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DECEMBER 2020

RAND TRENDS OVER THE LONG-TERM

Irrespective of short term moves in the Rand, the Rand is expected to weaken on a long-term basis

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Analytics Consulting FX Solutions seeks to provide the most efficient and cost-effective currency solutions for all clients. These may be individuals, institutions, corporates, international trade companies, wealth managers and family offices. AC FX Solutions is able to leverage its collective institutional scale for superior pricing power and downstream operational efficiencies across all clients regardless of transaction size

Sources:
Kevin Lings, *The Missing Piece*, Published Pan McMillan 2014
Charts, Data, Forecasts: Kevin Lings, Chief Economist, STANLIB

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RAND TRENDS OVER THE LONG-TERM

While it is important to be aware of short term trends in the value of the Rand in order to try and maximise the value of international transactions, it is also useful to be mindful of the Rand's long-term behaviour.

Critically, over the past few decades, the Rand has exhibited three key characteristics that appear likely to continue in the years ahead, namely:

- On a relative basis, the Rand is a fairly highly traded and liquid currency, which means that pricing is readily available. This tends to attract a disproportionally larger number of foreign currency speculators.
- The Rand tends to be a volatile currency. This volatility is a by-product of the liquidity that is available and the ease at which foreign investors can speculate in the currency. The Rand offers speculators a well-regulated market, with transparent pricing, conflict resolution mechanisms, favorable market hours and language, all providing a platform for trading confidence. Many analysts regard the Rand as a proxy for developments in emerging markets, which highlights that the Rand often weakens or strengthens due to factors that are largely unrelated to domestic economic conditions.
- The Rand tends to be structurally weak. In other worlds, the Rand tends to weaken by more than the inflation differentials between its major trading partners. This structural weakness if often referred to a "political risk premium" or "policy uncertainty premium".

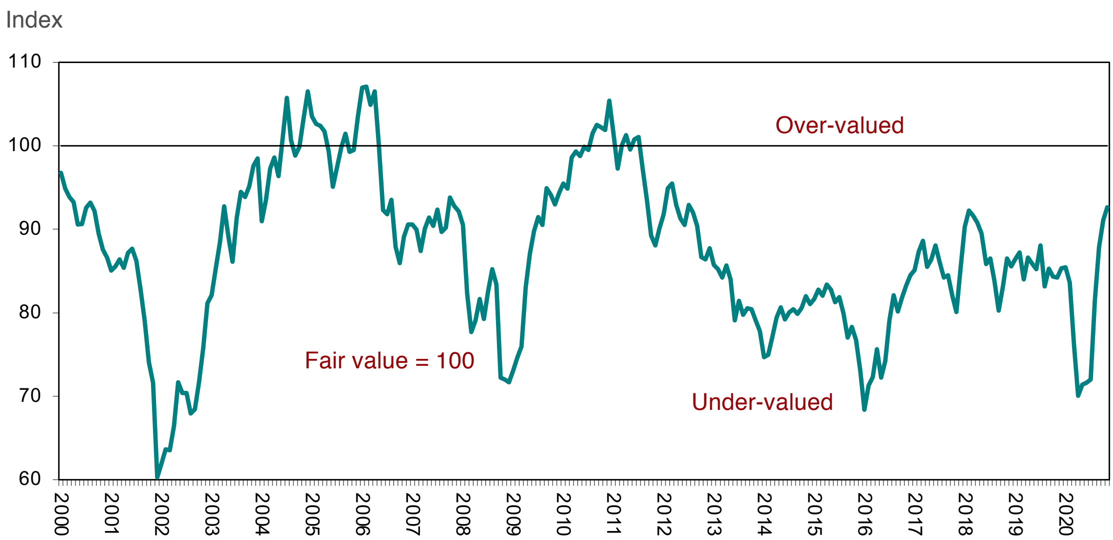
"It is naive to believe that the Rand can, or should, maintain its value against the major global currencies, such as the dollar, over time. This is because South Africa's inflation rate tends to be higher than the inflation rate in the major developed countries, such as the US. The simplest economic model used to explain the movements of any exchange rate over time is the idea of purchasing power parity (PPP). In essence, the PPP model argues that the value of one currency will depreciate against another currency in line with the difference in inflation between the two countries. So, for example, if South Africa's inflation rate is 6% and the inflation rate in the US is 2%, then the rand should fall by 4% a year against the dollar to maintain the currency's relative purchasing power. In theory, this would ensure that R100 buys as much in South Africa as R100 worth of dollars buys in the US. Consequently, in order for the rand to remain stable against the dollar, South Africa's inflation rate would have to fall to around 2%, and then be maintained at that level for a considerable period. This is highly unlikely given that South Africa's fiscal authorities have set an inflation target of 3% to 6% and appear willing to manage the inflation rate mainly through changes in interest rates. Significantly reducing the inflation rate to 2% would probably, at least at the outset, entail much higher interest rates." Kevin Lings, *The Missing Piece*, 2014.

