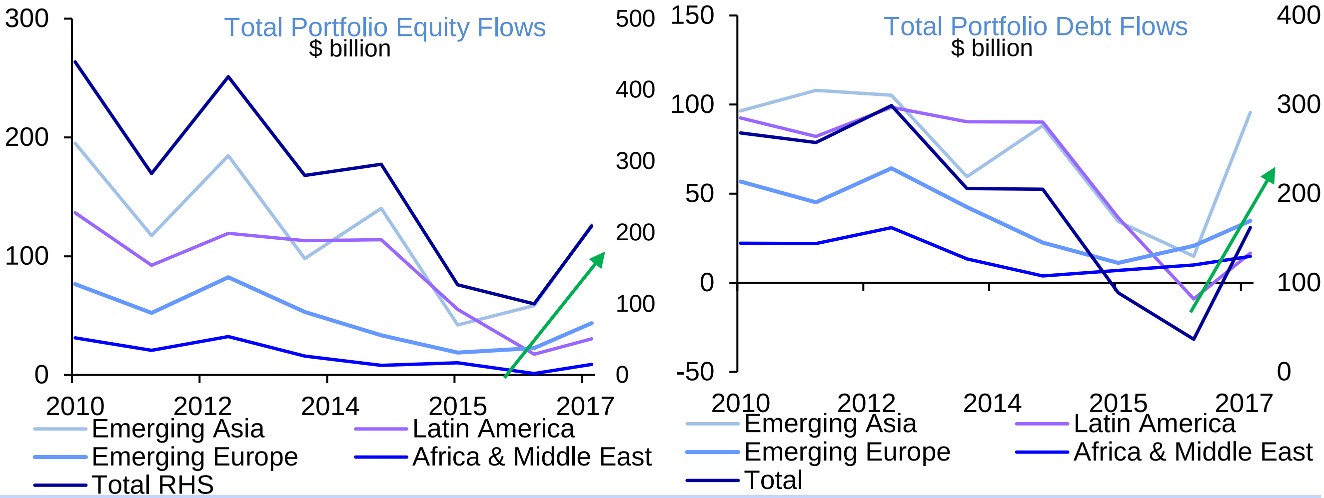
Investec

Rand outlook: fluctuations in global market expectations of US rate hikes, and domestic political uncertainty, continue to drive volatility

18th October 2017

Figure 1: Net portfolio flows for EMs



Source: IIF

Favourable financial market conditions have assisted in the strengthening of the global economy, on still very accommodative monetary policy in advanced economies (AEs), a bull run in equity markets and low bond yields (with low market volatility). The slow pace of monetary policy normalisation in advanced economies on restrained inflation has occurred as inflation expectations have become anchored at slightly lower levels with wages and prices seen to have become less responsive to demand and supply conditions, assisted by globalization (see figure **3** and **4**). Low inflation globally has also provided support for equity markets, reducing expectations of monetary tightening. The rand is particularly sensitive to any changes in market expectations of the timing and extent of US interest rate hikes. Emerging markets (EMs) have seen strong foreign portfolio inflows in the current period of global risk-on (see figure **1**) with net foreign purchases of South African debt at a heady R53bn in 2017 (see figure **6**). This prevented the rand from seeing the additional weakness that would normally be warranted given the high level of political uncertainty that is seen to have negatively impacted foreign holdings of SA equities, with net sales since mid-2015, of -R239bn. Despite rising global growth, South Africa's economic growth rate remains weak, dissociated with the global economic trend, which is

Figure 2: Exchange rate forecasts – averages for the expected case

Expected case	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19	Q3.19
USD/ZAR	13.45	13.60	13.40	13.05	12.80	12.45	12.10	12.20
GBP/ZAR (Av)	18.44	18.58	18.33	18.08	17.88	17.55	17.06	17.20
EUR/ZAR (Av)	15.95	16.12	15.95	15.73	15.55	15.19	14.88	15.01
ZAR/JPY (Av)	8.27	8.01	7.99	8.08	8.20	8.43	8.68	8.61

