

RAND: DOLLAR LIQUIDITY SQUEEZE

Rand overshoots; we expect the rand to correct to 12.90-12.80 in the short-term.

However, rising US borrowing cost and a dollar shortage will be negative for the carry-trade and will leave the rand vulnerable

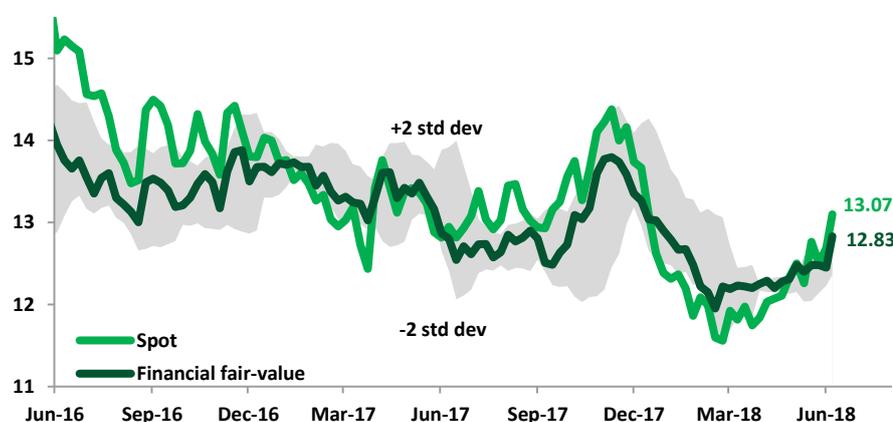
Our forecasts:

R12.50, 1H18

R13.10, 2H18

- The Fed FOMC looks set to raise rates this week to 2.0%: The **sell-off** in the rand and EM currencies **intensified** amid concerns that emerging markets will be faced with higher U.S borrowing costs. The US economy is powering ahead leading to the US Federal Reserve continuing with that path of **hiking interest rates** and **reversing quantitative easing measures**. In response some EM central banks (e.g. India, Indonesia and Brazil) **urged** the Federal Reserve to consider that tightening monetary conditions at too rapid pace may lead to a dollar shortage and a stronger US Dollar. This will not bode well for emerging markets.
- **Keep an eye on South Africa's current account for 1Q:18:** As indicated last week, local data has disappointed in recent weeks. Most notable was 1Q:18 GDP which contracted -2.2% q/q (saar). While GDP is expected to recover in 2Q:18, our attention is focused on the upcoming current account print for 1Q:18 (due for release on 21 June). Looking at the performance of net exports within the GDP data set, the bias in our view, lies firmly for a current account deficit that could come in wider than the Bloomberg consensus of -2.8% of GDP. Although this data print is backward looking, within an environment where EM external vulnerabilities are under the microscope, a wider-than-expected current account print may well carry more negative weight within FX markets than otherwise would have been the case. Keep in mind that recent rand weakness should see the value of exports rise throughout the rest of 2018.
- **From a technical perspective, we recommend keeping an eye on the \$-rand resistance level of R12.90 and support of R13.58** (see our latest Technical Strategy note: *"Margin call on the SA carry-trade"* of 8 June 2018 for a more detailed technical view on the currency).
- **We maintain our year-end target close to the 13.10 level:** The rand has reached our year-end target faster than expected. The rapid weakness in the rand potentially looks like an overshoot hence we are cognisant **not to extrapolate** current weakness too far into the future. As a result our forecast for the rand remains **13.10 by year-end**, and we will only revise our forecast our global \$-Liquidity measures move into contractionary state. Currently they have merely lost momentum.

Figure 1: Rand financial fair-value estimate



Source: Bloomberg, Nedbank CIB Research. Estimated using OLS regression method. Variable include DXY, Equity prices, US10yr, CDS spread, local-to-US 2y swap spread and oil price

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DOLLAR LIQUIDITY IS KING AND IT MATTERS FOR THE RAND

The **US Dollar** is deeply entrenched in the global economy (see [it's all about the US Dollar 08 May 2018](#)) and as a result the changes in the US Dollar and Dollar liquidity have a meaningful impact for the global economy and financial markets.

