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Dawie's Notes

The Rand Conundrum

During the past few years much of my investment advice emphasised the importance of offshore investments. The normal reasons applied; diversification, policy uncertainty, political risks, and of course the exchange rate of the rand. We argued, correctly, that a number of factors were pointing to an imminent depreciation of the rand.

Issues such as slow growth, deteriorating fiscal accounts, likely downgrades, as well as political and social tensions and questionable political leadership, suggested that the rand could potentially depreciate significantly. In addition, international economic developments clearly favoured a stronger US$ and lower commodity prices; all factors that are and were rand negative.

Our R/$ forecast a year ago was the most bearish of all economists' (that I am aware off), yet even our negative view turned out to be far too optimistic; the rand's collapse by year-end was nothing less than theatrical. And that's where we are now. Many factors remain rand negative with the only real difference from a year ago being that the rand is now significantly weaker. Can our currency go even lower?

I don't know. What I do know is that investors often get sucked into the hysteria of a sliding asset only to regret their disinvestment decision when this asset rallies. It has happened in the past to the rand as well when many investors took their money "out" when the rand was at its weakest only to bring it "back" when the rand rebounded, making huge losses. Could this be another bear trap? Will the rand make a U-turn and surprise us all again? Maybe history can assist.

I have been doing exchange rate forecasts for decades and I have learned that I am not very good at it. My only consolation is that nobody seems to be very good at it either! But what I have noticed is that whenever the rand bombs out completely, like now, a sharp reversal usually follows. It is not easy to see these movements by looking at nominal exchange rates only, but a few tweaks here and there can make things a bit clearer.

Exchange rate theory is based on purchasing power. In simple terms, a weaker currency can export goods more competitively than a stronger currency. Eventually currencies'

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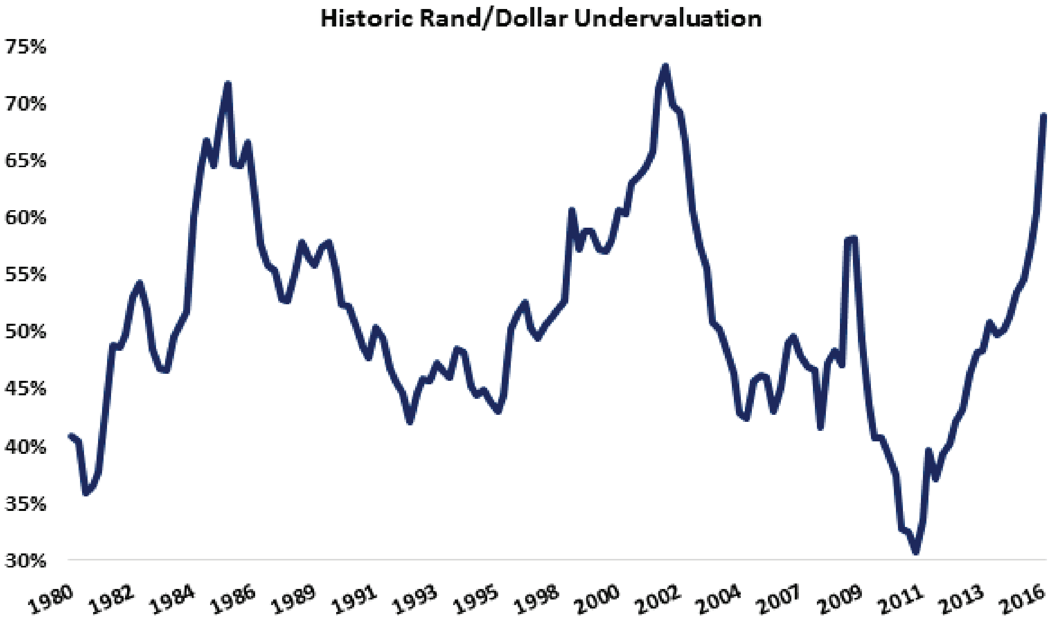
exchange rates will converge on purchasing power. This theory has been popularised by The Economist's Big Mac index where the over- or undervaluation of a currency is "calculated" by comparing the prices of Big Mac burgers in the various countries.

