DOLLARS, DEALS, DEBT AND DIVERSIFICATION

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There were a number of headline-grabbing events last week. What are the underlying connections and what investment conclusions can be drawn?

US President Trump's decision to pull out of the multiparty nuclear deal with Iran, as widely expected, saw oil prices surge further. Iran's crude oil exports fell by a quarter (around 500 000 barrels a day) in 2010 when sanctions in response to the country's nuclear programme were tightened and a similar-sized drop can be expected. Geopolitical tensions escalated with Israel and Iran exchanging fire in Syria in the following days. In an upset election victory, 92-year-old Mahathir Mohamed returned to power as Malaysia's Prime Minister, a post he occupied between 1981 and 2003. In another throwback to that era, Argentina has again approached the International Monetary Fund (IMF) for assistance following the slump in its currency.

The recent rebound of the US dollar underlies this decline in the Argentine peso and other emerging market currencies. The greenback has made up the losses it suffered earlier in the year, but still has to recover 2017's losses. People buy and sell currencies and currency futures for a multitude of reasons, but the recent gains in the dollar appear to be driven by perceptions that inflation and interest rates in the US will climb faster than elsewhere. Thursday's consumer price report showed that inflation in the US is rising, but by slightly less than expected. Though the Federal Reserve is highly likely to continue gradually hiking interest rates, subdued inflation means the risk of aggressive rate hikes is reducing. This took some of the wind out of the dollar's sails and supported equity and bond markets.

On a longer view however, the dollar looks overvalued, with the real trade-weighted dollar (i.e comparing the currency to the main trading partners of the US and adjusting for inflation differences between them) still above its longer-term average level (chart 1). It is still too early to talk about the resumption of the 2011 to 2015 dollar bull market that caused havoc across the financial world. The previous two big dollar bull markets in the early 1980s and late 1990s also coincided with emerging market crises.

Why does the dollar matter so much? Though the US share of global economic activity has declined with the rise of China and other large emerging markets, the US dollar retains its dominance in international trade and finance. Across the world, many companies and governments borrow in dollars rather than their own local currencies. When the dollar rises, these debts increase as well. The dollar's dominance is also why the US sanctions on Iran are so painful, even though there is almost no trade between the two countries. Any global bank that clears dollars has to abide by US rules, even if it involves a transaction between a German bank and an Iranian company.

EMERGING MARKETS **COLLATERAL DAMAGE**

Although most emerging market currencies have come under pressure with the increase of the dollar recently, investors do seem to be a bit more discerning this time, recognising that some countries have made progress in recent years. Argentina and Turkey, the hardest hit in recent weeks, both have a lot of foreign debt.

Turkey's central bank has hiked rates, but most investors are doubtful whether its central bank is independent enough to go further. Turkey's strongman President Erdogan faces re-election next month and has been highly critical of interest rate increases.

Argentina's problem is not that the central bank has been scared to act. After all, it jacked up interest rates to 40%. The problem is that once lost, credibility takes time to rebuild. The country has a history of currency and inflation crises, and with inflation already running above 20% even before the peso slump, investors have a right to be concerned. Prior to President Macri's election in 2015, it was even illegal to question official inflation statistics in Argentina. The country has a huge fiscal deficit and virtually no domestic bond market, hence the need to turn to the IMF. One consequence of this lost credibility is that Argentina, one of the world's larger economies, is not even considered an emerging market by index compiler MSCI, but rather a lower-tier "frontier" market.

RAND REMARKABLY **RESILIENT**

The rand has held up remarkably well considering the stronger dollar and all the geopolitical worries. Perhaps investors are recognising that there have been some real improvements since the 2013 "taper tantrum" (when then Fed Chair Ben Bernanke caught the market off guard by suggesting a tapering of the quantitative easing programme) and subsequent "fragile five" crisis (when India, Turkey, South Africa, Brazil and Indonesia were targeted for their high fiscal and current account deficits). South Africa's current account deficit has halved as a percentage of GDP since. And while the fiscal deficit remains sticky, the most recent Budget aims to address it more vigorously and realistically than previous versions. Investors certainly have more faith in President Ramaphosa implementing key reforms than his predecessor.

South Africa's dollar-denominated debt levels are not excessive. The bigger risk is that foreigners hold close to 40% of rand-denominated government debt. If they want to reduce emerging market exposure, this could lead to selling and upward pressure on interest rates. But there is no risk of the government not being able to fund itself and turning to the IMF.