Source: Investec

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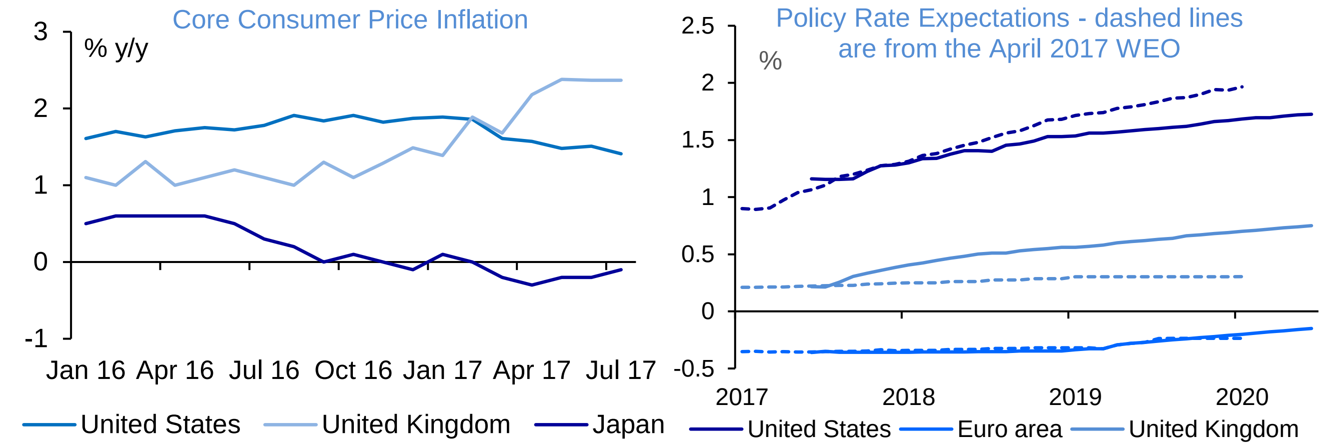
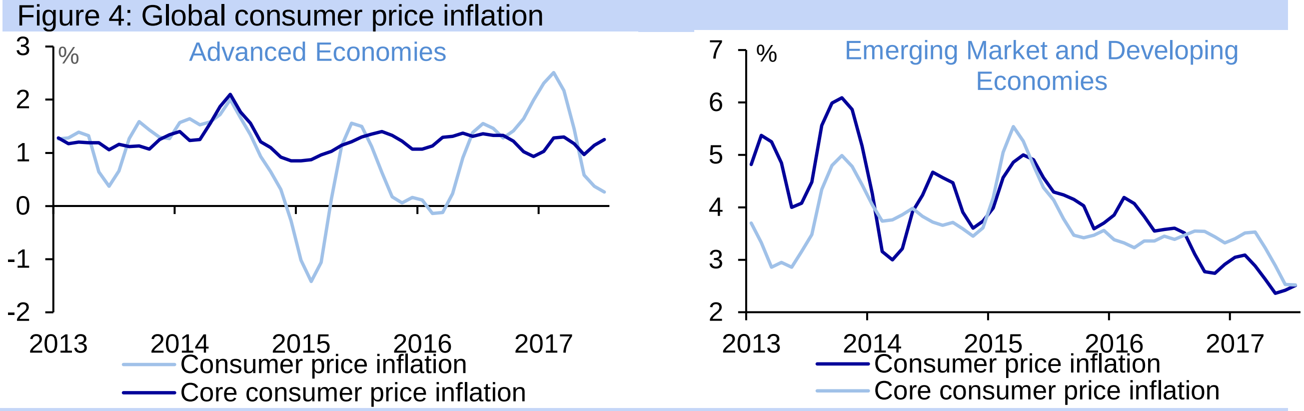
Figure 3: Global core consumer price inflation and policy rate expectations



Source: IMF WEO October 2017

also having a negative impact on sentiment towards SA. In particular, the heavy weight that politics has in SA, and the perception of frequent, conflicting political and economic policy proposals, especially populist ones, is seen to have negatively impacted sentiment, and so investment. In recent years, economic growth has been weak to contracting, credit rating downgrades (see figure 13) have occurred on deteriorating government finances and weak growth, and the poor fiscal health of many major state owned entities has required assistance from the government purse. Were it not for the strong risk-on experienced in global financial market investor sentiment, the rand would likely have seen even further depreciation, to date performing poorly against most other emerging market currencies this year compared to the US dollar (see figure 9). The outlook for SA's economic growth is particularly weak (0.6% y/y for 2017 rising to a measly 2.0% y/y by 2022), and the risks of political instability are expected

