Deutsche Securities
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27 September 2011

Global Markets Research

EM Special (South Africa)

Rand on the run? Not yet based on fundamentals

Economics

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The rand's performance over the past week has sparked some anxiety over its future direction. It may be premature to pin the rand's direction down right now, especially given the coordinated sell-off across most currencies against the dollar, which was followed by a small retracement over the past few days. However, we nevertheless investigate some of the fundamental factors. Our main conclusions are as follow:

- Based on our rand model, narrower EM growth differentials, reduced support from commodity prices, and flight to dollar quality, have turned the prospects towards a weaker rand exchange rate over the next few months compared to our previous view. These fundamentals are consistent with the rand trading at 7.50/USD by Q4, implying near-term strength from existing levels, and weakening to 8/USD by end 2012. This compares to our previous forecasts of 6.90 and 7.70 end-2011 and 2012, respectively.
- DB positioning indicators are showing that investors are still fairly neutral with no clear selling bias, or net short rand positions. While recent selling activity had been largely from leveraged accounts, there is clearly significant weakening potential ahead once real money funds start capitulating. The rand thus remains vulnerable to further deterioration in global risk sentiment.
- Compared to a basket of EM and commodity-based currencies, the rand's weakness may have been overdone, but this is not unusual for the rand. Importantly, the link between commodity prices and G7 industrial production has recently strengthened, and any further deterioration in G7 growth therefore implies that there may be more downside in commodity prices. As such, sustained pressure on the exchange rate cannot be ruled out.
- The overall picture of retreating commodity prices, much weaker growth in G7 economies and rising input costs suggests that export performance may not be bolstered as some may hope. G7 growth remains a far important driver of the trade balance. We have thus revised our CAD forecast to -3.7% of GDP for 2012 from -3.3% previously.
- On inflation, the direct impact of these revisions is marginal, with inflation expected to settle at 5.8% in 2012, though the short-term profile has been raised by 0.2ppts as a result of rand adjustments. In light of the SARB's preference for a market-determined exchange rate, we do not expect any undue intervention.

Our strategists maintain their neutral rand position for now, generally favouring defensive trades in EMEA FX.

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Rand in context

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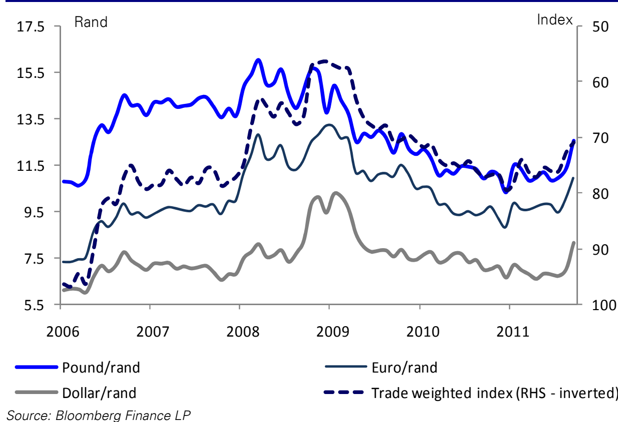
The rand has reached its worst levels in than two-and-a-half years against the dollar, and on a trade weighted level, the lowest since August 2009 (Figure 1). While nowhere near its weakest levels, it is no consolation given just how much unknown weakness may still lie ahead of us. Apart from the usually cited relationship with the euro/dollar, the local currency is being affected by heighted global risk aversion. Admittedly, the rand's near 25-30% overvaluation on PPP-metrics always made it vulnerable to a sharp correction. On a PPP-basis, when the rand reached 8.30/USD was still some 5% to 11% in overvalued territory.

Figure 1: Rand weakness in context

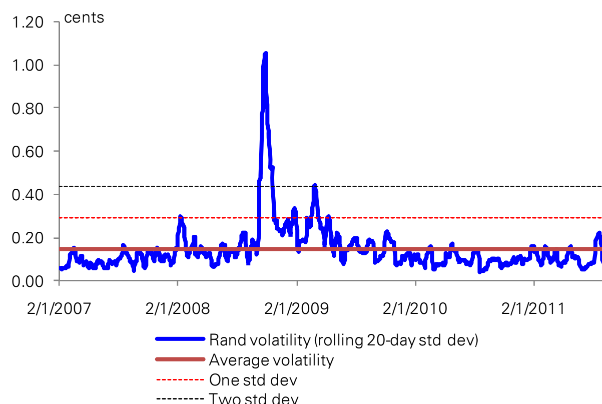


Source: Bloomberg Finance LP

The extent of the current risk-off mode, however, has seen a sharp spike in rand volatility, nearly two standard deviations above-average, which is usually where the currency enters oversold territory (March 2009), or stands the risk of seeing further upside (Oct 2008) (Figure 2).