It's certainly not a great time to be a motorist. The record-high inland petrol price of almost R15 per litre looks set to rise by another 70 cents per litre. Despite this, inflation is unlikely to increase meaningfully. Petrol is only 4.5% of the overall consumer price index, and rising petrol inflation is

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counteracted by disinflation in other categories. Chart 3 shows how volatile the rand oil price is and how, despite this, it has a muted impact on inflation. Further rate cuts are however off the table in the current environment of geopolitical risk and shifting sentiment towards emerging markets.

As long as inflation remains relatively well behaved, the softer rand in the second quarter is, broadly speaking, a good thing for the local economy, local markets and local investors. For the economy, the weaker rand supports exporters, import-competing manufacturers and tourism. Weak first quarter mining and manufacturing production numbers suggest these industries could use a weaker currency. Both mining and manufacturing output contracted in the first quarter, highlighting a gap between the "soft" survey data that show increased confidence and the "hard" activity data that still point to sluggishness.

For local markets, the weaker rand boosts the offshore earnings JSE-listed companies report locally. Investors therefore tend to benefit from higher local equity prices, but also higher rand values of global assets.

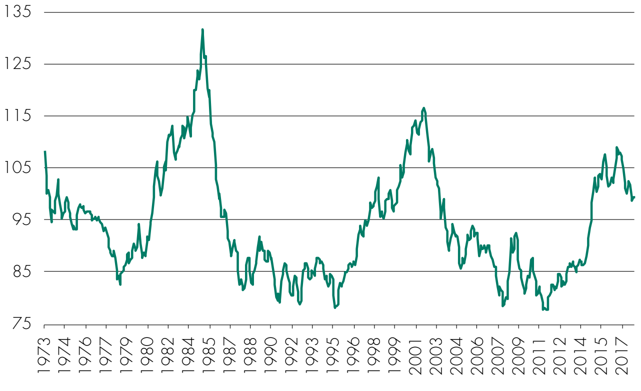
TAKING **STOCK**

Taking a step back, many investors are questioning the "global synchronised growth" narrative, but the overwhelming evidence is still that the world economy is doing quite well. Some economies are not quite living up to expectations, particularly Europe, but these expectations might have crept up unrealistically late last year. While the rising dollar needs to be monitored, and financial conditions are tightening, it is not dramatic. There is no sign of a global recession. Inflation is rising cyclically due to a higher oil price and a low base, but there is also nothing that suggests a sustained move higher in global inflation rates that will cause 1970s style "stagflation" to gain hold.

The backdrop remains favourable for equities. Companies have exceeded expectations to deliver one of the best earnings seasons on record. But rather than rewarding these results with higher share prices (as has been the case in recent years), the market seems to be saying "this is as good as it gets." But the strong earnings growth with flat to negative share prices means valuations have improved.

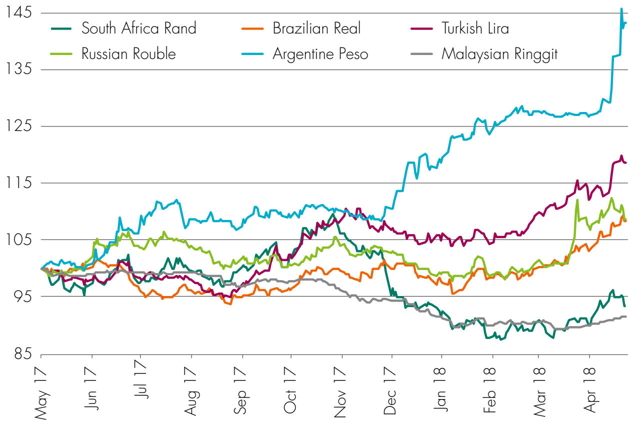
If risk appetite worsens significantly, the rand will be a shock absorber. Unlike other countries, the SARB won't try to defend it from falling but it might hike interest rates a few times to prevent inflation running away. Evidence from the past few years has been that the rand has a much smaller impact on inflation than previously assumed. Strategy Funds have substantial exposure to rand-hedge assets, but are well diversified. Since the rand is unpredictable, investors should also be positioned for a stronger rand. Bonds and other domestic interest rate-sensitive assets do well when the currency appreciates. Diversification might be a boring message in a fast-paced world, but it is precisely because things change so quickly that it makes sense.

