Cannon Asset Managers

FX Market Research

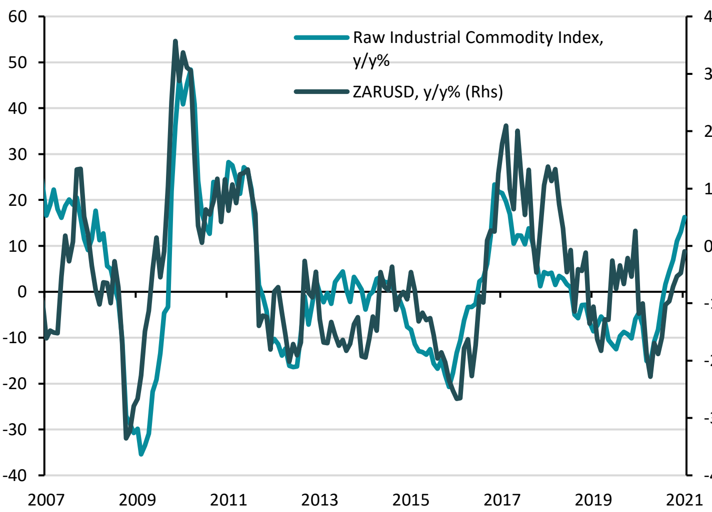
FX Outlook, Valuations and Forecasts

Global Outlook | January 2021

ZAR Landscape

The rand saw out 2020 on a wave of positivity, ending the year at R14,69/$ - a considerable improvement from the substantial depreciation seen during the onset on Covid-19 and a risk-off appetite which saw the rand blow out to R19,08/S in late April 2020. Since then, the rand has regained just over 30% before the end of 2020, where commodity prices have played a star role.

Figure 1 - Industrial Commodity Prices Impact the Rand



Overall, emerging market (EM) currencies gained 2,2% and 1,3% in November and December respectively. Commodity prices drove the recovery printing 10,8% y/y growth in November and 10,5% y/y growth in December. Subsequently, the rand appreciated against the US dollar by 5,0% and 5,3% over the same periods respectively. The strong relationship between the rand and commodity prices is highlighted in figure 1. Accompanying the commodity price recovery, global risk-on appetite has supported rand strength (figure 2), driven by EM economic fundamentals. Furthermore, the considerable strength in China's credit impulse has underwritten commodity price strength, which has seen y/y growth average 31.6% over the past 9 months. Figure 3 highlights the relationship between China's credit growth and commodity prices, with the former leading the latter by around 6 months.

Figure 2 - Emerging Market Economic Fundamentals Support Risk-On

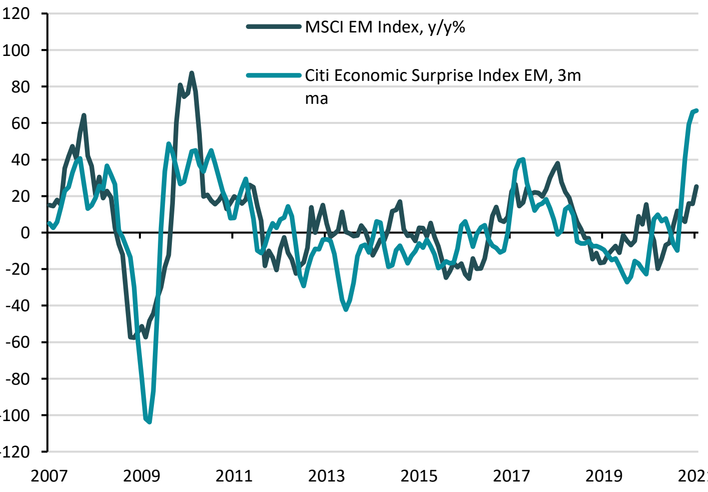
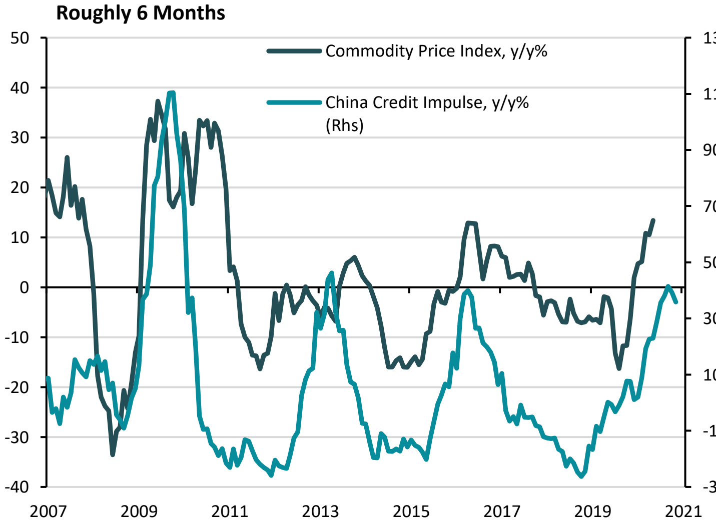
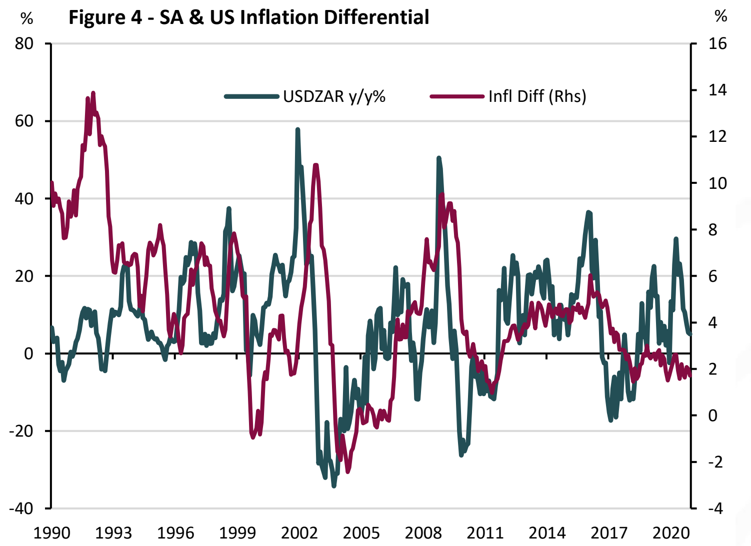


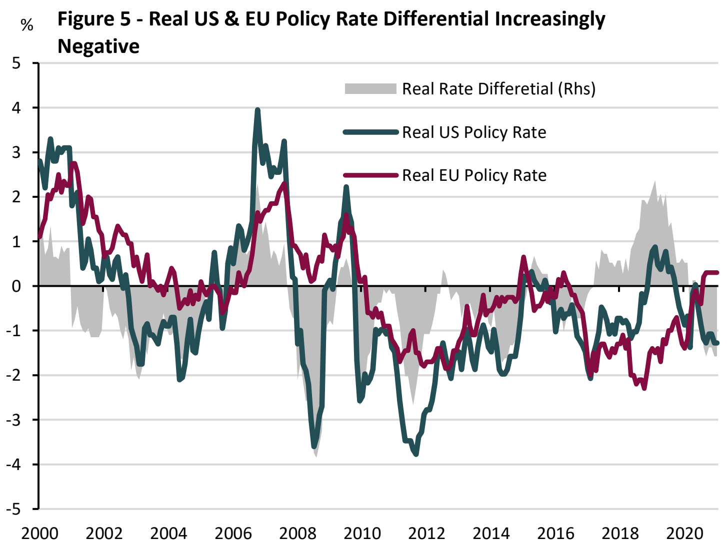
Figure 3 - China's Credit Growth Leads Commodity Prices By Roughly 6 Months

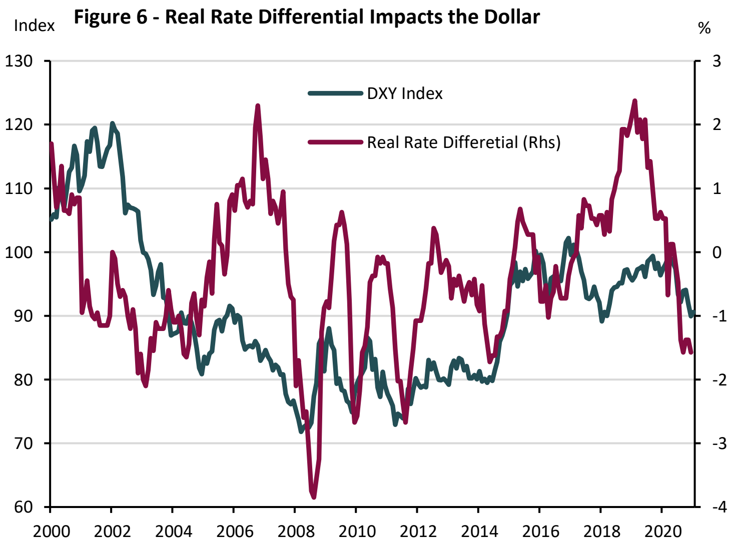


As 2021 starts to unfold, some of the improved confidence seen at the back end of 2020 has lost its grip amongst mutations of Covid-19, reimposed lockdowns and a Washington narrative that turned into a direct challenge to democratic institutions**. January saw continued growth in commodity prices, boasting a 13.4% y/y increase, which is the largest growth printed since February 2017.** The rand however did not continue to accompany commodity price strength, falling 3,2% against the US dollar in January.



