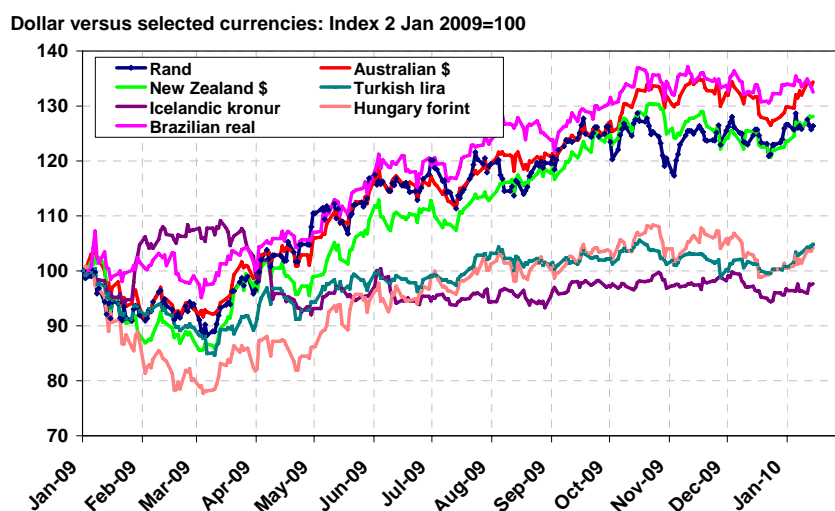


## Rand prospects: strength in the short term followed by second half weakness?

In *Rand prospects* at the beginning of last year, we forecast that the rand would remain weak and vulnerable in the short term because of the gloomy global conditions, but forecast that the currency would pull back strongly from heavily undervalued territory later in 2009 as markets started to factor in an economic recovery and investors started bargain hunting. Supporting factors were South Africa's policy flexibility (the ability to cut interest rates from very high levels and also to ramp up fiscal stimulus) and the approaching 2010 FIFA World Cup. In the event this turned out to be the case, with the rand falling in January and February before rising strongly over the remainder of the year. The magnitude of the turnaround again surprised. The rand rose by 22,8% against the trade-weighted basket, by 26,2% against the US dollar, 23,5% against the euro and by a massive 29,0% against the yen. It rose by just 13,1% against a recovering sterling. The key feature of 2009 was the attractiveness of commodity currencies as China forged ahead in its recovery. Figure 1 shows that the rand tended to track other commodity currencies, which in turn outperformed other emerging market currencies.

Figure 1: Commodity currencies outperformed in 2009



The outlook for 2010 is murkier. Unlike at the start of 2009, the rand is not massively under- or over-valued. Most purchasing power parity estimates (which use the inflation differential between South Africa and its trading partners) suggest that the currency is some 5% to 15% overvalued. This compares with between 15% and 25% in January 2009. Our own measure puts it at around 7% against the trade-weighted basket (see figure 2). Clearly perceptions among exporters will differ, with those competing in US dollars in sectors which are facing declining prices under considerably more stress than areas where prices have increased by enough to offset the declining dollar.

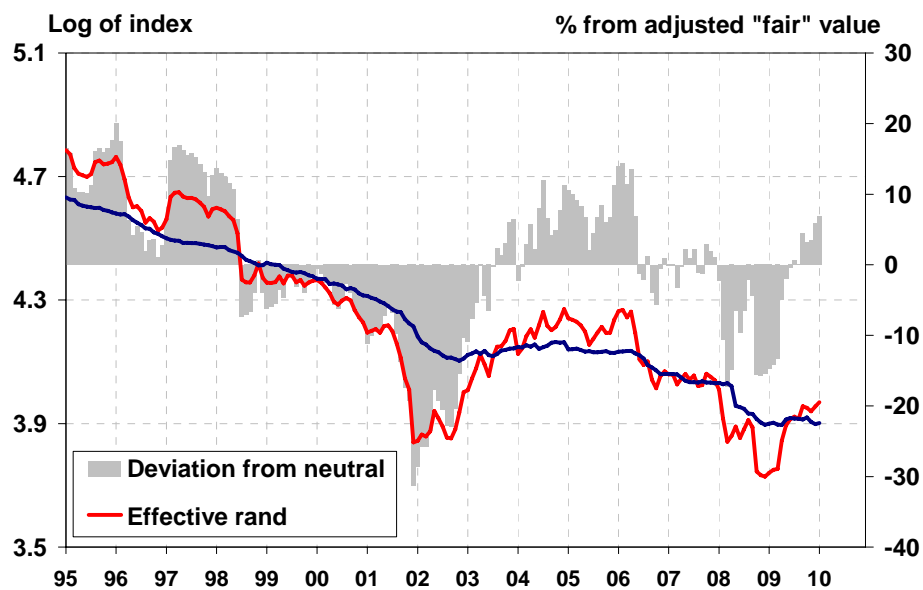
What is clear, however, is that the rand can still move higher from these levels, driven by the same international factors that prevailed for much of 2009. These would include positive views of relative prospects for emerging markets (and therefore commodity prices), diminishing risk aversion and the dollar carry trade play, where US dollars are borrowed at very low interest rates, and then exchanged and deposited into higher-yielding currencies such as the rand and the Australian dollar. Speculators have had the added comfort of knowing that the US authorities are unperturbed by its weakness and are also not likely to raise interest rates too soon, while at the same time the higher-yielding currencies are being supported by reasonable fundamentals and

