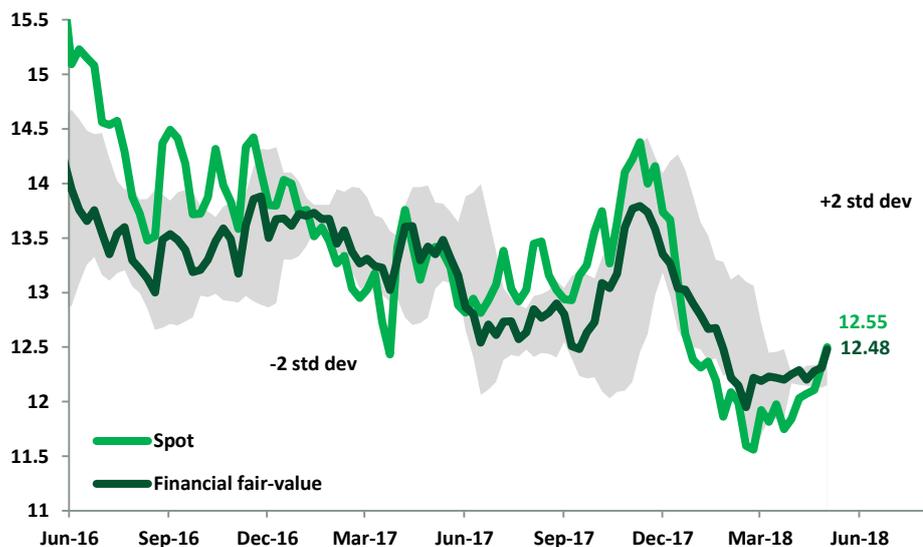


IT'S ALL ABOUT THE U.S DOLLAR, RAND CONVERGES TO OUR TARGET LEVELS

- The U.S Dollar has made a dramatic comeback, strengthening to a four-month high. This was marked by the first two-week period of outflows from emerging markets since 2016. As a result, the performance high beta carry-trade currencies (like the rand and other emerging market currencies) have come under pressure, explaining the sudden weakness in the rand.
- There are a number of factors behind the recent buoyancy in the US Dollar: 1) rising inflation expectations and supporting the prospect of higher interest rates from the Federal Reserve; 2) recoupling of interest rates between U.S and development peers; and 3) financial market participants take profit on stretched carry-trade positions amid concerns around slowing global growth and escalating trade tensions.
- As a result of the stronger U.S Dollar, tighter global financial conditions have eroded into the gains of the rand and as a result, the rand is now above our 2Q18 forecast of 12.40 at R12.65, which we only envisaged to materialize in between 2Q18 and 3Q18. This is further evidence supporting our view that the rand is very sensitive to changes in the global environment via the carry-trade mechanism ([see page two for more](#)).
- The U.S Dollar is a barometer of the changing global liquidity environment. A stronger U.S Dollar is a reflection of tighter global financial conditions which we believe does not bode well for risk assets like the rand, whereas a weaker U.S Dollar is a reflection of easier global financial conditions and bodes well for risk assets like the rand.
- With no clear bullish local events on the horizon, we believe that the rand will continue to trade in-line with the international environment which will be dictated by the U.S Dollar. Should the U.S Dollar continue on its path stronger, we leave the likelihood open that the rand will move closer to our R12.80 target, which we only expected to materialize in the second half of 2018.
- **Short-term, we recommend keeping an eye on support at R12.43 and resistance at R12.68** (see our latest Technical Strategy note: [“The US Dollar breaks out”](#) of 3 April 2018 for a more detailed technical view on the currency).

Figure 1: ZAR catches up to the deteriorating international environment



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

“ONLY WHEN THE TIDE GOES OUT DO YOU DISCOVER WHO’S BEEN SWIMMING NAKED – WARREN BUFFET”

We believe that since 2016 there has been a tide of global liquidity that has eased global financial conditions and has had a meaningful impact on the performance of emerging market currencies and the rand. The risk of the tide of global liquidity retreating should not bode well for the carry-trade which many emerging market have benefited largely from – hence the Warren Buffet quote.