The low interest rate environment in developed markets (DM) has aided capital flows toward EM in a search for yield and a risk-on appetite. The negative real policy rate differential between the US and UK turned negative in March 2020 following the Fed's initial policy amendments amid the onset of Covid-19 (figure 5). This negative spread has favored a weaker US dollar against the euro. It is likely that real rates in the US will stay negative on the back of the Fed's commitment to inflation targeting of 2% along with inflation being allowed to run above the 2% threshold in the immediate years, before policy action is taken. Dollar weakness is a key component of rand strength. Figure 6 may suggest that the US dollar should sell off and weaken more relative to its real rate, however this is unlikely given the dollar's "safe haven" status, along with the recent spike in treasury yields.





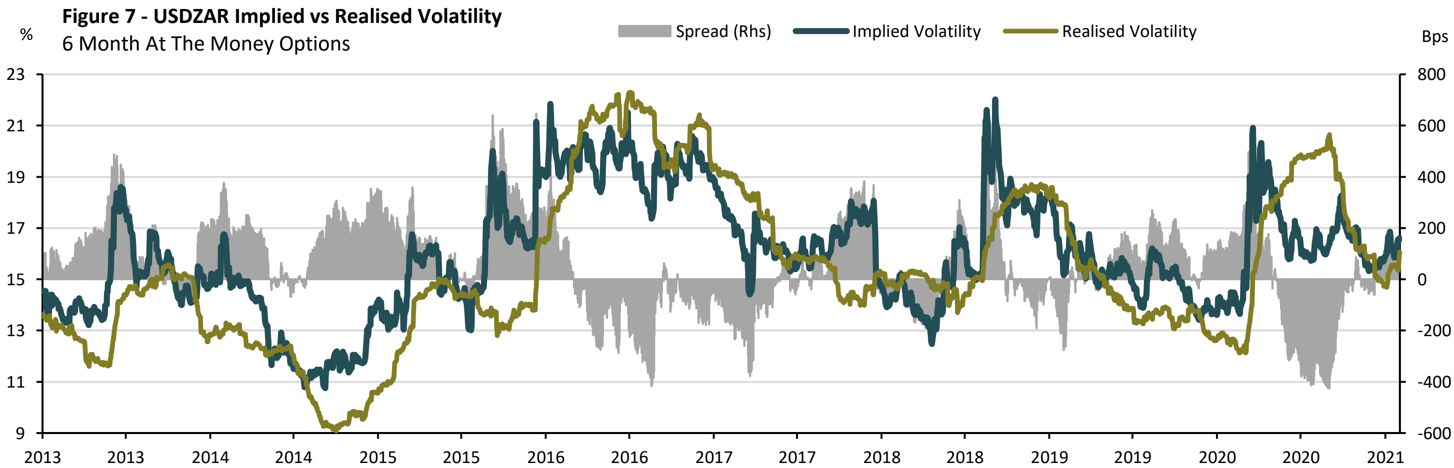


Figure 8 - USDZAR Implied Volatility Curves
At the Money Options

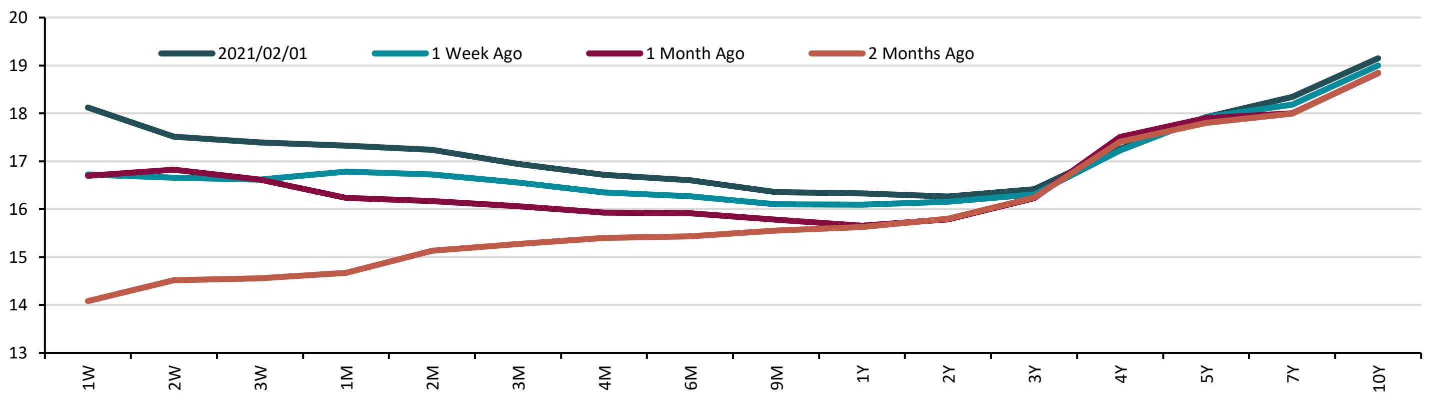


Figure 9 - USDZAR Implied Volatility
At the Money Options

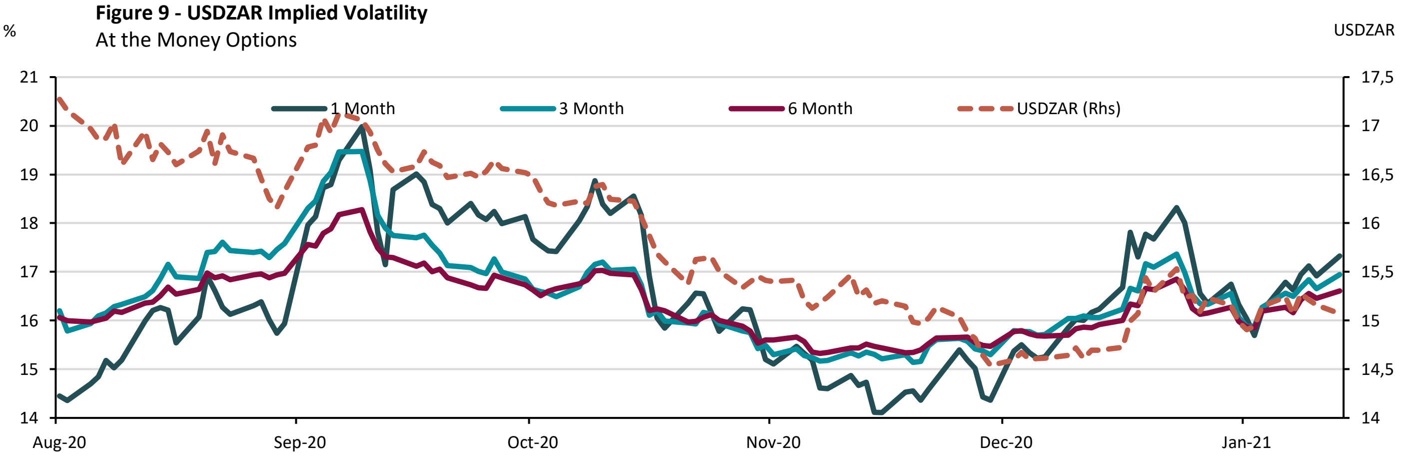


Figure 10 - USDZAR 25 Delta Risk Reversal Curve Changes
Volatility

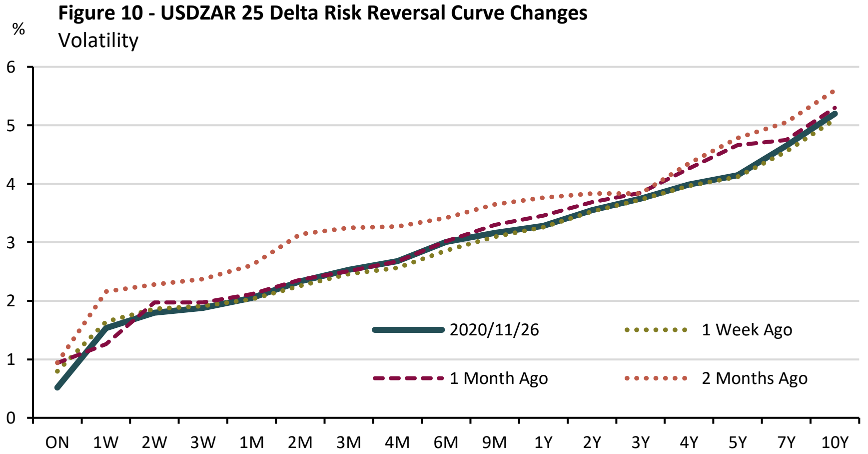
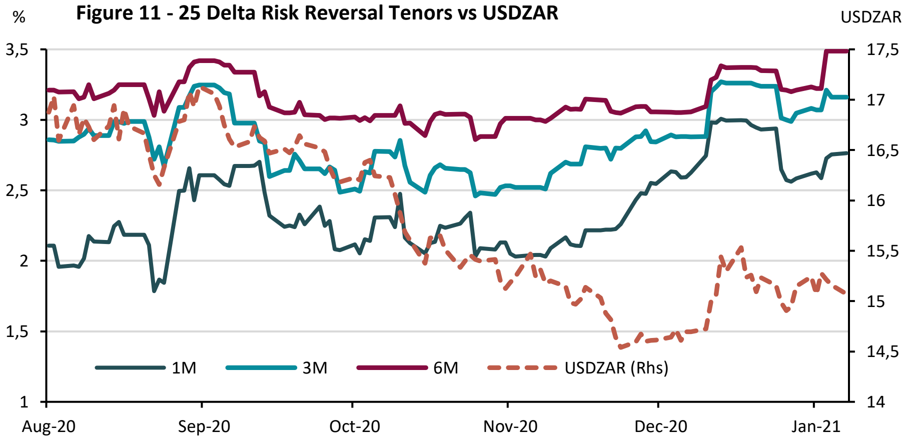


Figure 11 - 25 Delta Risk Reversal Tenors vs USDZAR



The weakening of the USDZAR over January (-3,2%), along with resurgent Covid-19 cases and loadshedding reflective across the rand's implied volatility term structure. The increase across the short-end of the curve is most evident, particularly at 1 to 2-weeks (figure 9). Overall the entirety of the curve up till the 3Y tenor is up versus 1W/ 1M/ 2M ago, highlighting the markets expected volatility in the USDZAR over each respective tenor.

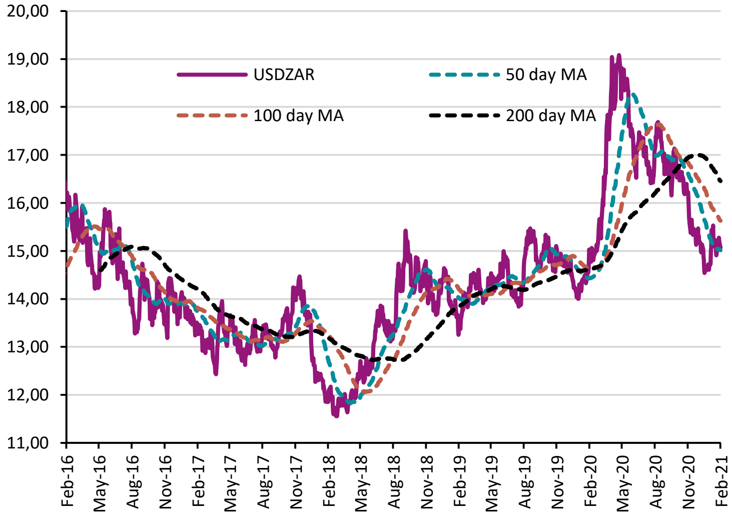
The rand's 1-month, 3-month and 6-month implied volatility has steadily increased over January off of December's lows (figure 10), along with rand weakness over the same period.

The rand's 6-month realized volatility has steadily increased since the latter stages of December, reducing the spread between implied and realized volatility up from an average of 40bps over December to an average of 96bps over January (figure 6).

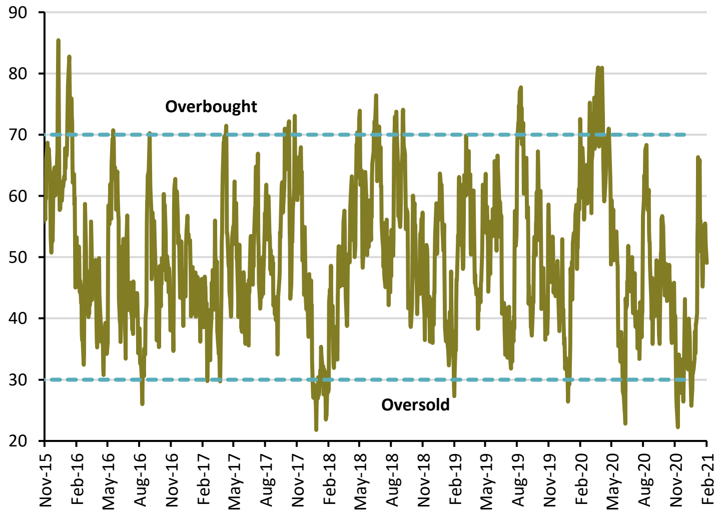
Given the current environment, we forecast the rand to hold out R15,25/US$ over 1Q2021.

