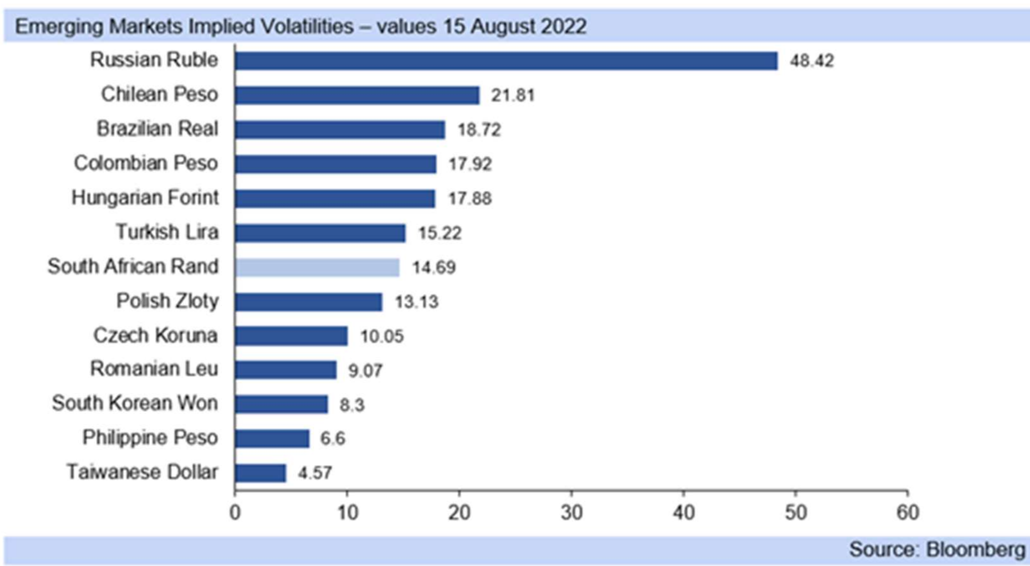
Investec | Out of the Ordinary

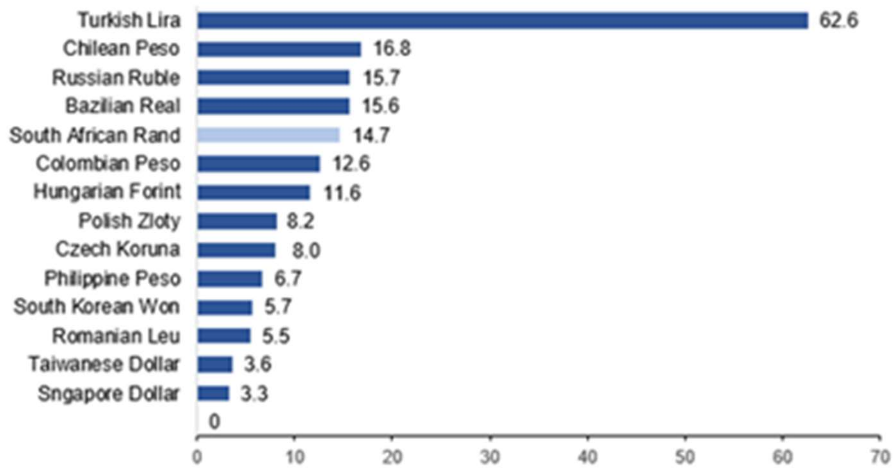
SA Economics

Monday 15 August 2022

Rand note: risk assets remain data dependent, including EM currencies

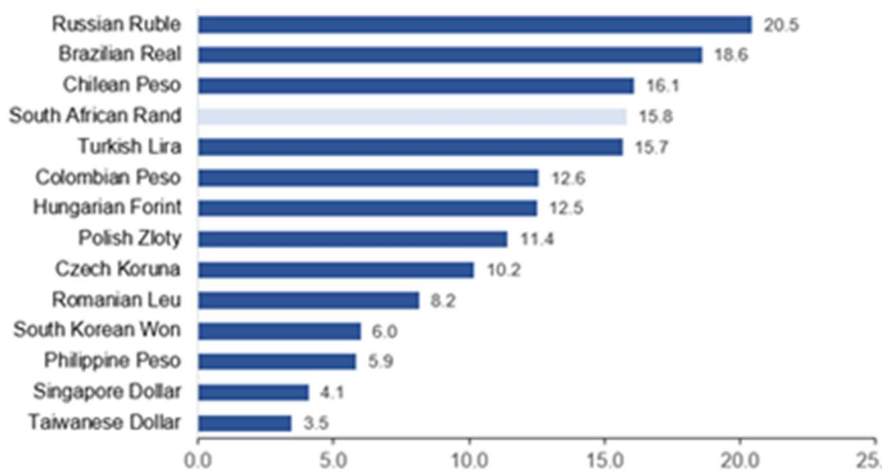


Emerging Markets Implied Volatilities – values 10 January 2022

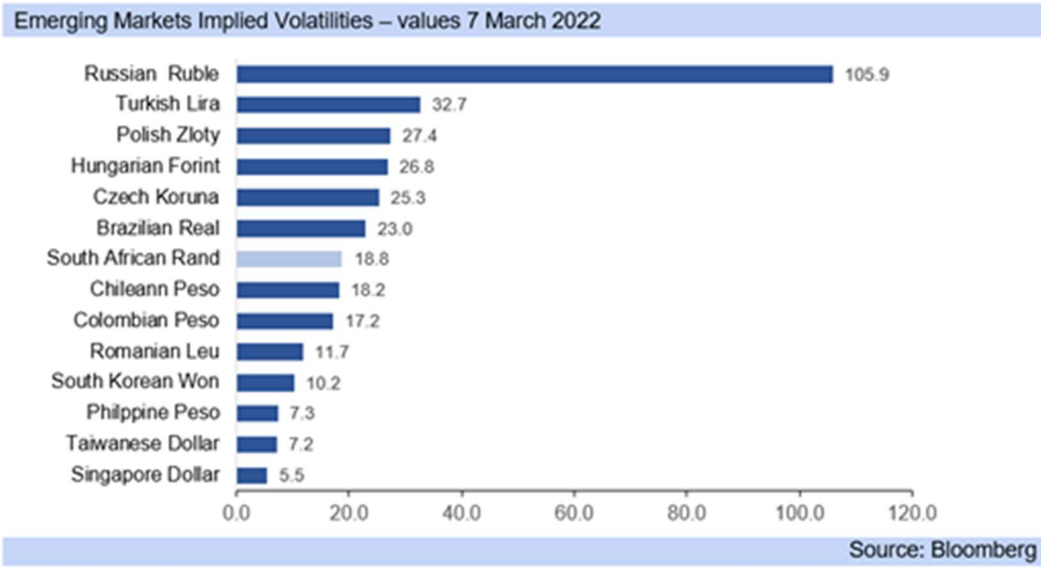


Source: Bloomberg

Emerging Markets Implied Volatilities – values 14 February 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	16.60	15.80	15.60	16.00	16.40	15.90	15.70	16.20	16.70	16.20
GBP/ZAR	20.40	19.59	19.87	18.80	18.64	19.28	20.09	19.88	20.10	21.06	22.55	22.36
EUR/ZAR	17.07	16.60	16.88	16.35	16.48	16.96	17.55	17.33	18.06	19.12	20.04	19.93
ZAR/JPY	7.65	8.33	8.32	8.70	8.49	8.06	7.74	7.89	7.83	7.28	6.89	6.79
CHFZAR	16.47	16.15	17.47	16.81	16.77	17.39	18.02	17.47	17.25	17.80	18.35	17.80
AUDZAR	11.02	11.14	11.50	11.06	11.15	12.00	12.55	12.00	12.25	12.64	13.03	12.64
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	1.04	1.06	1.06	1.07	1.09	1.15	1.18	1.20	1.23
USD/JPY	116	130	138	138	133	129	127	126	123	118	115	110

Note: averages, Source: Investec, Iress

- After strengthening to R16.16/USD by Friday, the rand has weakened somewhat, to R16.40/USD today, remaining influenced by international data releases, with weakness from China's economy apparent in July on the effect of its zero COVID policy restrictions.
- With China the world's second largest economy, a skew towards weaker growth outcomes as inflation has been slow to subside globally, if at all in some areas, has seen market risk aversion lift at the start of this week. High data sensitivity is likely to persist this year.
- The rand is at a weak level above R16.00/USD, and is likely to strengthen below R16.00/USD by the end of this year. It currently averages R16.75/USD for the first half of Q3.22, but likely to drop down towards R16.00/USD, if not stronger by the end of this quarter.
- The second and third quarters of the year tend to be risk averse quarters for global financial markets, while September/October usually sees increased risk taking, which benefits the rand and other EM currencies, as well as EM portfolio assets, and other risk assets.
- That is, the rand tends to strengthen in the fourth quarter of the year as key market players reposition for higher risk/reward, while the middle two quarters are usually weak quarters for the rand on thin market trading which exacerbates sensitivity to risk.

