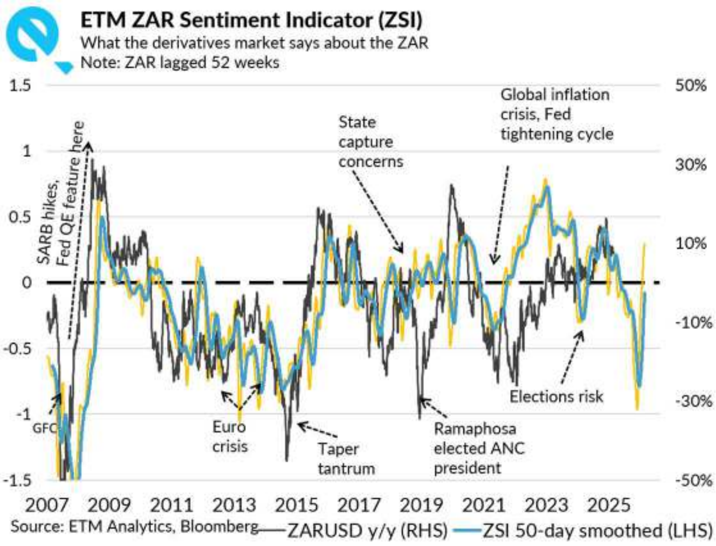
Viewpoint: ZAR fundamentally supported but tactically stretched

Key points

- ETM's ZSI dipped into negative territory earlier this year but has rebounded sharply back towards neutral, showing the ZAR's resilience despite renewed Middle East tensions.
- ETM's valuation framework suggests the ZAR is highly overvalued, with the USD-ZAR more comfortable north of 17.00. Consolidation or depreciation looks more likely than a retest of January's strength.
- Compressed implied volatility keeps the carry trade alive, although elevated downside skew and high risk-reversal ratios point to an asymmetric risk profile and a case for caution.
- Foreign bond inflows underpinned the ZAR’s 2025 rally, but slowing momentum argues against aggressively chasing further appreciation.
- Speculative USD positioning has turned its most bullish since 2015, reflecting hawkish Fed repricing, resilient data and elevated Treasury yields.
- Stabilising speculative gold positioning and robust central-bank demand retain the potential to support SA's terms of trade and cushion the ZAR.

BASELINE VIEW:
The ZAR remains fundamentally supported but tactically stretched. Falling volatility, positive carry and improved foreign bond participation are meaningful supports, yet slowing portfolio inflows and persistent downside skew suggest the appreciation phase has matured. The quantitative frameworks imply that the ZAR should be weaker than current levels, and although abrupt reversals look less likely without a leveraged positioning build-up, investors should avoid chasing ZAR strength.

ZSI drops and rebounds sharply back towards neutral



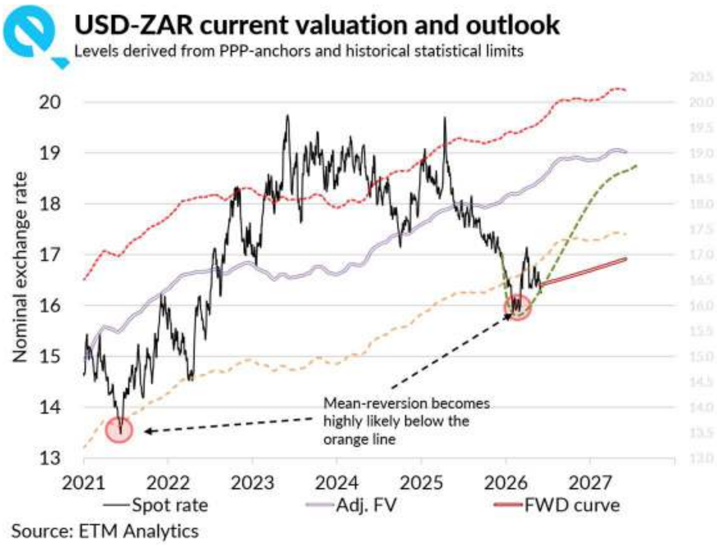
Quantitative models such as ETM's ZAR Sentiment Indicator (ZSI) help to navigate a market characterised by a high degree of geopolitical uncertainty. Just this week, US President Trump called an end to the US-Iran ceasefire and launched fresh attacks on Iranian targets. Interestingly, the ZSI hasn’t budged.

As illustrated in the adjacent chart, the ZSI dipped firmly into negative territory earlier this year as the lead-up to and the onset of war in Iran weighed on market sentiment and drove the market to hedge against ZAR selloff risk.

More recently, however, it has rebounded sharply, climbing back towards neutral.