It, therefore, seems fair to argue that in the ideal world, the Rand would be expected to decline in-line with the inflation differentials.

Currently, most Rand fair-value models (including from the SA Reserve Bank) reflect the fact that the rand is undervalued. The extent of the undervaluation varies depending on the specifics of the fair value model, but in general during April 2020 when the Rand was trading at around R19.00/$ the local currency was around 20% to 25% undervalued. However, at R15.50/$ the Rand is estimated to be only around 4% to 8% undervalued.

The trade weighted Rand is measured against a basket of South Africa's major trading partners. The 100 level reflects fair-value based on inflation differentials. The chart below reflects that the trade-weighted Rand is, in fact, very seldom at fair value or stronger. In other words, over the long-term the Rand has a tendency to remain somewhat undervalued. So, while the chart shows that the Rand is technically still undervalued, once you take account of the political risk premium associated with South Africa, it can be argued that the Rand is currently fairly close to fair-value or perhaps only moderately undervalued.

South Africa real effective (trade-weighted) exchange rate

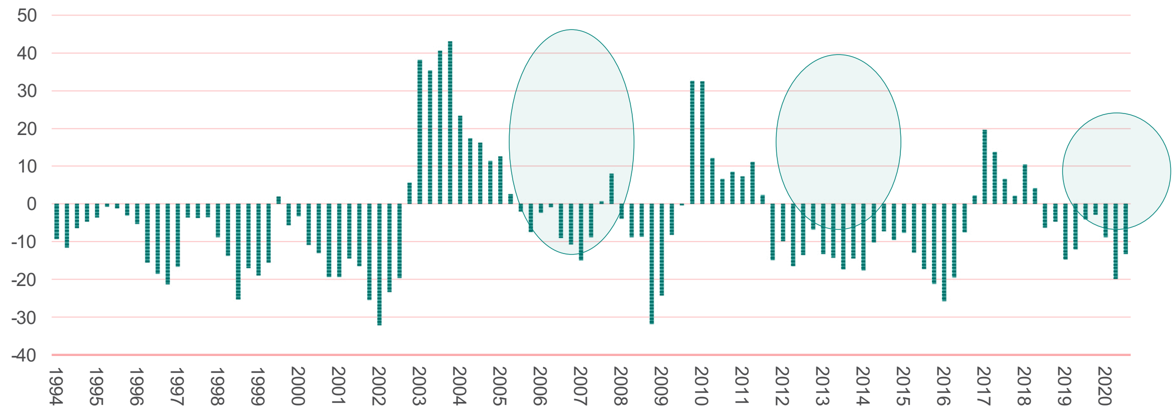


RAND TRENDS OVER THE LONG-TERM

Interestingly, over the long-term (15 years), the Rand has traded at fair-value or stronger only around 12% of the time. This structural weakness appears to be equivalent to around 2% in excess of the inflation differential on an annual basis. This does not mean that the Rand cannot remain relatively strong for considerable periods, it just suggests that the currency has a bias to the downside that typically exceeds the inflation differential.

SA Rand per US Dollar

Rand per Dollar, % year-on-year (since 1994)



Distribution of the Rand vs US Dollar annual performance since 1960:

Percentage change y/y

Out of last 61 years
Rand weakened in 39 of the years
Rand strengthened in 22 of the years

