FIC MARKETS

INSIGHT

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NEDBANK CIB

SARB ON HOLD: WE USE RAND STRENGTH TO REDUCE EXPOSURE

This week will see the first MPC meeting of the year. We expect the SARB to remain on hold: We continue to expect hawkish language, which on balance should support the rand in an environment where the Fed has turned more dovish. In **Table 1** below, we provide key discussion points that we believe are likely to feature in the MPC discussions and subsequent statement.

We see marginally lower headline inflation in 2019: We have adjusted our inflation forecast marginally lower and now expect inflation to average 5.3% in 2019. The adjustment comes largely on the back of lower energy prices (see **Chart 1**).

However, we believe the bias is still for a hike by the SARB later this year: Despite a marginally lower inflation forecast, we still believe the bias is for another hike by the SARB in 2019. Apart from headline inflation, we believe surveyed inflation expectations remain a key driver in the SARB's reaction function. The latest BER-surveyed two-year inflation expectation is still at 5.6% - well above the mid-point of the inflation target band of 4.5%.

Currently, we put the highest probability of a hike around the July meeting. As such, we believe the FRA market is too dovish and that the FRA curve needs to steepen somewhat into the 6x9FRA to reflect a greater possibility of at least one 25bps hike.

Technically, we are looking for short-term rand strength: From a technical perspective, we believe that current USDZAR weakness could extend towards 13.53 and 13.35, with an extended target at 13.12 (see **Chart 2**). As mentioned earlier, a hawkish SARB on Thursday may well aid this move and should favour a stronger rand against the USD. We, however, expect this move weaker in the USDZAR to be the final move of the correction phase (see Technical Analysis: FX and Bonds of 11 January 2019).

We will use this rand strength to reduce exposure: Despite short-term strength, from a fundamental perspective, we see a broad "fair value" range for the rand of R14.00-R15.00, and while bouts of rand strength or weakness beyond this range should be expected (as is currently the case), we view current strength as an opportunity to reduce rand exposure (see Rand: Looking ahead to 2019 of 11 December 2018).

While we believe the FRA market is too dovish on monetary policy, we think more patience is warranted before paying rates given the sensitivity of front-end rates to the currency: From a risk/return perspective, we would wait for rand strength towards 13.50 before considering a payer's position. A stronger rand is likely to drag front-end rates lower too.

Following the recent rally, we believe that upside for local bonds has become compressed: We read the current market stance as an environment where duration should be reduced rather than increased. This view is guided by both a fair value estimate for the 10-year bond yield of 9.20% (R186 just below 9.0%) and an FRA market, which in our view is too dovish (see Upside compressed after bond rally and dovish FRAs of 9 January) .

We do not believe Moody's will downgrade South Africa at its next country review, scheduled for 29 March; we think greater risk of such an event lies rather towards year-end. We believe that at 9.70%, the 10-year bond yield would fully reflect this downgrade risk (see **Chart 4**).

From a portfolio perspective, we are running a marginally short duration position in nominal bonds relative to the benchmark GOVI Index. At the same time, we have increased duration for ILBs for the first time in 12 months. We would look to reduce duration in nominal bonds further if the bond rally continues on the back of possible (short-term) rand strength (see The portfolio view - rolling back some risk of 14 December.

For a set of key forecasts, see page 6.

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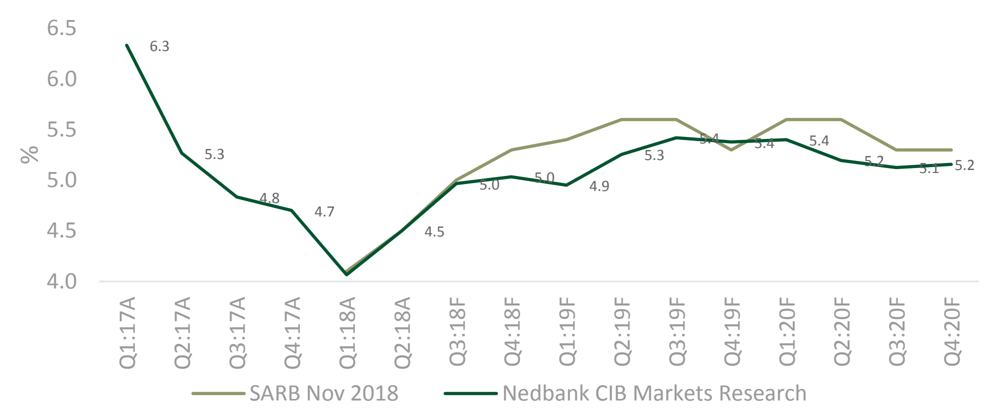
We have updated our inflation forecast and expect inflation to average 5.3% in 2019 (versus 5.5% previously)

