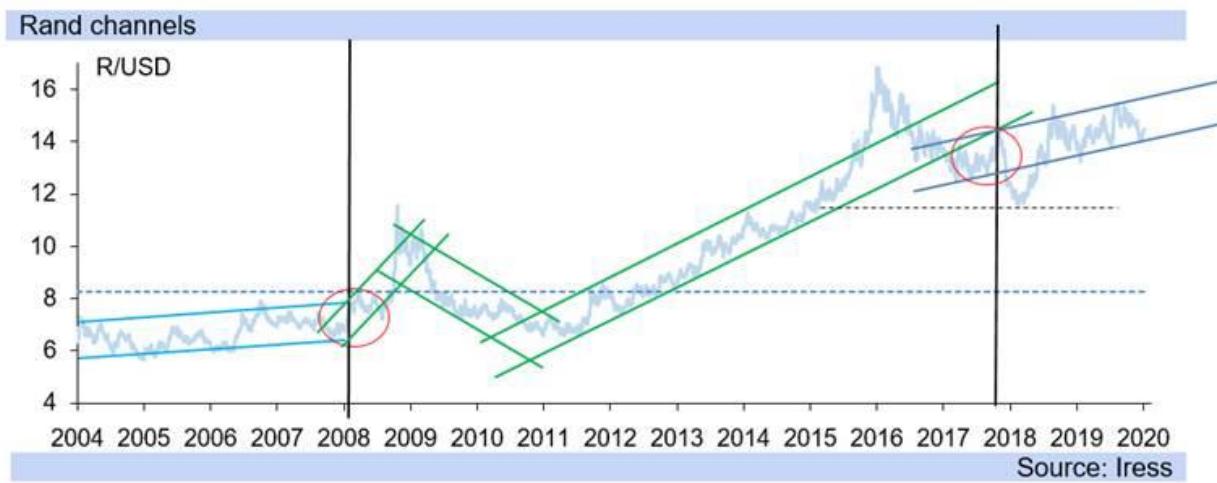


## Rand Note

Monday 27 January 2020

Rand falters on some global risk-off sentiment, as markets remain wary of SA risks - with such increased volatility over other EM currencies some small indication of the environment SA would face with a Moody's downgrade to sub-investment grade



- The rand has weakened to R14.57/USD, R16.06/EUR and R19.07/GBP today, after closing on Friday at R14.39/USD, R16.04/EUR and R18.81/GBP. While global market players have shown some risk aversion on worries about the spread of the coronavirus, SA's increasing risk of a Moody's downgrade is proving a dead weight for the domestic currency.
- EM currencies are weaker in general, but the rand has been most negatively affected as concerns over SA's debt projections raise fears of a Moody's downgrade, volatility has increased for the rand. Markets are also factoring in a greater chance of a downgrade as South Africa's CDS has climbed to 178, from 159 at the start of the year.

- We increased the likelihood of a Moody's downgrade to almost 50/50 – essentially a 50.6 chance of no downgrade (see "Bond note: demand for SA bonds sees yields drop into the end of 2019 as low inflation results in attractive real returns, SA bonds could see some further strength in 2020 if SA avoids a Moody's credit rating downgrade, 8<sup>th</sup> January 2020).
- That is, the chance of a Moody's downgrade is 49.4%, excluding the two up, and the severe (international), scenarios (see "Rand Note: volatility persists ahead of material risks for SA in 2020, with the proposed changes to the constitution on EWC, Moody's country review . . . Global events will also continue to materially impact the rand", 13<sup>th</sup> January 2020).
- The increase in the price of default 'insurance' (CDS) has occurred for SA as markets fear the planned rise in government borrowings and so reduced creditworthiness. SA's debt projections are due to be updated on 26th February 2020 in the Budget, with no certainty that the necessary expenditure cuts will be projected (to allow reduced borrowings).
- A Moody's downgrade is believed to be significantly priced in. A kneejerk reaction is anticipated on the event, at worst taking bond yields higher by over 100bp (with attendant currency weakness). Thereafter, yield seeking behaviour may eventually see SA's rates (bonds, forex etc) subside somewhat, but volatility would likely increase substantially.
- The global economic environment is expected to improve materially this year, (see "Gold & Commodities Note: The improving global trade outlook, on the diminution of conflict . . .", 23<sup>rd</sup> January 2020) which should lead to some risk-on, assisting SA's bond yields, currency and money markets rates to recover after a Moody's downgrade (should it occur).

