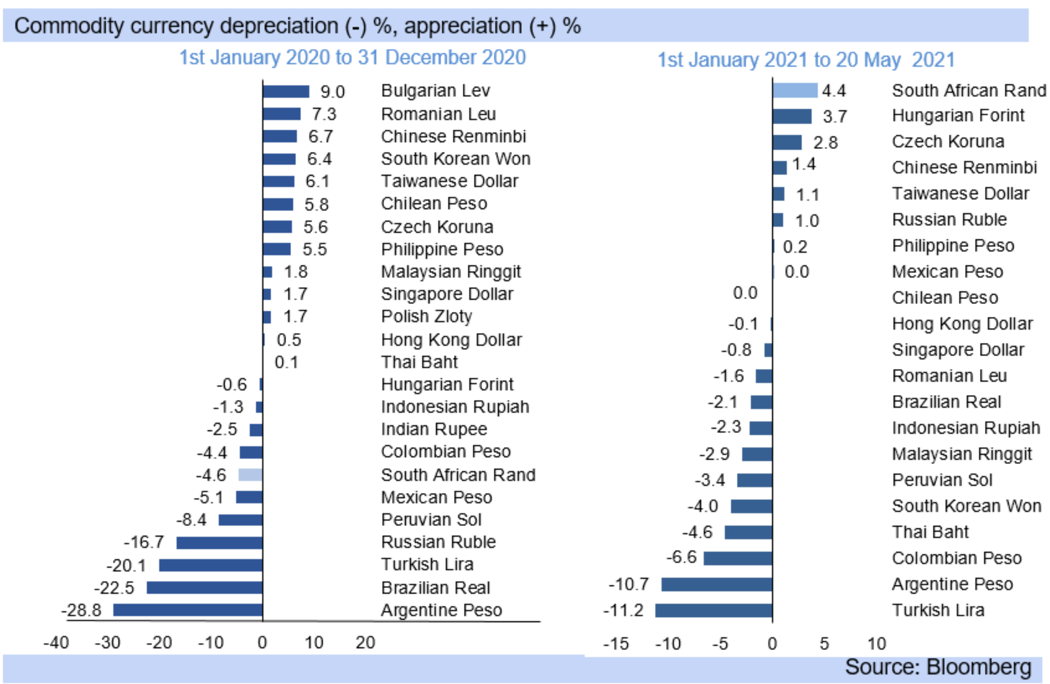
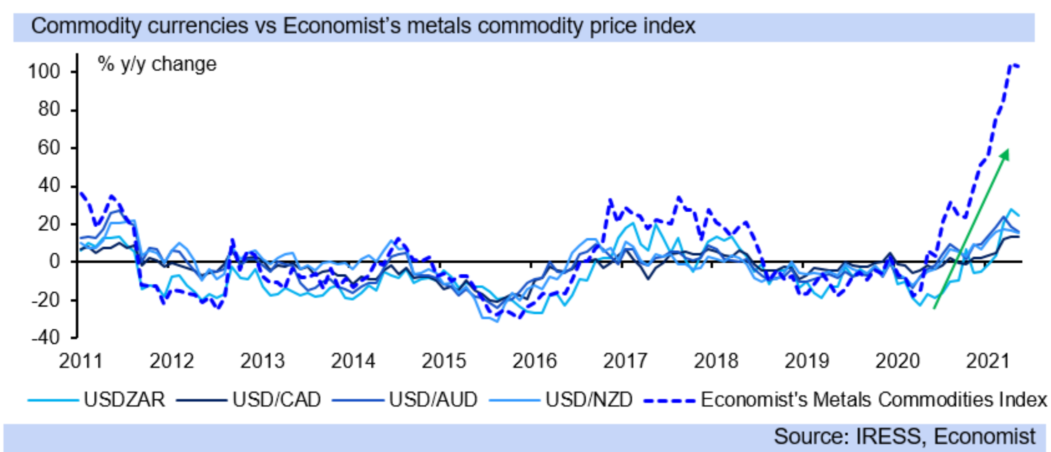
SA Economics

Thursday 20 May 2021

Commodity Currencies Note: the rand remains a key gainer from the run in commodity prices, but some small improvements in a few domestic fundamentals are also proving a positive driver this year for the rand and growth