It may be premature to pin the rand's direction down right now, especially given the coordinated sell-off across most currencies against the dollar, which was followed by a small retracement over the past few days. However, we find it constructive to evaluate a few fundamentals and positioning factors to assert whether the rand may be entering a weaker trading range against our previous call for between 6.90 and 7.20 in three and nine months' time.

Figure 2: Rand volatility at a critical level



Source: Deutsche Bank

Rand fundamentals: are the pillars of support buckling?

In our note published in May (*EM Special (South Africa): Sizing up rand fundamentals: four pillars of support*) we noted that pressure on the rand would predominantly come from waning real long-term interest rate differentials, and a moderately stronger dollar (implied by the dollar index). At that stage, we also emphasised the importance of favourable EM growth differentials (proxied by the MSCI indices of EM and G7), and supportive commodity prices (implicit in our trade openness indicator) as the two main factors providing support for the rand in 2H11.

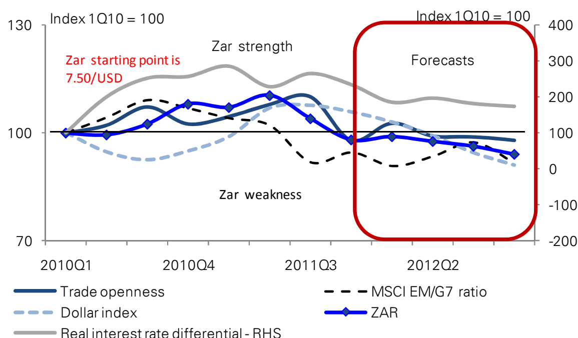
These dynamics have changed somewhat, as the flight to dollar quality has contributed to a much sharper increase in the dollar index than envisaged. Emerging markets have also become more sensitive to global growth revisions, with the latest sell-off in equities confirming the recoupling of growth cycles. While real interest rate fundamentals remain largely supportive of the rand (in respect of bond inflows), compared to our previous view, it could be insufficient to counter risk-driven weakness in the former three pillars.

- EM growth differentials, while still above the advanced world, have not kept up with our previous expectations. This is portrayed by the relative sell-off in EM stocks, which fell by 25% since August compared to 'only' 16% in G7 equities. As such, the growth differential in favour of EMs may be narrower than previously envisaged.
- Weaker commodity prices (see below) and downside risks to current global growth forecasts could elicit a much stronger response in emerging market growth,

which up to now has not been as sensitive to global growth revisions. This could, in turn, weaken the "commodity bias" that kept the rand well supported over the past two years.

In Figure 3, we illustrate these indicators based on latest developments. Fundamentals are consistent with the rand trading at 7.50/USD by Q4, weakening to 8/USD by end 2012, this compares to our previous forecasts of 6.90 and 7.70 end 2011 and 2012, respectively.

Figure 3: Rand fundamentals turning less upbeat



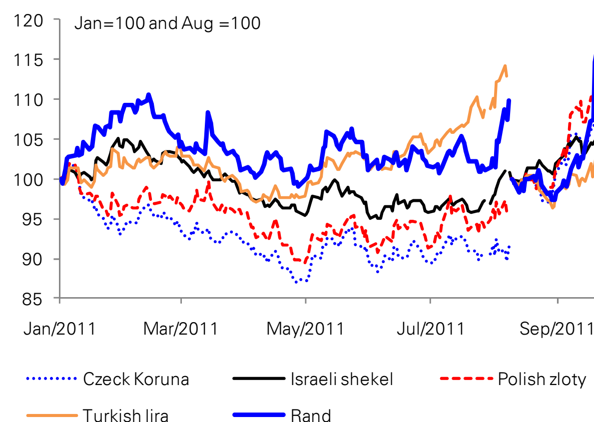
Source: Deutsche Bank, Bloomberg Finance LP, Stats SA, I-Net Bridge

In sum, the recent deterioration in growth fundamentals is pointing towards a much weaker rand environment in the short-term than previously expected. This weakness could of course extend much further given heightened risks around global growth, risk sentiment, and commodities prices. We briefly spend time below on assessing overall positioning levels and commodity price/growth dynamics.

Positioning relatively light

Emerging market currencies have been particularly vulnerable to recent tighter credit conditions and growing fears of recession. Figure 4 illustrates the diverging paths of a select few EM exchange rates since the start of the year and more recently when the sell-off began in August. There has generally been very little discrimination between EM currencies over the past two months. However, countries with relatively low exposure to risk have performed relatively well, such as the Israeli shekel.