- The volatility of the rand is still lower than a number of other EM countries, running closer to the middle of the Bloomberg basket than at the high end as it did in Q1.22, and generally EM currency volatility is higher than they were in Q1.22, reflecting elevated risk.
- The risk is tilted towards slower economic growth this year, particularly in Q4.22 and H1.23, and this could see the rand not make as markedly substantial gains as it usually does in the first and last quarters of the year on seasonal influences.
- There is increased global synchronisation on interest rate hikes (and acceleration in these hikes), which is adding to risk-on in financial market sentiment on global growth concerns, and so the current heightened risk sensitive environment.
- Uncertainty heightens risk aversion, which has added to the momentum in the rand's depreciation from R14.53/USD at the start of Q2.22, to a weak point of R17.26/USD a few weeks ago. The rand is expected to see strength into, and over Q4.22, but risks remain.

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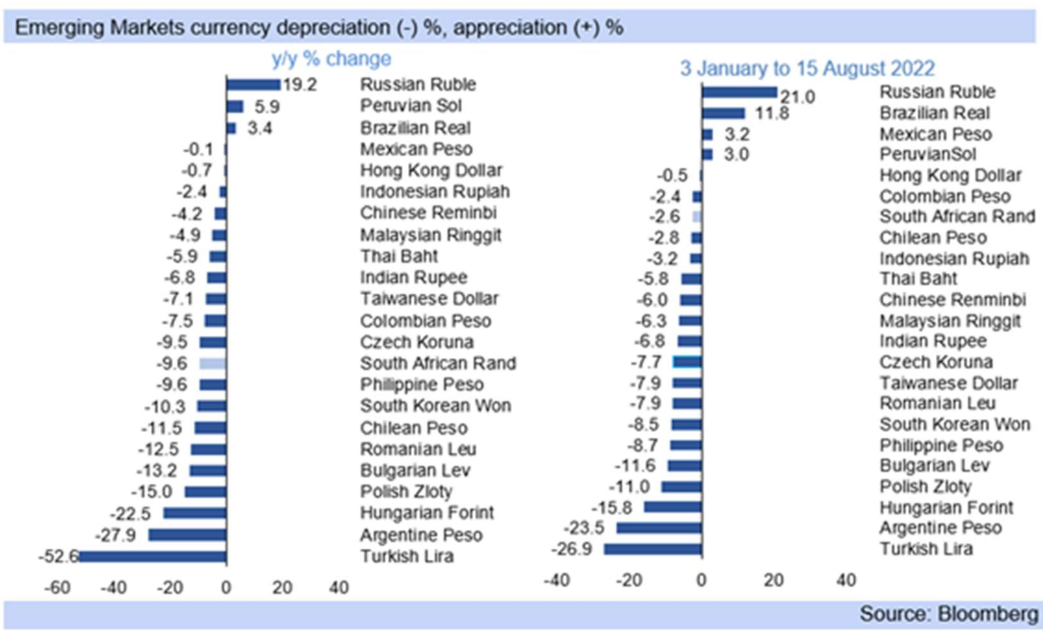
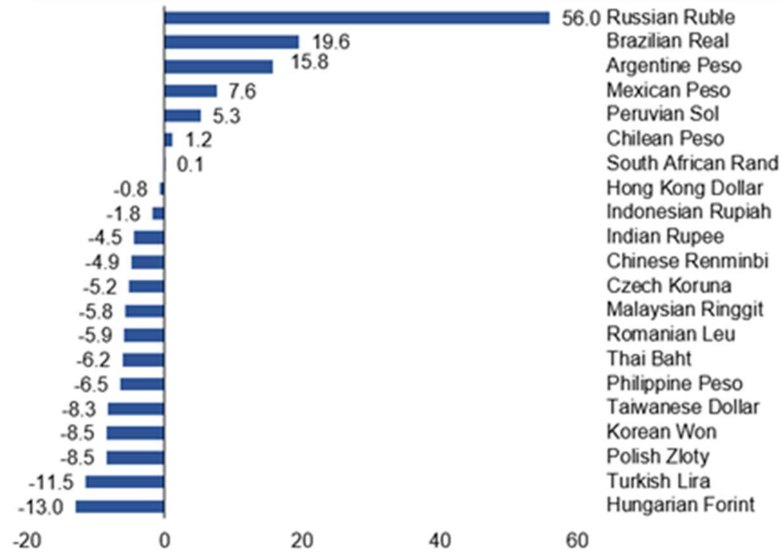
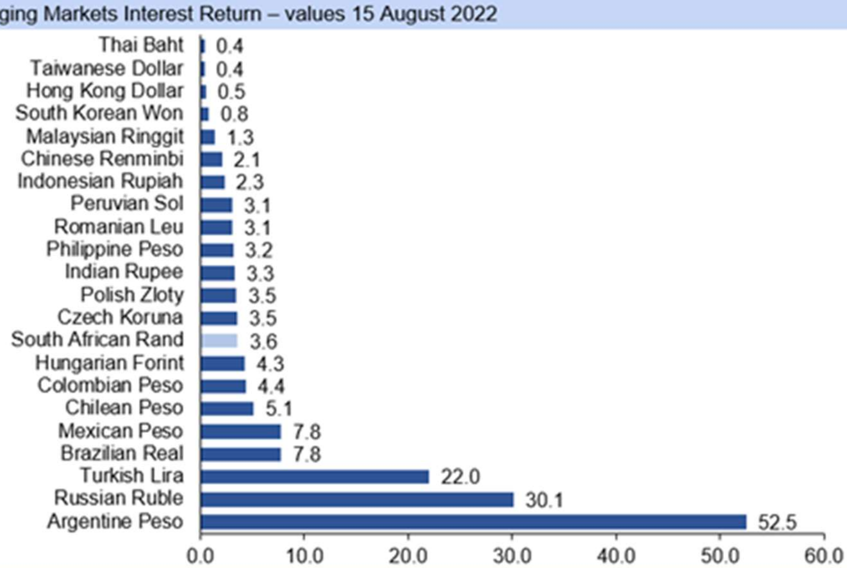