This ‘tide of global liquidity’ was a result of large-scale monetary accommodation from the global central banks and an improvement in global growth which has been a tailwind for financial markets. As a result of this ‘tide of global liquidity’, global financial conditions have been accommodative supporting record portfolio inflows into the emerging markets, including South Africa (see [Chart 1](#)). Emerging markets and South Africa have attracted record portfolio inflows totalling \$2.3tn and \$42bn since 2010, despite weakening economic fundamentals and a rise in political uncertainty.

Since the beginning of 2018, we have maintained a less-bullish stance on the rand compared to market consensus because we believe that the ‘tide of liquidity’ is retreating for two main reasons: 1) retreats as global central banks tighten their very accommodative monetary policy; and 2) as global growth loses momentum amid escalating trade tensions.

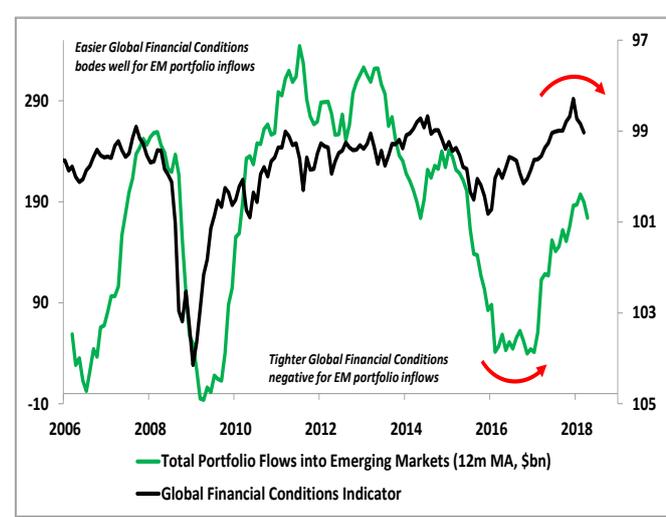
Global headwinds overshadow local tailwinds for the rand, even with improved external vulnerability measures

Our less-bullish stance on the rand (compared to consensus) continues to be not so much about the local economy. In fact, South Africa’s growth outlook has improved and its external vulnerability via its twin deficits (current account and government budget) is set to be smaller than a year ago. We expect South Africa’s current account deficit to come in at 2.4% of GDP in 2018, below the average deficit of 3.5% of GDP seen since the financial crisis, and well below the 6% deficit seen in 2013. This implies that the local currency is less vulnerable to global flows relative to other emerging market currencies now then. For example, in 2013 when the Fed first signalled its intention to embark on a tightening path. With that being said, South Africa has also received the largest amount of portfolio inflow as a percentage of GDP over the past six years at 45% of GDP vs emerging market peers of 23%, thus we do rule out the probability that the rand can come under severe/burdensome pressure should the carry-trade unwind.

We believe that tighter global financial conditions are underway, as reflected in the strengthening U.S Dollar and will remain a headwind for the performance of FX carry-trade returns like the rand ([Chart 2](#)).

We expect the rand to trade closer to R12.50-R13.00 against the dollar over the coming months.