Dollar is King: Since the United States is the only supplier of US Dollar's through its trade-deficit (US imports goods and services from the rest of the world and pays the rest of the world with US Dollars) the health of the US economy is very important to the outlook not only for the global economy but also for the US Dollar and dollar liquidity. Even though US GDP as a share of world GDP has fallen from 27% in 1990 to the current 18% level amid the rise of China and other emerging markets, the majority of global trade transactions and FX reserves held by other central banks are still conducted in the US Dollar. Despite the competition from the other currencies like the euro and the renminbi, **the dollar remains king.**

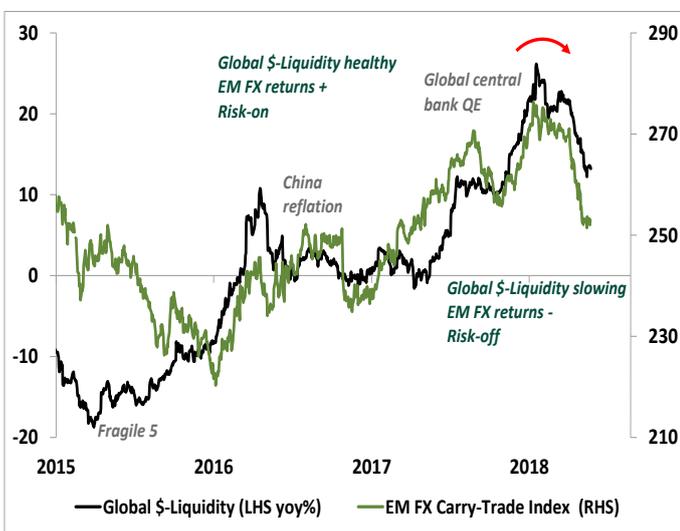
Why does this matter to South Africa? Like many EM's, South Africa is a small open economy with external funding requirements (via its current account balance). Much of the source of the funding is dollar-denominated. As a result, changes in the US Dollar and dollar liquidity can have a meaningful impact on the flow of funds to South Africa, to a great extent via unwinding of carry-trades ([Chart 1](#)). The 18 month period preceding December 2017 is a good example whereby the rand steadily appreciated (albeit with bouts of volatility) despite deteriorating local fundamentals. The reason why the rand (and other EM currencies) steadily appreciated is because the US Dollar was weak and dollar liquidity conditions were accommodative. This supported higher yielding currencies via the carry-trade. If South Africa is perceived to require even greater **external funding** than expected in an environment where dollar liquidity is contracting, it may lead to even more rand weakness – hence our focus on the upcoming current account data print highlighted above.

Outlook: The rand has reached our **year-end target faster than expected.** We are cognisant not to extrapolate the current weakness too far into the future given that, by our measures, the rapid weakness in the rand now starts to look like an overshoot. As a result our forecast for the rand remains **13.10 by year-end.**

While pull-backs from current levels remain likely in our view, global tailwinds which have supported the rand last year have turned into headwinds. As such we do not expect rand strength towards R12.50 against the US Dollar to be sustainable. The US Fed seems set to continue with rate hikes and tapering-off of its balance sheet over the next 12 months. This is likely to drive a stronger US Dollar and contribute negatively to the shortage of global dollar liquidity. This should **raise dollar borrowing costs** for various players in the global economy – including **dollar indebted** countries, companies, investors and speculators exposed to the **carry-trade**. Lastly it's worth noting that the concerns highlighted above in our view, are not entirely reflected by the options market ([Chart 2](#)) and is an opportunity for clients looking to hedge against rand weakness.

We expect the rand to trade close to R12.50-13.10 against the US Dollar as the year progresses.

Chart 1: Global dollar liquidity is slowing down. This is a major headwind for the rand and other EM currencies.



Source: Nedbank CIB markets Research

Chart 2: Cost of hedging against rand weakness, via the option market, remains low.



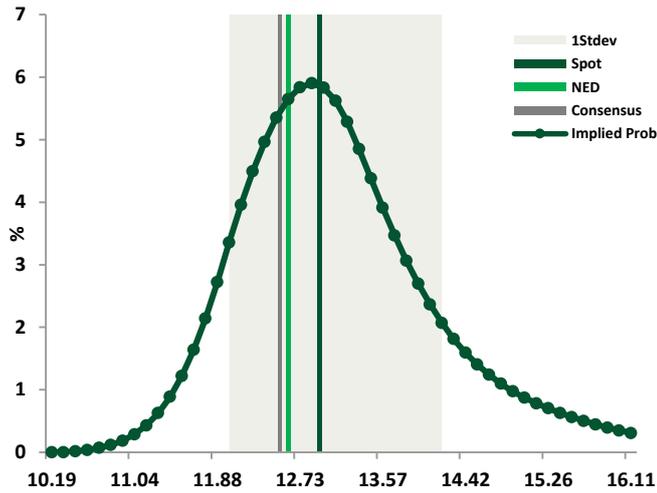
Source: Nedbank CIB markets Research

FX VOL RISING, BUT STILL BELOW THREE-YEAR AVERAGES

The forecast from the options market for the USDZAR remains more bearish than the Bloomberg consensus expectations:

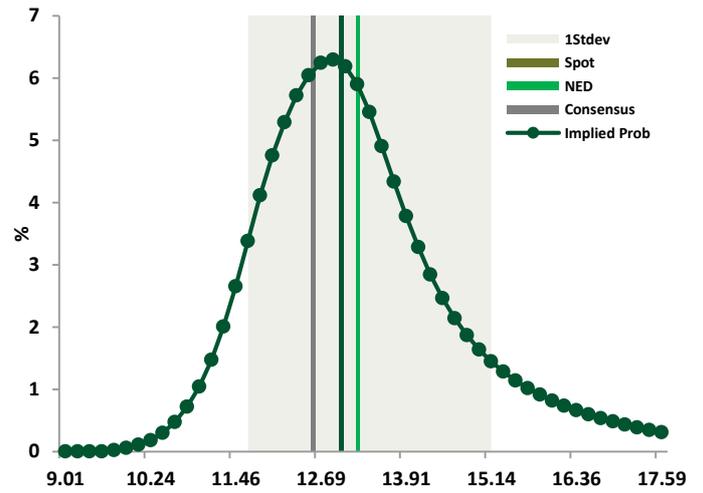
- On a three-month view, the options market suggests a one standard deviation trading range for the USDZAR of between 12.00 and 14.00 (see Chart 4).
- On a six-month view, the probability is skewed towards weakness, as one would expect, with the implied probability distribution suggesting a one standard deviation range of between 11.60 and 15.00 (see Chart 5).

Chart 3: 3m implied probability distribution vs forecast



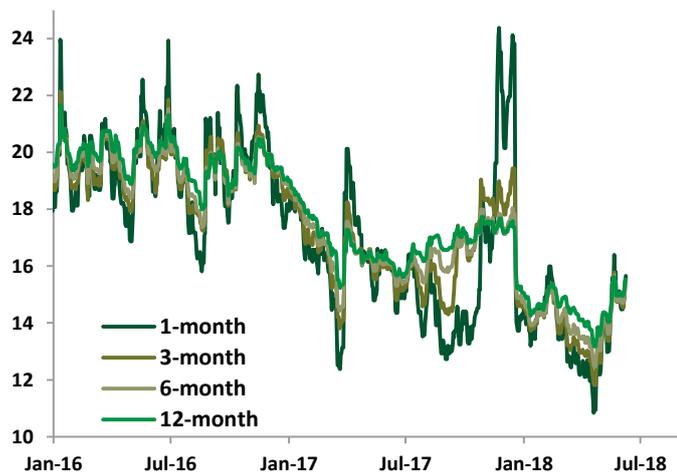
Source: IIF and Nedbank CIB Markets Research

Chart 4: 6m implied probability distribution vs forecast



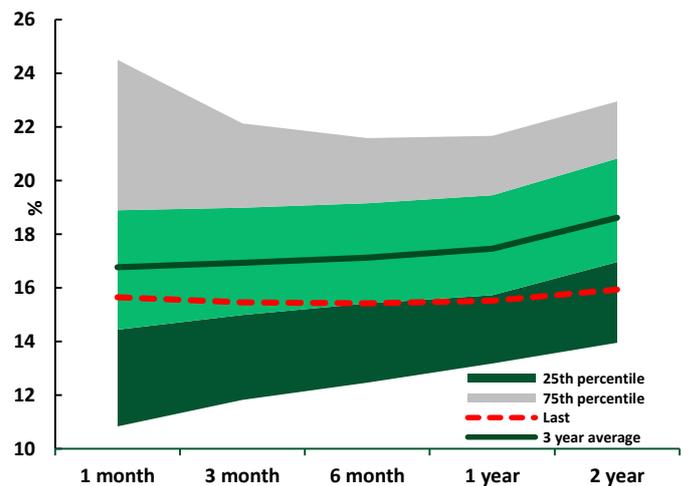
Source: IIF and Nedbank CIB Markets Research

