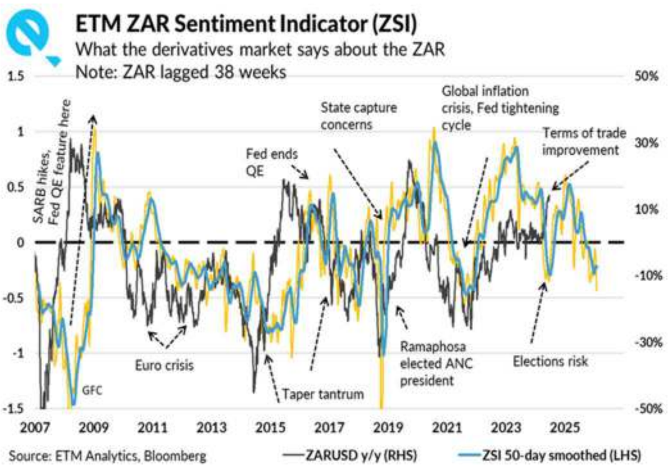
Key points

- The ZAR has had a stellar seven months, ranking amongst the best-performing emerging-market currencies. It has benefited from a rotation away from the USD, strong portfolio flows into emerging-market and SA bonds, and the commodity supercycle, which has boosted SA's terms of trade.
- However, an often-overlooked driver of currency performance is market positioning. To this end, it is important to note that the ZSI has turned negative, carry trade spreads have compressed, and gold and equity market positioning looks stretched. While the gold price is near record levels, it is difficult to turn too pessimistic on the ZAR; however, there is growing evidence that the ZAR might start to lose some of its momentum at the very least.

BASELINE VIEW: Importers are in a great position to enjoy some of the best levels in years and should start taking advantage of them amid a growing list of potential risks.

ZAR performance is not as extraordinary when compared to Ems



Oftentimes, investors look for fundamental justification for a market move to explain it. Most of the time, the diagnosis is wrong. Most forecasters, including the SARB, have a very poor track record in their currency forecasts.

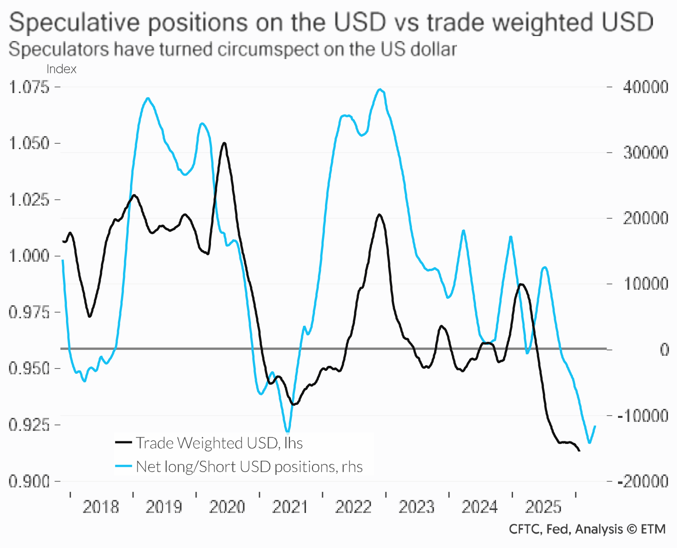
A currency market is driven by many factors, not all of them fundamental. Often, corporate deals can add a layer of flows through the market, sometimes giving the impression of a fundamental move playing out, when in fact the move has nothing to do with the fundamental justification.

A case in point was Saudi Arabia's Zahid Group's $1.4bn acquisition of Barloworld. Given that it was listed on the JSE, the bulk of those flows were repatriated, which had a positive impact on the ZAR, as banks involved would've sold USDs for ZAR to complete the transaction. At the margin, that would've played a role in shifting the bias in the ZAR market.

And as that bias has shifted, it is worth paying attention to the hedging behaviour of significant FX dealers in the ZAR market, including treasury professionals within corporates and fund managers that manage the country's biggest FX exposures. The ZAR Sentiment Indicator (ZSI) seeks to quantify sentiment that reflects their trading behaviour, and judging from the chart above, that sentiment recently turned negative.

One would expect the desire to hedge against ZAR weakness to tick up as the ZAR trades stronger. That forms a significant reason why the ZSI has dipped. The implication is that the ZAR will likely lose momentum in the coming months, potentially losing ground towards the middle of this year and into Q3.

