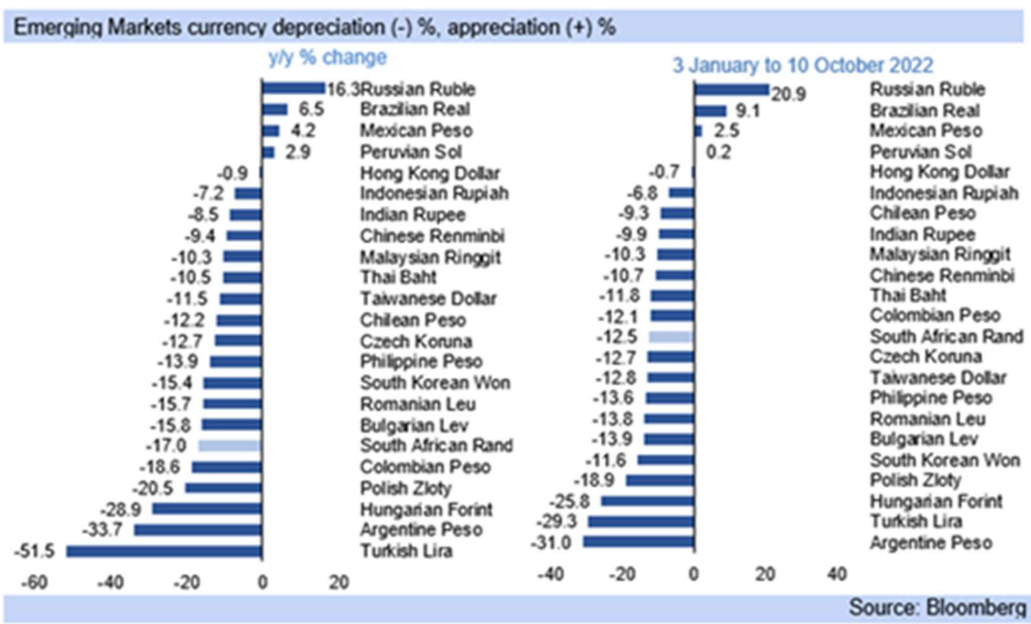
Investec | Out of the Ordinary

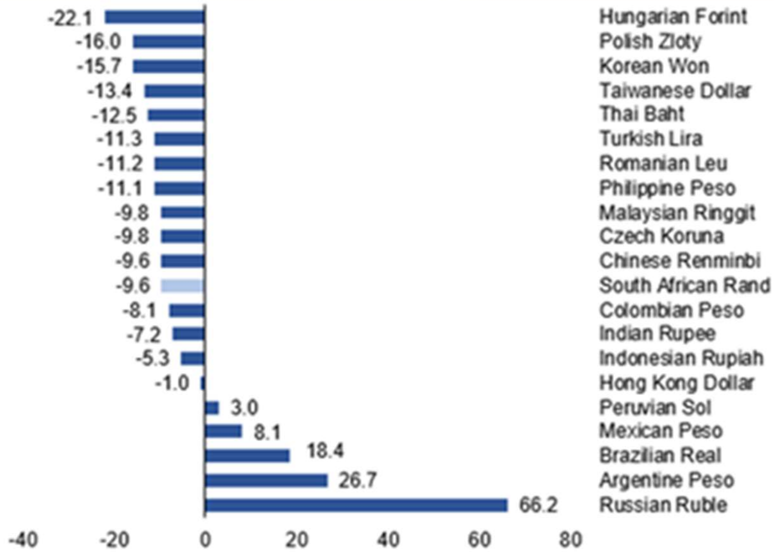
SA Economics

Monday 10 October 2022

Rand note: the rand continues to track weaker on the lengthy hawkish communication from the Fed

