

17 May 2011

Economic Commentary

Rand Prospects

Rand likely to remain volatile

- The rand has been extremely volatile over the past month, reflecting swings in global investor sentiment and dollar weakness rather than domestic factors.
- Emerging market currencies, including the rand, have been back in favour since late March.
- Foreign inflows into the domestic bond market have increased sharply, with R30 billion flowing into the domestic bond and equity market over the past month.
- The rand is likely to be supported by strong global liquidity in the short term. However, some easing is expected in the second half of the year as policy starts to tighten in key economies.

Comment

The rand has been extremely volatile over the past month, driven by swings in global investor sentiment rather than domestic factors. The rand appreciated by nearly 4% and 1,7% against the dollar and British pound in the last two weeks of April, but over the past month has fallen 2,5% and 1,5% respectively. The local unit was less volatile against the euro, appreciating by 0,2% over the period.

The rand pulled back strongly against the dollar at the end of April, reaching \$6,56 – its strongest level since the beginning of this year. This followed a period of dollar weakness on comments by Federal Reserve Chairman Ben Bernanke that gave little indication that monetary policy would be tightened anytime soon, despite the fact that inflation would average above the Fed's de facto 2% target this year. The Chairman rather opted to focus on the “transitory” nature of the current bout of inflation, highlighting the impact of higher commodity prices. The decision by rating agency Standard and Poor's to change the outlook on the US's AAA sovereign debt from neutral to negative, on concerns that the government would be unable to bring the debt burden back under control, also added to negative sentiment against the dollar. Research by EPFR Global, a company that tracks the flow of funds, shows that in April outflows from US-based money market funds hit a four-month high, while the equity market also continued to register net foreign outflows.

Over the past week Greece's fiscal troubles entered the spotlight again, helping the dollar to retrace some of its losses and moving it to close to a six-week high against the euro. As a result, the rand firmed back to below \$7. Greece is struggling to meet the commitments under its €110 bailout which was announced last year, with spreads on five-year credit default swap (CDS) remaining well above 1 300, on market scepticism surrounding either the Greek government's or the Eurozone's commitment to resolve the current crisis. The announcement that European finance ministers were meeting to discuss adding a further €60 billion to the package has failed to reduce either the CDS spreads or bond yields, which currently stand at 16,3% on the ten-year bond.

Group Economic Unit

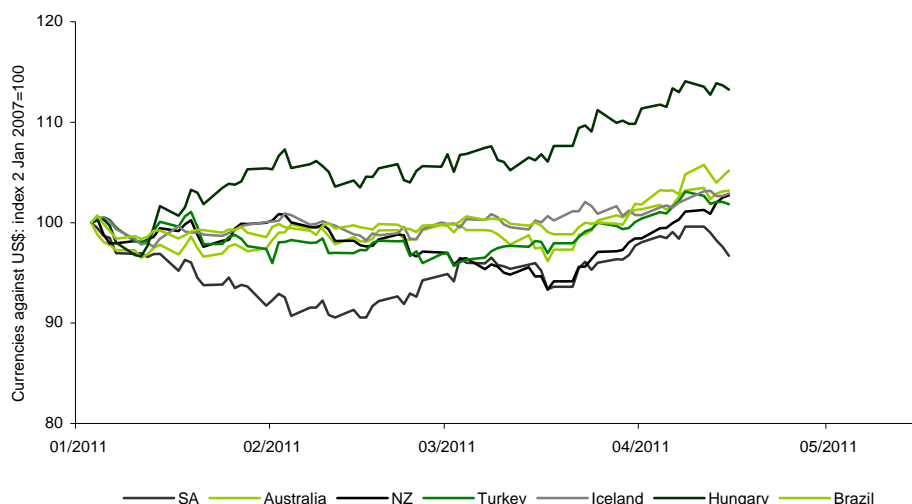
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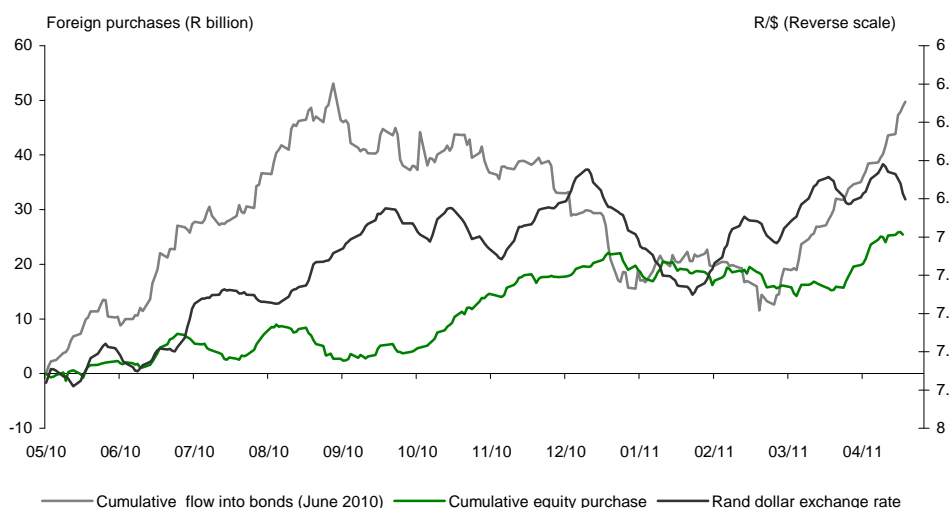
Chart 1 : Emerging market currencies have lost some ground



