

Can the Rand strengthen further?

Few would have believed that five years after the midnight cabinet shuffle that we now know as NeneGate, the Rand would be trading at a stronger level. Back then, and many times in-between, it has seemed that all is lost. South Africa was doomed, and the decline could be measured by the steady fall in the currency. Yet here we are. Is this a flash in the pan, or something more substantial?



**Michael
Porter**

The Rand depreciated to almost R17/\$ after Finance Minister Nene was fired in December 2015, and then to over R19/\$ at the height of the lockdown last year. As usual, South Africans were scrambling to take their money offshore, regardless of the exchange rate. But such impulsive behaviour seldom proves to be the correct long-term decision. Twelve months after we entered lockdown, the Rand is

trading at R14.5/\$ - very much in line with the average rate that has prevailed since the start of 2016. Is this an aberration? It hardly seems possible. The question is: where to from here?

We have often made the point that investors ignore the fundamentals of the currency at their peril. It is easy to sit in SA and sink into a mire of depression after reading the local newspapers. It appears that there is nothing but bad news. Sentiment can influence the currency from day to day, but the longer-term trend will always be determined by the bigger, structural forces at play. This is where the trends are more encouraging.

There are three key factors supporting our currency.

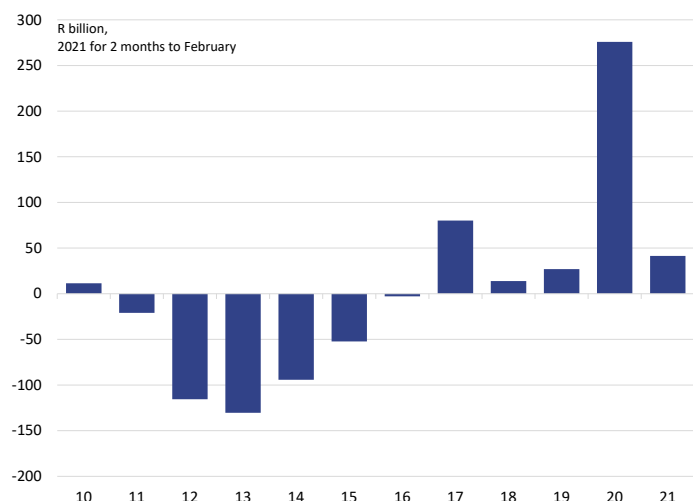
1. The trade account. This is simply a measure of our exports and imports. A trade surplus implies that we export more than we import, and vice versa. Study the chart below. For years we have run a trade deficit, meaning that we were importing more than we were exporting. The implication was that we were always on the back foot – having to buy more dollars to pay for imports than what we received in payment for our exports. That continual demand for dollars (and supply of rands) always exerted downward pressure on the exchange rate. However, in the past few years

SPEED READ

- The day-to-day level of the currency is influenced by a myriad of factors, including sentiment.
- But we have always argued that investors ignore the fundamentals at their peril. One cannot base decisions on sentiment alone.
- Contrary to local opinion, the medium-term trajectory depends on events in the US, not here.

that trend has changed. For the past four years we have recorded a trade surplus, and 2021 has started in the same vein. Now our exports far exceed our imports. The downward pressure on the currency has been alleviated, and indeed reversed.

SA TRADE BALANCE

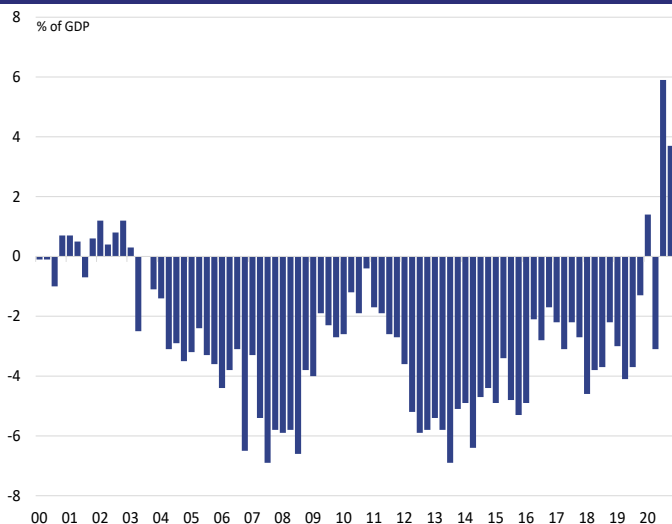


For years we recorded a trade deficit, but that trend has changed. We have now recorded a trade surplus for 4 years running, and 2021 has started in the same vein.

