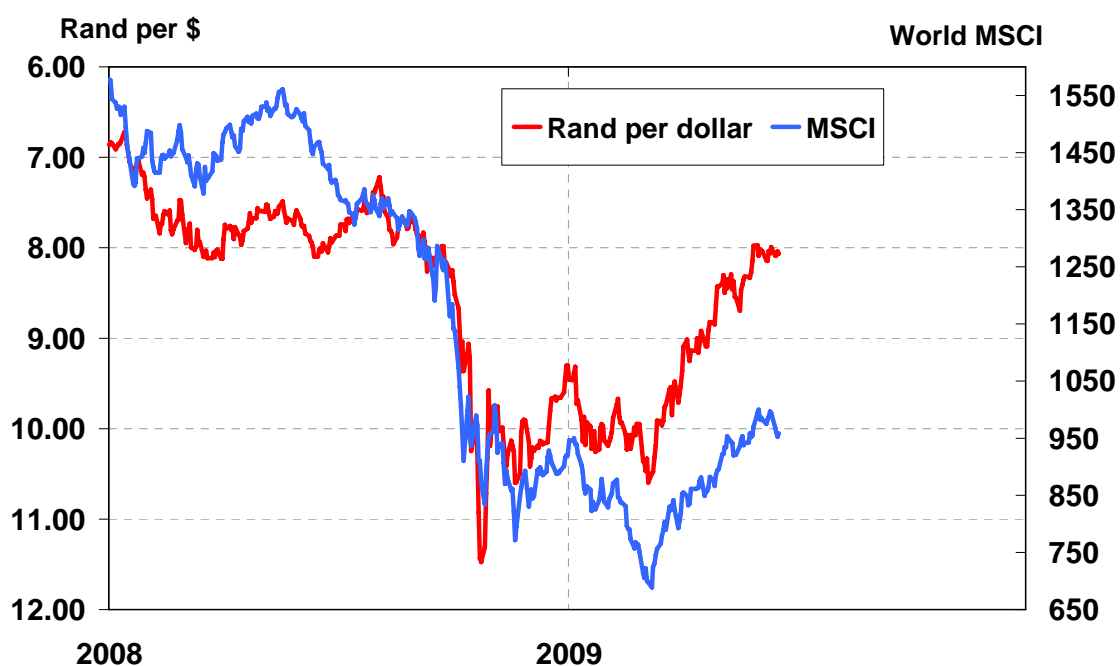


Rand prospects: can rand strength continue?

The rand continued to gain against major currencies over the past month, extending its recovery against the trade-weighted basket by 5,3% and rising by 7,8% against the dollar, 4,0% against the euro, 0,4% against sterling and 8,1% against the yen. The local unit's moves have mimicked that of other commodity-linked currencies, but recent performance has been better than that of other emerging market currencies. As usual, the rand remains a good barometer of developments in the global economy and of overall investor sentiment and has recently been reflecting hopes that conditions are starting to improve and that the outlook is starting to brighten.

Figure 1 below illustrates this point. The rand weakened significantly in late 2008 and again in early 2009 as the enormity of the implications of the financial crisis on economic activity started to be realised. More recently, however, some bounce in consumer and business confidence in the US in particular, and also some slowdown in the rate of deterioration in some key indicators helped equity markets recover into the second quarter of the year. The rand has followed a similar trend, not only because a recovery in the global economy would also be positive for commodity prices, but also because of the relative liquidity in the currency and in rand financial instruments more generally. It was therefore punished more than other currencies during the period of heightened risk aversion and has outperformed as nerves have steadied.

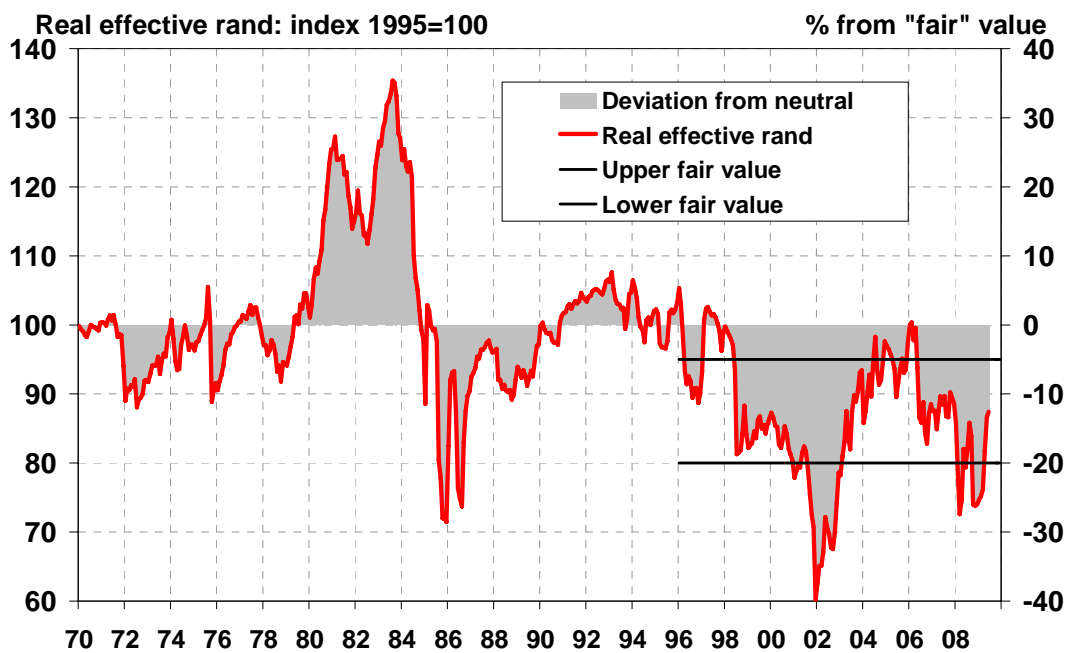
Figure 1: The rand continues to reflect global sentiment



