Rand Dynamics

ECONOMICS | SOUTH AFRICA

NEDBANK

The Reserve Bank lends the rand a helping hand

- The rand raced back to firmer ground after the Reserve Bank hiked interest rates more than the markets expected. The pullback followed two and half months of relentless downward pressure caused by a barrage of bad news on the domestic front, including fading growth prospects on the back of the worsening electricity crisis, the country's greylisting by the Financial Action Task Force (FATF) and S&P Global's downgrade of SA's credit ratings outlook. Adverse global developments weighed on the rand for much of March as global risk aversion spiked on the turmoil in the parts of the advanced country's banking sectors.
- The short-term outlook for the rand remains unfavourable, with global risk sentiment expected to remain volatile and weak as investors scrutinise news on the US and other banks while anxiously waiting for US interest rates to peak and pivot. The ongoing global economic slowdown and falling commodity prices will also hurt the rand. We still expect the rand to stage a more convincing recovery towards year-end as inflation recedes, and global growth prospects improve.

Table 1: Rand current conditions assessment as of 31 March 2023

Rand influences	Impact	Current impact on the rand		
		Negative	Neutral	Positive
Global forces				
Investor sentment: Risk-on or risk-off	Risk-on → Stronger rand			
US $ strength/weakness	Weaker $ → Stronger rand			
Global growth prospects	Positive → Stronger rand			
Global monetary policy & liquidity	AC easing → Stronger rand			
Emerging market risk appetite				
EME interest rate differentials	Rising → Boost carry trade			
SA interest rate differentials	Higher →Rand supportive			
International commodity prices	Upswing →Rand supportive			
Domestic forces				
Growth prospects				
Relative to AC	SA stronger → Rand supportive			
Relative to EMEs	SA stronger → Rand supportive			
Current account balance	Surplus → Rand supportive			
Policy & policy perceptions				
Fiscal policy	Prudent → Rand supportive			
Other policies	Sound → Rand supportive			
Rand under- or overvalued				
Based on PPP	Under → Rand supportive			

Note: EMEs = Emerging market economies, AC = Advanced economies

Strongly -	Mildly -	Leaning -	No impact	Mildly +	Strongly +

Source: Nedbank

RECENT TRENDS

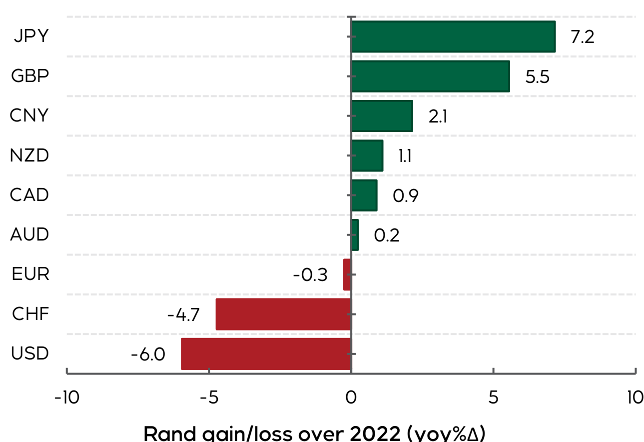
It has been a turbulent start to the year for the rand. The local unit came under pressure in January and February. The most severe triggers were homegrown. These included:

- South Africa's fading growth prospects in the face of relentless load-shedding, which led to significant downgrades to GDP growth forecasts by the Reserve Bank, National Treasury, all three major rating agencies and the IMF;
- Revelations of former Eskom CEO Andre De Ruyter of government involvement in corruption at the power utility;
- The greylisting of South Africa by the Financial Action Task Force, which triggered significant capital outflows from the local equity market;
- A disappointing set of Q4 2022 GDP numbers, reflecting the devastating impact of severe power outages on economic activity;
- S&P Global's downgrade of South Africa's credit rating outlook from positive to neutral; and
- An underwhelming cabinet reshuffle by President Ramaphosa, which expanded rather than reduced the size of the government and offered little hope that the electricity crisis would be resolved quickly.

The barrage of bad news completely erased the modest gains that followed this year's National Budget, in which the government stuck to its ambitious deficit reduction plan and offered Eskom substantial debt relief to remove over 60% of the utility's debt from its balance sheet.

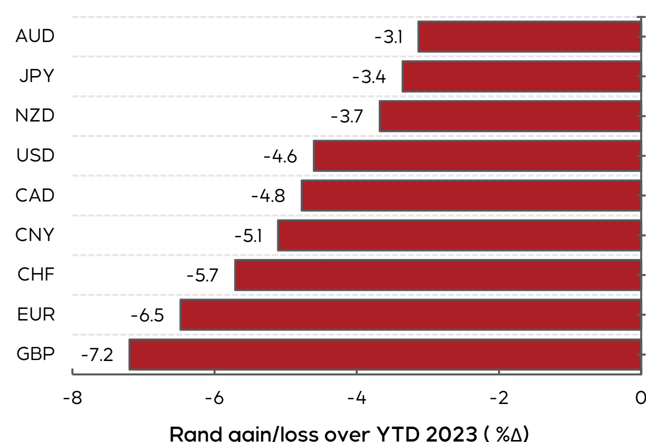
The pressure on the rand intensified in early March but then wholly reversed over the last two days of the month. This time the drag emanated from international forces, triggered by the turmoil in the global banking sector following the failures of three mid-sized US regional banks and the collapse and sale of Credit Suisse, a large Swiss bank. As a result, risk aversion spiked, fuelling a vicious selloff out of all risky asset classes and jurisdictions. A tentative calm returned after the US and Swiss authorities took several measures to inject liquidity and safeguard deposits. As risk aversion among international investors eased, the rand recovered marginally against a weaker US dollar. However, it regained considerable ground after the Reserve Bank unexpectedly hiked the repo rate by 50 bps at the end of March, ending the month 2.3% firmer against the US dollar.

Chart 1: Rand's performance in 2022



Source: Refinitiv

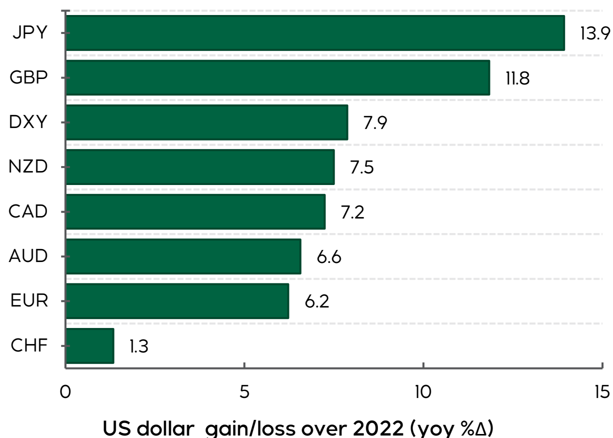
Chart 2: Rand's performance over 2023 to date



