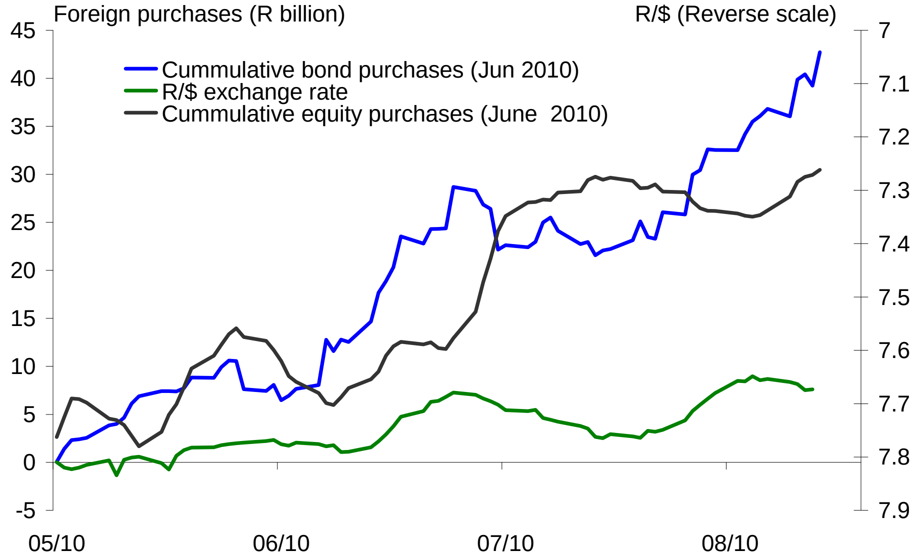
## Rand prospects: favourable yield differential drives local unit higher

The rand fell below the R7,20 to the dollar level on 10 September, despite the Reserve Bank's decision to cut interest rates on 9 September. However, this is perhaps not surprising as rate cuts have often resulted in the rand appreciating in the short run because easier monetary policy improves growth prospects and reduces long-bond yields. The dollar was stable against the euro and the British pound over the period as economic data failed to provide any real direction to the market. In contrast, emerging and commodity currencies remained the flavour of the month, with the Australia and New Zealand dollar, Malaysian ringgit, Brazilian real, Chilean peso as well as the South African rand, appreciating more than 1,5% against the dollar. Since the middle of August the rand has risen by 1,6% against the trade-weighted basket, with gains of 1,9% against the US dollar, 3% against the pound, 2% against the euro and 0,2% against the yen.

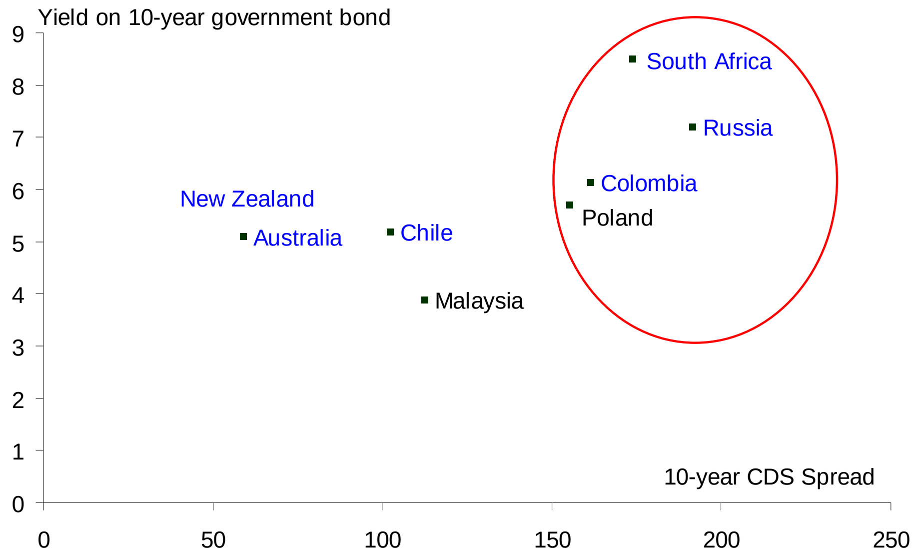
Figure 1: Inflows into bonds and equities since June 2010




Foreign purchases of domestic fixed-income securities have been one of the main contributors to the rand's strength over the past few months. The logic has been quite simple, a favourable yield differential combined with reduced exchange-rate risk, due to a virtuous cycle where increased foreign demand for local assets reduces, at least in the short term, the risk of a currency reversal, making local assets even more attractive. As a result, since the beginning of the year foreign purchases of domestic bonds have totalled R78,5 billion and nearly R50 billion since early June.