We expect inflation to average 5.3% in 2019, peaking at 5.4% in 3Q19 (Chart 1). The adjustment lower is driven largely by a lower oil price. While our base case is for inflation to average 5.3% in 2019, this is highly dependent on the trajectory of the rand exchange rate and the international oil price, notwithstanding the threat of an El Niño event as well (see Monthly Insight of 8 January).

Chart 1: We expect inflation to average 5.3% in 2019, marginally below the SARB's view



Source: Nedbank CIB Markets Research, Bloomberg

Tactically, we are looking for a stronger rand: USDZAR set to test lower

The rand is likely to remain strong on the back of EURUSD strength (see Technical Analysis: FX and bonds of 11 January 2019). We expect another wave down in the USDZAR. Potential target levels for this wave C are 13.53 and 13.38, with an extended target at 13.12 (Chart 2). Optimism towards emerging markets will likely increase as the C wave unfolds. That is the nature of correction phases; at the end of wave C, the mood will likely be nearly as bullish as it was in early 2018. We, however, expect this to be the final move of the correction phase that started in September 2018 at 15.70.

Chart 2: USDZAR – The corrective phase is not complete

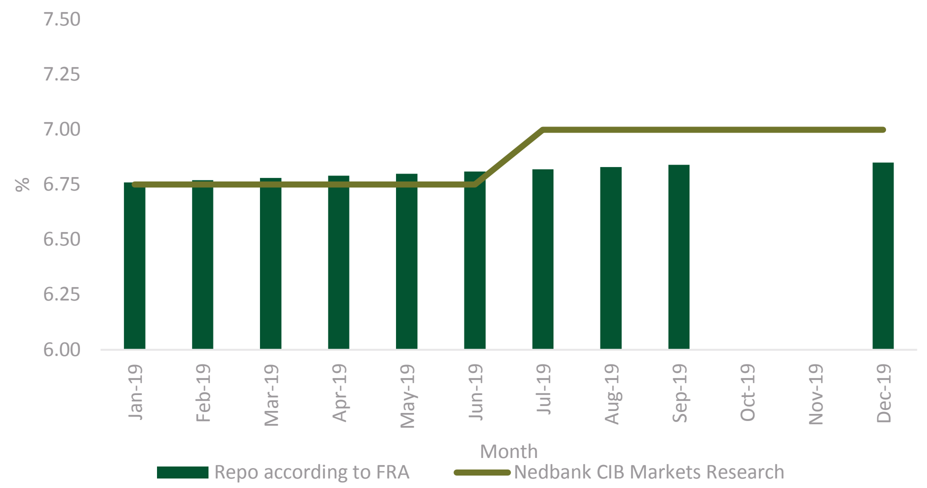
Source: Nedbank CIB Markets Research, Reuters

Front-end rates are too dovish, in our view, but we wait for a USDZAR move towards 13.53 to consider a payer's position

We continue to look for a 25bps hike by the SARB this year. At present, we see the highest probability of a hike around the May/July meetings. As such, we believe the FRA market is too dovish (Chart 3).

From a risk/return perspective, we would wait for rand strength towards 13.53 before considering a payer's position. A stronger rand is likely to drag front-end rates lower too.