Figure 4: Global consumer price inflation



Source: IMF WEO October 2017

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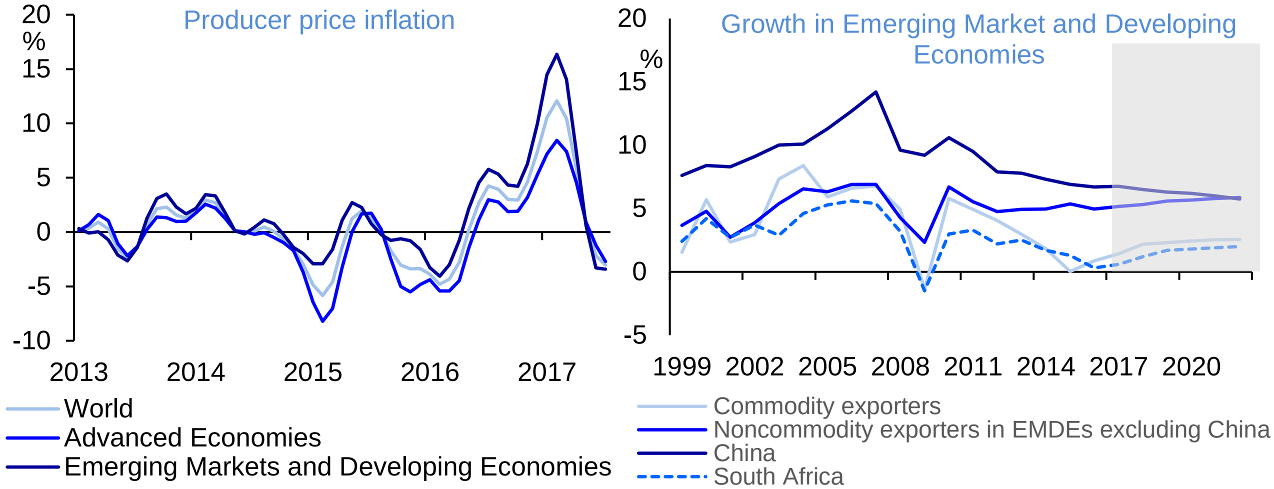
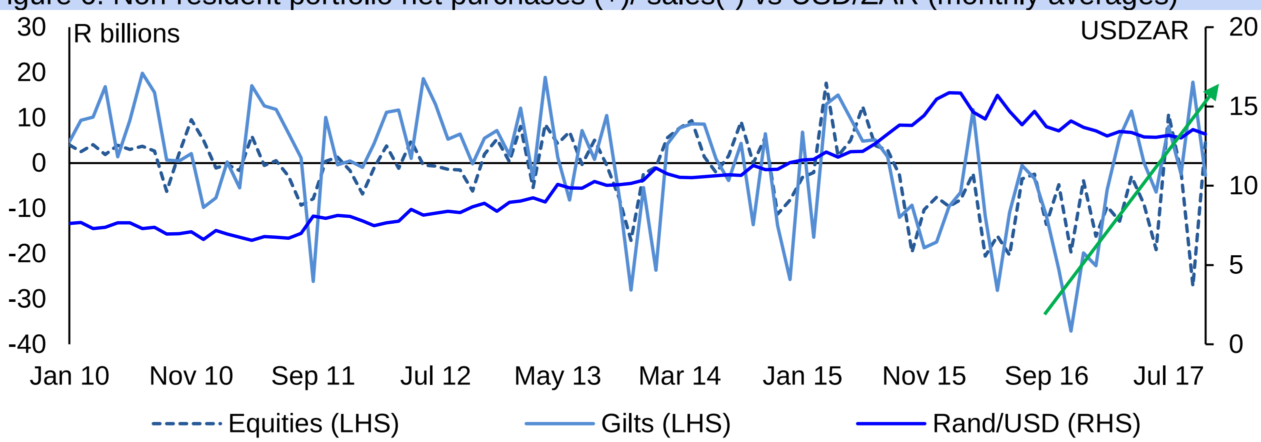
Figure 5: Global producer price inflation and growth in emerging and developing economies



Source: IMF WEO October 2017, IRESS

to climb in the run up to the national election in 2019, and in the period around the ANC's presidential election at the end of this year. Little is expected to change to meaningfully accelerate GDP growth as growth-promoting structural reforms are expected to be limited at best, and so weak growth outcomes are forecast, with foreigners likely to continue to sell off their holdings of SA equities on a net basis, preventing the rand from making marked appreciation. Instead, a flat to gradual return to PPP (purchasing power parity or the fair value of the rand) is expected (see figures **2**, **7** to **8** and **15**) by 2020. However, this could very well be derailed by SA unilaterally being downgraded to sub-

Figure 6: Non-resident portfolio net purchases (+)/ sales(-) vs USD/ZAR (monthly averages)



Source: IRESS, Investec

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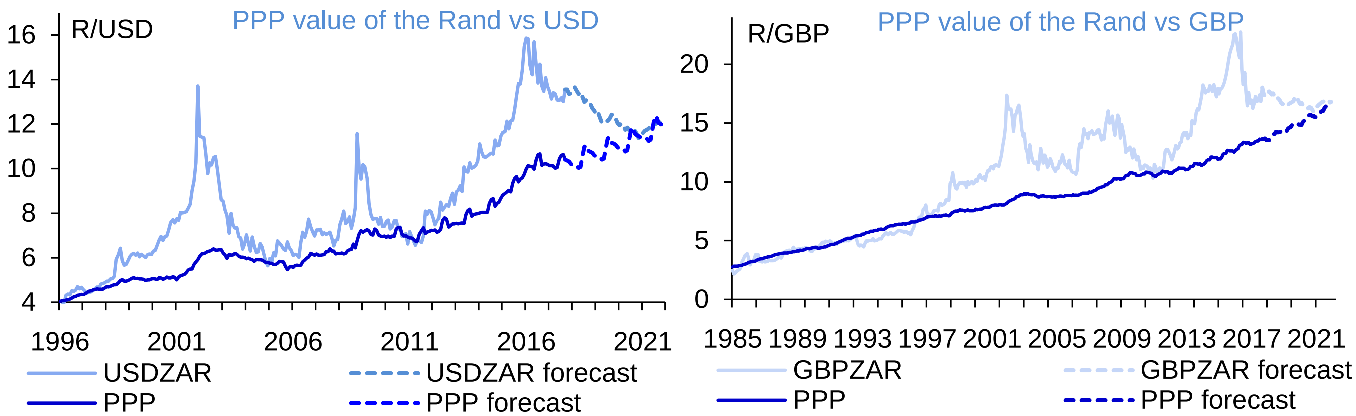
Figure 7: Purchasing price parity value of the rand