Source: Refinitiv

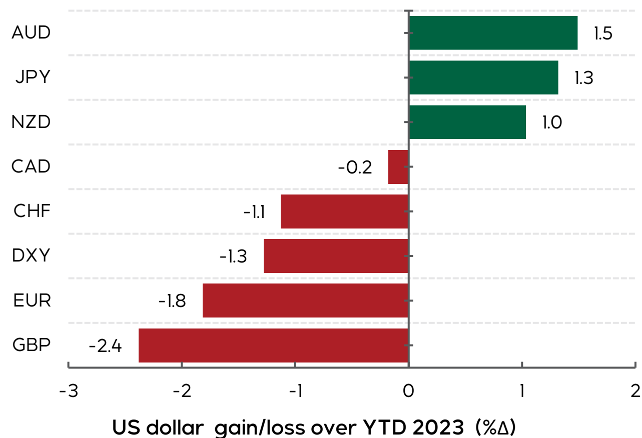
The US dollar has been volatile since the start of the year. This volatility stemmed from wild swings in risk appetites based on rapidly changing market expectations on the future course of US interest rates. The confusion stems from the difference in the views of investors and the US Fed on the underlying stickiness of inflation and the economy's strength. Most investors believe US interest rates are restrictive enough to cool the economy and the labour market sufficiently to force inflation down towards the central bank's 2% target over the next 12-18 months. However, the Fed has consistently struck a more hawkish tone, citing evidence of sticky inflation outcomes and a still robust labour market over January and February. The Fed has warned that interest rates will have to increase further and stay higher for longer. While the markets gradually started pivoting towards the Fed's stance over February, the turmoil in the US banking sector in March again altered interest rate expectations. Investors argued that the banking sector's stress threatened stability and would further tighten financial conditions. The banking turmoil will have the same impact as further interest rate hikes, choking off credit to the economy, mollifying demand from households and companies, and ultimately reducing price pressures. The Fed admitted as much after its March policy meeting but still raised rates by a further 25 bps and hinted that even further tightening might be 'appropriate' to ensure inflation's return to the 2% target. However, the US dollar weakened further after the meeting, with the trade-weighted dollar (DXY) depreciating by 2.5% over March. This suggests that the markets are betting on an early end to the US tightening cycle.

Chart 3: US dollar's performance in 2022



Source: Refinitiv

Chart 4: US dollar's performance over 2023 to date



Source: Refinitiv

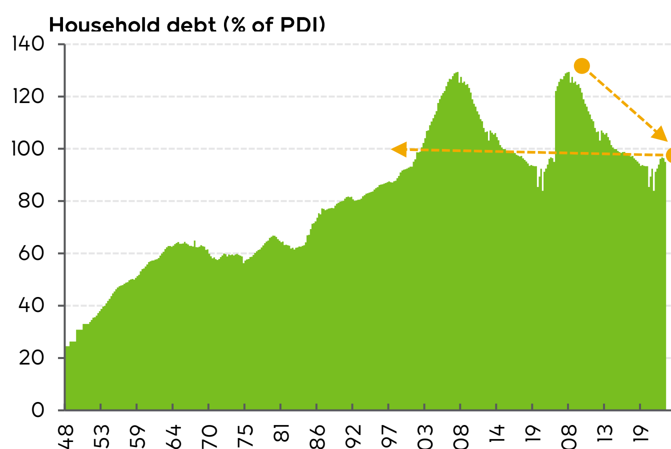
GLOBAL FORCES

Global risk sentiment oscillated since the start of the year, still heavily influenced by interest rate differentials and expectations. However, the unexpected turmoil in the US and Swiss banking sectors dominated headlines in March. The initial bank failures resulted in a sharp spike in risk aversion, which appears to be receding after significant regulatory and central bank interventions. While these developments dominated currency movements, world economic activity quietly moved to firmer ground, proving remarkably resilient.

Recent global economic developments

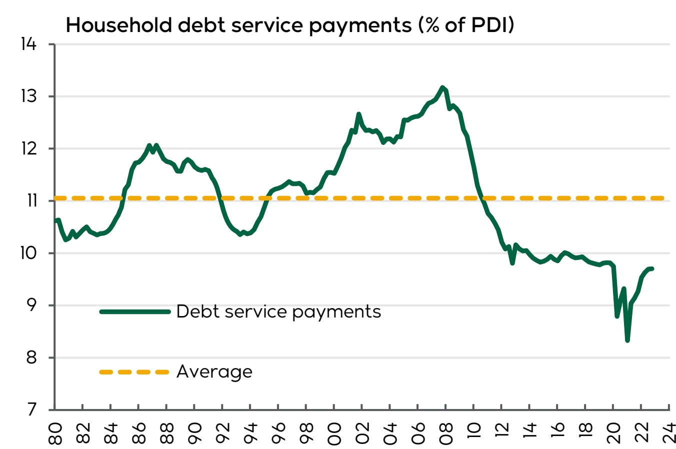
The US economy remained quite resilient in Q1 2023. There is clear evidence of a significant slowdown in industrial activity, but the expansion in services continued throughout the quarter. S&P Global's figures suggested that recessionary conditions beset the manufacturing sector in October last year, with the PMI dipping below the key 50 threshold separating expansion from contraction. The official industrial production numbers confirmed this downward trend, with output growth slowing to a crawl over December and January before shrinking by 0.2% yoy in February. On the upside, the latest PMI data suggest that trading conditions gradually improved over the quarter, increasing to 49.3 in March, just short of the breakeven mark. Services rebounded over the quarter, with PMI rising above 50 in February and March, supported by firm consumer demand. Retail sales surprised on the upside in January and February, suggesting that consumers are holding up better in the face of sticky inflation and sharply higher interest rates than widely anticipated.

Chart 5: Household debt burdens are still manageable



Source: US Fed & Haver Analytics

Chart 6: Debt service costs are creeping up

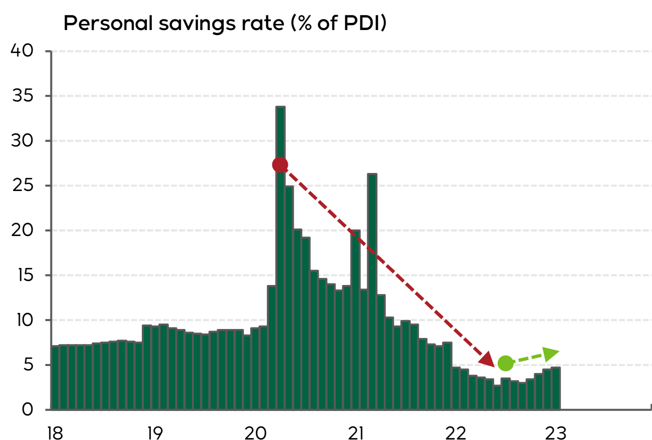


Source: Federal Reserve Bank of St Louis

Although inflation has outpaced earnings growth for over a year, households are still in a relatively sound financial position. Job creation continues at a healthy pace, with the unemployment rate hovering near record lows at 3.6%. At the same time, households still have positive wealth effects, manageable debt burdens, and ample savings. This made it possible for individuals to sustain spending through increased borrowing. Consumer credit accelerated to a peak of 8.2% yoy in December, only receding