It is noteworthy how calm the ZAR has been in the face of this year’s geopolitical shock, with implied volatility also reflecting reduced hedging demand (after an initial spike) since the war began in late February. This might explain why the ZSI has not turned lower in recent days despite renewed tensions in the Middle East.

ZAR's stretched valuation points to limited appreciation potential



The ZSI chart above, coupled with the adjacent ETM risk-adjusted valuation chart, implies the ZAR may struggle to test the strong levels seen back in January.

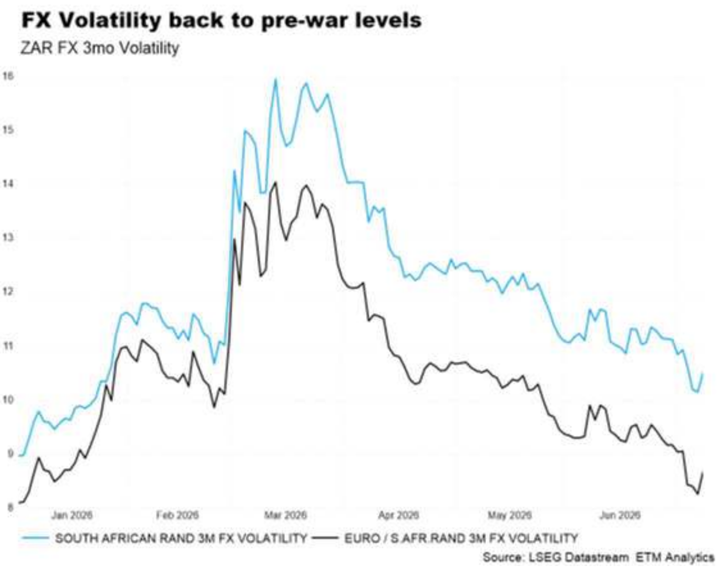
Instead, consolidation or depreciation is more likely over the next few months.

The ZAR enjoyed a strong tailwind from April 2025 until the onset of the war in Iran earlier this year, owing to market optimism about reform momentum, particularly the SARB's lowered inflation target and signs of intent regarding fiscal consolidation.

However, as illustrated in the adjacent chart, the ZAR is highly overvalued at current levels, to a degree that has been extremely difficult to sustain in the past.

The chart suggests that the USD-ZAR market would be more comfortable at levels north of 17.00. This is consistent with the lack of ZAR appreciation potential signalled by the ZSI and suggests that it has less to do with the US-Iran war and more to do with the stretched extent of past ZAR appreciation.

ZAR implied volatility levels have compressed to pre-war levels



Outright FX volatility for the ZAR has normalised significantly, keeping the ZAR carry trade alive and supporting the currency.

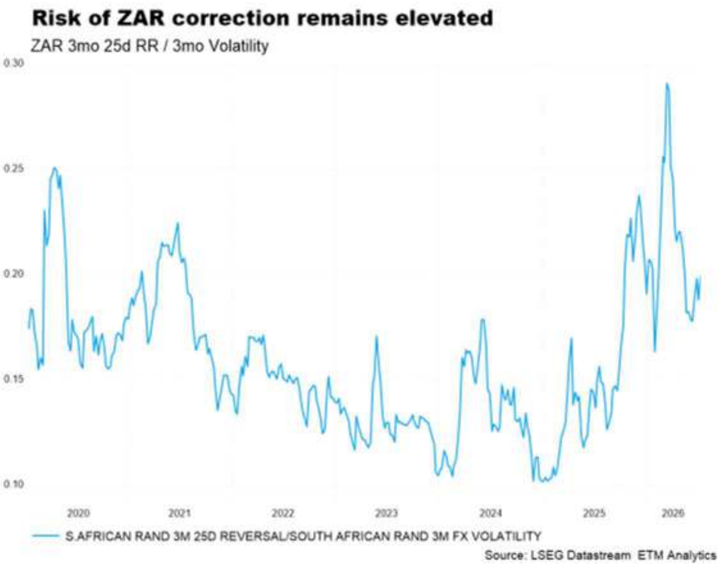
Three-month USD-ZAR implied volatility has fallen back towards pre-war levels after surging during the March shock, while EUR-ZAR volatility has also declined.

Fading geopolitical risk and favourable structural shifts, such as the SARB's lower inflation target, will help compress volatility levels.

This suggests that the market is no longer pricing persistent disorderly price action and remains relatively comfortable holding ZAR exposure.

The lower-volatility environment should continue to support demand for SA's attractive carry, although there is a notable contrast between subdued outright volatility and elevated downside skew that suggests a need for caution.