### Economic Scenarios: note downside currency updates

		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
<b>Extreme</b>	USD/Rand (average)	11.50	10.30	9.50	8.60	7.90	7.60	7.40	7.10
Up case	Repo rate (end rate)	6.00	6.00	5.75	5.75	5.50	5.50	5.25	5.25
1%	Fast, sustainable economic growth of 5-7% y/y. Change in political will with growth creating economic reforms that structurally lift private sector investor confidence and fixed investment. Global growth boom (including commodities), Trump protectionism removed, SA export and domestic growth boom lifts employment and incomes, poverty eventually eliminated. Property rights strengthened, individuals obtain title deeds in EWC without disruption to economy. Fiscal consolidation, credit rating upgrades to A grade.								
<b>Up case</b>		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
7%	USD/Rand (average)	13.00	11.50	10.00	9.95	9.90	9.70	9.65	9.45
	Repo rate (end rate)	6.25	6.25	6.25	6.00	6.00	6.00	6.00	6.00
	Persistent growth of 3-5%, higher probability of extreme up case. Better governance, growth-creating reforms (structural constraints overcome), greater socio-economic stability, strengthening in property rights, individuals obtain title deeds in EWC without disruption to economy and can leverage and obtain credit. High business confidence and fixed investment growth, substantial FDI inflows, fiscal consolidation. Strong global growth and commodity cycle, 'trade war' subsides. Stabilisation of credit ratings, with ultimately credit rating upgrades.								
<b>Base case</b>		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
39%	USD/Rand (average)	14.30	14.60	14.80	14.45	13.90	14.05	14.55	14.15
	Repo rate (end rate)	6.50	6.25	6.25	6.25	6.25	6.25	6.25	6.25
	Annual growth approaches 2.0% y/y by 2021. Rising confidence and investment levels over the five-year forecast period. SA retains one investment grade (Moody's) rating on its local currency long-term sovereign debt in 2019 and 2020 on a negative outlook. Avoids severe global risk-off environment, neutral to global risk-on. Modestly strengthening global demand to trend growth. Limited impact of EWC (expropriation without compensation) to abandoned, unused, labour tenets and government land (individuals are new owners and receive title deeds) does not have a negative effect on economy.								
<b>Lite (domestic)</b>		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
Down case	USD/Rand (average)	15.50	16.50	16.80	16.10	15.80	15.90	15.70	15.30
38%	Repo rate (end rate)	6.75	7.25	7.25	7.25	7.25	7.25	7.25	7.25
	SA is rated sub-investment grade by Moody's but substantial repair avoids further marked downgrades. Business confidence depressed, rand weakness, significant load shedding and weak investment growth until substantial repair effected. V shaped, credit-rating-downgrade related recession. However, a neutral to risk-on global financial market environment (the international environment is that of the base case) lessens the impact of the rating downgrade. Potentially combined with a modest expropriation of some private commercial sector property without compensation, with modest negative impact on economy.								
<b>Severe down case</b>		Q1.20	Q2.20	Q3.20	Q4.20	Q1.21	Q2.21	Q3.21	Q4.21
15%	USD/Rand (average)	16.00	17.50	18.50	19.80	19.50	18.90	18.50	18.00
	Repo rate (end rate)	7.00	7.75	8.50	9.25	10.00	10.00	9.50	9.00
	Continued global sharp economic slowdown resulting in a global recession, on a marked escalation of the US-China trade war – may include a global financial crisis. May also include severe escalation of US Middle East military conflict. A significantly more severe recession occurs in SA than in the lite down case, marked rand weakness, may eventually include widespread services load shedding and strike action. Potentially combined with expropriation of private sector property (title deeds not transferred to individuals) without compensation – severe negative impact on economy. SA rated sub-investment grade from all three key agencies, with further rating downgrades occurring.								

Note: Event risk begins Q1.20. Source: Investec, Iress historical data

- The risk is that a global event/s occur/s which scupper/s current market optimism. A severe worsening of the spread of the coronavirus is one such risk for market sentiment, as would be an about turn in the improvement in global trade relations that have occurred with the phase one deal - we encapsulate this in the severe down case risk, of 15%.
- The lite down case includes SA losing its Moody's credit rating, but also includes substantial repair thereafter to avoid further marked credit rating downgrades. Should such repair to government finances not occur, and the trajectory of deteriorating government finances not halt, SA would see its ratings drop lower from the speculative grade category.

