OFFSHORE SERIES:

Are you compensated sufficiently for the risk of holding your financial assets in South Africa?

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In Article 2 of the Offshore Series, we highlighted that the Rand has lost a cumulative -43% against the US dollar over the past 10 years. This equates to an annual average deprecation of -6.1%, which is more than double the average inflation differential of -2.6% over the same period – and reflects the additional risk the market attributed to holding Rands. In this article Analytics Consulting FX Solutions examine, in simple terms, whether South African investors have been compensated for the loss of purchasing power associated with holding Rands.

The level of interest rates is designed to not only control inflation, but also provide investors with an appropriate return that compensates them for the risk of holding their assets in a particular currency.

From a South African perspective this means that the Reserve Bank needs to keep the level of domestic interest rates significantly above the prevailing interest rate in the United States. The question is does the level of interest rates in South Africa fully compensate South African investors for the additional risk associated with the Rand?

To answer the question, we have examined the return on cash deposits over various time periods where an investor simply deposited their Rands in a South African bank account versus holding their cash in a United States bank account. Effectively, this means we calculated the cumulative return of holding R1 million on deposit in a South African bank account versus converting the R1 million into dollars at the relevant prevailing exchange rate and then holding that investment on deposit in a United States bank account.
To calculate the relevant deposit rate, we simply used the annual average of the daily Repo Rate for South Africa as well as the annual average of the daily Federal Funds Reference Rate for the United States. We made no adjustment for any tax implications or tax structures.

Table 1: Benefit of holding US dollars

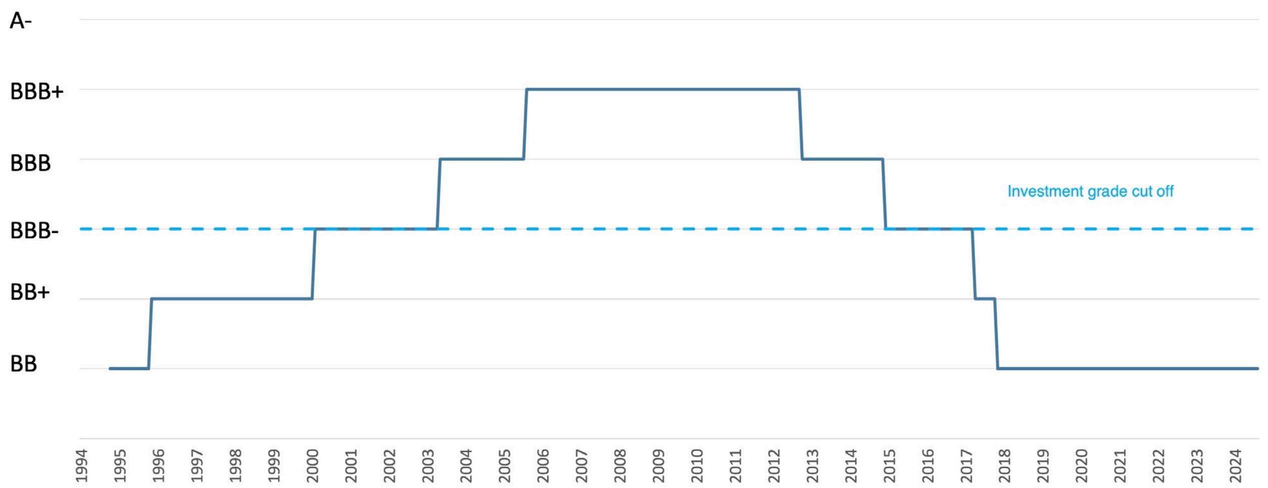
Bank Account	3 years ago	5 years ago	10 years ago	12 years ago	14 years ago
Initial Deposit 1 000 000	Deposit return Since 2021	Deposit return Since 2019	Deposit return Since 2014	Deposit return Since 2012	Deposit return Since 2010
Rand	1,174,080	1,306,468	1,778,899	1,966,389	2,216,816
Rand worth of USD	1,331,268	1,395,053	1,978,956	2,257,702	2,832,216
Difference	157,188	88,585	200,057	291,313	615,400
Percentage gain	13.39	6.78	11.25	14.81	27.76

The table above highlights that if you deposited R1 million into a South African bank account 10 years ago, it would have been worth R1.78m at the end of 2023. However, if you had converted your R1 million into US dollars 10 years ago and deposited it into a US bank account, it would be worth R1.98m at the exchange rate that prevailed at the end of 2023. This indicates that holding dollar assets outperformed the equivalent South African assets by a total of 11.25% over a ten-year period, which is meaningful. Clearly the extent of the outperformance varies depending on the time period selected, but in essence the higher interest rate in South Africa has not fully compensated local investors for the risk associated with holding Rand.

