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Economic Commentary

Rand Prospects

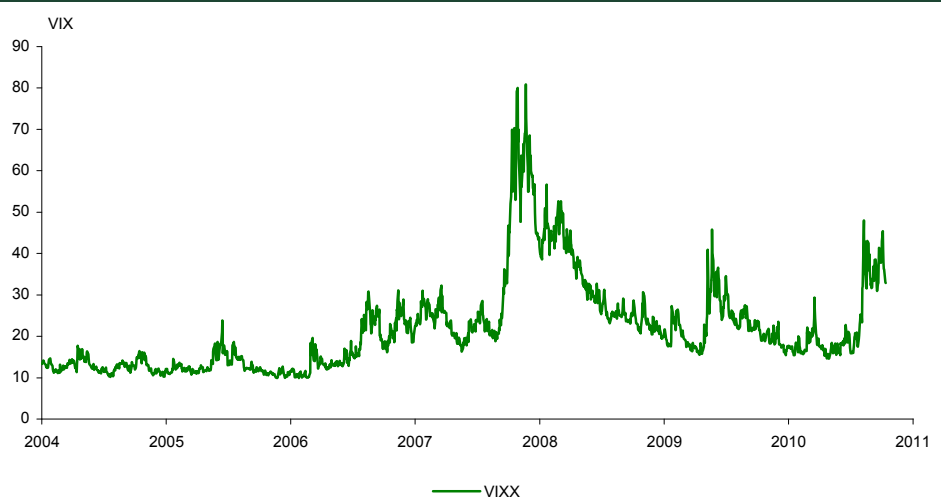
Volatility rises on heightened risk aversion

- The slump in global confidence intensified over the past month.
- The Euroland crisis worsened, with concerns over sovereign debt and banks.
- A flood of capital into the safe havens of the US dollar, Swiss franc, Japanese yen and gold puts pressure on emerging market currencies.
- Downside risks to the rand have increased in the near term, but much now depends on the policy response in developed countries.

Comment

In last month's Rand Prospects we highlighted how the rand usually acts as a barometer of global financial market sentiment, strengthening as confidence improves and falling on rising risk aversion. The past month has been no exception. In late September markets took another pounding. Economic data suggested that the Eurozone was teetering on the brink of recession, while growth in the US had stagnated. A new round of strikes in Greece as well as news that the government had missed fiscal targets raised concerns that authorities would be unable to meet the conditionalities set by the IMF and would fail to receive more funding. The large exposure of the French banking system to Greek debt as well as concerns that European banks would need to raise significant amounts of capital also weighed on the market. Concerns also centred on whether or not the German parliament would vote to expand the European Financial Stability Fund (EFSF) and to give it new powers. Between 15 August and 23 September, the rand lost 14%, 8,7% and 9,4% against the US dollar, the euro and the British pound respectively.

Chart 1 : VIX: a measure of stock market volatility has increased sharply again



Source: DataStream

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Subsequently risk aversion has abated somewhat, following the German parliament's decision to support the expansion of the EFSF as well as greater commitment by policymakers to resolve the crisis. This helped the rand pull back some of its losses, gaining 6,6%, 3,7% and 3,9% against the US dollar, euro and British pound since 23 September.

The next two months will be critical for how the crisis in the Eurozone evolves and will be a period marked by significant volatility for global equity and currency markets, as investors digest new economic news and size up how viable plans to resolve the European debt crisis are.

What needs to be done?

In a recent interview with the FT, outgoing ECB president Jean-Claude Trichet highlighted how very acute the European debt crisis had become, explaining how the interplay between the sovereign debt crisis and the banking sector had made the crisis into a systemic problem. He argued that a two pronged approach was needed to get ahead of the problem – improving the banking sector's balance sheets and restoring the credibility of the sovereign.

The performance of the rand will be closely linked to developments in Europe. It is therefore useful to gauge how the crisis in Europe may unfold, by looking at what needs to be done to resolve the crisis and where potential stumbling blocks may lie.

To restore the credibility of the sovereign it is important that one makes a clear distinction between sovereigns that are clearly insolvent like Greece and Portugal and those countries that are struggling with illiquidity, like Ireland and Italy. Although European leaders now appear to fully understand the gravity of the situation and that piecemeal policy action will not be sufficient to stem the crisis, a comprehensive action plan still needs to be devised.

Adequately resolving Greece's debt problems is the first piece of the puzzle. In July, as part of a new €109 billion bailout for Greece, private bondholders were asked to take an average implicit writedown of 21%. The deal involved a plan to swap current Greek bonds for new debt that would not be repaid for 30 years. The new bonds would be backed by European governments and would generate interest starting at 4%, well below the Greece's current market interest rate. However, the deal is still not sufficient to make Greece's debt sustainable. Private bondholders would need to accept a haircut (writedown) of between 50% and 60% to have a material impact on the sustainability of Greece's debt. But this is where the problem lies. European officials are adamant that Greece will not default, as they are concerned that a "credit event" would trigger insurance policies against such a default and would have widescale repercussions for the financial system, even if direct exposure to Greece is small. However, for a default not to occur, bondholders would need to agree to a large writedown, something which seems unlikely.

Solving Greece's fiscal troubles is just part of the problem. A credible solution needs to include measures to support countries that although not insolvent may have troubles servicing their debt if investors are unwilling to roll it over.