Risk Reversals reflect asymmetric risk profile



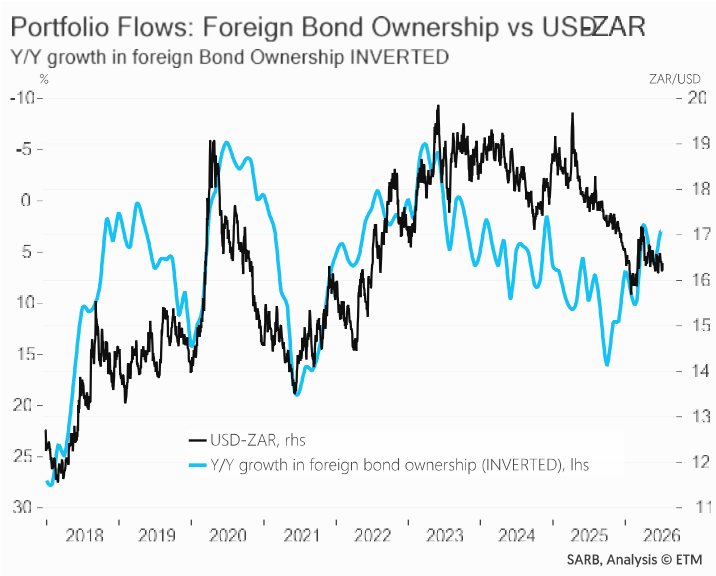
Risk reversals suggest that the risk of a ZAR correction remains elevated despite the currency's recent strength.

While outright 25D risk reversals have moderated in their level of ZAR bearishness, the three-month 25-delta risk-reversal-to-volatility ratio remains high by historical standards, even after easing from recent highs.

This indicates that investors are still paying a significant premium for protection against ZAR depreciation even as overall volatility levels decline.

While this does not imply that a reversal is imminent, it points to an increasingly asymmetric risk profile in which further ZAR appreciation may be gradual, while any deterioration in global risk appetite could produce a sharper correction.

Support from portfolio flows may start to wane



Meanwhile, foreign bond flows have provided an important fundamental underpinning for the ZAR rally, but the marginal impulse appears to be moderating.

The recovery in foreign ownership of South African bonds has broadly coincided with ZAR appreciation. This matters because the ZAR's recent strength has not been purely speculative or volatility-driven.

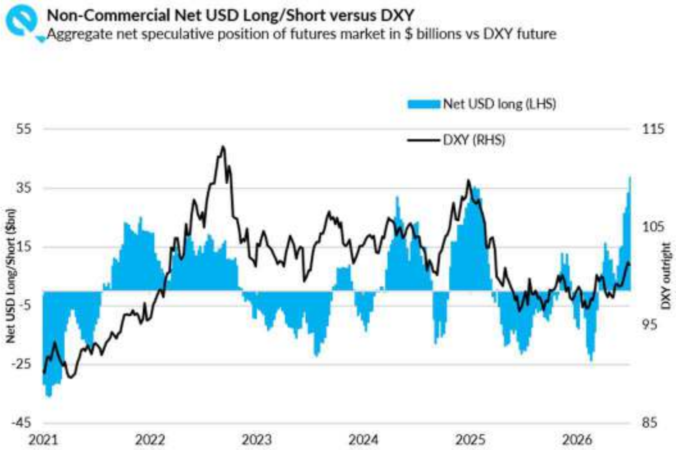
However, the latest easing in foreign-ownership growth suggests a loss of momentum in this support.

Overall, the ZAR remains fundamentally supported and tactically constructive, but the combination of slowing flow momentum and elevated downside hedging demand argues against aggressively chasing further appreciation.

Thus, there is an important difference between calling for a structurally weaker ZAR and warning against chasing ZAR strength. The charts do not currently suggest that sustained depreciation is inevitable. Falling volatility, positive carry and improved foreign bond participation remain meaningful supports.

However, the combination of slowing marginal portfolio inflows and persistently elevated downside skew suggests that the appreciation phase is maturing.