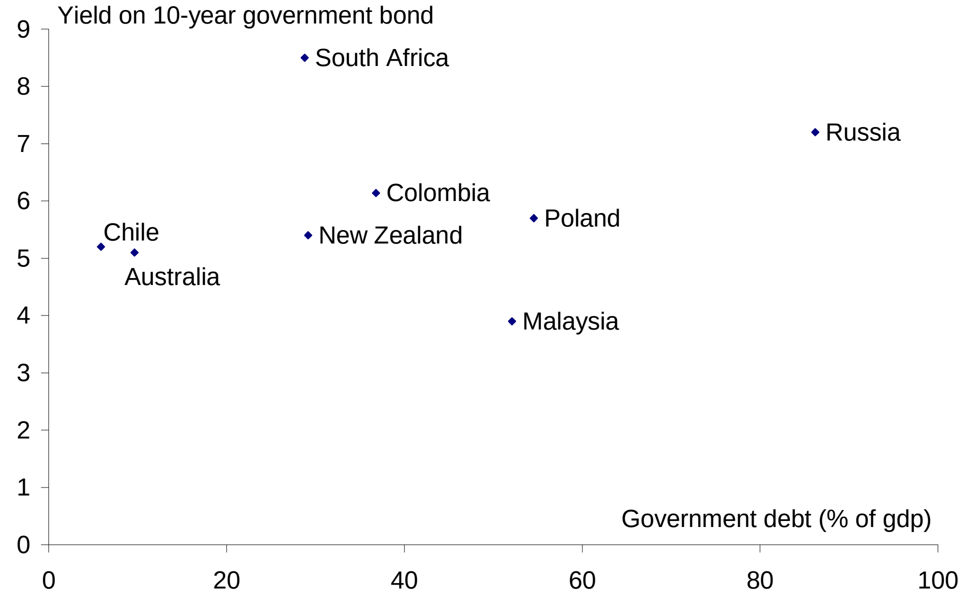
In last month's report we highlighted that it was too early to call a structural change to investors' perceptions and stressed the risk of a quick reversal in capital inflows. In order to assess how vulnerable South Africa is to a sudden exodus of foreign capital, it is useful to consider how attractive local bonds are relative to other emerging market debt.

Figure 2: South African bonds offer good return relative to risk



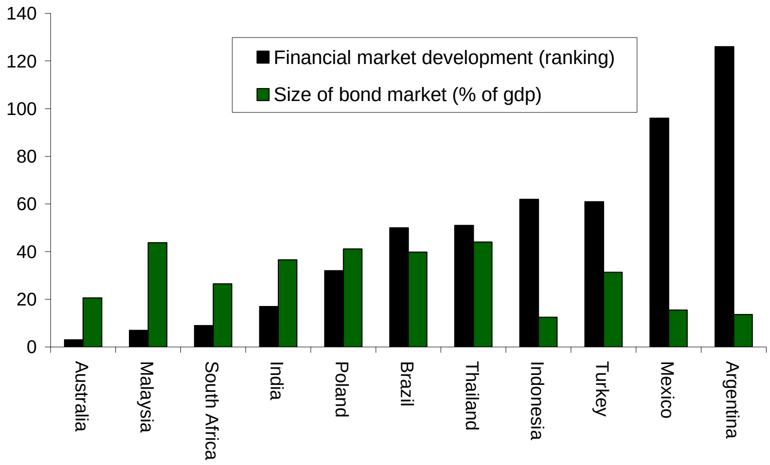

On most sovereign risk metrics emerging markets look much healthier than developed countries. However, how do emerging markets compare with each other, relative to the yield on offer? CDS spreads, which measure the cost of insuring a bond against default, provide one proxy for assessing sovereign risk. Graph 2 plots the 10-year government bond yield for a selection of emerging market countries that issue local currency debt against the 10-year CDS spread. South African bond yields look favourable on this basis, with a high return relative risk. Fiscal troubles in Southern Europe have increased investor's focus on government debt levels as a key risk measure. Graph 3 suggests that South Africa compares very favourably on this metric, with one of the lowest debt to gdp ratios among the group.