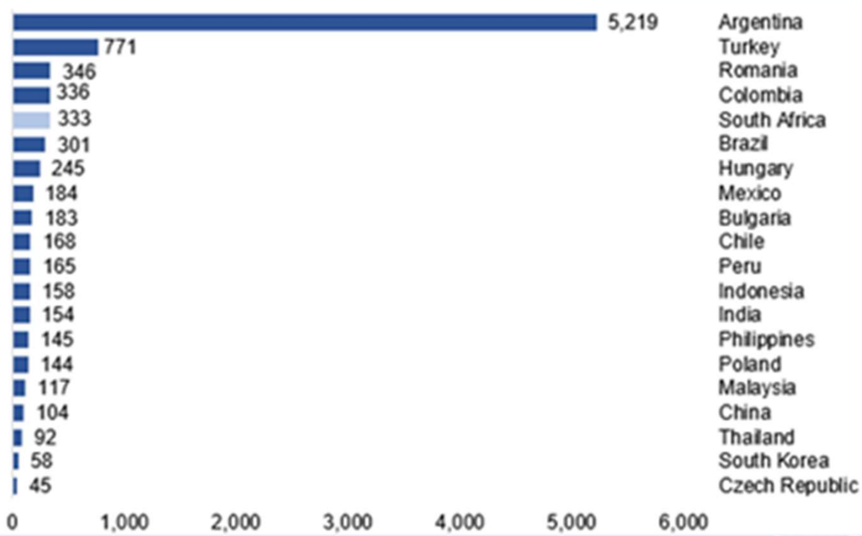


Emerging Markets Carry Return – values 10 October 2022



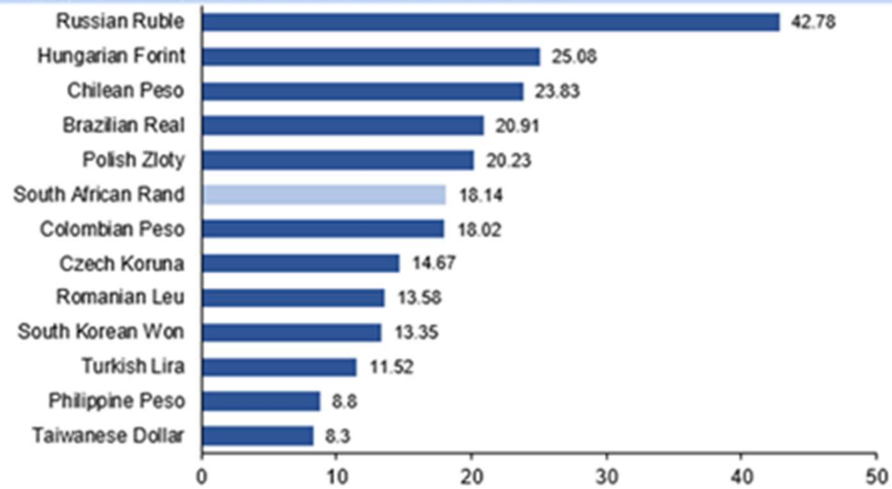
Source: Bloomberg

Emerging Markets CDS (risk) Spreads – values 10 October 2022



Source: Bloomberg

Emerging Markets Implied Volatilities – values 10 October 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	17.05	17.30	17.60	17.40	17.00	16.90	16.70	17.20	17.70	17.20
GBP/ZAR	20.40	19.59	20.06	17.73	17.95	18.36	18.53	19.10	19.71	21.50	23.36	23.74
EUR/ZAR	17.07	16.60	17.16	16.95	17.78	18.18	18.19	18.42	18.70	19.78	20.89	21.16
ZAR/JPY	7.65	8.33	8.12	8.21	7.90	7.84	7.85	7.75	7.66	6.98	6.50	6.40
CHFZAR	16.47	16.16	17.64	17.12	17.95	18.27	18.01	17.80	17.96	18.90	19.45	18.90
AUDZAR	11.02	11.14	11.65	11.42	12.06	12.44	12.58	12.84	13.03	13.42	13.81	13.42
GBP/USD	1.34	1.26	1.18	1.03	1.02	1.06	1.09	1.13	1.18	1.25	1.32	1.38
EUR/USD	1.12	1.06	1.01	0.98	1.01	1.05	1.07	1.09	1.12	1.15	1.18	1.23
USD/JPY	116	130	138	142	139	137	134	131	128	120	115	110

Note: averages, Source: Investec, Iress

- The rand reached R18.24/USD today on a continued escalation in risk aversion, the weakest point against the greenback this year, and only around a rand stronger than the historic weak point in April 2020, as the US dollar continues to climb to its high of the early 2000s.
- Risk aversion elevated in 2000 in global financial markets on the collapse of the dot-com bubble, which together with 9/11 and higher interest rates, drove US recession in 2001, prompting US fiscal stimulus of major tax cuts under the Bush administration.
- Y2K fears led to a boom in IT equipment purchases, stimulating the economy, which then saw a drop in stock markets in March 2000, causing the dot-com bubble to burst. At the same time, US CPI inflation rose to 3.8% y/y in March, and the core PCE deflator began increasing.
- The US hiked interest rates over 2000 to seek to contain inflation, which worsened economic conditions, with the cumulative effects resulting in a US recession from March to November 2001, exacerbating market risk-off and strengthening the US dollar on safe haven flows.
- Markets fear a US monetary policy misstep that aids the US economy into recession, with risk aversion elevating since April this year on the lengthy hawkish communication from

the Fed in the face of high inflation, well removed from its implicit inflation target of 2.0% y/y.

