# ZAR performance compares well with EM currencies

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**Key points**

- ZAR's strength in recent months has perplexed many who continue to think the ZAR should always trade at a deep discount due to the state of the economy, fiscal challenges, and the effects of government maladministration. However, the ZAR is not alone; EM currencies in general have appreciated vs the USD for similar reasons.
- Exposure to commodities, improvements in risk appetite, rotation away from the USD, and better fiscal positions mean that these currencies, including the ZAR, have a firm justification for appreciation.

**BASELINE VIEW: ZAR can sustain its for so long as EM sentiment remains strong, the USD remains vulnerable, and commodity prices remain well supported as investors rotate away from US assets. Importers will enjoy a purple patch.**

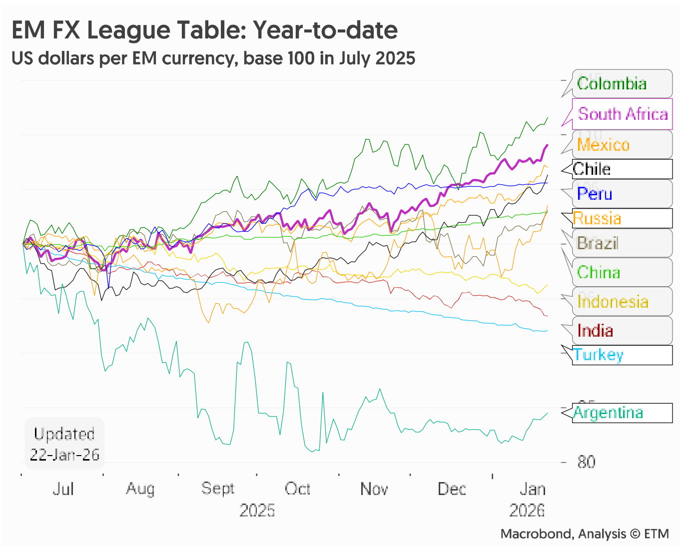
## ZAR performance is not as extraordinary when compared to EMs

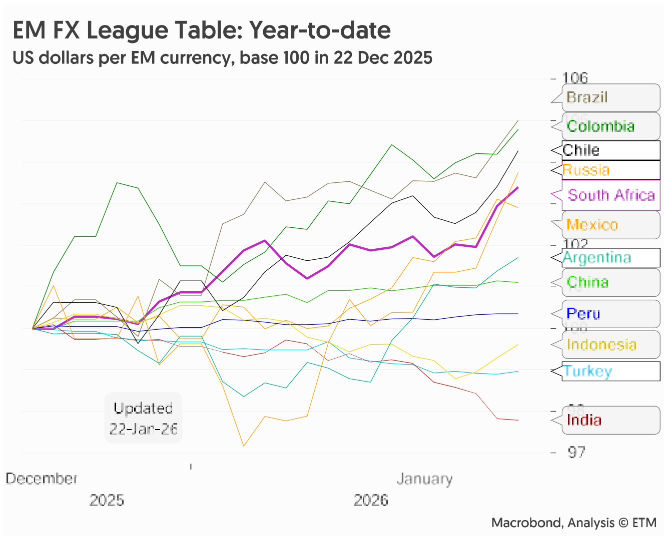
In the past six months, the ZAR has performed well. It was one of the best-performing emerging-market (EM) currencies in the world, second only to Colombia. The six-month window was chosen to highlight just how impressive the ZAR's performance has been.

It coincides with when the GNU struck a deal on SA's fiscal policy, which prevented a split in the GNU; it covers the exit from the grey list and the EU list, the S&P credit rating upgrade, and the 3% inflation target.

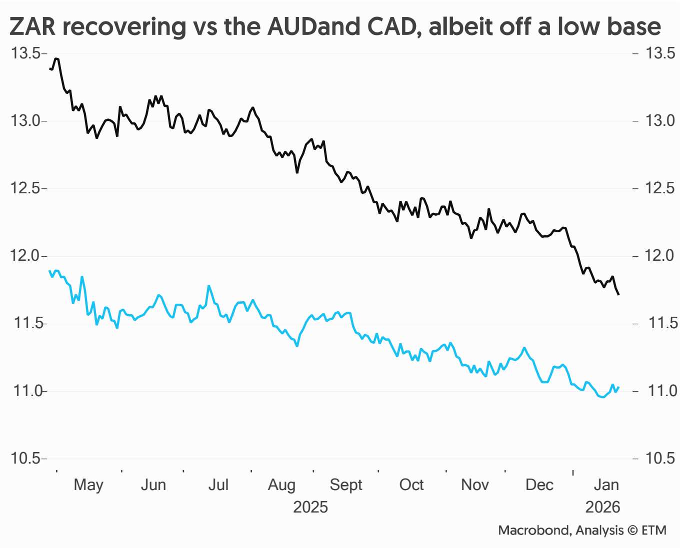
It also coincided with a very strong surge in commodity prices and a rise in risk appetite that has encouraged the "quiet quit" from US assets, as geopolitical strategies seek to diversify away from the US. uite obviously, the depreciation of the USD is an equally important factor that lent solid support to the EM currency surge.

