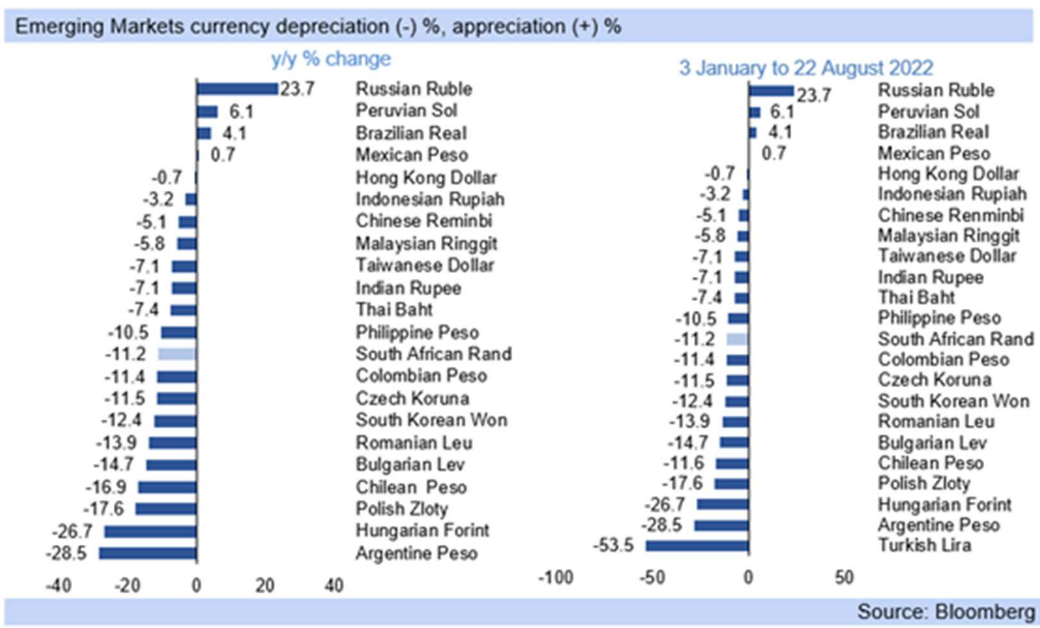
Investec | Out of the Ordinary

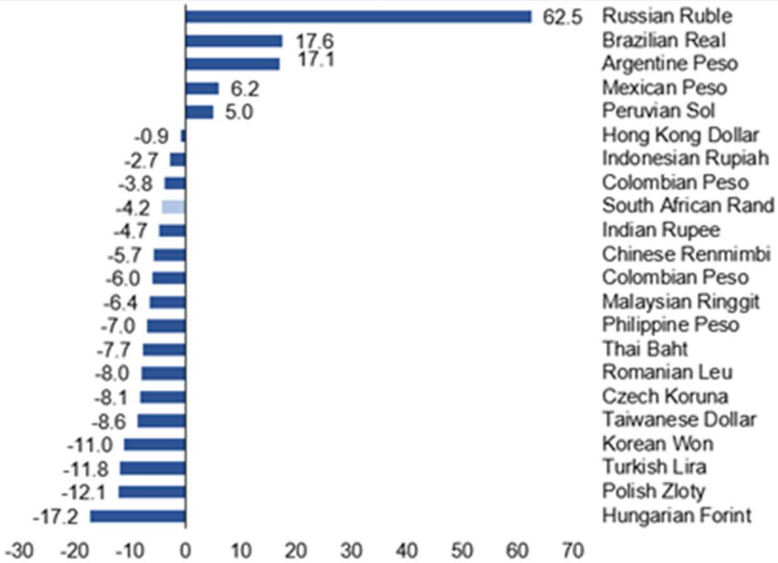
SA Economics

Monday 22 August 2022

Rand note: with global supply chains not bouncing back from the pandemic, and supply costs sticky, markets are still adjusting to stagflation

