Rand Dynamics

ECONOMICS | SOUTH AFRICA

A sudden turn in global risk appetites ends the rand's rout

- The rand recovered vast tracks of lost territory over the last two days, after five months in the wilderness. The catalyst for the rebound was the lower-than-expected US inflation outcome for October, which reinforced the view that US interest rates need not rise much further or for much longer to return inflation to its 2% target. As a result, risk appetite recovered, the dollar weakened, and the rand and the currencies of other emerging market economies (EMEs) strengthened. The domestic news flow was mixed but had little impact on the rand. The Medium Term Budget Policy Statement (MTBPS) was well received by the markets, but has subsequently been overshadowed by persistent rolling blackouts, the strike at Transnet, and more recently the start of what could be a prolonged public sector strike.
- The rand should end this year around current levels. The risk to the near-term outlook remains tilted to the downside, with another Fed policy meeting in December and the ANC set to elect its leader also in December. Next year the threat of global recession will weigh on all EME currencies, resulting in bouts of weakness. Despite this, we expect the rand to strengthen moderately over the second half of 2023, as risk appetites return in anticipation of lower US interest rates and the passing of the worst of the global downturn.

Table 1: Rand current conditions assessment as of 14 November 2022

Rand influences	Impact	Current impact on the rand		
		Negative	Neutral	Positive
Global forces				
Investor sentiment: 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			

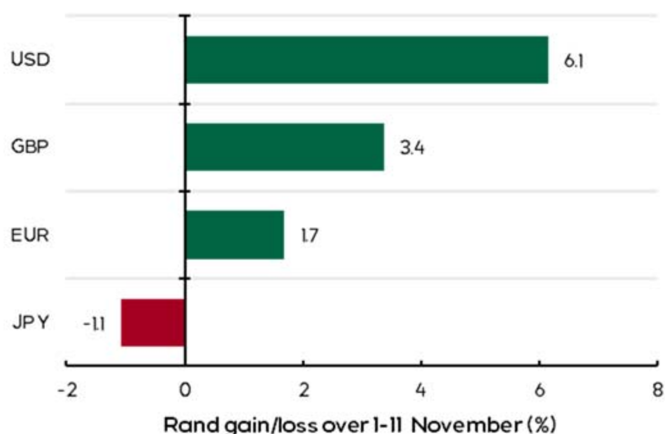
Note: EMEs = emerging market economies, ACs= advanced economies

Source: Nedbank

RECENT TRENDS

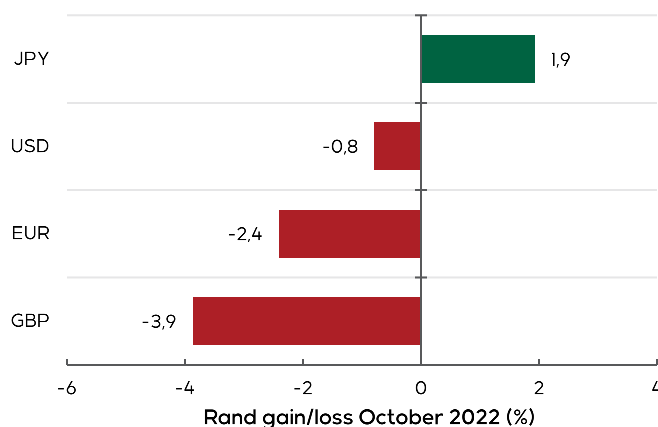
The rand (ZAR) strengthened over the past six days. The strongest pullback occurred after the release of cooler US inflation numbers on Thursday, stirring hopes that the US Fed will pivot on its aggressive policy tightening. The trade-weighted rand appreciated by 3.2% during the first two weeks of November, after weakening for five months in a row. The trade-weighted measure is now up 0.7% over the year to date. The ZAR gained an impressive 6.1% against a retreating US dollar (USD), after depreciating by 0.8% in October and a sharp 5.7% in September. The ZAR also strengthened against the euro and the British pound but weakened against a stronger yen.

Chart 1: Rand's performance in early November



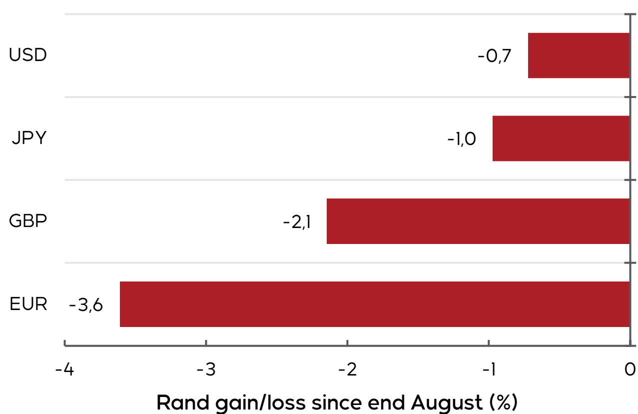
Source: Refinitiv

Chart 2: Rand's performance over October



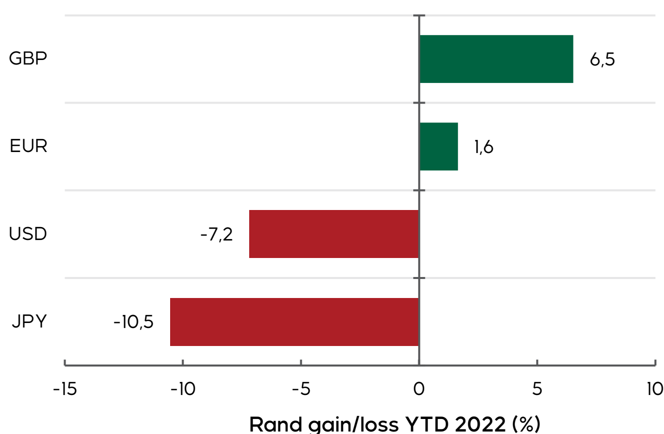
Source: Refinitiv

Chart 3: Rand's performance over three months



Source: Refinitiv

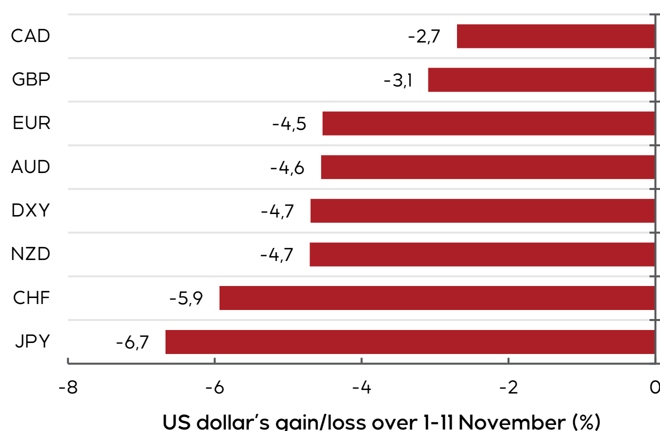
Chart 4: Rand's performance over the year to date



Source: Refinitiv

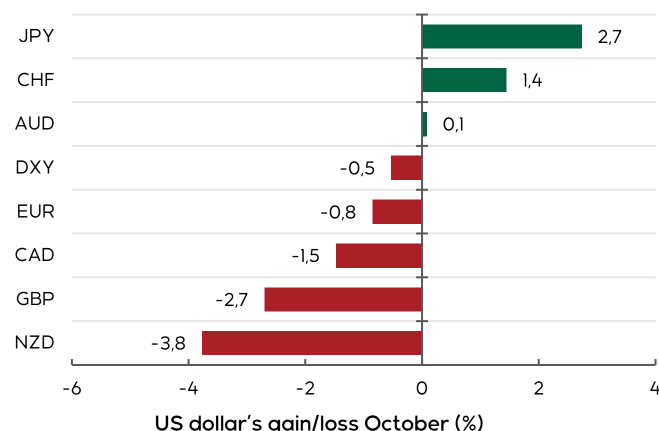
A weaker dollar was the main driver of the rand's rapid rebound. The dollar depreciated by 4.5% against the euro in early November. This followed a softer performance in October, when the dollar eased by 0.8% against the euro, after four months of strong dollar gains against the euro and all other major currencies. The British pound (GBP) regained more lost ground over the past few days, after turning the corner in October, supported by the appointment of Rishi Sunak as prime minister and the introduction of more sensible fiscal policies. The Japanese yen (JPY) benefitted the most from the dollar's retreat over the past week. The greenback depreciated by 6.7% against the yen over the month to date, after strengthening by 2.7% in October, 4.2% in September, and 4.3% in August.

