11 May 2011

Economic Commentary

Rand Prospects

Rand likely to remain range bound

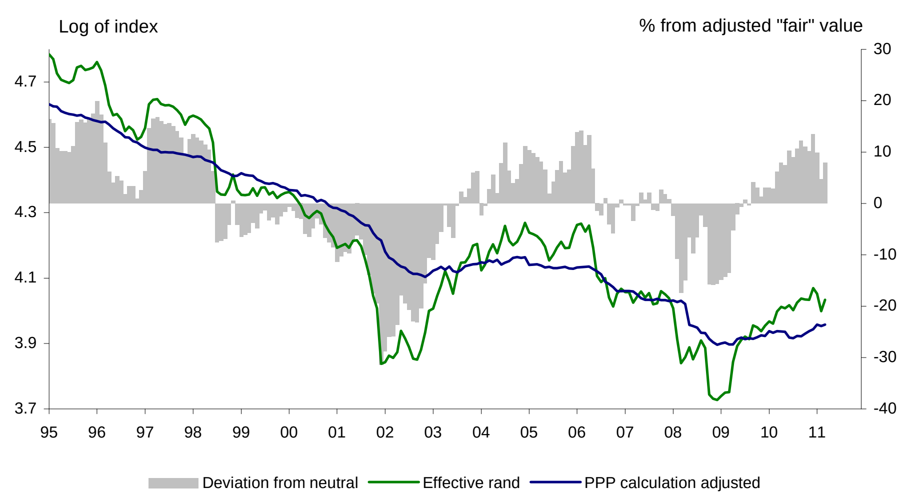
- The rand's recent rise to above R7 to the dollar, as the worsening nuclear crisis in Japan has caused traders to dump riskier assets and push funds into safer assets, illustrates how vulnerable the currency is to global events
- Historically the rand has been very sensitive to falling commodity prices, brought about by weaker global economic growth.
- Unsurprisingly there is a close link between commodity prices and global growth. Although global growth is set to remain robust during 2011, the risks to the downside have increased substantially over the past month
- Domestic polices and politics also remain a source of risk

Comment

The rand has had a volatile start to the year. In February the currency benefited from its status as an emerging market commodity currency and concerns that higher oil prices might stunt US growth. The earthquake in Japan and possible nuclear disaster has seen the rand weaken slightly as investors saught the safety of US Treasuries and German Bunds. Despite recent weakness, the rand has gained against major currencies, rising by 5,1%, 1,1% and 7,%, against the dollar, euro and pound respectively since the last report.

Once again the rand looks overvalued (see chart 1), albeit slightly less so than late last year. Although we still believe that the rand will continue to trade around these levels over the coming months, it is useful to consider what might trigger a sharp reversal in the rand's fortunes.

Chart 1 : The rand is firmly in overvalued territory



Source: Inet

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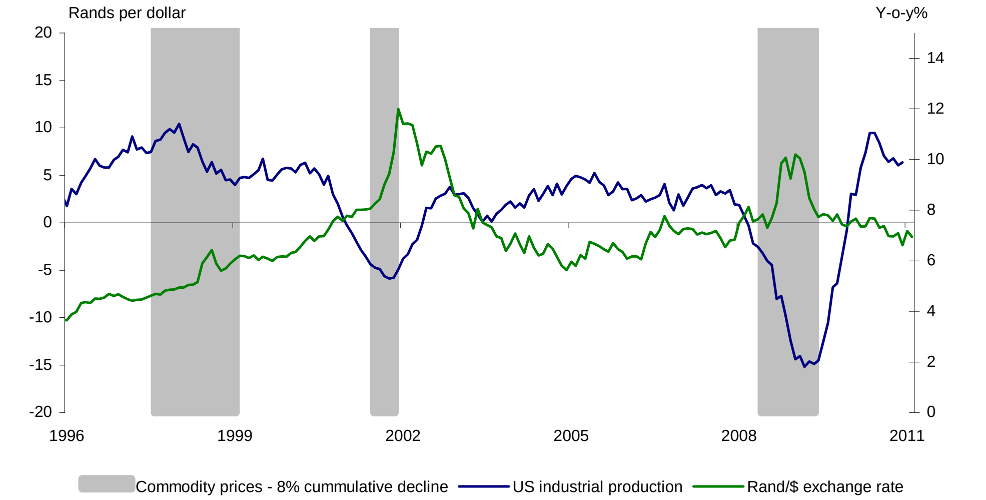
Chart 2 : The rand and commodity prices



Source: DataStream

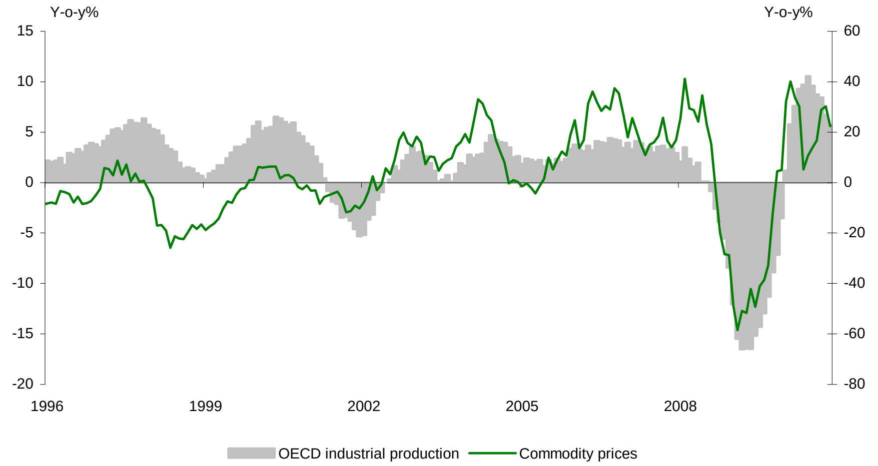
Historically the rand has been very sensitive to falling commodity prices, brought about by a weaker global economy (chart 2). Unsurprisingly there is a close link between commodity prices and global growth (chart 3).