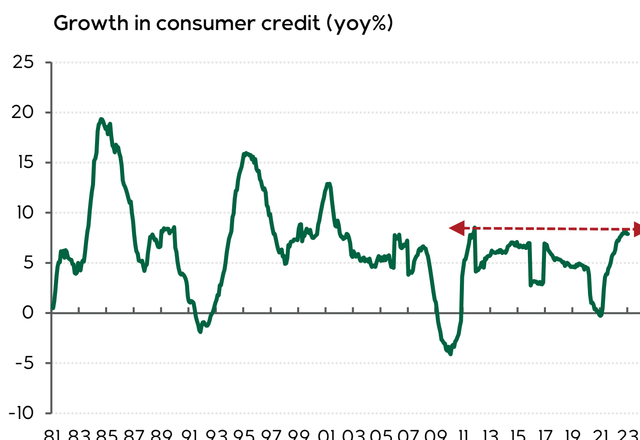
slightly to 7.9% in January, floating around levels last experienced in 2011. Although debt service payments consume an ever-increasing share of households' disposable income as interest rates climb higher, it remains well below the levels historically associated with significant consumer stress. Households also drew on savings to support spending throughout last year. However, they now appear to be rebuilding their savings. The personal savings rate rose to 4.7% of disposable income in January after receding to a low of 2.7% in June last year from well over 10% in 2020 and 2021. At this stage, households appear to have sufficient reserves and healthy enough balance sheets to continue leaning on credit to sustain living standards. This could continue for some time and tends to support the US Fed's caution on inflation. However, the screws will tighten as employment declines, house prices fall, equity portfolios lose value, and increased borrowing amid higher interest rates compounds debt service payments.

Chart 7: Household savings rates remain positive



Source: US Fed & Haver Analytics

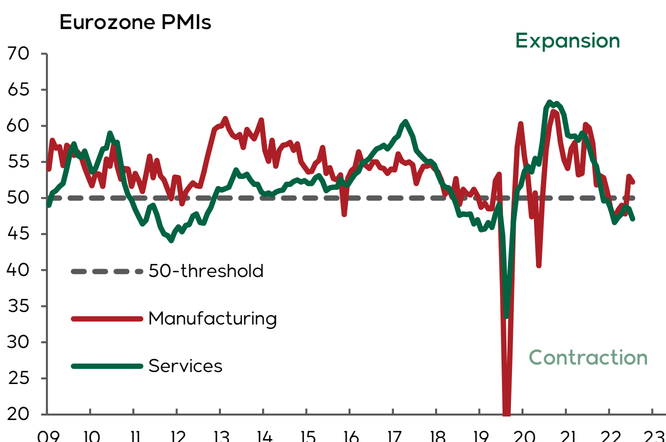
Chart 8: Consumer credit growth has accelerated



Source: Refinitiv

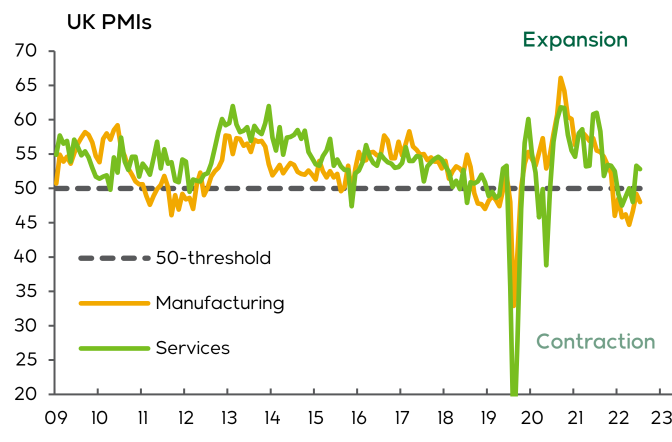
At this stage, the US economy seems set for a slowdown but not necessarily a recession. The markets expect GDP growth to slow to less than 1% qoq annualised from Q2 onwards, averaging 1% in 2023, down from 2.1% in 2022. If the turmoil among small- to mid-sized banks turns into a full-blown crisis, leading to multiple bank failures, thereby choking off credit to households, then deep recession would mostly follow.

Chart 9: The Eurozone is showing resilience



Source: S&P Global

Chart 10: The UK is also holding up better than expected



Source: S&P Global

Similar trends unfolded in the **Eurozone** and the **UK**. Real activity held up better than expected, with a strong recovery in services compensating for shrinking industrial output. In both the Eurozone and the UK, unemployment rates remained low, but consumer confidence weakened, the cost of living remained exceptionally high, and credit growth generally slowed in response to higher interest rates. Consumer spending on goods contracted further. In real or inflation-adjusted terms, Eurozone retail sales fell by a further 2.4% yoy in January, while those of the UK shrunk by 3.5% yoy in February. This suggests that the boost came from spending on other services, including the continued normalisation of travel, tourism, hospitality, and a pickup in financial services. The performances of the industrial sector diverged. Eurozone industrial production recovered somewhat in January, growing by a modest 0.7% yoy, but UK industrial output declined by a sharp 4.3% yoy in January. The manufacturing PMIs suggest that trading conditions weakened over March in both regions as output and new orders declined further. However, business confidence stabilised somewhat, with companies expecting firmer conditions heading into the summer, given falling energy prices and much-improved supply chains.

The risk of entering technical recession remains relatively high for the Eurozone and the UK, but it now appears much less inevitable than at the end of last year. The consensus forecast for the UK still points to a recession, with the markets expecting the economy to shrink by 0.5% in 2023. In contrast, the Eurozone is forecast to narrowly escape technical recession, expanding by a weak 0.5% in 2023, down from 3.5% in 2022.

Japan also enjoyed a robust revival in services, amplified by the lifting of all Covid restrictions and the reopening of the borders. The au Jibun Bank's services PMI raced to a relatively robust 54.2 in March from 52.3 in January. Like the US, Eurozone, and the UK, trading conditions in the industrial sector remained weak, with the manufacturing PMI stuck below the key 50 threshold. However, the environment improved marginally in March. The rate of decline in factory output and new orders moderated noticeably, and business optimism returned. Increased regional trade following China's reopening and improved supply chains boosted sentiment. Encouragingly, cost pressures receded in March, with input costs slowing to their lowest levels since August 2021. The markets expect Japan's economy to slow only fractionally to about 1% in 2023, down from 1.3% in 2022.

Unsurprisingly, **China's economy** rebounded in Q1 after scrapping its zero-Covid policy and lifting health restrictions. Retail sales rose by 3.5% yoy over January and February, while industrial production grew by 2.4% yoy over the same period. The Caixin services and manufacturing PMIs climbed above the 50-mark at the start of the year, with both sectors returning to expansionary territory. Domestic freight traffic and container throughput improved dramatically. Even property sales edged up slightly, although it remains well off the levels that prevailed before the slump of the past two years. China is likely to post strong growth in 2023, with estimates ranging from 5% to 6%, but last year's low base heavily inflates the forecast. The rebound in China benefitted most emerging Asian economies.

India's economy also moved into higher gear in early 2023. According to S&P Global's manufacturing PMI, the expansion in manufacturing output and new orders entered its 20th month in February. The services PMI accelerated to a 12-year high due to strong growth in new orders.

