

## US interest rates: how they'll affect SA

As long term investors, we need to ignore high-frequency economic data and short term forecasts. There will always be market or media pundits predicting or forecasting the next big crash or stock market meltdown. And in the words of the Oracle of Omaha, aka Warren Buffet – “*market forecasters will fill your ear but will never fill your wallet*”.

One of the major business cycle drivers in the world is the US GDP growth and the US interest rate cycle. It is well known and publicised that the US is growing (albeit below its long term average) and the prospect of higher interest rates in the world's largest economy could come this year has already sent the dollar surging against most currencies, including the South African Rand.

The question is, what will happen to South African interest rates when the US Fed starts to raise interest rates?

### SA's current account deficit

South Africa is running a current account deficit, ie, South Africa has less net foreign assets than liabilities (importing more goods/services than it is exporting) or to put it another way... “the country is living outside of its means”. A current account deficit is not inherently bad, for example if a country uses external debt to finance investments that have a higher return than the interest rate on the debt, it can remain solvent. If a country is unlikely to cover the current debt levels with future revenue streams, it may become insolvent (Zimbabwe is a good example).

South Africa is unfortunately not using this external debt to finance investments but that is a topic for another day....

As mentioned, South Africa is running a current account deficit and this deficit is financed through foreign capital flows. So as long as these foreign capital flows continue to flow into a deficit economy (like South Africa), the current account deficit is maintained and the economy generally grows.

### The role of interest rates

If this foreign capital stops flowing into the country (for example the US hikes rates and makes US yielding or debt investments more attractive relative to SA), the South African Reserve Bank will have no choice but to raise interest rates in South Africa. The Reserve Bank Governor will be forced to raise interest rates in order to keep South African bonds and currency attractive enough for global investors not to pull their capital out in order to keep on financing the current account (as explained above).

There is a clear inverse relationship between interest rate changes and market movements. In very simple terms, interest rate changes have an impact on the market and its sectors; rising rates are bad and falling rates are good.

It is important to remember that it is not the “absolute” level of interest rates that counts but more the direction in which the interest rate is moving.

**“in the 13 of the 16 times the Federal Reserve of the US raised rates (since WW2), the market went into a pullback (negative 5%), a correction (negative 10%) or a bear market (negative 20%) in the six months before the increase began” – Sam Stovall**

It is extremely important to be mindful of the above-mentioned fact. Even though this data is relevant to the US stock market, this is most definitely applicable to our own market as the US is a massive driver of the

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JSE's All Share Index. The All Share Index has already retraced 5.57% since it reached its all-time high of 55,355 on the 24th of April 2015

### Markets are cyclical

All markets are cyclical. They go up, peak, go down and then bottom. When one cycle is finished, the next begins. The point of this commentary is not to be a "profit of doom" and to scare the reader into thinking that an imminent correction or bear market is on its way. But rather to inform the reader that the one thing we can say with absolute certainty in financial markets is that the "existence of cycles" is real.

We have to be aware of these cycles, corrections and pullbacks so that when they do happen, we remind ourselves that the markets cannot be timed, that we need to be emotionally strong when markets inevitably overreact (on both the up and the downside) and that we have to keep investing throughout the cycle.

So remember - *"Bulls make money and Bears make headlines"* –Anonymous

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