Chart 3: FRA market too dovish compared to our base-case expectation for the SARB



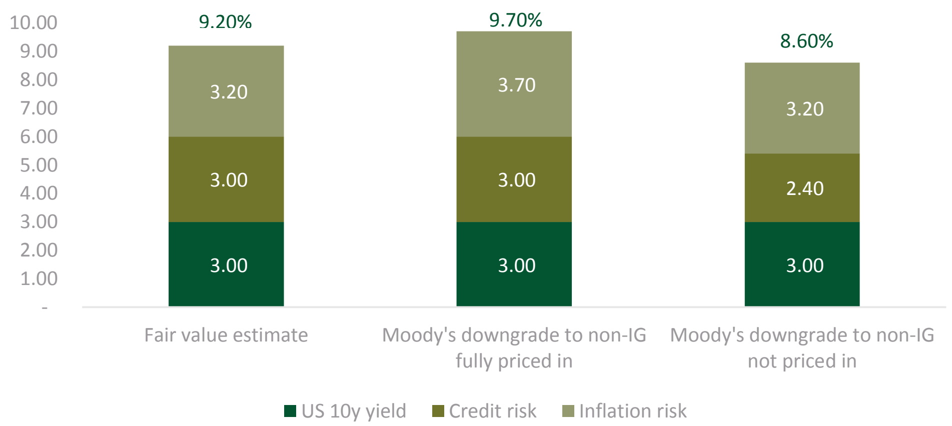
Source: Nedbank CIB Markets Research, Bloomberg

Our fair value estimates and a market pricing out SARB hikes suggest that upside is compressed

We pin our fair value estimate for South Africa's 10-year bond yield at 9.2%. This would put the R186's fair value just below 9.0%. This is based on a US 10-year yield at 3.0%. We think of this fair value estimate as a six-month view into mid-year (Chart 4).

Bonds are unlikely to benefit from a stronger rand to the same degree as front-end rates. The fact that bonds are now trading below our fair value estimate and that the FRA market seems to be dovish on monetary policy suggests that upside for local bonds has become compressed. We read the current market stance as an environment where duration should be reduced already rather than increased.

Chart 4: Fair value estimate (6-month view) for South Africa's 10-year bond yield



Source: Nedbank CIB Markets Research, Bloomberg

We expect the SARB to lower its inflation and growth estimates, while still maintaining a hawkish stance as it tries to support real rates

Despite trying to maintain a hawkish stance in the current hiking cycle, we expect the SARB's forecasts to remain dovish, with further downward revisions to its headline forecasts, as its input assumptions would need to be revised. To put this into perspective, we believe the output gap is likely to remain negative over the forecast period and will possibly widen further this year as the SARB reduces its growth assumptions, while its oil price forecast may decline, following the upward revision recently. The SARB's core inflation estimates are elevated in the absence of strong exchange rate pass-through and demand-pull inflation pressures.

While we anticipate no change to the repo rate this week, we do believe the bias is still for a hike by the SARB later this year as the SARB tries to reach its 2% real rate target, and lower inflation expectations closer towards the 4.5% mid-point.

