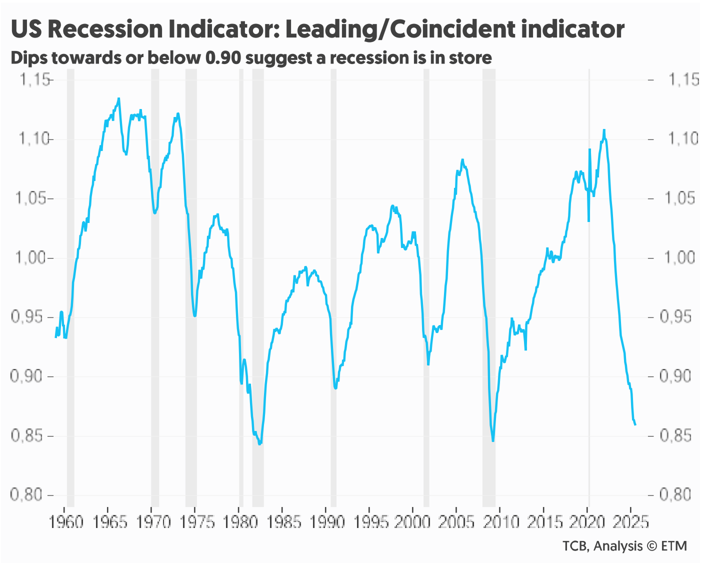
ZAR to find support as carry trades come back in vogue

Key points

- Global economic indicators are converging to signal an approaching growth inflection point, with traditional recession predictors flashing warning signs and the US economy showing mounting vulnerabilities that historically precede meaningful downturns.
- The anticipated economic slowdown will likely trigger substantial monetary accommodation from major central banks, flooding the system with liquidity that systematically seeks higher-yielding emerging market opportunities as carry trade strategies regain favour.
- The ZAR is exceptionally well-positioned to capitalise on this shift, ranking second out of 22 countries in ETM's Carry Attractiveness framework, supported by attractive real yield premiums, improving terms of trade, and the SARB's measured policy approach relative to more aggressive central banks globally.

BASELINE VIEW:
As the global business and credit cycles approach a critical turning point, the ZAR stands to benefit significantly from renewed carry trade activity. The combination of an impending US economic downturn, subsequent central bank policy accommodation, and South Africa's superior yield premium creates a compelling backdrop for ZAR strength. With the Japanese yen resuming its funding currency role and global liquidity cycles poised to turn higher, the ZAR's elevated carry attractiveness ranking positions it as a primary beneficiary of the search-for-yield dynamics that typically emerge during monetary easing cycles.

A growth inflection approaches



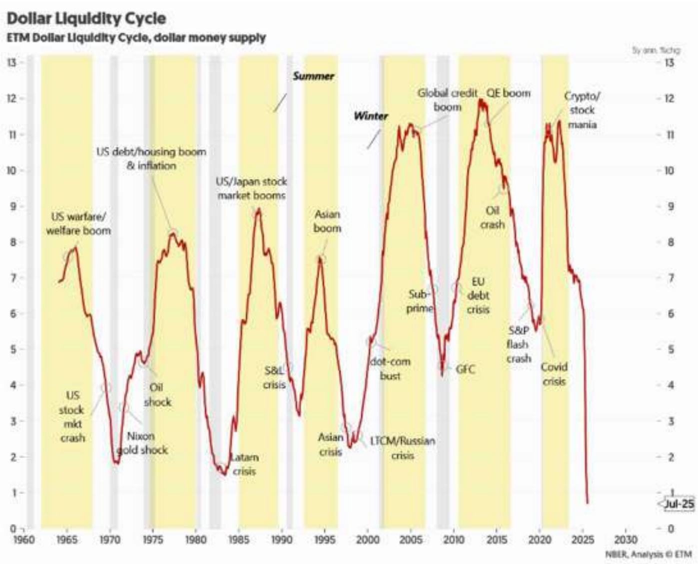
Multiple economic indicators are converging to signal that the US economy, alongside the broader global economy, is approaching a significant growth inflection point.

Recent data suggests mounting pressures across key sectors, with labour markets showing early signs of softening and consumer sentiment remaining fragile despite resilient corporate performance.

Historical patterns indicate that such convergence of leading indicators typically precedes meaningful economic downturns.

With interest rates remaining elevated and liquidity still being withdrawn by major central banks, the global economy continues to face headwinds. Credit conditions are tightening whilst household and corporate balance sheets show increasing strain. The adjacent recession indicator reinforces this assessment, highlighting elevated risks of a near-term US downturn.

