

22 August 2011

Economic Commentary

Rand Prospects

Rand's prospects have dimmed

- Government debt troubles in the developed world mounted over the past month as concerns about a possible double-dip recession gained traction, increasing risk aversion and putting the rand under pressure.
- The short-term outlook for the rand will depend on the credibility of the US and European policy responses. The currency is likely to be volatile but stable, with downside risks if the debt situation deteriorates or the global economy continues faltering, but upside potential if risk aversion subsides and investors opt to chase higher yields in emerging markets.
- Over the medium term the risks of rand weakness will rise on a renewed slump in global activity, intensification of the debt crisis or domestic policy mistakes.

Comment

In last month's Currency Insight we highlighted that the rand had acted as a barometer of global confidence over the past few years and risked correcting if global risk aversion rose. The events of the past month have borne this out again. In early August, markets grew anxious. Italy and France, which had largely avoided investors' attention so far, suddenly came into the spotlight. Investors grew weary about Italy's large debt burden, second only to Greece, in the Eurozone, and expressed concerns about French banks exposure to peripheral Eurozone countries. The decision by Standard and Poors' to downgrade the US's sovereign credit rating to AA+ as well as concerns that the US might slip into a double dip recession, also added to the selloff.

The rand was not alone in coming under pressure in recent weeks. The rand was not alone in coming under pressure in recent weeks. The rand fell by 3,2% against the dollar, while the Australian dollar and the Brazilian real fell by 2% and 1,9% respectively. The New Zealand dollar declined by a modest 0,1%. In contrast, the Turkish lira came under significant selling pressure, declining by 7% against the US dollar.

Since the start of the year, the picture looks slightly different. The rand has fallen by 7% against the dollar, although the probably reflects the high base established at the end of 2010. The Turkish lira fared even worse, declining by 12%. However, most emerging market and commodity currencies have gained against the dollar since the beginning of the year. The New Zealand dollar as well as the Hungarian forint are 8,3% and 10% higher against the US currency, while the Australian dollar and the Brazilian real have gained 2,1% and 3% respectively.

Group Economic Unit

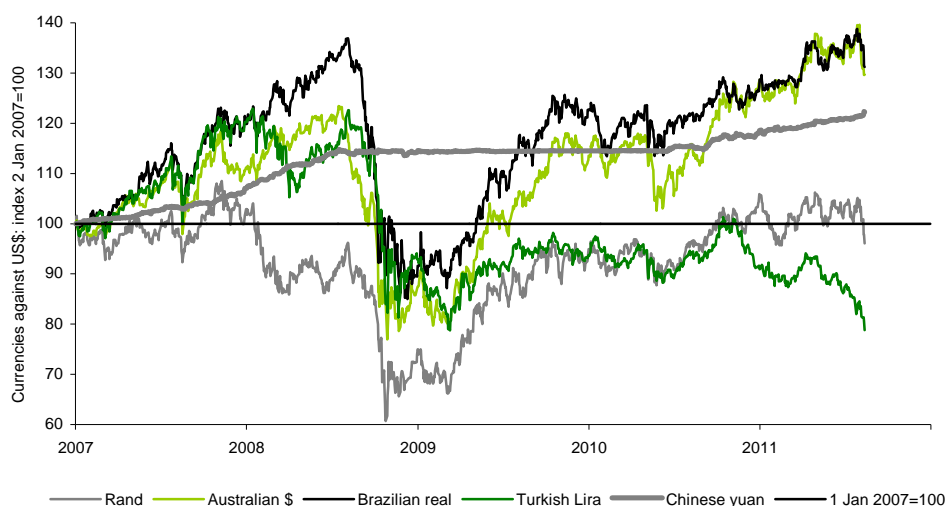
Carmen Altenkirch
+27 11 295 9878
CarmenAl@nedbank.co.za