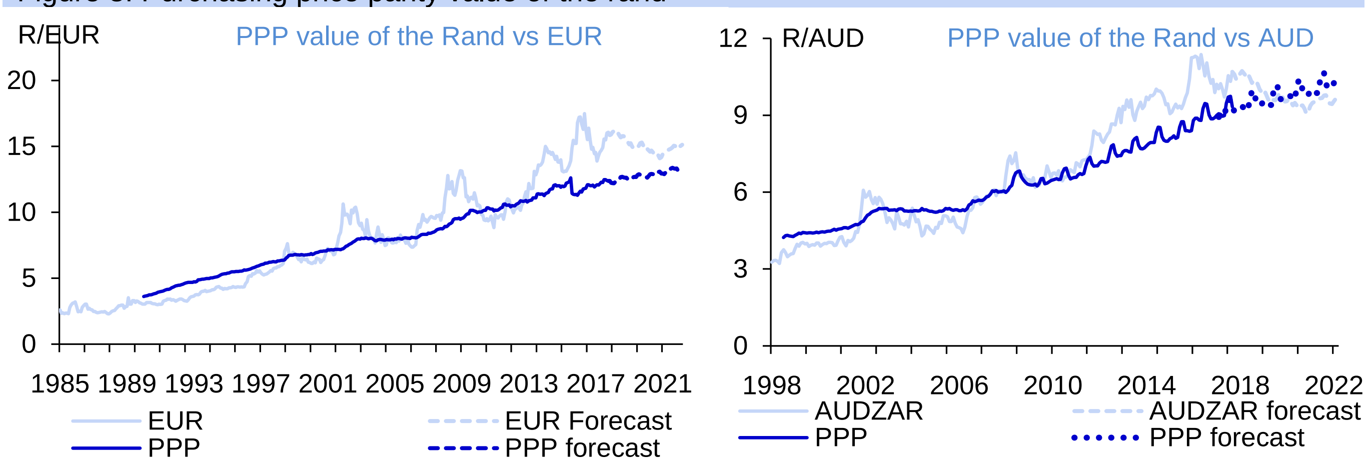


Source: Investec, IRESS

investment grade by the key agencies (see figure **16**).

Government's updated debt and deficit to GDP forecast ratios, scheduled for publication in the MTBPS of October 25th 2017 are likely to provide fodder for the rating agencies, only two of which still have SA on an investment grade rating (see figure **13**), but on a negative outlook (which means the next move will be a downgrade). Should the country escape downgrades to sub-investment grade in October, or at the country reviews in November, then December becomes the next period to watch with the ANC's

Figure 8: Purchasing price parity value of the rand



Source: Investec, IRESS

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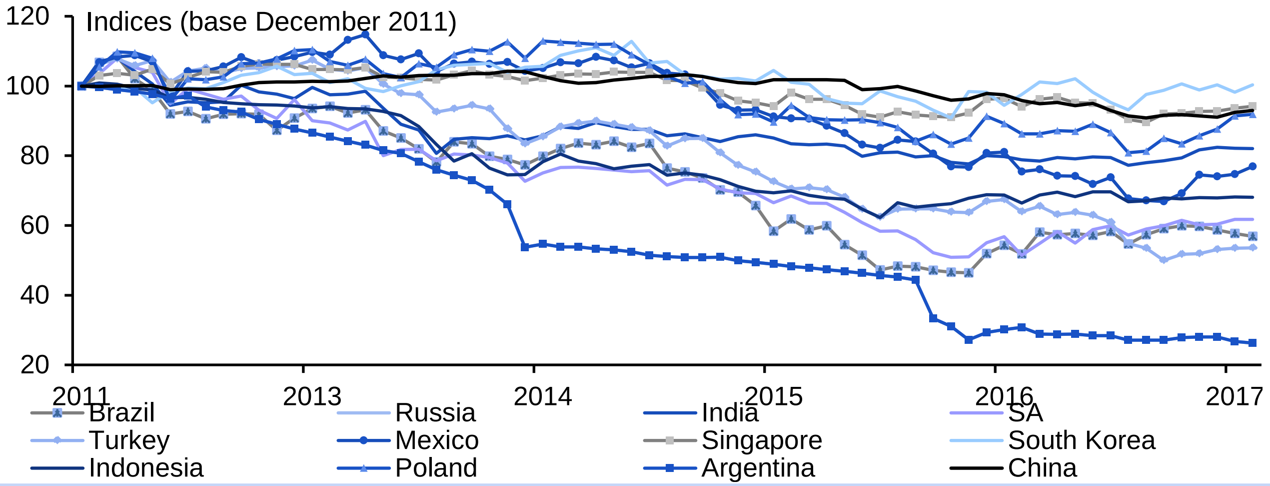
Figure 9: Volatility index for selected emerging market currencies



Sources: IRESS, Investec

presidential election on 16th to 20th December 2017. However, the agencies may wait until after the Budget in February 2018 before considering an adjustment to the current ratings and/or outlooks. Loss of all key (Moody's, Fitch and S&P) investment grade credit ratings (Fitch has already downgraded SA to sub-investment grade) would mean the rand would be unlikely to return to PPP, except under extraordinary circumstances.

There are a number of factors which could change the trajectory of the rand from the expected case (including the potential advent of QE4 after a financial crisis or should North Korea make a successful strike on the US, see Risk update: material risk of SA losing its investment grade ratings persists; additional scenarios include US/allies & North Korea (brief) missile exchange, 8th September 2017, website address below). On the up case, market sentiment could improve substantially if the elected leader of the ANC at the end of this year is favoured by the markets (versus one who is not favoured) as a favoured leader would likely see foreigners reduce their net sell-off of their holdings of SA equities, and then a net purchase of SA equities could ensue instead, should the global market sentiment remain risk-on, strengthening the domestic currency (see up case in figure **16**).

