Investec

SA Economics

Rand Note

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Sell-in-May-and-go-away strikes financial markets again, on bearish global growth concerns on the intensification of the US-Sino trade disputes, with EM currencies weakness tilting the rand towards the downside

The new scenarios –the traditional down case has been split into a domestic event driven only down case, and a down case of both international and domestic events

		Q1.19	Q2.19	Q3.19	Q4.19	Q1.20	Q2.20	Q3.20	Q4.20
Domestic (lite) Down case 25% 25%+10% =35%	Rand/USD (average)	14.01	15.50	17.50	17.75	16.90	16.00	15.50	15.25
	Repo rate (end rate)	6.75	7.00	7.75	7.75	7.50	7.50	7.50	7.50
	Partial expropriation of (certain groups') private commercial sector property (including productive land) without compensation. Business confidence remains depressed, marked rand weakness, significant load shedding and weak investment growth. SA **sub-investment grade Moody's rating in 2019**, but substantial repair avoids further marked downgrades. SA experiences a mild, credit rating downgrade related, recession. However, modestly strengthening global demand and elevated commodity prices help lessen the longer-term impact of domestic disturbances. Sedate global monetary policy normalisation occurs – a severe global risk-off environment is avoided, with neutral to global risk-on.								
International & (worse) domestic Down case 10%	Rand/USD (average)	14.01	16.00	18.00	18.50	19.60	18.00	17.50	17.25
	Repo rate (end rate)	7.00	7.25	8.00	8.50	8.50	8.50	8.50	9.00
	Expropriation of private commercial sector property (full or partial, and including productive land) without compensation, plus wide scale land grabs, title deeds not transferred to individuals - nationalisation. Confidence and investment depressed, marked rand weakness, significant strike action and widespread electricity (water and other services) load shedding. SA sub-investment grade, increased chance of further credit downgrades. Faster than expected global (US) monetary policy normalisation, general market risk-off, global sharp economic slowdown (commodity slump), marked escalation of US-China trade war, short global financial crisis (SA V shaped recession). Material risk of further credit rating downgrades to junk.								

Note: Event risk begins Q2.19. Source: Investec (Q1.19 data Iress)

- The rand has weakened materially to R14.89/USD, R16.62/EUR and R18.85/GBP, from R14.16/USD, R15.91/EUR and R18.41/GBP after SA's elections, as risk aversion in global financial markets has risen from mid-May on growing concerns around the outlook for world economic growth following the exacerbation of trade tensions between the US and China.

- The rand typically sees material risk from the second quarter of each year, with the advent of the sell-in-May-and-go-away season for emerging market portfolio assets, as risk concerns are amplified. Last year, markets adjusted to the realization that US interest rates were likely to take a hawkish path, this year concerns centre around a full-blown trade war occurring.

- With the bulk of global markets' wealth held in the Northern hemisphere, markets tend to become risk averse during the Northern Hemisphere's summer vacation period, with investors switching to perceived less risky investments (typically selling EM portfolio assets), and often returning to 'higher yielding/high risk' markets in September/October.

- Last year, South Africa saw –R166.3bn of foreign sales net of purchases of SA bonds and equities, from May to end 2018. The rand saw a weakening trend develop from mid-May in 2018 as the domestic currency weakened from R12.18/USD, R14.57/EUR and R16.54/GBP to R15.70/USD, R18.12/EUR and R20.13/GBP by September 2018.

- This year, global markets have come under the influence of worsening US Sino trade tensions, raising significant concerns recently of weaker world economic growth, which has negatively impacted sentiment in global financial markets, with fears of a marked slowdown in global growth, if not an actual recession on a full blown trade war.

- Initially the US was not expected to escalate trade tensions with China to the extent of an outright trade war. Investec's down case encapsulates such an outcome on the international side – allowing for a substantial slowdown in global growth, with risk of a financial crisis as financial markets crash and emerging markets see huge sell–off of EM assets as risk aversion elevates.

- With US 2019 'municipal' elections upcoming in November ahead of the 2020 Presidential elections, trade tension could persist, and worsen, as the Trump administration seeks to gain leverage on this politically. This time around however, China is taking a firmer stand in the face of escalating US protectionism, which has seen concerns over global growth rise.

- However, should equities markets and economic performance come under sustained pressure on the back of the US-led rhetoric and tariff escalation, the pursuit of US-led protectionism may begin to ease, given the negative impact it could have at the polls. China's reaction is key too, with the world's second largest economy becoming tougher in its stance recently.

- Trade policy has proved volatile, but increasingly protectionist under Trump. However, this does not necessarily mean that markets are set for a lengthy bear period, as positive developments on the trade front in negotiations with China could be met with a rally. A sustained bear market caused by Trump led protectionism is unlikely to be good for his re-election.

