May 2021

You can't be too bearish on the rand

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The fast view

- The current account should remain supportive for the rand, but less so than in the past year.
- Capital flows are hard to predict, but on balance, the dynamics for the rand remain favourable.
- The positive outlook for inflation leaves some breathing room for our central bank to keep interest rates lower for longer.
- SA bonds are attractive versus emerging market peers, US treasuries and inflation.
- The Ninety One Flexible Bond Strategy is constructively positioned with respect to SA bonds given the attractive yields on offer and recent positive fiscal momentum; The shorter dated inflation linked bond allocation adds diversification with the lower trend in CPI now priced in.

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The rand has been one of the best-performing currencies over the last 13 months. In March of last year – at the height of the Coronavirus crisis – the rand went into free fall, reaching R19.35 against the US dollar. A little more than a year later, the SA currency is trading at around R14.32 to the dollar (as at 6 May 2021). The rand has performed even better than some of the developed market currencies. While South Africa has its challenges, we have been saying to clients for some time that you can't be too bearish on the rand.

Since the pandemic last year, South Africa has been running a massive current account surplus. Essentially, we're exporting a lot more than we're importing. Gold and base metals, which comprise a substantial part of our export earnings, have enjoyed strong price increases. This, together with bumper agricultural production, has boosted our exports. On the other hand, the value of our imports has fallen, thanks to weak demand and last year's sharp fall in the price of oil, a major import. This surplus has helped South Africa source foreign exchange from the world, underpinning currency strength as individuals and businesses convert those traded dollars into rands.

Bouts of weakness a reality

While trade flows make for a positive picture, capital flows have been much more unpredictable. Because the rand is highly liquid and correlated to emerging markets (EMs), it is easy for foreign investors to move their money in and out of South Africa as sentiment swings. Over the last year when investor sentiment was poor, there were periods when the rand moved 50 cents to R1.00 in a couple of weeks, as foreign investors exited our market. Moves such as these are a stark reminder that the rand is one of the most volatile currencies in the world.

Because South Africa faces many economic and fiscal challenges, it's easy to attribute every bout of rand weakness to our domestic problems. But the fortunes of the rand tend to be closely tied to global factors. When global investor sentiment is poor, appetite for risk assets, especially EM investments, tends to wane. The result is capital outflows as investors seek to move their money to traditional safe havens such as developed markets.

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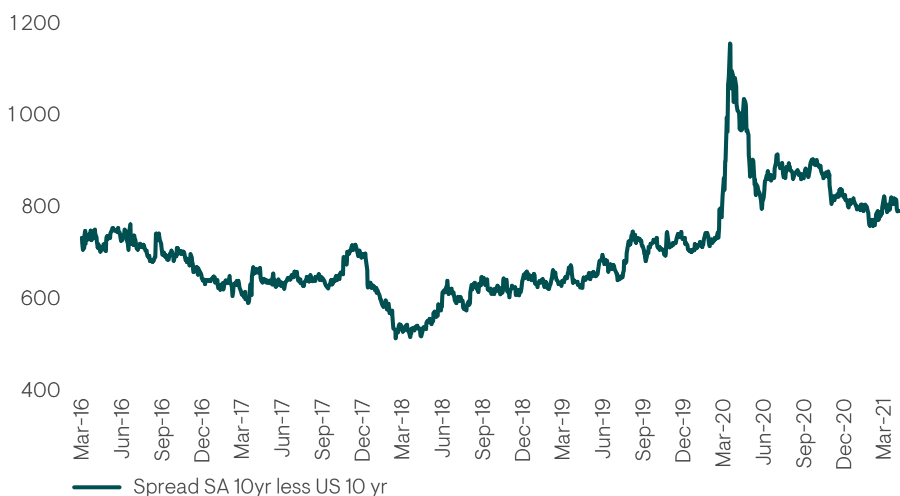
Figure 1: Global bonds re-pricing inflation risks



Source: Ninety One, data as at 4 April 2021.

Earlier this year, we had a big rerating in the US bond market – US treasury yields spiked on global inflation fears. In turn, this led to a sell-off in our bond market, and we saw foreign capital flowing out of the country and the rand weakening. Over the last year, the rand experienced a few of these speed bumps due to capital outflows. So, the direction of the rand can largely be seen as a battle between the current account and the capital account. While our currency has been resilient this year, bouts of weakness are par for the course.

> Capital flows are hard to predict, but on balance, the dynamics for the rand remain supportive.

The current account should remain supportive for the rand, but marginally less so than in the past year. As the global economy recovers, the oil price has risen. South Africans are also expected to spend more on items that are imported as our economic situation improves. We would thus need to see more persistent capital inflows for the rand to appreciate materially from current levels. Capital flows are hard to predict, but on balance, the dynamics for the rand remain supportive.