Figure 10: Reuters October 2017 Foreign exchange rates poll: ZAR/USD

Release/Effective Date	31 Oct 2017	29 Dec 2017	29 Mar 2018	28 Sep 2018
Median	13.5000	13.6500	13.7000	13.7250
Highest forecast	13.9000	14.3000	14.5000	15.5000
Lowest forecast	12.8542	12.4000	12.4667	12.0000
Number of forecasts	36	42	41	40

Source: Reuters

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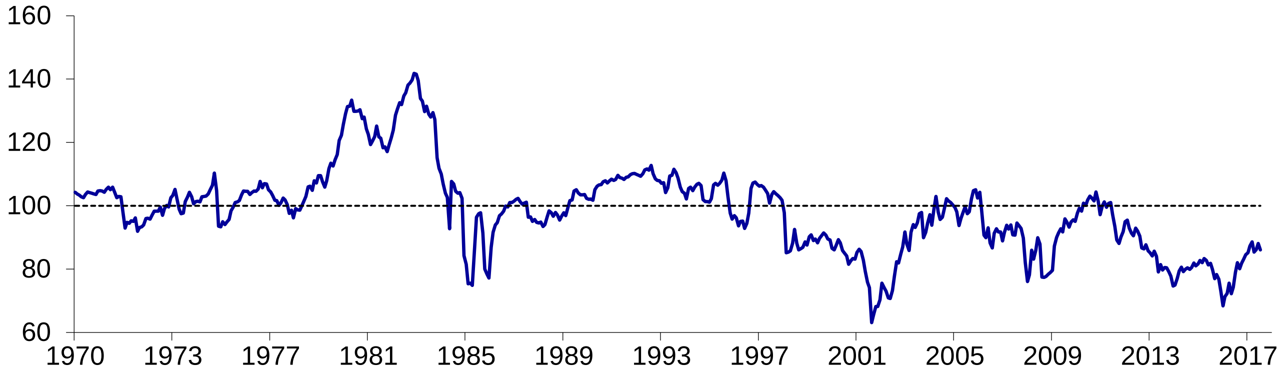
Figure 11: SA's real effective exchange rate

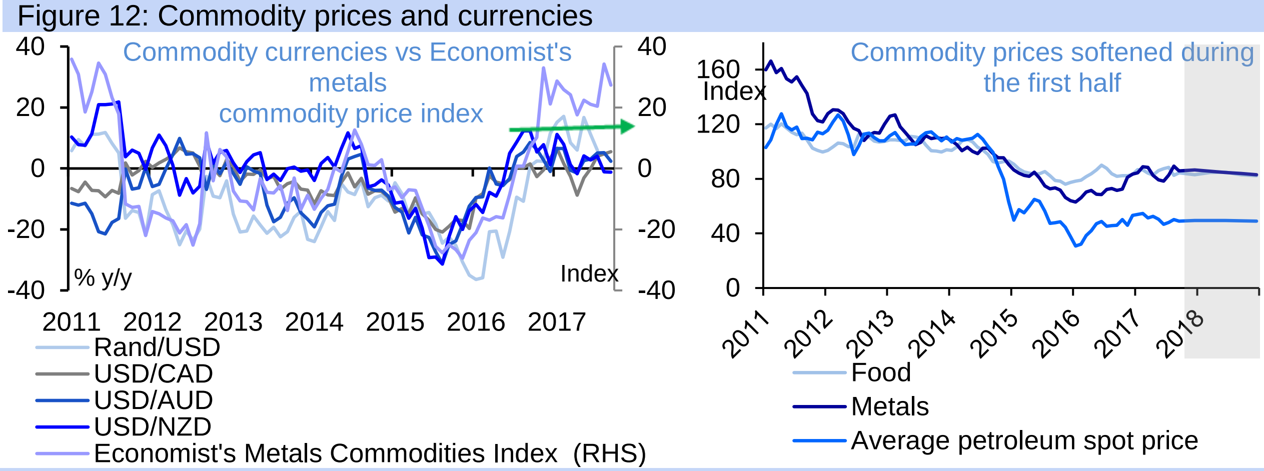


Source: SARB

South Africa cannot afford more than a couple of further 25bp cuts in its repo rate, to 6.25% at most as it is bucking the global interest rate cycle, which although very gradual is still upwards. SA needs to maintain a significant differential between SA and AEs interest rates (see figure 14) to prevent marked depreciation of the rand. The narrower the differentials gets, the lower the premium offered for risk, and SA is deemed to be going through a high risk (period of uncertainty) from both a political and economic point of view. While global risk-on in financial markets and low AE bond yields has made EM debt attractive, SA still needs a substantial interest rate differential above AE in order to attract foreign investment into its debt market.

