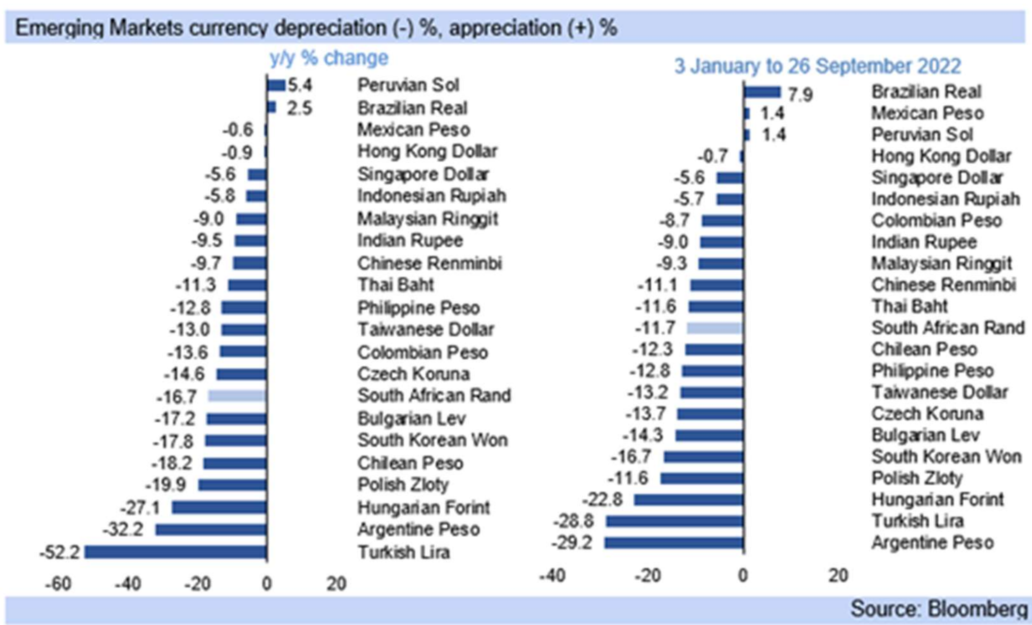
Investec | Out of the Ordinary

SA Economics

Monday 26 September 2022

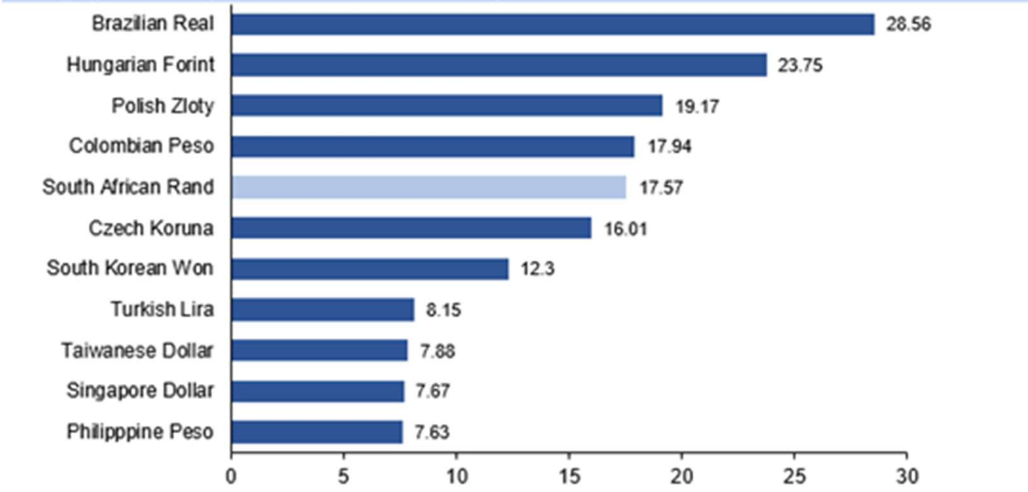
Rand note: risk aversion has climbed higher in global financial markets on hawkish Central Banks, global recession fears



