EFFICIENT GROUP

DAWIE'S NOTES

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VALUING THE RAND: AN UPDATE

- By Dawie Roodt

The South African (SA) rand is one of the most traded emerging market currencies. The SA financial markets are exceptionally well regulated, very well integrated with global financial markets and, importantly, very liquid. That is certainly a blessing in good times but in bad times, it can be a curse.

Significant changes on the political front (as we have seen recently), as well as other developments (like the budget) can have a big effect on the rand's exchange rate for exactly this reason – the nature (liquidity) of our financial markets. As with all financial markets, the exchange rate of the rand also tends to overreact. Then what is the correct value of the rand?

Many economic forces affect the exchange rate of a currency. Factors like, the balance on the current account, capital flows in and out of a country, interest rates, and the like. For this reason, sophisticated models attempt to incorporate a myriad of economic data to forecast the exchange rate of a currency. Yet very few of these models are accurate.

Most exchange rate theories are based on purchasing power. This theory states that the exchange rate of currencies will converge to the buying power of currencies or purchasing power parity (PPP). The reason why the exchange rate of currencies will, according to this theory, reflect buying power is because once the price of goods is more expensive in one country than in another, imports and exports will eventually "force" prices to be the same (i.e. exchange rate PPP).

For example, should the exact same hamburgers (like the famous Big Mac) cost more in country A than in country B, then country B will export their hamburgers to country A until the price of this product is the same in both countries. Of course, in practice this will never really be the case because there are factors like transport costs, insurance, taxes, risk premia, and underlying differences in supply and demand. Ignoring these factors, identical products should cost the same in all countries.

But usually they don't. Why not?

Apart from the factors mentioned above, the only reason why the prices of similar goods differ must then be because the exchange rate between currencies is "wrong".
There is another and very important variable that also affects the exchange rate of a currency: inflation. Inflation erodes the value of a currency. If the inflation rate of one currency is higher than that of another, then (again theoretically) the currency with the higher inflation rate will fall in value relative to the currency with the lower inflation rate, by exactly the difference in the inflation rate of these two currencies (the inflation differential).

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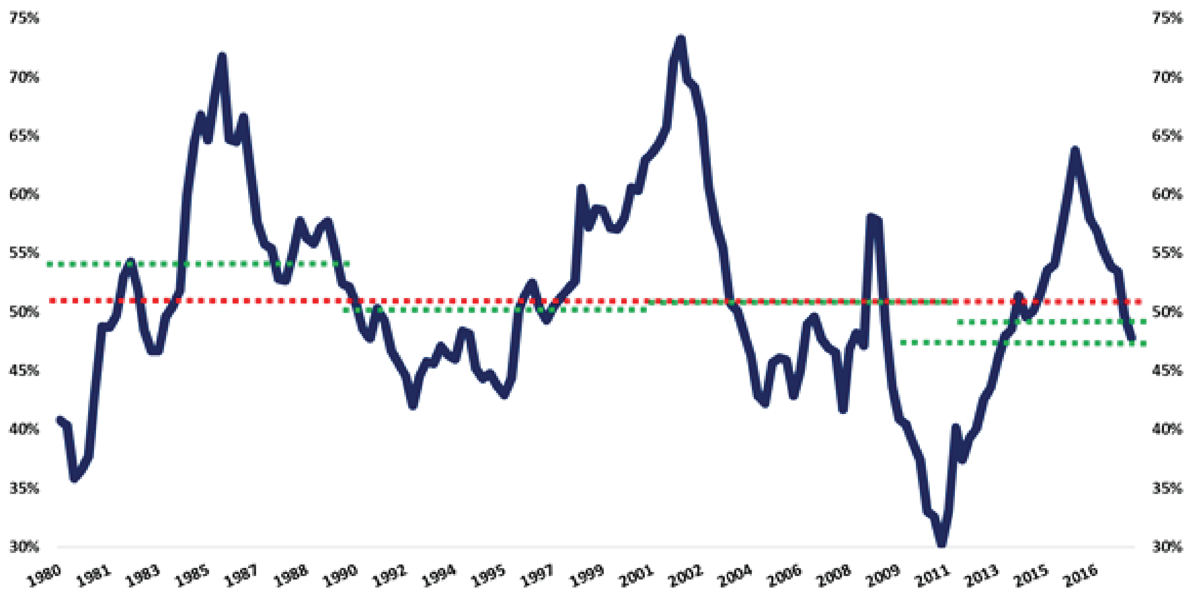
For example, since the 1970's the SA Rand has lost more than 99% of its value to inflation which is an important reason why the rand lost so much against other "hard" currencies with lower inflation rates.

However, even when the inflation differentials are included in the calculation of the "correct" future value of a currency, exchange rates still seem to be "incorrect". Clearly, even the purchasing power theory of exchange rates is also not without its own challenges.

Despite all the misgivings regarding the purchasing power calculations, we still consider this to be the best approach to predict the medium- to long-term rand exchange rate.

We follow a similar approach to that of the popular "Big Mac Index". Instead of a single product, we use a more representative basket of goods. We then calculate the "correct" purchasing value of the rand compared to the US Dollar, as well as its percentage deviation from this level.

The graph shows the result of our calculations:



Based on our calculations, the rand "should" be trading at R6.26 to the US Dollar. At the current level of R11.99 it is 48% "weaker" than its PPP. On average, the rand has been 51% undervalued to the US Dollar since 1980. The graph also provides average undervaluation and extreme movements of the currency for various periods.

For instance, during the 1980s the rand weakened sharply to an undervaluation of 72%. This was related to the "Rubicon" speech of P.W. Botha. A similar reaction occurred during the dot-com bubble during 1995 to 2001, as well as during the Asian financial crisis in 2002. The "weakest" the rand has been since 1980, was in March 2002 when the rand was trading at an equivalent of R23.39 to the US Dollar (73% undervalued). While the "strongest" the rand has been, was in June 2011 when it traded at the equivalent of R8.97 to the US Dollar (30% undervalued).

What is of interest, is that the rand traded on average at 47% undervaluation to the US Dollar during the Zuma-years – better on average than the preceding nearly 30 years!

Nevertheless, at the current exchange rate of R11.99 the rand is approximately 48% undervalued, 3% better than the average undervaluation since 1980. However, since the current level is not that far off historic averages, the valuation of the currency should not at present play an important role in one's financial decisions.

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Yet it is important to note that the rand can potentially fall to as much as R23.39 to the US Dollar or appreciate to approximately R8.97, based on previous lows and highs, if "very" good or "very" bad things should happen.

The only real value in the calculations explained above, is not necessarily its predictive value but rather its value in forcing a reality check on all of us. Although the medium- to longer-term outlook for the currency must be for a weaker rand (simply because of our higher inflation rate relative to the Americans), in the shorter term the rand is trading at slightly better levels. Better than its average since 1980.

It is also important to keep in mind that if the rand's nominal exchange rate remains unchanged, in terms of its PPP undervaluation it will gradually "appreciate" because of negative inflation differentials. Put differently, should the rand's exchange rate remain where it is, it will gradually become stronger in PPP terms as inflation "catches up".

That also means that if the rand depreciates at the inflation differential, currently 4-6%, then its PPP will remain unchanged.

In summary, it seems as if the exchange rate of the rand is currently close to its historic valuation. It also means that a depreciation of 4-6% annually can be expected. Moving part of your portfolio offshore seems to suggest that a 4-6% rand-gain should be realistic.

Additionally, recent developments affecting the attack on property rights may provide an additional reason to diversify abroad. It seems as if an investor can't go wrong by moving a portion of their portfolio offshore if their time horizon is the medium to longer term.