Emerging Markets Carry Return – values 15 August 2022



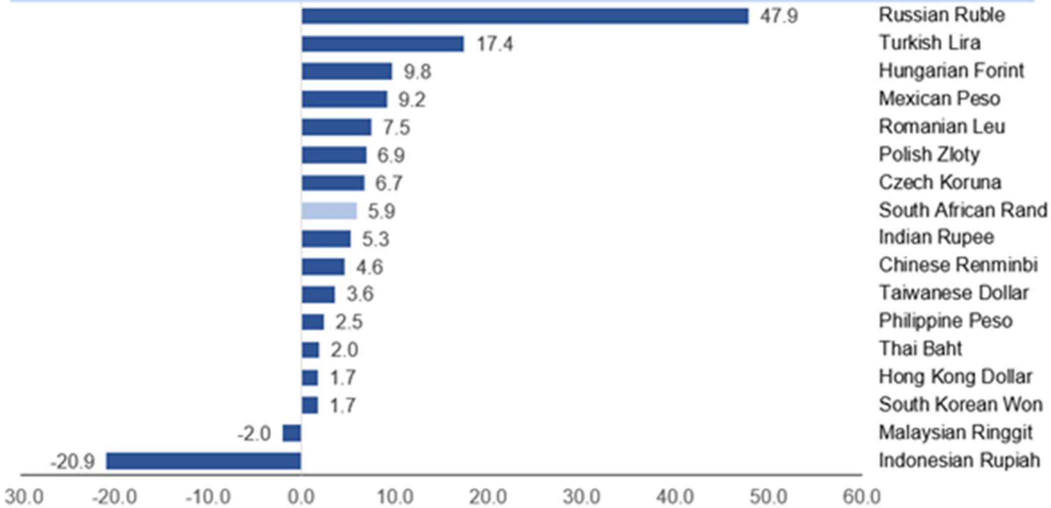
Source: Bloomberg

Emerging Markets Interest Return – values 15 August 2022



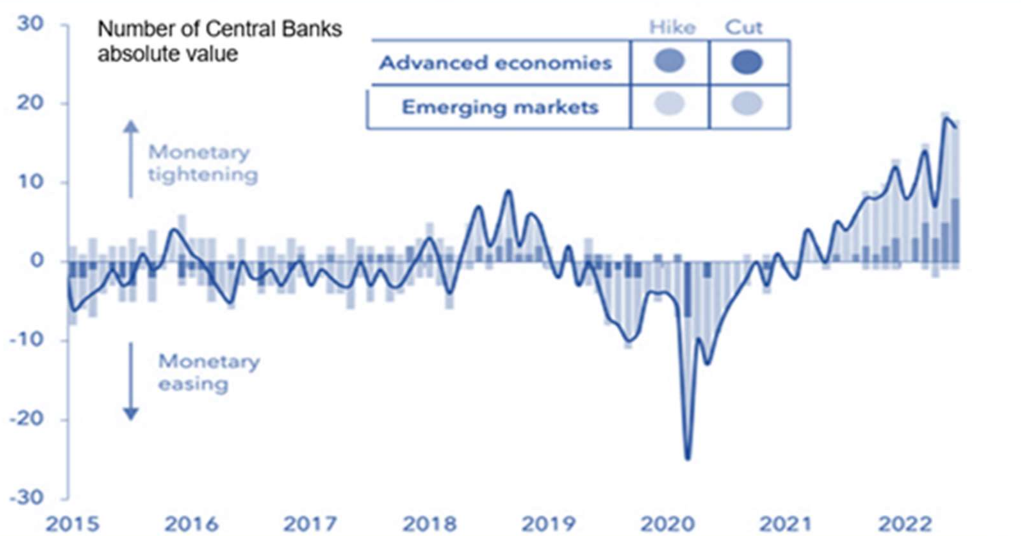
Source: Bloomberg

Emerging Markets Implied Rates – values 15 August 2022



Source: Bloomberg

Hiking Peak – the number of central banks hiking interest rates has increased dramatically in recent months as inflation rose to fresh highs



Source: IMF

- The focus in advanced economies, and in most emerging markets remains price stability, with inflation risks still seen to the upside, and the IMF warns “central banks must continue normalizing to prevent inflationary pressures from becoming entrenched”.
- A rapid normalisation of monetary policy, i.e. hiking interest rates to neutral levels which are levels that do not stimulate economic activity, nor impede it, is seen as the best case for economic growth in the US, with interest rates expected higher there in order to slow activity.
- Currently 2023 is expected to see US interest rates exceed the neutral mark in the US dot plot graph, while markets are divided over whether a 50bp or 75bp hike will occur at the September FOMC meeting, which is adding to market uncertainty.

- "The IMF adds that for Central Banks there is a “need to act resolutely to bring inflation back to their target, avoiding a de-anchoring of inflation expectations that would damage credibility built over the past decades.”
- “Monetary policy can’t resolve remaining pandemic-related bottlenecks in global supply chains and disruptions in commodities markets due to the war in Ukraine. It can however slow overall demand to address demand-related inflationary pressures, so a tightening of financial conditions is the goal.”