Chart 5: US dollar's performance in early November



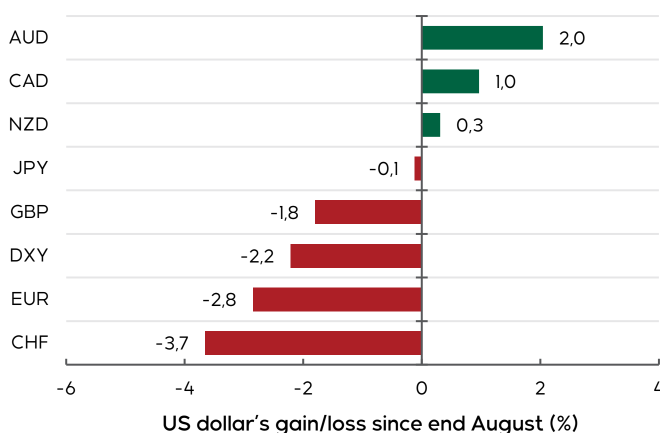
Source: Refinitiv

Chart 6: US dollar's performance over October



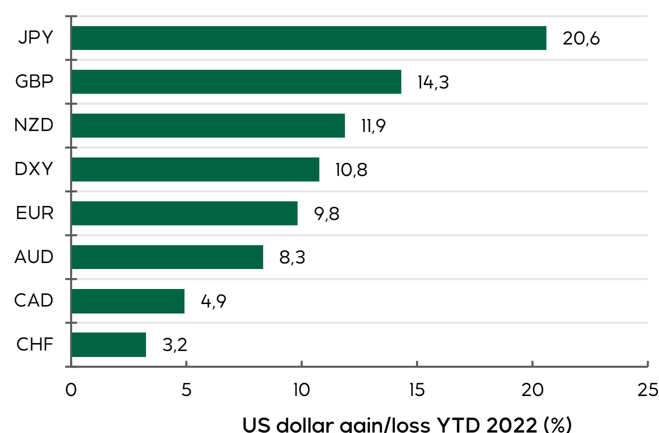
Source: Refinitiv

Chart 7: US dollar's performance over three months



Source: Refinitiv

Chart 8: US dollar's performance over year to date



Source: Refinitiv

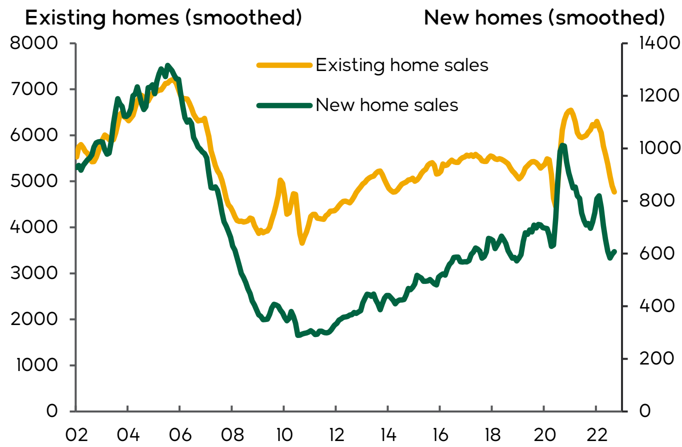
GLOBAL FORCES

Risk appetites returned over the past six days, after almost three months of gloom. There is now an active search a foot for good news on inflation, and growing calls for the Fed to slow the pace of interest rate hikes. The markets fear that the Fed and other central banks will once again misread inflation trends, tightening further as inflation turns and moderates, and thereby plunge the US and others into an unnecessarily painful and potentially prolonged recession. October's US inflation numbers provided some validation for this view, sparking a robust risk-on rally. The problem is that inflation remains high in the US and continues to rise in other advanced countries. There are signs that the rise in interest rates is starting to cool down the US economy, but these are far from compelling. The US labour market remains relatively healthy, with unemployment hovering near record lows and staff shortages still pervasive. It is probably too soon to announce a victory over inflation.

Recent global economic developments

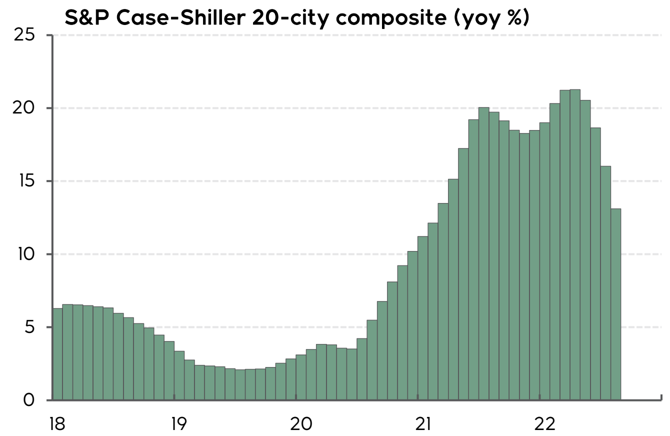
The **US economy** emerged from a technical recession in Q3. Real GDP bounced back, growing by an annualised 2.6% qoq, after shrinking by 0.6% and 1.6% in Q2 and Q1, respectively. However, the rebound was driven by a big jump in net exports, which contributed a whopping 2.8 percentage points to headline growth. This masked a noticeable slowdown in consumer spending - the bedrock of the US economy. Growth in consumer spending slowed to 1.4% from 2% as households reduced outlays on motor vehicles, food, and beverages. The downside was capped by higher outlays on services, notably health care. The numbers also reveal more evidence of stress in the housing market, suggesting that higher interest rates are hurting. Residential investment declined for the 6th straight quarter by a steep 26.4%. New and existing home sales are down considerably from last year's levels, while building permits granted and housing starts turned negative over August and September. Growth in house prices is also starting to moderate, easing to 13% yoy in August, still a healthy increase but down from a peak of 21.3% in April this year.

Chart 9: US new and existing home sales



Source: Refinitiv

Chart 10: US house prices

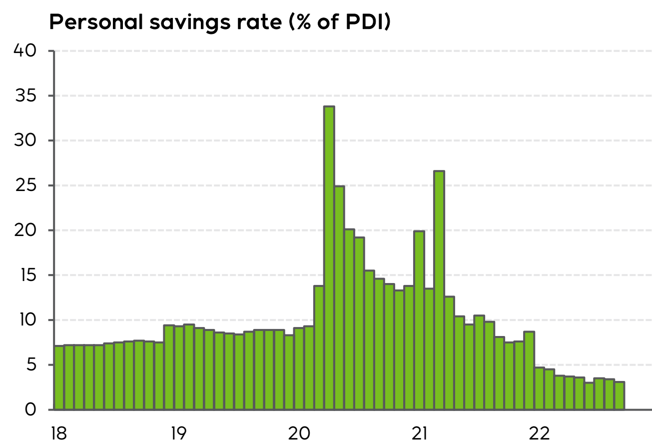


Source: Refinitiv

Although US consumers have long been concerned about high inflation, several factors have helped to shield household incomes from inflation's erosive impact. Firstly, healthy savings built up during the pandemic years, boosted by generous government transfers, the sharp drop in interest rates during that period, and the strong rally in asset prices that followed. Secondly, an exceptionally tight labour market, where unfavourable demographics, anti-immigration policies and changed work preferences combined to create acute shortages in certain industries. This led to the third buffer – higher wages. These pillars of household incomes are only now starting to show signs of wear and tear.