Chart 5: USDZAR implied volatility



Source: IIF and Nedbank CIB Markets Research

Chart 6: ATM USDZAR implied volatility cone



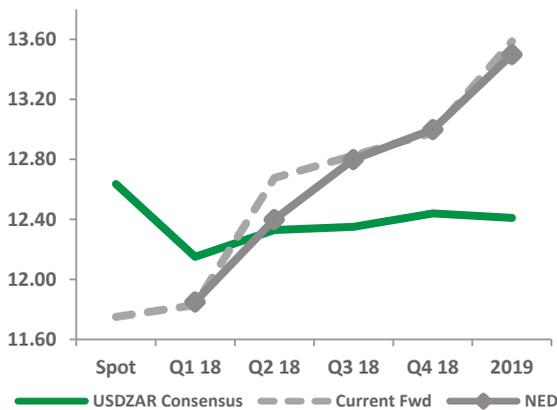
Source: IIF and Nedbank CIB Markets Research

Chart 7: Rand currency forecast table vs consensus and forwards (period end)

	Current Spot	Q1 18	Q2 18	Q3 18	Q4 18	2019
USDZAR						
Nedbank	13.00	11.85	12.40	12.80	13.00	13.50
Current Fwd	13.00	11.83	13.04	13.19	13.35	13.98
Consensus	13.00	12.15	12.33	12.50	12.50	12.50
EURZAR						
Nedbank	15.34	14.40	14.88	15.23	15.15	16.00
Current Fwd	15.34	14.58	15.42	15.71	16.02	17.33
Consensus	15.34	14.82	14.80	15.00	15.25	16.00
GBPZAR						
Nedbank	17.45	16.47	17.36	17.92	18.46	19.58
Current Fwd	17.45	16.58	17.52	17.80	18.09	19.30
Consensus	17.45	16.89	16.77	17.00	17.13	17.13
AUDZAR						
Nedbank	9.90	9.24	9.67	10.50	10.66	11.21
Current Fwd	9.90	9.08	9.93	10.05	10.18	10.71
Consensus	9.90	9.48	9.37	9.63	9.63	10.00