- "The IMF also highlights that “(t)he outlook for the world economy has darkened and risks of recession are rising.” “Inflation is higher than expected and has broadened beyond food and energy prices.”
- “There is a substantial risk that high inflation becomes entrenched, and inflation expectations de-anchor. “In that event, central banks will have to be more resolute and tighten more aggressively to cool the economy, and unemployment will likely have to rise significantly.”
- “Amid signs of already poor liquidity, faster policy rate tightening may result in a further sharp decline in risk asset prices—affecting equities, credit, and emerging market assets. Yet restoring price stability is of paramount importance“.
- Higher interest rates are seen as the most likely outcome for the remainder of 2022, which will have a negative effect on economic growth expectations and on economic growth itself, causing market sensitivity to risk to persist, and so place a drag on the rand.

Economic Scenarios: note updated forecasts

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	14.00	13.80	13.70	13.60	13.40	13.30
Repo rate (end rate)	4.25	4.75	4.00	3.75	3.75	3.75	3.50	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	15.00	14.90	14.90	14.70	14.60	14.50
Repo rate (end rate)	4.25	4.75	4.50	4.25	4.00	4.00	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 50%

	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
USD/Rand (average)	15.21	15.59	16.60	15.80	15.60	16.00	16.40	15.90
Repo rate (end rate)	4.25	4.75	5.50	6.50	6.50	6.50	6.50	6.50

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.