The US is expected to see a 75bp to 1.50% hike in its interest rate over the next few years (see

Figure 12: Commodity prices and currencies



Source: IMF WEO October 2017, IRESS

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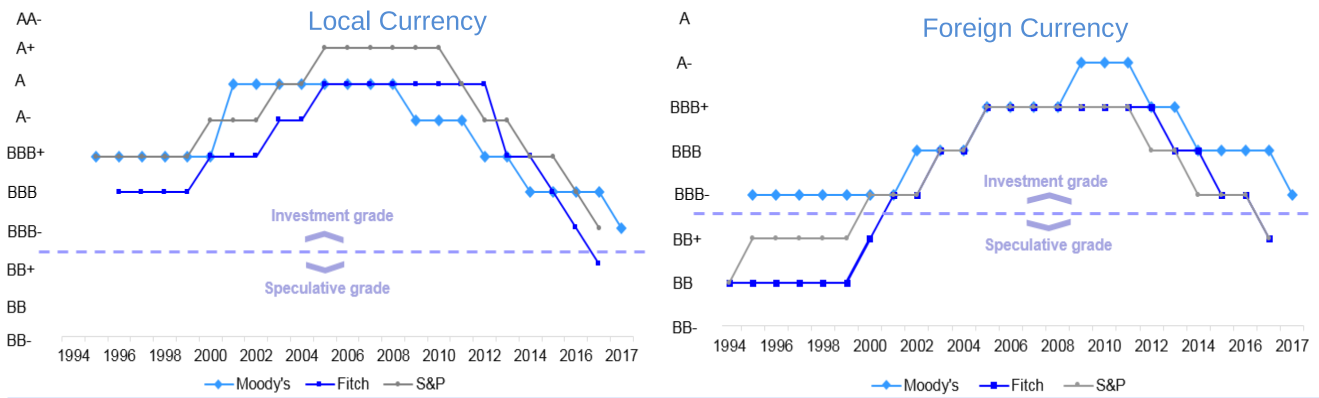
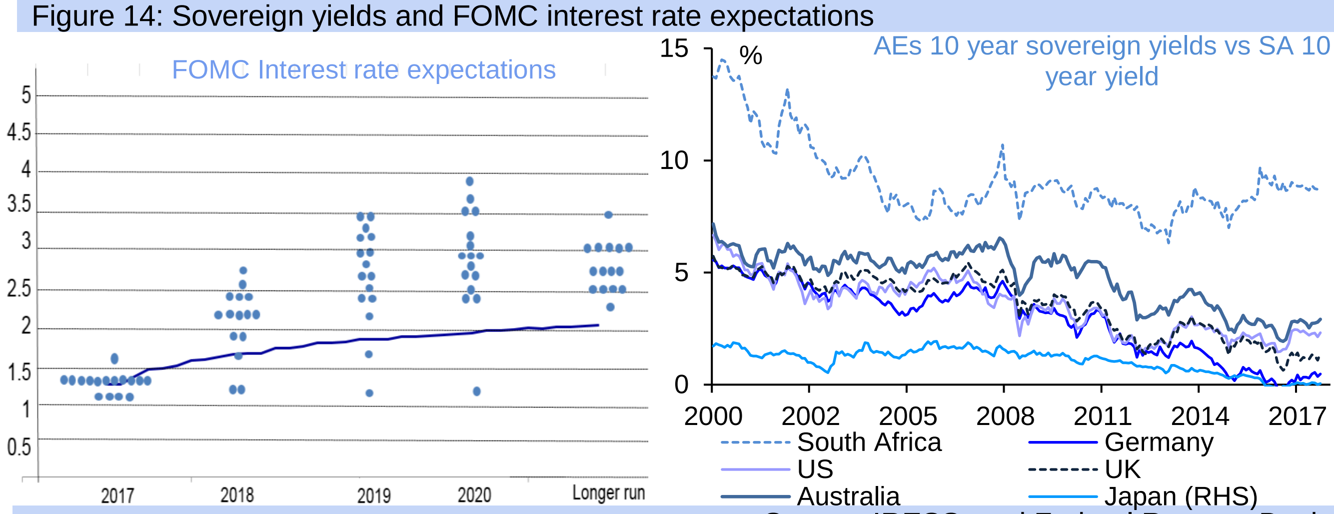
Figure 13: South African local and foreign currency long-term sovereign credit ratings



Source: Moody's, Fitch, Standard and Poor's

figure 14), and the US dollar tends to strengthen as the market revises up the trajectory of expected future US interest rate hikes, and weakens with the reverse. US dollar strength generally causes the rand to weaken against the US dollar, and vice versa. With possible higher interest rates in the US than the markets currently anticipate (see figure 14), the risk is tilted towards further rand weakness - see down case in figure 16 where faster than anticipated global monetary normalisation is highlighted as a material risk. Inflation globally is likely to lift gradually in the second half of 2018, if not 2019, resulting in higher interest rates. However, an actual high global inflationary environment for a significant period is not anticipated. Domestically, politics will likely continue to weigh on the domestic currency.