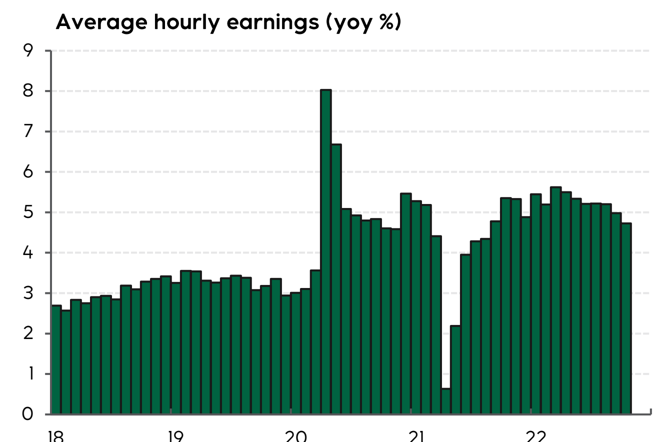
The **savings rate** (household savings as a percentage of disposable income) declined to 3.1% in September, slightly lower than 3.4% in August, but down sharply from 8.7% at the end of last year. However, the labour market remains tight. The unemployment rate has been hovering around record lows between 3.5% and 3.7% since March. **Job vacancies** have eased somewhat over the past three months but remain near historic highs. The labour force participation rate has been stuck in a narrow range of 62.1% to 62.4% for most of the year, receding to 62.2% in October. The most compelling evidence of some softening in labour market conditions comes from the pace of **job creation**, which slowed over the past three months. The US economy added an average of around 289 000 jobs per month from August to October, almost half the average of 450 000 jobs per month created from January to July.

Chart 11: US personal saving rates



Source: Refinitiv

Chart 12: US wage growth



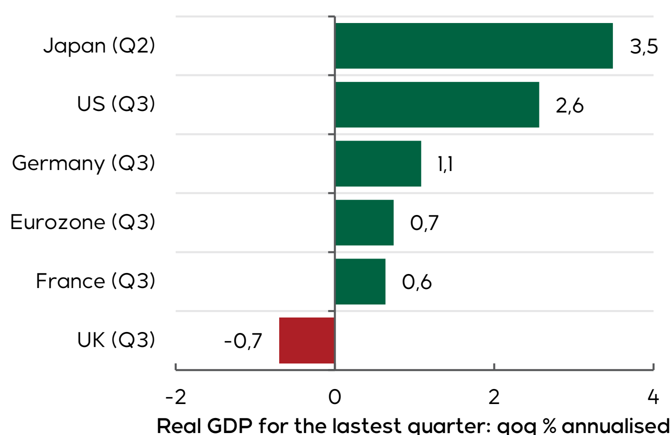
Source: Refinitiv

Wage growth is also slowing, although it remains at high levels by pre-pandemic standards. According to the US Bureau of Labour Statistics, growth in average hourly earnings for all employees on private non-farm payrolls moderated to 4.7% yoy in October, after easing to 5% in September from growth of over 5% during the preceding eight months. Even so, this suggests that real or inflation-adjusted earnings have been shrinking since August last year. The data from the US Bureau of Economic Analysis reflects generally higher growth rates in nominal wages, but also points to some moderation over the past quarter. Wage growth slowed to an average of 8.5% over the three months to September, broadly in line with inflation, from around 9.5% over the preceding 12 months. Both sets of statistics confirm that real household incomes are under slightly more pressure, which is starting to weigh on consumer spending, particularly on demand for goods.

The slowdown in demand for goods is also starting to weigh on prices. **Headline inflation** moderated for 4th consecutive month to 7.7% in October, beating market forecasts of 8%. Softer fuel, electricity, and food prices exerted the most downward force. A modest moderation was also evident in the prices of other goods. In contrast, shelter costs rose further, up to 6.9% yoy from 6.6% in August. Services inflation also remained high. **Core inflation** nonetheless receded, easing to 6.3%, after hitting a 40-year high of 6.6% in September.

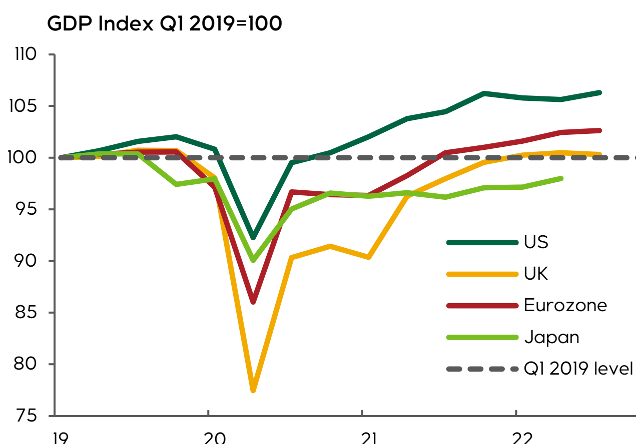
While consumer demand became more hesitant, **industrial activity** remained strong, growing by a robust 5.3% yoy in September. The strength was widespread. Manufacturing production rose by 4.7%, boosted by higher output of motor vehicles, fabricated metal products, machinery, chemicals, aerospace, and other transport equipment, as well as food and beverages. Mining production surged by 11.1% yoy, after expanding by an equally robust 8.7% in August, benefitting from strong export demand for US oil and gas. Utilities posted the smallest gain of 0.5% yoy.

Chart 13: Recent GDP outcomes in advanced countries



Source: Refinitiv

Chart 14: GDP relative to pre-pandemic levels



Source: Refinitiv

The **Eurozone**'s economy also defied the doomsayers, growing by 0.2% qoq (0.7% annualised) in Q3, down from 0.8% and 0.6% in Q2 and Q1, respectively. Stronger performances from Germany and Italy provided much of the momentum, while growth in France and Spain slowed. More recent indicators still suggest that the bloc's economy is faltering. Retail sales declined for the 3rd straight month in August, hurt by fragile consumer confidence grappling with diminishing purchasing power due to the relentless upward march in inflation driven by energy and food prices, and higher interest rates. Eurozone inflation surged to 10.7% in October, from an already high 9.9% in September. While a resilient industrial sector has offered some counterweight up to the end of September, S&P Global's manufacturing purchasing managers index (PMI) suggests that this support will fall away in Q4, with the index dipping deeper into contractionary territory in October.

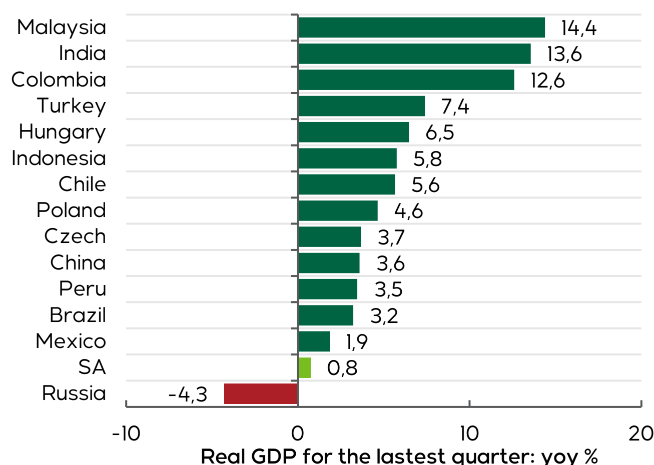
The **UK** economy has been subjected to severe political instability, policy uncertainties, and financial market turmoil over the past quarters caused by Liz Truss's short but calamitous stint as prime minister. Calm returned after Rishi Sunak took over the leadership and reverted to more sustainable fiscal policies. While the financial markets settled down, real economic conditions deteriorated. Real GDP shrunk by 0.2% qoq in Q3, compared with growth of 0.2% and 0.7% in Q2 and Q1, respectively. Consumer spending contracted by a sharp 0.5% qoq, hurt by fragile confidence, high inflation, and rising interest rates. In sharp contrast to the US and the Eurozone, industrial output declined by an even steeper 1.5%, with business investment down 0.5%. Both the manufacturing and services PMIs fell even further into contractionary territory in October.

Japan's economy bucked the trend, and gathered pace in Q3, supported by the return of foreign tourists and a revival in services after the country eased Covid-19 travel restrictions. Retail sales growth accelerated from 1.5% yoy in June to a healthy 4.5% in September. The services PMI shot up to well above the 50 threshold. Industrial production also rebounded, posting strong growth in August and September, after shrinking for five months. The yen's sharp depreciation, particularly against the US dollar, has boosted the international price competitiveness of Japan's numerous export-orientated industries. Industry also benefitted from the relaxation of Covid restrictions in China, which enabled a rebound in regional trade. S&P Global's manufacturing PMI not only confirms the improvement in trading conditions but suggests that the upward trend continued into October.

