PICTET WEALTH MANAGEMENT
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CURRENCIES: SOUTH AFRICAN RAND

AS GOOD AS IT GETS

Author

LUC LUYET
lluyet@pictet.com

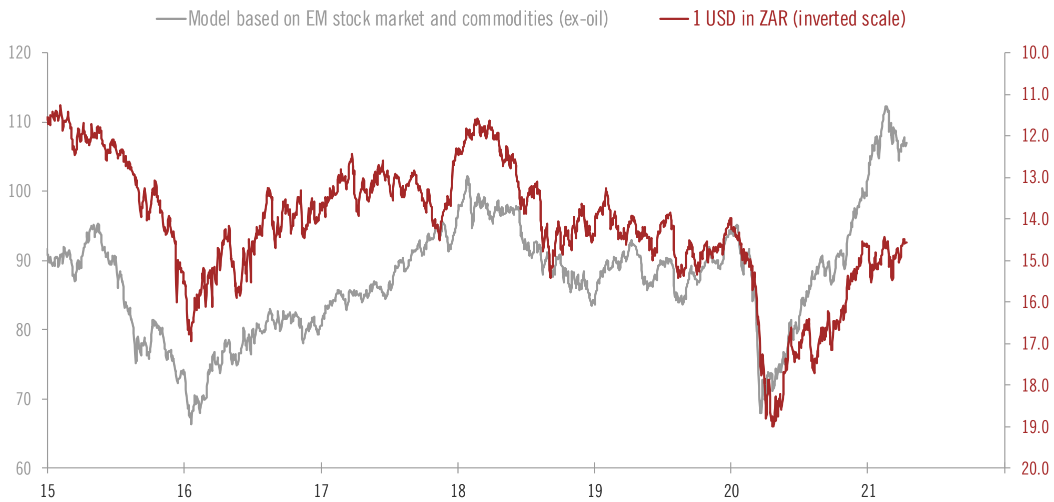
SUMMARY

› The South African rand has performed well since the rebound in risky assets in April 2020, mostly reflecting the rise in commodity prices and stronger risk appetite for EM assets.
› While domestic factors have been relatively more supportive than in other EM countries, low productivity growth and South Africa's fiscal imbalance could remain long-term headwinds for the rand.
› Factors that have helped rand appreciation are likely to soften in the coming quarters, suggesting limited scope for a further rise in the currency.
› Our projections for the USD/ZAR rate are ZAR14.5 on a three-month horizon, ZAR15.0 on a six-month horizon and ZAR15.5 on a 12-month horizon.

The rand has been particularly strong

Since the rebound in risky assets at the end of March 2020, the South African rand has been one of the best-performing emerging Market (EM) currencies, gaining 22% against the US dollar since 23 March 2020. As a net exporter of commodities, the rand has benefited significantly from the rise in commodity prices, which has improved South Africa's current account. Compared to other EM countries with high-beta currencies, macro developments in South Africa have been relatively positive for the rand (i.e. no immediate fiscal or geopolitical risks nor concerns surrounding financial institutions). Finally, South Africa lost its last investment-grade rating in March 2020. This prompted foreign investors to lower their rand exposure, leaving most to scramble to rebuild their positions when risk assets rebounded. Overall, the rand has been well placed to benefit from strengthening global risk appetite.

CHART 1: USD/ZAR VS INDEX BASED ON EM STOCK MARKET AND COMMODITY PRICES (EX-OIL)