What makes the currency comparison all the more interesting is if one shortens the timeframe. Analysis of the past month shows that the ZAR relinquished its 2nd place among 12 countries to rank 5th. On a shorter time horizon, the ZAR is not as impressive and there are indeed other EM currencies that are performing even better. Notably, the best performers have been the LATAM currencies, which have appreciated faster than the ZAR over the past month.



## ZAR even appreciated vs other major commodity currencies

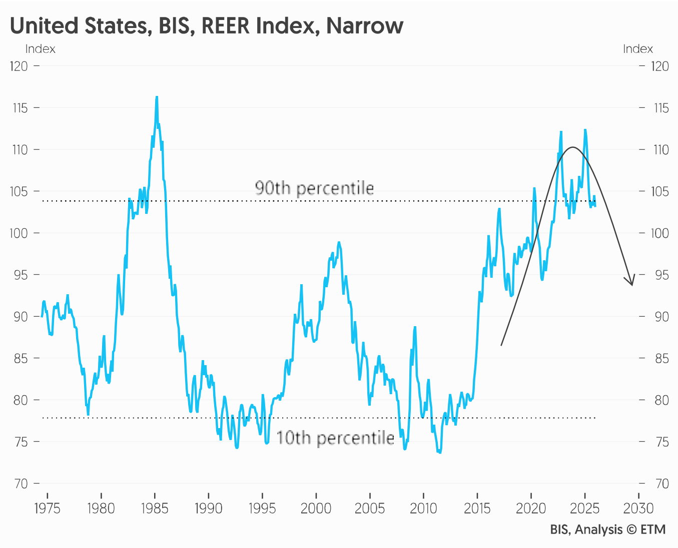



Notably, the ZAR even appreciated against other major commodity currencies. So it is safe to say that this is more than just a recovery against a weakening USD or a commodity play. If it were a commodity play, one would not expect the ZAR to stage the magnitude of recovery seen against the AUD or the CAD.

The fact that it has done so gives credence to the argument that there is something idiosyncratic about the ZAR's move. Although it has moved in unison with other emerging markets, it is not hard to find some local justification for the ZAR's appreciation.

SA's GNU held together; it exited the grey list and the EU's list, received a credit ratings upgrade, and achieved improved fiscal performance. While the real test will be February's budget announcement, the ZAR has enjoyed some positive sentiment.

## USD remains overbought and vulnerable



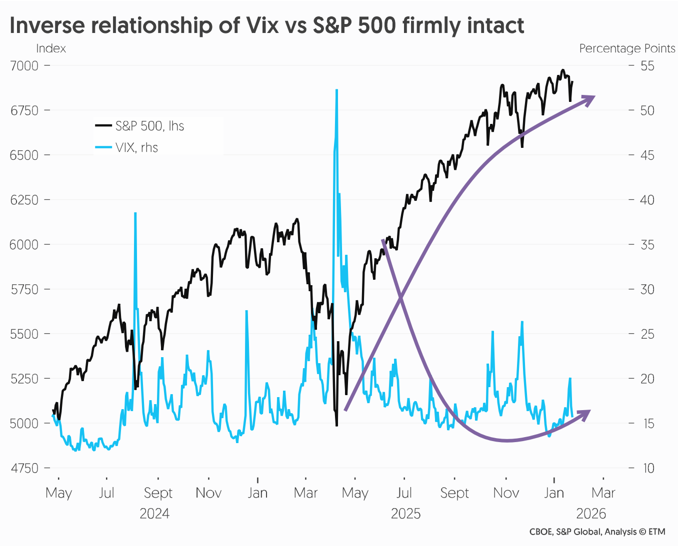

A major factor in the overall direction of currencies will be the USD's performance. EM currencies may be appreciating in their own right, but the USD is on the defensive and looking vulnerable.

