Daniel Mminele: Key financial market developments in South Africa

Remarks by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Financial Markets Department Annual Cocktail Function, Pretoria, 21 April 2016.

*   *   *

Good evening, Ladies and Gentlemen

It is once again an honour for me to welcome you to the annual cocktail of the Financial Markets Department (FMD). This cocktail is a small gesture from the South African Reserve Bank (Bank) to show appreciation for the good working relationship we have with you, our partners in the financial markets. These relationships are of critical importance to us, and we are keenly aware of the efforts you make in assisting us with our task of analysing and interpreting market events, executing our daily market operations, and the support you provide through various forums, such as the Financial Markets Liaison Group (FMLG), when it comes to formulating the rules that govern the functioning of our markets. Ensuring success in the execution of these activities is aimed at enhancing the effective functioning of our markets as well as their integrity and reputation, ultimately for the benefit of all market participants and society as a whole.

Central banks have been, for a number of years now, operating in a challenging and increasingly complex environment. Not only are some central banks implementing policy measures that have never been tested before, but increasingly, authorities in different countries are facing challenges that are becoming more diverse, and the implications of measures being implemented across different jurisdictions, and the effectiveness of policies, are becoming more difficult to assess. Many central banks may indeed yearn for less interesting times, as what they believed to be temporary unconventional measures, appear to be assuming more permanent characteristics.

As usual, my intent is to use this opportunity to provide you with an update on our views of key market developments. Consequently, there is no better place to start than a very brief reminder of the thoughts I presented last year. At that time, we believed there were four key factors that would dominate the outlook for our, and other emerging countries', financial markets in 2015, namely: the pace of normalisation in US interest rates, growth and monetary policy dynamics in the Eurozone, growth developments in China (and to a lesser extent in other emerging market countries), and the outlook for commodity prices. We also highlighted our concern that volatility in financial markets was likely to increase.

While this analysis seemed very reasonable in early March 2015, by the time we got to the third quarter, it had seemed that our fears may have been misplaced. Equity market volatility, as expressed by the VIX index, had declined from its highs of 21,0 in January 2015 to 12,0 in July 2015, before it increased rapidly to 40,7 in August 2015, following the devaluation of the Renminbi by the Peoples Bank of China. After this the VIX remained elevated, but nevertheless continued its declining trend. Volatility in the bond market had also subsided, albeit to a lesser extent. By and large, global markets had tracked sideways. The S&P 500 index in the US had hardly moved from the 2,100 level, and the US dollar index and Treasury bonds were range trading throughout the period.

In the domestic markets, things were not much different. The yield on the benchmark R186 bond had drifted slightly weaker, from below 8.0 per cent to around 8.25 per cent, and money market yields had also drifted higher. This slight deviation from trends in the US markets was not really a surprise as the Monetary Policy Committee had raised the repo rate by 50 basis points by July and the trade weighted rand had depreciated by around 4.5 per cent. The only sign of stress at that time was in the US market with the widening of high yielding and other corporate debt relative to Treasury yields. However, this was largely seen as a reflection of the impact of lower oil prices on the earnings of oil producers. It therefore appeared as if our concerns about a possible increase in market volatility may have similarly been misplaced.

But as has become such a regular feature of financial markets, things were not as benign as they seemed. The first real cracks on the global stage started to show with the sudden decline of the Chinese equity markets in June, when the Shanghai Composite Index declined by 32 per cent in less than a month, and a further 16.5 per cent by the end of August. Besides some modest weakness in our local equity market, South Africa seemed largely unscathed by these events.

Unfortunately, this relative stability in our markets was not to last. As we progressed through the third quarter, domestic factors started to have a negative effect on the price formulation in local assets and the market increasingly anticipated further ratings downgrades from the rating agencies. In this vein, South African asset prices, specifically bonds and foreign exchange, weakened in the latter months of the year as market participants became increasingly convinced that further negative ratings actions were imminent. Unfortunately, they were proven to be correct.

At this point, it is worth commenting on the interplay of different asset prices to get a better understanding of the nature of the market views. Here I would like to highlight the divergence in the pricing of cash interest rate assets versus their derivative counterparts. Specifically, from the fourth quarter of 2015, the spread of bond yields over swaps widened quite considerably. The benchmark R186 yield, which was trading around 15 basis points below its matched-maturity interest rate swap, weakened to nearly 30 basis points over the swap yield in early 2016. This effect was even more pronounced when one looks at longer maturity bonds. The swap spread of the 32-year R2048 bond has widened from less than 50 basis points to more than 130 basis points over the swap curve. Such pronounced weakening of bonds is of concern as the cost of funding for the government increases, but also, it seems to reflect a steady deterioration in 'real money' investor confidence as the bond curve has steepened sharply in relation to the swap curve. Similar price action was observed in the spread of South Africa's foreign currency yields and credit default swaps (CDS) spread when compared to emerging market averages (such as the JP Morgan Emerging Market Bond Index in the case of bond yields).