Speculators remain net bearish on the USD



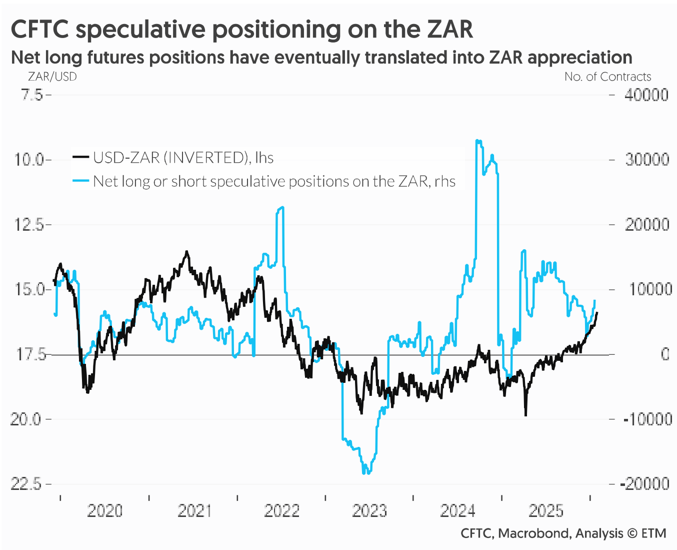
Offsetting the effects of the professional market hedging against ZAR weakness is what is happening to the USD. It has steadily lost ground in recent months, and there are no clear signs that investors are becoming more bullish.

On the contrary, analysis of the CFTC data shows that speculators have turned net bearish on their USD positions, and this is the largest net short position on USD since the 2009 global financial crisis. Back then, investors did not understand quantitative easing as a policy and mistakenly believed it would lead to the imminent destruction of the USD as a safe-haven currency.

The parallels to now are that the degree of uncertainty is high. Not as high as it was in 2009, but the Trump Administration's unorthodox management of US geopolitical relationships and the use of tariffs has injected uncertainty. What the US court decides on the legality of the Trump tariffs will be critical.

Finally, it is also worth adding that the recent pressure President Trump has placed on Fed Chairman Powell and the legal challenges to Fed Chairman Powell's decisions while in charge have not helped matters. They have raised concerns of political interference and monetary policy manipulation to satisfy political objectives.

Net long positions on ZAR eventually find expression in ZAR appreciation

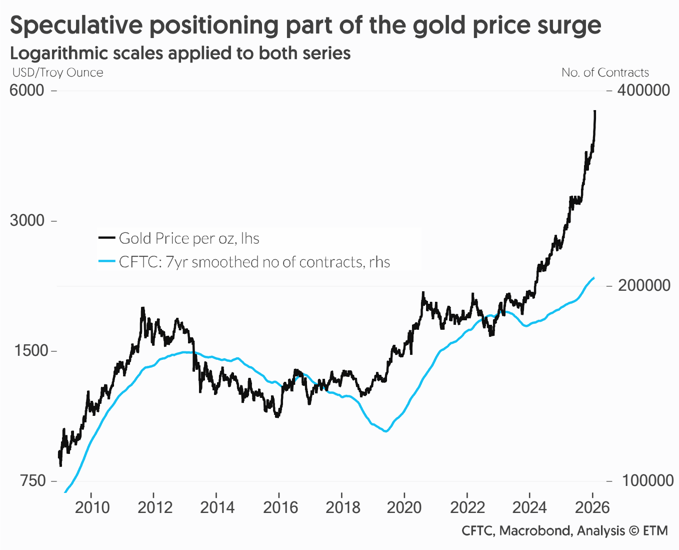


The same study, when applied to the ZAR reveals a very different outcome. Speculators have been net long the ZAR for most of the past two years, and that persistent improvement in sentiment towards the ZAR reflects market positioning for many of the reasons listed below:

1. GNU holds and improves governance
2. SA exits FATF grey list
3. SA receives credit rating upgrade from S&P
4. SARB adopts a lowered 3% inflation target
5. Gold and platinum prices surge to record levels
6. Stock markets rise and keep risk appetite alive
7. General uncertainty on US policy counts against USD
8. Central bank diversification away from USD assets
9. Broad-based emerging market undervaluation

Given the broad-based undervaluation of emerging market currencies and their exposure to commodities, they have performed extremely well against the USD. The ZAR has been one of the best-performing currencies alongside some of its Latin American peers. The risk now concerns whether this is sustainable.

Speculation in the gold market has played an equally powerful role



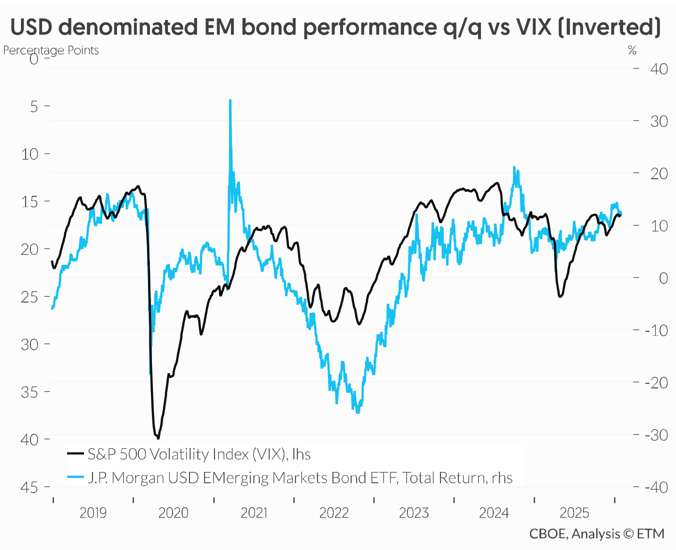
The log scales of both the gold price and the cyclically adjusted CFTC data, used to isolate underlying trends in speculative demand, make for interesting reading. Although not the entire story, it is clear that the speculative element within the gold market has played a role in driving up the gold price.