Long-Term Spot Trends

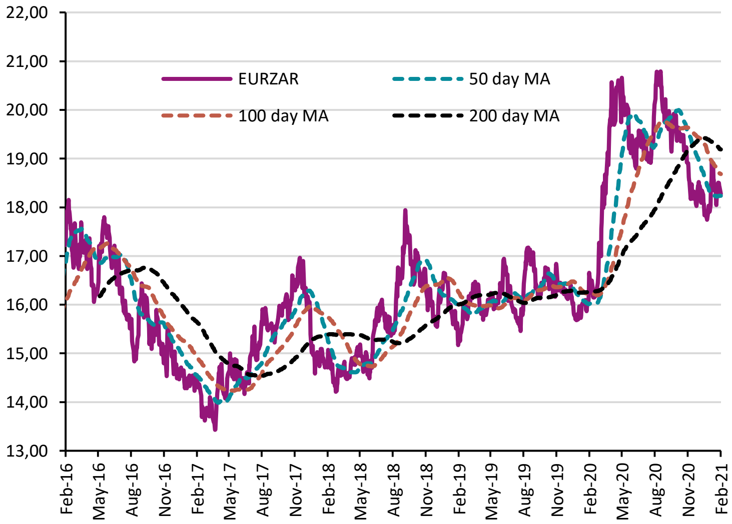
FX Spot Rate - USDZAR



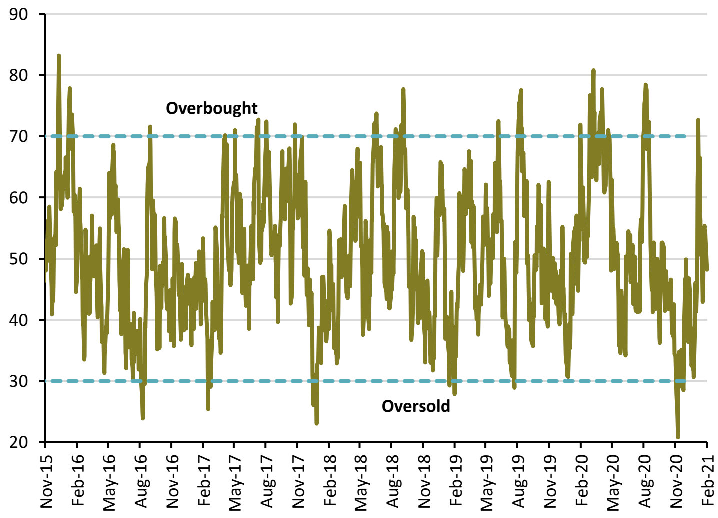
14 Day Relative Strength Index - USDZAR



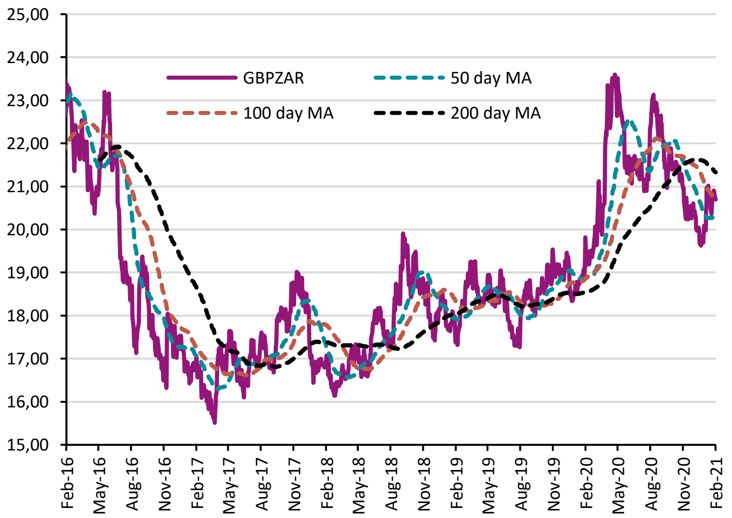
FX Spot Rate - EURZAR



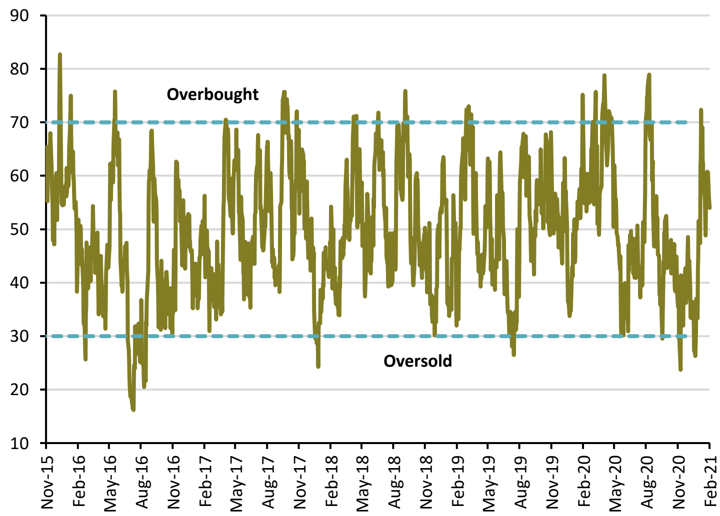
14 Day Relative Strength Index - EURZAR



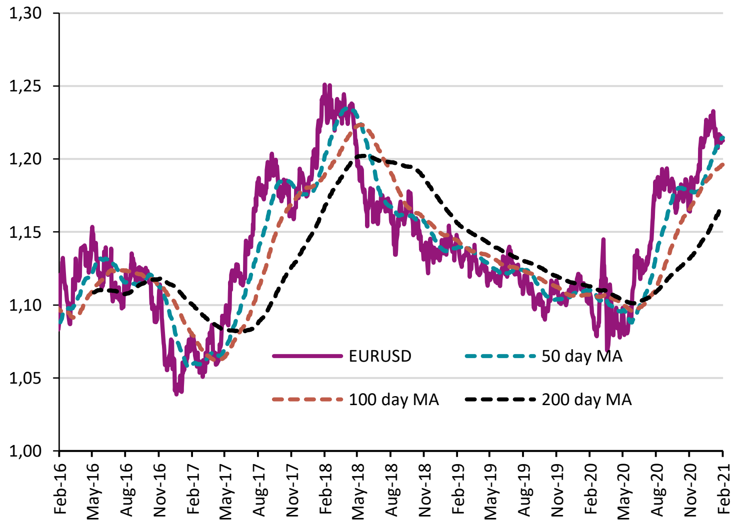
FX Spot Rate - GBPZAR



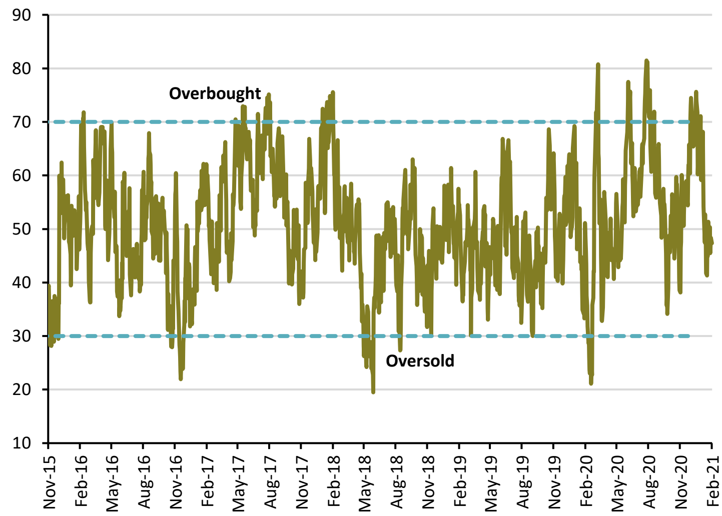
14 Day Relative Strength Index - GBPZAR



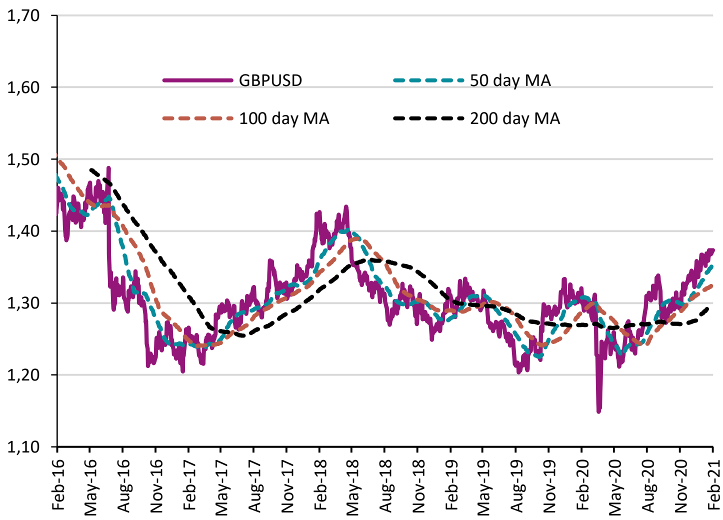
FX Spot Rate - EURUSD



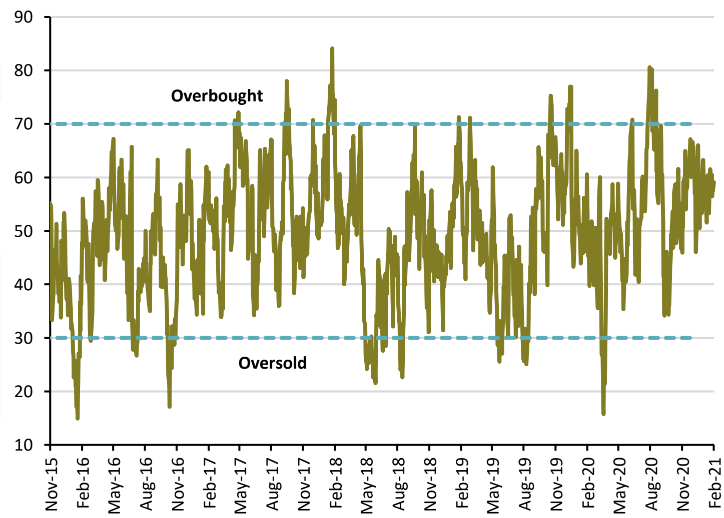
14 Day Relative Strength Index - EURUSD



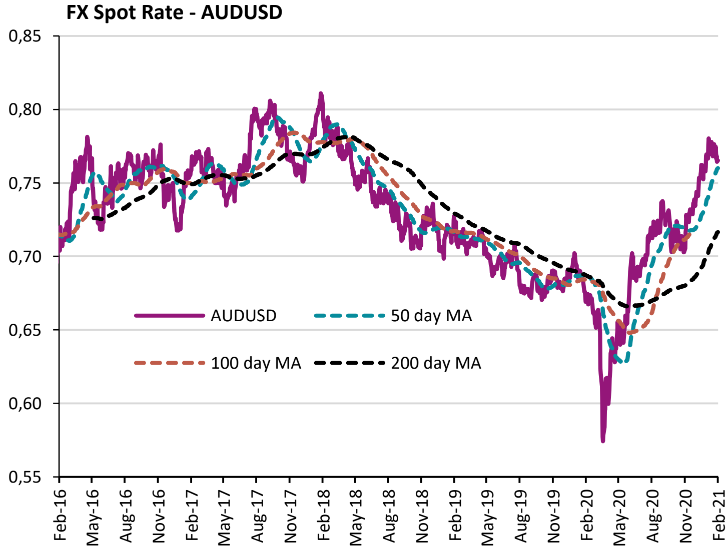
FX Spot Rate - GBPUSD



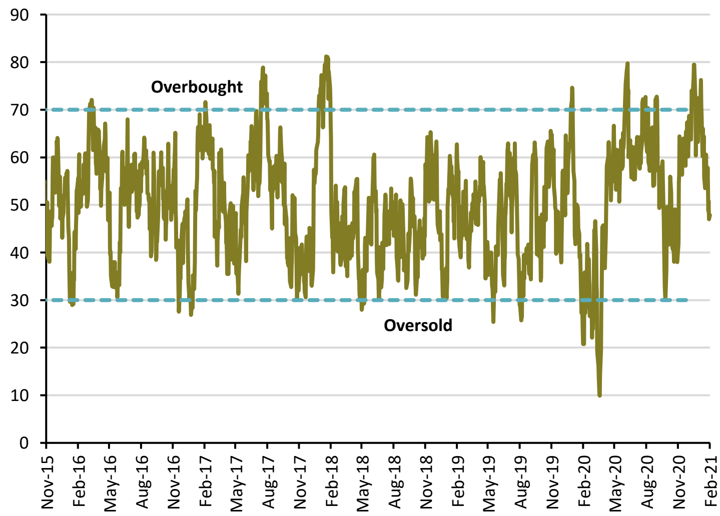
14 Day Relative Strength Index - GBPUSD



FX Spot Rate - AUDUSD



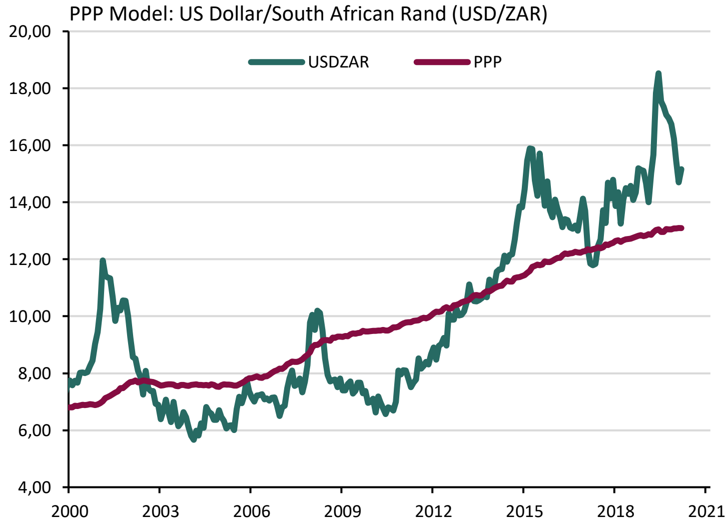
14 Day Relative Strength Index - AUDUSD



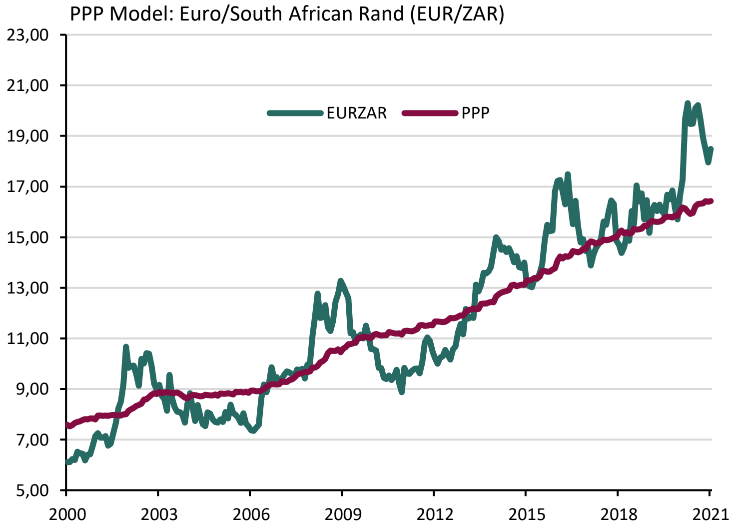
Currency Fair Value