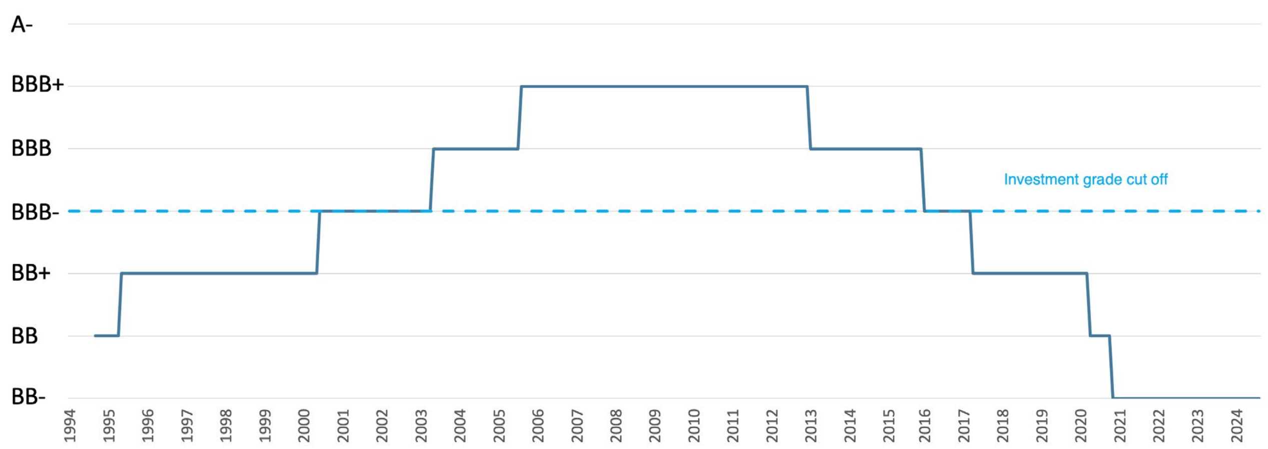
This result is not especially surprising if you consider all the factors South African investors endured during the past 10 years (economic and political uncertainty, severe electricity outages, the impact of COVID, etc.), it could have been considerably worse. It can be argued that the Reserve Bank could have maintained a slightly higher interest rate over the period to reflect the increased South African perceived risks, but this would have added further downward pressure on the South African economy and might have added significant unintended consequences. Overall, the choice of whether to hold your funds in Rands or US dollars appears to hinge on whether the risk attributed to the country is commensurate or in line with the interest rate differentials between the two countries.

It is also important to highlight that the result of this analysis would have been different had we included a time when the South African economy was performing significantly better, and the risks associated with investing in South Africa were diminishing. This is crudely illustrated by the fact that from 1994 to 2012 the Rand depreciated by an annual average of only -3.4% while the Repo rate averaged 11%. At the same time South Africa's credit rating was being revised systematically higher or was maintained at an elevated level. In contrast, the Rand declined by an average annual of -5.5% from 2014 to 2023 with a Repo rate average of 6.0% and a credit rate that was being revised systematically lower.

