Viewpoint: Higher For Longer: Can The ZAR Carry On?

TreasuryONE Optimising Your Cash Flows

etm ANALYTICS

Key points

- Higher developed-market rates increase the return available in lower-risk markets, narrowing South Africa's relative yield advantage at the margin. At the same time, further BoJ normalisation raises the cost of JPY funding and increases the risk that a stronger JPY triggers an unwind of leveraged carry positions, which could result in broader EM FX selling and higher ZAR volatility.
- Consequently, the SARB needs to maintain a restrictive policy stance and may need to tighten further if elevated energy prices feed into broader inflation pressures, helping to preserve the ZAR's relative yield advantage even as domestic growth remains weak.

BASELINE VIEW: The global backdrop is becoming more challenging for the ZAR as developed-market rates move higher, oil prices remain elevated and the BoJ gradually reduces the availability of cheap JPY funding. This may limit the scope for sustained ZAR appreciation, particularly if higher volatility triggers an unwind of carry positions. Domestically, the SARB is likely to retain a restrictive stance and could tighten further if energy prices generate broader inflation pressures, helping preserve the ZAR's yield advantage. Our baseline therefore remains continued support from carry and domestic reforms, but with higher vulnerability to global risk-off episodes and sharper position unwinds.

Global central banks tightening monetary policy

The global monetary policy environment has shifted markedly as the escalation of the Middle East conflict and higher energy prices have renewed inflation pressures, interrupting the global easing cycle. At the same time, weakening economic growth and elevated global bond yields are complicating the policy outlook. With higher yields already tightening financial conditions, central banks face an increasingly difficult balance between containing renewed inflation pressures and avoiding an unnecessarily sharp slowdown in economic activity.

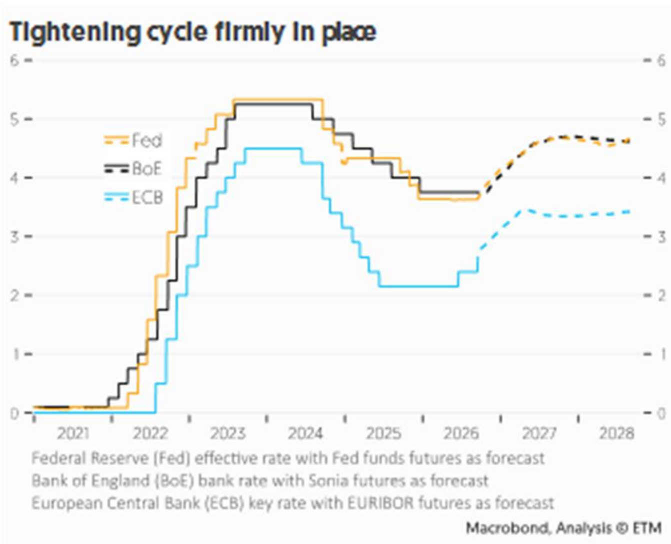
The Fed reinforced the shift towards tighter policy this week, raising the federal funds target range by 25bp to 3.75%-4.00%. While softer growth and elevated bond yields may argue for caution, resilient domestic spending and persistent inflation have given the Fed sufficient scope to tighten policy. The extent of any further tightening will depend on whether inflation pressures remain elevated as economic momentum slows.

The ECB has also changed course, raising policy rates by 25bp last week, linking the move to renewed inflation pressures from the Middle East conflict. Slightly stronger growth gives the ECB room to tighten further should inflation pressures persist.

The BoE kept its Bank Rate unchanged at 3.75% this week but delivered a notably more hawkish signal, with three MPC members favouring an immediate 25bp hike. While weak domestic demand argues for caution, persistent energy prices and second-round effects could prompt a hike in November.