In our analysis of currency fair value, we adopt a long-run methodology initially proposed by Ohno (1990), which circumvents the common base period problem by adopting a long-run average of historical relative consumer prices, as opposed to only using a single year as the base period for estimating PPP. This is achieved by multiplying a long-term average exchange rate by a ratio of current consumer prices divided by a long-term average of consumer prices. This method is seen as being less bias and a better estimate of PPP. This is achieved through the actual exchange rate oscillating around the estimated PPP line over the long-term, as opposed to sitting either above or below the PPP estimate, which is often the result of selecting a single year as the base period.

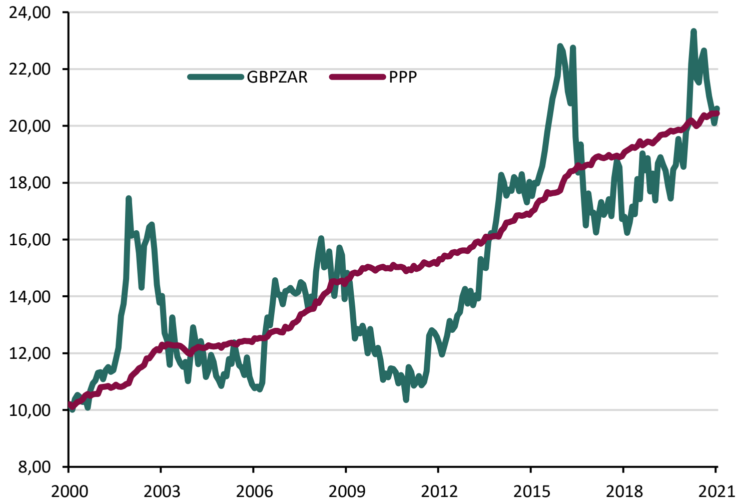
The rand is still cheap, falling within its 20% threshold
PPP Model: US Dollar/South African Rand (USD/ZAR)



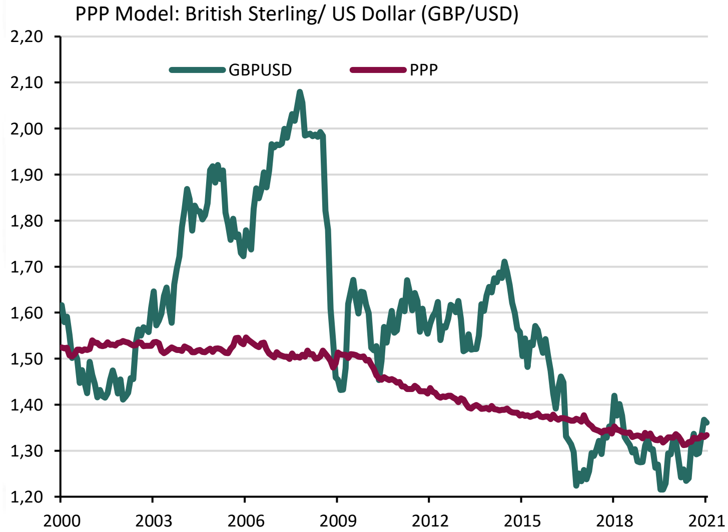
The euro is expensive, while the rand is cheap
PPP Model: Euro/South African Rand (EUR/ZAR)



The rand's valuation is close to fair value
PPP Model: British Sterling/South African Rand (GBP/ZAR)