What are the possibilities over the next few months? The first is that the global recovery becomes more entrenched, commodity prices continue rising aggressively and risk aversion fades. The rand would clearly gain ground under this scenario as export volumes and values would improve and the carry trade would re-emerge as a key factor. The second is that global growth disappoints but there are no further serious relapses. The rand's performance under this scenario would be mixed as it would lose some of its commodity shine but still gain from lower risk aversion. The third is that there is a relapse in both global growth and in investor sentiment more generally. Depending on how harsh the relapse is, the rand would fall sharply under this set of assumptions.

Commodity and equity markets are probably betting on some variation of the first, a V-shaped recovery. Economists are generally more pessimistic and are collectively looking more at some sort of U-shaped recovery, given the nature of the downturn (characterised initially by both the popping of speculative bubbles and a banking crisis). The chance of some sort of W-shaped recession remains very strong, however. The initial impetus provided by various stimulus packages will need to be backed up by sustained consumer and business confidence as well as some normality in credit markets. This could prove more illusive than is currently hoped for, and lead to market corrections as the danger season (September to early November) approaches.

Figure 2: Further rand strength will hamper exports



A further factor that could hamper rand strength in the second half of the year is that it is now approaching levels where competitiveness is starting to be compromised. Figure 2 shows that the real effective rand is now in the middle of the fair value range (determined by purchasing power considerations). Exporters are already struggling in the current difficult global environment and will be hurt if the rand breaks convincingly through the R8 to the dollar level. This observation may have prompted the Reserve Bank governor's remarks on possible intervention to prevent more strength. Although these were subsequently qualified, it does show some level of official discomfort that was lacking during the rand's pullback from the end of 2001 to early 2006.

Conclusion

The rand will remain firm while hopes of global revival prevail. However, the risks of disappointment surfacing later in the year are significant. We therefore expect that the rand will end the year weaker on a trade-weighted basis.

19 June 2009

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 been mixed, at times hurt by lower risk aversion, but helped by European woes.	Becoming more ambiguous given EU weakness. Weaker long-term trend still likely, especially following the massive fiscal and monetary stimulation now taking place.
Commodity prices	Strong commodity prices are rand supportive.	Some improvement on industrial commodities and oil as hopes of firmer Chinese demand increases. However, precious metals have faltered on lower risk aversion.	In the long term Chinese demand will again be a dominating force. However, medium-term weakness is likely, given the serious deterioration in the global economy.
Interest rate gap	Higher = positive, but depends on circumstances.	SARB has started to cut interest rates more aggressively, but this could be seen as positive given the global climate. Interest rates are still attractive in nominal terms.	SA will continue to relax in 2009, but interest rates are now close to the trough.
Emerging market perceptions	Positive = good for rand.	Some easing in risk aversion but climate still potentially volatile.	Risks of a relapse in sentiment if global economy disappoints later in the year.
Predominantly domestic			
Growth perceptions	Rand strength if perceptions of relative growth are positive	SA's first quarter gdp figure was terrible, falling by an annualised 6.4%. Early indications from the second quarter are not favourable.	Depends on global growth cycle, but could become more favourable in relative terms as 2010 approaches.
Current account	Large unsustainable deficit would be rand negative.	Rose to 7,0% of gdp in the first quarter after narrowing to 5,8% of gdp in the 4 th quarter 2008. Recent trade figures have shown some improvement and the deficit will probably narrow.	Will remain wide in the global context; sustainability depends on consumer/ investment mix, commodity price cycle, policy and external perceptions. Lower dividend payments will help.
Policy and policy perceptions	Rand positive, if promotes financial stability and economic growth.	Policy debate has re-opened with potentially negative consequences for the rand. The mandates of the current economic portfolios need to be clarified.	Less supportive in the medium term, although uncertainty will be reduced after the elections.
Exchange controls	Relaxing potentially negative for rand in short term, positive in long term as foreign investment picks up.	No major changes expected in the short term.	Uncertain, but probably less impetus for relaxation.
Abnormal flows	Inflows/ outflows related to FDI transactions	Vodacom deal recently provided a boost to the rand.	Uncertain. Inflows should pick up once political and policy environment becomes clearer and global climate settles.
Rand under- or overvalued?	If overvalued then will depreciate in long term and vice versa.	More fairly valued at current levels although undervalued on strict PPP.	Should revert to long-run fair value based on adjusted PPP.

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