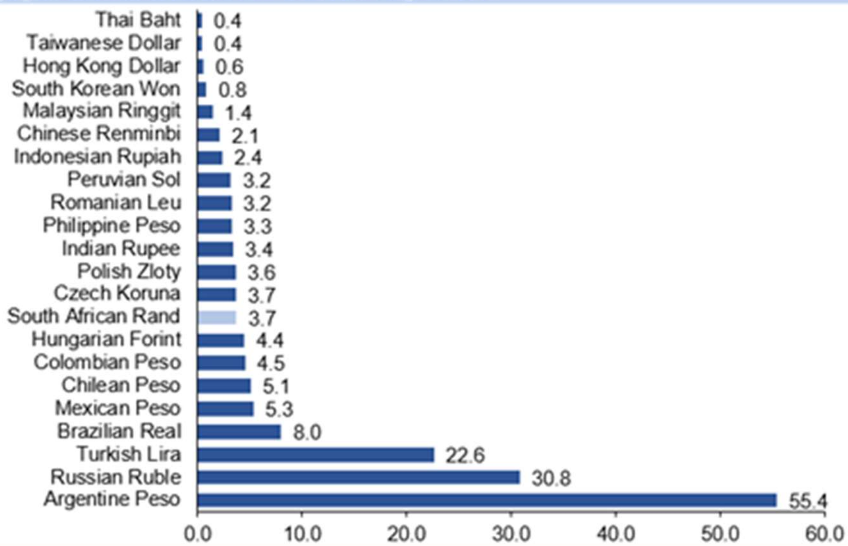


Emerging Markets Carry Return – values 22 August 2022



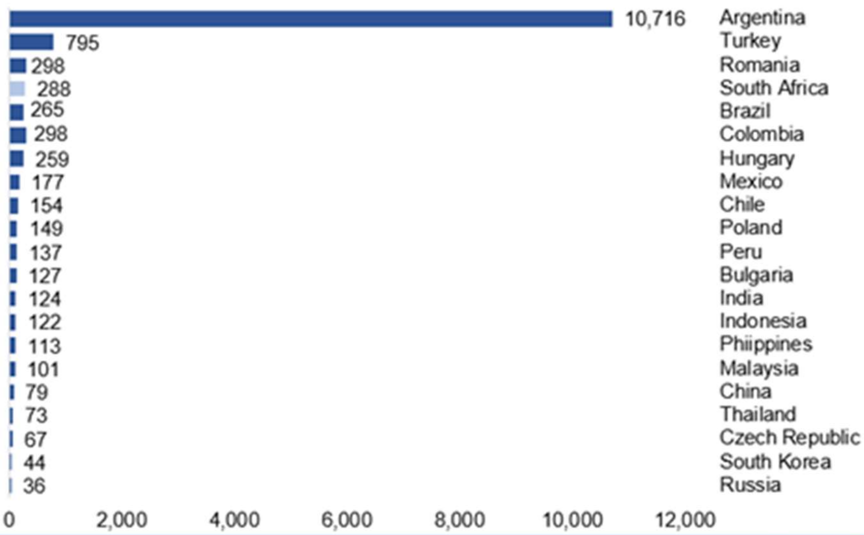
Source: Bloomberg

Emerging Markets Interest Return – values 22 August 2022



Source: Bloomberg

Emerging Markets CDS Spreads – values 22 August 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	16.46	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

- The rand breached R17.00/USD on Friday, losing ground over the course of last week against the US dollar as global economic growth concerns rose, while the dollar moved back to parity against the euro. The rand is now at virtually the same rate against the USD as EUR.
- That is, the rand is trading at R17.06/USD and R17.06/EUR, with the USD and EUR essentially valued equally following the dollar's run of strength last week, which accelerated in particular in the second half of the week on the publication of the US FOMC minutes.
- Against the euro, the rand has seen milder depreciation, but still apparent, as perceived risk assets such as equites, EM portfolio assets and EM currencies have weakened, along with commodity prices, as risk aversion has increased in global financial markets.
- Economic growth forecasts have become more negative across the board as the risk of global recession is seen to have risen, while slower global growth is seen as very likely, particularly on higher interest rates due to inflation concerns.
- The global inflation surprise, as the IMF puts it, means global inflation has come out much higher, and persisted for longer, than was widely expected this year, with the US initially slow to hike interest rates, along with a number of other advanced economies.