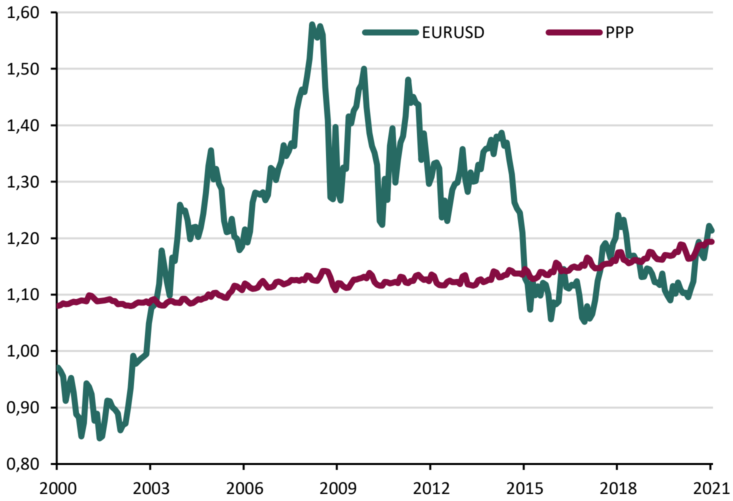


US dollar is cheap, but within 5% range
PPP Model: British Sterling/ US Dollar (GBP/USD)



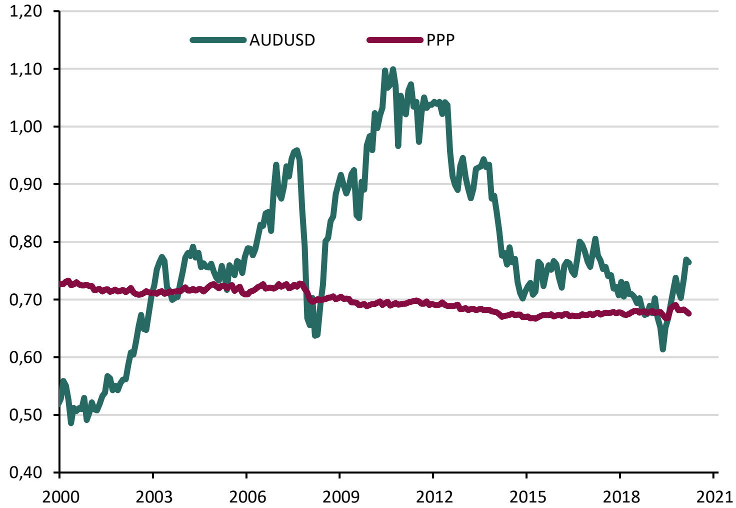
Dollar weakness leads Euro "richness", within 5% range

PPP Model: Euro/US Dollar (EUR/USD)



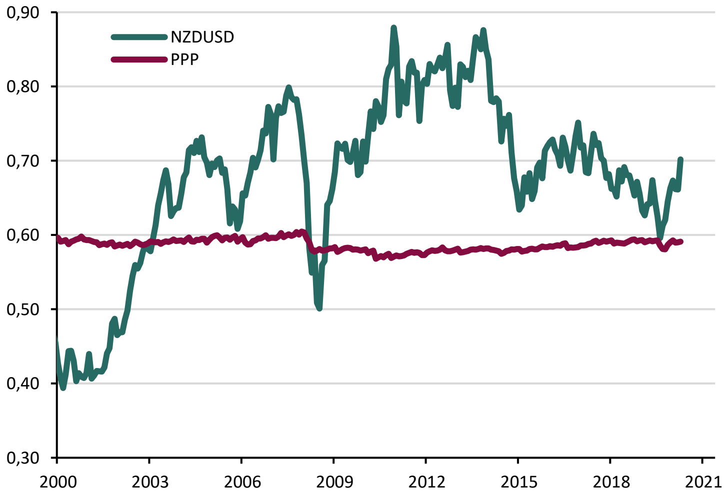
Aussie dollar is expensive

PPP Model: Australian Dollar/US Dollar (AUD/USD)



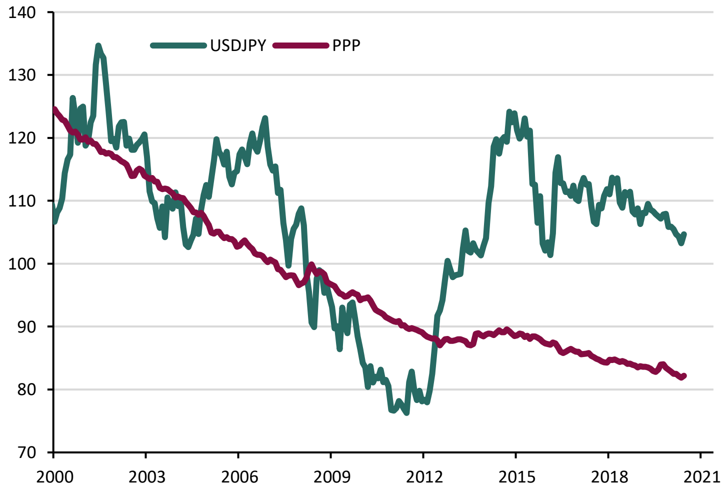
Kiwi dollar is expensive

New Zealand Dollar/US Dollar (NZD/USD)



Yen maintains long-term trends and is very cheap

US Dollar/Japanese Yen (USD/JPY)