Over -25	-25 to -20	-20 to -15	-15 to -10	-10 to -5	-5 to 0	0 to 5	5 to 10	10 - 15	15 to 20	Over 20
2015	1996	2013	2018	2014	2012	2019	1979	2017	2004	2009
2008	1985	2011	2006	1999	1999	2007		2016	1986	2003
2001	1981	2000	2005	1991	1997	1978		2010	1973	2002
1984	1975	1998	1993	1989	1995	1977		1987		
		1988	1983	1971	1994	1976		1980		
			1982		1990	1969				
					1974	1967				
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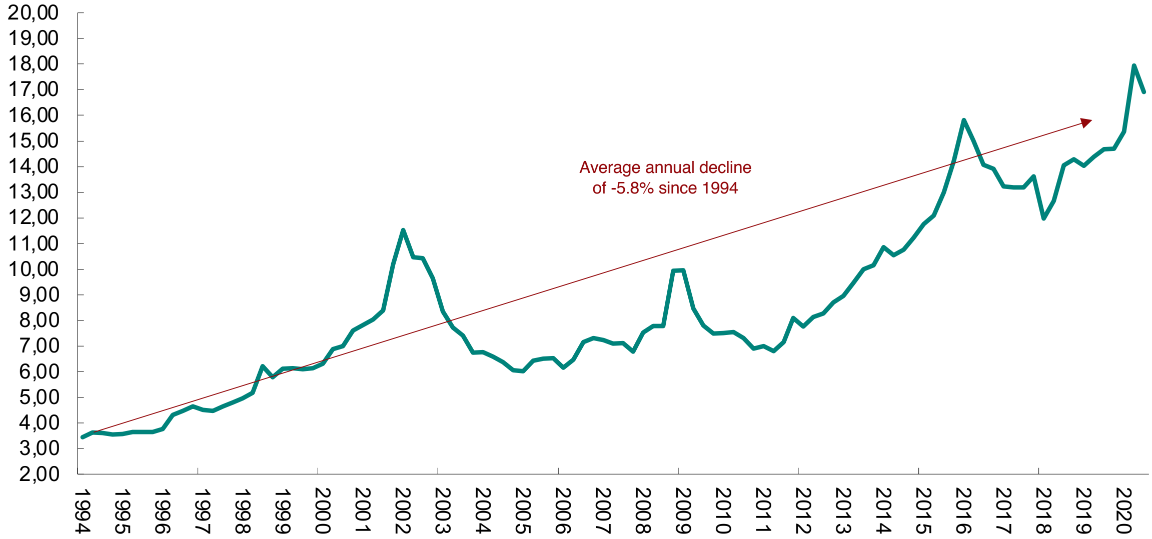
					1963					
					1962					

An analysis done in May 2020 showed that over a full 10 year period, South Africans had lost a third of their international purchasing power. During that period, the SA Rand declined by 56.5% against the US Dollar. Or vice versa, the US Dollar has gained 129.8% against the SA Rand. Over the same period, consumer inflation rose by a cumulative 63.6%, slowing noticeably in the past 2 years despite significant currency weakness. Unfortunately, even if your salary had kept pace with inflation over the full 10-year period, you would be 30% worse off in US dollar terms. In other words, South African households lost 30% of their international purchasing power in 10 years if they simply kept all their assets, especially investment assets, in South Africa.

RAND TRENDS OVER THE LONG-TERM

SA Rand per US Dollar, % change year on year

SA Rand per US Dollar (Since 1994)



South Africa's current economic fundamentals suggest that this trend is likely to continue over the next ten years. This does not mean that the Rand will weaken by more than inflation each month or even each year, but it does suggest that over the next ten years, the value of the Rand is most likely to have, once-again, depreciated by more than inflation.

Furthermore, it seems clear that over the past two years the Rand has systematically become more vulnerable to bouts of weakness. This vulnerability stems from the fact that foreign investors have systematically reduced their holdings of both South Africa equities as well as government bonds since March 2018.

As at September 2020, foreigners had sold R270 billion worth of SA bonds and equities in the prior 12 months (fairly evenly split between bonds and equities). R270bn is more than enough to ensure that the Rand keeps weakening even though the country is running an exceptionally large trade surplus. This portfolio disinvestment can be attributed to concerns about South Africa's sustained weak economic growth, the deterioration in fiscal balances, and more recently exacerbated by the impact of COVID-19, the exclusion of SA from the World Government Bond Index (WGBI) and the recent credit rating adjustments. In order for South Africa to manage the vulnerability of the currency,

South Africa would need to find a way to lift economic growth, but in a manner that simultaneously encourages foreign portfolio investment back into the country.

CONCLUSION

Generally, most currency market participants have grown to accept that the rand has a tendency to weaken by more than the inflation differentials. Forecasting the Rand in the short-term (3, 6 -12 months) would entail taking into account how economic conditions may change, namely seasonal factors, some specific capital flow factors, global sentiment towards emerging markets, how risk parameters around the world are going to change and interest rate changes. Beyond 12-18 months, these factors play less of a role. This is when one must look at inflation differentials as a guide to currency direction, and in South Africa's case, one would need to price in an element of risk premium. This is would suggest that the Rand can be expected to depreciate by around 4% to 5% a year.