Price action in the rand appears to confirm this interpretation. For much of 2015, the rand was steady against its commodity and emerging market peers. However, by early 2016, it had depreciated meaningfully against these peers. By comparison, the JP Morgan Emerging Market Currency Index had depreciated 14,0 per cent from end-June 2015 to mid-January 2016, while the rand had declined 37 per cent against the US dollar!

As indicated, the rand was not the only currency to weaken during this period. Many emerging market and commodity currencies were on the back foot in reaction to poor economic data in China. In addition, market expectations for the US Federal Open Market Committee to increase its interest rate at the December meeting had risen sharply. To some extent, with the rand being viewed as a high-beta currency, whereby it trades in an exaggerated manner to its emerging market peers, the larger sell-off in the rand was to be expected in such an environment. However, local factors played a key role as Standard & Poor's, while affirming the country's credit rating, had revised the outlook on the rating to negative, a move that was not generally expected by the market. In addition, the changes in the Ministry of Finance shortly after the ratings action, drew an adverse reaction from the markets and contributed to further significant depreciation.

Since the low of the rand to the dollar at R16.87 on 18 January 2016, the rand has recovered considerably. By the close of business yesterday, the rand was trading at R14.21, an appreciation of 15.8 per cent against the dollar from the 18 January low. This strong appreciation in the rand was predominantly driven by global factors as the JP Morgan Emerging Market Currency Index had rallied 9.8 per cent over the same period. This rally was triggered by a more benign view in the market on the likely trajectory of interest rate increases in the US, unexpected policy stimulus in Europe and Japan, and improving economic data out of China. Portfolio flows to emerging markets, which had been negative in the second half of 2015 and early 2016, reversed into significant inflows in February and March. According to Institute of International Finance (IIF) data, portfolio flows into emerging markets totalled USD36,8 billion in March compared to the outflow of USD53,7 billion for the second half of 2015. In South Africa, portfolio inflow totalled USD1,6 billion in March compared to outflows of USD2,2 billion for the second half of 2015. However, local factors also played a role. The Budget delivered in February showed strong commitment to fiscal prudence, and the 75 basis points of interest rate increases by the Monetary Policy Committee in 2016 seemed to assure the market of the Bank's commitment to maintain price stability.

The recent strengthening of the rand is welcomed, following the sharp sell-off late last year. However, as the rand remains vulnerable to negative external and domestic factors, we will need to continue to monitor economic and financial developments in China as a key driver for commodity prices and emerging market currencies. Ongoing concerns about a shallow and hesitant global economic recovery (as again highlighted last week with the release of the IMF's World Economic Outlook) will also be a key factor. Also, the expected trajectory of the policy rate in the United States will be important, with there still being a significant discrepancy between expectations of policy makers when compared to those of market participants, and uncertainties arising from how the Fed will factor in what seems to be an increased sensitivity of policy makers to international developments. In addition, at this juncture the jury is still out on the likely effectiveness and impact of negative interest rates as a policy tool. Lastly, decisions by the credit rating agencies may have an important effect on asset prices in South Africa.

By this time, I am sure there is a need to replenish your refreshments, but before I conclude, allow me to take this opportunity, on a slightly different note, to announce that the Bank published its Official Gold and Foreign Exchange Reserves Management Investment Policy on its website today. The Investment Policy outlines the governance structures, roles and responsibilities pertaining to the reserves management operations. Our objective is to improve transparency around the reserves management and to align the Bank with global best practices.

Also, you will recall that we launched the department's newsletter, the *FMD Update*, last year, which provided a high-level review of the FMD operations and projects. Copies of the 2016 *FMD Update* are available here tonight, and you will also be able to find the newsletter on the Bank's website.

In conclusion, and to emphasise my comment at the start, the Bank extends its appreciation to market participants for their co-operation and support over the years and we look forward to continuing our positive interactions in the future. Last but not least, I would like to sincerely thank our financial markets team, under the leadership of Leon Myburgh, for the sterling work over the past year, for their dedication and commitment to the task. Thank you also to our staff at the Conference Centre for organising this event.

Thank you.