

# FX AT A GLANCE

11 December 2018



## RAND: LOOKING AHEAD TO 2019

- **2018** will likely be remembered for the **USD reasserting itself as a key driver of financial markets**. This played an important role in unsettling global financial markets, despite the US recording widening twin deficits and US President Trump's inward-looking economic policies.
- Emerging markets such as Turkey have been at the centre of the global USD shortage. Tighter financial conditions exposed poor local fundamentals (a lack of institutional strength, especially central bank independence in the case of Turkey, weaker growth dynamics and rising political uncertainty). **South Africa was not spared**, with the country's external vulnerability being exposed as portfolio flows into bonds and equities reversed, i.e., the carry trade.
- **Looking ahead, we see one of three broad scenarios playing out in the currency market**. Our base case is Scenario 3. We also believe that Scenario 2 is more likely than Scenario 1. Scenario 1, in our view, is too optimistic given the status of the local/global macro and geopolitical environment.

Our Scenarios	Likelihood	USDZAR	EURUSD
1. The best of both worlds	Low to Medium	R14.00-R13.00	1.20 and higher
2. A messy 2019	Medium	Above R15.50	Flirting with parity, 0.80-1.00
3. A repeat of 2018	Base case	R14.00-R15.00	Volatile, 1.05-1.15

- **Scenario 1: The best of both worlds:** Internationally, the expected slowdown in global growth is reversed, led by China and the Eurozone. At the same time, US growth slows as the fiscal stimulus wears off. This allows the Fed to stop its tightening cycle sooner than expected (only one Fed hike in 2019, and balance sheet unwinding is halted). This translates into a weaker USD (**EURUSD: 1.20 and higher**). Because of a more dovish Fed and better global growth, global \$-Liquidity shortages subside and global financial conditions ease, providing tailwinds for risk assets. Locally, economic growth improves as business confidence picks up, especially as the land reform process unfolds in a stable and predictable manner. This paves the way for faster-than-expected fiscal consolidation. Fiscal consolidation also provides room for the SARB to keep the repo rate unchanged. **From a local currency perspective:** The rand benefits due to stronger growth in China (higher commodity prices) and easier global financial conditions. We would not be surprised if the rand traded below **R14.00**, extending to **R13.00**, since the rand is a highly liquid currency proxy for EM risk sentiment.
- **Scenario 2: A messy 2019:** The contraction in global \$-Liquidity accelerates as the Fed continues to tighten monetary policy (three hikes and balance sheet tapering accelerating in 2019) along with other global central banks. Global growth slows down markedly. Financial stability risks move to the forefront, exposing record-high debt levels and cross-border USD-denominated debt, especially within EMs. Portfolio flows reverse from most EMs, including South Africa. A slowdown in global growth and a decline in asset prices ensue, with fiscal and monetary policy makers having limited policy options to reflate the global economy and financial markets. Locally, the SARB is forced to raise the repo rate by 75bps to counter the effect of a weaker currency on inflation (amid a weaker rand and an acceleration in capital outflows), raising the risk of SA entering another recession and making fiscal consolidation even harder. South Africa is downgraded by Moody's to non-investment grade in mid-2019, resulting in further capital outflow from the local bond market. At the same time, the USD strengthens due to the contraction in global \$-Liquidity (**EURUSD: 1.00 and below**). **From a local currency perspective:** Because of weaker growth, lower commodity prices and the rand being a proxy for EM risk sentiment, we expect the rand to trade **above R15.50**.
- **Scenario 3: A repeat of 2018:** Like 2018, local and external headwinds remain in place. US growth slows only marginally to around 2%, while the US Fed hikes two more times (and balance sheet tapering remains) in 2019. The global USD shortage persists and, as a result, global financial conditions remain restrictive. Global trade wars and geopolitical tensions also likely continue. Locally, the overall growth outlook remains uncertain, but South Africa avoids a recession. There is little room for fiscal or monetary policy to provide relief to an embattled consumer. There is little progress on resolving the financial and management crises at SOEs, and government bailouts continue. Moody's moves South Africa's local currency rating from a stable to a negative outlook by mid-2019. The USD is largely range-bound at **EURUSD 1.05-1.15**. **From a local currency perspective:** SA is highly sensitive to external headwinds through capital flows (via the carry trade), and commodity prices pose a threat to the rand. In this scenario, we expect the rand to trade in the **R14.00 to R15.00 range** for most of the year. While bouts of weakness and strength beyond this range should be expected, they are unlikely to be sustainable.