Performances among emerging economies in Central and South America diverged towards the end of last year and into early 2023. Economic activity in **Brazil** deteriorated, with real GDP contracting by 0.2% qoq in Q4 2022. The sharp rise in interest rates over the past two years started to weigh on households and companies. Consumer spending and fixed investment declined in Q4, outweighing the support emanating from a stronger net export position and continued growth in government spending. Recent indicators suggest that the downturn intensified in the first two months of this year. The manufacturing and services PMI dipped deeper into contractionary territory, with output, new orders, and employment under pressure.

In contrast, **Mexico's economy** picked up some pace. Business confidence improved marginally. Industrial production expanded further in January, and trading conditions strengthened in February, with factories reporting the strongest growth in new orders in four years. The boost came from a revival in export orders. Despite high inflation and interest rates, retail sales surged in January, growing by 5.2% yoy, after slowing to 2.5% in December. In Eastern Europe, activity faltered under persistent pressure from double-digit inflation and higher interest rates. Real GDP in **Poland**, **Hungary**, and the **Czech Republic** contracted over the final quarter of last year, and more recent data suggest the downturn broadly continued in the first two months of this year.

Altogether, the world economy is still expanding, albeit noticeably slower. High-frequency statistics suggest that trading conditions were starting to improve slightly in some advanced countries. China's reopening has offered a much-needed boost to some developing countries, but on average, most emerging economies appear to be losing momentum, weighed down by much tighter financial conditions. Although encouraging, the banking travails have increased uncertainty, introducing further downside risks to the global growth outlook.

Global monetary policy and liquidity conditions

The synchronised global tightening in monetary policies mostly continued in early 2023. However, the **US Fed**'s policy choices have become much more challenging. Central banks are tasked with maintaining low and steady inflation while ensuring the integrity and stability of the financial system. The stress in the banking sector unfolded before the Fed could declare victory in its fight against inflation. The banking woes now pitch the two objectives of the central bank against each other. Higher interest rates have reduced the security portfolios of some banks, encouraging depositors to flee to larger banks or higher-yielding money market funds. Cutting interest rates would ease the pressure on banks, but it could also stimulate demand, aggravate an already tight labour market and worsen price pressures. Simply put, the policy choice that may ease one problem could exacerbate another. So far, the US regulators and the Fed have opted to shore up the banking system by:

- Extending deposit guarantees, even to deposits above the $250 000 threshold. The rationale is that there is no incentive to flee if all deposits are safe.
- Injecting liquidity into the banking system through the discount window and the introduction of a generous lending scheme, which aims to protect banks from the risks of holding long-dated securities
- Negotiating equity injections from large banks into smaller banks to relieve funding pressures.

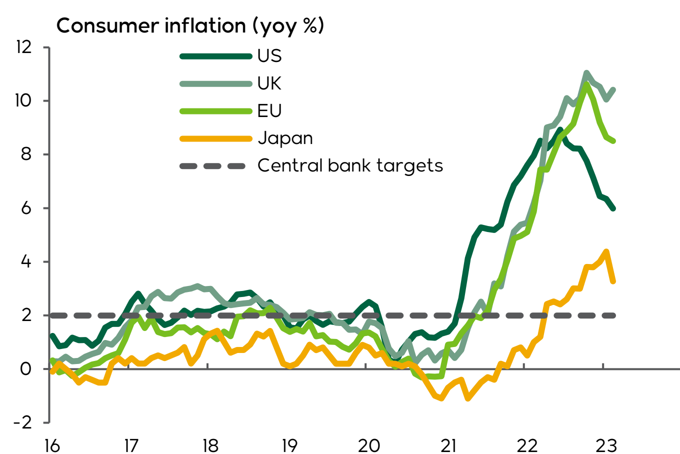
Although it is still early, these interventions appear to be working, with some calm returning to the system. However, the risk of contagion remains. Depositors can be unpredictable. Even with the guarantees in place, in a rising interest rate environment, depositors may still opt to move their funds, not out of fear for their safety, but in search of more lucrative returns elsewhere. Therefore, a bank's ability to retain its deposits will depend on whether the interest rate it offers can compete with other

instruments. Furthermore, banks' share prices could come under renewed pressure, eroding capital and straining balance sheets. Finally, all these uncertainties may convince banks to tighten lending standards, restricting the flow of credit to households and companies, which would amplify the downward force on the economic activity already emanating from higher interest rates.

At this month's policy meeting, the Fed acknowledged that the turmoil could lead to tighter credit conditions, subdue economic activity, job creation, and inflation. Despite this, the Fed pressed ahead with another 25-bps hike, raising the federal funds rate (FFR) to 4.75%-5%. The FOMC still considered inflation risks to be elevated. As such, the committee anticipated some additional policy '*firming*' may be appropriate to ensure inflation's return to the 2% target. The **Summary of Economic Projections** shows that the interest rate expectations of most FOMC members remained broadly unchanged from December's meeting, with FFR projected at 5.1% in 2023, slightly higher at 4.3% in 2024 (4.1% in December) and unchanged at 3.1% in 2025. PCE inflation was forecast to be higher at 3.3% in 2023 (3.1% in December) before easing to 2.5% in 2024 (unchanged from December). Committee members anticipated that economic growth would be slightly weaker at 0.4% in 2023 (0.5% previously) and then recover moderately to 1.2% in 2024 (from 1.6% previously).

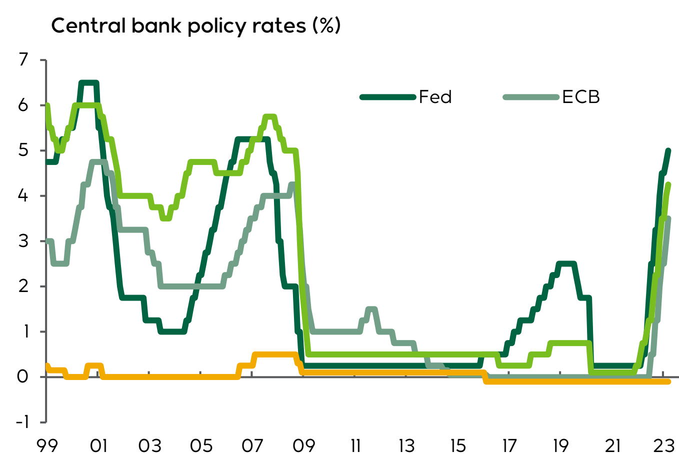
The **European Central Bank (ECB)** also raised its policy rates by 50 bps, taking the main refinancing rate to 3.5%, the marginal lending facility rate to 3.75%, and the deposit facility rate to 3%. The hike was widely anticipated, given the stubbornly high inflation. Eurozone inflation eased slightly to 8.5% in February from 8.6% in January. Energy price increases moderated considerably, but food inflation accelerated. The ECB still expected headline inflation to decelerate, returning to the 2% target in the second half of 2024. Headline inflation is forecast to average 5.3% in 2023, 2.9% in 2024 and 2.1% in 2025. The core inflation forecast was revised up to an average of 4.6% for 2023, suggesting that the ECB expected underlying price pressures to remain elevated. The **Bank of England (BoE)** sang from the same hymn sheet as the Fed, hiking its bank rate by 25 bps to 4.25%. UK inflation surprised on the upside in February, edging up to 10.4% from 10.1% in January. The main culprit was food inflation, which accelerated to an alarming 18% yoy, reaching its highest level since August 1977. The surge in food prices was attributed to shortages of vegetables, poor weather conditions in southern Europe and parts of Africa, and higher electricity costs. Core inflation also disappointed, climbing to 6.2% yoy in February from 5.8% in January. The BoE expected inflation to recede rapidly in the months ahead but signalled that it would not hesitate to tighten signs of persistent price pressures. The ECB and BoE said their banking systems are healthy, with strong capital and liquidity ratios. In sharp contrast, the **Bank of Japan (BoJ)** stuck to its highly accommodative stance, leaving its key short-term interest rate unchanged at -0.1% and the target for the 10-year bond yield around 0%. Japan's inflation rate moderated to 3.3% in February after accelerating to 4.4% in January, its highest level since 1991.

