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SA Economics

Commodity Currencies Note

Wednesday 22 July 2020

Rand continues to make gains, along with the other commodity currencies, bolstered also by USD weakness and the climb in the gold price, along with waning risk aversion as global fiscal measures increase

- The rand has continued on its strengthening trend since May, accelerating as market confidence in the recovery of the global economy improved, with commodity prices lifting noticeably on the same, particularly the metals' price index. The rand is heavily influenced by metals prices, with metals a key component of its exports, and SA in a trade surplus on average this year.

- Metals prices are up 15.6% y/y (14.0% m/m), and have been accelerating since May (Economist Commodities Price Index), while industrial commodities' prices returned positive growth against a year ago for the first time this year in July (currently up 10.4% y/y), as has the overall commodities price index at 10.5% y/y (all Economist commodity price indices).

- The gold price continues to see a boom, attempting to exceed its all-time high of US$1 921/oz in 2011, driven by the huge scale of QE in the US which has weakened the US dollar. US dollar weakness places upwards pressure on the gold price given the yellow metal's measure of real value (while US QE increases the supply of dollars).

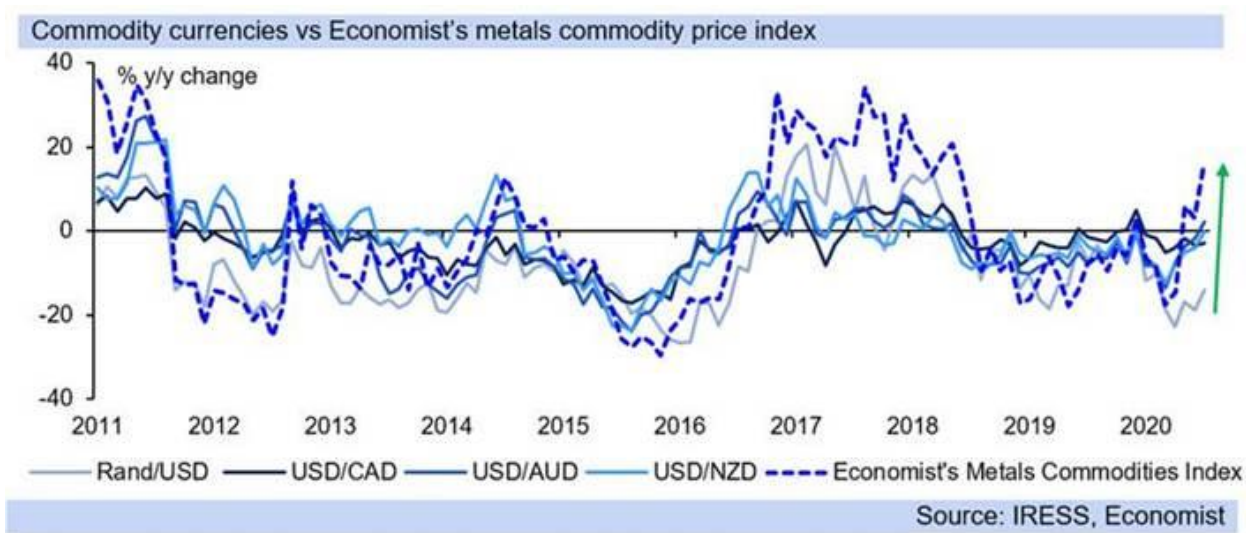
- The climb in the gold price has aided the strengthening trend in the rand, with the domestic currency reaching R16.34/USD today, gaining also against the euro and UK pound, of R18.90/EUR and R20.77/GBP respectively. ECB QE is seen to likely weaken the euro, with a massive increase in euros of €1.4trillion planned until the middle 2021.