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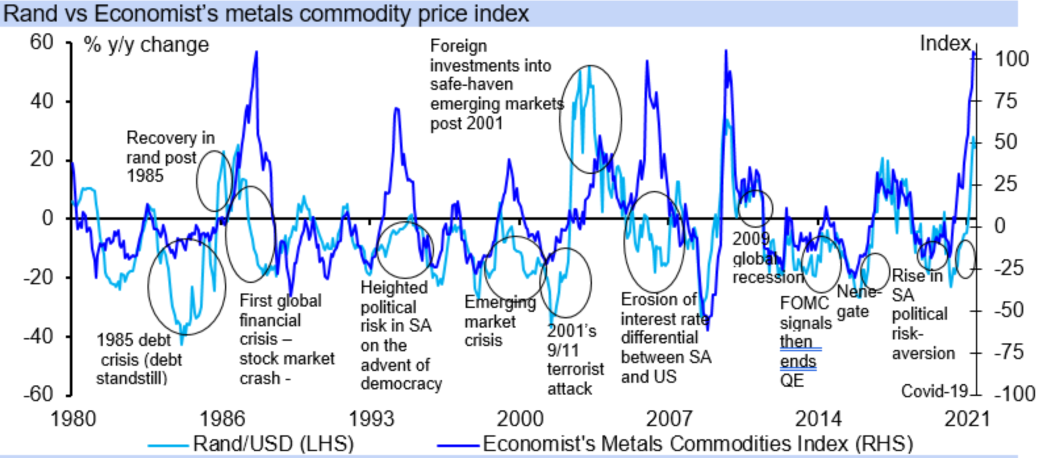
Rand vs Economist's metals commodity price index



Source: IRESS, Investec

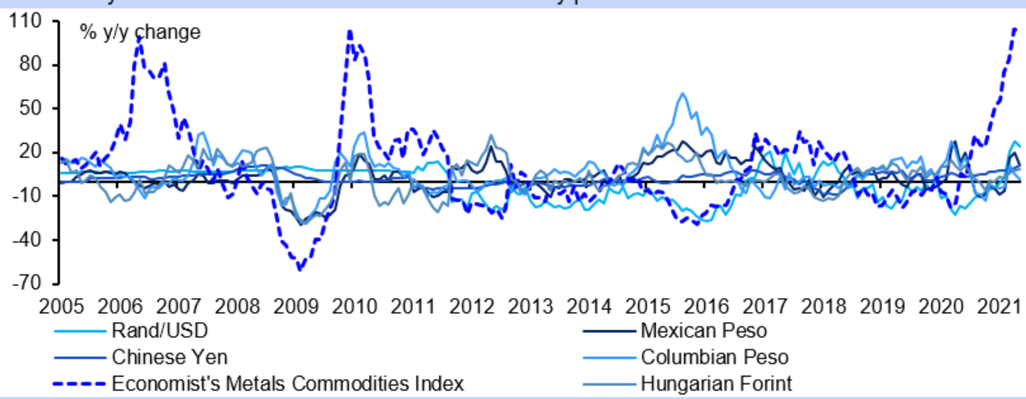
- The rand continues to see gains this year that are outpacing both other EM, and commodity, currencies, around R14.05/USD today. While the domestic currency remains affected by a multitude of drivers, small, ongoing structural gains in South Africa are assisting.
- That is, risk-on sentiment in global financial markets has been a key driver of the rand's appreciation, as have the strength of commodity prices in the current boom, but SA itself is showing some progress, albeit slow, on structural reform and the outlook has brightened.
- We continue to forecast a reform led recovery in SA's economy that will improve exposure to global growth, with domestic GDP rising from 1.5% y/y in 2022 to 3.0% y/y by 2026. This year is likely to see a statistical rebound between 3.0% to 4.0% y/y, after 2020's -7.0% y/y drop.
- The repair and resolution of SA's main structural challenges and constraints to strong economic growth remains key, including limitations on electricity and water supply and SA's transport systems and onerous bureaucracy. However, quicker reforms will quicken growth.
- SA could see an even faster economic growth trajectory out to 2026, and higher levels of employment and incomes, if it achieves Vulindlela quickly, instead of the slow pace of implementation since 2018, after the marked deterioration of much of the 2010s.
- While growth prospects have brightened, financial market investors may also be feeling somewhat more comfortable given how SA handled its bond market rout a year ago, as well as its recent improved fiscal plans on better revenue figures than budgeted in the MTBPS.
- That is, the reduction in government debt projections on the 2020/21 corporate tax led revenue overrun improved investor confidence towards SA, as has the drop in weekly

bond issuance, but markets will still be watching intently to see if fiscal consolidation is achieved.

- With the impetus also growing on the attempted prosecution for corruption of SA's previously deemed untouchable, high ranking political figures, the rand is also likely gaining some positive momentum from this source.
- It should be noted however that not all proposed reforms in SA are market focussed, and some still heed back to the prior regime's populist agenda, while the rand will remain volatile as global market events continue to impact its direction, as will commodity prices.

