11 MAY 2022

FIXED INCOME AND FX

INSIGHT

NEDBANK CIB

Rand not cheap enough; maintain a weakening bias

The rand may be much weaker now than a month ago, but it may not be cheap enough. At 14,50, we were better buyers of USD and although the rand has moved a lot in the past month, its weakness can extend much further. It's too soon to get bullish on the rand. As a result, even though it is trading above our fair-value range, cyclically, we prefer to maintain a weakening bias.

We update our "extreme peaks" USDZAR model and adjust our fair value

We update our "extreme peaks" model for the USDZAR. We find the model useful in an environment where growth uncertainty is high and volatility rises. We adjust our fair-value point estimate for the USDZAR from 15,20 to 15,50 and our fair-value range to 15,40-16,00 (from 15,10-15,70). Cyclically, even with the rand at 16,20, we maintain a weakening bias.

Rand weakness not extreme, especially if US growth slows further

Although the rand has moved a lot in the past month, its weakness can extend much further. That is because "extreme" rand weakness tends to coincide in periods where global growth, and in particular US growth, slows. And our US recession model is giving us a strong signal for a US recession that is already having implications for local markets in South Africa (see A local markets blueprint for a US recession dated 14 April).

SARB MPC meeting in May will be important for the currency – we expect a 50 bps hike

The influence of monetary policy on currencies has been amplified in recent months as the focus remains on inflation. This will hold true for SARB and the rand, too, in our view. If SARB hikes by less than 50 bps at the May MPC meeting, we would look for rand weakness to accelerate.

Rand weakness, as with rand strength, is unlikely to be in a straight line

Rand weakness, as with rand strength, would not be continuous, and there are likely to be pullbacks towards our neutral range of 15,40-16,00. Cyclically, we would use these pullbacks to buy USD.

Weakness can extend much closer to 18,00 if growth slows further

Until either (1) the global growth outlook stabilises or (2) rand weakness has extended towards 3 standard deviations from our model trend (which is just above 18,00 against the USDZAR), we would prefer to maintain a weakening bias on the currency.

ANALYST DETAILS

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Rand weak but likely not weak enough

The rand has depreciated substantially in the past three weeks, moving from 14,50 against the USD in mid-April to the current 16,20 level. At 14,50, we were better buyers of USD. We prefer to maintain a weakening rand bias.

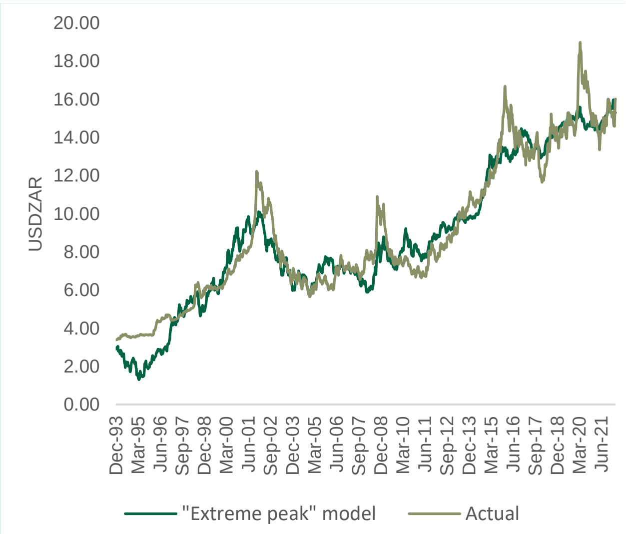
We update our "extreme peaks" USDZAR model and adjust our fair value

We update our "extreme peaks" model for the USDZAR. We find the model useful in an environment where uncertainty is high and volatility rises. This is because rand weakness and strength tend to be consistent in the deviation-from-model trend. As such, it provides us with an indication of where the USDZAR is in the distribution of possible outcomes for "extreme moves". We adjust our fair-value point estimate for the USDZAR from 15,20 to 15,50 and our fair-value range to 15,40-16,00 (from 15,10-15,70).

Rand may be cheap, but the weakness is not close to extreme yet

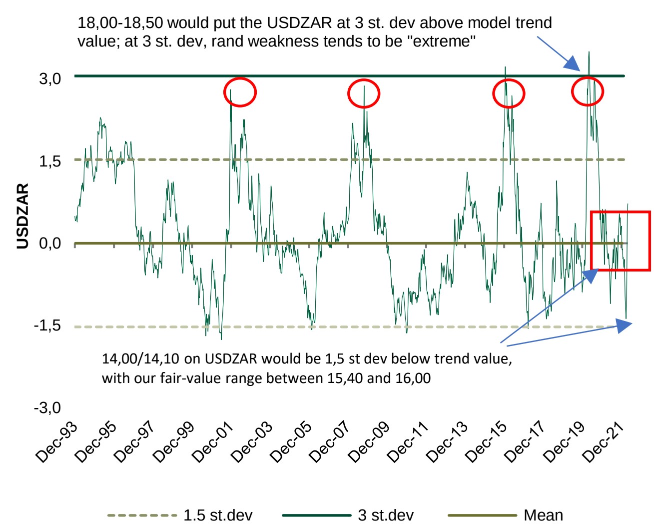
Although the rand has depreciated a lot in the past month, its weakness can extend much further. That is because "extreme" rand weakness tends to coincide in periods where global growth, and in particular US growth, slows. This is evident in Exhibit 2, which shows how growth concerns pushed rand weakness consistently to 3 standard deviations above our model trend. This happened in 2001, 2008, 2016 and 2020. If the US goes into a recession, this time is likely to be no different. Currently, 3 standard deviations from our model trend would put the USDZAR above 18,00.