Chart 11: Inflation in the major economies



Source: Refinitiv Comparative

Chart 12: Policy rates of the major economies



Source: Refinitiv

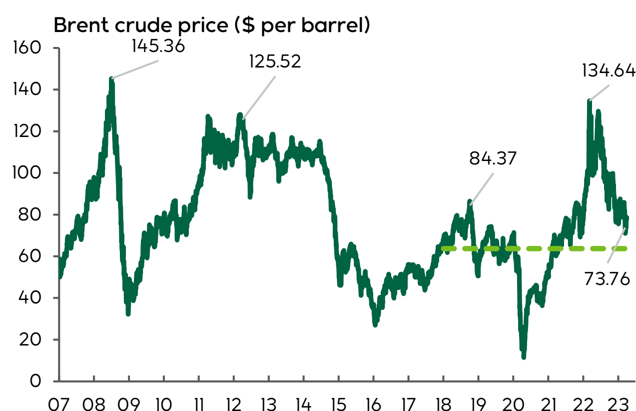
Policy decisions among EME central banks diverged. Mexico upped its policy rate to 11.25% even as inflation eased to 7.6% after reaching a high of 8.7% in August last year. Colombia also increased interest rates to a steep 13% as inflation remained stuck at 13.3% in February after climbing to this level in January from a low of 1.5% in November 2020. Some Asian EMEs also raised their interest rates further since the start of this year, including India, the Philippines, Taiwan and Thailand and South Korea. However, Hungary, the Czech Republic and Poland have left their respective policy rates unchanged since September last year despite inflation running at 25.4%, 16.7% and 19%, respectively. Brazil's central bank also left its Selic rate untouched at 13.75%, but it is winning the battle against inflation, with the headline rate falling to 5.6% in February from a peak of 12.1% in April last year. The People's Bank of China (PBoC) reduced its reserve ratio for financial institutions by 25 bps. Still, it kept the one and five-year lending rates steady for the 7th consecutive month at 3.65% and 4.3%, respectively.

International commodity prices

Commodity prices have weakened significantly since the start of the year. The S&P Goldman Sachs Commodity Spot Price Index (S&P GSCI) declined by 6.8% over the year to date after ending last year almost 26% up over 2021. The drag came from **energy**

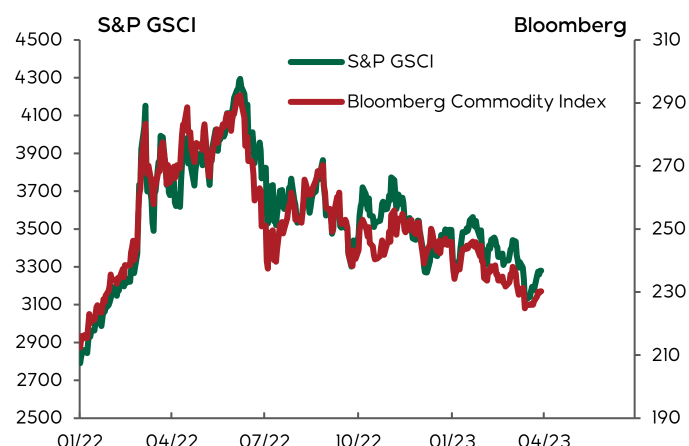
prices falling sharply off last year's highs. Natural gas prices declined by 51.2% in Q1, while the Brent crude oil price dropped by 9.7%. Softer demand in advanced countries due to weaker economic activity and mild winter weather conditions in Europe, combined with relatively high inventories, contributed to a sharp fall in energy prices. Uncertainty over the outlook for US interest rates and worries over the implications of the stress in the global banking sector also weighed on energy prices. These factors outweighed the impact of higher energy demand stemming from China's reopening. Crude oil prices started drifting marginally higher towards the end of the month on an unexpected drop in US inventories and renewed supply disruptions caused by Turkey's decision to halt pipeline flows from producers in Iraq's Kurdish region. At the same, Russian oil production fell short of its quotas. Despite these supply concerns, oil prices are still expected to remain under pressure as the Northern Hemisphere enters summer and global economic activity slows. Coal prices declined sharply in Q1, losing almost 19% of their value.

Chart 13: Global oil prices



Source: Refinitiv

Chart 14: Major commodity price indices



Source: S&P Goldman Sachs Commodity Price Indices & Bloomberg

Metal prices were mixed. Precious metal prices held up relatively well, boosted by an 8.6% jump in the gold price, whose safe-haven appeal was strengthened by the spike in risk aversion caused by fears of another banking crisis. Platinum group metals, nickel and lead prices declined sharply, while iron ore, tin and copper prices recovered considerable lost ground, benefiting from strong demand from China.

The downward trend in **food prices** continued, supported by higher food production. The S&P GSCI for agricultural products fell by a further 3.4% in Q1. The UN Food and Agricultural Organisation's food price index fell for the 11th month in February. Compared with the same month a year ago, food prices declined by 8.1% in February. A sharp reversal in food oil prices exerted the most downward pressure, but the prices of meat, dairy and grains also declined further. The only exception was sugar prices, which picked up renewed momentum over March, jumping by 6.9% mom.

The implications for global risk appetites and the rand

The dollar's lacklustre performance reflects the bewildering swings in investors' expectations on the future course of US interest rates. The strain on regional banks has triggered a significant downward adjustment in rate expectations. The Fed's hawkish messaging and the market's pricing are again at odds. Investors are betting that the US Fed is more likely to reverse its policy course in the face of the risks posed to economic activity and financial stability by the banking sector's woes than other advanced countries. For now, expected interest rate differentials have shifted against the US dollar. However, interest rate expectations have been highly volatile and could easily change again if the banking sector stabilises, the US economy and employment surprise on the upside and inflation continues to prove persistent. While the world economy has proved more resilient than most anticipated, stubbornly high inflation and tighter financial conditions will weaken economic activity. If global growth prospects disappoint and recession threatens, risk aversion is likely to return, strengthening the safe-haven appeal of the US dollar.

Most EME currencies strengthened against the US dollar after the troubles at some banks emerged. The IIF's (Institute for International Finance) data show that portfolio flows to EMEs improved moderately since October last year and increased further over the first two months of this year. The bulk of the improvement reflected renewed purchases of Chinese equities after the economy lifted Covid restrictions. However, foreign investors remained wary of China's bond market, but other EMEs experienced relatively robust inflows. The primary beneficiaries were other Asian and Latin American countries. Capital inflows to Emerging Europe, Africa and the Middle East remained weak and patchy.