Figure 3: Bond yields and government debt




Although sovereign risk plays an import role, liquidity risk and interest rate risk (duration) are also key considerations. Compared with other emerging markets, South Africa has a well developed, liquid financial market with the size of the bond market equivalent to 30% of gdp (graph 4). South Africa's short-term interest rate and inflation outlook also appears more favourable, particularly when compared with some Asian and Latin American countries, where interest rates have already begun to rise to curb inflation.

Figure 4: Development of financial sector




Despite favourable fundamentals supporting the local bond market, which could continue to drive yields lower, two key risks persist that could see investors exit the market. Globally, the risk of either a double-dip recession or a European sovereign defaulting remain, which would quickly send investors heading back to the safety of US Treasury Bills. On the domestic side, next week's ANC National General Council (NGC) meeting will be watched closely, where issues such as a tax on short-term capital inflows, as well as degrees of nationalisation are likely to feature on the agenda. Although the debate has not deterred investors so far, there is a danger that the intent to consider these policies more seriously may hurt sentiment.

**Conclusion**

The rand rose to its strongest level against the dollar since January 2008 in mid September, supported by strong demand for emerging market assets and improved certainty, following the announcement of the Basle III recommendations on banks' capital requirements. Strong demand for emerging market debt, and particularly South African bonds, could continue to support the local currency in the coming months. However, the risk of a correction remains, with capital inflows possibly reversing over a short period if emerging market growth disappoints or a shift in domestic policy unsettles the market.

16 September 2010

| **Influences on the rand** | | | |
|---|---|---|---|
| **Factors** | **Effect** | **Tendency** | |
| | | **Recent** | **Expected longer-term** |
| ***External or international*** | | | |
| US dollar | Weak dollar normally implies firmer trade-weighted rand. | Dollar range bound as economic data failed to provide the market with any direction | Difficult to predict as EU has structural weaknesses and US growth prospects are better. However, $ will probably improve in the short- to medium term but remain in a longer-term downward cycle. |
| Commodity prices | Strong commodity prices are rand supportive. | Mixed, but mostly off peaks seen early in 2010. | In the long term Chinese demand will again be a dominating force. However, medium-term weakness is possible, given the possibility of economic setbacks. |
| Interest rate gap | Higher = positive, but depends on circumstances. | Further rate cut is still possible, if growth substantially weaker. | Although gap could close slightly in the short term, the carry trade will remain a strong supporting force. |
| Emerging market perceptions | Positive = good for rand. | Risk aversion eased slightly, markets are still more focused on Europe than emerging markets. | Woes could spread to emerging markets if the global economy disappoints over the next few months. |
| ***Predominantly domestic*** | | | |
| Growth perceptions | Rand strength if perceptions of relative growth are positive | Gdp rose by 3,1% in the second quarter, lower than market expectations. Recent figures have been mixex. | Will still be positive, but a global double-dip recession would spell trouble for domestic prospects as well. |
| Current account | Large unsustainable deficit would be rand negative. | Deficit widened to 4,6% of gdp in the first quarter of 2010 after falling to 2,9% in the fourth quarter. | Will widen as domestic economy improves; sustainability depends on consumer/ investment mix, commodity price cycle, policy and external perceptions. |
| 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. Government is also considering a tax on short-term capital inflows. | 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. | Minor changes in February 2010 budget following major relaxation in October 2009. | 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 | Has been relatively limited. | Uncertain. Inflows should pick up once political and policy environment becomes clearer and the global climate settles. |
| Rand under- or overvalued? | If overvalued then will depreciate in long term and vice versa. | Over 10% overvalued at current levels. | Should revert to long-run fair value based on adjusted PPP implying some above-inflation differential depreciation at some point. |