- In particular, insufficient monetary and other policy support measures are feared as Central Banks around the world are typically hiking interest rates, and plan to go past the normalisation of monetary policy to tighten it in attempt to control very high rates of inflation.
- US dollar strength continues to see the rand weaker against the US dollar than against the euro, at R17.70/EUR today. Against the British pound, the rand is at R20.18/GBP, as the UK is in the process of repairing some communication misfires on fiscal policy recently.
- Markets have become jittery into this week as the US inflation figures are set for release, with a moderation expected in both US CPI and PPI headline inflation rates for September, although excluding food and energy the measures are expected unchanged to higher.
- Core measures of inflation are key to the Fed, including the PCE deflator e. September's US CPI excluding food and energy is expected to accelerate by 6.5% y/y, from 6.3% y/y, which has worsened risk aversion levels. A higher print risks further rand depreciation.

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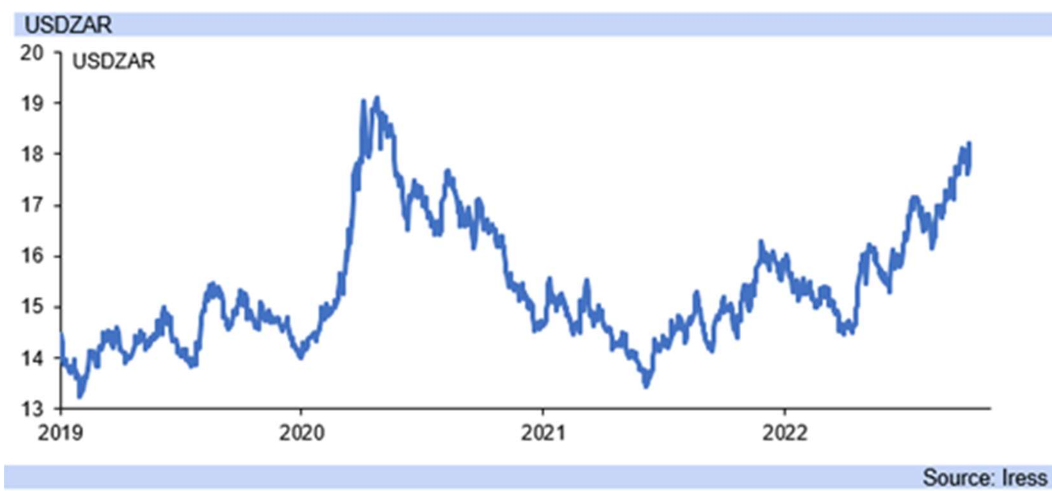
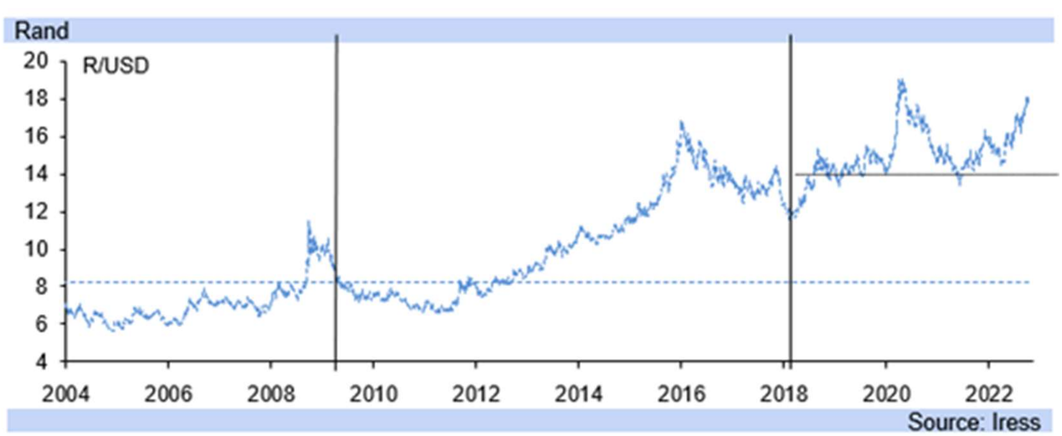
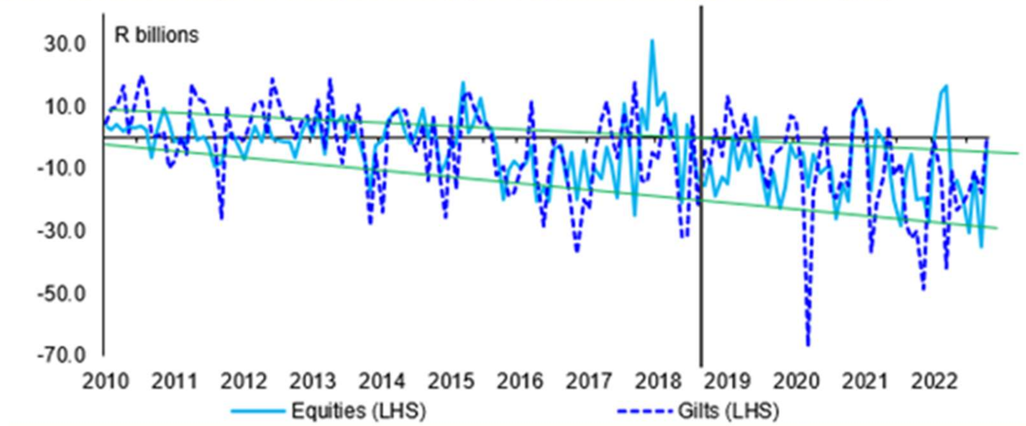