China also fared better in Q3, mainly due to the lifting of the Covid-induced lockdowns on Shanghai and other major manufacturing and transport hubs. Real GDP growth recovered to 3.9% yoy, after slowing to only 0.4% in Q2. The threat of fresh lockdowns continues to cloud the growth outlook. Despite growing calls to ease Covid restrictions, the authorities recently reiterated its commitment to its strict zero-Covid policy. On top of this, President Xi Jinping secured a historic precedent-breaking third term as the leader of the Communist Party and replaced the party's top leadership with his loyal allies, tilting the country already stuck in one-party rule towards one-man rule. The President also reaffirmed China's determination to reunite Taiwan with mainland China, ominously refusing to rule out the use of force in pursuit of this objective. These statements rattled

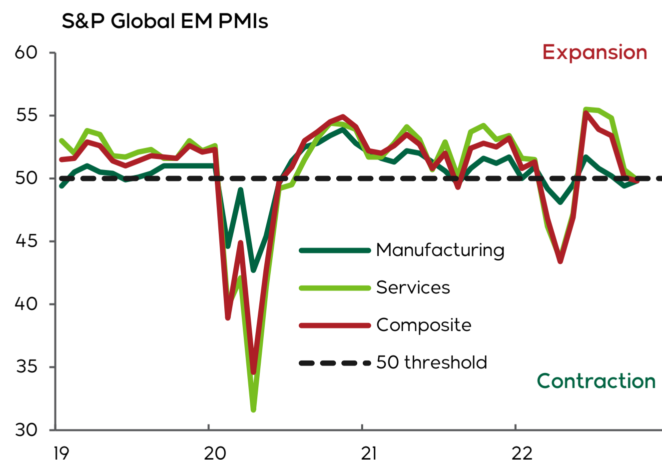
the markets, fuelling fears of a potential military conflict between China on one side and Taiwan and the US on the other. Finally, economic conditions remain lacklustre, with no compelling evidence of upward momentum. Most of the traction is coming from industrial production, which bounced back once the lockdowns were lifted. However, retail sales remained patchy, falling back to a soft growth of 2.5% yoy in September, reflecting the impact of the slump in the property market and the country's battles with Covid outbreaks on consumer confidence.

Chart 15: Recent GDP outcomes in EMEs



Source: Refinitiv

Chart 16: Emerging market PMIs



Source: S&P Global PMIs

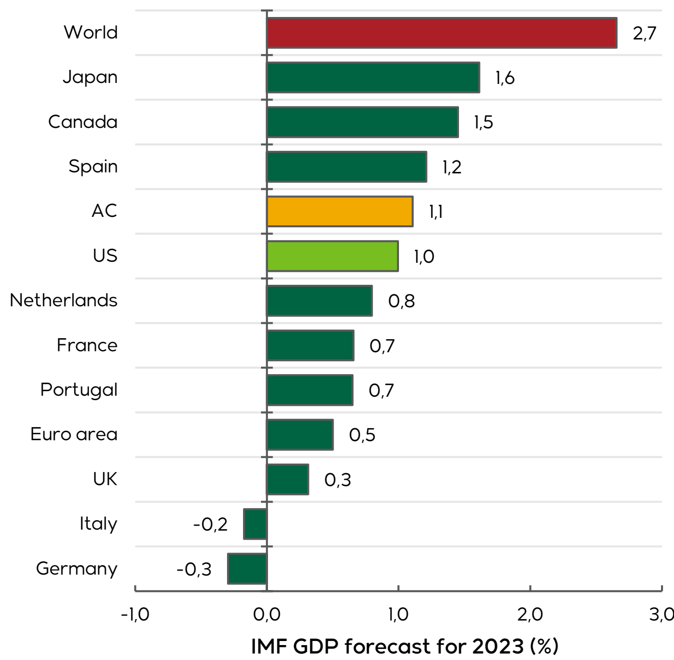
Activity in most other **Asian EMEs** remained robust in Q3. S&P Global's PMIs show that manufacturing output and underlying operating conditions improved in India and Indonesia throughout Q3 and into Q4, but the trading environment deteriorated in Malaysia as the country's manufacturing PMI fell deeper into contractionary territory. Inflation is also starting to gather alarming pace in Asian EMEs. Price pressures are most elevated in India, where the headline figure raced to 7.4% in September, up from 7% in August and 6% in January. In Indonesia, inflation moderated somewhat to 5.7% in October, after hitting a seven-year high of 5.95% in September, up sharply from only 2% in January. Similar trends unfolded in Malaysia, where inflation eased to 4.5% in September after racing to a 16-month high of 4.7% in August from a subdued 2.3% in January. Despite the region's resilience, economic growth is likely to slow as higher inflation, rising interest rates, and more importantly slower global demand start to weigh on consumer spending and export volumes.

Latin American EMEs are another resilient group. Brazil's economy picked up modest pace in Q2. More recent indicators suggest trading conditions remained buoyant in Q3, driven by a strong expansion in services, reinforced by steady conditions in manufacturing. Mexico also produced consistent growth over the first three quarters of this year, expanding by 1% qoq in Q3, after growing by 0.9% and 1% in Q2 and Q1, respectively. In year-on-year terms, Brazil grew by a healthy 3.2% in Q2 and Mexico expanded by a robust 4.2% in Q3. Both countries benefitted from firm international commodity prices and the strong revival in international tourism since the start of this year. Most Latin American countries were quick to respond to signs of rising price pressures by tightening monetary policy well ahead of the US and most other advanced countries. These prudent policy responses appear to be yielding results, particularly in Brazil, where inflation is firmly trending lower, moderating for the 7th consecutive month to 8.7% in September.

In contrast, economic activity in most of **Europe's EMEs** weakened noticeably over the past two quarters. Poland's economy contracted over Q2, while the Czech Republic shrunk over Q3. Hungary's economy grew but at a slower pace. However, economic activity in all three countries remained well above last year's levels, reflecting remarkable resilience in the face of double-digit inflation rates and higher interest rates. In Poland, Hungary, and the Czech Republic inflation clocked 17.9%, 20.1%, and 18%, respectively. At the same time, interest rates have increased from their respective troughs in 2021 by 650 bps in the Czech Republic, 1240bps in Hungary, and 665 bps in Poland.

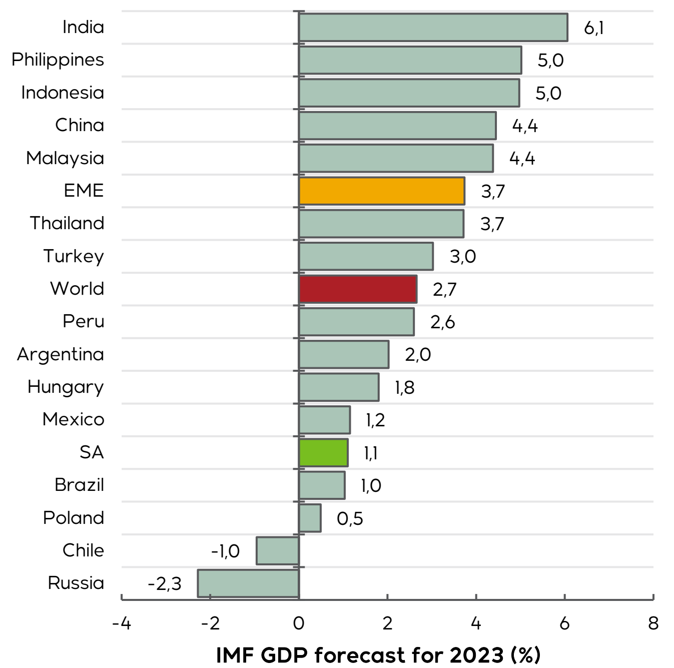
In the conclusion, the world economy is still expanding although performances are mixed and there is evidence of a slowdown in more countries than was the case in the first half of the year. The IMF and other forecasters remain decidedly downbeat, expecting the slowdown to intensify, only reaching its trough in the first half of next year. The IMF revised its growth forecast for 2023 down to 2.7% in October from 2.9% in July and a robust 3.6% back in April. Advanced countries are expected to grow by only 1.1% while emerging and developing countries are expected to clock 3.7% growth in 2023.