Chart 1: Strong relationship between Global Financial Conditions and EM portfolio outflows



Source: BBG, IIF and Nedbank CIB markets Research

Chart 2: Strong relationship between Global Financial Conditions and the rand



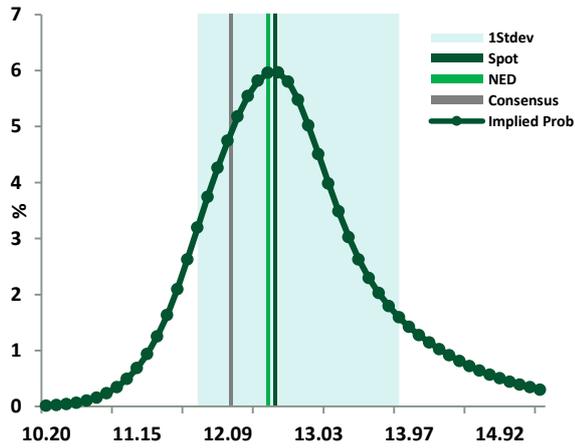
Source: BBG, Nedbank CIB Markets Research

FX VOL STILL LOW AS LOCAL EVENT RISK SETTLES

The forecast from the option market for the USDZAR has shifted away from Bloomberg consensus in recent weeks:

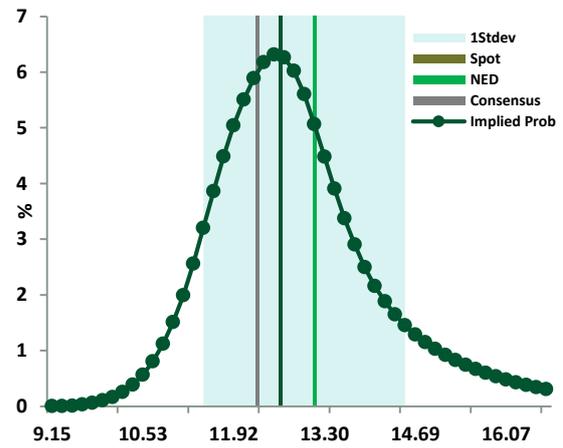
- On a three-month view, the option market suggests a one standard deviation trading range for the USDZAR of between 11.80 and 13.80 (see Chart 3).
- On a six-month view, the probability is skewed towards weakness, as one would expect, with the implied probability distribution suggesting a one standard deviation range of between 11.45 and 14.80 (see Chart 4).