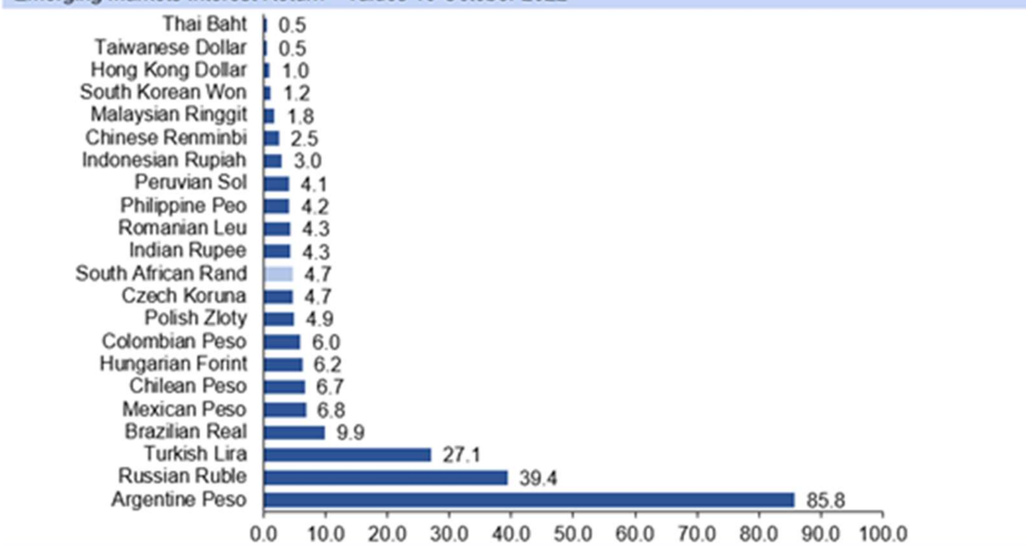


Volatile non-resident portfolio net purchases (+)/ sales (-) vs USD/ZAR (monthly averages)