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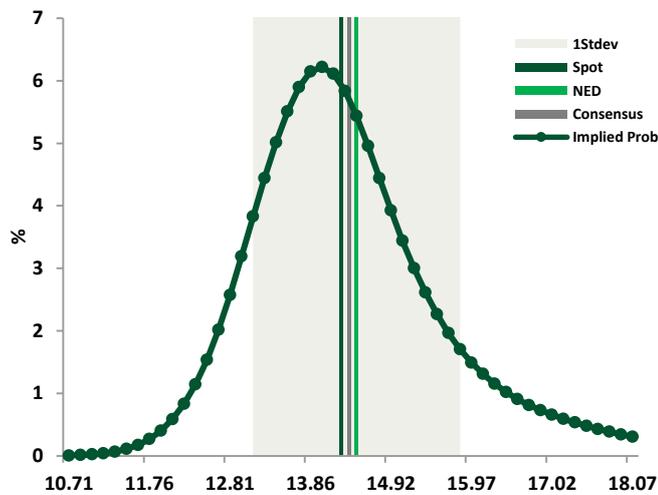
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# FX VOL CURVES: STABLE

Implied volatility in the options market has stabilised. The volatility curve is slightly below the three-year average, indicating that near-term risks are well priced in. We believe the market may be underestimating the risk that we highlight into year-end from our view above. That said, the options market’s forecast for the USDZAR remains more bearish than Bloomberg consensus expectations:

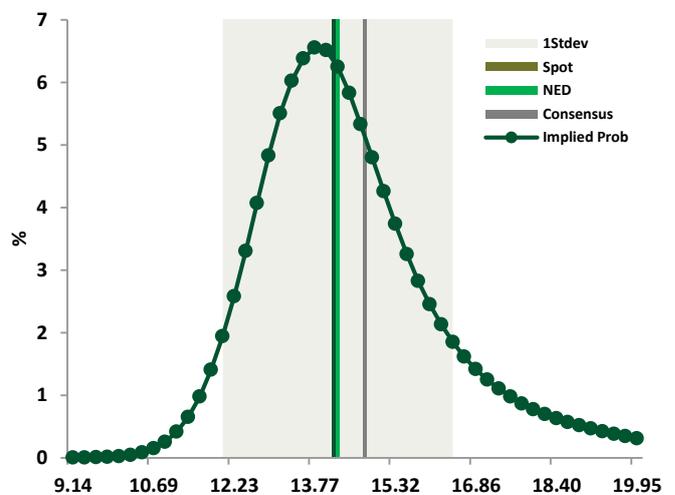
- On a three-month view, the options market suggests a one standard deviation trading range for the USDZAR of R13.03-15.26 (see Chart 3)
- On a six-month view, the probability is skewed towards weakness, as one would expect, with the implied probability distribution suggesting a one standard deviation range of R12.56-16.57 (see Chart 4).