Table 1: Discussion points likely to feature in the MPC statement

Global/Local	Factor	SARB Nov 2018 MPC meeting	Recent developments
GLOBAL ECONOMY	**Geopolitical developments**	The global economic outlook is expected to remain broadly favourable over the short term. However, medium-term risks are tilted to the downside due to less synchronised global growth. This is amplified by elevated policy uncertainty emanating from escalating trade tensions, tightening global financial conditions and rising geopolitical risks.	The US and China are currently in talks to end the 90-day trade truce that was implemented in November 2018. The IMF has warned that ongoing trade tensions would hamper global growth. It lowered its forecast for global growth to 3.7% for 2019 from 3.9%. The OECD has said that the ongoing trade conflict could reduce world trade by up to 2% by 2021. The eventual impact of a protracted trade war, combined with a no-deal Brexit and tighter monetary policy, may be substantially worse in the long run. Export-oriented economies like Germany and Japan have been hard hit by reduced exports, with both countries contracting in 3Q18. Political uncertainty had risen in some parts of Europe and exacerbated by an uncertain Brexit outcome. These factors will likely add to the uncertainty surrounding the global macroeconomic outlook. Global financial conditions have continued to tighten as the Fed has continued with its hiking cycle and the ECB ends its QE programme. Despite the central banks' own forecasts, the market remains quite dovish, forecasting rate cuts in the US and no hike in the Eurozone this year.
LOCAL ECONOMY	**GDP growth and the output gap**	The SARB now forecasts growth in 2018 to average 0.6% (down from 0.7% in September). The forecast for 2019 and 2020 is unchanged at 1.9% and 2.0% respectively. At these growth rates, the negative output gap is wider than at the time of the previous MPC meeting. The output gap will narrow but will not close by the end of 2020, as previously expected. The MPC assesses the risks to the growth forecast to be moderately on the downside. As previously highlighted the Committee remains of the view that current challenges facing the economy are primarily structural in nature and cannot be solved by monetary policy alone.	While 4Q has started off on a positive footing as a result of better high-frequency economic data, growth is still below potential, keeping the output gap negative. The SARB maintains an elevated growth profile relative to consensus (1.5% and 1.8% for 2019 and 2020, respectively) and Nedbank forecasts of 1.6% for 2019 and 2% for 2020. We believe risks to the growth outlook are to the downside and that the SARB is likely to revise its forecasts lower at upcoming meetings, in line with the global backdrop.
	Inflation, inflation forecasts, inflation expectations	The inflation forecast has improved marginally since the previous MPC The SARB's model projects an increase in headline inflation, albeit slightly lower than the September projection. Headline inflation is now expected to average 4.7% in 2018 (down from 4.8%), before increasing to 5.5% in 2019 (down from 5.7%) and moderating to an unchanged 5.4% in 2020. Headline CPI inflation is now expected to peak at around 5.6%, in the third quarter of 2019. The forecast for core inflation is 4.3% in 2018 (down from 4.4%), 5.3% in 2019 (down from 5.6%) and 5.5% in 2020. These inflation projections are based on an interest rate path generated by the SARB's Quarterly Projection Model (QPM). The MPC continues to assess the risks to the longer-term inflation outlook to be on the upside. The MPC noted the rising inflation trajectory which, while remaining within the target range, continues to deviate from the mid-point of the target range. The approach of the MPC is to look through the first-round effects and focus on the possible second-round effects of supply side shocks. However, shocks of a persistent nature such as extended periods of currency depreciation, elevated oil prices and multi-year electricity price increases make it difficult to disentangle these first and second round effects.	SA's CPI inflation surprised to the upside in November, rising to 5.2% y/y from 5.1% previously and expected. Core inflation rose to 4.4% y/y from 4.2% previously, driven by higher goods inflation. Transport inflation and administered prices remained roughly unchanged because of stable fuel costs in November. However, we believe this would have eased in December because of the 11% reduction in fuel costs. The key inflationary driver for November, however, was prices of alcoholic beverages and tobacco, which added 10bps to headline inflation. SA's CPI is expected to rise gradually in 2019. While our base case is for inflation to average 5.3% in 2019, this is highly dependent on the trajectory of the rand exchange rate and the international oil price, notwithstanding the threat of an El Niño event as well. Consumers are likely to remain hard-pressed by the elevated unemployment rate, rising interest rates and inflation, and slow growth and are unlikely to prop up sales activity closer to its long-run trend. This would imply limited demand-pull inflation in 2019. Inflation expectations, however, remain uncomfortably high, with BER two-year forecasts at 5.6% y/y. We currently project CPI inflation at 5.3% in 2019 and 5.2% in 2020.
	Market expectations	The FRA curve flattened since the last MPC meeting, as front-end yields rose sharply. The market is now seeing 3.8 hikes of 25bps each over the next two years	The FRA curve is now fairly dovish relative to the SARB's QPM, with the FRA market pricing in just one hike of 25bps in the current cycle, but only in 2020. We believe the FRA curve is too flat and that it should steepen as the SARB remains hawkish at upcoming meetings.