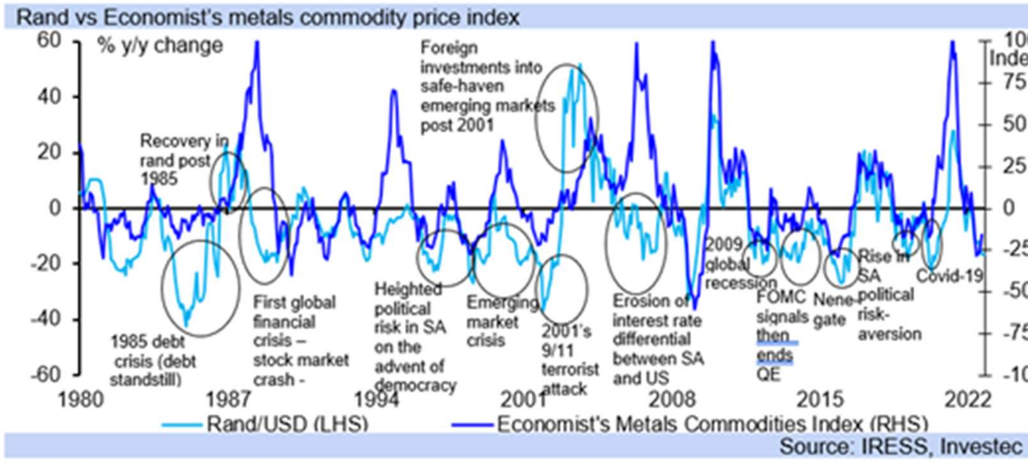


Source: Iress, Investec

Emerging Markets Interest Return – values 10 October 2022



Source: Bloomberg



- Last week saw the US employment rate drop on Friday. This increased market risk aversion levels further as expectations solidified for a 75bp hike in US interest rates at the next FOMC meeting on data indicating the US job market is still tight, exerting inflationary pressures.
- The pace of job creation did slow somewhat in September, with US non-farm payrolls dipping to an additional 263 000 new jobs from 315 000 in August, but below market expectations of 255 000, which added to the risk-off sentiment ensuing from a still buoyant labour market.
- US unemployment is at its pre-pandemic rate, which is the lowest rate since 1953. President Joe Biden is reported to have said that September jobs figures are "an encouraging sign" that the US economy is approaching "steady" growth.
- The US Central Bank will remain focused on curtailing inflation through slowing economic growth, with IMF research showing that the "recent sharp interest rate hikes by central banks are likely to help prevent high inflation expectations from becoming entrenched".
- October's World Economic Outlook (WEO) revealed that "IMF researchers studied 22 episodes of high inflation and falling real wages in advanced economies over the past 50 years and found most subsided quickly."
- Adding "sustained wage-price spirals are historically rare". "Risks of a sustained wage-price spiral appear limited since underlying inflation shocks come from outside the labor market and monetary policy is tightening aggressively."
- "Wage hikes over the past two years were driven by production capacity and labor supply shocks, while prices were driven up largely by a build-up of private savings and the release of pent-up demand as the pandemic eased".
- The implied Fed Funds futures have priced in a 74bp hike for November's FOMC meeting now, from a 68bp hikea week ago, and 52bp lift for December, up from 46bp expected for December (a week ago). Financial markets remain highly sensitive to key US economic data.
- The rand will consequently remain vulnerable to weakness, as well as some volatility this quarter, led by US data releases and FOMC members commentary, although towards year end the tone of FOMC hawkishness is expected to ease somewhat.

Economic Scenarios: note updated probabilities

Extreme Up case 1%

	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
USD/Rand (average)	15.21	15.59	17.05	15.40	14.50	14.00	13.60	13.40
Repo rate (end rate)	4.25	4.75	6.25	5.25	4.25	3.75	3.75	3.50

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.

Up case 1%

	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
USD/Rand (average)	15.21	15.59	17.05	16.00	15.30	15.00	14.70	14.60
Repo rate (end rate)	4.25	4.75	6.25	5.50	4.75	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.

Base case 48%

	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
USD/Rand (average)	15.21	15.59	17.05	17.30	17.60	17.40	17.00	16.90
Repo rate (end rate)	4.25	4.75	6.25	7.00	7.50	7.50	7.25	7.00

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.

Lite (domestic) Down case 39%

	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
USD/Rand (average)	15.21	15.59	17.05	17.40	17.70	17.80	17.70	17.90
Repo rate (end rate)	4.25	4.75	6.25	7.50	8.00	8.50	9.00	9.00

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.

Severe down case 11%

	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
USD/Rand (average)	15.21	15.59	17.05	18.00	18.30	18.50	18.60	19.00
Repo rate (end rate)	4.25	4.75	6.25	8.00	9.00	10.00	10.50	10.50

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. Failure to transition to renewable energy and to sufficient measures to alleviate the impact of climate change on the economy.

