6%	69%	-22%	-81%	-4%	57%	-58%	47%	

Source: Bloomberg, YTD

Chart 15: Correlation matrix – commodities vs currencies

	Gold	Plat	Pall	Ironore	Copper	T-Coal	Brent	BRL	AUD	CAD	ZAR	EM FX
Gold		68%	35%	8%	-1%	1%	13%	-20%	52%	-38%	-41%	47%
Plat	68%		53%	-4%	3%	13%	26%	-22%	58%	-43%	-47%	50%
Pall	35%	53%		-12%	4%	7%	27%	-12%	35%	-30%	-29%	32%
Ironore	8%	-4%	-12%		-2%	-1%	-13%	4%	-1%	-10%	-2%	-1%
Copper	-1%	3%	4%	-2%		11%	17%	-6%	3%	0%	-10%	-1%
T-Coal	1%	13%	7%	-1%	11%		5%	-6%	4%	1%	-6%	4%
Brent	13%	26%	27%	-13%	17%	5%		-6%	19%	-31%	-14%	14%
BRL	-20%	-22%	-12%	4%	-6%	-6%	-6%		-22%	16%	28%	-40%
AUD	52%	58%	35%	-1%	3%	4%	19%	-22%		-60%	-58%	64%
CAD	-38%	-43%	-30%	-10%	0%	1%	-31%	16%	-60%		47%	-48%
ZAR	-41%	-47%	-29%	-2%	-10%	-6%	-14%	28%	-58%	47%		-81%
EM FX	47%	50%	32%	-1%	-1%	4%	14%	-40%	64%	-48%	-81%	

Source: Bloomberg, YTD

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