The cycle is at a turning point

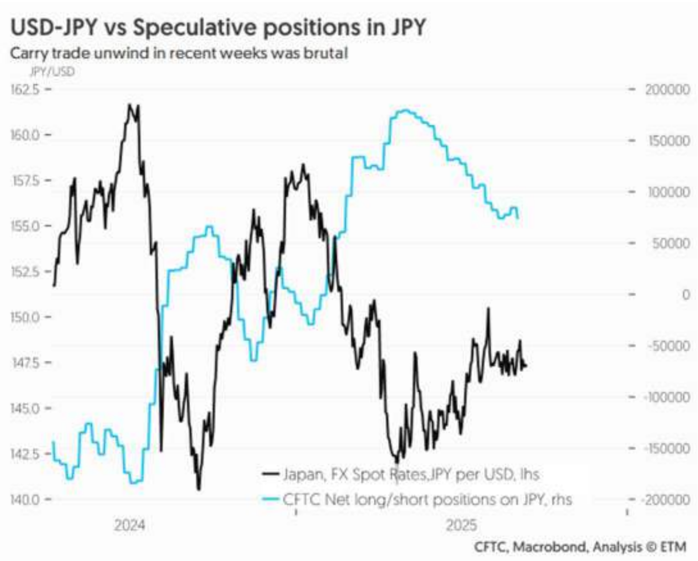


This cyclical turning point carries profound implications for global financial markets and currency dynamics. As economic momentum wanes, central banks' policy responses typically follow predictable patterns. Previous downturns have consistently triggered substantial monetary accommodation, flooding the system with liquidity that subsequently seeks higher-yielding opportunities in emerging markets.

The adjacent chart illustrates this phenomenon clearly, showing how global dollar liquidity cycles bottom-out during recessions (the grey bars). During periods of economic weakness, the Federal Reserve and other major central banks invariably shift from restrictive to accommodative policy stances, dramatically expanding money supply.

Once this monetary stimulus enters the financial system, it generates a powerful search-for-yield. Institutional investors, faced with depressed returns in developed markets, systematically reallocate capital toward higher-yielding assets. Emerging market currencies, bonds, and equities become increasingly attractive as risk appetite recovers and carry trade strategies regain favour. This cyclical pattern has played out repeatedly across previous economic cycles, with emerging market assets typically outperforming during the early stages of monetary easing cycles.

Carry trades likely to find favour again

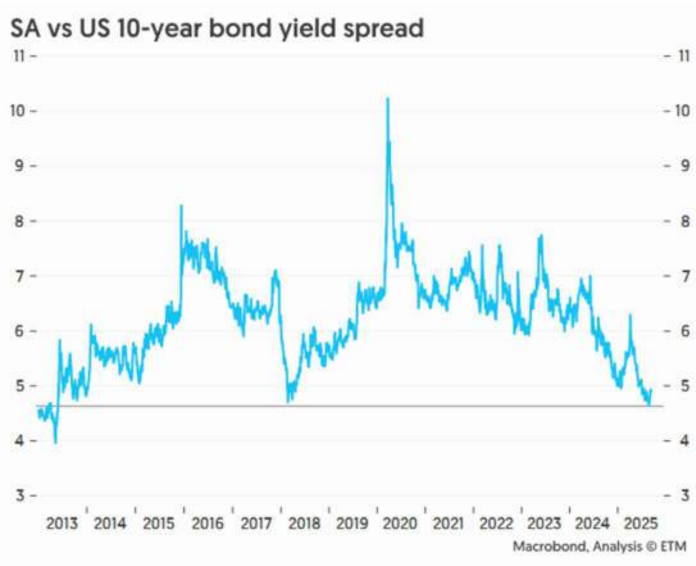


Already, we are witnessing early signs of this transition taking shape. The Japanese yen (JPY) is particularly noteworthy, as it begins to reclaim its traditional role as the preferred funding currency for global carry trades.

Data from the CFTC shows that speculative net long JPY positions are being trimmed, having gone from a net long position of $15bn to $6bn currently. This has largely been a function of a build-up of gross short positions, which are currently at their highest this year, partly because political risks in Japan have escalated. With the resignation of Prime Minister Ishiba, investors are wary of a potential successor like LDP veteran Sanae Takaichi, who favours looser fiscal and monetary policies and has criticised BOJ rate hikes

The JPY has already shown signs of weakening, albeit with this contained for now amid USD weakness. However, if Japan shifts toward maintaining loose monetary policy, net longs will shift to net shorts and the JPY would likely become a major funding currency again. That would be a strong ZAR-supportive factor given the ZAR's high carry appeal.