Chart 17: IMF GDP forecasts for ACs



Source: IMF World Economic Outlook October 2022

Chart 18: IMF GDP forecast for EMEs

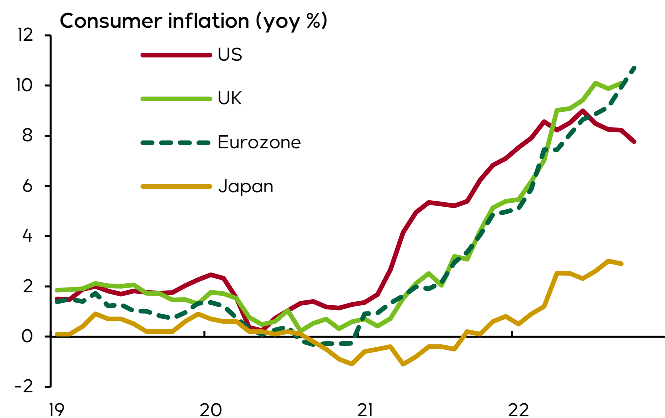


Source: IMF World Economic Outlook October 2022

Global monetary policy and liquidity conditions

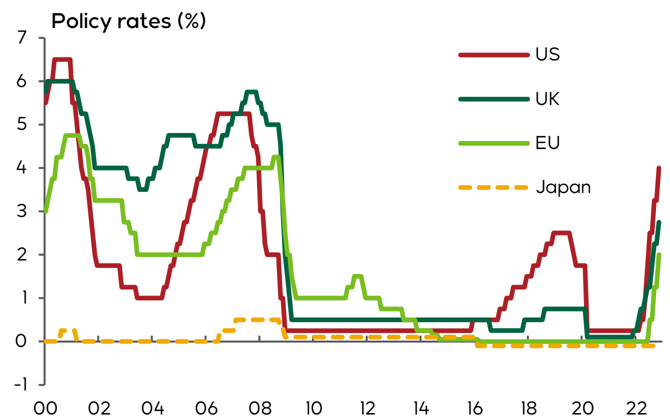
The **US Fed** followed through as promised on its 4th consecutive 75-bps hike in November, taking the range for the federal funds rate to 3.75%-4%, its highest since December 2007. The rate hike was widely expected and fully priced in. The FOMC again anticipated that further rate increases would be needed to return inflation to the 2% target. However, the Committee indicated that it will now consider the amount by which rates have already been increased, the time it takes for higher interest rates to impact economic activity and inflation as well as economic and financial developments in determining the pace of future rate increases. In effect, the Fed hinted that it would take its foot off the accelerator. This is exactly what the markets hoped for a signal that the pace of rate increases would soon slow. At the press conference, Jerome Powell provided more context, stressing that the Fed might move slower but towards a higher peak than initially expected. He also noted that the Fed was more worried about under- than over-tightening as the former was much harder to fix than the latter.

Chart 19: Inflation in the major economies



Source: Refinitiv Comparative

Chart 20: Policy rates of the major economies



Source: Refinitiv

The US tightening cycle now appears set to enter a new phase of gradual ascent. Rising interest rates will still hurt economic growth no matter the size of each increase. A lower peak would help contain the downside for the economy. If the deceleration in US inflation over October proves more than a blip, then the peak in the policy rate may come sooner at a lower level than the Fed and the markets currently expect. Both the more gradual tightening and the possibility of a lower peak could support risk appetites.

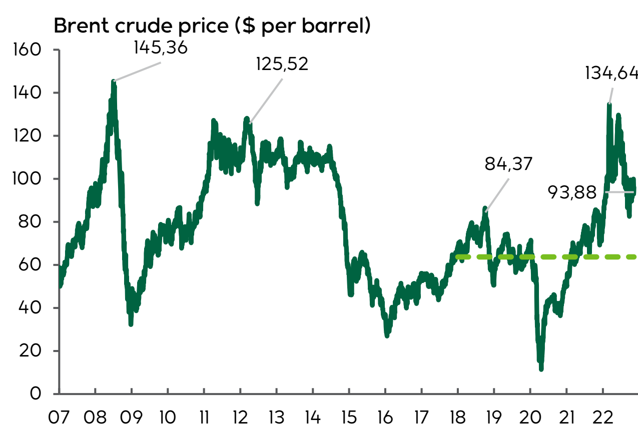
The central banks of most other advanced countries also pressed ahead with larger-than-usual rate hikes. The **Bank of England (BoE)** raised its benchmark bank rate by 75 bps to 3% in November. The BoE said that further increases may be required, but probably at a lower peak than priced into the markets. The central bank expected the economic downturn to last until the first half of 2024, while inflation was forecast to decline more convincingly throughout next year, dipping below 2% in 2024. The **European Central Bank (ECB)** lifted its key policy rate by another 75 bps to 2%, a level last experienced in early 2009. With inflation hitting the double-digits, the ECB signalled more rate hikes, but policy decisions are likely to become harder if the economy enters recession as most analysts anticipate. In sharp contrast, the **Bank of Japan (BoJ)** stuck to its highly accommodative stance, leaving its short-term interest rates unchanged and continuing its bond-buying programme to keep the 10-year government bond yield anchored at 0%.

Policy decisions among EME central banks diverged. Asian countries hiked interest rates more aggressively as their inflation rates only recently started accelerating. Most Latin American countries paused after tightening early and aggressively. Eastern European central banks were mixed. Poland and the Czech Republic left their policy rates unchanged, steady at 13.75% and 9.25%, respectively. Hungary also kept its benchmark policy rate unchanged at 13% but raised its overnight collateralized lending rate by a massive 950 bps to 25% and created a new one-day deposit facility with an interest rate of 18%. These measures were implemented to protect the local currency, which plunged by 24% against the US dollar over the year to date, reaching a record low on 12 October.

International commodity prices

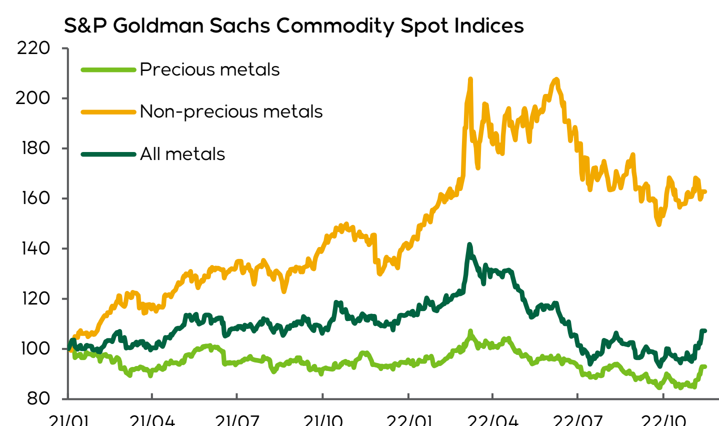
Commodity prices have been extremely volatile. According to the S&P Goldman Sachs all commodities index (S&P GSCI), prices dropped 1.3% over the first 10 days of November, after climbing 6.7% in October following two months of heavy losses. The drag came from a reversal in the energy index, which declined by 1.7% over the past two weeks, compared with a jump of 7.8% in October. Most commodity analysts expect **crude oil and natural gas prices** to ease a little further during the remainder of this year, hurt by higher inventories and weaker global growth. However, crude oil and natural gas prices are forecast to edge higher in early 2023 on a combination of constrained supply and higher demand over the coldest spell of the Northern Hemisphere's winter. World supplies are expected to be affected by continued uncertainty over Russia's production capacity and its use of energy as a weapon against Western countries, the start of the EU ban on crude imports from Russia on 5 December, the 2 million barrels per day cut to OPEC+ production and the likely depletion of strategic inventories over the winter season.