We believe that global risk sentiment will remain volatile in Q2, unsettled by continued doubts over the outlook for US monetary policy and the risk of a deeper-than-expected global economic downturn. EME currencies will also be affected by persistent concerns over mounting fiscal and other external vulnerabilities in some countries amid tighter global financial conditions. We

still expect EME currencies to regain some lost ground in the year's second half once the US rate hiking cycle is over and global growth improves as inflation abates and confidence rebounds in anticipation of lower interest rates. EME countries with relatively good growth prospects, prudent macroeconomic policies, and strong external buffers will likely outperform.

Global forces will continue to weigh on the rand over the next few months but should become more supportive towards the end of the year and throughout next year.

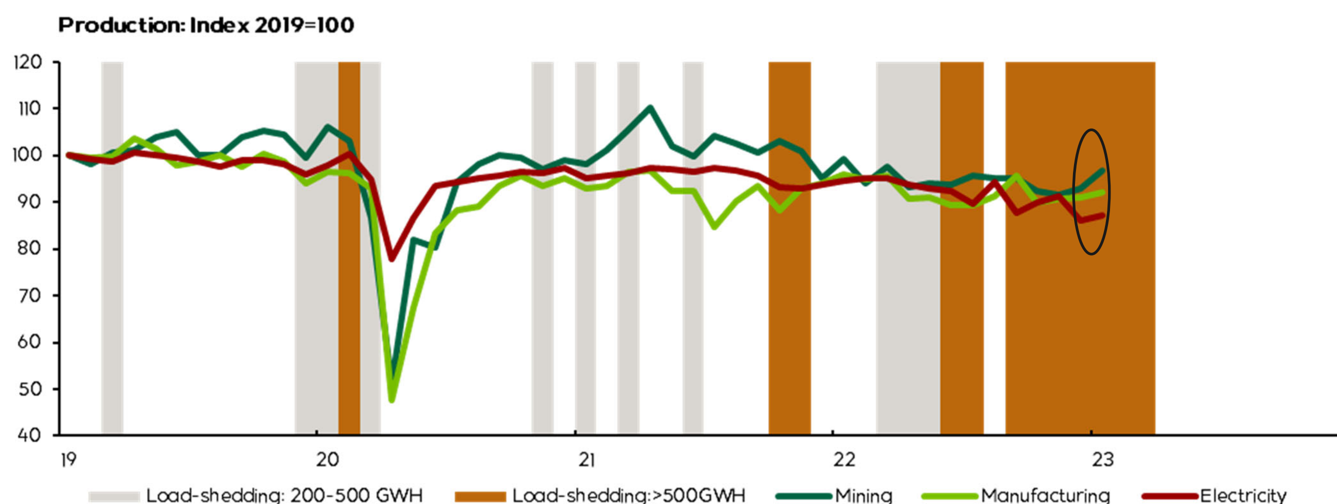
DOMESTIC FORCES

Economic growth performance

Economic conditions deteriorated significantly towards the end of last year as power outages reached unprecedented levels. Real GDP contracted by a deeper-than-expected 1.3% qoq in Q4 2022, with drag coming from a sharp deterioration in the country's net export position due to load-shedding, rail and port disruptions, weaker demand in advanced countries and falling commodity prices. So far this year, load-shedding has intensified, and other logistical constraints have persisted. However, global activity was better than expected, lifted by the scrapping of Covid restrictions in China.

Against all odds, Stats SA's monthly production and sales figures showed a marked improvement in most industries on a mom basis in January. Mining and manufacturing production rose by 4.4% and 1.1%, respectively. Most surprising of all, electricity production rose 1.3% mom. Services also fared better, with retail and wholesale sales up 1.5% and 0.4%, respectively. In volume terms, new vehicle sales rose further over January and February, although growth rates slowed. Hospitality income declined as domestic and foreign tourists returned to work, but food services increased by a robust 4.7% mom. Although we expect activity to relapse in February and March, the January bounce nonetheless lifts our Q1 2023 GDP forecast to 0.2% qoq from -0.4% qoq. It now appears less likely that the economy entered a technical recession at the start of this year.

Chart 15: Economic activity remained remarkably resilient in January



Source: Stats SA, EskomSePush, Nedbank

Despite the surprisingly resilient start to the year, economic activity will suffer under the combined weight of persistent and severe load-shedding, slower global growth, falling commodity prices, sticky domestic food and other prices, and sharply higher interest rates. Export volumes are forecast to decline sharply, falling short of import volumes and worsening the drag emanating from the country's negative net export position. Growth in consumer spending is forecast to slow down to a modest 1.2% in 2023, hurt by fragile confidence, renewed doubts over job security, slower income growth, sticky inflation, and the surge in interest rates. The downside will be capped by positive savings and relatively low levels of indebtedness. Growth in fixed investment activity is also forecast to moderate, easing to around 2.3%, down from 4.7% in 2022. Increased outlays on renewable energy generation and improved infrastructure spending by the government should support capital expenditure. Still, the electricity shortage, other infrastructure flaws and the anticipated slowdown in domestic and global economic activity will convince more companies to postpone or delay capital expenditure projects. Altogether, we expect GDP growth to slow to 0.4% in 2023, which is up from our previous forecast of 0.1%.

SA's underperformance relative to its EM peers on the growth front is expected to pose further downside risks to the rand, although much of the immediate bad news has probably already been priced in.

Monetary policy

The MPC raised the repo rate by a higher-than-expected 50 bps to 7.75% in March. The hawkish twist was based on recent sticky inflation outcomes, rising inflation expectations, and continued upside risks to the inflation outlook. The key risks included still elevated global prices, a tight global oil market, the possibility of further dramatic hikes in domestic electricity tariffs, a weak rand, and even higher food prices as load-shedding drives up production costs and drier weather conditions threaten domestic crops. The MPC was also worried about wages and salaries, fearing that stubbornly high food and fuel prices could trigger another round of aggressive increases.

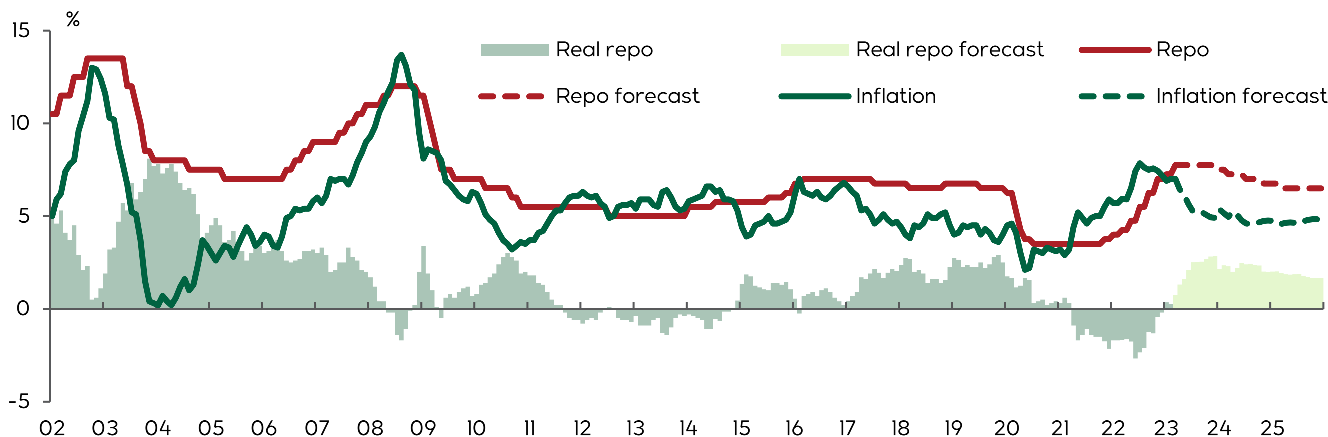
The Reserve Bank now expects headline inflation to average a much higher 6% in 2023 (5.4% previously) before moderating to 4.9% in 2024 (4.8% previously) and 4.5% in 2025 (unchanged). Alarmingly, inflation is only expected to dip below the upper 6% limit of the inflation targeting range in Q3. There were no significant changes to the core inflation forecast at 5.1% in 2023, 4.7% in 2024 and 4.5% in 2025.