rising commodity prices. In South Africa's case there will be the added psychological and actual boost provided by the 2010 FIFA World Cup.

These conditions might start to unravel later in the year, however. The first possibility is a return of risk aversion and a flight back into safe-haven currencies such as the US dollar. This could result from disappointing economic setbacks in both developing and developed markets. We continue to believe that the global economy is still fragile, with bank credit extension likely to be impeded by stronger regulatory demands and the negative recent history. Many developing countries, such as China, have done well in focusing inwards as export demand has soured, but this may not be as sustainable in the medium term as most now think.

The second possibility is that the US dollar itself rebounds on relatively good economic performance, with the more flexible US economy recovering more rapidly than Europe. Thirdly, South Africa's own perceived attractiveness could fade after the World Cup. The last possibility is a policy change, where South African authorities try and push the currency to more competitive levels, possibly changing the Reserve Bank's inflation-targeting mandate - something that is probably not desirable or likely, but still possible.

Figure 2: Rand is now overvalued on a purchasing power parity basis



## Conclusion

The rand will probably remain underpinned by favourable global conditions and the approaching 2010 FIFA World Cup for much of the first half of the year. However, there is an increased danger of setbacks in the second half of the year, with a potential correction taking it down to levels slightly below that predicted by inflation differentials for the year as a whole

15 January 2010

<b>Influences on the rand</b>			
<b>Factors</b>	<b>Effect</b>	<b>Tendency</b>	
		<b>Recent</b>	<b>Expected longer-term</b>
<b>External or international</b>			
US dollar	Weak dollar normally implies firmer trade-weighted rand.	Dollar has been falling against peer currencies as US continues to encourage a competitive devaluation and investors become more disillusioned.	Difficult to predict as EU also has structural weaknesses and the US current account deficit is likely to improve over time.
Commodity prices	Strong commodity prices are rand supportive.	Commodity prices have improved on the back of the weaker dollar and positive view of prospects in commodity-intensive economies such as China. Precious metals have gained as a dollar alternative.	In the long term Chinese demand will again be a dominating force. However, medium-term weakness is likely, given the possibility of economic setbacks.
Interest rate gap	Higher = positive, but depends on circumstances.	SARB paused at the last MPC meeting.	MPC will probably keeps rates unchanged into 2011, with the next move up.
Emerging market perceptions	Positive = good for rand.	Risk aversion has eased and investors are looking to emerging markets for economic growth.	Strong risks of a relapse in sentiment if global economy disappoints over the next few months.
<b>Predominantly domestic</b>			
Growth perceptions	Rand strength if perceptions of relative growth are positive	Gdp rose by 0,9% in the third quarter, signalling the end of a sharp recession. However, economic conditions remain tough.	Depends on global growth cycle, but could become more favourable in relative terms in 2010.
Current account	Large unsustainable deficit would be rand negative.	Fell to 3,2% of gdp in the third quarter after improving to 3,4% in the second from 6,7% of gdp in the first.	Will remain wide in the global context; sustainability depends on consumer/ investment mix, commodity price cycle, policy and external perceptions. Low dividend payments will help.
Policy and policy perceptions	Rand positive, if promotes financial stability and economic growth.	Policy debate has re-opened with potentially negative consequences for the rand. The mandates of the current economic portfolios need to be clarified. Despite this, Moody's has moved SA into the A3 category.	Less supportive in the medium term, with dangers of policy relapses occurring if weak global and local conditions persist.
Exchange controls	Relaxing potentially negative for rand in short term, positive in long term as foreign investment picks up.	Recent move to relax was unexpected. Further relaxation looks possible but not in short term.	Exchange control relaxation is being used as a tool to take upward pressure off rand. Further moves are possible.
Abnormal flows	Inflows/ outflows related to FDI transactions	Some prospects for deals in motor vehicle sector given government incentives.	Uncertain. Inflows should pick up once political and policy environment becomes clearer and global climate settles.
Rand under- or overvalued?	If overvalued then will depreciate in long term and vice versa.	Probably slightly overvalued at current levels.	Should revert to long-run fair value based on adjusted PPP implying some above-inflation differential depreciation at some point.

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