LOCAL ECONOMY	**Rand exchange rate**	Since the September MPC, the rand has appreciated by 3.8% against the US dollar, by 6.6% against the euro, and by 5.2% on a trade-weighted basis. The implied starting point for the rand is R14.50 against the US dollar, compared with R14.20 at the time of the previous meeting. At these levels, the QPM assesses the rand to still be undervalued. Tighter global financial conditions, financial market volatility and the change in investor sentiment towards emerging markets remain key external risks to the rand. Over the medium term, it is likely that the rand, along with other emerging market currencies, will remain volatile.	Since the last MPC meeting, the rand has weakened by 1.2% against the USD and by 1.6% against the EUR and remained unchanged against the GBP. As a result, the trade-weighted rand has weakened by 1% in the same period. The rand has remained the second most volatile currency in the world after the Turkish lira and is likely to remain so for much of this year. Our base case for the rand is still for a range of R14.00-R15.00/USD in 2019 – bouts of weakness and strength beyond this range should be expected, but they are unlikely to be sustainable through the year.
	Administered prices	Administered prices, including fuel, electricity and water tariffs, are expected to increase at rates above the upper end of the inflation target range.	Eskom's tariff application is being considered by the NERSA, which is set to release its decision on 1 March 2019. Eskom has applied for a 15% tariff increase, over and above the 4.4% RCA clawback it received for the next three years. The 4.4% tariff hike will take effect in April 2019, which may add pressure on administered prices. Since the last MPC meeting, the price of petrol has fallen by R3/litre, or 18%. This, as the rand price of Brent crude has declined by more than 4%. A further, albeit smaller, fuel price reduction is expected in February as well, which could ease administered costs in the interim before electricity prices add pressure.

Source: SARB and Nedbank CIB Markets Research

Key forecasts and target values

	Target values				Broad trading range	
	3m	6m	12m	Year-end	High	Low
Fed funds	2,50	2,75	3,00	3,00	2,50	3,00
US 10-year bond yield	2,80	3,00	2,80	2,80	2,30	3,20
Repo rate	6,75	6,75	7,00	7,00	6,75	7,00
SA 10-year bond yield	9,20	9,60	9,40	9,40	8,60	9,70
R208 (%)	7,00	7,10	7,20	7,20	6,90	7,40
R186 (%)	8,90	9,30	9,10	9,10	8,30	9,40
R2048 (%)	10,00	10,20	10,30	10,30	9,50	10,50
EURUSD	1,15	1,16	1,14	1,13	1,13	1,17
USDZAR	14,00	14,50	14,50	14,00	14,00	15,00
EURZAR	16,10	16,10	16,53	15,82	15,50	17,00
GBPZAR	17,60	18,60	18,20	17,50	17,00	18,50
AUDZAR	10,00	10,60	10,30	10,00	9,50	10,50
Nedbank CIB Markets Research/Nedbank Group Economics						
	1Q19	2Q19	3Q19	4Q19	2019 Avg.	2020 Avg.
SA headline CPI	5,00	4,90	5,30	5,40	5,30	5,20
SA core inflation	4,40	4,50	4,50	4,60	4,50	4,50
SA GDP	1,60	1,70	2,10	2,30	1,60	2,00
Current account as a % of GDP					-3,3	-3,6
South African Reserve Bank						
	1Q19	2Q19	3Q19	4Q19	2019 Avg.	2020 Avg.
SA headline CPI	5,40	5,60	5,60	5,30	5,50	5,40
SA core inflation	4,90	5,20	5,40	5,60	5,30	5,50
SA GDP	-	-	-	-	1,90	2,00
Current account as a % of GDP	-	-	-	-	-3,9	-4,1
National Treasury						
	1Q19	2Q19	3Q19	4Q19	2019 Avg.	2020 Avg.
SA headline CPI	-	-	-	-	5,60	5,40
SA core inflation	-	-	-	-	-	-
SA GDP	-	-	-	-	0,70	1,70
Current account as a % of GDP	-	-	-	-	-3,2	-3,7

Source Nedbank CIB Markets Research, Nedbank Group Economics, SARB, NT

All numbers in % unless otherwise indicated

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