Corporate Place, 135 Rivonia Road,
Sandown, 2196, South Africa

<http://nedbankgroup.co.za>

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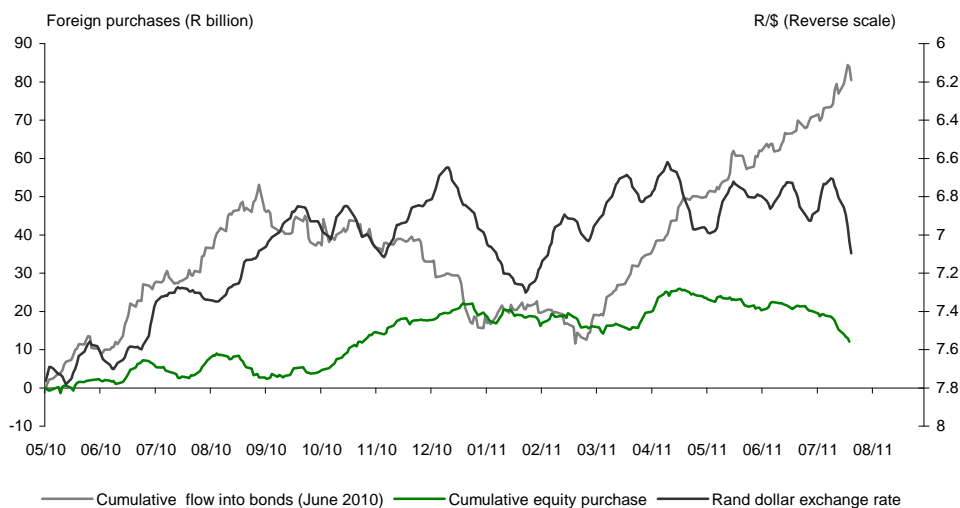
Chart 1 : Recent performance of emerging market currencies against the dollar



Source: Inet

The events of the past month suggest that investors are yet to distinguish the rand from other emerging market currencies, despite more fervent talk about nationalisation or at least more state interventions as well as the release of a policy paper on National Health Insurance, which if implemented, will add an additional R125 billion to the government’s bill next year alone. For the moment, investors continue to focus on short-term positive attributes, such as the yield differential between South African and funding currencies such as the yen and dollar.

Chart 1 : Purchases of South African securities by foreign investors have remained strong



Source: Inet

What lies in store for the rand?

With global markets appearing to have calmed slightly and the rand holding firm over the past few days, it provides a useful vantage point to consider what might lie in store for the currency over the coming months.

In the first scenario, we stand near the cusp of a larger correction in the rand, and asset prices in general. The recent correction prices in the possibility that growth, particularly in advanced economies, will be below expectations and that debt troubles in both Europe and the US could pose a serious threat to global growth. However, the reality of double-dip recession in the US, combined with a full-blown debt crisis in Europe would push markets

over the edge. Policy gaffs at home, in an environment of heightened risk aversion, could also contribute towards a steep depreciation in the currency. Past experience suggests – and events of 2008 probably provide a good example of this – that the rand tends to over react in times of market turmoil, overshooting on the downside, but quickly recovering as confidence returns.

In the second scenario, the stop-start growth of the past two years continues. With growth in advanced economies broadly stagnating in this scenario, investors will be drawn to the higher yields offered by emerging markets. In this scenario the rand will retrace its losses of the past few weeks and will settle somewhere below R7 to the dollar.

A combination of both these scenarios is not out of the question either. The currency could well consolidate and recover in the coming weeks, as investors focus on the good rather than the bad news. However, with no meaningful solution insight for the European debt crisis and growth in the US weighed down by a crippled housing market, companies which seem too scared to hire more workers and fiscal tightening on the way – the risk that the US falls back into recession seems to be increasing.

Conclusion

Downside risks to the rand have increased in recent weeks, as cracks in the global economic recovery have become more glaring. In the short term, investors may well opt to focus on more positive news and stop-gap policy measures taken by governments. However, with few policy options left to the US to prevent a downturn turning into a recession and European policymakers seemingly unwilling to make the hard decisions needed to resolve the debt crisis, the risks of a more sizeable correction has increased.

Table 1 : 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 has pulled back after earlier weakness.	The dollar could firm once stimulatory policy is withdrawn and European woes persist. However, the long-term trend is probably still down.
Commodity prices	Strong commodity prices are rand supportive.	These have been mixed but gold has been very strong.	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.	Local rates are moving sideways and rates elsewhere are trending higher.	The carry trade will remain a supporting force as local rates move into the upcycle from 2012 onwards.
Emerging market perceptions	Positive = good for rand.	Risk aversion has increased, but 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 4,8% in the first quarter, higher than market expectations. Recent figures suggest weak growth in the second quarter, however.	Will still be positive, but could lose some momentum on a weaker global environment.
Current account	Large unsustainable deficit would be rand negative.	Deficit widened to 3,1% of gdp in the first quarter of 2011, up from 1,0% 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 stance has become more interventionist and protectionist, but monetary and fiscal stance continues to allay investor fears.	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.	Further relaxation in the budget. Government is considering a tax on short-term capital inflows but this is unlikely to be imposed.	Exchange control relaxation is being used as a tool to take upward pressure off rand. Further relaxation is possible.
Abnormal flows	Inflows/ outflows related to FDI transactions	Walmart deal eventually approved but future inflows likely to be limited in current climate.	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.

Source: Nedbank Economic Unit

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