Chart 3: 3m implied probability distribution vs forecast



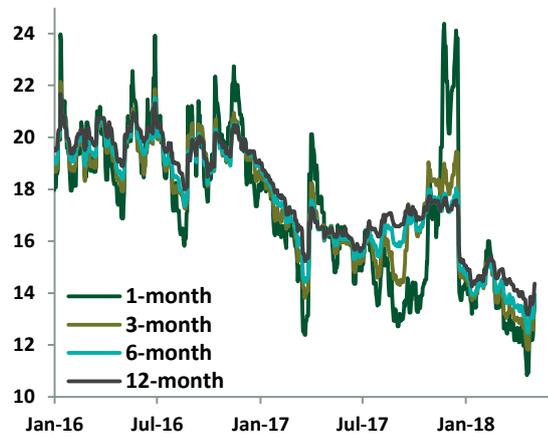
Source: Bloomberg

Chart 4: 6m implied probability distribution vs forecast



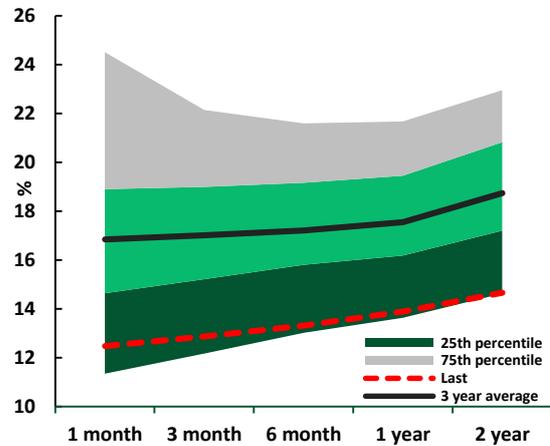
Source: Bloomberg

Chart 5: USDZAR implied volatility



Source: Bloomberg

Chart 6: ATM USDZAR implied volatility cone



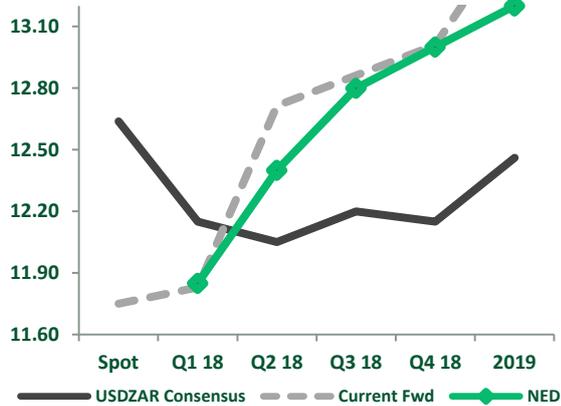
Source: Nedbank CIB Research; Bloomberg

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	12.55	11.85	12.40	12.80	13.00	13.20
Current Fwd	12.55	11.83	12.63	12.78	12.93	13.50
Consensus	12.55	12.15	12.12	12.23	12.20	12.50
EURZAR						
Nedbank	15.00	14.40	14.88	15.23	15.15	15.64
Current Fwd	15.00	14.58	15.16	15.44	15.75	17.01
Consensus	15.00	14.82	14.79	15.17	15.37	16.25
GBPZAR						
Nedbank	16.99	16.47	17.36	17.92	18.46	19.14
Current Fwd	16.99	16.58	17.15	17.42	17.71	18.85
Consensus	16.99	16.89	16.97	17.24	17.32	17.32
AUDZAR						
Nedbank	9.44	9.24	9.67	10.50	10.66	10.96
Current Fwd	9.44	9.08	9.50	9.62	9.74	10.23
Consensus	9.44	9.48	9.33	9.42	9.64	10.00