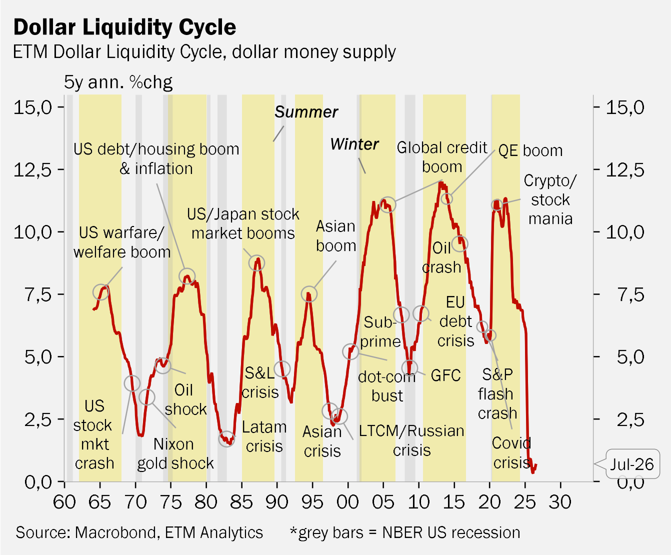
Finally, the BoJ raised its policy rate by 25bp to 1.25%, the highest in three decades and the fastest pace of policy normalisation since 1990. However, the widely anticipated move provided little support to the JPY, with USD-JPY trading back towards 157 following the decision. The 7-2 vote and absence of significantly more hawkish forward guidance also limited expectations for an accelerated tightening cycle, with Governor Ueda continuing to make further hikes conditional on the inflation and economic outlook. Crucially, the move does little to close the still-wide interest-rate differential with the US as further Fed rate hikes are expected.

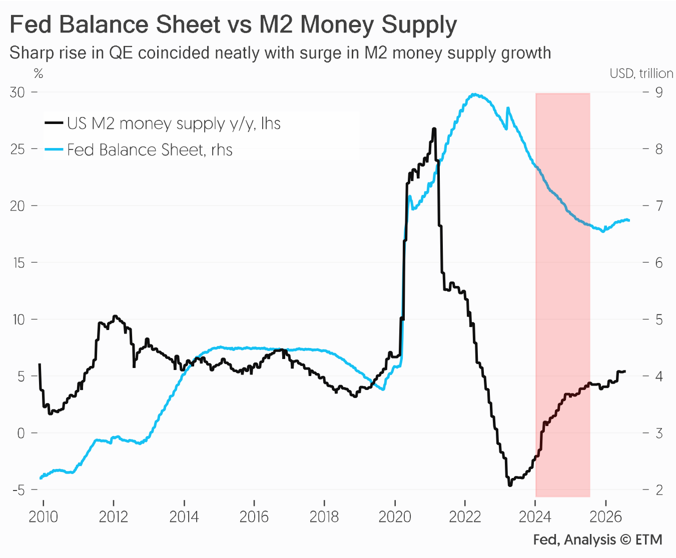
Higher rates are likely to persist



The accompanying chart shows how the market expects interest rates to continue to rise. Specifically, Fed and BoE policy rates are expected to reach around the mid-4% area in 2027, while ECB rates are also expected to rise. This matters for financial markets because currencies continue to respond strongly to relative interest rates and expected policy trajectories. For example, the expected Fed-ECB policy differential is an important driver of EUR-USD and broader USD direction. That relationship remains relevant, although the picture is now more complicated as several major central banks respond simultaneously to a common inflation shock. Higher policy rates also increase the hurdle for capital to move into emerging markets. Investors need sufficient compensation for taking on additional currency and credit risk when developed markets offer comparatively attractive returns.