Emerging Markets currency depreciation (-) %, appreciation (+) %

Source: Bloomberg

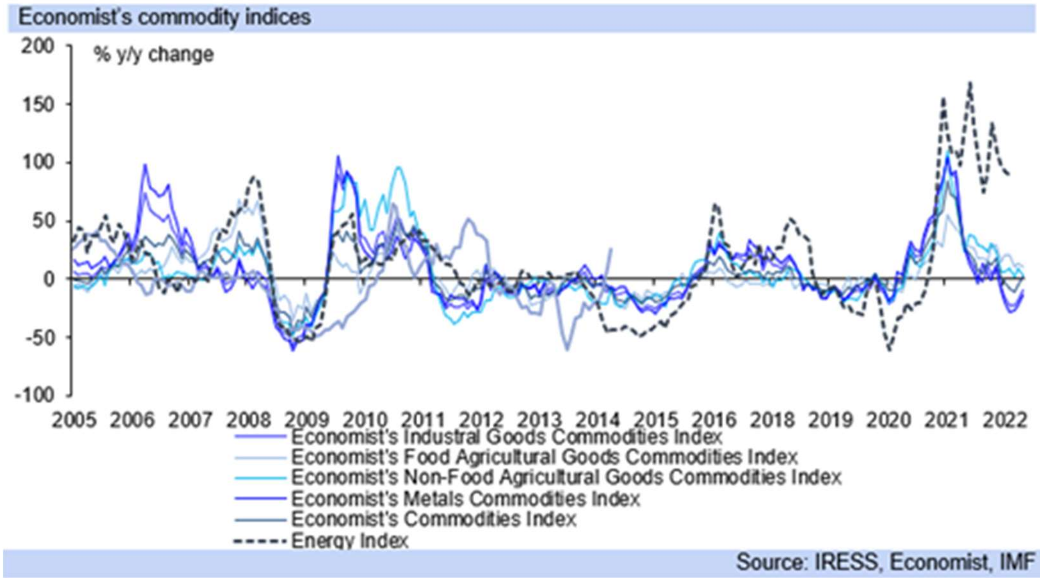
Emerging Markets Implied Volatilities – values 26 September 2022



Source: Bloomberg

Emerging Markets Carry Return – values 26 September 2022

Source: Bloomberg



Expected Case: Exchange Rate forecasts

	2022				2023				2024			
	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23	Q1.24	Q2.24	Q3.24	Q4.24
USD/ZAR	15.21	15.59	16.80	16.00	15.80	16.20	16.60	16.10	15.90	16.40	16.90	16.40
GBP/ZAR	20.40	19.59	20.08	19.04	18.88	19.52	20.34	20.13	20.35	21.32	22.82	22.63
EUR/ZAR	17.07	16.60	17.14	16.32	16.27	17.01	17.76	17.55	17.81	18.86	19.94	20.17
ZAR/JPY	7.65	8.33	8.13	8.34	8.29	7.96	7.65	7.80	7.74	7.20	6.80	6.71
CHFZAR	16.47	16.15	17.37	16.65	16.60	17.18	17.59	16.96	17.47	18.02	18.57	18.02
AUDZAR	11.02	11.14	11.63	11.20	11.30	11.99	12.53	12.32	12.40	12.79	13.18	12.79
GBP/USD	1.34	1.26	1.20	1.19	1.20	1.21	1.23	1.25	1.28	1.30	1.35	1.38
EUR/USD	1.12	1.06	1.02	1.02	1.03	1.05	1.07	1.09	1.12	1.15	1.18	1.23
USD/JPY	116	130	137	134	131	129	127	126	123	118	115	110