SA rates still hold an attractive real premium

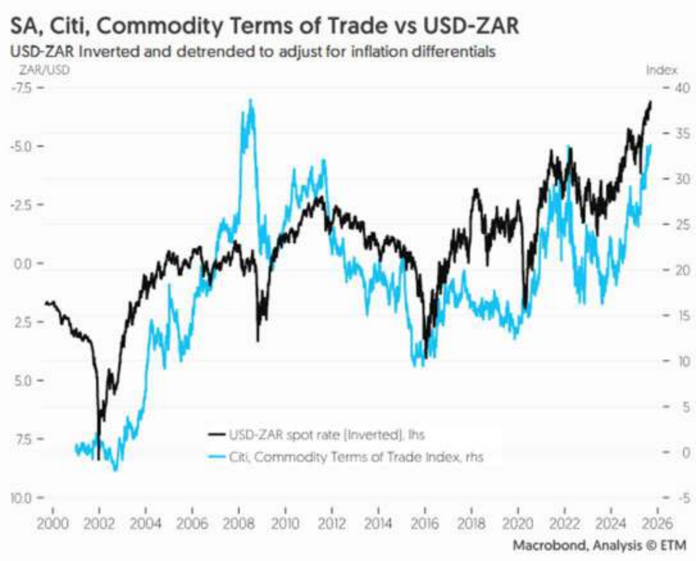


A major factor for SA's carry appeal is the premium that can be achieved over less risky assets. The SA vs US 10yr yield spread may have narrowed to some of the lowest levels since 2013, but that represents concerns about US fiscal policy just as much as it does some local fiscal consolidation.

The spread is currently near 500bp. Taking this into account against a backdrop of the SARB now targeting a 3% inflation target, which is not much different to where US inflation is currently, and we find that SA bonds offer a healthy real spread over the US counterparts.

It should also be noted that SA's inflation outlook remains fairly benign, even though we have seen a slight acceleration in recent months. ETM's Inflation Risk Index shows that disinflationary pressures are still likely to exert some influence over prices through the months ahead, which will limit any further rise in inflation.

SARB's more measured approach to support the ZAR

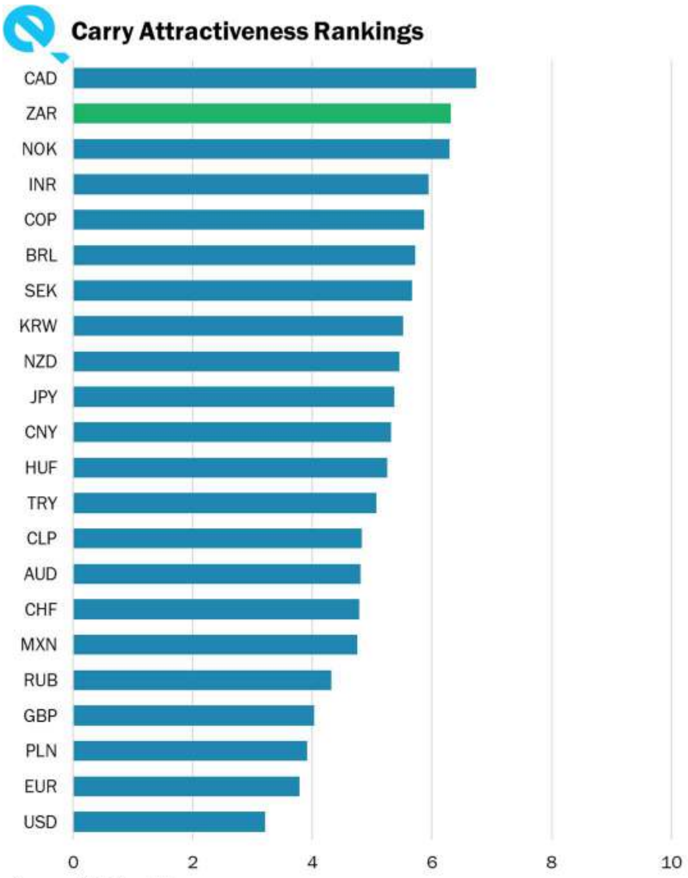


Another factor we have often spoken about as being strongly supportive of the ZAR is SA's terms of trade. This forms part of the ETM Carry Attractiveness Index and thus is important to revisit. Carry attraction will be boosted in countries whose terms of trade are positive. The correlation between these two is tight and therefore will be ZAR supportive.

South Africa's terms of trade have reached levels last seen in early 2022, providing substantial support to both the trade balance and the ZAR. This improvement reflects the country's favourable position in global commodity markets, particularly given the recent rise in gold prices.

While such levels have proved difficult to sustain historically, expectations are that gold prices are to remain elevated, while downside risks to the oil market are gaining momentum. This suggests that SA's terms of trade will continue to find support going forward, even if we do see some degree of a correction lower from the current lofty levels.

Carry attractiveness rankings



Source: ETM Analytics

Amongst others, the above considerations are neatly captured in ETM's Carry Attractiveness framework, in which the ZAR currently ranks second out of 22 countries. With South Africa's policy rate maintaining a substantial premium over developed market counterparts, the currency offers attractive nominal and real yields that become increasingly appealing as global risk appetite recovers.

The framework's methodology captures both the yield premium and underlying economic fundamentals that determine carry trade sustainability. South Africa's high ranking suggests that when global liquidity conditions improve and investors resume their search for yield, the ZAR is well-positioned to attract significant capital inflows. This positioning becomes particularly relevant as we approach the anticipated turning point in the global monetary cycle, where accommodative central bank policies should support renewed emerging market currency strength and carry trade activity.

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