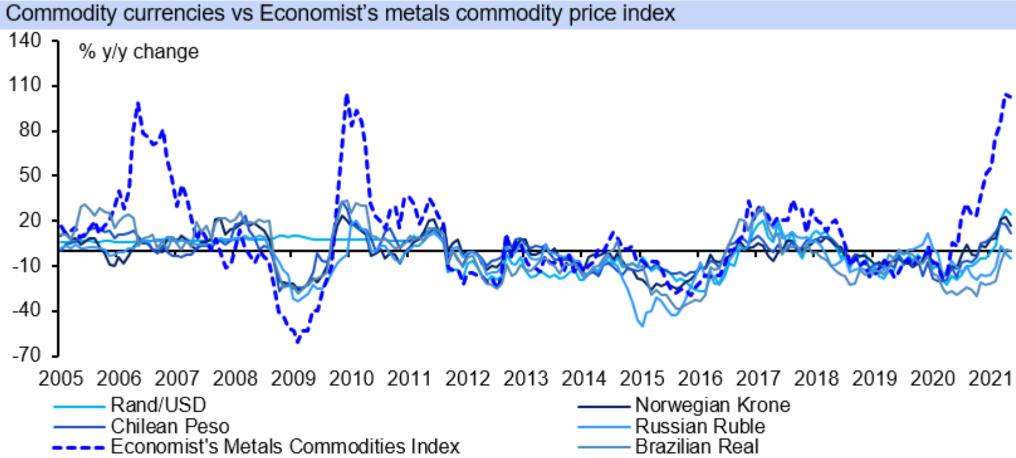
Please scroll down to the second section below

Commodity currencies vs Economist's metals commodity price index



Source: IRESS, Economist

Commodity currencies vs Economist's metals commodity price index



Source: IRESS, Economist

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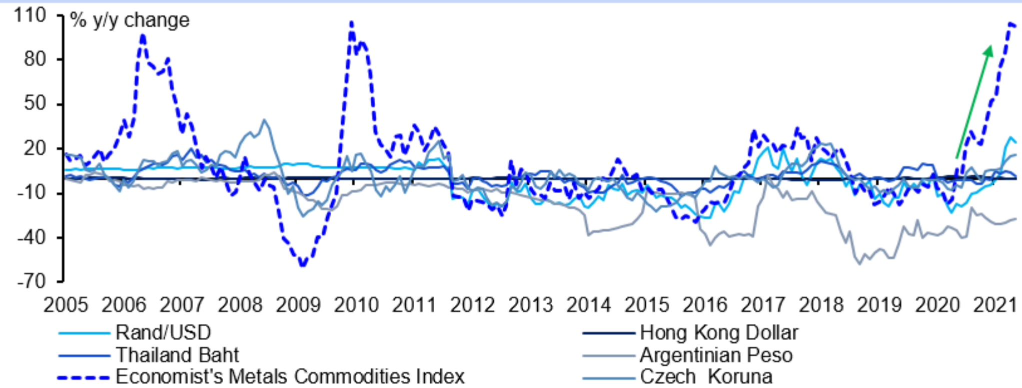
Commodity currencies vs Economist's metals commodity price index



Source: IRESS, Economist

- Furthermore, while the 2021 Budget saw some slight improvement in plans for fiscal consolidation, the borrowing trajectory remains extremely high, and the elevation in credit risk reflects the sharp climb in borrowing over the last decade, bolstering yields.
- SA's ten-year (generic) government bond yield, now at 9.50%, reached 6.50% in 2013. The differential between South Africa's five year and ten year government bond yields currently is 2.28% (it reached 0.90% in 2013 and has been closer to 1.0% in the past several years).
- The differential between South Africa's ten year government bond and the three month JIBAR rate is 5.73% (it reached 1.50% in 2013 and has been closer to 2.00% historically). SA is not out of the woods yet by any means, its debt trajectory is still not sustainable.
- The 2021 Budget shows that SA's debt trajectory is forecast to rise from current elevated levels which are already very high at 80.3% of GDP for the current fiscal year, versus around 33% of GDP in the decade of the 2000, and forecast to peak at 89.9% of GDP in 2025/26.
- The quantum of state debt has ballooned, with rating downgrades over the 2010s decade reflecting perceived deteriorated creditworthiness. SA's credit risk is still elevated, as the likelihood of default is deemed to have risen since early in the last decade (the 2010s).
- SA's credit risk is likely to remain elevated this year, and into next. Markets will wait to see if SA's government actually does lower expenditure (with particular focus on civil servants wages and support to Eskom), and stabilise its debt quantum.
- The state has forecast some expenditure cuts and does not plan to spend the 2020/21 revenue overrun, but this has not seen SA's credit risk subside much yet, as the likelihood of default is deemed to have risen since early in the last decade (the 2010s).
- SA's credit risk could remain elevated this year and into next as SA's highly deteriorated fiscal metrics worry investors, placing SA portfolio assets in the high-risk category.