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	16.90	17.00	17.50	17.60	17.50	17.70
Repo rate (end rate)	4.25	4.75	5.75	6.75	6.75	7.25	7.75	8.25

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 9%

	Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
USD/Rand (average)	15.21	15.59	17.50	18.00	18.30	18.50	18.60	19.00
Repo rate (end rate)	4.25	4.75	6.00	7.00	7.50	8.00	8.50	9.00

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	16.90	17.00	17.50	17.60	17.50	17.70	18.00	17.80	17.60	17.70
GBP/ZAR	20.40	19.59	20.23	20.23	20.91	21.21	21.44	22.13	23.04	23.14	23.76	24.43
EUR/ZAR	17.07	16.60	17.18	17.60	18.46	18.66	18.73	19.29	20.70	21.00	21.12	21.77
ZAR/JPY	7.65	8.33	8.17	8.09	7.57	7.33	7.26	7.09	6.83	6.63	6.53	6.21
CHFZAR	16.47	16.15	17.79	18.09	18.82	19.13	19.23	19.45	19.78	19.56	19.34	19.45
AUDZAR	11.02	11.14	11.71	11.90	12.51	13.20	13.39	13.36	14.04	13.88	13.73	13.81
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	1.04	1.06	1.06	1.07	1.09	1.15	1.18	1.20	1.23
USD/JPY	116	130	138	138	133	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	17.50	18.00	18.30	18.50	18.60	19.00	19.30	19.40	19.30	19.30
GBP/ZAR	20.40	19.59	20.94	21.42	21.87	22.29	22.79	23.75	24.70	25.22	26.06	26.63
EUR/ZAR	17.07	16.60	17.79	18.63	19.31	19.61	19.90	20.71	22.20	22.89	23.16	23.74
ZAR/JPY	7.65	8.33	7.89	7.64	7.24	6.97	6.83	6.61	6.37	6.08	5.96	5.70
CHFZAR	16.47	16.15	18.42	19.15	19.68	20.11	20.44	20.88	21.21	21.32	21.21	21.21
AUDZAR	11.02	11.14	12.12	12.60	13.08	13.88	14.23	14.35	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	1.04	1.06	1.06	1.07	1.09	1.15	1.18	1.20	1.23
USD/JPY	116	130	138	138	133	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	15.00	14.90	14.90	14.70	14.60	14.50	14.90	15.00	14.50	14.50
GBP/ZAR	20.40	19.59	17.95	17.73	17.81	17.71	17.89	18.13	19.07	19.50	19.58	20.01
EUR/ZAR	17.07	16.60	15.25	15.42	15.72	15.58	15.62	15.81	17.14	17.70	17.40	17.84
ZAR/JPY	7.65	8.33	9.21	9.23	8.89	8.78	8.70	8.66	8.26	7.87	7.93	7.59
CHFZAR	16.47	16.15	15.79	15.85	16.02	15.98	16.04	15.93	16.37	16.48	15.93	15.93
AUDZAR	11.02	11.14	10.39	10.43	10.65	11.03	11.17	10.95	11.62	11.70	11.31	11.31
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	1.04	1.06	1.06	1.07	1.09	1.15	1.18	1.20	1.23
USD/JPY	116	130	138	138	133	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	14.00	13.80	13.70	13.60	13.40	13.30	13.10	13.10	12.90	12.80
GBP/ZAR	20.40	19.59	16.76	16.42	16.37	16.39	16.42	16.63	16.77	17.03	17.42	17.66
EUR/ZAR	17.07	16.60	14.23	14.28	14.45	14.42	14.34	14.50	15.07	15.46	15.48	15.74
ZAR/JPY	7.65	8.33	9.87	9.96	9.67	9.49	9.48	9.44	9.39	9.01	8.91	8.59
CHFZAR	16.47	16.15	14.74	14.68	14.73	14.78	14.73	14.62	14.40	14.40	14.18	14.07
AUDZAR	11.02	11.14	9.70	9.66	9.80	10.20	10.25	10.04	10.22	10.22	10.06	9.98
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	1.04	1.06	1.06	1.07	1.09	1.15	1.18	1.20	1.23
USD/JPY	116	130	138	138	133	129	127	126	123	118	115	110

Note: averages, Source: Investec, Iress