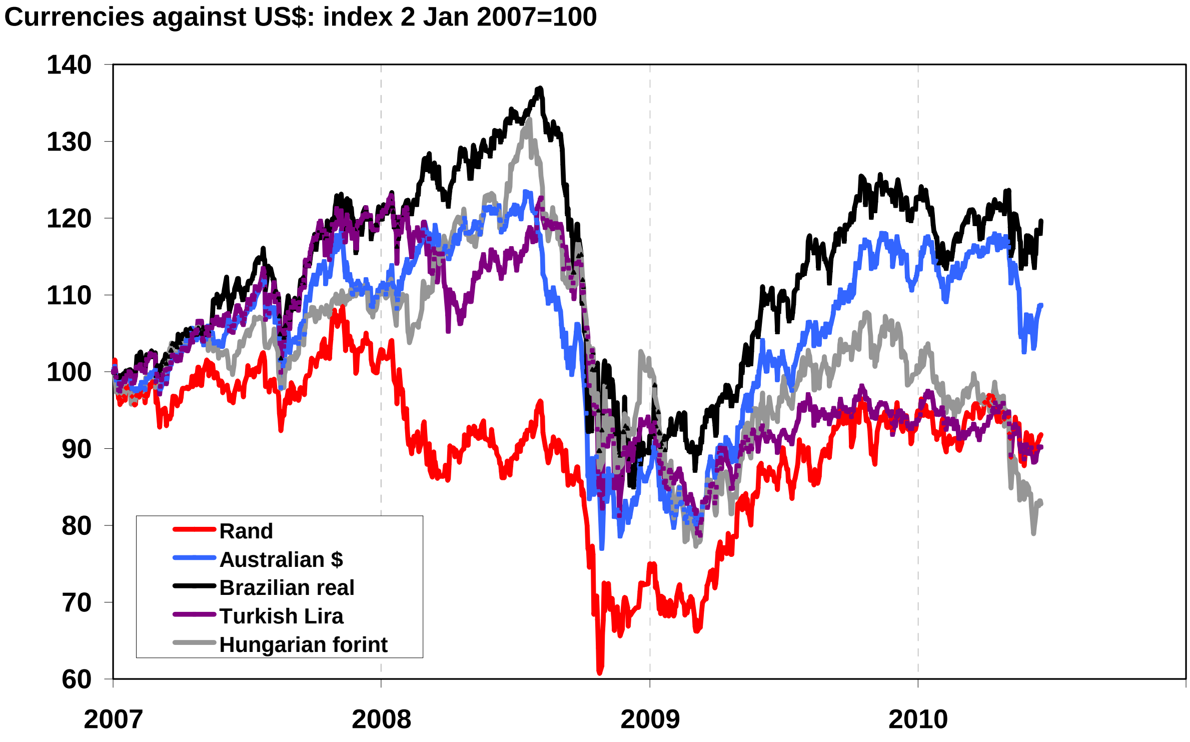
Rand prospects: Currencies continue to reflect uncertain global prospects

The rand eased marginally against the trade-weighted basket over the past month, falling by 0,6% from mid May. However, this masked some weakness in late May when risk aversion soared due to the European debt crisis. Over the period the rand was reasonably steady against most major currencies, initially falling strongly against the yen, but later recouping most of these losses. It also lost ground to sterling as political uncertainty in the UK waned following the establishment of a coalition government. Against peer (emerging market and commodity) currencies the rand did reasonably well, performing similarly to the Brazilian real and the Turkish lira, but rising against the Australian dollar and the Hungarian forint. Australia's proposed mining super tax has had a cold reception in markets, while confused signals from Hungary's new government have unsettled markets during a period when policy predictability and responsibility is crucial to maintaining confidence. However, as a group, peer currencies continue to reflect global optimism (from March 2009 through to the end of 2009) as well as global jitters (reflected in volatility for much of this year). While emerging market and commodity economies are still seen as good bets over the medium term given China's likely dominance, there is considerable uncertainty over what happens next in the global economy and therefore in financial markets. Figure 1 shows the lack of real direction since late 2009.

Figure 1: Some divergences in peer currency performance, but big trends remain in place



The rand's likely course over the second half of the year will depend on two main drivers. First, the direction of the US dollar against other major currencies and second, domestic factors that could distinguish South Africa from its peers in either a positive or a negative way.