Note: averages, Source: Investec, Iress

- The US dollar continues to power ahead, driven by high levels of risk aversion in global financial markets as recession fears grow. Risk assets, including equities, EM portfolio assets and EM currencies have fallen, as investors move increasingly into safe haven investments.
- Bear markets loom as the Fed is seen as hiking the global economy into recession (by 2023), while the largest economic area, the EU is believed to have already fallen into recession in H1.22 and the US dollar is at multi-decade highs as market fears grow.
- Business activity has already contracted in both the EU and in the US, showing slowing economic growth for the US, and the EU at risk of contraction, with high energy prices, economic and political uncertainty and rising interest rates afflicting confidence in the EU.
- With the differential between US and EU interest rates widening on rapid US interest rates, the dollar has strengthened against the euro, while US interest rate hikes are also outdoing those in South Africa, adding to both rand and euro weakness against the US dollar.
- In addition, the ECB has warned that it could tighten its momentary policy (above the neutral interest rate) which will dampen economic activity for the purpose of reducing inflationary pressures, and ensuring inflation expectations do not become de-anchored.

- The World Bank warning that the risk is rising of global recession in 2023 “and a string of financial crises in emerging market and developing economies that would do them lasting harm”, amid simultaneous rate hikes has added to market fears.
- The World Bank further warns that “the currently expected trajectory of interest-rate increases and other policy actions may not be sufficient to bring global inflation back down to levels seen before the pandemic”, which is also roiling markets.
- But “(u)nless supply disruptions and labor-market pressures subside, those interest-rate increases could leave the global core inflation rate (excluding energy) at about 5 percent in 2023—nearly double the five-year average before the pandemic”.
- The high levels of uncertainty are negatively afflicting investor confidence, in particular the long lead time up to a potential for global recession by 2023, while Central Banks hawkishness has increased again, also negatively affecting risk assets, and so the rand.

