NEDBANK

18 January 2011

Economic Commentary

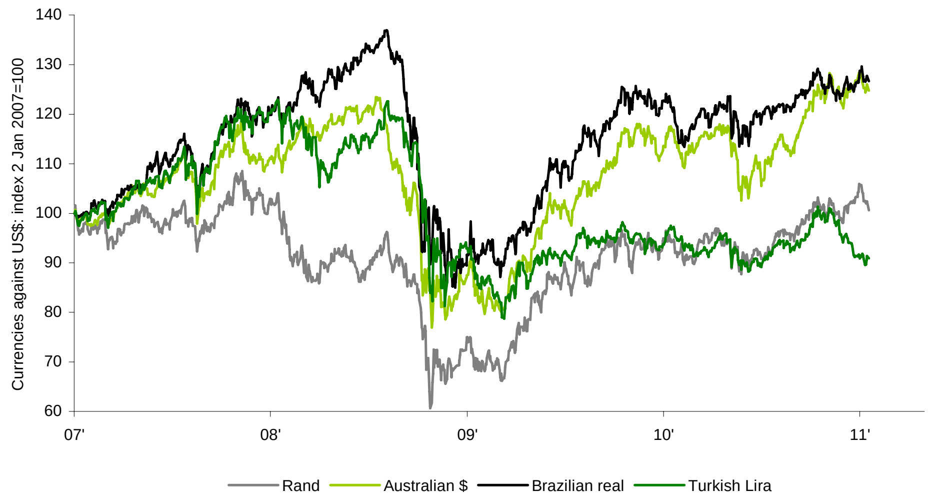
Rand Prospects

Further upward pressure on the rand likely to be limited

Comment

In Rand Prospects at the beginning of last year, we acknowledged that the outlook for the rand was "murky", as the currency was neither massively over nor undervalued. However, we suggested that at least in the first half of the year, the rand could still move higher, driven by favourable relative growth 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. We also suggested that there would be an added psychological and actual boost provided by hosting the 2010 FIFA World Cup. These predictions proved to be accurate, with the rand gaining nearly 3% on a trade-weighted basis in the year to June.

Chart 1 : Emerging market currencies, including the rand, have weakened recently



Source: Inet

For the second half of the year, we thought that more favourable global economic conditions might start to unravel, causing the rand to weaken. The first possibility was a stronger dollar, either due to increased risk aversion or the US outperforming Europe. The second possibility was that South African policymakers would opt to introduce policies to weaken the rand. In reality, the rand continued from strength to strength, gaining a further 10% on a trade-weighted basis. There were a number of reasons for the rand's stellar performance. The carry trade play remained attractive, with an estimated $40 billion invested in emerging market bond funds in the first nine months of the year, while South Africa saw a total of R60 billion being invested in the domestic bond market. This was encouraged by the US Federal Reserve's second quantitative easing programme, which was first touted in August 2010 and added to excess liquidity and investors' search for yield.

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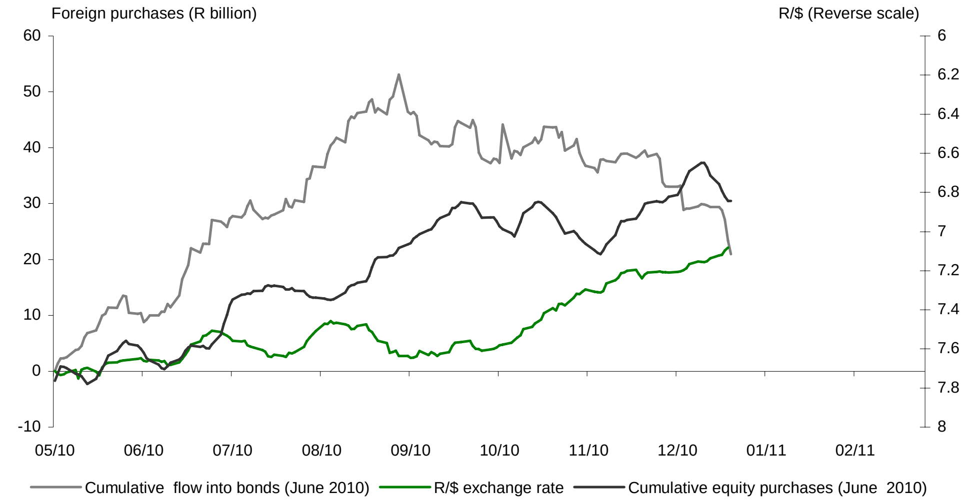
A general increase in risk aversion failed to materialise despite fiscal troubles in Europe. At the same time the South African Reserve Bank's decision to increase the pace of reserve accumulation and the National Treasury's announcement of measures to loosen exchange controls further failed to weaken the rand.