- Supply chain constraints have not been overcome, nor have other supply side cost pressures, and the outlook has weakened, particularly over 2023, as Central Banks focus on tightening interest rates to avoid broad based inflationary pressures from becoming entrenched.
- However, risk assets focus particularly on growth expectations. Higher global interest rates, which are intended to slow economic growth, and so demand, materially, have a negative effect on the expected returns of risk assets, and so on the assets themselves.
- The FOMC minutes released in the middle of last week, but for the July meeting, already showed the FOMC was aware of the weakening in US activity, but also that the focus remained on controlling inflation, and so a further increase/s in the US rate hike cycle.
- The US dollar has consequently strengthened, buoyed also by increased safe haven flows into the US, weakening the rand against the USD; but there is also an element of outright rand weakness, which has occurred on investors increasing their switch out of risk assets.

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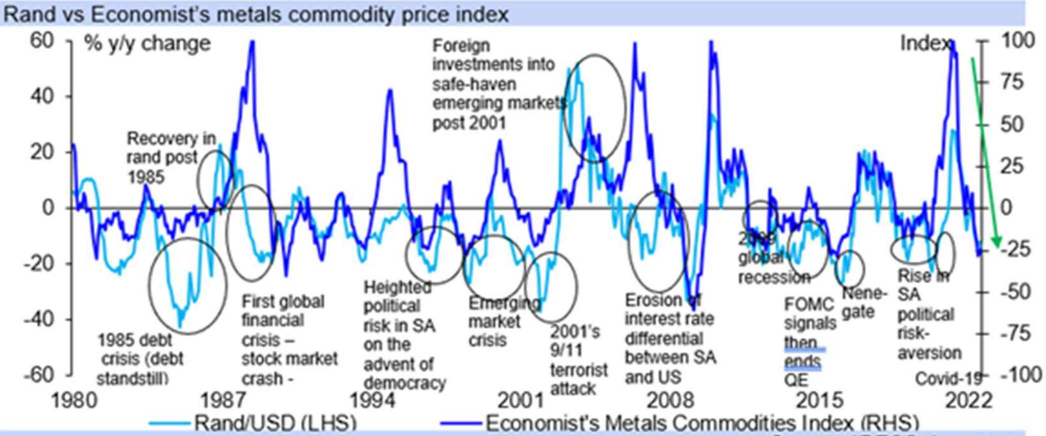
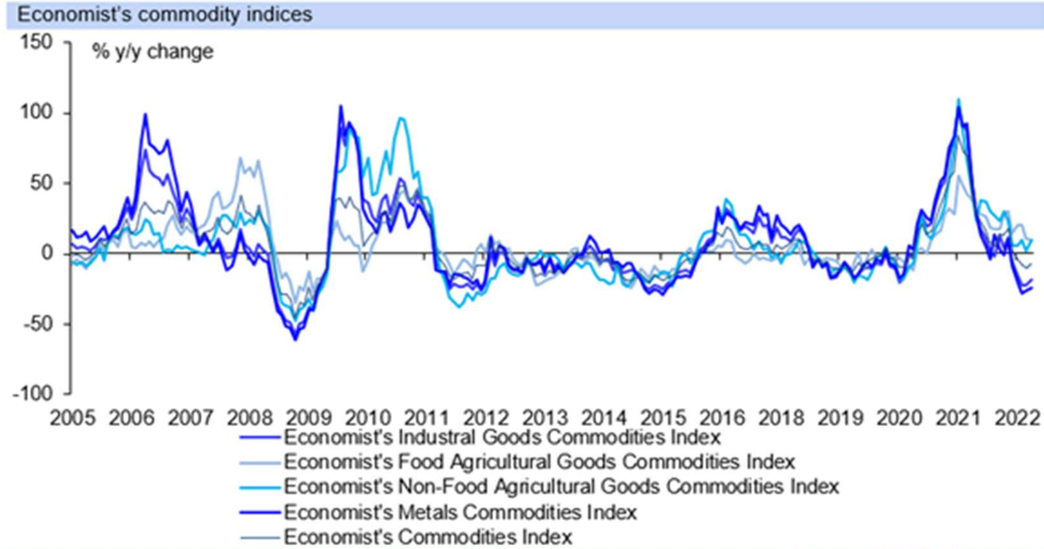
Rand vs Economist's metals commodity price index