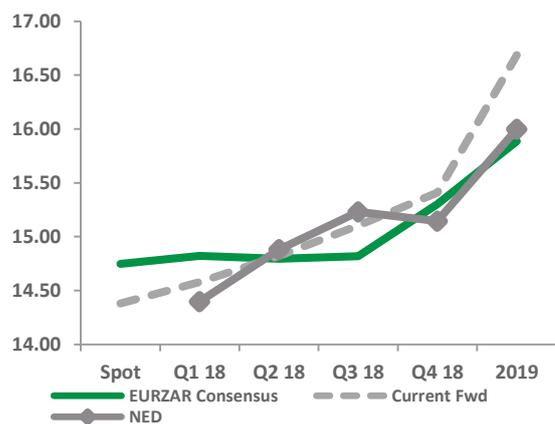
Source: Bloomberg, Nedbank CIB

Chart 8: USDZAR forecasts, consensus and forwards



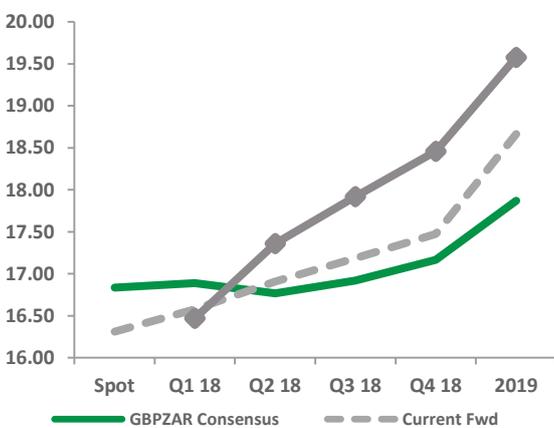
Source: Bloomberg, Nedbank CIB

Chart 9: EURZAR forecasts, consensus and forwards



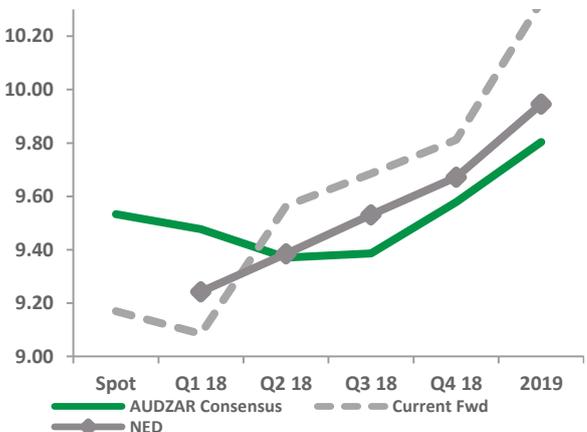
Source: Bloomberg, Nedbank CIB

Chart 10: GBPZAR forecasts, consensus and forwards



Source: Bloomberg, Nedbank CIB

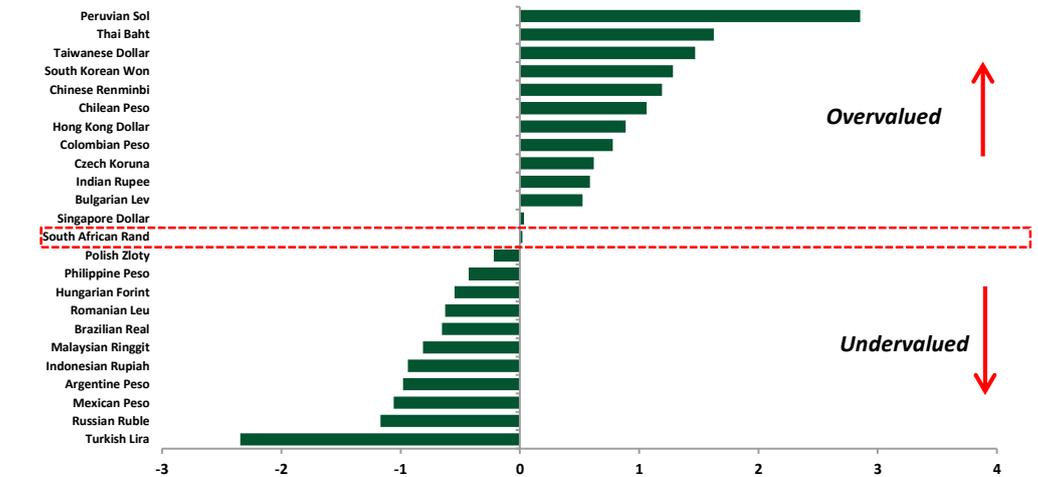
Chart 11: AUDZAR forecasts, consensus and forwards



Source: Bloomberg, Nedbank CIB

Chart 12: EM currencies overvalued vs undervalued (z-scores)

Rand in fair value territory according to PPP metrics



Source: Bloomberg and BIS. A larger value indicates the spot rate has a larger deviation from PPP metrics

Chart 13: EM currency performance

	CNY	JPY	KRW	TRY	MXN	RUB	THB	INR	AUD	BRL	GBP	EUR	CAD	ZAR	USD
CNY		-1.074	2.336	19.563	5.451	9.975	-0.036	7.674	4.268	19.682	2.375	3.199	5.078	7.133	1.594
JPY	1.082		-3.286	-17.786	-6.326	-9.550	-1.052	-8.120	-5.126	-17.440	-3.357	-4.194	-5.846	-7.695	-2.618
KRW	-1.639	3.442		-14.463	-3.040	-6.448	2.313	-4.954	-1.874	-14.528	-0.051	-0.910	-2.617	-4.560	0.731
TRY	-16.384	20.860	16.885		13.338	9.655	19.591	11.352	14.701	-0.104	17.020	16.646	13.829	12.814	18.485
MXN	-5.176	6.286	3.144	-11.778		-3.560	5.629	-1.623	1.216	-11.742	3.175	2.252	0.487	-1.064	3.984
RUB	-8.549	10.538	6.896	-8.810	3.634		10.078	2.731	5.029	-8.654	7.539	6.413	4.112	2.884	8.064
THB	0.000	1.056	-2.295	-16.403	-5.161	-8.590		-7.119	-4.104	-16.438	-2.170	-3.220	-4.830	-6.696	-1.630
INR	-7.124	8.830	5.209	-10.232	1.748	-1.832	7.668		3.282	-10.303	5.244	4.248	2.566	0.149	5.982
AUD	-4.088	5.385	1.917	-12.809	-1.229	-4.525	4.240	-2.985		-13.011	1.866	0.953	-0.521	-2.416	2.608
BRL	-16.448	20.952	16.993	0.081	13.167	9.433	19.678	11.471	14.870		17.118	15.893	13.934	11.649	17.950
GBP	-2.103	3.521	0.058	-14.497	-2.926	-6.250	2.189	-5.172	-1.823	-14.503		-0.864	-2.548	-4.181	0.757
EUR	-3.189	4.410	0.923	-14.192	-2.359	-5.556	3.283	-3.831	-0.831	-13.741	0.905		-1.451	-3.269	1.705
CAD	-4.853	5.930	2.684	-12.697	-0.626	-3.932	5.030	-2.538	0.785	-12.233	2.650	1.677		-1.772	3.333
ZAR	-7.481	7.916	5.636	-11.378	2.430	-2.840	7.154	-0.155	2.404	-9.722	4.686	3.801	1.770		5.073
USD	-1.569	2.682	-0.694	-15.052	-3.833	-7.180	1.612	-5.371	-2.536	-15.104	-0.696	-1.633	-3.218	-4.513	