**Chart 3: 3m implied probability distribution vs forecast**



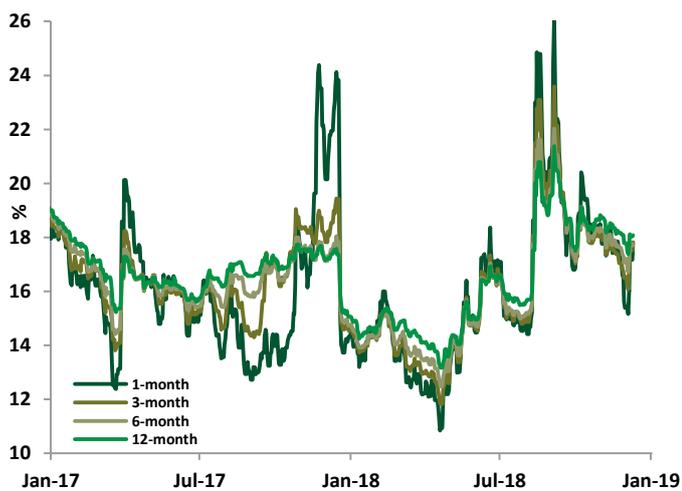
Source: Bloomberg, Nedbank CIB

**Chart 4: 6m implied probability distribution vs forecast**



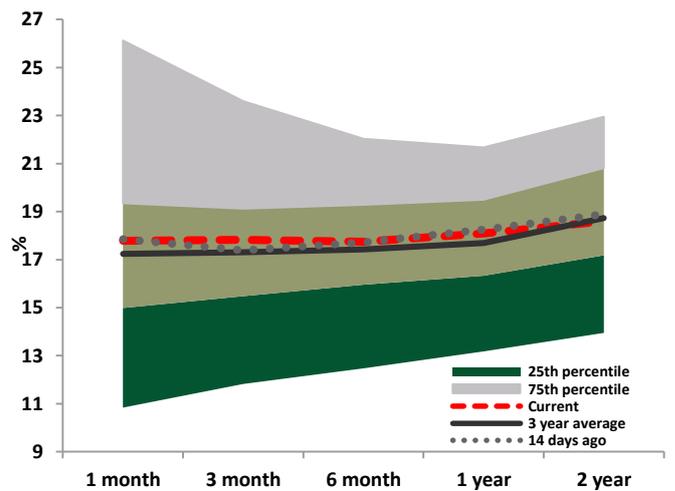
Source: Bloomberg, Nedbank CIB

**Chart 5: USDZAR implied volatility**



Source: Bloomberg, Nedbank CIB

**Chart 6: ATM USDZAR implied volatility cone**



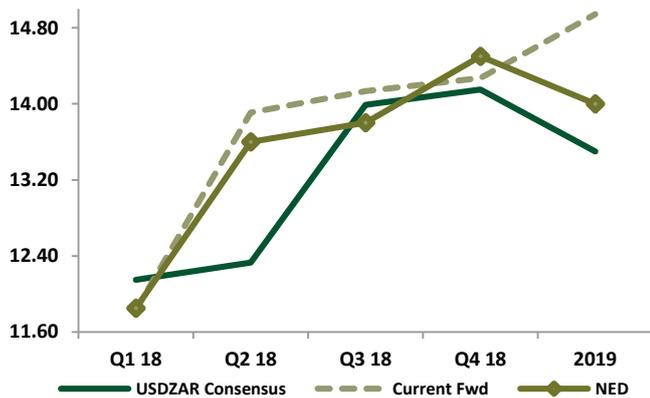
Source: Bloomberg, Nedbank CIB

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

	Current	Q2 18 Actual	Q3 Actual	Q4 18F	2019F
<b>USDZAR</b>	<b>14.24</b>	<b>13.72</b>	<b>14.14</b>		
Nedbank CIB Markets		13.60	13.80	14.50	14.00
Forward market		13.91	14.13	14.27	14.94
Consensus		12.33	13.99	14.15	13.50
<b>EURZAR</b>	<b>16.26</b>	<b>16.03</b>	<b>16.41</b>		
Nedbank CIB Markets		15.78	16.08	16.89	16.59
Forward market		16.13	16.40	16.32	17.65
Consensus		14.80	16.09	16.27	16.20
<b>GBPZAR</b>	<b>18.04</b>	<b>18.18</b>	<b>18.43</b>		
Nedbank CIB Markets		17.95	18.77	20.59	20.30
Forward market		18.25	18.42	18.11	19.29
Consensus		16.77	18.19	18.40	18.40
<b>AUDZAR</b>	<b>10.27</b>	<b>10.16</b>	<b>10.21</b>		
Nedbank CIB Markets		10.06	10.21	10.73	10.50
Forward market		10.17	10.36	10.31	10.87
Consensus		9.37	10.21	10.19	10.13