USD positioning turns most bullish since 2015

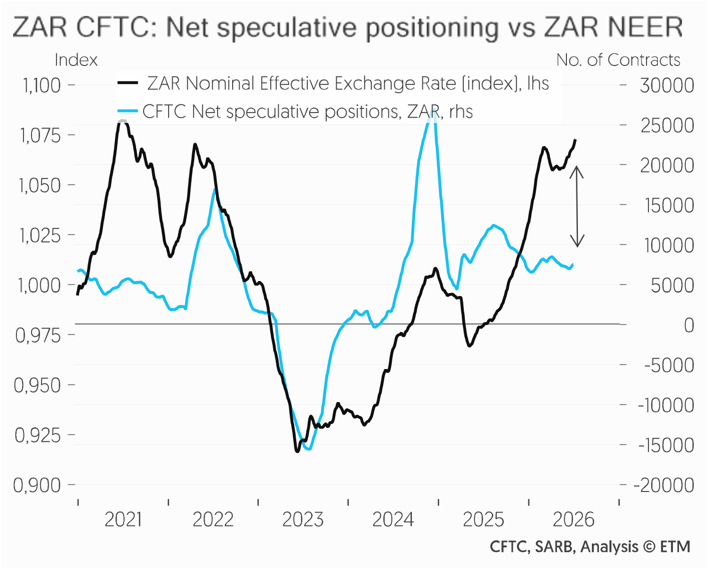


Building on the recent shift in USD sentiment, speculative positioning now points to a much stronger USD bias than prior to the outbreak of the war. Bullish USD bets have increased for a seventh consecutive week, rising by $5.26bn to $38.52bn, leaving positioning at its most bullish level since 2015.

The build-up in long USD exposure reflects a combination of hawkish Fed repricing, resilient US economic data and elevated Treasury yields. Fed Chair Kevin Warsh's emphasis on restoring inflation to the Fed's 2% target and minutes from his first FOMC meeting revealed a more hawkish tone.

This reinforced expectations that US interest rates will remain higher for longer, widening the USD's yield advantage over most major currencies.

Fundamentals continue to underpin the ZAR



Applying the same framework to the ZAR provides insight into the ZAR's underlying drivers. The trade-weighted ZAR NEER remains out of sync with speculative ZAR positioning, suggesting the ZAR should be weaker than it is.

This suggests that the ZAR is being supported by factors beyond short-term investor sentiment, including expectations that the SARB will maintain a relatively hawkish policy stance.

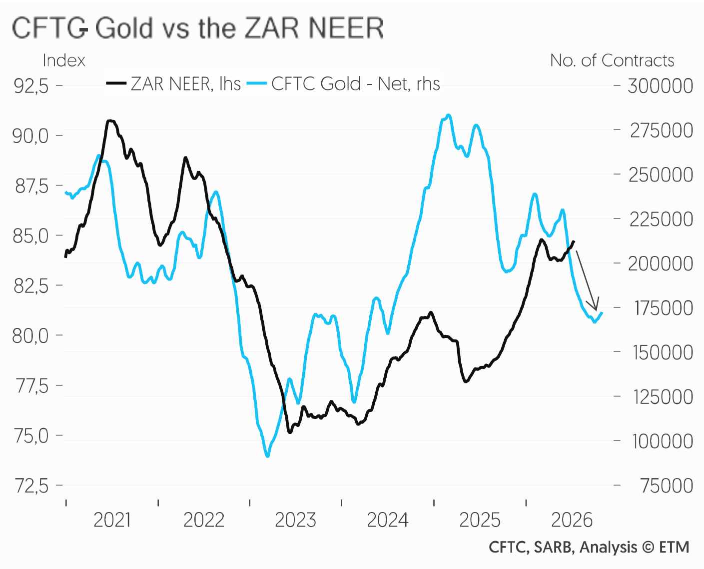
The market is pricing in a further 25bp SARB rate hike by year-end, helping sustain the ZAR's carry appeal despite a more hawkish Fed

Investors appear content to maintain existing ZAR exposure rather than adding materially to long positions.

At the same time, the ZAR has demonstrated notable resilience in the face of a stronger USD, higher US Treasury yields and renewed geopolitical tensions in the Middle East, suggesting that underlying support has become increasingly fundamental rather than speculative.

This implies that, although the absence of a significant build-up in leveraged positions may limit the ZAR's short-term upside, it also reduces the risk of abrupt reversals associated with volatile hot-money flows, leaving the currency better supported by macroeconomic fundamentals than by speculative capital alone.

Speculative gold interest has moderated, but could recover with the end of the war in sight



Another notable development is that speculative long positioning in gold appears to have stabilised after a recent retreat.

While bullish positions remain well below the highs reached during the height of geopolitical tensions, the decline may have largely run its course.

The data suggests that selling pressure has eased and that speculative investors are no longer actively reducing exposure.

For SA, this is an important development. Elevated gold prices have been a key support for the country's terms of trade, export earnings and, ultimately, the ZAR. The stabilisation in speculative gold positioning suggests that this important tailwind for the ZAR has not disappeared.

Looking ahead, the direction of gold prices will remain an important determinant of the ZAR's performance. Should geopolitical tensions ease further and investors rotate decisively into risk assets, gold may struggle to generate another strong leg higher.

However, with speculative positioning no longer being unwound and structural demand from central banks remaining robust, the gold market retains the potential to provide continued support to SA's external position.