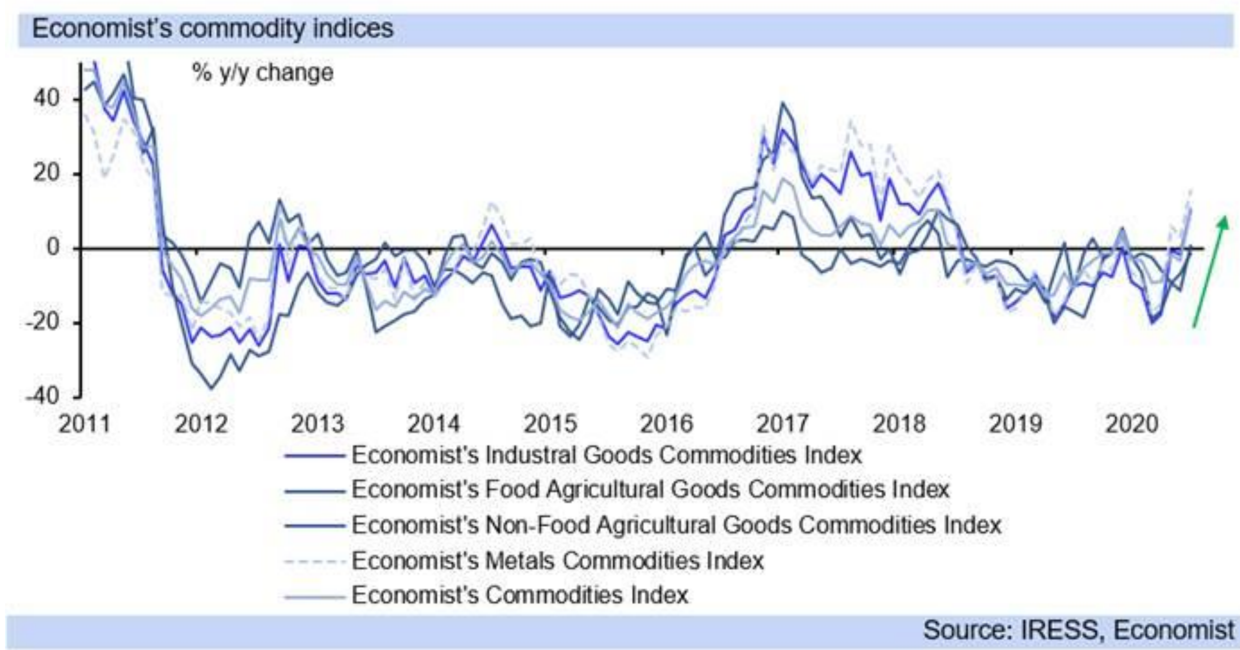
- While QE has bolstered portfolio inflows into EM's, and lifted the gold price and market expectations for global recovery, QE has historically not necessarily delivered on substantial economic growth (due to its suppressing effect on the appetite for lending from banks), and so commodity currencies, including the rand, are likely to remain volatile as the global recovery proves uneven.

- That is, the global recovery is likely to be unsynchronised and patchy in nature, causing market sentiment to wax and wane, as data releases recording various sectors and countries' economic performances do, with commodity prices and currencies, as well as EM currencies, experiencing volatility as a result.

- Markets however currently believe a linear global economic recovery is underway, with exuberance also on positive developments for a vaccine against Covid-19, but disappointing economic data, another spike in Covid-19 infections and/or any other event/s perceived to likely disrupt the economic recovery would have a negative effect on EM and commodity currencies.

- While the rand could see some further strength from current levels, it has nevertheless been strengthening very rapidly of late, and is in overbought territory, while foreigners have been purchasing SA government bonds, with CPI inflation last recorded at a historical low of 2.1% y/y (May), while the yield on the R2030 is at 9.15%.
- However, SA's inflation rate will rise toward 3.0% y/y in the next two prints, while SA's rapidly deteriorating government finances, resultant credit rating downgrades and SARB bond buying cap will see the rand unlikely to gain over the medium-term. In the short-term, a correction is likely, although the domestic currency may continue to track towards R16.00/USD first.





- With QE flattening yield curves in a number of economies instituting it, lower longer-term bond yields have occurred as interest rates fall to zero, or close to zero, in the short-end of the yield curve. This has narrowed the spread (difference) between long and short interest rates, reducing bank net interest margins which tends to suppress the appetite for lending from banks.

- That is, banks typically borrow in the short-end of the yield curve (at short-term interest rates) and lend at longer-term interest rates. When there is very little spread between them, profitability can be reduced, disincentivising bank lending, even when bank rates (such as the refi, repo or fed funds rate) are (essentially) zero bound as long-term rates (bond yields) are extremely low.