The Reserve Bank changed its GDP growth forecasts slightly. It now expects growth of only 0.2% in 2023, down from January's already gloomy forecast of 0.3%. After that, the central bank anticipates a slightly firmer recovery, forecasting growth of 1% (0.7% previously) and 1.1% (versus 1%). Unsurprisingly, the main obstacles to growth remained load-shedding and other logistical constraints. The bank considered the risk to the growth outlook to be balanced. With actual GDP growth forecast at 0.2% and potential output estimated at -0.2%, the output gap amounts to zero, suggesting that the expected growth outlook is unlikely to have a material impact on inflation.

Towards the end of last year, we noted that inflation was receding too slowly, pointing to broader price pressures. Given the Reserve Bank's latest forecast, they expect this painfully slow descent to continue for much of this year, only picking up downward traction from next year onwards. We are less bearish on the inflation outlook. We still expect the headline figure to dip below 6% in June and to end the year at 4.9%, averaging 5.8% in 2023. We believe the downward trend in global oil prices will continue as weaker demand outweigh the impact of supply disruptions. We also feel that the most significant boost from China's reopening is probably over. While load-shedding is hurting profit margins throughout the food supply chain, there is still a limit to which companies can pass these cost increases onto consumers without hurting sales volumes disproportionally.

For the same reason, we are not convinced that the sharp loss of growth momentum will have little to no impact on inflation. With GDP growth of only 0.4%, the downward pressure on companies' turnover will increase, ultimately forcing companies to discount to sustain volumes. As a result, we see the March hike as the last of this upcycle.

Chart 16: While the nominal repo rate is now above 2011-2019 levels, the real repo rate is barely positive



Sources: SARB, Nedbank forecast

Over the very short term, the risk to our forecast resides on the upside. Another rate hike cannot be ruled out completely. Food prices could easily rise further as companies try to restore margins while sales volumes remain reasonable. Also, the decision to hike by a more aggressive 50 bps was probably heavily influenced by the sustained pressure on the rand since the start of the year. The weaker rand more than likely contributed to inflation's slow decline by offsetting much of the benefits of the sharp fall in global oil and food prices. Given SA's poor growth prospects, a widening current account deficit and the country's recent greylisting against the backdrop of global financial stability concerns and volatile risk sentiment, the risk of significant capital outflows is high. The MPC probably felt that interest rate differentials needed to compensate for these shortcomings. Before the meeting, the interest rate differential between SA and the US narrowed significantly, dropping to only 250 bps, its lowest level since early 2006. The rand's strong bounce following the rate decision suggests that the fading rate margin was a factor behind the currency's weakness. Unfortunately, if the Fed sticks to its plan and hikes by another 25 bps at its next meeting, the interest rate differential will again narrow to 250 bps, potentially leading to renewed rand weakness unless the MPC follows suit.

Beyond the next meeting, we forecast interest rates to remain unchanged at current levels for the rest of the year. Here the risk resides on the downside. If inflation falls faster than expected due to recessionary economic conditions, the MPC could still move the first rate cut forward to the end of this year. Although the Reserve Bank's Quarterly Projection Model only reflects a modest policy easing over the next two years, we see room for more aggressive cuts as inflation slides towards 4.5%.

Fiscal policy

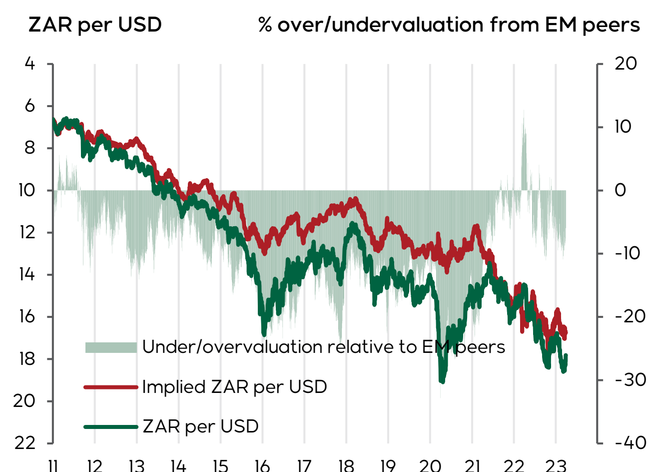
Fiscal risks remain relatively contained. National Treasury managed to limit the consolidated budget deficit to a lower-than-expected 4.9% of GDP in 2022/23 and presented an ambitious National Budget, which aims to cut the deficit to 3.2% by 2025/26. Treasury also offered Eskom significant debt relief, giving the utility space to focus on its many operational challenges. With debt service costs still expected to outpace most other expenditure priorities, the government plans to restrict growth in non-interest expenditure to the low single-digits in nominal terms, translating into a cut in real or inflation-adjusted terms. If the government meets its expenditure targets, it will run a primary surplus this year. However, it appears highly unlikely. Significantly weaker economic growth and falling commodity prices will undermine tax revenues. At the same time, expenditure is likely to overshoot due to the higher-than-budget wage agreement, extensions to the Social Relief of Distress grant, and continued bailouts to other financially fragile SOEs. As a result, S&P Global recently downgraded the country's rating outlook from positive to neutral. More dramatic downgrades are not expected as fiscal policy is on a sounder footing than two years ago.

Further downgrades to the country's rating outlook will undoubtedly result in rand depreciation, but fiscal risks are not expected to be a significant driver of the rand in 2023.