- This year is still not expected to see as extreme a sell-off period as last year. However, much will depend on the extent of retaliation to US protectionism from China and other countries, as to whether an actual trade war, and prolonged severe risk-off market reaction, is achieved. Currently the rand is tilting towards, but not, in the down case, partly on these fears.

International & (worse) domestic down case	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4
ZARUSD	14.01	16.00	18.00	18.50	19.60	18.00	17.50	17.25
ZARGBP	18.25	20.93	23.65	24.81	26.86	24.84	24.36	24.27
ZAREUR	15.92	18.02	20.34	21.09	22.83	21.24	20.83	20.87
JPYZAR	7.86	6.90	6.06	5.84	5.46	5.89	6.03	6.06
ZARCHF	14.06	15.89	17.69	18.26	19.52	18.00	17.50	17.39
ZARAUD	9.98	11.36	12.51	12.95	14.21	13.14	12.78	12.77

Note: averages, Source: Investec, Iress

- In South Africa the Reserve Bank changed its tone in early May to a substantially dovish tilt, indicating the growing likelihood of a 25bp cut in its repo rate, potentially in Q1.20, but possibly earlier. However, substantial rand weakness since then, and the growing risk aversion in global markets, if sustained, may see the MPC tone return to neutral at its next meeting.

- Generally, an interest rate cut is perceived to lead to some rand weakness, as it is seen to lower the return for foreigners investing in SA's portfolio assets. While some of the rand's weakness post the MPC meeting this month (23rd) may be ascribed to this (with the FRA curve now factoring in a 25bp repo rate cut this year), this is unlikely to be the key reason.

- Concerns over politics within the ANC are seen to have materially added to rand depreciation, along with the delay in appointing cabinet members, but rising global markets risk-off sentiment is likely to have also been a key reason for the marked depreciation of the rand during the second half of this month.

- The reality of a number of South Africa's weak fundamentals are seen to be tempering market enthusiasm, including high government, and Eskom, debt levels, and Moody's recent warning of a material risk of a downgrade to SA's investment grade status (see "Credit Ratings Note: Moody's warns of a credit rating downgrade ", 16th May 2019, website address below).

- With President Ramaphosa inaugurated recently, markets have hoped he would trim his perceived bloated cabinet down, with some ministries combined, new executives appointed, and a strong focus on deliverables with the objectives of economic growth, job creation and transformation. The delay in cabinet appointments is seen to have negatively impacted the rand.

- Political uncertainty has also risen, with recent rand weakness also attributed to the increasing likelihood that David Mabuza will become Deputy President, after an initial delay in his becoming an MP on an ANC integrity commission enquiry. SA politics have, and likely will continue to have, a significant influence on the domestic currency.

- With SA's GDP figures due to be published next week, the growing risk of a contraction in GDP (see "Industrial production note: GDP is likely to contract in the first quarter of this year with industrial production already falling by -10% qqssa in Q1.19, while longer term, regulatory blockages can contribute to deindustrialisation in SA", 28th May 2019) is also afflicting the rand.

- SA often sees a contraction in GDP in the first quarter of the year, while last year this leached into the second quarter as well, delivering a recession. The weak state of SA's economy, and declining trend in economic growth over most of the past decade, has made it easy for SA to see quarters of contraction in GDP, specifically given the volatility of some small sectors.

- With the primary sector of the economy having the smallest weighting in GDP, substantial swings in activity in the agricultural and mining sectors can have a material effect on GDP. Q1.19 saw industrial production (mining, manufacturing and electricity production) contract by 10% qqsaa (quarter on quarter, seasonally adjusted, annualised), partly on the back of load shedding.

- With the headline GDP data deseasonalised, a drop in activity related to the festive period (with activity slow to start in January, demand weak, holidays extended etc) should not have an impact on the headline GDP figure. However, it may have in general since 2014 (given the contractions), perhaps requiring a review of the calculations deseasonalising the data.

Domestic (lite) down case	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4
ZARUSD	14.01	15.50	17.50	17.75	16.90	16.00	15.50	15.25
ZARGBP	18.23	20.28	22.99	23.81	23.16	22.08	21.57	21.46
ZAREUR	15.90	17.46	19.78	20.24	19.69	18.88	18.45	18.45
JPYZAR	7.87	7.12	6.23	6.08	6.33	6.63	6.81	6.85
ZARCHF	14.04	15.39	17.20	17.52	16.83	16.00	15.50	15.38
ZARAUD	9.97	11.01	12.16	12.43	12.25	11.68	11.32	11.29

Note: averages, Source: IRESS, Investec