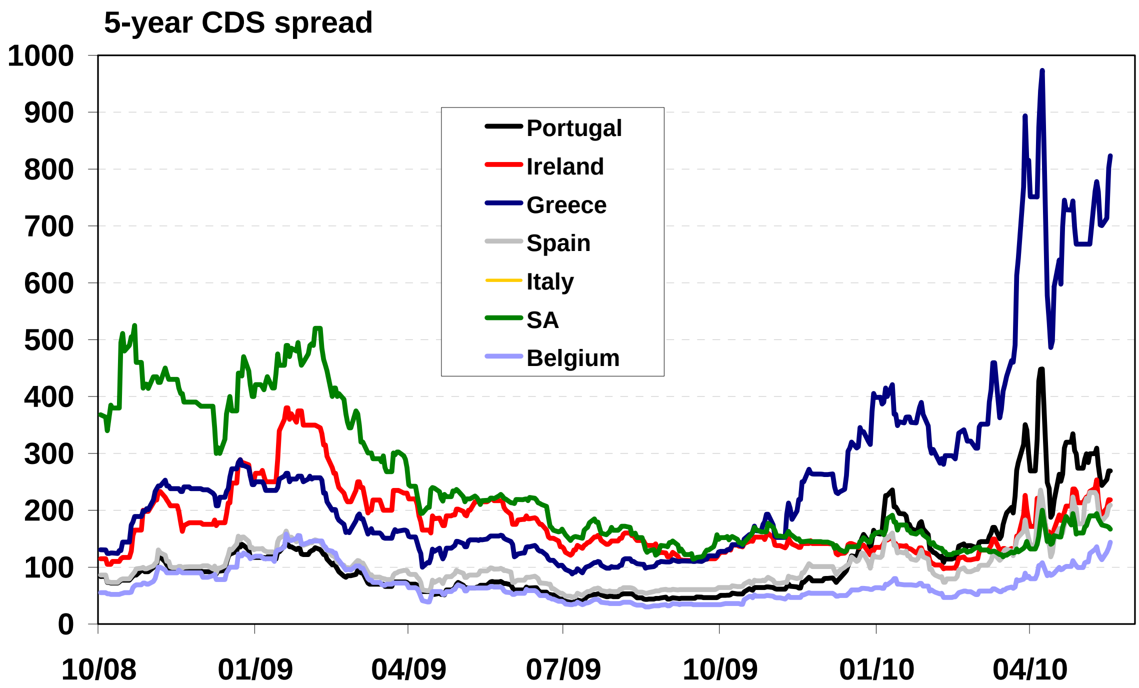
On the first, our guess is that the dollar should resume its firmer trend after the current correction. Under a scenario where global growth continues to muddle along or even improves more significantly, economic news out of the US is likely to be better than that coming out of the Eurozone as a whole, although certain countries within the region could surprise on the upside.

Clearly part of the cure for the fiscal woes in Europe would be a depreciating euro and the markets will probably oblige. Alternatively, further bouts of financial market worries or a renewed slump in global activity would also help the dollar due to its safe-haven status.

A firmer dollar under the first set of circumstances (a relatively favourable economic and financial global environment) would imply that the rand and its peers would ease further against the dollar, but improve against most other major currencies. In contrast, dollar strength under an increased risk aversion scenario would probably mean rand weakness against the dollar *and* other major currencies. Depending on the source of the troubles (a fallout in China, for example), commodity currencies could come under even more pressure than other emerging market currencies.

On the second set of drivers – domestic issues – the key risk remains a negative policy surprise. There is a strong lobby within government for calling for the rand to be weakened artificially to help manufacturing. If this lobby is successful, experience globally has shown that either the attempts will prove unsuccessful (very little changes in the currency's value, for example Brazil over the past few months) or that they will be too successful (a strong run on the currency that feeds on itself and erodes competitiveness through higher inflation and interest rates). However, the market is not overly concerned that there will be any negative surprises. Figure 2 shows that South African risk has receded in relative terms since early 2009 and that the sovereign is viewed favourably at present.

Figure 2: South African risk has been favourably priced in the credit default swap market



Conclusion

The rand will probably weaken in the second half of the year on the back of a firmer US dollar. The depreciation will probably be relatively mild, with the key risks of a sharper fall being a renewed global downturn or some South African policy surprise.

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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 risen strongly against the euro on continuing sovereign debt concerns in Europe, but more recently has eased slightly off the highs.	Difficult to predict as EU also has structural weaknesses and US growth prospects are better. However, $ will probably improve in the short- to medium term but remain in a longer-term downward cycle.
Commodity prices	Strong commodity prices are rand supportive.	Mixed, with certain base metals easing but precious metals and oil firming.	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.	SARB could cut once more in this cycle but rates are close to bottom.	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 relatively high once again, but the markets are more focused on Europe.	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 4,6% in the first quarter, higher than market expectations. Most recent figures have been positive.	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.	Eased to 2,8% of gdp in the fourth quarter of 2009 after falling to 3,1% in the third quarter. Latest trade statistics have been encouraging.	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 debate has re-opened with potentially negative consequences for the rand. The mandates of the current economic portfolios still need to be properly clarified.	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.	Minor changes in February budget following major relaxation in October 2009.	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.	Around 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.