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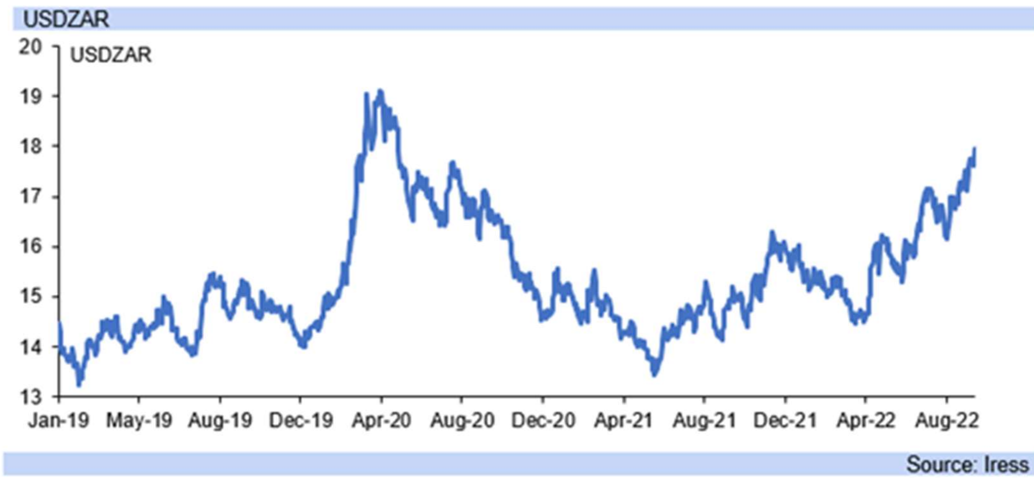
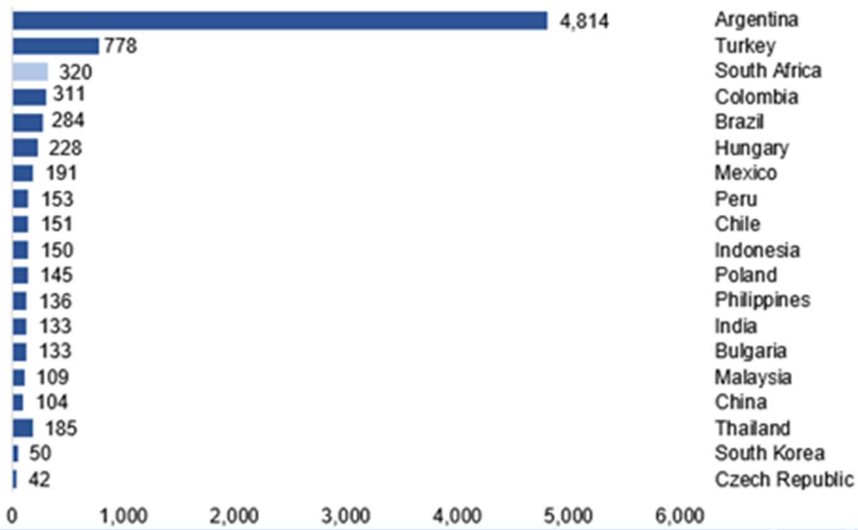
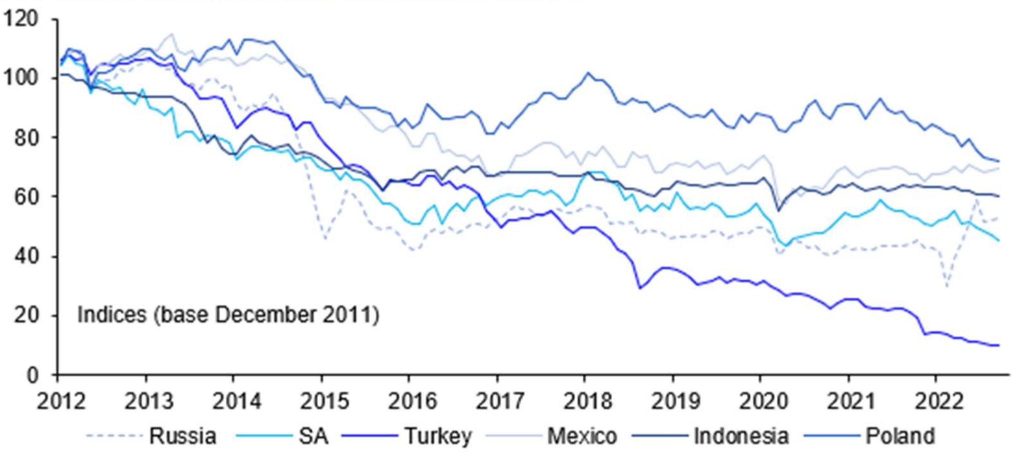