Gold has gained prominence as a hedge against uncertainty, a weaker USD, and inflation, all three factors arising from the Trump administration's actions on the global geopolitical stage.

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.

A suppressed VIX offers emerging market bonds strong support

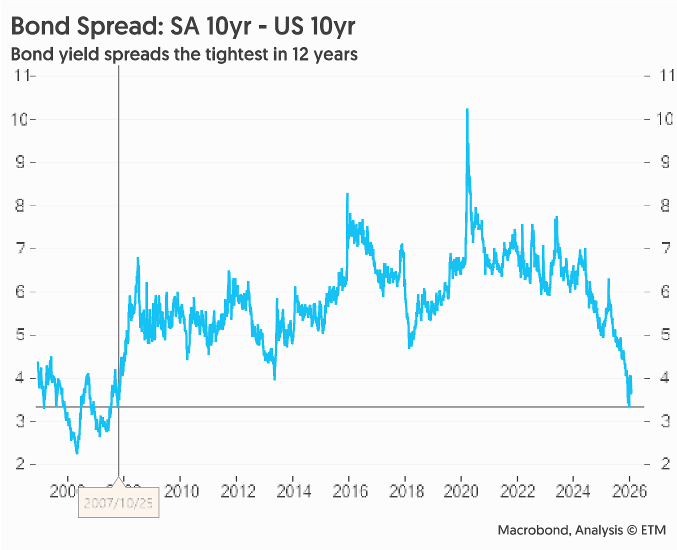


The VIX is often utilised as a gauge of global risk appetite. It is indeed a useful tool that responds rapidly to changing market conditions and therefore serves its purpose. The accompanying chart shows the strong relationship between demand for emerging-market bonds and the VIX.

The lower the VIX (Inverted in this chart), the greater the demand for emerging-market bonds. SA's bond market has thrived through the latest bout of VIX suppression and continues to hold on to its impressive gains of the past year.

While it may be a little unnerving how much these emerging-market bond markets have rallied, it is also worth noting that many of these markets enjoy far more prudent fiscal policies and lower levels of government debt than their more developed-market peers.

Carry trade positioning a concern

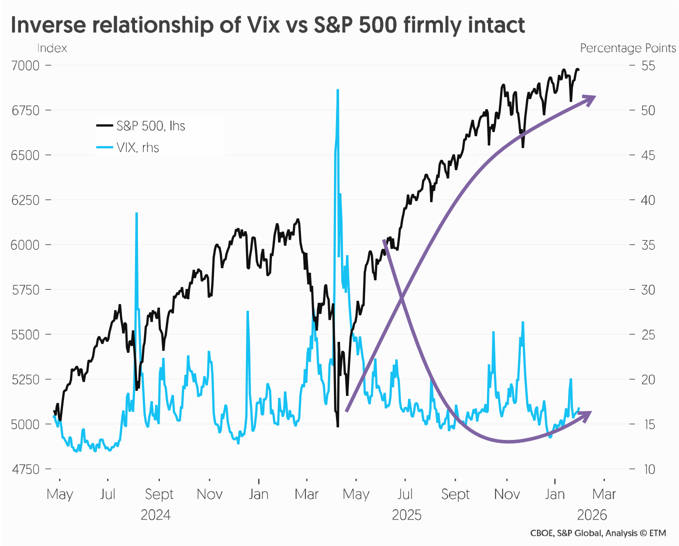


While there may be good reasoning behind the compression in the spread between SA bond yields and their US equivalents, the extent of the compression will raise some eyebrows.

Analysis of the spread reveals that it has tightened to its lowest levels since before the global financial crisis, when South Africa was still an investment-grade country. SA's fiscal position has deteriorated significantly since then, and so investors would be justified in questioning whether such market positioning is sustainable.

If US bond yields drop precipitously due to a slowdown in the US economy, the spread will likely widen back out. That would be a prerequisite for maintaining some ZAR stability through raising the attraction of the SA bond yields relative to what would be available in the US

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



The final point for consideration would be the recent surge in equity markets relative to the VIX. The VIX has been subdued, which one would expect in an environment of such powerful stock market gains. Some of the gains in global equity markets might even be fully justified.

However, the gains have led to very stretched valuations, leaving some investors nervous that they are unsustainable. Any major correction in stock markets and a spike in the VIX would likely drive a strong bout of risk aversion and a shift away from riskier emerging markets.

Whether that playbook will unfold as it has done in the past is debatable. After all, the world appears to have turned against the USD.

However, it is important to highlight this as a risk.

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