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NEWSLETTER

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ECONOMIC COMMENTARY - By Francois Stofberg

Monthly review – the rand

The big news in August, which has dragged into September, was about emerging markets and their currencies. Unlike the developed world, the emerging economies have not done enough to introduce much-needed structural changes since the 2008-09 global financial crisis. As a result, large current account and budget deficits, high dollar-denominated debt, as well as weak policies and leaders still plague most emerging economies.

Turkey has lead the charge in recent months. The independence of their central bank has deteriorated, production is down, weak policies has allowed for close to hyperinflation, confidence is at 2009-lows, their president appointed a family member as the minister of finance, and the list goes on. Hot on their heels is Argentina who last week asked the International Monetary Fund (IMF) to hurry with the payment of $50 billion in aid.

On this point, SA looks nowhere near as bleak as these economies. Even though our weak political leaders are unable to introduce the correct policies to sufficiently grow the economy at levels needed to address social tensions: our inflation is well under wraps at levels around 5%, the central bank is still very much independent; our exposure to US$ debt is only about 10%, our markets are liquid; we don't do a lot to upset the world order, like Turkey trying to play ball with the Americans; and we don't have a lot of socio-political tensions with our neighbours.

So, why all the attention? Investors have grown suspicious of the very good returns they've been enjoying in global markets, especially from tech firms in the United States (US). The S&P 500, an index that tracks the 500 largest firms in the US, is now in its longest recorded bull-run (according to most indicators) – just short of 10 years. On top of that, next year June will mark the longest non-recessionary period the US has ever been in. Everyone is expecting trouble and as soon as something looks troublesome, like the troubles in the EU banking sector or the current problems in emerging markets, they mindlessly follow the flock in believing this is where the next recession will come from. It usually isn't that simple. However, rising rates in the US and the possibility of seeing a yield-curve inversion, trade tensions between the global powerhouses, and social-political risks in important regions like the Middle East, are making investors very weary.

How are the currencies performing? We've done a lot of research, especially on the rand, using our trusted purchasing power parity (PPP) tools. Most currency research uses PPP in some form or another as it accurately measures price differences between countries. Economic factors which should be driving exchange rate differences are causing price differences. What the PPP-exchange rate therefore does is that it removes a lot of the short-term sentiment factors that influence a currency. These indirect factors, like political and social noise, can change the long-term prices indirectly by changing the economy fundamentally but shouldn't change a currency directly. The nominal exchange rate (the one which we all know is R14.70/$1) doesn't do this. For this reason, the PPP-exchange rate is a good indicator of the cost of living and probably the best tool to use when comparing countries.

The Russian Ruble, Mexican Peso, and Indian Rupee, all seem to be trading within range, even after the recent slump in these currencies because of negative emerging market sentiment. The fact is that their PPP-exchange rates, call it their economic wellbeing, has been deteriorating compared to the developed economies. However, even taking the current turmoil into account, the Argentinian Peso, Brazilian Real, and Turkish Lira are all trading far outside their standard level of deviation. Locally, the rand's standard deviation from its long-term undervaluation (50.35%) is roughly 8.56%, measured from 1980. At current levels (R14.70) the rand is only 7.13% undervalued, meaning that it's not trading at levels that are too unnatural. However, the long-term average level of deviation is only 0.86%. Reading between the lines, this means that the rand is very volatile and likes jumping back to more normal levels, that is, closer to R13.50 (if one considers "normal" levels of negative sentiment).

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