In prior years, South Africa's inflation rate has tended to average around 6%. More recently, however, the inflation rate has moderated to an average of around 4.5%. At the same, the inflation rate in most other countries has also remained extremely subdued. In fact, currently, the inflation rate in emerging markets tends to average 4% to 5%, while in developed economies it tends to be around 1% to 2%. Consequently, South Africa's trade weighted inflation differential can be estimated at around 3% (biased 60% to developed market inflation and 40% to emerging market inflation including China, being a large trading partner). Adding a political risk premium of 1% to 2% would suggest a weakening of 4% to 5% per year as a rough guide as to the likely path for the Rand over the long term.

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On balance, in the short term the Rand appears fairly well supported. Under these circumstances the Rand may trade around R15.50/$ or close to fair value for several months, However, as the country's growth rate begins to improve in 2021, South Africa will tend to draw in more imports, which is likely to result in some downward pressure on Rand. There are no major government policy announcements expected in November and December, which means that the next policy focal point is the opening of parliament as well as the National Budget in February 2021.

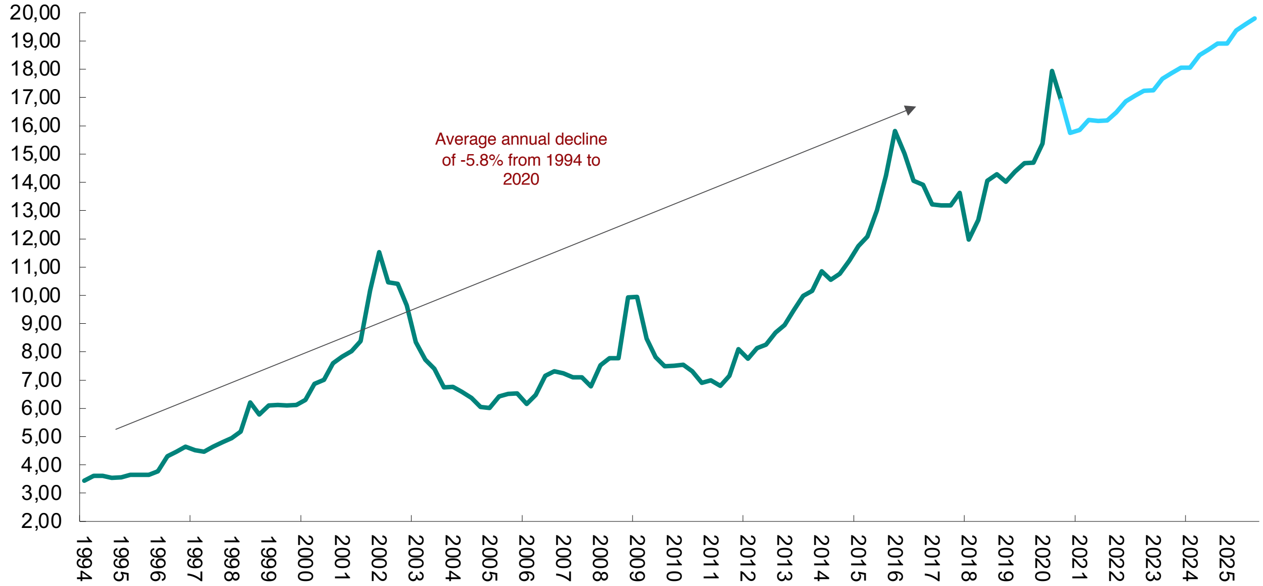
Unfortunately, concerns regarding government's progress in implementing fiscal reforms could start to emerge around the time of next year's budget. This is likely to be exacerbated by the need for Government to negotiate its next multi-year wage agreement, while at the same time starting to focus on the local Government elections, which are due to take place around the middle of 2021.

Consequently, the Rand is expected to weaken somewhat during the first half of 2021, possibly returning to levels of around R16.20/$ by mid to end 2021 and R17.25/$ end 2022 (STANLIB).

Lastly, the Rand is currently fairly close to fair value, certainly relative to where it was earlier this year. It is therefore appropriate to use the PPP model as a guide in helping to determine to the long-term outlook for the Rand. Beyond 2022, returning to the inflation differentials plus a risk premium, forecasts stand at R18.06/$ end 2023, R18.91/$ end 2024 and R19.80/$ end 2025.(STANLIB).

Forecast SA Rand per US Dollar, % change year on year

SA Rand per US Dollar (Since 1994)



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