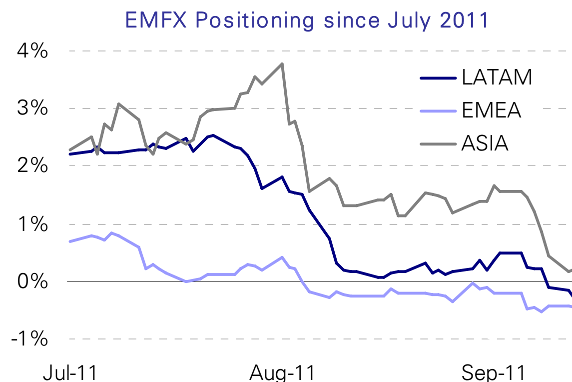
Figure 4: Rand sell-off in comparison to EM peers



Source: Deutsche Bank, Bloomberg Finance LP

Our positioning indicators show that there has been a huge switch in positioning between July and August, with much lighter positioning in August and September (Figure 5). Investors have turned net short of EMEA currencies (most vulnerable to EU crisis) since early August, and recently also of Latam currencies.

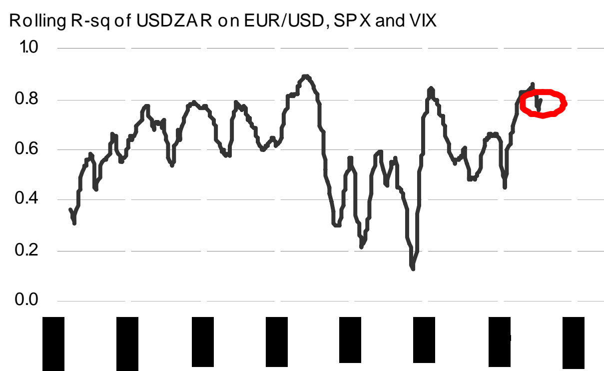
Figure 5: Lighter speculative positioning across EMFX



Source: Deutsche Bank, I-Net Bridge

High beta currencies, such as the rand, have obviously fallen out of favour given their heightened sensitivities to risk. The rand's correlation to euro/usd, the S&P500 and short-term volatility indicator (VIX) means that most news headlines have had negative consequences for the rand (Figure 6).

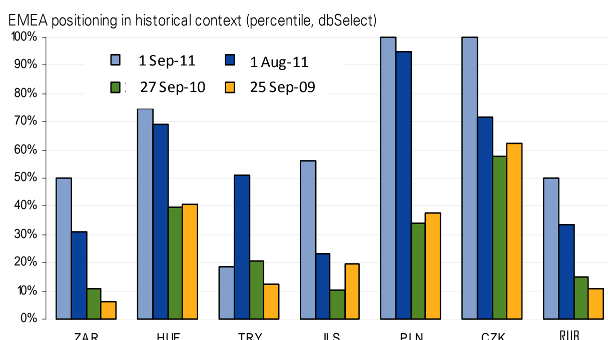
Figure 6: Rand remains a high beta play



Source: Deutsche Bank

However, looking at positioning in the rand on a historical basis (Figure 7), where zero is maximum net short, and one is maximum net long positions; the rand's net short position since August was not extended and currently, there is still no clear bias at this stage which could push the rand strongly in either direction.

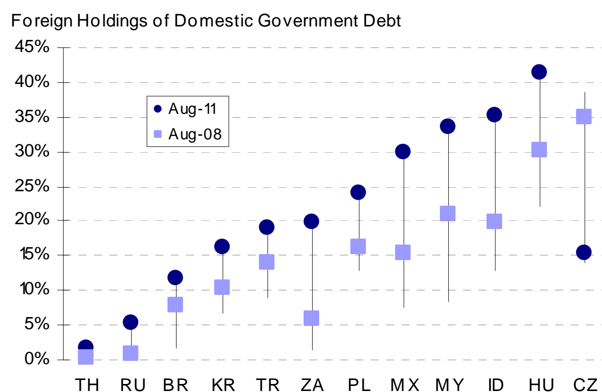
Figure 7: DB positioning indicator is still ZAR-neutral



Source: Deutsche Bank

One of the reasons why the rand may have overshot most EM peers could be related to foreigners' large holdings of local equities and bonds, in addition to the rand's overvaluation. We estimate that foreigners hold approximately 20% of local bonds (however, we've seen estimates of between 25% and 30%), while equity ownership is also around 20-25%. Compared to 2008, foreign holdings of local bonds nearly quadrupled as a share of the total market – South Africa is one of four other economies in the EMEA region that received sizeable inflows over this period (Figure 8). In September, foreigners turned net sellers of local bonds to the value of R14.7bn (+R10.8bn in August), the largest since October 2008, when net outflows from the bond market reached R21bn.