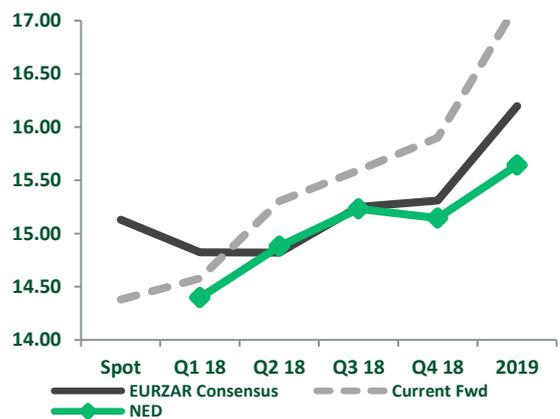
Source: Bloomberg, Nedbank CIB

Chart 8: USDZAR forecasts, consensus and forwards



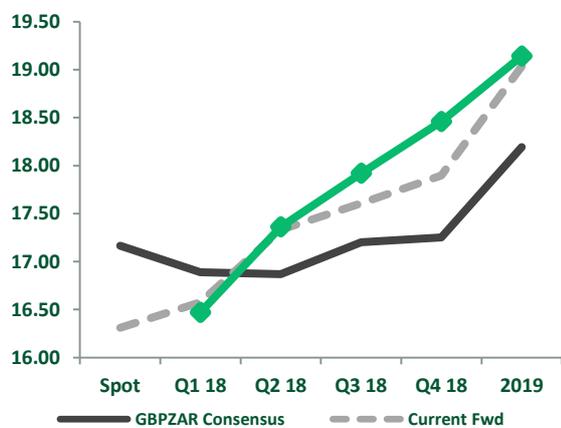
Source: Bloomberg, Nedbank CIB

Chart 9: EURZAR forecasts, consensus and forwards



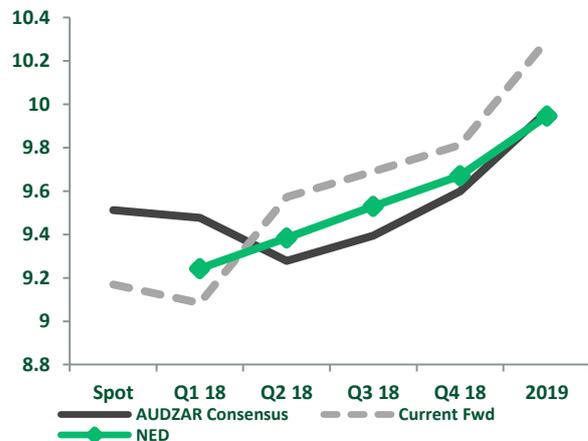
Source: Bloomberg, Nedbank CIB

Chart 10: GBPZAR forecasts, consensus and forwards



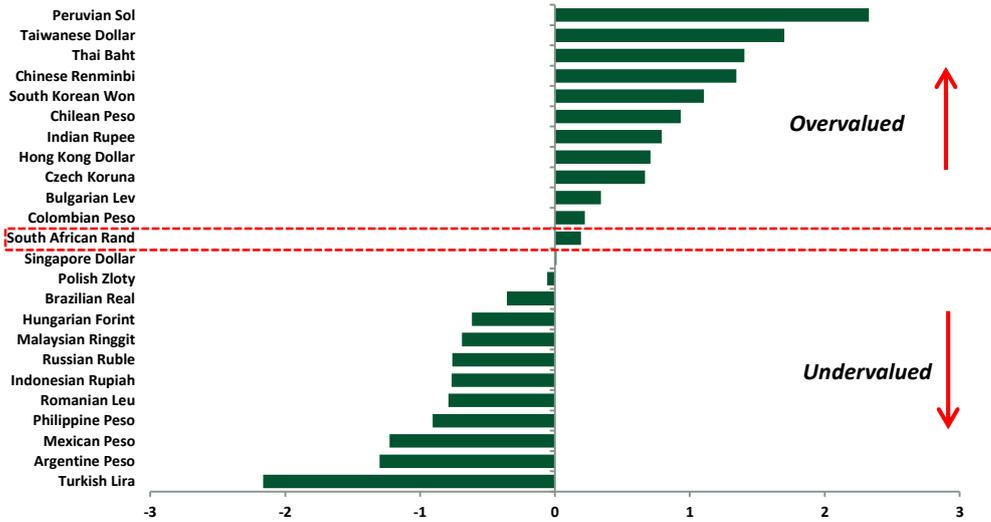
Source: Bloomberg, Nedbank CIB

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		-0.935	3.487	13.006	-0.793	13.062	-0.384	7.184	6.504	9.252	1.935	2.700	5.078	4.427	2.407
JPY	0.940		-4.025	-12.797	-0.175	-11.046	-0.327	-7.453	-6.653	-9.210	-2.700	-3.203	-5.322	-5.022	-3.133
KRW	-3.279	4.211		-8.539	4.145	-7.314	3.857	-3.608	-2.706	-5.409	1.409	0.711	-1.325	-1.029	0.898
TRY	-11.508	13.909	9.322		13.837	1.503	13.543	5.676	6.369	3.388	11.074	11.042	7.858	9.456	11.021
MXN	0.787	0.000	-4.011	-12.189		-11.003	-0.166	-7.143	-6.588	-9.063	-2.522	-3.080	-5.197	-4.465	-2.952
RUB	-10.330	12.422	7.890	-1.493	12.355		12.329	5.991	5.082	2.059	10.124	9.319	6.479	7.730	9.329
THB	0.350	0.315	-3.607	-11.937	0.351	-10.759		-7.119	-6.315	-8.910	-2.267	-2.935	-4.999	-4.749	-2.867
INR	-6.703	7.592	3.735	-5.337	7.749	-4.108	7.677		0.930	-2.127	5.204	4.463	2.475	2.378	4.664
AUD	-6.128	7.091	2.833	-5.981	6.912	-4.525	6.731	-0.995		-2.768	4.234	3.655	1.662	2.126	3.748
BRL	-8.486	10.136	5.711	-3.312	9.727	-2.020	9.790	2.159	2.869		7.381	6.294	4.339	4.540	6.482
GBP	-1.926	2.835	-1.385	-9.866	2.660	-8.594	2.255	-5.172	-4.053	-6.759		-0.522	-2.667	-2.174	-0.446
EUR	-2.715	3.352	-0.782	-9.897	3.066	-8.333	3.009	-4.138	-3.400	-5.962	0.559		-1.904	-1.486	0.144
CAD	-4.826	5.352	1.342	-7.890	5.477	-6.081	5.227	-2.031	-1.387	-4.139	2.774	2.152		0.591	2.219
ZAR	-5.056	4.823	1.876	-8.664	6.083	-7.216	4.910	-2.279	-2.108	-3.596	2.410	1.882	-0.559		1.546
USD	-2.353	3.234	-0.928	-9.330	3.047	-8.164	2.908	-4.240	-3.599	-6.294	0.511	-0.100	-2.175	-1.234	