Figure 14: Sovereign yields and FOMC interest rate expectations



Source: IRESS, and Federal Reserve Bank

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Figure 15: **Exchange rate history and forecast:** annual averages

	2015	2016	2017	2018	2019	2020	2021	2022	2023
EURUSD	1.11	1.11	1.13	1.20	1.23	1.24	1.24	1.25	1.25
EURGBP	0.73	0.82	0.86	0.87	0.87	0.87	0.86	0.86	0.86
GBPEUR	1.38	1.22	1.16	1.15	1.15	1.15	1.16	1.16	1.17
GBPUSD	1.53	1.36	1.31	1.38	1.41	1.43	1.44	1.45	1.46
USDJPY	121	109	112	107	105	106	107	107	107
EURJPY	134	120	126	128	129	131	133	134	134
GBPJPY	185	147	146	147	148	151	154	155	156
EURCHF	1.07	1.09	1.10	1.16	1.19	1.20	1.19	1.19	1.18
USDCHF	0.96	0.98	0.98	0.97	0.97	0.97	0.96	0.95	0.94
GBPCHF	1.47	1.33	1.28	1.33	1.36	1.38	1.38	1.38	1.37
AUDUSD	0.75	0.75	0.77	0.79	0.79	0.79	0.80	0.81	0.81
EURAUD	1.49	1.49	1.47	1.52	1.55	1.56	1.55	1.55	1.54
AUDJPY	90	81	86	84	83	84	86	86	87
GBPAUD	2.05	1.82	1.70	1.75	1.79	1.80	1.80	1.80	1.80
ZARUSD	12.76	14.68	13.26	13.21	12.28	11.73	11.86	12.28	12.81
ZARGBP	19.48	19.92	17.22	18.21	17.34	16.71	17.08	17.80	18.71
ZAREUR	14.15	16.26	15.01	15.83	15.07	14.51	14.74	15.34	16.02
JPYZAR	9.48	7.33	8.39	8.07	8.56	9.07	9.02	8.72	8.35
ZARCHF	13.26	14.93	13.56	13.65	12.71	12.10	12.36	12.92	13.63
ZARAUD	9.58	10.93	10.22	10.42	9.70	9.29	9.49	9.88	10.38

Source: IRESS, Investec

Figure 15: **Exchange rate history and forecast:** annual averages

	2017				2018				2019			
	Q1.17	**Q2.17**	**Q3.17**	**Q4.17**	**Q1.18**	**Q2.18**	**Q3.18**	**Q4.18**	**Q119**	**Q2.19**	**Q3.19**	**Q4.19**
EURUSD	1.07	1.10	1.16	1.19	1.19	1.19	1.21	1.22	1.22	1.23	1.23	1.23
EURGBP	0.86	0.86	0.87	0.87	0.87	0.87	0.87	0.87	0.87	0.87	0.87	0.87
GBPEUR	1.16	1.16	1.15	1.16	1.15	1.15	1.15	1.15	1.16	1.15	1.15	1.15
GBPUSD	1.24	1.28	1.33	1.37	1.37	1.37	1.39	1.40	1.41	1.41	1.41	1.42
USDJPY	114	111	112	111	109	107	106	105	105	105	105	105
EURJPY	121	122	131	132	129	127	127	128	128	129	129	129
GBPJPY	141	142	150	153	149	146	146	147	148	148	148	149
EURCHF	1.07	1.08	1.12	1.14	1.15	1.16	1.17	1.18	1.18	1.19	1.19	1.18
USDCHF	1.00	0.98	0.96	0.96	0.97	0.97	0.97	0.97	0.97	0.97	0.97	0.96
GBPCHF	1.24	1.26	1.28	1.32	1.32	1.33	1.34	1.35	1.37	1.36	1.36	1.37
AUDUSD	0.76	0.75	0.78	0.78	0.79	0.79	0.79	0.79	0.79	0.79	0.79	0.79
EURAUD	1.41	1.47	1.50	1.52	1.51	1.51	1.53	1.54	1.54	1.56	1.56	1.56
AUDJPY	86	83	87	87	86	85	83	83	83	83	83	83
GBPAUD	1.64	1.70	1.72	1.75	1.74	1.73	1.75	1.77	1.78	1.78	1.78	1.80
ZARUSD	13.22	13.19	13.18	13.45	13.60	13.40	13.05	12.80	12.45	12.10	12.20	12.35
ZARGBP	16.35	16.85	17.22	18.44	18.58	18.33	18.08	17.88	17.55	17.06	17.20	17.54
ZAREUR	14.08	14.52	15.49	15.95	16.12	15.95	15.73	15.55	15.19	14.88	15.01	15.19
JPYZAR	8.54	8.39	8.36	8.27	8.01	7.99	8.08	8.20	8.43	8.68	8.61	8.50
ZARCHF	13.18	13.41	13.70	13.96	14.08	13.81	13.50	13.24	12.84	12.52	12.63	12.84
ZARAUD	10.03	9.92	10.42	10.52	10.68	10.59	10.31	10.11	9.84	9.56	9.64	9.76

Source: IRESS, Investec

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Figure 15: **Exchange rate history and forecast:** annual averages