Already the newly implemented EFSF, with resources of €440 billion, is not viewed as having enough ammunition to deal with the crisis. To put it into perspective, the current EFSF is sufficient to cover around 70% of Greece, Ireland and Portugal's outstanding debt. If one includes Spain, this drops to 30% and with Italy it falls to only 10%. Herein lies the difficulty, for a plan to be credible, it needs to have sufficient funds to adequately cover the debt repayments of all Europe's troubled sovereigns.

There are a few alternative plans being considered at the moment that would increase the size of the EFSF (and ultimately the permanent European Stability Mechanism (ESM)). The first centres on allowing the EFSF to leverage itself, either by being granted a banking licence and borrowing funds from the European Central Bank (ECB) or allowing the EFSF to borrow funds from the market. An alternative proposal is to allow the EFSF to act as an insurer of new sovereign debt. It is generally agreed that it would not have to insure the full amount just the amount that could be subject to a haircut. Although this would not resolve solvency concerns, it might go a far way to improving liquidity in the bond market.

France and Germany will come under growing scrutiny to ensure a definitive deal to end the crisis is ready for the G20 meeting in Cannes, which will be held in early November. One of the biggest challenges facing the Eurozone is getting agreement across all 17 countries, a

process that has proven long and fractious. For example, the original European Financial Stability Fund proposal, which was initially proposed in July, has just received final approval from Slovakia. This suggests that even if agreement can – in principal – be reached on how to resolve the crisis, it will be some months before any proposal can be ratified.

Table 1 : Calendar of key events in Europe

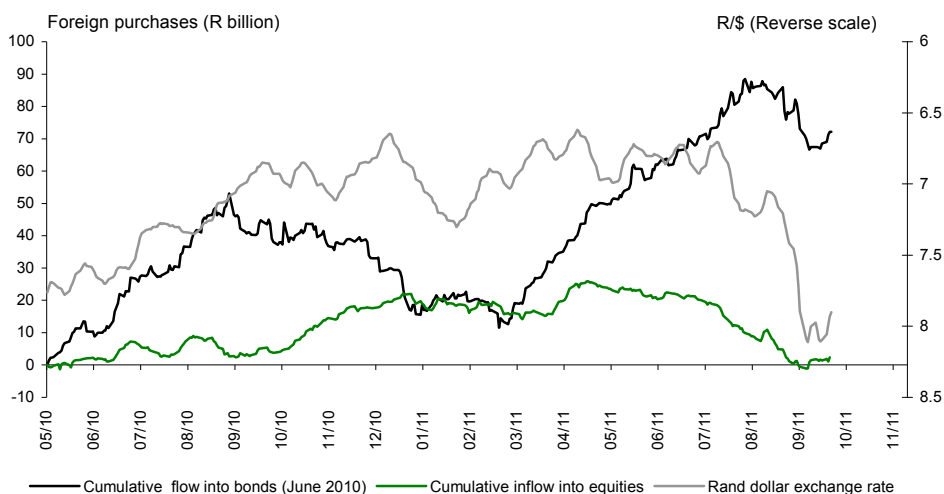
Date	Event
17-18 October	EU Council (heads of state) meeting
27-Oct	Ireland presidential elections
31-Oct	Greece plans to have voted on 2012 budget law
31-Oct	Disbursement of 6th tranche (EUR8bn in total) of the Greek bailout
03-Nov	ECB interest rate decision
03-Nov	G20 meeting in Cannes, France
07-Nov	Eurogroup meeting
20-Nov	Spanish general election
29-Nov	Eurogroup meeting
08-Dec	ECB interest rate decision
09-Dec	EU council (heads of state) meeting

Source: Newswires

What next for the rand?

The rand's fortunes will remain linked to global developments in the weeks ahead. Unfortunately, the currency is always going to be a geared play on investor sentiment and therefore will move more strongly than its peer group the more abnormal market conditions become.

Chart 2 : Foreign purchases of domestic bonds and equities



Source:

Over the past two years the rand has benefited sharply from strong inflows into the domestic bond market. We have frequently raised concerns that a sharp outflow of funds from the domestic bond market would see the rand depreciating sharply. The past month has in some ways been encouraging. Despite rising from R7,80 to over R8,50 to the dollar, foreign sales of bonds were relatively contained, suggesting a level of maturity with investors focused on longer-term opportunities rather than short-term fears.

Conclusion

Much now depends on the ability of the developed world policymakers to restore some level of confidence. Even though the global financial system is malfunctioning and the global economy is weak, there are practical steps to restoring health. What the markets are looking for is a path back to health rather than health itself. Risks to the rand are expected

to remain over the coming weeks as policymakers seek to find a solution to the crisis. The G20 meeting in Cannes in early November will be a critical point, failure to reach an adequate solution to the crisis may see risk aversion rise sharply again.

Table 2 : 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 once 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 been mixed but gold has been strong.	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 but rates elsewhere are also softening.	The carry trade will remain a supporting force as local rates move into the upcycle from late 2012 onwards.
Emerging market perceptions	Positive = good for rand.	Risk aversion has increased, with emerging market currencies easing.	Woes could spread more strongly 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 only 1,3% in the second quarter. Recent figures suggest weak growth continued in the third quarter.	Will still be positive, but could lose some momentum on a weaker global environment.
Current account	Large unsustainable deficit would be rand negative.	Deficit widened to 3,3% of gdp in the second quarter of 2011, up from 3,1% in the first 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 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 to be imposed.	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	Walmart deal eventually approved but future inflows likely to be limited in the current climate.	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.	Overvaluation has slipped to below 10% on purchasing power calculations given recent weakness.	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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