2. The current account. The current account incorporates

the trade account but includes payments for services as well, as well as other foreign currency flows, such as foreign investment into local investments and foreign direct investment. Once again, the chart below tells a story. The last time we had a surplus on our current account was in 2002. Ever since, we have recorded persistent, and often growing, deficits. Simply put, more money was leaving SA than coming in, again putting constant downward pressure on the exchange rate. Last year, that negative trend was reversed. For 3 out of the 4 quarters, we recorded a surplus, due to declining interest and dividend payments to foreign investors.

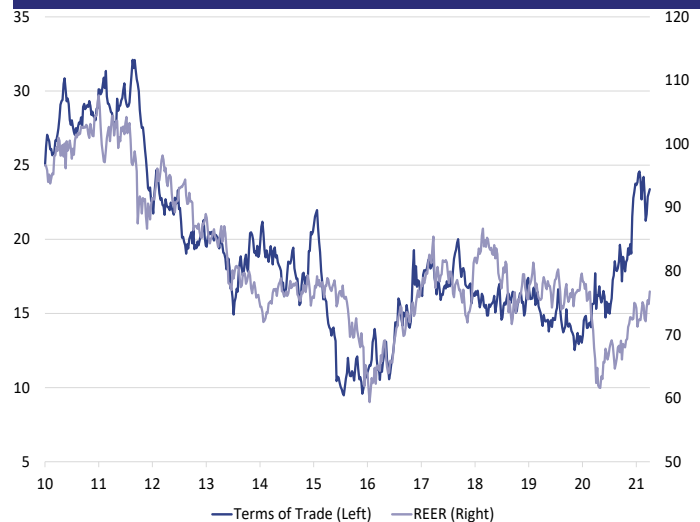
CURRENT ACCOUNT AS % OF GDP



We have seldom ever recorded a current account surplus, but we did so in three of the four quarters last year.

3. Our terms of trade. The question is whether the above can last and in this regard, our terms of trade are instructive. Terms of trade refer to the price of our exports relative to the price of our imports. When the prices of our exports are strong, the terms of trade improve, and vice versa. At present, commodity prices are soaring thanks to strong global growth. This is especially so for iron ore, coal, platinum, palladium, and gold – our key mineral exports. But agricultural prices are strong as well. At the same time, key import prices have risen (notably oil), but not by the same extent. Hence the improvement in our terms of trade. As the chart below shows, there is a close correlation between the terms of trade and the real effective exchange rate (the exchange rate adjusted for inflation differentials.) This chart suggests that all else being equal, the Rand has room to strengthen further.
4. This might sound too good to be true. What's the catch? Whilst the underlying fundamentals for the currency

TERMS OF TRADE VS REER



Improving terms of trade imply a stronger real effective exchange rate. The Rand has room to strengthen further given the trends in underlying commodity prices.

have improved, which implies a stronger exchange rate over the longer term, the medium-term outlook (next 6-12 months) all hinges on one factor – the trend in US government bond yields. At the peak of covid-related volatility last year, bond yields collapsed to a record low of 0.5%. At the time of writing, that same yield is now 1.75% on fears that strong GDP growth will result in rising inflation. The problem is that higher US interest rates spread like tentacles throughout the world. They suck money out of the periphery and back to the US. Why take risk in South African bonds when you can earn a decent income in the safety of US Treasuries? Yields in the US have risen from 1% to 1.75% over the past 8 weeks, a period that has seen a corresponding outflow from SA bonds by foreigners of R43 billion. A similar trend occurred in 2013 – a period now referred to as the “taper tantrum” when US yields started to normalize after the GFC and emerging market currencies experienced significant pressure. We don’t expect a similar reaction this time for all the reasons mentioned above. Structurally, our currency is now on a far firmer footing.

Provided that US yields stabilize, then we would expect a resumption of investment back into SA, for the fundamentals to reassert themselves, and for the Rand to appreciate accordingly. However, if US yields continue to rise, the Rand will weaken. That is why the world’s eyes are so firmly fixed on US inflation data. We may be in for a few interesting months, but remember not to make impulsive decisions. The Rand is not as doomed as it may often appear.



We are excited to announce the resumption of our seminar program in April. Our first seminar will remind investors of what we have endured over the past 12 months, and what lies ahead for the rest of 2021.

Please save the date below. Please note that due to Covid protocols, numbers are strictly limited to 100 per session, and only drinks (no food) will be served. Booking is therefore essential.



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Topic: **Exiting the Recession: what lies ahead?**

Natal Midlands

Date:	Wed 21st April
Venue:	Fernhill Hotel Midmar / Tweedie Road Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg

Date:	06 May 2021
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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