I have done the same but instead of a burger index, I used a more representative basket and calculated the rand's undervaluation to the US$ expressed as a percentage, see graph: I have decided to use the lowest intraday nominal exchange rate of the rand as the final data point, roughly R18, reached on 11 January 2016.

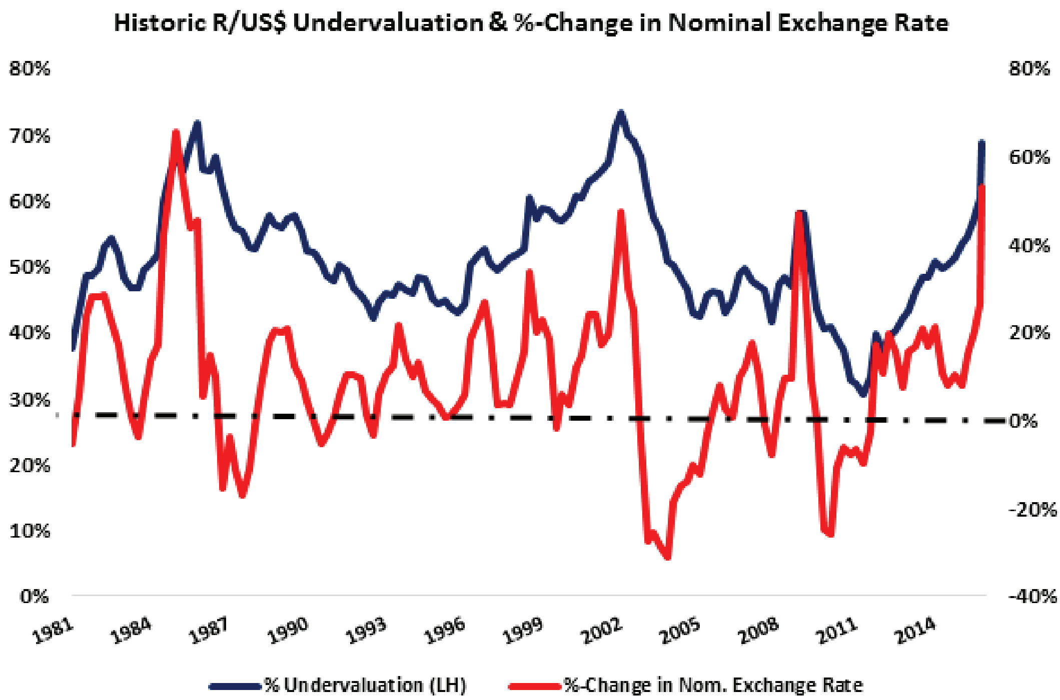


Now, this note is not intended to defend a particular economic theory. What I wanted to achieve is to get a sense of the extent of the rand's movement the past few months compared to historic changes.

Two factors are very important. The rand's percentage undervaluation from this approach changes either if the nominal exchange rate itself changes, or if the percentage undervaluation changes because the rand becomes less (or more) undervalued due to the effect of inflation.

All this sounds very confusing. All I am saying is that the longer the rand remains "too" undervalued the more this value will become the "correct" value because inflation will eventually "catch-up".

The following graph is similar to the previous one but also includes a percentage change in the nominal R/$ graph, as per the right hand axis:



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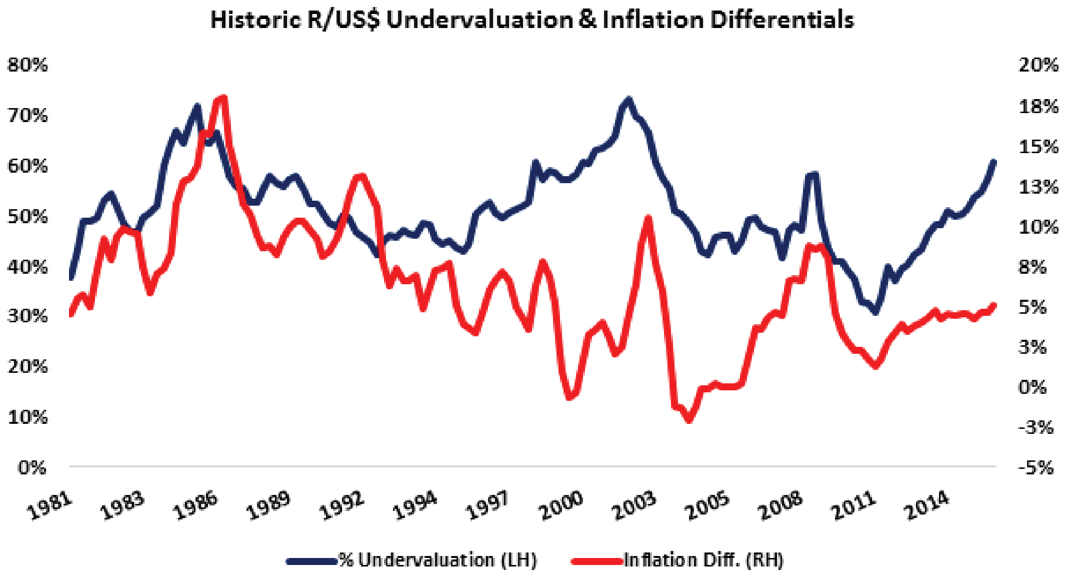
The following graph again shows the percentage undervaluation of the rand but this time the inflation differential (difference between SA's inflation and that of the US) is included:



A few observations:

- During 1985 the rand collapsed after the Rubicon speech; it recovered shortly after because of a nominal appreciation, but mostly because inflation accelerated.
  - This depreciation was fully domestically "manufactured" and saw the rand reach a level 72% undervalued against the US$ (keep in mind that the long-term average, 1980-2015, has only been 51%).
  - In terms of year-on-year exchange rate percentage change, this was the sharpest nominal decline in the history of the currency, 66%!
  - If the rand had depreciated in nominal terms today with 66%, the rand would have reached a low of R19.49, and not "only" R18.00.
  - If today's nominal exchange rate were to reach its 1985 undervaluation lows, the rand would now be trading at R19.85/$1.

- During 2002 the rand's collapse was mostly caused by international events; the Asian Crisis.
  - The rand quickly recovered again mostly because of a nominal exchange rate correction but, again, also because of some inflation.
  - Once again, if today's nominal exchange rate were to reach its 2002 undervaluation lows of 73% (the lowest ever), the rand would now be trading at R20.98/$1, although the nominal percentage fall was "only" 47%.

- During the 2008 financial crisis, the rand also took a short lived dip and corrected, but, this time mostly through a nominal exchange rate correction and less through inflation.

- In 2015/16 the rand took another massive blow mostly because of domestic reasons, although some international forces were also at play.
  - It reached a nominal intraday low of roughly R18 to the US$ which was 69% weaker than parity, undervalued.
  - If it goes to the undervaluation low reached in 2002, the rand today will fall to R20.98.

So there we have it. The rand is at roughly R16 and very weak compared to the US$, but not as weak as during its all-time low. I am convinced the rand's undervaluation will correct but I am unsure how it will correct. Will the exchange rate improve or will inflation eventually render the current nominal exchange rate "more" correct? My suspicion is that inflation will take most of the pressure.

I am also not sure if we have seen the end of this flick. The rand may continue its nominal fall over the next few months especially if we get a downgrade, enter a recession or if our weak political leadership remain at the helm.

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So here's my best advice as an economist:

+ If you don't know, wait.
+ If you want to move cash overseas, park it locally for a few weeks before making a call.
+ If the rand goes to R21 or weaker soon, it's probably a total overreaction; bring cash ''back''.
+ If the rand goes to R16.00 or better, the equivalent level achieved a year after the 1985 collapse, take money ''out''.
+ Anything in between should be determined by normal investment considerations.

All the above is economic gibberish simply because nobody knows what will happen tomorrow. It does appear as if the rand is unnaturally weak at R16.00 to the US$, but that is for today. Within a few months rising inflation may suggest that R16.00 is "cheap". Furthermore, given the political blunders that we've been getting accustomed to R16.00 could also be "cheap" if certain macro-economic policy-threats are actually implemented.

Personally, I think I will buy rands at R16.50 or cheaper and sell them at around R14.00. But, that is today; tomorrow I may feel different...

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