Source: Bloomberg

Chart 14: Correlation matrix – markets vs FX

	VIX	SPX	US	US	SA	TOP40	EM FX	DM FX	MXN	AUD	CAD	ZAR
VIX		-80%	-48%	-38%	14%	-33%	-27%	-4%	22%	-20%	22%	23%
SPX	-80%		38%	28%	-19%	41%	40%	10%	-35%	42%	-35%	-34%
US	-48%	38%		92%	-3%	22%	7%	-6%	-8%	3%	-11%	-8%
US	-38%	28%	92%		0%	15%	-2%	-10%	-3%	-4%	-2%	0%
SA	14%	-19%	-3%	0%		-25%	-52%	-10%	41%	-25%	25%	63%
TOP40	-33%	41%	22%	15%	-25%		27%	-6%	-12%	25%	-22%	-13%
EM FX	-27%	40%	7%	-2%	-52%	27%		-20%	-75%	70%	-56%	-77%
DM FX	-4%	10%	-6%	-10%	-10%	-6%	-20%		2%	0%	-1%	-4%
MXN	22%	-35%	-8%	-3%	41%	-12%	-75%	2%		-52%	53%	57%
AUD	-20%	42%	3%	-4%	-25%	25%	70%	0%	-52%		-65%	-60%
CAD	22%	-35%	-11%	-2%	25%	-22%	-56%	-1%	53%	-65%		51%
ZAR	23%	-34%	-8%	0%	63%	-13%	-77%	-4%	57%	-60%	51%	

Source: Bloomberg, YTD

Chart 15: Correlation matrix – commodities vs currencies

	Gold	Plat	Pall	Ironor	Coppe	T-Coal	Brent	BRL	AUD	CAD	ZAR	EM FX
Gold		67%	32%	7%	-8%	2%	20%	-44%	51%	-36%	-43%	58%
Plat	67%		51%	-2%	-4%	20%	29%	-39%	54%	-40%	-43%	57%
Pall	32%	51%		-16%	-6%	9%	34%	-23%	42%	-29%	-28%	39%
Ironor	7%	-2%	-16%		1%	-1%	-8%	5%	0%	-10%	-10%	1%
Coppe	-8%	-4%	-6%	1%		15%	5%	6%	-4%	5%	3%	-8%
T-Coal	2%	20%	9%	-1%	15%		7%	-12%	5%	1%	-12%	6%
Brent	20%	29%	34%	-8%	5%	7%		-22%	25%	-38%	-22%	25%
BRL	-44%	-39%	-23%	5%	6%	-12%	-22%		-43%	29%	46%	-57%
AUD	51%	54%	42%	0%	-4%	5%	25%	-43%		-65%	-60%	70%
CAD	-36%	-40%	-29%	-10%	5%	1%	-38%	29%	-65%		51%	-56%
ZAR	-43%	-43%	-28%	-10%	3%	-12%	-22%	46%	-60%	51%		-77%
EM FX	58%	57%	39%	1%	-8%	6%	25%	-57%	70%	-56%	-77%	

Source: Bloomberg, YTD

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