Chart 21: Global oil prices



Source: Refinitiv

Chart 22: Metal prices



Source: S&P Goldman Sachs Commodity Price Indices

Metal prices bounced back in early November, propped up a softer US dollar, and hopes of an earlier end to the Fed's rate tightening cycle. The S&P Goldman Sachs all metals index, shot up by 7.6%, driven by rebounds in precious and industrial metals. Gold prices rose by 5% over the first 10 days of November, after seven straight months of decline. However, the outlook for metal prices remains relatively bleak, weighed down by the expected slowdown in global demand over 2023. Some recovery is likely towards the middle of next year as the worst of the economic downturn passes and the global interest rate cycle gradually reverses.

Food prices declined further over October. According to the UN's Food and Agriculture Organisation, food inflation moderated to 2% yoy in October, after easing to 5.2% in September from a peak of 34% in March. Prices of oils are falling, down 18.8% yoy in October. The prices of cereals and dairy products are still up from last year, but the rate of increase is at least moderating. The outlook for grains continues to hinge on whether the Black Sea Grain Initiative will hold as tensions between Ukraine and Russia intensifies and the war drags on into next year. Recent reports suggest that Russia is already prolonging the processing of cargo at security checkpoints, resulting in significant backlogs. The delay tactics come as Russia suffered heavy losses on the

battlefield over the past few months. Despite these uncertainties, food prices are expected to fall further in 2023 as global planting conditions improve.

The implications for global risk appetites and the rand

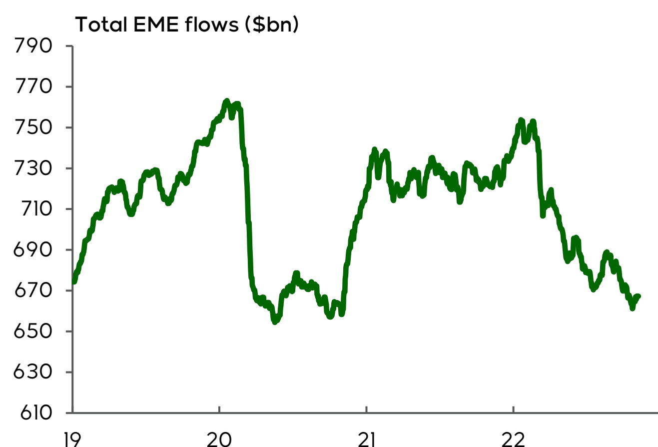
Despite the current enthusiasm, general risk appetites are likely to remain volatile, fluctuating on key data releases. The focus will probably remain on US inflation outcomes and the Fed's interest rate decisions. If US inflation again surprises on the upside, proving stickier than expected, investors are likely to fear that the Fed will raise rates to a higher peak or leave rates at the anticipated peak (currently about 5%) for longer. Under these circumstances, risk-off sentiment is likely to return, adding to the US dollar's appeal. If inflation continues to beat expectations or starts to decelerate convincingly, calls for the start of the rate easing cycle will probably intensify, boosting risk appetites and weighing on the greenback. According to Reuters' consensus forecast, US interest rates are expected to peak around 4.75%-5% in Q1 2023 and stay at the peak until the end of Q3, with the first rate cut expected in Q4 2023. If this forecast is realised, the US dollar will probably face stronger and more persistent headwinds from early next year.

Interest rate differentials are just one driver. As the US policy rate peaks and stabilises, growth differentials and geopolitical risks could matter more. On growth prospects, the US economy remains the most dynamic and resilient. If the world were to enter a recession, the US dollar would probably be the main beneficiary. Equally, any escalation in the Russia-Ukraine war or worsening tensions between China and Taiwan, or a new global risk event would trigger risk-off sentiment and boost safe-haven demand for the dollar.

This year interest rate differentials, commodity prices, and exposure to Russia and China dominated the performance of EME currencies against the US dollar. It has been an erratic year. In the first half, some commodity-exporting countries benefited from the dislocation in the commodity markets caused by Russia's invasion of Ukraine. This benefit faded quickly as China's growth suffered in Q2 under the combined weight of strict lockdowns and the slump in the property market. As the world economy lost momentum throughout Q3, the drag on the currencies of commodity exporters intensified. The most resilient nations then became those that hiked interest rates early and aggressively, while economic activity defied the odds and remained relatively robust. So far this year, the best-performing currencies have been Brazil, Mexico, Indonesia, Chile, and India.

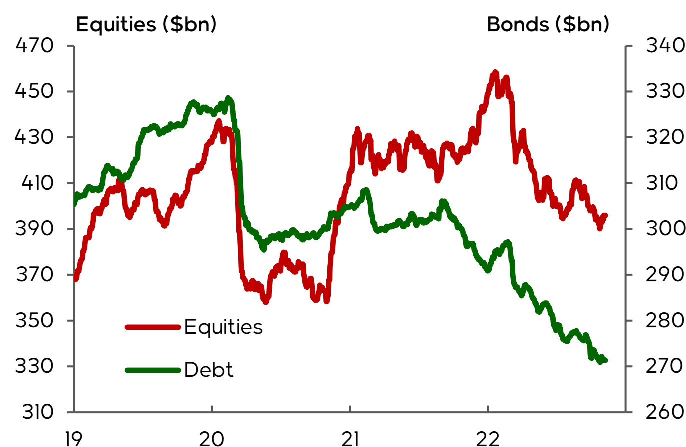
We still believe that the selloff out of EMEs has been extreme. The IIF's (Institute for International Finance) data show that portfolio flows to EMEs excluding China stabilised somewhat over October and ticked up ever so slightly in the first week of November. It remains low, though, given that many EMEs offer attractive interest rate margins, and some have displayed significant economic resilience. Some correction appears overdue in the near term. The outlook for next year is clouded by the threat of global recession, China's policy and economic woes, and mounting fiscal and other external vulnerabilities in some EMEs. However, we expect EME currencies to regain some lost ground in 2023, particularly in the second half of the year as the US dollar recedes and the outlook for global growth improves once inflation abates and interest rates start to ease. EME countries with relatively sound growth prospects, prudent macroeconomic policies, and strong external buffers are likely to outperform.