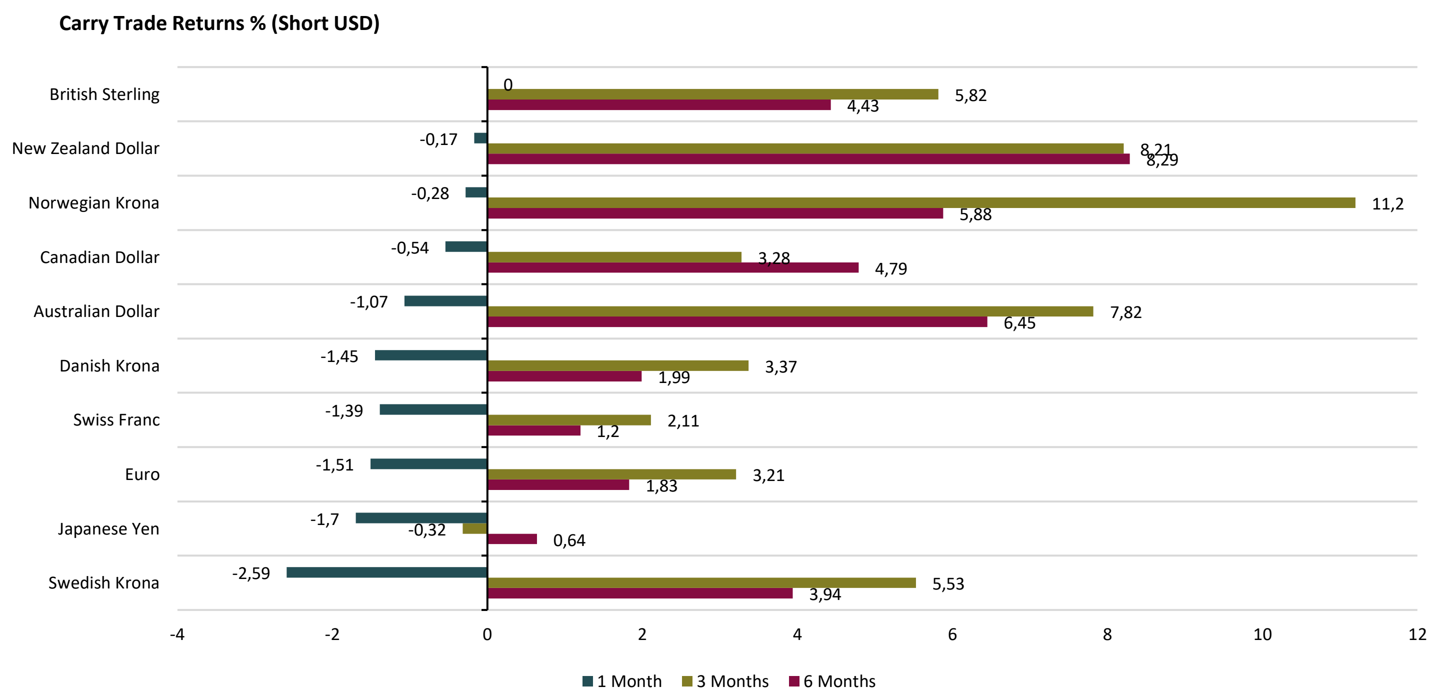


FX Forecasts

		2021				2022	2023
ZAR Crosses	Spot	1Q21	2Q21	3Q21	4Q21		
USDZAR	15,07	15,25	15,20	15,15	15,10	15,20	15,31
GBPZAR	20,69	21,66	22,34	22,66	21,14	22,07	21,11
EURZAR	18,27	19,06	19,91	20,30	20,23	20,51	19,53
ZARJPY	6,95	6,75	6,63	6,68	6,63	6,52	6,57
AUDZAR	11,53	12,17	12,48	13,51	12,32	12,25	11,53
		2021				2022	2023
USD Crosses	Spot	1Q21	2Q21	3Q21	4Q21		
GBPUSD	1,37	1,42	1,47	1,50	1,40	1,45	1,38
EURUSD	1,21	1,25	1,31	1,34	1,34	1,35	1,28
USDJPY	105	103	101	101	100	99	100
USDCHF	0,89	0,89	0,89	0,89	0,89	0,90	0,93
AUDUSD	0,77	0,76	0,77	0,78	0,79	0,79	0,79
NZDUSD	0,72	0,71	0,72	0,73	0,74	0,74	0,74
		2021				2022	2023
EUR Crosses	Spot	1Q21	2Q21	3Q21	4Q21		
EURGBP	0,88	0,89	0,89	0,90	0,90	0,90	0,86
EURNOK	10,38	10,35	10,25	10,19	10,04	9,78	-
EURSEK	10,15	10,10	10,00	10,00	9,91	9,75	9,70
EURJPY	127	126	126	127	127	131	134
EURCHF	1,08	1,09	1,09	1,10	1,10	1,13	1,14

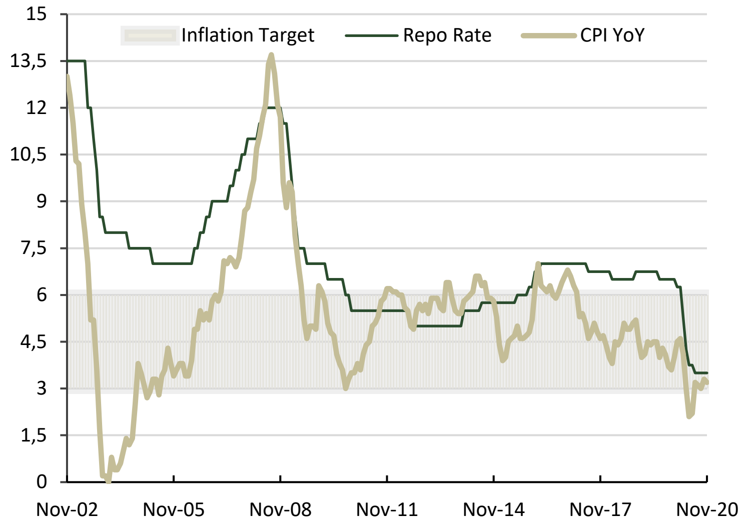
Source: Cannon Asset Managers, Bloomberg. As at COB 1 Feb-21. **Note:** Forecast values are averages over the respective period.

