

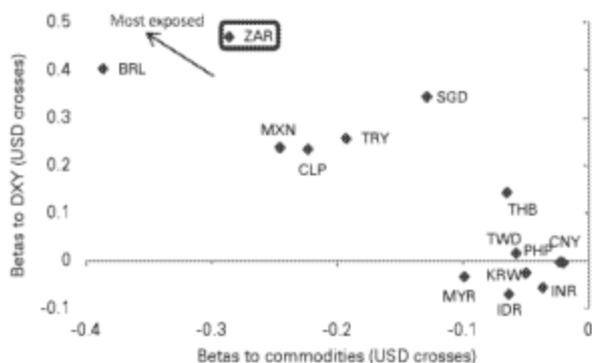


Theme #5: Zar Wars: the return of Yuan solo – buy USD/ZAR

■ The rand was one of the worst performing currencies in 2015. We remain pessimistic for 2016, as ZAR continues to face major headwinds from external factors (Fed, commodities, China) and domestic risks (lack of growth, structural problems, political uncertainty, current account deficit). Stay long USD/ZAR.

Fed and commodities: We expect the broad dollar uptrend to remain intact this year as the focus turns to the timing of the next hike and the possibility of faster-than-expected Fed normalization. This is bad news for the rand, which has one of the highest betas in EM to dollar strength. Moreover, broad dollar strength, along with dwindling demand and persistent oversupply issues, will continue to drive commodities weakness in the coming year. According to our Commodities research team, the outlook for metals is particularly pessimistic, and we have some way to go before calling a bottom to the cycle. This again is bad news for the rand, given South Africa's reliance on both precious and industrial metals exports.

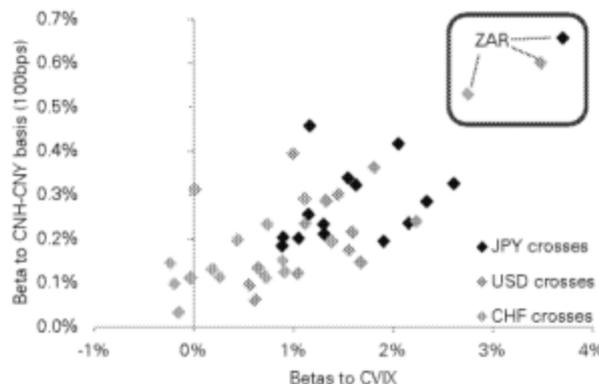
ZAR is among the most exposed in EM: high beta to broad dollar strength and to commodities weakness



Source: Deutsche Bank, Haver Analytics

China is arguably the most critical external risk factor for 2016. First, potentially weaker growth in China, and growth rebalanced towards consumption rather than commodity-intensive investment, will have a particularly bearish impact on the price of metals (China is the major global consumer). Iron ore is of particular concern – China consumes nearly 60% of the world's iron ore, which is a major South African export. Second, South Africa's direct trade links with China are substantial. Third, ZAR is the most vulnerable currency to general EM FX volatility and a widening of the CNH-CNY basis that would accompany noise around any 'disorderly' yuan depreciation (see chart below). The Chinese authorities' recent shift in focus towards a RMB basket has added further uncertainty, and has increased the prospect of USDCNY upside.

Spikes in CVIX and CNH-CNY basis are associated with substantial ZAR depreciation vs. all three 'risk off' currencies (USD, CHF, JPY)



Source: Deutsche Bank, Bloomberg Finance LP, Note: CVIX is DB's currency volatility index

Several reasons on the domestic front to be bearish
External imbalances: South Africa's external financing requirements are high. Sticky and high demand for imported goods keeps the C/A deficit elevated (-4% of GDP), while the low level of fx reserves (<100% of short-term external debt + C/A deficit) provides little protection against rand depreciation. ZAR is therefore particularly exposed to external shocks and tightening global liquidity conditions (e.g. through QT or a hawkish Fed).

Domestic economy slowdown: GDP growth is weak, and DB Economics expects a meager 1% expansion in 2016, with a further scaling back of capital investment likely. Business and consumer confidence are also at multi-year lows. There is no respite on the horizon: corporate profits are in recession, the business cycle downswing is expected to intensify in 2016, a major drought is underway and global growth is anemic.

Structural roadblocks: These cyclical problems are compounded by structural issues which are an impediment to growth but are difficult to rectify in the near term. Electricity shortages persist, and are estimated to subtract 1pp from annual growth. Unemployment is entrenched above 25% and there is a constant threat of large-scale labour strikes.

Monetary policy is unlikely to provide a backstop to rand weakness in 2016. The SARB's hands are somewhat tied – it can hike rates to maintain interest rate differentials with the US and attempt to cap currency depreciation; however, it will be hiking into a major domestic economy downswing, which will likely only provide temporary rand support.