Source: Bloomberg

Chart 14: Correlation matrix – markets vs FX

	VIX	SPX	US	US	SA	TOP40	EM FX	DM FX	MXN	AUD	CAD	ZAR
VIX		-81%	-56%	-45%	13%	-34%	-31%	-2%	26%	-18%	21%	25%
SPX	-81%		45%	34%	-19%	42%	46%	9%	-42%	41%	-31%	-36%
US	-56%	45%		92%	-2%	16%	10%	-1%	-15%	-1%	-9%	-9%
US	-45%	34%	92%		2%	9%	-2%	-1%	-6%	-7%	2%	1%
SA	13%	-19%	-2%	2%		-32%	-37%	-7%	23%	-12%	23%	53%
TOP40	-34%	42%	16%	9%	-32%		32%	-14%	-18%	23%	-27%	-13%
EM FX	-31%	46%	10%	-2%	-37%	32%		-35%	-73%	70%	-57%	-68%
DM FX	-2%	9%	-1%	-1%	-7%	-14%	-35%		16%	-7%	3%	0%
MXN	26%	-42%	-15%	-6%	23%	-18%	-73%	16%		-57%	62%	48%
AUD	-18%	41%	-1%	-7%	-12%	23%	70%	-7%	-57%		-61%	-49%
CAD	21%	-31%	-9%	2%	23%	-27%	-57%	3%	62%	-61%		46%
ZAR	25%	-36%	-9%	1%	53%	-13%	-68%	0%	48%	-49%	46%	

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		69%	35%	7%	-15%	2%	28%	-50%	54%	-39%	-39%	66%
Plat	69%		58%	-3%	1%	22%	38%	-50%	55%	-37%	-36%	60%
Pall	35%	58%		-8%	-9%	12%	38%	-32%	35%	-24%	-23%	39%
Ironor	7%	-3%	-8%		1%	6%	-16%	6%	-1%	4%	-14%	5%
Coppe	-15%	1%	-9%	1%		19%	0%	11%	-5%	7%	-4%	-1%
T-Coal	2%	22%	12%	6%	19%		6%	-21%	11%	-4%	-17%	13%
Brent	28%	38%	38%	-16%	0%	6%		-42%	30%	-36%	-36%	45%
BRL	-50%	-50%	-32%	6%	11%	-21%	-42%		-52%	37%	40%	-68%
AUD	54%	55%	35%	-1%	-5%	11%	30%	-52%		-61%	-49%	70%
CAD	-39%	-37%	-24%	4%	7%	-4%	-36%	37%	-61%		46%	-57%
ZAR	-39%	-36%	-23%	-14%	-4%	-17%	-36%	40%	-49%	46%		-68%
EM FX	66%	60%	39%	5%	-1%	13%	45%	-68%	70%	-57%	-68%	

Source: Bloomberg, YTD

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