Carry Trade Returns

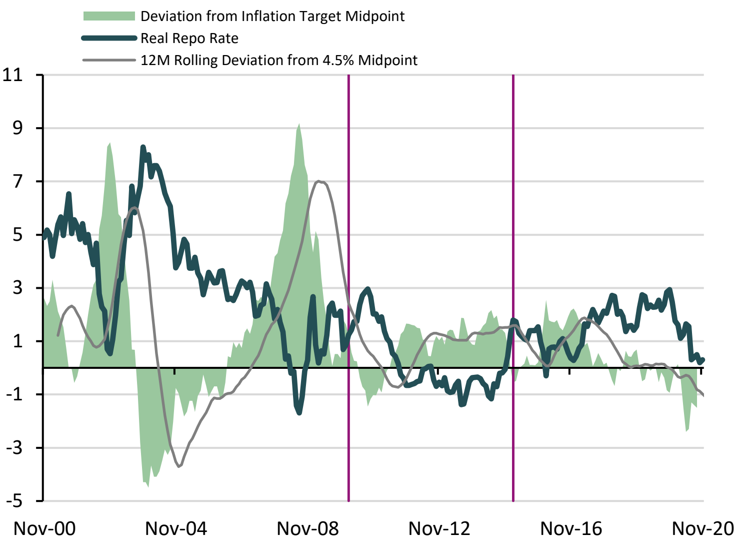


Interest Rate Monitor: South Africa

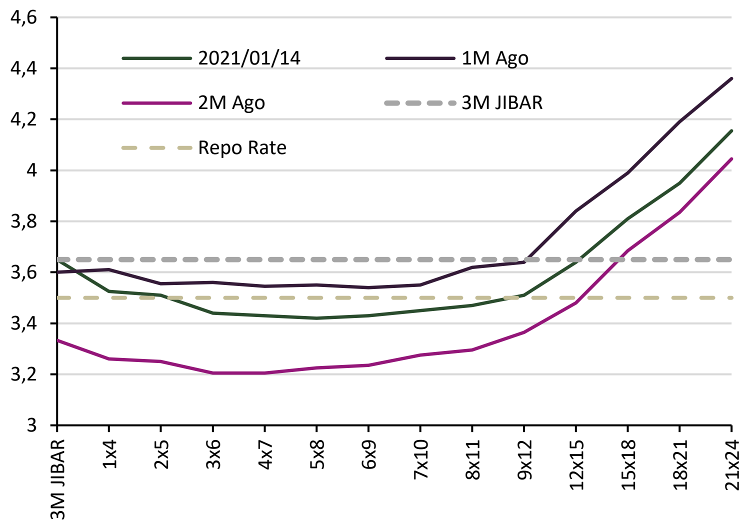
CPI vs Repo Rate



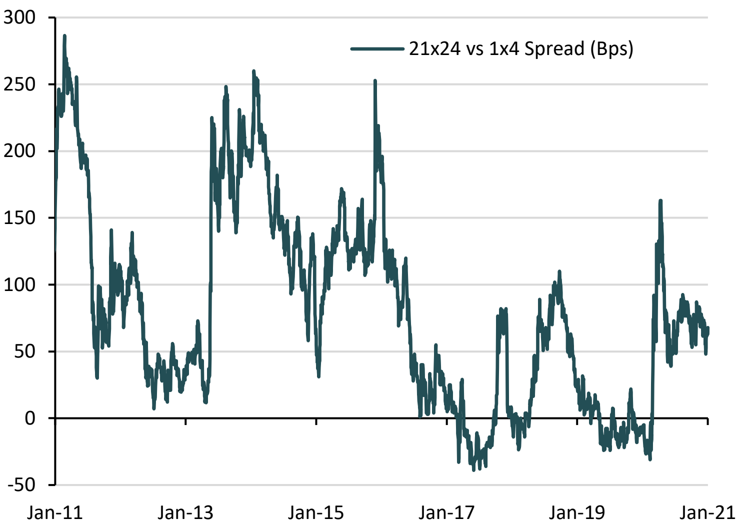
SARB Performance



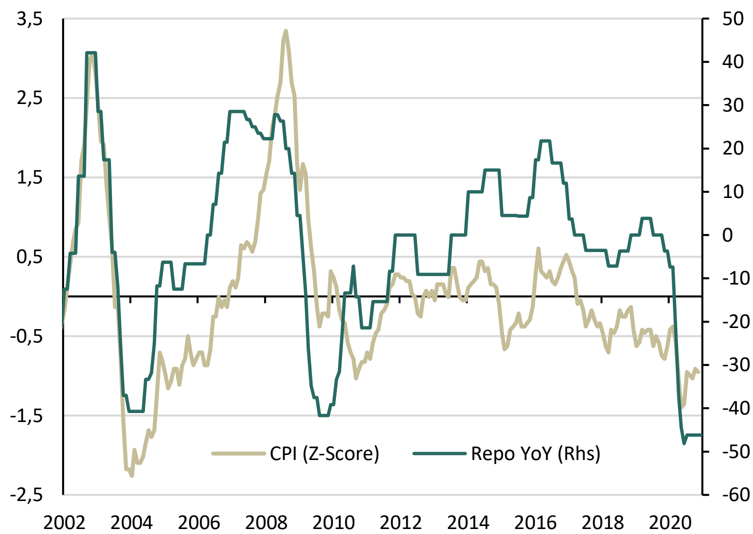
FRA Curve



FRA Curve Shape



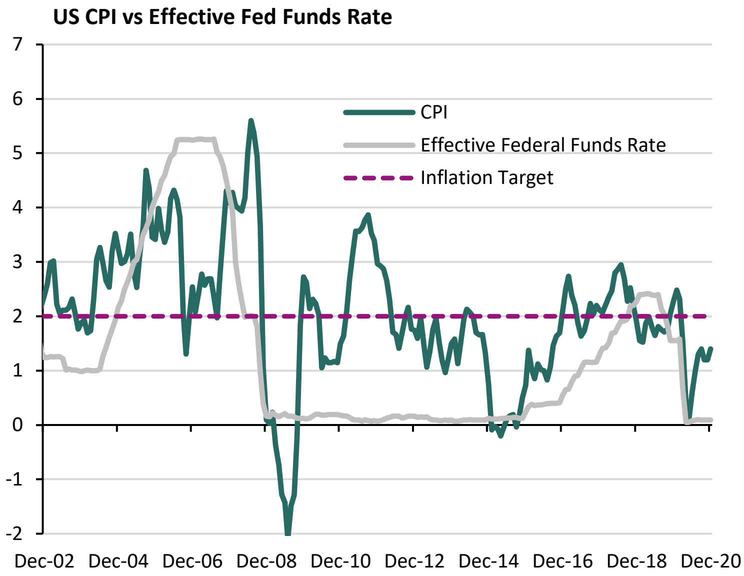
SA Inflation Risk vs Repo

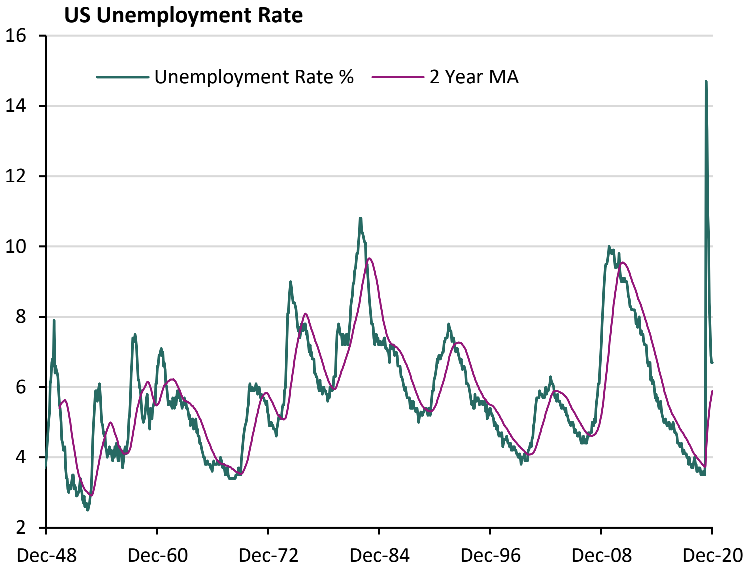


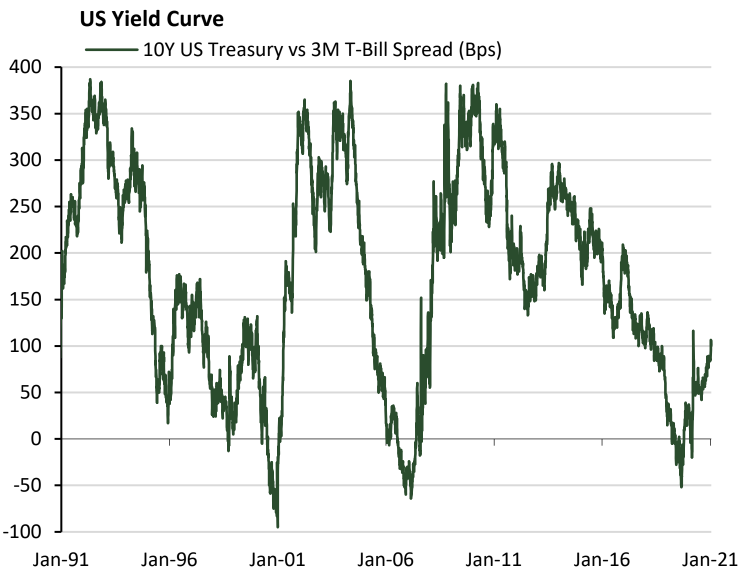
The economic confidence and improved confidence observed through the backend of 2020 has lost some of its momentum as we move into the new year. Factors at play in this wobbling included the last-gasp efforts at navigating (negotiating) Brexit, a Washington narrative that turned into a direct challenge to democratic institutions, mutations of the covid virus and challenges to production and distribution of vaccines. It remains the case that even with these improvements in the last part of the year, the world economy finished 2020 about 4,4% smaller than it started according to the International Monetary Fund (IMF).

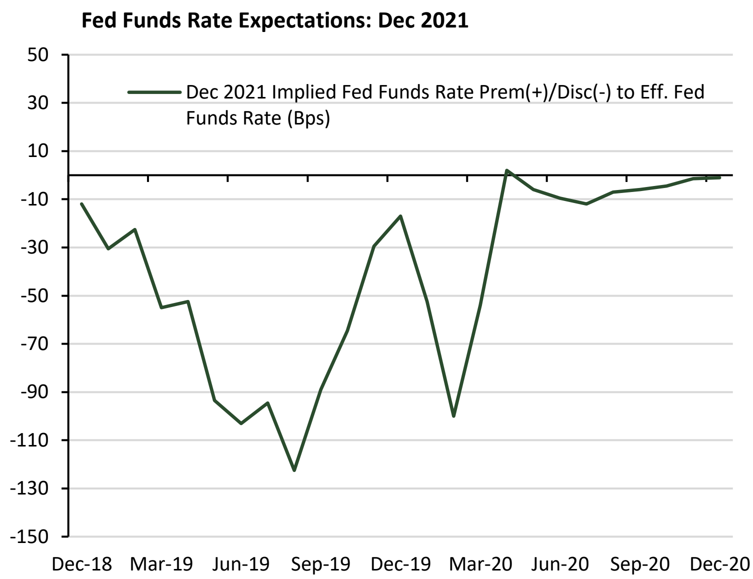