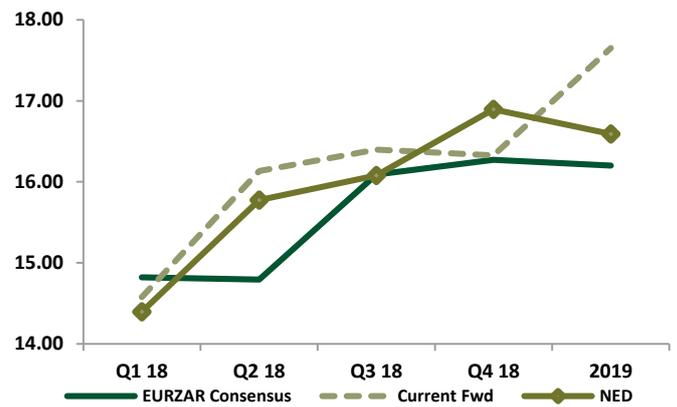
Source: Bloomberg, Nedbank CIB

Chart 8: USDZAR forecasts, consensus and forwards



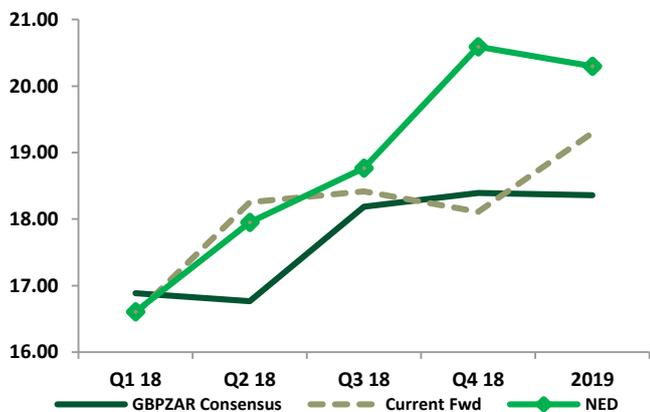
Source: Bloomberg, Nedbank CIB

Chart 9: EURZAR forecasts, consensus and forwards



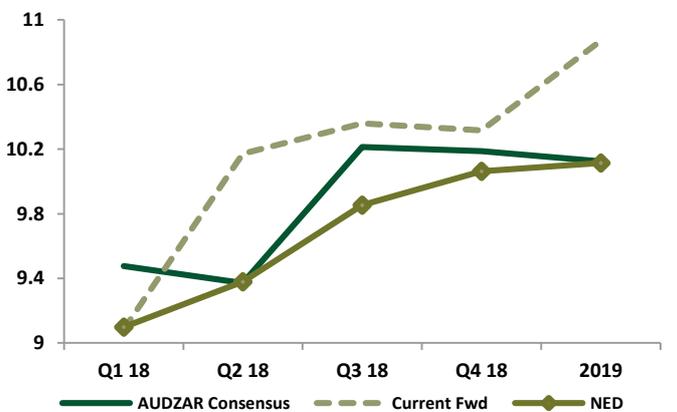
Source: Bloomberg, Nedbank CIB

Chart 10: GBPZAR forecasts, consensus and forwards



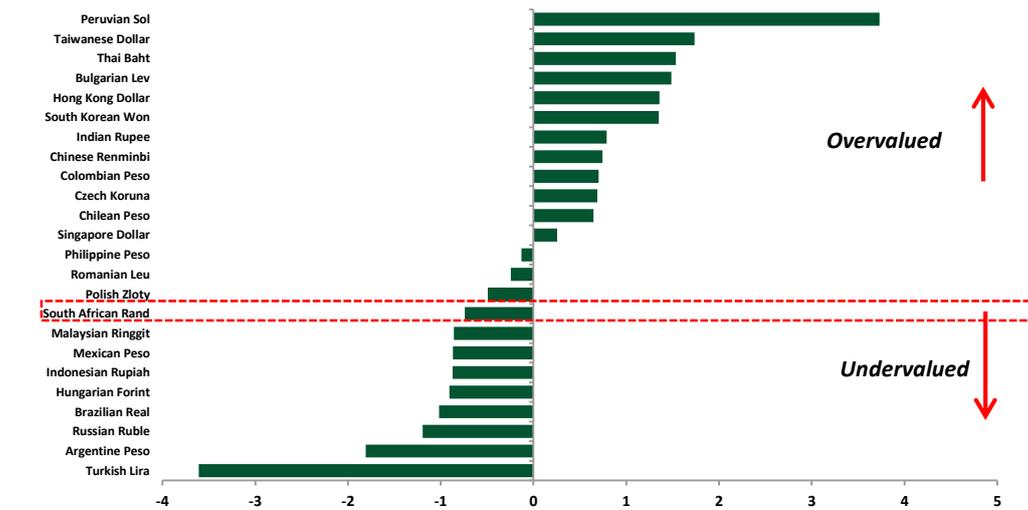
Source: Bloomberg, Nedbank CIB

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 Purchasing Power Parity (PPP) metrics**



A larger value indicates that the spot rate has a larger deviation from PPP metrics; Source: Bloomberg, BIS