	2020				2021				2022			
	Q1.20	**Q2.20**	**Q3.20**	**Q4.20**	**Q1.21**	**Q2.21**	**Q3.21**	**Q4.21**	**Q1.22**	**Q2.22**	**Q3.22**	**Q4.22**
EURUSD	1.23	1.24	1.24	1.24	1.24	1.24	1.24	1.25	1.25	1.25	1.25	1.25
EURGBP	0.87	0.87	0.87	0.87	0.86	0.86	0.86	0.87	0.86	0.86	0.86	0.86
GBPEUR	1.15	1.15	1.15	1.15	1.16	1.16	1.16	1.15	1.16	1.16	1.16	1.16
GBPUSD	1.42	1.42	1.43	1.43	1.44	1.44	1.44	1.44	1.45	1.45	1.45	1.45
USDJPY	106	106	106	107	107	107	107	107	107	107	107	107
EURJPY	130	131	131	133	133	133	133	134	134	134	134	134
GBPJPY	151	151	152	153	154	154	154	154	155	155	155	155
EURCHF	1.19	1.20	1.20	1.20	1.19	1.19	1.19	1.20	1.19	1.19	1.19	1.19
USDCHF	0.97	0.97	0.97	0.97	0.96	0.96	0.96	0.96	0.95	0.95	0.95	0.95
GBPCHF	1.37	1.38	1.39	1.39	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
AUDUSD	0.79	0.79	0.79	0.80	0.80	0.80	0.80	0.80	0.80	0.80	0.81	0.81
EURAUD	1.56	1.57	1.57	1.55	1.55	1.55	1.55	1.56	1.56	1.56	1.54	1.54
AUDJPY	84	84	84	86	86	86	86	86	86	86	87	87
GBPAUD	1.80	1.80	1.81	1.79	1.80	1.80	1.80	1.80	1.81	1.81	1.79	1.79
ZARUSD	12.00	11.80	11.65	11.45	11.65	11.85	12.00	11.95	12.00	12.20	12.40	12.50
ZARGBP	17.04	16.76	16.66	16.37	16.78	17.06	17.28	17.21	17.40	17.69	17.98	18.13
ZAREUR	14.76	14.63	14.45	14.20	14.45	14.69	14.88	14.94	15.00	15.25	15.50	15.63
JPYZAR	8.83	8.98	9.10	9.34	9.18	9.03	8.92	8.95	8.92	8.77	8.63	8.56
ZARCHF	12.42	12.16	12.01	11.80	12.14	12.34	12.50	12.45	12.63	12.84	13.05	13.16
ZARAUD	9.48	9.32	9.20	9.16	9.32	9.48	9.60	9.56	9.60	9.76	10.04	10.13

Source: IRESS, Investec

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Figure 16: Economic Scenarios

Extreme up Case 1%

	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19
Rand/USD (average)	13.18	11.70	10.60	9.50	8.60	7.90	7.60	7.40
Repo rate (end rate)	6.75	6.50	6.00	5.50	5.00	5.00	5.00	4.50

Fast, sustainable economic growth of 5.0-7.0% y/y plus. SA sees change in political will with growth creating economic reforms in line with global norms that structurally lift private sector investor confidence and so fixed investment. Global growth boom (including commodities), SA export and domestic growth boom lifts employment and incomes to the degree that poverty is eliminated. Fiscal consolidation, credit rating upgrades to A grade ultimately, interest rate cuts.

Up case 10%

	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19
Rand/USD (average)	13.18	12.60	12.20	11.80	11.50	11.20	10.50	10.55
Repo rate (end rate)	6.75	6.50	6.50	6.25	6.25	6.00	5.50	5.50

Persistent economic growth of 3.0 – 5.0%, with growing probability of extreme up case thereafter. Better governance, growth creating economic reforms in line with global norms (structural constraints are overcome) and greater socio-economic stability. This lifts business confidence and so private sector fixed investment growth rises to double digits, fixed investment inflows occur, resulting in faster GDP growth and fiscal consolidation. Strong global growth and commodity cycle. Stabilisation of credit ratings, with ultimately credit rating upgrades.

Base line case 35%

	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19
Rand/USD (average)	13.18	13.45	13.60	13.40	13.05	12.80	12.45	12.10
Repo rate (end rate)	6.75	6.50	6.25	6.25	6.25	6.50	6.50	6.50

Trend growth rate of 2.0% y/y, reached by 2023. Suppressed confidence and weak investment. Rand structurally weaker on downgrades so slower return to PPP (by 2020). SA retains two investment grade (IG) ratings on its local currency (LC) long-term sovereign debt this year. Sedate global monetary policy normalisation – avoid severe global risk-off environment, neutral to global risk-on. Modestly strengthening global demand.

Down case 35%

	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19
Rand/USD (average)	13.18	16.00	18.00	19.00	19.50	18.50	17.80	16.90
Repo rate (end rate)	6.75	7.00	7.50	8.25	9.00	10.00	10.50	10.50

SA's foreign and local currency long-term debt sub-investment grade, increased chance of further credit downgrades. Marked rand weakness, confidence and investment measures depressed. Government's capacity for expenditure reduced, including social welfare grants. Faster than expected global monetary policy normalisation, global sharp economic slowdown (commodity slump), and substantial period of risk-off (SA V shaped recession).

Extreme down case 19%

	Q3.17	Q4.17	Q1.18	Q2.18	Q3.18	Q4.18	Q1.19	Q2.19
Rand/USD (average)	13.18	17.00	19.00	21.00	22.80	24.00	25.50	26.00
Repo rate (end rate)	6.75	8.00	10.00	13.00	15.50	17.00	19.00	22.00

State bankruptcy, and so the path to a failed state. Credit ratings drop to junk, sovereign debt default, debt restructure. Lack of funds to pay public sector employees' wages and social grants, persistent government services outages, civil unrest/war. Partial loss of commercial private sector property rights under state custodianship. SA economic depression, global economy falls into recession, global financial crisis.

Note: Event risk begins Q4.17 Source: Investec, IRESS

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