Core inflation forecasts are still muted, lifting modestly to 3.5% in 2021 and 4.0% in 2022. the rand has recovered substantial ground, making back 410 cents of the lost 500 cents to reach R14,95 in the third week of January, having gone to R14.54 in December.

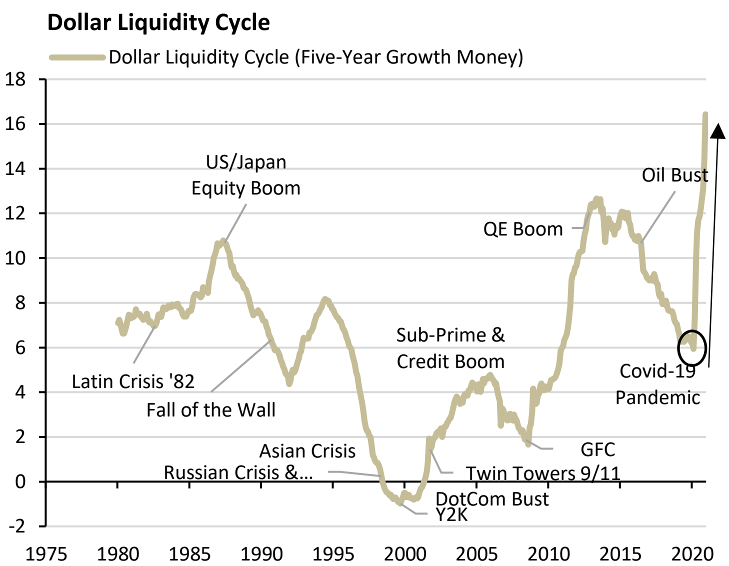
Interest Rate Monitor: United States











The market anticipates forthcoming discussions from the FED regarding the pace at which QE has progressed and continued over the course of the pandemic. Certain indicators hint toward inflation breaching 2% over the course of the spring months. Several FOMC members have subtly hinted that the FED will have to re-evaluate policy when inflation prints above 2% for consecutive months. Markets believe that the FED should re-asses its pledge to purchase securities in its QE program from a minimum pace, to that of a flexible approach, like the ECB.

Discussions of a rate hike are not on the table until 2022, however markets are likely to discuss the prospect on the back of increased GDP and inflation numbers.

Economic recovery is expected over the second half of 2021, leaving potential for further steepening in the yield curve. With rates expected increase in 2022, the yield curve is expected to start flattening then.