Figure 8: Foreign holdings of domestic govt. debt



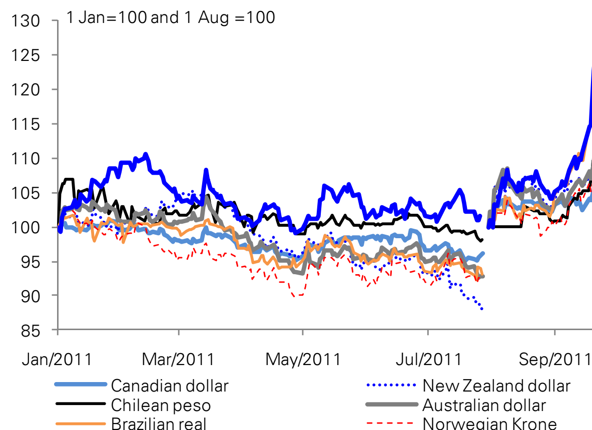
Source: Deutsche Bank

All in, our positioning indicators are showing that there is no clear net selling bias just yet. While recent selling activity had been largely from leveraged accounts, there is clearly significant weakening potential ahead once real money funds start capitulating. The rand thus remains vulnerable to further deterioration in global risk sentiment.

Constructive on commodities but risks are looming

Most commodity currencies have also borne the brunt of sell off since the start of September. However, from the bunch of commodity currencies illustrated in Figure 9, only the Brazilian real, and to a lesser extent the Chilean peso, have weakened by similar magnitudes over this period and since last year. The rest of them, though weaker than the start of August, are still marginally stronger than last year's rates, given the extent of appreciation this year.

Figure 9: Commodity currencies also generally weaker



Source: Deutsche Bank, Bloomberg Finance LP

Admittedly, this comparison places the rand at a disadvantage, given its overbought position at the start of the year, which was nonetheless reached several times this year. Be that as it may, the rand's sell-off seems

somewhat overdone compared to its commodity currency peers.

Our global commodities team has also revised lower their forecasts, though largely paring optimism over the scale of further upside potential. The sharpest revisions were made to platinum group and industrial metals. Oil forecasts remain broadly similar to previous forecast (see Figure below). Our team believes that at global growth of 3.5%, the negative implications for commodity demand growth are containable. The most dangerous threat to oil is if global growth falls below 3% in 2012.

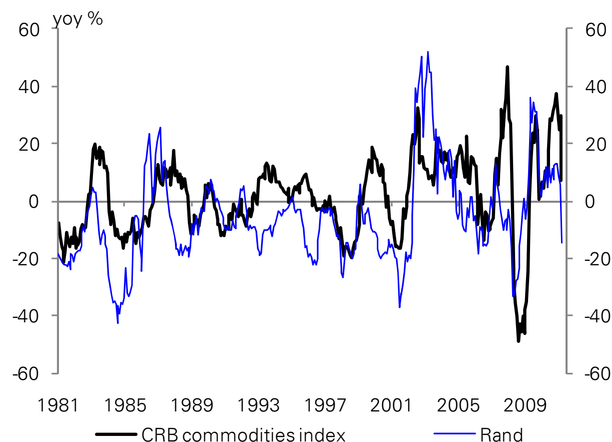
Figure 10: DB commodity forecasts

	2011	2012	2013
Platinum ($/oz)	1754	1875	1950
% change from previous forecast	*-3.6*	*-11.8*	*5.4*
Gold ($/oz)	1590	1900	1800
% change from previous forecast	*1.3*	*0*	*5.9*
Oil ($/bl)	112	115	120
% change from previous forecast	*-1.6*	*-1.7*	*0*
Copper ($/t)	2486	2588	2650
% change from previous forecast	*-5.3*	*-12.3*	*-7*
Iron ore	175	164	145
% change from previous forecast	*-2*	*-9*	*21*

Source: Deutsche Bank. Figures are period averages

Several rand correlations come and go, but its performance against commodities usually remains fairly consistent. It is striking that the rand's performance remains in line with the commodity cycle (Figure 11), even though having overshot the levels implied by the latest easing in commodity prices (illustrated by the CRB index). As seen from the Figure, growth in commodities moderated quite extensively to around 7% compared to last year. However, the rand being nearly 15% down from last year's levels suggests that there may have been some short-term overshooting. Based on the below relationship, the rand should have remained at least at last year's rate of around 6.95/USD, or marginally stronger if it was to keep pace with most other commodity currencies.