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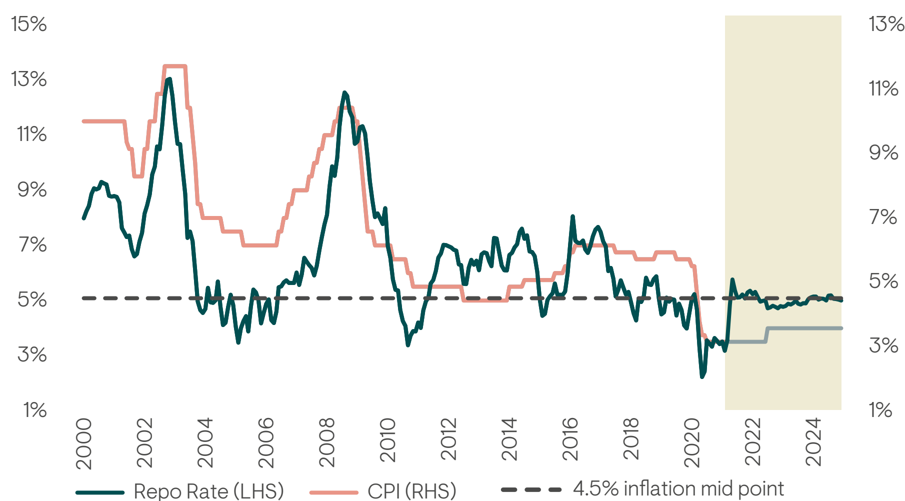
SA inflation contained but economy still in a tough spot

The stronger rand has helped to keep domestic inflation in check. With CPI currently at 3.2%, inflation remains well below the midpoint of the SARB's 3-6% target band. Oil and food prices have been rising, but we expect inflation for the year to remain contained at around the midpoint of 4.5%. The positive outlook for inflation leaves some breathing room for the South African Reserve Bank (SARB) to keep interest rates at record lows for longer, which should help to bolster SA's fragile economy. The SA economy limped along in 2019, and subsequently shrank 7% in 2020 due to the pandemic crisis. We expect the economy to grow by 3.5% this year, but that still means that our level of economic output at the end of 2021 will still be considerably below the 2019 level. So even though the current growth picture is better than feared, the few green shoots are not enough to pull the country out of the economic doldrums. We believe key policy reforms would substantially boost South Africa's growth prospects. While implementation has been slow, we are seeing some concrete measures to build a more capable state, stabilise government expenditure and boost infrastructure development.

> Key policy reforms would substantially boost South Africa's growth prospects.

Figure 2: Rates lower for longer



Source: Ninety One, data as at 31 March 2021.

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SA bond market regaining its composure after junk downgrade

When you look at current SA bond prices versus where they were on the eve of the downgrade to junk, it has been a remarkable comeback. Last year, investors saw 10-year bonds spike intra-day to 13.25% in late March (from below 8.75% at the time of the February budget). Currently, SA bonds are trading at 9.2% (as at 30 April 2021). South Africa’s institutional strength has played a key role in stabilising our market during these turbulent times. At the height of the crisis last year, the SARB restored market functioning by supplying liquidity and buying bonds in the secondary market – an unprecedented but justifiable move. The central bank also cut interest rates aggressively to multi-decade lows when the ravages of the pandemic reverberated through the SA economy. Importantly, the SARB had the firepower to do so because inflation was well contained, and the Bank had maintained high real interest rates over time. We’ve also seen initiatives to beef up the South African Revenue Service’s audit and tax collection capacity, and measures aimed at containing the public sector wage bill. Thanks to better-than-expected revenue collections, National Treasury has been able to reduce its bond issuance, which has been positive for the fixed income market.

Portfolio positioning | Flexible Bond Strategy

We are comfortable to hold SA bonds given their attractive yields and recent positive fiscal momentum.

From a positioning standpoint, cash rates remain at record lows, and government bonds, despite their post-COVID comeback, are still offering very attractive yields. We are comfortable to hold SA bonds given their attractive yields and recent positive fiscal momentum.

For some time, because of the yields on offer and generally attraction valuations, our duration position has been overweight. We have added some diversification to the portfolio through an allocation to shorter dated inflation-linked bonds, as we believe the lower trend in inflation is now priced in and has bottomed out.

We believe our long held underweight position in listed property is justified, owing to an increased volatility of the asset class and uncertainty around dividend distributions.

We are slightly underweight on valuation grounds relative to history to investment-grade credit, although it remains a key pillar in the portfolio. We have minimal exposure to the cyclical sectors of the economy, maintaining a preference for quality defensives.

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Tel: 0860 500 100. The scheme trustee is FirstRand Bank Limited, RMB, 3 Merchant Place, Ground Floor, Cnr. Fredman and Gwen Streets, Sandton, 2196, tel. (011) 301 6335.

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Issued, May 2021.

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