Exhibit 1: Our USDZAR "extreme peaks" model



Source: Nedbank CIB Markets Research

Exhibit 2: Extreme deviations from trend coincide with US recessions



Source: Nedbank CIB Markets Research

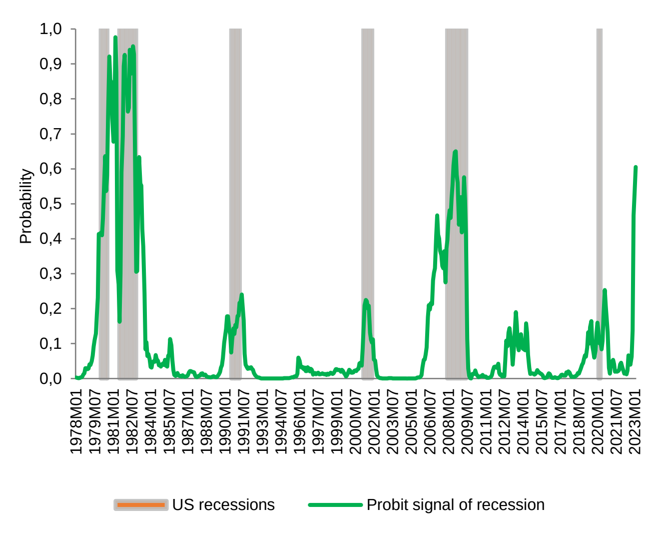
A strong signal for a US recession suggests more weakness in the works

If the rand weakens towards "extremes" amid weak global growth, indications are that one should prepare for more rand weakness, at least cyclically.

As highlighted in mid-April, our US recession model gives us a strong signal for a US recession by late 2022 or early 2023, and it has implications for local markets in South Africa as well (see A local markets blueprint for a US recession dated 14 April).

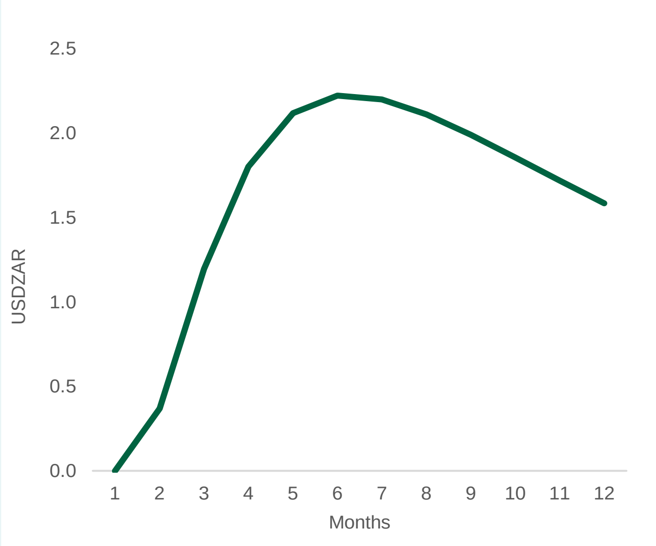
We simulate the impact on local markets based on the strength of our current recession signal, and our estimates suggest rand weakness of just under R2,50 against the USD (Exhibit 3 and Exhibit 4). The USDZAR weakness would flow from foreign selling of local-currency bonds and equities and an accompanied increase in demand for USD. It is worth noting that we do not see the economic slowdown in China and the US as mutually exclusive, which in our view increases the probability of a weaker rand.

Exhibit 3: Our probit US recession model generates a strong signal



Source: Nedbank CIB Markets Research

Exhibit 4: Additional rand weakness suggested by our recession signal



Source: Nedbank CIB Markets Research

SARB MPC in May will be important for the currency – we expect a 50 bps hike

The influence of monetary policy on currencies has been amplified in recent months as the focus remains on inflation. This will hold true for SARB and the rand, too, in our view.

At the meeting in May, we expect SARB to hike the repo rate by 50 bps. In fact, 50 bps is already priced in by the FRA market. As such, if SARB decides to hike by 25 bps instead of 50 bps, we would expect the pace of rand weakness to accelerate. Such rand weakness will ultimately force SARB to act more hawkishly later, as even more inflationary pressure is likely to build with a weaker rand.

Our fair value is unlikely to change much despite a tactical bias for weakness

Despite our cyclical preference for more rand weakness, it is worth noting that as in previous periods of extreme rand weakness, our fair-value estimate, from a fundamental perspective, is unlikely to move much for the USDZAR. This would also imply that the more the USDZAR deviates from trend, the larger the correction would be in the future. For now, however, we favour the odds of more weakness.

Rand weakness, as with rand strength, is unlikely to be in a straight line

Rand weakness, as with rand strength, would not be continuous, and there are likely to be pullbacks towards our neutral range of 15,40-16,00. We would use these pullbacks to buy USD until either (1) the global growth outlook stabilises or (2) rand weakness has extended towards 3 standard deviations from our model trend.

Exhibit 5: Summary of our core macroeconomic and market views

Growth	We expect GDP growth of 1,8% yoy in 2022 and 1,9% in 2023.
Currency	We update our USDZAR fair-value estimate to 15,50. Our neutral range for the USDZAR is between 15,40 and 16,00. Tactically, we maintain a weakening bias.
Inflation	We forecast CPI (average) at 5,6% in 2022 and 5,1% in 2023.
SARB	We expect SARB to hike by 50 bps in May. We expect the repo rate at 5,25% by year-end.
Bond yields	Our fair-value estimate for the 10-year yield is 9,9% (R2032). Our fair-value range for the R2048 is 10,50-11,00%.
Rating action	Fitch rates South Africa “BB-/Stable”, Moody’s “Ba2/Stable” and S&P “BB-/Stable”. We expect no further changes in either the outlook or the rating from any of the three rating agencies in 2022.

Source: Nedbank CIB Markets Research