Chart 23: Capital inflows to EMEs remain low



Source: IIF

Chart 24: EME bond flows have been hardest hit



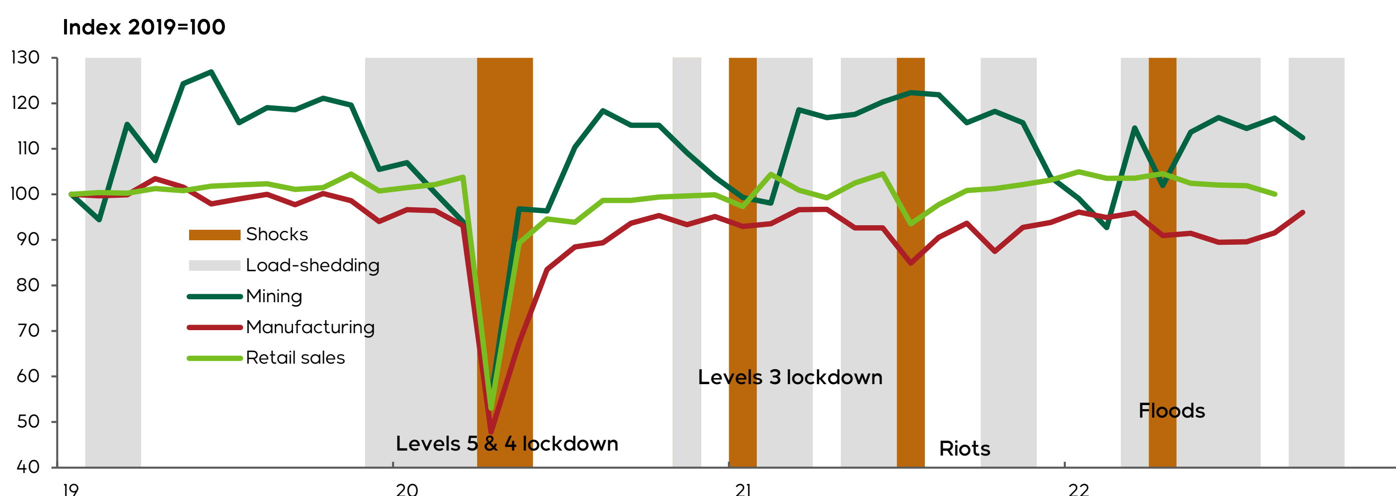
Source: IIF

DOMESTIC FORCES

Economic growth performance

High-frequency statistics suggest that the economy returned to growth in Q3 despite relentless rolling blackouts. The country endured 22 days of power outages in July, 7 days in August, and an alarming 25 days in September. The intensities ranged between load-shedding stages 2 to 4, with brief spells at stages 5 to 6. Remarkably, most industries experienced a rebound in output over this period. Mining and manufacturing production increased by 2.2% qoq and 1.9% in Q3, respectively. These outcomes are somewhat deceptive, greatly amplified by the low base established in Q2, when production was struck down by some combination of the floods in Kwazulu-Natal, power outages, a prolonged strike in the gold mining industry, and the lockdowns in China. Elsewhere there were also pockets of resilience. The recovery in travel, tourism, hospitality, and food services continued. Real income earned by hotels and other accommodation grew by a robust 7.3% over the three months to August compared with the previous three months, while that of restaurants, takeaways, and catering (food services) increased by 4.6% over the same period. Similar to the trend in most other countries, consumers reduced outlays on goods. Wholesale and retail sales declined by 0.4% and 2.1% over the three months to August, while real income from motor trade contracted by 1.4% over the same period. New vehicle sales fell throughout Q3, ending the quarter 4% lower, and the downward trend intensified in October. Freight volumes increased by an impressive 8.8% over the three months to August, but the number of passenger rail journeys declined slightly. Altogether, we now expect a slightly better GDP growth in Q3 of around 0.5% qoq, mainly on account of the stronger-than-expected performances of mining and manufacturing. Thereafter, we still anticipate softer growth of about 0.2% in Q4 We forecast GDP growth of 0.5% qoq in Q3, followed by another 0.2% in Q4, which translates into GDP growth of a slightly higher 1.9% for 2022. The risks to this year's forecast probably reside on the upside. If mining, manufacturing, and domestic trade fare only slightly better than our assumptions, it easily bumps the growth rate for 2022 up to 2% or slightly above.

Chart 25: Economic activity struggling in the face of multiple shocks



Source: Stats SA, EskomSePush, Nedbank

GDP growth is still forecast to slow to 1.2% in 2023. The drag will come from net exports. Import volumes, propped up by continued albeit slower consumer spending and fixed investment, are expected to outpace export volumes, undermined by weaker global demand and lower commodity prices. This deficit is forecast to widen significantly in 2023. Growth in consumer spending is also forecast to slow as this year's surge in inflation and interest rates gradually erode real income growth and reduce the funds available for discretionary spending. These pressures will be partly countered by higher nominal wage increases and moderate job creation as the labour-intensive travel and tourism industries return to pre-pandemic levels. Growth in fixed investment will also slow but at least remain positive, underpinned by increased infrastructure spending by general government, much higher outlays on renewable and embedded energy-generation projects, and the continued drive to modernise production capacity in most industries. We expect continued modest growth in government consumption expenditure. We believe that government spending will be higher than the target set out in last month's Medium Term Budget Policy Statement (MTBPS), which reflects a relatively steep cut in real government expenditure for the 2023/24 fiscal year. However, the MTBPS target depends on securing a modest below-inflation 3% increase in the public sector wage bill, which appears unlikely to materialise. With public sector unions on strike from 10 November, the pressure will mount to compromise.

Monetary policy

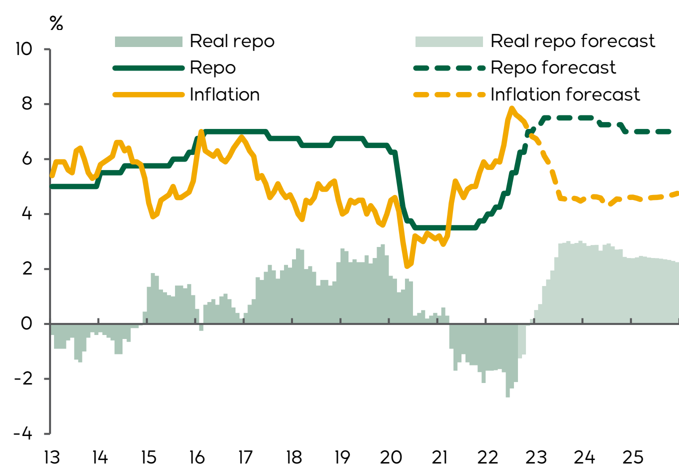
The SARB's MPC kept pace with the Fed's rate hikes, raising the repo rate by another 75 bps in September to 6.25%, returning the repo rate to the level that prevailed in February 2020 just before the pandemic struck. The motivation for the hike remained unchanged, including continued above-target inflation outcomes, persistent upside risks to the inflation outlook, and evidence of rising inflation expectations. The MPC is widely expected to hike rates again later this month. According to the latest Reuters

survey conducted on 14 October, the average market forecast is for a 50 bps increase, taking the repo rate to 6.75%. We have a slightly more hawkish view, expecting another 75 bps rate hike, with repo ending the year at 7% and prime at 10.5%.

Our motivations are:

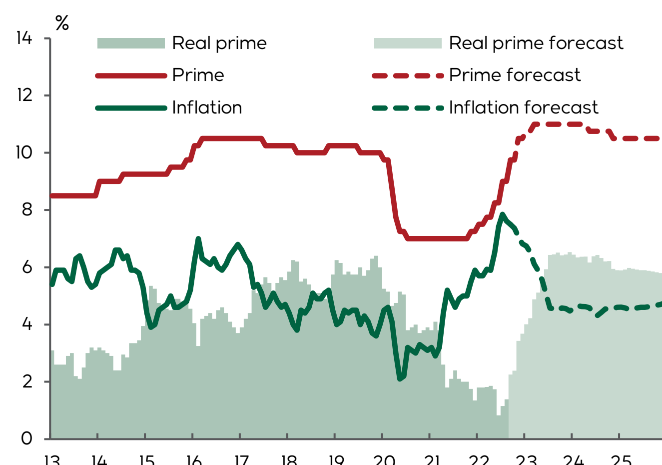
- Although inflation probably peaked at 7.8% in July and since eased to 7.5% in September, it is receding very slowly and remains well above the upper 6% limit of the SARB's target range. We expect headline inflation to remain above 7% over the next two months, easing only slightly to 7.4% and 7.1% in October and November, respectively.
- US Fed is still expected to hike its policy rate by another 50 bps in December, which coupled with November's 75 bps hike will erode SA's interest rate differential with the US substantially. This is likely to weigh on the MPC despite the rand's recent rally and the rebound in global risk appetites.
- As explained above, the outlook for global oil prices remains murky. The tightening sanction on Russian supplies, the OPEC+ cuts, and the upcoming winter could place renewed upward pressure on global oil prices. As it is, domestic fuel prices rose again in October, and will likely prevent a faster descent in headline inflation. Beyond March next year, we do foresee a relatively sharp decline in global oil prices, amplified by significant base effects, which is anticipated to translate into a series of domestic petrol and diesel price cuts.
- A closer look at the inflation numbers show that food inflation is still accelerating, galloping to 12.3% yoy in September, driven by surging bread and cereal prices, which rose by an alarming 19.3% yoy. It appears that local producers, merchants, and retailers are trying to restore margins after absorbing the bulk of the sharp escalation in transport and other raw materials costs for over a year and a half. This coupled with the fallout at Tongaat, which could seriously undermine the supply of sugar and molasses to the market, is likely to keep the MPC on guard. Beyond the next few months, the outlook for food prices is relatively encouraging. Local estimates point to another sound summer crop, which should help secure supplies of maize and feedstock in 2023. Global food prices have declined significantly. Weather conditions in most of the world's major food-producing regions have improved substantially, supporting expectations of higher output in 2023. Global supply-chain bottlenecks have also eased noticeably, supported by the gradual normalisation of operations in most countries from the lockdown-induced disruptions of the past two years. Therefore, healthy domestic output, the drop in global food prices, better functioning supply chains, and this year's high base should result in falling food inflation next year.
- The gradual climb in core inflation resumed in September, which hints at second-round inflation effects from the initial shock to fuel and food prices.
- Even more concerning, inflation expectations have increased, and are translating into much higher wage demands. Wage increases appear to be settling between 6% and 7%. It is unlikely that these will be offset by commensurate productivity gains. Strike action has also increased dramatically since the start of this year, undermining productivity, and raising production costs even further.
- Administered price inflation remains high, running at 16.8% yoy in September. With Eskom constantly pushing for above-inflation tariff increases to resolve its many operational woes, it will continue to pose significant upside risks to the inflation outlook.