Global liquidity conditions remain challenging



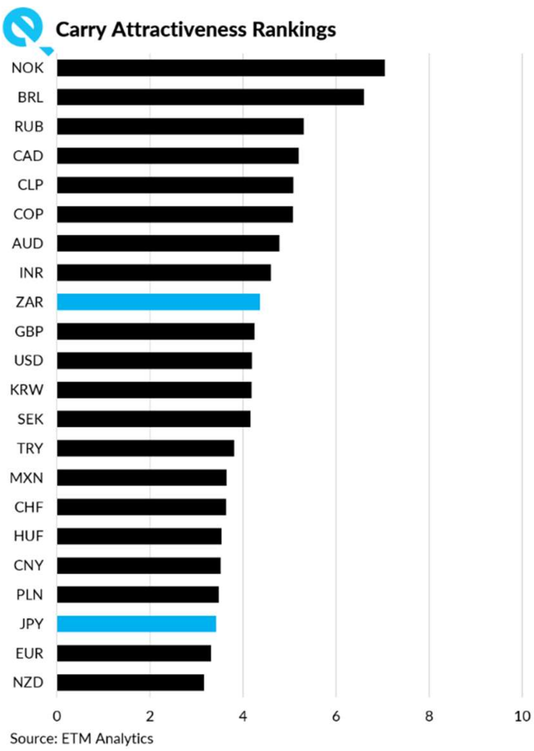


Another complication for the financial market outlook is that global dollar liquidity conditions remain tight as central banks tighten monetary policy. The accompanying chart is one of ETM's key tools for assessing the financial markets' outlook. It tracks the ebb and flow of global dollar liquidity, a key underlying driver of global asset prices and risk appetite. Peaks in global dollar liquidity correspond with prosperous periods, while troughs coincide with financial market downturns dating back to the 1960s.

The recent marginal uptick in the dollar liquidity indicator suggests that low dollar liquidity may start to stabilise. However, the indicator remains historically low and therefore reinforces the notion of a thin investment pool. For higher-beta emerging-market currencies such as the ZAR, this matters because abundant dollar liquidity typically increases investors' capacity and willingness to allocate capital to higher-yielding, higher-risk assets. Conversely, when liquidity is scarce, capital tends to become more selective and emerging-market currencies become more sensitive to changes in global yields, volatility and risk appetite.

The combination of restrictive interest rates and low liquidity is therefore particularly challenging. Higher developed-market yields increase the return available on lower-risk assets at precisely the time that the pool of global liquidity available to seek returns elsewhere remains constrained. This raises the hurdle for capital to flow into emerging markets and means attractive carry alone may not be sufficient to generate sustained ZAR appreciation.

If money growth continues to recover in the US, some of the negative effects of higher policy rates could be absorbed. The risk is that renewed monetary tightening eventually starts suppressing money and credit growth again. If that occurs, markets will face the more difficult combination of high interest rates, elevated energy prices, and low liquidity. Indeed, tentative signs already suggest that the recovery in US money-supply growth may be starting to level off, reinforcing the risk that renewed monetary tightening could further constrain liquidity.

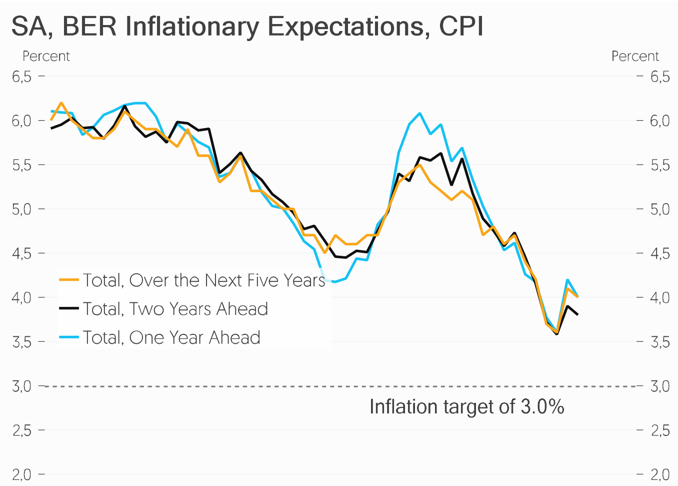


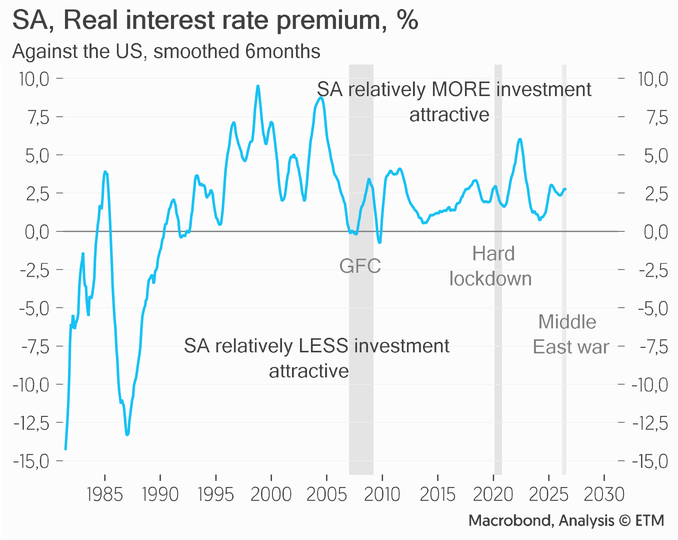
JPY-funded carry trades remain relevant for the ZAR