Emerging Markets CDS (risk) Spreads – values 26 September 2022

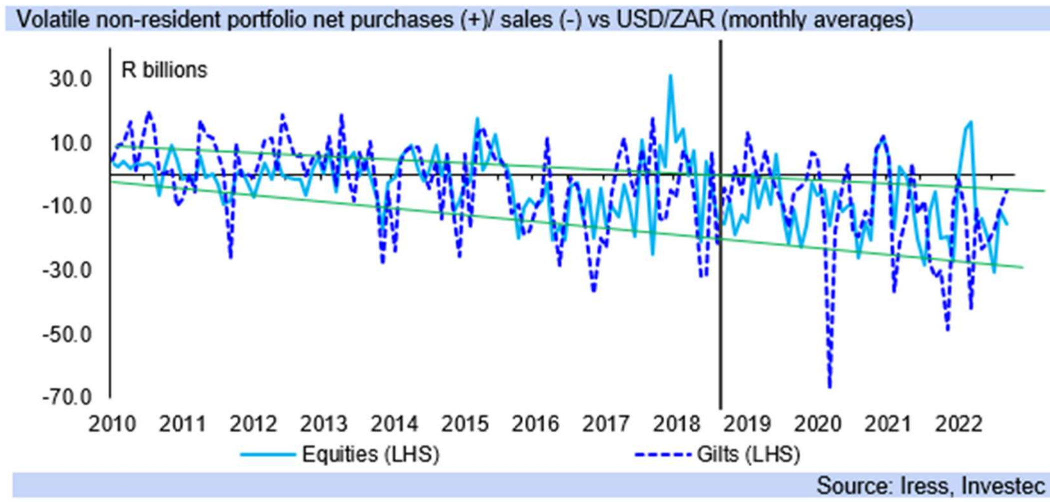


Source: Bloomberg

Volatility index for selected emerging market currencies



Sources: Iress, Investec



- Indeed, the World Bank adds in its recent report that global growth is already “slowing sharply, with further slowing likely as more countries fall into recession.” “The global economy is now in its steepest slowdown following a post-recession recovery since 1970”.
- “To cut global inflation to a rate consistent with their targets, central banks may need to raise interest rates by an additional 2 percentage points” over current expectations of an almost 4% lift into “2023 – an increase of more than 2 percentage points over their 2021 average.”
- “Global consumer confidence has already suffered a much sharper decline than in the run-up to previous global recessions. The world’s three largest economies—the United States, China, and the euro area—have been slowing sharply.”
- Financial markets take commentary from key advanced economies’ Central Bank governors very seriously, as they do from key multilaterals, such as the World Bank, IMF. Each time the hawkish nature of Central Banks increase, risk aversion rises further, quelling risk assets.
- So too, dire warnings from multilateral organisations about future economic growth also has a very quelling effect on market sentiment, with investors increasingly wary about rising investment risk, which is worsening market losses.
- High inflation is not at an end, despite some expectations early in H1.22 that inflation would slow on the earlier weakening in supply chain costs. Instead, supply chains have a twelve to eighteen month feed through into inflation and inflation was not going to drop quickly.
- The large fiscal expenditure package announced last week in the UK, financed through increased debt, and focusing on tax cuts to stimulate the UK economy caused UK bond yields to jump by multi-decade increases and the pound to weaken on investor concerns.
- The rand has gained against the UK pound consequently, reaching R18.68/GBP today, from R20.32/GBP last week, and saw some strength against the euro, reaching R17.25/EUR today, from R17.77/EUR last week.
- The increase in the hawkish tone of the FOMC last week caused risk assets to weaken further, including EM currencies, and so the rand as markets factor in a higher US interest rate trajectory, for longer, in the face of crumbling global growth.

Economic Scenarios: note updated forecasts, scenarios

		Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
Extreme	USD/Rand (average)	15.21	15.59	16.80	15.40	14.50	14.00	13.60	13.40
Up case	Repo rate (end rate)	4.25	4.75	4.50	4.00	3.75	3.75	3.50	3.50

1%

SA economic growth rises to 3–5%, then 5-7%. Good governance, growth-creating reforms (structural constraints eradicated), strong property rights, no nationalisation or expropriation without compensation. High business confidence and fixed investment growth, substantial FDI, fiscal consolidation drives debt to low ratios of 2000s. Very subdued domestic inflation on extreme rand strength, very favourable weather conditions. Strong global growth, risk-on, commodity boom. Rapid upgrades of credit ratings. Strong transition away from fossil fuel usage, a quick transition to renewable energy.

		Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
Up case 1%	USD/Rand (average)	15.21	15.59	17.00	16.00	15.30	15.00	14.70	14.60
	Repo rate (end rate)	4.25	4.75	4.75	4.50	4.25	4.25	4.25	4.25

Economic growth of 3%, rising confidence and investment levels, structural constraints eroded, global growth strong, global financial markets risk-on. No nationalisation or expropriation without compensation. Low domestic inflation on favourable weather and global conditions, rand strength, lower state-controlled price inflation on increased private privatisation. Positive outlooks on credit ratings turn into upgrades fiscal consolidation, debt projections fall substantially. Substantial transition to renewable energy away from fossil fuel usage, comprehensive measures to alleviate climate change impact on economy.

		Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
Base	USD/Rand (average)	15.21	15.59	17.12	16.80	16.60	17.00	17.40	16.90
case	Repo rate (end rate)	4.25	4.75	6.25	7.00	7.50	7.50	7.25	7.00

50%

Economic growth modest but lifts towards 3.0% y/y over five years on sufficient domestic policy support measures, global financial market risk sentiment is neutral to positive. South Africa in the BB credit rating category bracket as fiscal consolidation (debt to GDP stabilisation) occurs leading to some positive outlooks. The rand sees mild weakness and inflation is impacted by the course of weather patterns via food price inflation. Little expropriation without compensation occurs and has no negative effect on economy, no nationalisation. A modest transition to renewable energy and slow move away from fossil fuel usage occurs and measures to alleviate the impact of climate change on the economy are modestly implemented. The Russian/Ukraine conflict eases and does not exacerbate.

		Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
Lite	USD/Rand (average)	15.21	15.59	17.25	17.40	17.70	17.80	17.70	17.90
(domestic)	Repo rate (end rate)	4.25	4.75	7.00	7.50	8.00	8.50	9.00	9.00

Down case **39%**

The international environment (incl. risk sentiment) is that of the base case. South Africa fails to see debt projections stabilise, falls into single B (local and foreign currency) credit ratings from all three agencies. Recession occurs. Business confidence depressed, significant load shedding, weak investment growth, civil and political unrest. High inflation on unfavorable weather conditions, marked rand weakness. Little transition to renewable energy or measures to alleviate the impact of climate change. Very limited expropriation of private sector property without compensation, with some negative impact on the economy. Substantial fiscal consolidation ultimately occurs, preventing ratings falling into the C grades.

		Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
Severe	USD/Rand (average)	15.21	15.59	17.60	18.00	18.30	18.50	18.60	19.00
down	Repo rate (end rate)	4.25	4.75	7.50	8.00	9.00	10.00	10.50	10.50

case **9%**

Lengthy global recession, global financial crisis – insufficient monetary and other support domestically and internationally. Limited expropriation of private property without compensation with a marked negative economic impact. Very high inflation on very adverse weather conditions, severe rand weakness. SA rated single B from all three key agencies, downgrades eventually into CCC grade, increased risk of default. Government borrows from increasingly wider sources, sinks deeper into a debt trap, widespread, severe services load shedding, severe civil and political unrest. SA economy in depression. Failure to transition to renewable energy and to sufficient measures to alleviate the impact of climate change on the economy.

Note: Event risk begins Q3.22. Source: Investec

Lite Down Case: Exchange Rate forecasts

	2022				2023				2024			
	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23	Q1.24	Q2.24	Q3.24	Q4.24
USD/ZAR	15.21	15.59	17.25	17.40	17.70	17.80	17.70	17.90	18.10	18.20	18.20	18.00
GBP/ZAR	20.40	19.59	20.61	20.71	21.15	21.45	21.68	22.38	23.17	23.66	24.57	24.84
EUR/ZAR	17.07	16.60	17.60	17.75	18.23	18.69	18.94	19.51	20.27	20.93	21.48	22.14
ZAR/JPY	7.65	8.33	7.92	7.67	7.40	7.25	7.18	7.01	6.80	6.48	6.32	6.11
CHFZAR	16.47	16.15	17.83	18.11	18.60	18.88	18.75	18.85	19.89	20.00	20.00	19.78
AUDZAR	11.02	11.14	11.94	12.18	12.66	13.17	13.36	13.69	14.12	14.20	14.20	14.04
GBP/USD	1.34	1.26	1.20	1.19	1.20	1.21	1.23	1.25	1.28	1.30	1.35	1.38
EUR/USD	1.12	1.06	1.02	1.02	1.03	1.05	1.07	1.09	1.12	1.15	1.18	1.23
USD/JPY	116	130	137	134	131	129	127	126	123	118	115	110