Source: Inet

Emerging market currencies have regained favour since late March. In the first three months of the year, investors disinvested around \$25 billion from emerging market equity funds on speculation that the dollar was likely to stabilise and probably strengthen on improved growth prospects. In April and early May, the carry trade play returned in force, with investors investing nearly \$4 billion in higher yielding currencies in the final two weeks of April. According to the EPFR Group, Asia - particularly China, Korea and Thailand - remained popular with investors, while Turkey and Africa (mainly South Africa) also saw positive inflows. Foreign inflows into the domestic bond market have increased sharply, with R30 billion flowing into the domestic bonds and equities over the past month.

Chart 2 : Foreign purchases of bonds and equities



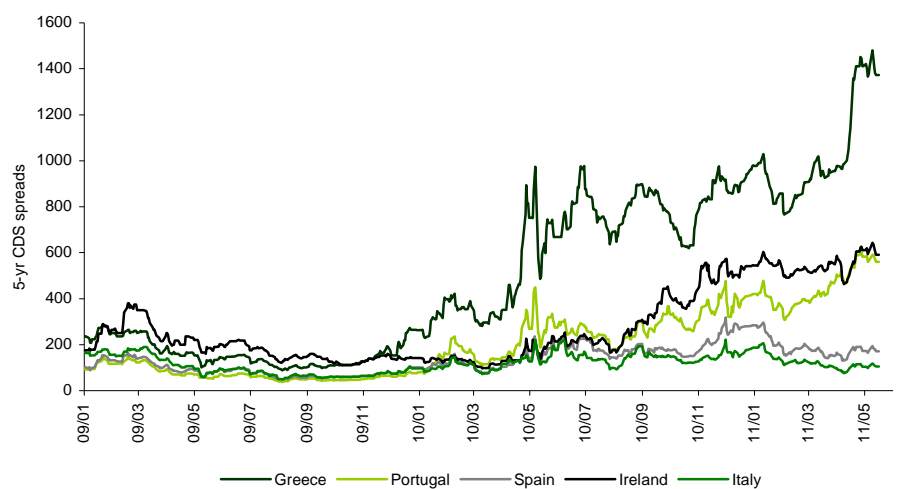
Source: Inet

The rand is likely to remain volatile, but firm in the short term, supported by the US's loose monetary policy. The Federal Reserve's quantitative easing programme will continue until the end of June, with excess liquidity and diverging interest rates will remain a feature of financial markets. As a result, the carry trade will remain important in the short term at least. The Fed Chairman recently re-affirmed his commitment to complete the full \$600 billion programme by the end of June, at which point the easing cycle would come to an end. However, Bernanke said that the first tightening that would take place would be a decision not to re-invest early repayments from the Bank's security programme. He indicated that such a decision was some way off, suggesting that higher interest rates would be still further off.

The rand is expected to trend weaker in the second half of the year. The loose monetary policy in the US, which contributed towards both dollar weakness and the carry trade, will start to be withdrawn and tighter economic policy in the Eurozone, in China and in other major emerging markets will probably begin to weigh on growth and contain investors' appetite for riskier assets.

However, key risks remain in both the short and medium term. Although European officials have repeatedly reaffirmed their commitment to support Greece, investors are extremely sceptical. Further negative news could add to risk aversion, and put downward pressure on rand. Policy mistakes and unintended effects as fiscal and monetary stimulus is removed could also negatively affect the global economic and investment climate.

Chart 3 : Five-year CDS spreads



Source: Inet

Conclusion

The rand is likely to remain volatile but relatively firm in the short term. The dominant factors behind the carry trade, including excess liquidity and divergent interest rates, will remain in effect at least until the end of June and should support the currency. However, these supporting factors are expected to start diminishing in the second half of the year as policy in developed markets starts to tighten and growth begins to slow. The risks of an accident occurring in this phase remains significant, which would also make the currency more vulnerable to heightened risk aversion.

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 in the second half as 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 eased after earlier strong rises.	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 strong supporting force as local rates move into the upcycle from 2012 onwards.
Emerging market perceptions	Positive = good for rand.	Risk aversion has 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 4,4% in the fourth quarter, higher than market expectations. Recent figures have been mixed but first quarter growth of over 4% is likely.	Will still be positive, but could lose some momentum on a weaker global environment.
Current account	Large unsustainable deficit would be rand negative.	Deficit narrowed to 0,6% of gdp in the fourth quarter of 2010, down from 3,1% of gdp in the third quarter. Recent trade statistics have been relatively favourable.	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.	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	Has been relatively limited and opposition to Walmart deal casts a cloud over foreign involvement.	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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