**Chart 13: EM currency performance vs USD**

	CNY	JPY	KRW	TRY	MXN	RUB	THB	INR	AUD	BRL	GBP	EUR	CAD	ZAR	USD
CNY		-5.913	-0.569	30.081	-3.370	8.564	-5.038	5.457	1.779	11.511	0.440	-1.124	-0.207	8.700	-5.869
JPY	6.283		-5.350	-28.124	-2.784	-12.809	-0.931	-10.782	-7.542	-15.607	-6.319	-4.889	-5.721	-13.434	-0.036
KRW	0.000	5.677		-23.586	2.824	-7.881	4.654	-5.716	-2.287	-10.841	-1.004	0.596	-0.369	-8.540	5.630
TRY	-23.133	38.245	30.812		34.492	20.783	36.968	22.872	27.861	16.654	29.742	32.431	30.370	21.030	39.082
MXN	3.481	2.857	-2.764	-25.678		-10.415	1.821	-8.766	-4.983	-13.174	-3.630	-2.181	-3.053	-10.604	2.851
RUB	-7.302	14.674	8.558	-17.219	11.624		14.326	2.733	6.186	-3.235	8.157	9.598	8.156	0.129	15.091
THB	5.305	0.938	-4.262	-26.965	-1.670	-11.987		-9.916	-6.642	-14.793	-5.277	-4.017	-4.815	-12.600	0.859
INR	-5.177	12.139	6.047	-18.585	9.571	-1.832	11.007		3.624	-4.991	5.345	6.615	5.833	-2.386	12.034
AUD	-1.726	8.130	2.333	-21.793	5.223	-5.882	7.092	-3.980		-8.743	1.323	2.837	2.202	-6.087	8.089
BRL	-10.329	18.503	12.151	-14.263	15.065	3.341	17.368	5.263	9.573		11.188	12.575	11.738	2.531	18.436
GBP	-0.213	6.799	1.024	-22.872	3.723	-7.031	5.542	-5.172	-1.297	-9.982		1.529	0.663	-7.358	6.706
EUR	1.055	5.175	-0.488	-24.445	2.123	-8.333	4.181	-6.590	-2.646	-11.200	-1.474		-0.604	-8.618	5.162
CAD	0.174	5.791	0.365	-23.791	3.130	-7.551	5.014	-6.091	-1.907	-10.519	-0.624	0.806		-7.972	5.926
ZAR	-8.759	15.014	10.242	-17.402	13.341	-0.186	14.414	2.382	6.399	-1.755	8.189	9.870	8.654		15.000
USD	6.235	0.034	-5.314	-27.643	-2.772	-12.797	-0.909	-11.003	-7.480	-15.568	-6.224	-4.867	-5.594	-12.744	

Source: Bloomberg

**Chart 14: Correlation matrix – Markets vs FX**

	VIX	SPX	US	USTIPS	SA 10yr	TOP40	EM FX	DM FX	MXN	AUD	CAD	ZAR
VIX		-81%	-42%	-32%	20%	-35%	-29%	-6%	23%	-22%	21%	28%
SPX	-81%		37%	27%	-18%	40%	34%	11%	-30%	36%	-27%	-33%
US 10yr	-42%	37%		91%	-5%	19%	13%	-8%	-9%	-1%	-10%	-12%
USTIPS	-32%	27%	91%		2%	12%	5%	-11%	-5%	-10%	1%	-3%
SA 10yr	20%	-18%	-5%	2%		-29%	-59%	-6%	36%	-33%	28%	70%
TOP40	-35%	40%	19%	12%	-29%		21%	-5%	-9%	30%	-28%	-28%
EM FX	-29%	34%	13%	5%	-59%	21%		-7%	-68%	65%	-49%	-82%
DM FX	-6%	11%	-8%	-11%	-6%	-5%	-7%		4%	8%	-2%	-4%
MXN	23%	-30%	-9%	-5%	36%	-9%	-68%	4%		-44%	45%	56%
AUD	-22%	36%	-1%	-10%	-33%	30%	65%	8%	-44%		-62%	-60%
CAD	21%	-27%	-10%	1%	28%	-28%	-49%	-2%	45%	-62%		49%
ZAR	28%	-33%	-12%	-3%	70%	-28%	-82%	-4%	56%	-60%	49%	

Source: Bloomberg, YTD

**Chart 15: Correlation matrix – Commodities vs currencies**

	Gold	Plat	Pall	Ironore	Copper	T-Coal	Brent	BRL	AUD	CAD	ZAR	EM FX
Gold		67%	37%	8%	2%	1%	16%	-20%	53%	-40%	-43%	48%
Plat	67%		49%	-4%	5%	13%	29%	-20%	56%	-43%	-49%	50%
Pall	37%	49%		-10%	7%	6%	31%	-12%	38%	-31%	-34%	34%
Ironore	8%	-4%	-10%		-1%	-1%	-9%	1%	-2%	-8%	-1%	-1%
Copper	2%	5%	7%	-1%		10%	17%	-8%	5%	-4%	-13%	3%
T-Coal	1%	13%	6%	-1%	10%		4%	-6%	3%	1%	-6%	3%
Brent	16%	29%	31%	-9%	17%	4%		-6%	20%	-33%	-17%	15%
BRL	-20%	-20%	-12%	1%	-8%	-6%	-6%		-22%	15%	27%	-39%
AUD	53%	56%	38%	-2%	5%	3%	20%	-22%		-62%	-60%	65%
CAD	-40%	-43%	-31%	-8%	-4%	1%	-33%	15%	-62%		49%	-49%
ZAR	-43%	-49%	-34%	-1%	-13%	-6%	-17%	27%	-60%	49%		-82%
EM FX	48%	50%	34%	-1%	3%	3%	15%	-39%	65%	-49%	-82%	

Source: Bloomberg, YTD

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