The general trend of the "quite quit" out of US assets is ongoing and will likely continue to weigh on the trade-weighted USD.

As countries tackle the weight of President Trump's foreign policy, they are doing what they can to mitigate those risks and explore trading opportunities with different jurisdictions that might be more friendly and amenable to fair negotiations.

Some of the world's central banks have diversified their holdings away from the USD, which, combined with the uncertainty around the US fiscal outlook as investors await a US court decision on the legality of Trump's tariffs and further Fed easing, will weigh on the USD.

## Risk appetite remains favourable for EMs......for now

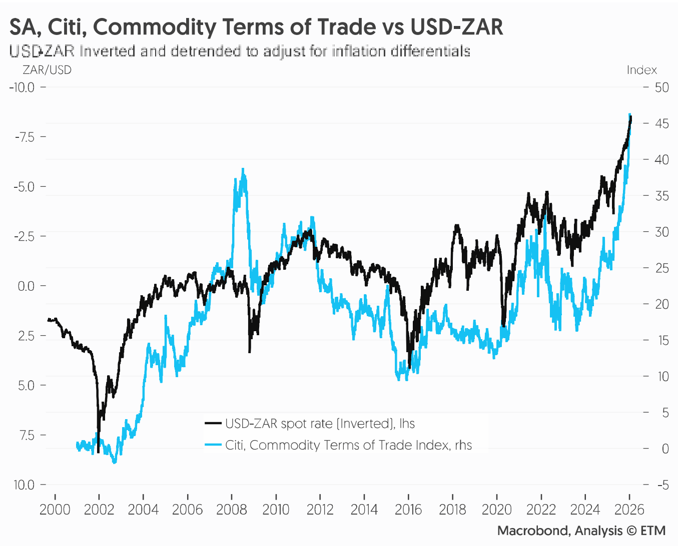



Market watchers often refer to the VIX as a barometer for risk appetite. The higher the VIX (the cost of hedging against an adverse sell-off in the S&P 500), the weaker the sentiment and the greater the probability of volatility.

From the accompanying chart, it is clear that the VIX spiked in November, but quickly settled back down, helping the S&P 500 return to record levels. Such reduced VIX levels were a signal to investors to participate in traditionally riskier markets.

While the S&P 500 remains well elevated and the VIX suppressed, the environment remains supportive of EM FX. The debate now revolves around whether these levels will be sustained. Significant risks are on the horizon. One of them could manifest as early as next week in the form of the US court decision on the legality of the Trump tariffs. If deemed illegal, the consequences for US markets could be severe and the market-friendly risk appetite could disappear.

## Terms of trade continue to support EMs and the ZAR in particular

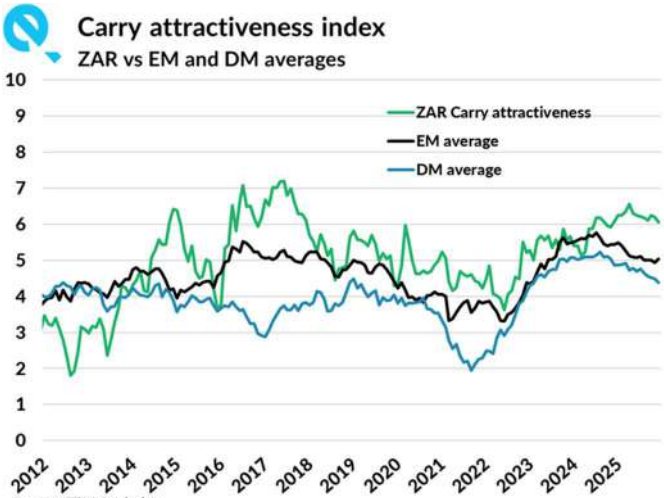



SA's terms of trade have had a stellar run in recent years, and the accompanying chart highlights the impact on USD-ZAR. The terms of trade are now higher than they were at their peak in 2008, which marked a particularly strong period of ZAR strength and resilience.

The world appears to be navigating a new era in which commodity prices, particularly metal and precious metal prices, are surging higher. Although South Africa's mining industry is underperforming its peers and production is stagnant at best, the prices of the minerals that SA still mines for export have risen to such a degree that they have helped boost the ZAR's performance.

If one believes that the commodity price trend remains on a firm upward trajectory, then one would favour a long EM FX position. The ZAR would benefit from this, both directly and indirectly, through improved sentiment towards EMs.