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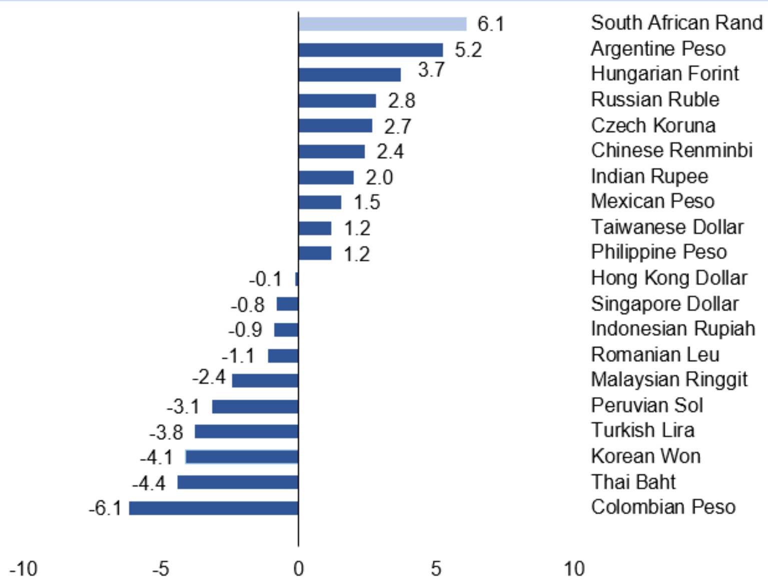
Foreigners are likely to continue their wait and see approach on SA bonds, along with the rating agencies.

- There is still very good return offered on the carry trade which is a key support in the current strength in the rand, and SA's higher inflation outcome has not dented the rand yet, although risk from this source remains, particularly as market sentiment will not always remain risk-on.

Emerging Markets Carry Return – values as at 20 May 2021



Source: Bloomberg

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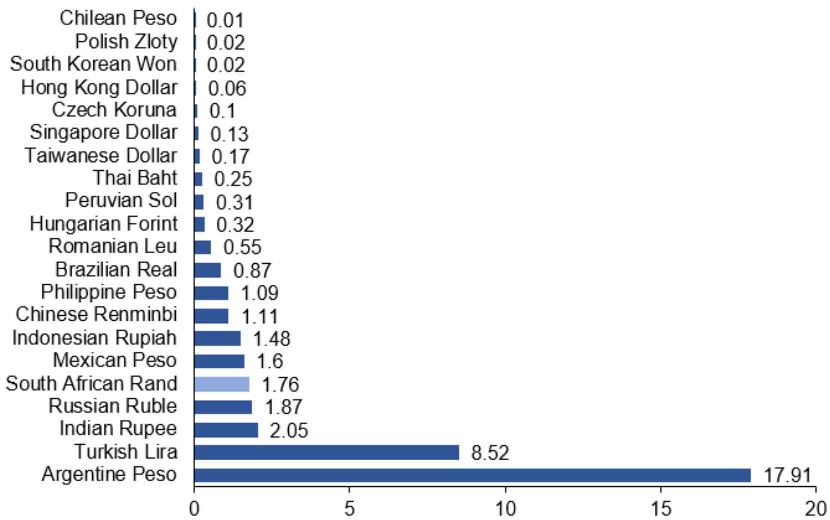
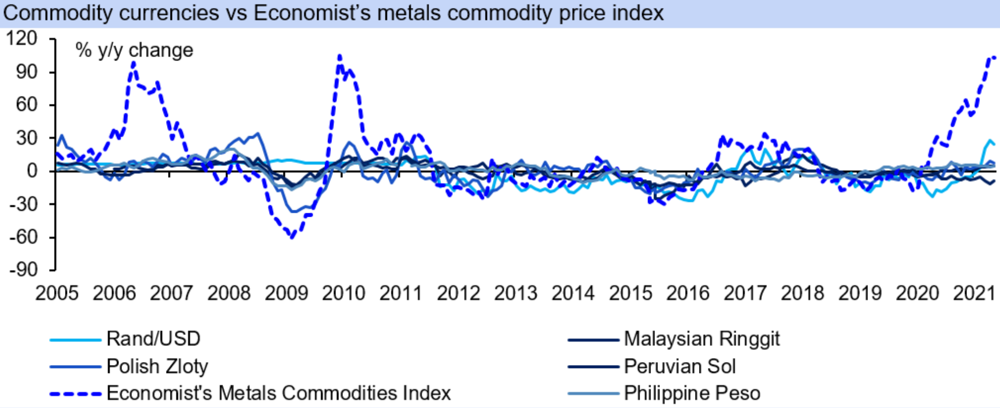
Emerging Markets Interest Return – values as at 20 May 2021



Source: Bloomberg

Commodity currencies vs Economist's metals commodity price index



Source: IRESS, Economist