- Such a deterioration to a highly speculative credit rating (single B categories, down from the double BB or speculative grade categories), would result in a substantially volatile, and likely deteriorated, investor sentiment towards South Africa, with SA likely falling into the severe down case - even without the driver/s of any negative international events.
- While the severe down case currently has a low probability of occurring, its probability would rise if SA continues to lack the political will to dramatically curb the burgeoning in government expenditure that has pushed up government debt, and so weakened government finances, bringing SA to the brink of a sub-investment grade Moody's rating.
- The risk is not just that SA will receive a Moody's credit rating downgrade this year, but that SA will continue to receive downgrades from the three key rating agencies, falling from highly speculative to the substantial risks category of C grade, and onwards to the 'default imminent with little chance of recovery' credit rating category (IMF bailout territory).
- In the past decade, business confidence has remained depressed and the rand has weakened materially. SOEs have also been weakened, contributing to load shedding and weak investment growth. Besides the Moody's downgrade, SA also faces the risk of expropriation of private sector property without compensation, which could weaken growth further.
- While the global economy, and so global financial market risk sentiment, could well outperform expectations this year, diluting some of the impact on SA financial indicators from a Moody's downgrade, SA is not expected to see substantial rand strength before February's Budget, and indeed not until substantial repair has occurred in government finances.

Expected case: Exchange Rates forecasts	2020	2020	2020	2020	2021	2021	2021	2021	2022	2022	2022	2022
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
USD/ZAR	14.30	14.60	14.80	14.45	13.90	14.05	14.55	14.15	13.75	14.40	14.70	14.00
GBP/ZAR	18.78	19.07	19.26	19.21	18.77	19.25	20.29	19.73	19.17	20.08	20.50	19.52
EUR/ZAR	15.87	16.50	16.95	16.62	16.40	16.86	17.90	17.69	17.19	18.00	18.38	17.50
ZAR/JPY	7.45	7.26	7.13	7.23	7.63	7.54	7.29	7.49	7.71	7.43	7.28	7.64
ZARCHF	14.43	14.86	15.06	14.71	14.33	14.64	15.16	14.74	14.47	15.16	15.47	14.74
ZARAUD	9.72	9.78	9.99	9.83	9.73	10.26	10.91	11.04	10.73	11.23	11.47	10.92
GBP/USD	1.31	1.31	1.30	1.33	1.35	1.37	1.39	1.39	1.39	1.39	1.39	1.39
EUR/USD	1.11	1.13	1.15	1.15	1.18	1.20	1.23	1.25	1.25	1.25	1.25	1.25
USD/JPY	107	106	106	105	106	106	106	106	106	107	107	107

Note: averages, Source: IRESS, Investec

Lite Down case: Exchange Rates forecasts (domestic event)	2020	2020	2020	2020	2021	2021	2021	2021	2022	2022	2022	2022
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
USD/ZAR	15.50	16.50	16.80	16.10	15.80	15.90	15.70	15.30	15.00	15.10	15.05	14.80
GBP/ZAR	20.36	21.55	21.86	21.40	21.33	21.78	21.89	21.34	20.92	21.06	20.99	20.64
EUR/ZAR	17.21	18.65	19.24	18.52	18.64	19.08	19.31	19.13	18.75	18.88	18.81	18.50
ZAR/JPY	6.87	6.42	6.28	6.49	6.71	6.67	6.75	6.93	7.07	7.09	7.11	7.23
ZARCHF	15.64	16.80	17.10	16.38	16.29	16.56	16.35	15.94	15.79	15.89	15.84	15.58
ZARAUD	10.54	11.06	11.34	10.95	11.06	11.61	11.78	11.93	11.70	11.78	11.74	11.54
GBP/USD	1.31	1.31	1.30	1.33	1.35	1.37	1.39	1.39	1.39	1.39	1.39	1.39
EUR/USD	1.11	1.13	1.15	1.15	1.18	1.20	1.23	1.25	1.25	1.25	1.25	1.25
USD/JPY	107	106	106	105	106	106	106	106	106	107	107	107