Note: averages, Source: Investec, Iress

Severe Down Case: Exchange Rate forecasts												
	2022				2023				2024			
	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23	Q1.24	Q2.24	Q3.24	Q4.24
USD/ZAR	15.21	15.59	17.60	18.00	18.30	18.50	18.60	19.00	19.30	19.40	19.30	19.30
GBP/ZAR	20.40	19.59	21.03	21.42	21.87	22.29	22.79	23.75	24.70	25.22	26.06	26.63
EUR/ZAR	17.07	16.60	17.95	18.36	18.85	19.43	19.90	20.71	21.62	22.31	22.77	23.74
ZAR/JPY	7.65	8.33	7.76	7.42	7.16	6.97	6.83	6.61	6.37	6.08	5.96	5.70
CHFZAR	16.47	16.15	18.20	18.73	19.23	19.62	19.71	20.01	21.21	21.32	21.21	21.21
AUDZAR	11.02	11.14	12.18	12.60	13.08	13.69	14.04	14.54	15.05	15.13	15.05	15.05
GBP/USD	1.34	1.26	1.20	1.19	1.20	1.21	1.23	1.25	1.28	1.30	1.35	1.38
EUR/USD	1.12	1.06	1.02	1.02	1.03	1.05	1.07	1.09	1.12	1.15	1.18	1.23
USD/JPY	116	130	137	134	131	129	127	126	123	118	115	110
Note: averages, Source: Investec, Iress												

Up Case: Exchange Rate forecasts												
	2022				2023				2024			
	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23	Q1.24	Q2.24	Q3.24	Q4.24
USD/ZAR	15.21	15.59	17.00	16.00	15.30	15.00	14.70	14.60	14.40	14.90	15.40	14.90
GBP/ZAR	20.40	19.59	20.32	19.04	18.28	18.08	18.01	18.25	18.43	19.37	20.79	20.56
EUR/ZAR	17.07	16.60	17.34	16.32	15.76	15.75	15.73	15.91	16.13	17.14	18.17	18.33
ZAR/JPY	7.65	8.33	8.04	8.34	8.56	8.60	8.64	8.60	8.54	7.92	7.47	7.38
CHFZAR	16.47	16.15	17.58	16.65	16.08	15.91	15.57	15.38	15.82	16.37	16.92	16.37
AUDZAR	11.02	11.14	11.77	11.20	10.94	11.10	11.10	11.17	11.23	11.62	12.01	11.62
GBP/USD	1.34	1.26	1.20	1.19	1.20	1.21	1.23	1.25	1.28	1.30	1.35	1.38
EUR/USD	1.12	1.06	1.02	1.02	1.03	1.05	1.07	1.09	1.12	1.15	1.18	1.23
USD/JPY	116	130	137	134	131	129	127	126	123	118	115	110
Note averages, Source: Investec, Iress												

Extreme Up Case: Exchange Rate forecasts												
	2022				2023				2024			
	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23	Q1.24	Q2.24	Q3.24	Q4.24
USD/ZAR	15.21	15.59	16.80	15.40	14.50	14.00	13.60	13.40	13.30	13.10	13.10	12.90
GBP/ZAR	20.40	19.59	20.08	18.33	17.33	16.87	16.66	16.75	17.02	17.03	17.69	17.80
EUR/ZAR	17.07	16.60	17.14	15.71	14.94	14.70	14.55	14.61	14.90	15.07	15.46	15.87
ZAR/JPY	7.65	8.33	8.13	8.67	9.03	9.21	9.34	9.37	9.25	9.01	8.78	8.53
CHFZAR	16.47	16.15	17.37	16.03	15.24	14.85	14.41	14.11	14.62	14.40	14.40	14.18
AUDZAR	11.02	11.14	11.63	10.78	10.37	10.36	10.27	10.25	10.37	10.22	10.22	10.06
GBP/USD	1.34	1.26	1.20	1.19	1.20	1.21	1.23	1.25	1.28	1.30	1.35	1.38
EUR/USD	1.12	1.06	1.02	1.02	1.03	1.05	1.07	1.09	1.12	1.15	1.18	1.23
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