RAND VALUATION & CONCLUSION

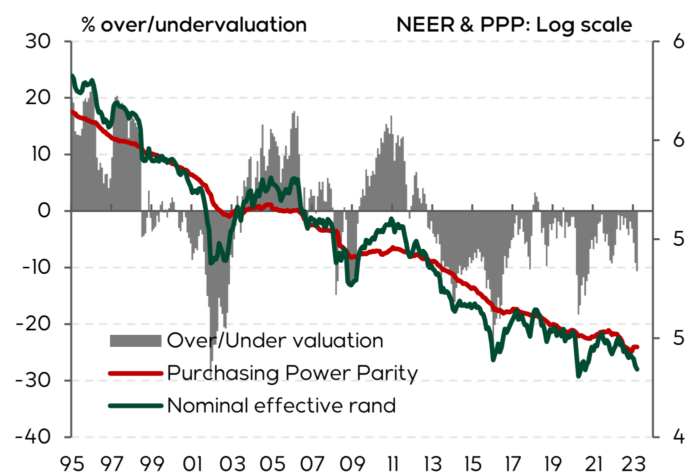
The rand's strong pullback over the past two days reflects the Reserve Bank's aggressive interest rate hike, which helped rebuild some of SA's lost margin over US rates. Although encouraging, the rand will likely come under renewed pressure over the very short term. International investors are expected to remain skittish, scrutinising developments in the world banking sector and anxiously waiting for US interest rates to peak and pivot. The ongoing global economic slowdown and falling commodity prices will also hurt the rand. We still expect the rand to stage a more convincing recovery towards year-end as inflation recedes, and global growth prospects improve.

Chart 17: The rand relative to EM risk appetites



Source: Refinitiv, MSCI, Nedbank

Chart 18: Rand based on purchasing power parity



Source: SARB, Nedbank

Table 2: Monthly exchange rate forecasts

		USD/EUR	CHF/USD	YEN/USD	USD/GBP	ZAR/USD	ZAR/GBP	ZAR/EUR
2022	January	1.117	0.932	115.4	1.343	15.58	20.92	17.47
	February	1.116	0.926	115.5	1.337	15.38	20.57	17.16
	March	1.117	0.924	121.6	1.314	14.49	19.03	16.19
	April	1.055	0.972	130.3	1.253	15.88	19.91	16.75
	May	1.074	0.960	128.0	1.260	15.55	19.60	16.70
	June	1.044	0.956	136.4	1.164	16.20	18.86	16.92
	July	1.025	0.951	132.6	1.195	16.42	19.62	16.83
	August	1.002	0.974	138.4	1.168	16.96	19.81	17.00
	September	0.983	0.976	144.4	1.118	17.90	20.00	17.59
	October	0.994	0.998	147.9	1.160	18.25	21.17	18.15
	November	1.035	0.954	138.6	1.197	17.35	20.77	17.96
	December	1.065	0.924	132.5	1.205	16.97	20.45	18.07
	Year Average	1.052	0.954	131.8	1.226	16.41	20.06	17.23
2023	January	1.084	0.926	130.3	1.235	17.42	21.51	18.88
	February	1.059	0.938	136.4	1.204	18.45	22.22	19.53
	March	1.088	0.916	133.3	1.237	17.82	22.04	19.40
Forecast	April	1.090	0.915	132.8	1.242	17.76	22.06	19.35
	May	1.091	0.914	132.3	1.248	17.69	22.08	19.31
	June	1.093	0.912	131.8	1.253	17.63	22.09	19.26
	July	1.098	0.909	131.5	1.255	17.52	21.99	19.24
	August	1.104	0.905	131.2	1.257	17.40	21.88	19.21
	September	1.109	0.901	130.9	1.259	17.29	21.78	19.19
	October	1.108	0.902	131.0	1.257	17.22	21.65	19.07
	November	1.106	0.903	131.2	1.255	17.14	21.52	18.96
	December	1.104	0.903	131.3	1.253	17.07	21.39	18.84
	Year Average	1.094	0.912	132.0	1.246	17.53	21.85	19.19
2024	January	1.102	0.902	131.1	1.256	17.14	21.53	18.90
	February	1.101	0.900	130.9	1.259	17.22	21.68	18.95
	March	1.099	0.899	130.8	1.262	17.29	21.82	19.01
	April	1.108	0.899	130.9	1.261	17.13	21.61	18.99
	May	1.117	0.900	131.0	1.260	16.98	21.40	18.96
	June	1.125	0.901	131.2	1.259	16.82	21.19	18.93
	July	1.130	0.899	130.4	1.263	16.72	21.12	18.88
	August	1.134	0.898	129.7	1.267	16.61	21.05	18.83
	September	1.138	0.897	128.9	1.271	16.50	20.97	18.78
	October	1.140	0.896	129.0	1.270	16.51	20.97	18.83
	November	1.142	0.895	129.0	1.269	16.53	20.97	18.88
	December	1.145	0.894	129.1	1.268	16.54	20.97	18.93
	Year Average	1.123	0.898	130.2	1.264	16.83	21.27	18.91
2025	January	1.148	0.894	128.8	1.269	16.61	21.08	19.06
	February	1.151	0.894	128.5	1.271	16.68	21.19	19.20
	March	1.154	0.893	128.3	1.272	16.75	21.30	19.33
	April	1.158	0.891	127.6	1.277	16.58	21.18	19.20
	May	1.163	0.888	126.9	1.283	16.41	21.05	19.07
	June	1.167	0.885	126.2	1.289	16.23	20.92	18.94
	July	1.164	0.888	126.8	1.283	16.17	20.76	18.82
	August	1.161	0.891	127.4	1.278	16.11	20.60	18.70
	September	1.158	0.894	128.0	1.273	16.05	20.44	18.58
	October	1.151	0.896	128.4	1.265	16.07	20.32	18.50
	November	1.145	0.898	128.8	1.256	16.09	20.20	18.43
	December	1.139	0.900	129.1	1.247	16.10	20.08	18.35
	Year Average	1.155	0.893	127.9	1.272	16.32	20.76	18.85

Source: Nedbank Group Economic Unit

GROUP ECONOMIC UNIT

Nicky Weimar +27 10 234 8357 nickywe@nedbank.co.za

DISCLAIMER

The information furnished in this report (the "report"). which information may include opinions. estimates. indicative rates. terms. price quotations and projections. reflects the existing judgment of the author(s) and the prevailing market conditions as at the date of this report. which judgment and conditions are subject to change without notice. modification or amendment. This report does not necessarily reflect the opinion of Nedbank Limited ("Nedbank"). The information herein has been obtained from various sources. the accuracy and/or completeness of which Nedbank does not guarantee and for which Nedbank accepts no liability.

Any prices or levels contained herein are preliminary and indicative only and do not represent bids or offers. These indications are provided solely for your information and consideration. The information contained in this publication may include results of analyses from a quantitative model which represent potential future events that may or may not be realised. and is not a complete analysis of every material fact representing any product. Any estimates included herein constitute Nedbank's judgment as of the date hereof and are subject to change without any notice. Nedbank and/or its affiliates may make a market in these instruments for our customers and for our own account. Accordingly. Nedbank's may have a position in any such instrument at any time.

Nedbank recommends that independent tax. accounting. legal and financial advice be sought should any party seek to place any reliance on the information contained herein. This report is intended for use by professional and business investors only. It may not be considered as advice. recommendation or an offer to enter into or conclude any transactions. This report has been prepared for general dissemination and information purposes only and may not be construed as an offer to buy or sell or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy in any jurisdiction. Any additional information relative to any financial instruments and/or financial products reviewed in this report is available upon request.

p

All rights reserved. Any unauthorised use or disclosure of this report is prohibited. This report may not be reproduced without the prior written consent of Nedbank. The information contained in this note is intended solely for the recipient and may not be distributed by the recipient.

All trademarks. service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of Nedbank or its affiliates.