Chart 2 : Foreign inflows into bonds have fallen off sharply

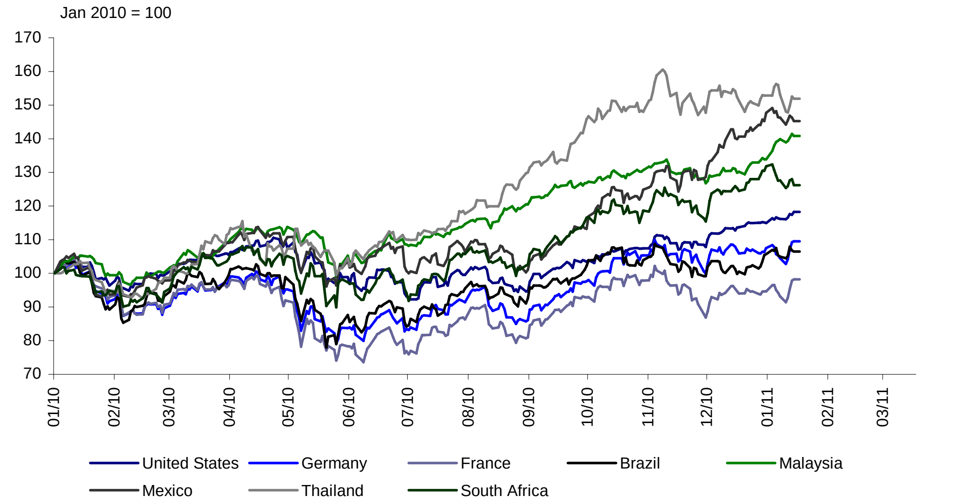


Source: DataStream

What does 2011 hold in store for the rand?

One of the key themes last year was the influx of foreign capital into the bond and later the equity market. In 2010 the carry trade was largely viewed as a one way bet, where a large interest rate differential was made even more attractive by steadily appreciating emerging market currencies. In 2011, while cheap money is still in abundance, markets appear to have taken a less sanguine view of global prospects, making greater volatility in emerging market currencies more likely and therefore the carry trade more risky.

Chart 3 : Emerging market equities ran hard in 2010



Source: DataStream (MSCI index in USD)

Added to that, emerging market equities, which had a bumper year last year, are starting to look overvalued, while stocks in the US and Europe may offer investors' greater opportunity.

Efforts to stem the rand's appreciation, which had little impact last year, may prove more effective in 2011. The National Treasury has always been reluctant to announce changes to the tax regime in the Medium-Term Budget Policy Statement and therefore tackled rand strength indirectly through exchange control relaxation. However, February's annual Budget speech may still see the introduction of a Brazilian-style tax on foreign capital. Reserve accumulation may also prove more effective at weakening the currency in a less bullish market.

The risk of further problems in Europe developing is high, although most believe that neither Ireland, Greece or Portugal will default this year, investors' may start pricing in a greater probability of restructuring next year. So far the EU and the IMF's attempts to restore the market's confidence in the debt-laden peripheral Eurozone countries have provided investors with little more than temporary solace. A spike in risk aversion could see investors exiting emerging market positions, and particularly currencies like the rand where they have built up significant positions.

Fiscal austerity across much of Europe, combined with concerns about debt restructuring will weigh on European growth relative to the US, as a result the strong dollar-weak euro theme that we identified last year may play out more decisively this year. This should see the rand lose some ground against the dollar.

Conclusion

With the carry trade likely to play a less dominant role this year and more bearish market forces making reserve accumulation slightly more effective, upward pressure on the rand is likely to be limited. The chance of a reversal has also increased this year, as the currency is well into overvalued territory. Over the past month foreign investors have withdrawn R20 billion from the domestic bond market. Increased risk aversion, particularly from Europe, could accelerate this trend.