- While this is negative for the performance of the financial sector, and financial services sectors tend to be significant portions of these economies, it is also negative for economic recovery as one of the key functions of the banking industry of an economy is to circulate money through the economy by lending and taking in deposits.

- The circulation of money is a key driver of economic growth, and limitations on it typically slows down economic growth, and also the recovery in economic activity. Lower appetite for lending by banks therefore lowers the appetite for the circulation of money, despite QE.

- QE sees money pushed into banks by the creation of electronic money, and then Central Bank purchases of typically government debt (but also corporate debt as well in many instances) held by the banks, which funnels money in return into banks' reserves. The banking system can draw down on these reserves to increase its ability to lend.

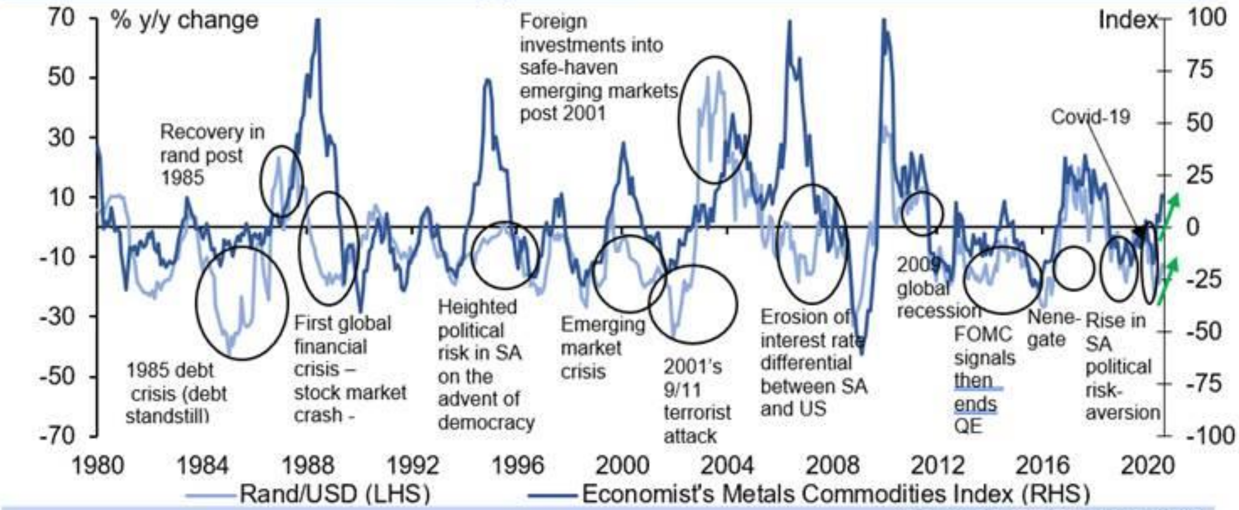
- But bank lending compromises varying degrees of risk, and compressed lending margins reduce the appetite for risk by reducing the reward, particularly if the risks are seen as elevated by very suppressed economic activity on the impact of the lockdowns on economic activity. Instead, appetite for relatively low risk, higher return investments increases, such as some EM bond yields.

- While EM bonds are not all equal in risk or return, short-term investment into many of the EM assets certainly is stimulated, with QE benefiting these countries' currencies. Fiscal measures are key however to stimulate economies, and additional measures from the EU has bolstered market sentiment in the prospects of recovery.

- In South Africa the financial services sector is a key contributor to economic growth, but domestic bond yields are relatively high even with short-interest rates not at zero, the spread is attractive, not least for the carry trade. There has been some anecdotal evidence of a pick-up in appetite for corporate borrowings, but this has yet to translate through into the official data.

- Additional stimulus measures from the advanced economies bolster market sentiment for recovery, and so commodity prices and commodity currencies. The EU's €750bn (R1.4trillion) package, with particular support (€390bn non-repayable grants) to hard hit EU areas is a key building block in supporting EU (the largest economic bloc in the worlds), and so global, economic recovery.

Rand vs Economist's metals commodity price index



Source: IRESS, Investec