## ZAR outperforming both EM and DM peers

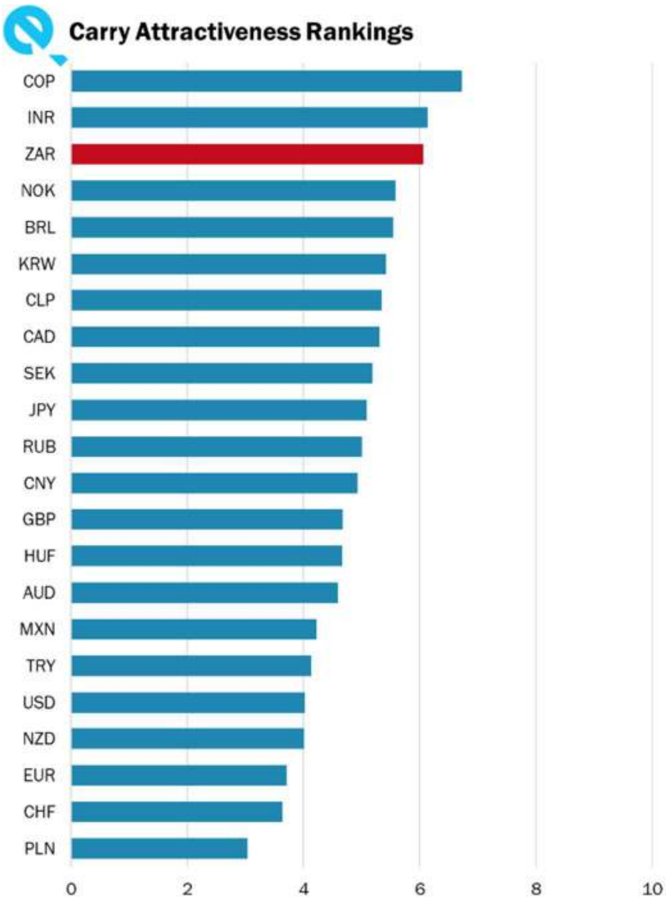


Source: ETM Analytics

ETM's carry attractiveness index provides further perspective on the outperformance of emerging markets relative to developed markets. As a group, EM average scores are slightly higher than those of developed markets. The relative attraction will come from various sources, but in many cases will be driven by interest rate differentials, valuations, and current account viability, which is closely linked to terms of trade.

While historically, the ZAR's carry attractiveness score has moved in parallel with that of emerging markets, the ZAR's score has deviated slightly in the past two years. SA has gradually differentiated itself positively from other emerging markets, and this is now reflected in the ZAR's overall performance not only against the majors but also against some of its EM peers.

## ZAR ranks near the top of a twenty-two-country sample



Source: ETM Analytics

It should therefore come as no surprise that the ZAR finds itself near the top of the rankings. The ZAR is currently enjoying several tailwinds.

1. Improved fiscal performance
2. A more stable GNU
3. Greater political accountability
4. Improved business and consumer confidence
5. Economic reforms to favour the private sector
6. A lower inflation target of 3% aligns with EMs
7. Exit from the FATF greylist
8. A credit rating upgrade from S&P
9. Strong commodity prices and terms of trade
10. Low currency volatility

This is indeed a powerful list of tailwinds, which have helped generate a virtuous cycle. As this virtuous cycle has materialised, SA has been able to attract foreign capital to its shores, which will always help strengthen the currency, especially against the backdrop of a balanced current account.

Being at the top of the carry attractiveness index, with a score over 6/10, means SA contracts quite sharply with the USD, which ranks second from the bottom, and the EUR, which ranks fourth from the bottom. Although the GBP ranks a little higher, it remains in the bottom half of this table and does not look particularly attractive either.

## Conclusion

The ZAR is enjoying a period of solid support. The tailwinds are numerous and have helped sustain the ZAR's recent appreciation. One of those tailwinds has been the general trend of firmer emerging-market currencies, and over the past month, the ZAR has struggled to keep pace with other EMs.

As always, risks loom. The most likely near-term risk is a US court's decision on the legality of President Trump's tariffs. If ruled illegal, there will be a significant reversion to previous tariff levels, although it is unclear what the consequences will be. At least one scenario anticipates that the USD will lose significant ground due to the uncertainty that this event will trigger.

However, another suggests that the rise in risk aversion that follows could spark a sell-off out of risk markets. All that said, there is fundamental justification for the ZAR trading this firmly, which could signal the start of the ZAR shifting into a firmer range.

Analyst(s):

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