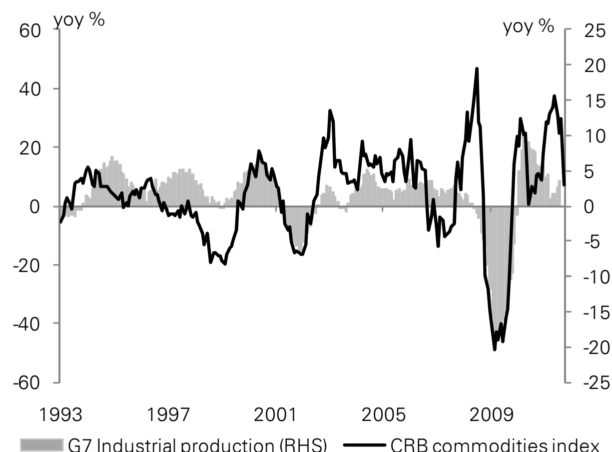
Figure 11: Rand and CRB index in sync



Source: Deutsche Bank, I-Net Bridge

The CRB index generally also bears a good relationship with advanced world industrial cycles (G7 industrial production (IP)) with a slight lead (Figure 12). Commodity-hungry EM activity and the allure of commodities as an asset class often explain the deviations between the CRB index and G7 IP growth. However, it now appears that the commodities cycle has once again become more consistent with G7 growth, raising the risk to commodity prices if growth in these countries starts to slide further.

Figure 12: Link between G7 IP and CRB index re-established



Source: Deutsche Bank

Anticipated weakness in G7 growth implies that there may be more downside in commodity prices, and hence sustained pressure on the exchange rate.

Implications

Balance of payments

In times of global economic weakness the rand acts as a shock absorber for export markets as it help to partly offset weakness in commodity prices However, this is not an ideal position. Firstly, the trade balance remains sensitive to G7 growth, given the bulk of manufactured exports headed to these markets. Secondly, the rand's weakness is only a benefit for the sector in so far as it's not eroded by rising input costs (in this case rand-induced). From a terms-of-trade perspective, it is less desirable that the oil price has not adjusted by the same margin as some of our export commodities. In this respect, the path implied by DB's oil forecasts implies a weaker terms of trade position, which is a negative onslaught on input costs, and incomes.

The overall picture of retreating commodity prices, much weaker growth in G7 economies and rising input costs suggests that export performance may not be bolstered as some may hope. Internal demand is another driver of the trade balance, and amid weaker growth prospects, help to keep at least the trade balance from generating negative balance of payments pressure. On balance, the risks to the current account deficit are on the upside. We have revised this forecast to -3.7% of GDP, compared to -3.3% before.

In the current environment, one can also expect investors to become more discriminative of EM countries. However, with EM macro fundamentals remaining more favourable than those in DM, and with very low real rates, one should guard against being too negative with respect to EM flows. We cannot discount the risk that sharp increases in risk aversion trigger fund redemptions, similar to 2008, which basically sets in motion a vicious cycle. For this reason, expect global funds to remain especially cautious of countries with high external vulnerability, direct exposure to the Eurozone sovereign credit, and poor fiscal dynamics. This could at least keep real money inflows in short supply for now.

Inflation and monetary policy

The direct impact of a weaker rand exchange rate has marginal implications for inflation, taking our annual average estimate for 2012 back to 5.8% (previously 5.7%). However, because of the movements in September, coupled with weaker assumptions into 2012, the inflation profile takes a 0.2 percentage points direct knock. We would be hesitant to account for strong secondary effects in our model from a much weaker rand at this stage. That said, we still see sizeable upside risks to inflation, especially if the rand's weakness remains persistent.

- The pass through to core prices will be questionable in the event of much softer growth.
- A weak rand may act as a shock absorber for exporters, but this time around the impact on profits may be less desirable if squeezed by rising input costs and lower volumes.
- This, along with other market factors, makes it probable that wage inflation could be under more pressure, than our base case view of 7.5% wage growth for 2012.

Where the rand ultimately settles, or not, will have a bearing on the interest rate view. As highlighted in our recent post-MPC analysis, this, but more importantly global growth risks, is an important caveat. Moreover, we do not see the SARB stepping in at any stage to limit any rand fall out, barring absolute extreme cases where markets become highly dysfunctional. We retain our view of an unchanged interest rate stance until late 2012. It is our sense from SARB engagements that even though inflation has been revised marginally lower, this is not the appropriate time to become too cheerful of a well-contained inflation profile.

Appendix 1

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