Credit rating by S&P
South Africa



Credit rating by Fitch
South Africa



Sovereign credit rating by Moody's
South Africa

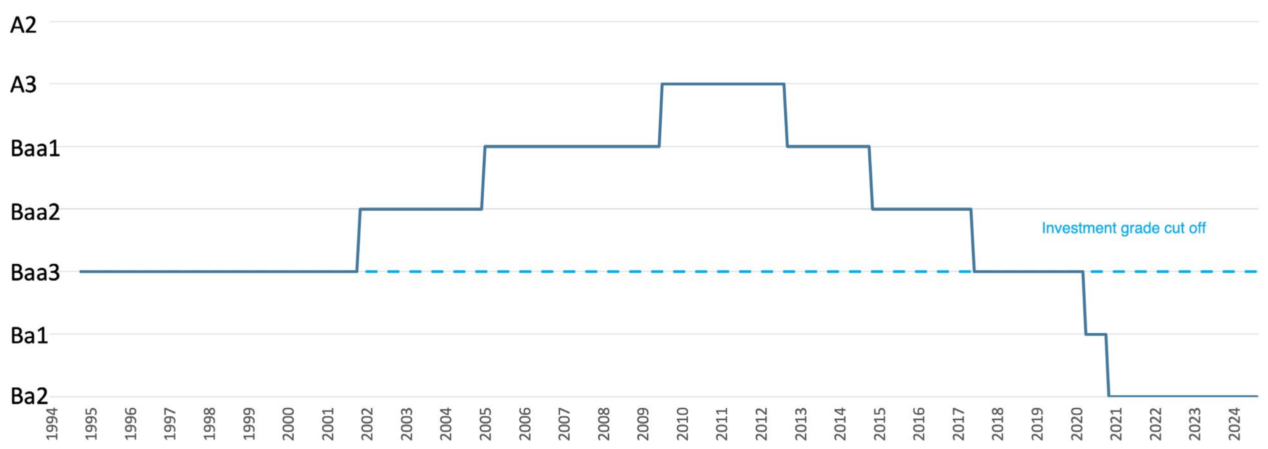


Table 2: Taking account of step changes in the economy

Bank Account	5 years ago	10 years ago	12 years ago	14 years ago	15 years ago
Initial Deposit 1 000 000	Since 2019	Since 2014	Since 2012	Since 2010	Since GFC
Rand	1,306,468	1,778,898	1,966,388	2,216,815	2,392,149
Rand worth of USD	1,395,053	1,978,956	2,257,702	2,832,216	2,267,616
Difference	88,585	200,057	291,313	615,400	-124,533
Percentage gain	6.78	11.25	14.81	27.76	-5.21

More positively, now that South Africa has formed a Government of National Unity, the risk associated with South Africa have started to abate. We have therefore provided various scenarios below for the investor to consider based on their economic outlook for South Africa.

Possible scenarios

Neutral approach to South Africa – risk reflects interest rate differentials over the next 5 years

If you believe that SA will steadily implement key policy reforms that lift South Africa's GDP performance in a measured and sustainable manner, it would be advisable to have a mix of South African and offshore assets. In this case, the outlook for the Rand would not be a major consideration, but rather one of many factors that would include growth opportunities, valuations, and the need for diversification.

Positive approach to South Africa

If you believe the country will get overwhelmingly better over the next 5 years, a local portfolio would be expected to generate better returns than offshore assets, especially considering that most South African assets (including equities, bonds, and property) are relatively undervalued. In the extreme case, investors may even look to repatriate a sizeable portion of their offshore assets in favour of local opportunities. However, South African residents must be mindful of the limited opportunity to externalise a portion of their portfolio with prevailing exchange control regulations.

Bearish approach to South Africa

If you believe the current policy reform process will fade and prove relatively ineffective, disappointing, and underwhelming. Under these circumstances the negative risk perception about South Africa would persist and investors would be better off holding a higher weight of offshore assets even at current valuations.

Conclusion

On balance, given the set of risks that have prevailed over the past 10 years, investors would have been better off having more money offshore than locally. A 5% to 10% return differential over 10 years is meaningful, especially considering that the differential would increase substantially if the assets were invested in the US equity or bond market rather than a simple deposit account.

It is very encouraging that since the National Election on 29 May 2024 investor sentiment in South Africa has risen significantly, helped by an improvement in electricity production, an easing of inflation, heightened expectations of interest rate cuts, and the embracing of private/public partnership as the best way to rejuvenate South Africa's ailing infrastructure. Under this circumstance it is unsurprising that the South African equity market recently achieved a record high, and the Rand strengthened to below R18.00/$. But will the improvement be sustained?

The degree of international exposure depends on your risk appetite, and your perception of SA's political risk premium. Investors also must be mindful of the limited opportunity to globalise South African assets given the prevailing exchange control regulations. Analytics Consulting FX Solutions provides its FX Partners with ongoing analysis of currency trends and perspectives for their clients looking to invest offshore.

Analytics Consulting FX Solutions partners with wealth managers to assist their clients with efficient, cost-effective, and bespoke currency solutions for all clients. AC FX Solutions leverages its collective institutional scale to disarm all pricing ladders associated with international transactions.

Source: Analytics Consulting FX Solutions

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