Source: PWM - AA&MR, Refinitiv, 14 April 2021

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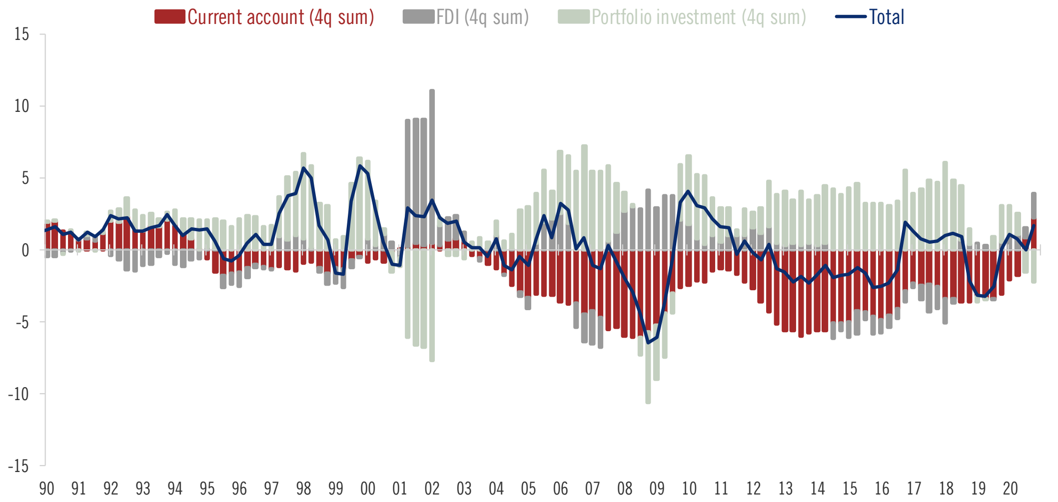
Looking forward, however, we see an increasing risk that most of the factors that have driven the rand's strong performance will fade, leaving limited further upside potential.

But limited scope for further outperformance

Fiscal risks in South Africa are more contained than in Brazil, another highly indebted country. The 2021 budget unveiled at the end of February was a positive surprise. While it extends short-term social relief measures, the budget also aims to increase tax revenue and tighten controls on expenditures. Taking into account the estimates contained in the budget, South Africa's debt -GDP-ratio could be lower than projected in the medium-term budget policy statement (MTBPS) set out by the ministry of finance in October 2020. While it may quell short-term investors' concerns about the fiscal outlook, implementation of some of the measures to reign expenditure may be challenging. In particular, wage negotiations with public-sector labour unions are likely to be protracted and, based on previous experience, the budget's wage bill assumptions will end up diluted. Furthermore, very low productivity growth in South Africa means there is a risk that economic activity surprises on the downside in the next few years. Finally, rising global interest rates are putting upward pressure on the government's cost of borrowing. Consequently, fiscal concerns are likely to re-emerge in the medium term and challenge the peak in debt-to-GDP ratio of 88.9% by 2025-2026 projected in the 2021 budget.

The South African current account improved significantly from a deficit of 3% of GDP in 2019 to a surplus of 2.2% in 2020. Although much will depend on precious metal and iron ore prices (South Africa's main exports), we would expect the country's favourable current-account dynamics to fade in the coming quarters, notably because imports are set to pick up as domestic demand rebounds.

CHART 2: SOUTH AFRICA CURRENT ACCOUNT, FDI AND PORTFOLIO INVESTMENT (AS % OF GDP)



Source: PWM - AA&MR, Refinitiv, 14 April 2021

Monetary policy may not be as hawkish as the latest South Africa Reserve Bank (SARB) monetary policy committee statement of 25 March implies. In that statement, the SARB set the scene for two 25bp rate hikes in the second and fourth quarters of this year. Yet inflationary pressures are lower than in other EM countries such as Turkey, Brazil or

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Russia. The risk of further waves of covid-19 waves before herd immunity is achieved could also make the SARB more patient about normalising monetary policy.

External conditions are unlikely to support the rand as much as they did in the second half of 2020. Our base scenario is for a further rise in US long-term interest rate this year, while the US dollar is unlikely to be as weak as in 2020. The short-term outperformance of the US economy relative to the rest of the world is an additional drag for EM currencies in general.

Unlike some other ex-Asian EM currencies, the rand is not undervalued. As such, it may be more vulnerable to a deterioration of the macro backdrop than other undervalued currencies that are already discounting a hefty dose of macroeconomic concerns.

Gradual decline in the rand likely

Overall, we fail to see any sustainable drivers for medium- to long-term appreciation of the rand. Our in-house stance on EM equities and commodities suggest that the rand may not receive much support from either source. The domestic macro backdrop remains becalmed, but is not particularly attractive either, in our view. We do not expect bold reforms to tackle structural issues such as low productivity and fiscal imbalances unless the economic outlook worsens drastically. The lack of structural reform is likely to remain a long-term negative factor for the rand, especially once commodity prices become less supportive.

Our projections for the USD/ZAR rate are ZAR14.5 on a three-month horizon, ZAR15.0 on a six-month horizon and ZAR15.5 on a 12-month horizon.

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