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ZAR – A volatile currency

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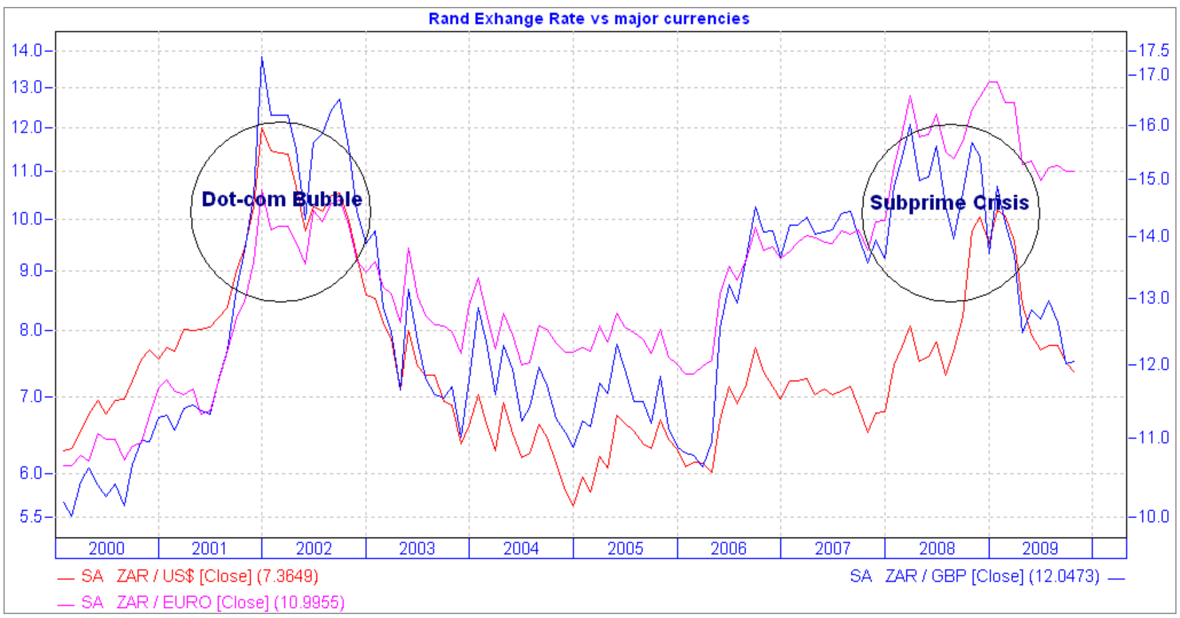
History has once again taught us that South Africa is part of the global village and is directly affected by global events. In times of uncertainty a volatile Rand is almost the only thing investors can be certain of. This can be deduced from the graph below. It illustrates the tendency of the Rand to weaken to extremely low levels in times of economic or market uncertainty. Currency volatility seems to be the order of the day, even after markets have bottomed-out.



Why is the currency so volatile and difficult to predict?

The movement of the Rand is influenced by an abundance of factors that are ever changing. In order to accurately forecast the direction of the Rand, the primary driving force behind the Rand needs to be identified. This, in itself, is a daunting task, as economists more often than not have conflicting views and seldom reach consensus when forecasting the fair value of the Rand.

In the past few weeks market participants have once again been surprised by the movement of the Rand. This time by the shear strength of the currency, resulting in it now being branded as overvalued. This recent Rand strength can, amongst other things, be attributed to dollar weakness, a strong recovery in the price of commodities, an improvement in global risk appetite and the wide interest rate differential between SA and the rest of the world.

Current concerns and the impact of the strong Rand:

A widespread concern has been voiced by multiple key individuals that South Africa is potentially on the verge of a currency dilemma. South Africa could potentially suffer a prolonged recession as a strong Rand prevents our exporters to take advantage of the subdued global recovery.

A number of economists have pointed out that a strong Rand has contributed to the disappointing and below expected manufacturing and mining data, mainly due to a collapse in exports. On the contrary, a strong Rand bodes well for imports. However, domestic sales figures remain at depressed levels as the South African consumer continues to struggle. This does not bode well for economic growth as these sectors form an integral part of South Africa's GDP.

From a consumers point of view a strong Rand is positive. It drives inflation lower which in turn increases consumer's real household income. However, the effect on the consumer will be lagged. Should interest rates remain low consumer spending (in the medium term) should recover, boosting domestic demand and economic growth.

Tito Mboweni, our reserve bank governor, has warned on various occasions that the Rand is too strong at current levels and will hamper economic recovery. Although the central bank's primary objective is inflation targeting rather than controlling the exchange rate, questions surrounding the SARB's policy towards the Rand have been raised again. While the SARB did not explicitly state any intervention, recent economic data suggests that monetary action has been taken in an attempt to curb the strong Rand. Treasury has been building foreign reserves through the selling of Rands. While this can be effective, it is extremely expensive especially in light of the risks to South Africa's medium-term fiscal position.

Monetary action in the form of interest rate cuts can also be undertaken to curb a strong currency. A rate cut will narrow the interest rate differential between SA and the rest of the world. Theoretically this will translate into less foreign capital inflows, which in turn will be supportive of a weaker currency. A weaker currency supports export volumes and this should lead to job creation as the economy expands. However, the desired effect is not always guaranteed. The currency does not always weaken in response to a cut in interest rates, as investors already anticipate higher economic growth.

However, irrespective of who predicts what, it should be evident that the Rand plays an integral role in the South African economy. It has enormous repercussions if it over- or undershoots its fair value which is unfortunately not an uncommon phenomenon, especially in times of uncertainty. To deliver sustainable growth a country ideally needs a fairly valued and competitively priced currency. This is partly why the reserve bank has so often been criticized in the past for not doing enough to create financial stability in South Africa.

So what does it mean for the investor?

Extreme volatility in the Rand can translate into sizeable profits or losses over the short term and in turn increase the risk in your portfolio. Your asset manager should essentially be able to successfully tap into offshore investing opportunities for better diversification in your portfolio, but at the same time limit the inherent currency risk. It is a fine balance and extremely difficult to achieve, especially in the shorter term.

As an example, Glacier Research conducts a quarterly survey (commonly known as the Bull and Bear report), which collates the performance expectations of leading South African asset managers over the coming 12 months. According to this survey, the majority of managers indicated that the Rand is currently overvalued and a Rand/Dollar level closer to R8 should be expected over the following few months. Not one of the eight managers predicted a Rand/Dollar exchange rate below R7.50. This could potentially lead to the offshore component of a balanced portfolio detracting from performance in the short term due to the Rand's continued strength. Investors should however remember that any investment view (good offshore investment opportunities combined with a weaker rand) takes time to play itself out. Investor's should caution against placing too much emphasis on the short term and remember that the patient and disciplined investor will be rewarded handsomely in the long term.

References

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Financial Mail, 2009, "What's the ideal level?"