Chart 26: Repo rate forecast



Source: SARB, Stats SA, Nedbank

Chart 27: Prime rate forecast



Source: SARB, Stats SA, Nedbank

For these reasons, we believe it is probably wise to push through a more aggressive rate hike before year-end. We expect the pace of rate hikes to slow noticeably next year. The downturn in headline inflation is likely to gather traction, slipping to about 6.8% in December, before to dropping off quite quickly from this year's high base to reach 4.5% by around July next year. Global goods inflation and international commodity prices are likely to retreat as the world economy slows. Domestic goods inflation

should also moderate on softer local demand and lower global inflation. The rand will remain vulnerable but should nonetheless retrace some of this year's heavy losses once US interest rates stabilise. Within this context, we have reduced our interest rate forecast for 2023. We now forecast a cumulative increase of 50 bps (down 75 bps previously), taking repo and prime rates up to peaks of 7.5% and 11% respectively early next year.

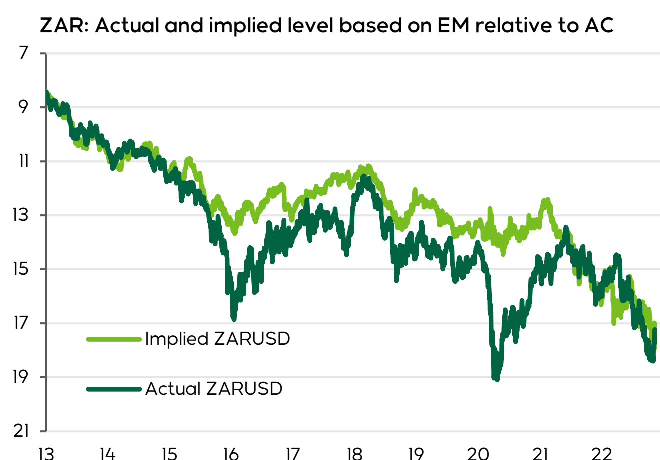
Fiscal policy

Fiscal risks have receded. Last month's MTBPS with its message of faster deficit reduction and quicker debt stabilisation was welcomed by the markets. The underlying message is that the budget deficit will be much lower for this fiscal year, estimated at 4.9% of GDP compared with February's estimate of 6%. Higher-than-expected tax revenue more than offset higher-than-budgeted expenditure. Government also aims to double down on fiscal consolidation, reducing the deficit to 4.1% of GDP in the upcoming fiscal year and eventually to 3.2% of GDP by 2025/26. This would stabilise the gross debt burden sooner at a lower peak of 71.4% of GDP in the current fiscal year. This ambitious path relies on significant expenditure restraint. As mentioned above, much depends on the government's ability to keep the growth rate in the public sector wage bill in check. We believe that the state will probably be forced to settle for a wage increase closer to inflation. While the MTBPS estimates already include additional bailouts for several SOEs, the risk of fresh calls for support remains high given the perilous financial position of so many SOEs. However, government has not explained how it will handle the take-over of a chunk of Eskom's debt, The details will only be announced in February. This also poses upside risks to expenditure, particularly debt service costs. In conclusion, we believe that the path to a 3%-of-GDP deficit will take longer to complete than the MTBPS projects. Even so, fiscal issues are not expected to impact adversely on the rand over the next year.

RAND VALUATION & CONCLUSION

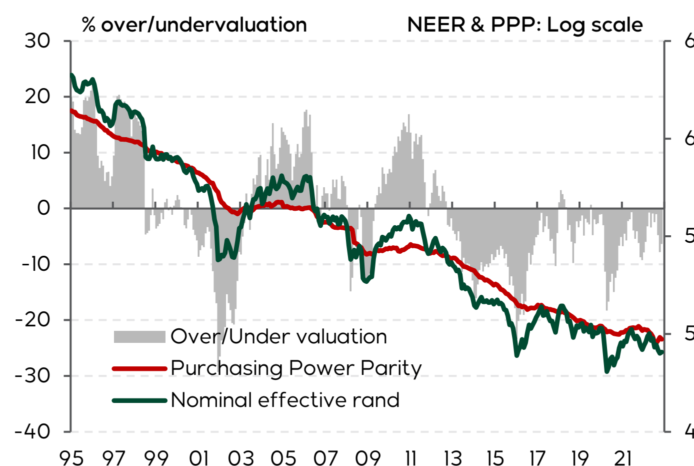
The rand's strong pullback over the past two days mainly reflects the US dollar's retreat from a long rally underpinned by the faster and steeper-than-expected rise in US interest rates throughout the past year. Although it is far too early to draw any firm conclusions, the recent slide in the dollar could be the beginning of a more fundamental correction. October's better-than-expected US inflation outcome has already shifted the market narrative to disinflation from stagflation. Investors now appear convinced that the end of the US rate hiking cycle is near, with sentiment turning risk-on from a downcast risk-off just a few days ago. This sort of volatility is normal near turning points. We expect risk appetites to remain choppy but believe that the tide is starting to turn. As mentioned in our last report, a correction was due. It came much later than we expected, but the wheels now appear to be in motion. The rand should end this year around current levels. The risk to the near-term outlook remains tilted to the downside, with another Fed policy meeting in December and the ANC set to elect its leader also in December. Next year the threat of global recession will weigh on all EME currencies, resulting in bouts of weakness. Despite this, we expect the rand to strengthen moderately during the second half of 2023, as risk appetites return in anticipation of lower US interest rates and the worst of the global downturn passes.

Chart 28: The rand relative to EM risk appetites



Source: Refinitiv, MSCI, Nedbank

Chart 29: 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	1.000	0.976	144.2	1.148	17.35	19.93	17.35
	December	1.006	0.953	140.5	1.137	17.45	19.84	17.56
	Year Average	1.044	0.958	132.9	1.216	16.49	19.99	17.18
2023	January	1.008	0.952	139.8	1.139	17.36	19.76	17.49
	February	1.010	0.951	139.2	1.140	17.26	19.68	17.43
	March	1.011	0.950	138.6	1.142	17.17	19.60	17.36
	April	1.013	0.948	138.2	1.141	17.20	19.62	17.43
	May	1.015	0.946	137.8	1.139	17.23	19.63	17.49
	June	1.017	0.945	137.4	1.138	17.26	19.64	17.56
	July	1.016	0.947	138.0	1.137	17.32	19.69	17.60
	August	1.014	0.949	138.6	1.135	17.39	19.75	17.64
	September	1.012	0.951	139.2	1.134	17.46	19.80	17.68
	October	1.019	0.949	138.4	1.140	17.34	19.76	17.66
	November	1.025	0.947	137.7	1.145	17.22	19.72	17.64
	December	1.031	0.946	136.9	1.151	17.10	19.68	17.62
	Year Average	1.016	0.948	138.3	1.140	17.28	19.69	17.55
2024	January	1.033	0.947	137.0	1.153	17.03	19.63	17.59
	February	1.035	0.948	137.1	1.154	16.97	19.59	17.57
	March	1.037	0.949	137.2	1.156	16.91	19.54	17.54
	April	1.035	0.949	137.4	1.156	17.00	19.66	17.59
	May	1.032	0.949	137.6	1.156	17.10	19.77	17.65
	June	1.030	0.950	137.8	1.157	17.20	19.89	17.71
	July	1.037	0.948	137.3	1.156	17.05	19.71	17.69
	August	1.045	0.946	136.9	1.155	16.91	19.53	17.66
	September	1.052	0.944	136.5	1.154	16.77	19.36	17.64
	October	1.054	0.944	136.3	1.156	16.74	19.36	17.64
	November	1.056	0.943	136.1	1.158	16.71	19.36	17.64
	December	1.057	0.943	135.8	1.160	16.68	19.36	17.64
	Year Average	1.042	0.947	136.9	1.156	16.92	19.56	17.63

Source: Nedbank Group Economic Unit

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