JPY positioning underwent a dramatic reversal in the week ending 8 September according to CFTC data, with speculators covering $8.14bn of bearish exposure and moving from a $7.25bn net short to a $0.88bn net long. The swing coincided with USD-JPY falling from above 160 toward 155 as expectations for a September BoJ hike intensified and investors unwound crowded JPY-funded carry trades. However, developments since the reporting period suggest this shift may prove temporary. Despite the BoJ subsequently raising rates by 25bp to 1.25%, the absence of significantly more hawkish forward guidance, alongside the Fed's 25bp hike, has seen USD-JPY rebound towards 158.

The persistence of a wide US-Japan interest-rate differential means the JPY is likely to remain an important global funding currency despite the BoJ's normalisation cycle. This raises the prospect that speculative JPY shorts could begin rebuilding as volatility settles, particularly if markets conclude that BoJ normalisation will remain gradual. This has implications well beyond Japan. Low-cost JPY funding has historically financed positions in higher-yielding assets, including emerging-market currencies such as the ZAR. For the ZAR specifically, a rebuilding of JPY-funded carry trades could provide some support by encouraging renewed demand for higher-yielding emerging-market currencies. Conversely, further BoJ tightening, renewed intervention or another sharp appreciation in the JPY could trigger another carry-trade unwind, adding to ZAR volatility independently of South Africa's domestic fundamentals.

Does the SARB need to respond?





The global backdrop has become more challenging for ZAR carry, although it is not uniformly negative. Fed and BoJ hikes, alongside the BoE's hawkish hold, raise funding costs and improve returns on lower-risk assets, reducing South Africa's relative yield advantage unless domestic rates rise in tandem. Elevated oil prices compound these pressures through South Africa's import bill and inflation outlook.

The SARB's priority is to anchor inflation expectations, which remain above its 3% inflation target and prevent energy costs and currency weakness from feeding into broader price pressures. This argues for maintaining restrictive policy and tightening further if evidence of second-round effects strengthens, despite weak domestic growth. Markets already anticipate higher rates, with the ZARONIA OIS curve pricing in roughly 40bp worth of hikes over the next six months.

For the ZAR, delivering the anticipated tightening would help preserve its interest-rate advantage, although much of that support is already priced in. A more hawkish outcome could strengthen carry demand if it reinforces confidence in the inflation outlook, while less tightening than expected could leave the currency exposed, particularly if inflation remains elevated and if developed market central banks keep tightening further.

Carry attractiveness depends on the yield differential relative to exchange-rate volatility. Credible SARB policy could help contain volatility, but a sharp ZAR depreciation, higher structural EM FX volatility due to tighter financial conditions, or an unwind of JPY-funded positions could quickly expose ZAR vulnerability. Carry therefore remains a source of support, but with its durability increasingly dependent on policy credibility and orderly global markets.

SARB prudence should limit potential ZAR depreciation

Global monetary conditions are expected to remain restrictive, with higher developed-market rates, elevated energy prices and low dollar liquidity limiting support for emerging-market assets. For South Africa, this keeps the SARB biased towards holding rates high or tightening further, needed to preserve the ZAR's carry appeal. JPY-funded carry trades could provide additional support, but the ZAR remains vulnerable to higher global yields, any renewed JPY appreciation, and broader risk aversion as the Middle East war continues. Carry should therefore offer some support if the global environment puts the ZAR under pressure, helping to limit the extent of the depreciation.

Analyst(s):

Lloyd Miller

Laura Campbell

Get in touch with us!

research@etmanalytics.com