

OFFSHORE SERIES: The benefits of a more stable currency

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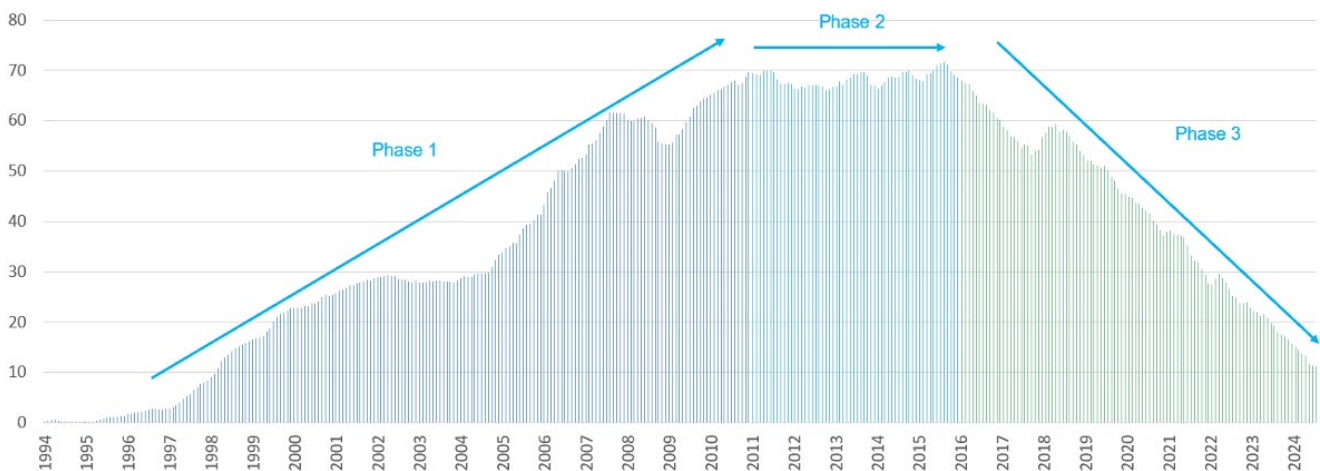
ARTICLE 4 | 18 SEPTEMBER 2024

Introduction

In Article 3, we discussed whether the level of South African interest rates compensated investors for the risk of holding South African financial assets relative to holding the equivalent Dollar assets. In this Article we show that the perception of risk associated with South African assets has diminished, albeit over a relatively short period since the National Election at the end of May 2024.

A detailed analysis of the daily volatility of the Rand/Dollar exchange rate from the beginning of June to the end of August each year since 2016 reveals that the most recent three-month period (June to August 2024) represents the Rand's lowest level of volatility and highest level of persistent gains in nine years. We chose 2016 as our starting point, given the clear deterioration in the perception of South Africa after that year, as reflected in the net cumulative foreign buying of South African equities shown in the chart below.

Chart 1: Net cumulative foreign buying of SA equities
\$ billion



Source: STANLIB, SARB

A meaningful improvement in the level of optimism regarding South Africa's economic prospects

Given that financial market volatility is almost always an indication of uncertainty and risk, the more reduced level of volatility coupled with sustained strength suggests that the Rand's performance since the National Election on 29 May 2024 has been underpinned by a meaningful improvement in the level of optimism regarding South Africa's economic prospects. Alternatively, had the Rand strengthened since the election, but remained extremely volatile, it would have reflected opportunistic and speculative activity on the back of sustained high levels of uncertainty and risk aversion.

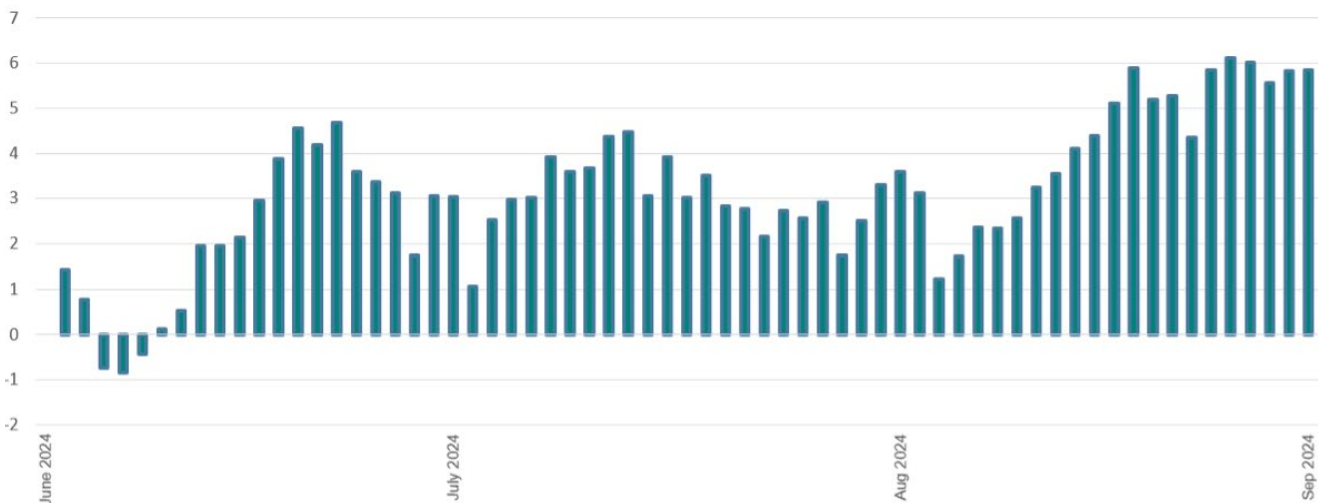
Table 1 alongside illustrates that recent Rand strength has been accompanied by improved currency stability relative to prior years. It is important to highlight that prior to 2016, the Rand did experience more regular phases of strength, which were accompanied by reduced volatility. In general, these phases were helped by an improved economic and policy backdrop relative to the years from 2016 to 2023.