Global growth is expected to remain robust this year, supporting commodity prices. China, in particularly, has also become a dominant force in global commodity markets, consuming up to 45% and 30% of world steel and copper output, which has supported prices throughout the global recession. Increased investor interest in commodities has also boosted prices prices.

However, the risks to the downside have increased substantially over the past month. Oil prices above $110 a barrel pose a concern, particularly if they remain at current levels for an extended period of time - or if prices increase further. Europe's periphery is looking vulnerable again, as bond yields have risen sharply. It is increasingly likely that Portugal will need to seek assistance from the EU/IMF bailout facility and Spain could follow suit, if yields don't decline significantly. Heightened uncertainty across the region, combined with austerity measures could weigh heavily on growth.

China's growth prospects have also dimmed slightly. The latest Purchasing Managers' Index fell to a 17-month low, as new orders declined, while growth in retail sales slowed to its lowest level in five years. While the Chinese authorities will continue to try and engineer a soft landing for the economy, rising inflation and the need to hike interest rates and curb lending, could result in a sharper-than-anticipated slowdown.

Chart 3 : Strong correlation between commodity prices and growth



Source: DataStream

The rand's recent rise to above R7 to the dollar, as the worsening nuclear crisis in Japan has caused traders to dump riskier assets and push funds into safer assets, illustrates how vulnerable the currency is to global events. The rand is one of the most liquid emerging market currencies and tends to overshoot, as investors use the currency as a proxy for less liquid assets. Intensification of conflict in the Middle East and North Africa, a default in Greece or a Spanish bailout as well as a spike in the oil price could all trigger a large correction in the rand. A sharp outflow of foreign funds from the domestic bond and equity market would exacerbate the decline (chart 5).

Chart 4 : European CDS spreads remain elevated

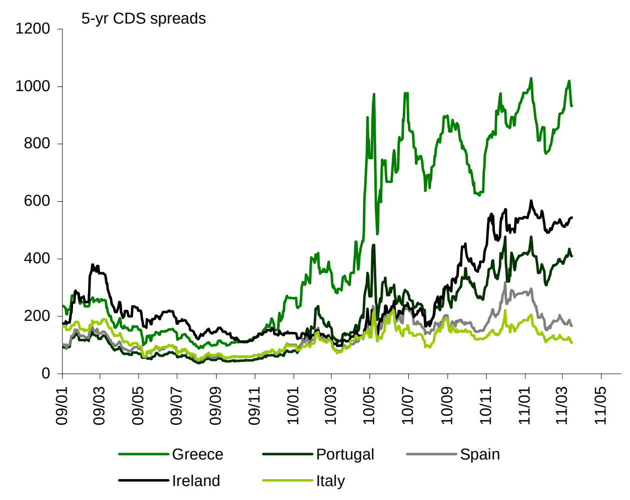
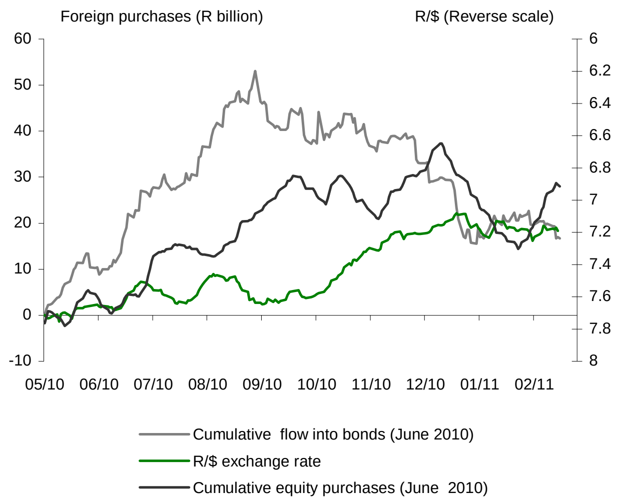


Chart 5 : Inflows into bonds and equities



Source: US Federal Reserve

Domestic polices and politics also remain a source of risk. Although the 2011 budget was met with approval from the market, particularly as no further mention was made of measures to stem the upward pressure on the rand, risks on the policy and political front still remain. The local government elections are due to be held on 18 May. Electioneering could see some particularly dirty laundry being aired and could elicit some populist promises, including more talk on nationalisation, which might unsettle markets.

Conclusion

The rand has had a volatile start to 2011, reaching a high of R6,86 to the dollar and depreciating to R7,31 to the dollar in mid-February. Although the US's policy of quantitative easing will continue to push liquidity into the financial system until the middle of this year, and could support the currency, we believe that the risks to the currency are on the downside, as bad news is expected to outweigh good news over the coming months.

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 weakened further after the announcement of QE2.	The dollar is expected to weaken over the medium term, partly due to quantitative easing.
Commodity prices	Strong commodity prices are rand supportive.	Sharply higher in the fourth quarter of 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.	Rates expected to remain unchanged until May 2012.	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 2,6% in the third quarter, lower than market expectations. Recent figures have been mixed.	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 3% of gdp in the third quarter of 2010, down from 2,5% of gdp in the second 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	Government is considering a tax on	Less supportive in the medium term,

	stability and economic growth.	short-term capital inflows.	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 October 2010.	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.

Source: Nedbank Economic Unit

Regular economic analysis is available on the Nedbank Group's internet site, http://www.nedbankgroup.co.za