Note: averages, Source: IRESS, Investec

Up case: Exchange Rates forecasts	2020	2020	2020	2020	2021	2021	2021	2021	2022	2022	2022	2022
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
USD/ZAR	13.00	11.50	10.00	9.95	9.90	9.70	9.65	9.45	9.30	9.15	9.00	9.20
GBP/ZAR	17.08	15.02	13.01	13.23	13.37	13.29	13.46	13.18	12.97	12.76	12.55	12.83
EUR/ZAR	14.43	13.00	11.45	11.44	11.68	11.64	11.87	11.81	11.63	11.44	11.25	11.50
ZAR/JPY	8.19	9.22	10.55	10.50	10.71	10.93	10.98	11.22	11.40	11.69	11.89	11.63
ZAR/CHF	13.12	11.71	10.18	10.13	10.21	10.10	10.05	9.84	9.79	9.63	9.47	9.68
ZARAUD	8.84	7.71	6.75	6.77	6.93	7.08	7.24	7.37	7.25	7.14	7.02	7.18
GBP/USD	1.31	1.31	1.30	1.33	1.35	1.37	1.39	1.39	1.39	1.39	1.39	1.39
EUR/USD	1.11	1.13	1.15	1.15	1.18	1.20	1.23	1.25	1.25	1.25	1.25	1.25
USD/JPY	107	106	106	105	106	106	106	106	106	107	107	107

Note: averages, Source: IRESS, Investec

Extreme Up case: Exchange Rates forecasts	2020	2020	2020	2020	2021	2021	2021	2021	2022	2022	2022	2022
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
USD/ZAR	11.50	10.30	9.50	8.60	7.90	7.60	7.40	7.10	6.95	6.75	6.95	7.15
GBP/ZAR	15.11	13.46	12.36	11.43	10.67	10.41	10.32	9.90	9.69	9.41	9.69	9.97
EUR/ZAR	12.77	11.64	10.88	9.89	9.32	9.12	9.10	8.88	8.69	8.44	8.69	8.94
ZAR/JPY	9.26	10.29	11.11	12.15	13.42	13.95	14.32	14.93	15.25	15.85	15.40	14.97
ZAR/CHF	11.60	10.49	9.67	8.75	8.14	7.92	7.71	7.40	7.32	7.11	7.32	7.53
ZARAUD	7.82	6.90	6.41	5.85	5.53	5.55	5.55	5.54	5.42	5.27	5.42	5.58
GBP/USD	1.31	1.31	1.30	1.33	1.35	1.37	1.39	1.39	1.39	1.39	1.39	1.39
EUR/USD	1.11	1.13	1.15	1.15	1.18	1.20	1.23	1.25	1.25	1.25	1.25	1.25
USD/JPY	107	106	106	105	106	106	106	106	106	107	107	107

Note: averages, Source: IRESS, Investec

Severe Down case: Exchange Rates forecasts (global event/s)	2020	2020	2020	2020	2021	2021	2021	2021	2022	2022	2022	2022
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
USD/ZAR	16.00	17.50	18.50	19.80	19.50	18.90	18.50	18.00	17.50	17.00	16.60	16.25
GBP/ZAR	21.02	22.86	24.07	26.32	26.33	25.89	25.80	25.10	24.40	23.71	23.15	22.66
EUR/ZAR	17.76	19.78	21.18	22.77	23.01	22.68	22.76	22.50	21.88	21.25	20.75	20.31
ZAR/JPY	6.66	6.06	5.70	5.28	5.44	5.61	5.73	5.89	6.06	6.29	6.45	6.58
ZAR/CHF	16.15	17.82	18.83	20.15	20.10	19.69	19.27	18.75	18.42	17.89	17.47	17.11
ZARAUD	10.88	11.73	12.49	13.46	13.65	13.80	13.88	14.04	13.65	13.26	12.95	12.68
GBP/USD	1.31	1.31	1.30	1.33	1.35	1.37	1.39	1.39	1.39	1.39	1.39	1.39
EUR/USD	1.11	1.13	1.15	1.15	1.18	1.20	1.23	1.25	1.25	1.25	1.25	1.25
USD/JPY	107	106	106	105	106	106	106	106	106	107	107	107

Note: averages, Source: IRESS, Investec