Table 1: The difference between the average daily loss and the average daily gain
For the period end May to end August per year

Year	Ave Daily Loss	Ave Daily Gain	Difference
2016	-1.23	1.09	-1.32
2017	-0.59	0.68	-1.26
2018	-1.15	0.57	-1.72
2019	-0.77	0.58	-1.35
2020	-0.79	0.82	-1.61
2021	-0.72	0.64	-1.35
2022	-0.80	0.64	-1.44
2023	-0.85	0.81	-1.65
2024	-0.68	0.57	-1.25

Source: Analytics Consulting FX Solutions, Macrobond.

Chart 2: Rand cumulative gain/loss against the US Dollar
For the period end May to end August 2024



Source: Analytics Consulting FX Solutions, Macrobond

Why is currency stability important?

A relatively high degree of currency volatility is extremely helpful for investors as well as the household sector, business community and government policy officials such as the Reserve Bank. While it can be argued that some currency traders/speculators could benefit from the increased uncertainty, there is no doubt the currency stability improves and is reinforced by economic stability.

For business owners, a volatile exchange rate has a negative impact on budgeting, pricing strategy, inventory levels and competitiveness, which ultimately undermines confidence. While some of this risk can be mitigated by disciplined hedging strategies, this adds a layer of cost, complexity and administration that distracts management from the core focus of their business.

For policy makers, such as the South African Reserve Bank, the task of keeping inflation inside the target range is undermined by a volatile exchange rate, while for the National Treasury, a volatile currency can substantially disrupt their budgeting process, especially when it negatively impacts their debt repayment schedule.

Critically, currency stability can become self-reinforcing. For example, if the currency is relatively stable for an extended period, then businesses and the household sector start to change their approach to undertaking offshore transactions and are less likely to "over-react", both in terms of delaying foreign currency inflows as well as accelerating currency outflows if the currency weakens/strengthens unexpectedly (the so-called "leads and lags" which reinforces much of South Africa's excess currency volatility).

For investors, gauging the appropriate level of offshore assets in a diversified portfolio is a constant challenge. This is aggravated by sharp fluctuations in the currency that can trigger the need to rebalance the portfolio on an a much more regular basis. This adds additional costs and can disrupt the fund manager's endeavors to achieve a smooth investment return profile.

The Rand remains vulnerable to an increased risk premium

A relatively stable currency can help market participants to estimate future cash flows as well as future debt repayments and investment returns. This is especially true if the currency depreciates mostly in line with the inflation differentials. Table 2 below outlines the Rand's potential performances against four major currencies in 10 years' time. We have used the current Analytics Currency Decoder's estimate of fair value as a starting point (not current market) as the Decoder fair value eliminates volatility and non-US Dollar effects. We then applied the expected inflation differentials based on the current inflation targets. The table highlights the impact of the country's risk premium applied, given that each person can have their own perception of SA's political risk premium:

Column A reflects our expectation on the currency value in 10 years' time if you assume that SA's historical risk premium disappears. While this would be a welcome outlook, it is unlikely to materialize given SA's historical volatility.

Column B illustrates the currency value in 10 years' time if we apply the risk premiums that have prevailed over the previous 10 years. This is a fairly realistic assessment of the outlook given that while SA's Rand has been more stable recently, the time frame is not long enough to be confident that that stability can persist over the coming years.

Column C assumes that the risk premium deteriorates by 50% which results in a weaker exchange rate. In order to simplify the calculation, we have used the implied risk premium from the Rand versus the US dollar across all currency pairs. (The rate of depreciation of Rand against the US dollar exceeds the inflation differentials by a certain percentage and this percentage is the implied risk premium associated with South Africa). This provides an indication of the order of magnitude that one could anticipate.

While the risk premium is unlikely to disappear entirely, an improvement in South Africa's economic fundamentals could at least reduce the risk premium giving us a currency forecast that exists somewhere between Column A and Column B.

Table 2: Projections of Rand values in 10 years' time based on historic and adjusted risk premiums

Currency Pair	Currency Decoder Estimated Fair Value Starting Point	Column A	Column B	Column C
		Bullish	Neutral	Bearish
		No Risk Premium	Past 10 Year Risk Premium	Double Risk Premium
ZARUSD	17.57	22.63	22.63	37.61
ZAREUR	19.18	24.70	25.64	41.06
ZARGBP	21.16	27.25	25.58	45.29
ZARAUD	12.76	15.94	16.37	26.45

Source: Analytics Consulting FX Solutions, Macrobond, Decoder Values - Dr Lance Vogel.

Conclusion

South Africa has enjoyed a three-month phase of improved currency stability that has been brought about by the Government of National Unity (GNU) and the uplift in economic sentiment. This demonstrates that if South Africa can maintain a more stable political environment that is focused on lifting economic growth performance, then one of the benefits could be a less volatile currency that helps all economic participants.

Historically, the Rand has attracted a risk premium that has resulted in the currency weakening by more than the inflation differentials. The risk premium has reflected the political and policy uncertainty that has persisted since 1994.

A GNU that is focused on improved economic growth and the inclusion of the private sector could lead to a reduction in South Africa's currency risk premium resulting in both an improvement in currency stability but also a moderation in the rate of depreciation.

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Source: Analytics Consulting FX Solutions

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