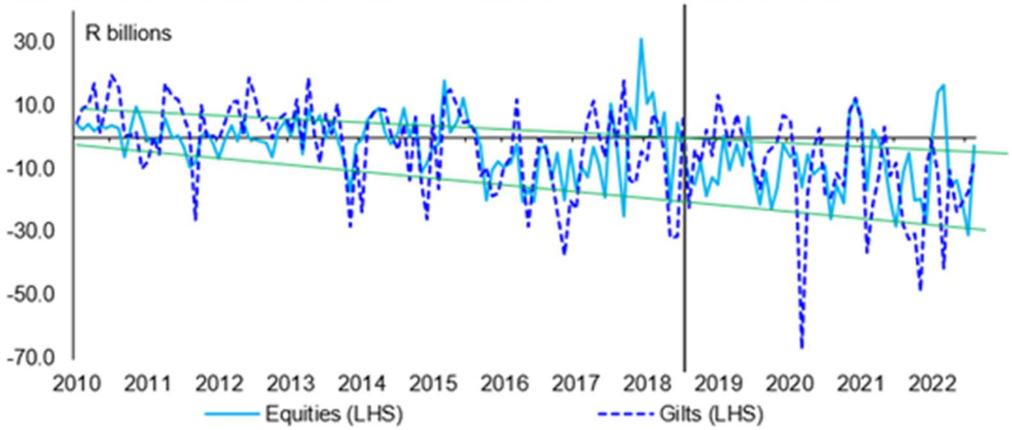
Source: IRESS, Investec

Economist's commodity indices



Source: IRESS, Economist

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



Source: Iress, Investec

Rand

Source: Iress

Emerging Markets Implied Volatilities – values 22 August 2022

Source: Bloomberg

- While there are some signs that inflationary pressures could moderate by slightly more than expected in 2022, it is still too soon to be able to be certain. However, fuel prices have dropped markedly, and food prices are moving in the right direction to support this.
- It should still be noted that fuel prices are higher compared to a year ago, which will support inflation to some extent as the headline measure is based on year on year changes, and so a collapse in inflation is not likely, just a moderation over H2.22.
- While the risk to inflation in the first half of 2022 was to the upside, the risk in the second half may well prove to be to the downside if international commodity prices maintain their moderation, which has occurred on slowing global demand.
- However, Central Banks are seeking to return inflation to their target ranges/points (official or unofficial in the case of the US), and so falling inflation on its own will not be enough to stop the rate hike cycles taking place in many areas of the world.
- While falling inflation (disinflation) is certainly a move in the right direction, it is not any guarantee of inflation targets being met, or of them rapidly being met, and monetary policy is mostly unanimous globally in calling for inflation rates to see a rapid return to targets.
- This is because, Central Banks worry that the longer inflation rates are removed from their targets, the more difficult it will be to get them back to within the target, as expectations of high inflation become entrenched by consumers, and the expectations self-fulfilling.
- Central Banks consequently are adopting hawkish tones in their communication on monetary policy to try and adjust expectations on inflation as well, and the FOMC is expected to strengthen its hawkish tone in the upcoming Jackson Hole meetings.
- Financial markets are adjusting to these communications, and data releases, with inflation expected to fall in H2.22, perhaps even slightly quicker than expected, but not to return to target by year end, which has heightened market concerns.
- Market players worry that Central Banks will be too harsh, hiking interest rates so that economies slow very sharply, risking, or causing the global economy to fall into recession, and with the US the world’s largest economy, it has yet to allay these concerns.

Economic Scenarios: note updated forecasts

Scenario		Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
Extreme Up case 1%	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.

Scenario		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	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.

Scenario		Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
Base case 50%	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.

Scenario		Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
Lite (domestic) Down case 39%	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.

Scenario		Q1.22	Q2.22	Q3.22	Q4.22	Q1.23	Q2.23	Q3.23	Q4.23
Severe down case 9%	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

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