Note: Event risk begins Q4.22. 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	17.05	17.40	17.70	17.80	17.70	17.90	18.10	18.20	18.20	18.00
GBP/ZAR	20.40	19.59	20.06	17.84	18.05	18.78	19.29	20.23	21.36	22.75	24.02	24.84
EUR/ZAR	17.07	16.60	17.16	17.05	17.88	18.60	18.94	19.51	20.27	20.93	21.48	22.14
ZAR/JPY	7.65	8.33	8.12	8.16	7.85	7.67	7.54	7.32	7.07	6.59	6.32	6.11
CHFZAR	16.47	16.16	17.64	17.22	18.05	18.69	18.75	18.85	19.46	20.00	20.00	19.78
AUDZAR	11.02	11.14	11.65	11.48	12.12	12.73	13.10	13.60	14.12	14.20	14.20	14.04
GBP/USD	1.34	1.26	1.18	1.03	1.02	1.06	1.09	1.13	1.18	1.25	1.32	1.38
EUR/USD	1.12	1.06	1.01	0.98	1.01	1.05	1.07	1.09	1.12	1.15	1.18	1.23
USD/JPY	116	130	138	142	139	137	134	131	128	120	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	17.05	18.00	18.30	18.50	18.60	19.00	19.30	19.40	19.30	19.30
GBP/ZAR	20.40	19.59	20.06	18.45	18.67	19.52	20.27	21.47	22.77	24.25	25.48	26.63
EUR/ZAR	17.07	16.60	17.16	17.64	18.48	19.33	19.90	20.71	21.62	22.31	22.77	23.74
ZAR/JPY	7.65	8.33	8.12	7.89	7.60	7.38	7.18	6.89	6.63	6.19	5.96	5.70
CHFZAR	16.47	16.16	17.64	17.82	18.66	19.43	19.71	20.01	20.75	21.32	21.21	21.21
AUDZAR	11.02	11.14	11.65	11.88	12.54	13.23	13.76	14.44	15.05	15.13	15.05	15.05
GBP/USD	1.34	1.26	1.18	1.03	1.02	1.06	1.09	1.13	1.18	1.25	1.32	1.38
EUR/USD	1.12	1.06	1.01	0.98	1.01	1.05	1.07	1.09	1.12	1.15	1.18	1.23
USD/JPY	116	130	138	142	139	137	134	131	128	120	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	17.05	16.00	15.30	15.00	14.70	14.60	14.50	14.90	15.00	14.50
GBP/ZAR	20.40	19.59	20.06	16.40	15.61	15.83	16.02	16.50	17.11	18.63	19.80	20.01
EUR/ZAR	17.07	16.60	17.16	15.68	15.45	15.68	15.73	15.91	16.24	17.14	17.70	17.84
ZAR/JPY	7.65	8.33	8.12	8.88	9.08	9.10	9.08	8.97	8.83	8.05	7.67	7.59
CHFZAR	16.47	16.16	17.64	15.84	15.60	15.75	15.57	15.38	15.59	16.37	16.48	15.93
AUDZAR	11.02	11.14	11.65	10.56	10.48	10.73	10.88	11.10	11.31	11.62	11.70	11.31
GBP/USD	1.34	1.26	1.18	1.03	1.02	1.06	1.09	1.13	1.18	1.25	1.32	1.38
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USD/JPY	116	130	138	142	139	137	134	131	128	120	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	17.05	15.40	14.50	14.00	13.60	13.40	13.30	13.10	13.10	12.90
GBP/ZAR	20.40	19.59	20.06	15.79	14.79	14.77	14.82	15.14	15.69	16.38	17.29	17.80
EUR/ZAR	17.07	16.60	17.16	15.09	14.65	14.63	14.55	14.61	14.90	15.07	15.46	15.87
ZAR/JPY	7.65	8.33	8.12	9.22	9.59	9.75	9.82	9.78	9.62	9.16	8.78	8.53
CHFZAR	16.47	16.16	17.64	15.24	14.79	14.70	14.41	14.11	14.30	14.40	14.40	14.18
AUDZAR	11.02	11.14	11.65	10.16	9.93	10.01	10.06	10.18	10.37	10.22	10.22	10.06
GBP/USD	1.34	1.26	1.18	1.03	1.02	1.06	1.09	1.13	1.18	1.25	1.32	1.38
EUR/USD	1.12	1.06	1.01	0.98	1.01	1.05	1.07	1.09	1.12	1.15	1.18	1.23
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