CHART 1: REAL TRADE-WEIGHTED US DOLLAR INDEX (HIGHER VALUES INDICATE STRONGER DOLLAR)



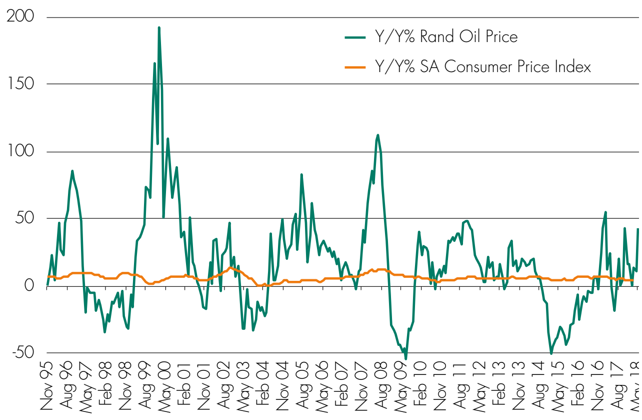
Source: Thomson Reuters Datastream

CHART 2: EMERGING MARKET CURRENCIES INDEXED AGAINST THE US DOLLAR (HIGHER VALUES INDICATE STRONGER DOLLAR)



Source: Thomson Reuters Datastream

CHART 3: SA AND OTHER EMERGING MARKETS' 10-YEAR GOVERNMENT BOND YIELDS, %



Source: Thomson Reuters Datastream

INDICATORS

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 124.0	1.68%	1.77%	1.00%	12.32%
United States	S&P 500	US$	2 728.0	2.44%	3.02%	2.02%	13.95%
Europe	MSCI Europe	US$	1 789.0	0.85%	0.00%	-0.45%	8.56%
Britain	FTSE 100	US$	10 461.0	2.20%	1.20%	0.58%	9.88%
Germany	DAX	US$	1 462.0	1.25%	1.88%	0.07%	15.85%
Japan	Nikkei 225	US$	208.1	1.00%	1.25%	2.98%	18.46%
Emerging Markets	MSCI Emerging Markets	US$	1 157.0	1.85%	-0.60%	-0.09%	15.70%
Brazil	MSCI Brazil	US$	2 110.0	2.83%	-2.13%	4.30%	10.41%
China	MSCI China	US$	92.3	3.77%	2.47%	4.27%	33.30%
India	MSCI India	US$	575.2	-0.24%	-2.51%	-5.86%	6.71%
South Africa	MSCI South Africa	US$	568.0	2.71%	0.18%	-6.12%	13.60%

EQUITIES - SOUTH AFRICA (TR UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	58 423.0	1.34%	0.32%	-1.82%	7.96%
All Share	All Share (Total Return)	Rand	8 403.0	1.35%	0.37%	-0.56%	11.21%
TOP 40/Large Caps	Top 40	Rand	7 441.0	1.86%	0.87%	-0.09%	12.28%
Mid Caps	Mid Cap	Rand	16 381.0	-1.62%	-3.29%	-3.50%	4.46%
Small Companies	Small Cap	Rand	20 842.0	-1.55%	-0.80%	-0.86%	0.56%
Resources	Resource 20	Rand	2 518.5	2.65%	3.61%	10.16%	27.33%
Industrials	Industrial 25	Rand	14 613.0	1.48%	0.13%	-3.33%	4.85%
Financials	Financial 15	Rand	9 802.0	1.37%	-0.90%	0.98%	23.37%
Listed Property	SA Listed Property	Rand	2 066.0	0.19%	-3.14%	-16.15%	-4.84%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global Government Bonds	Citi Group WGBI	US$	949.0	0.00%	-0.64%	0.09%	5.39%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	623.3	0.04%	-1.19%	6.07%	12.48%
Government Bonds	BESA GOVI	Rand	619.9	0.03%	-1.21%	5.72%	12.20%
Corporate Bonds	SB JSE Credit Indices	Rand	119.3	0.25%	0.00%	-5.43%	-15.79%
Inflation Linked Bonds	BESA CILI	Rand	257.0	0.30%	0.33%	1.72%	3.83%
Cash	STEFI Composite	Rand	392.9	0.13%	0.21%	2.60%	7.41%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	77.0	2.70%	2.63%	14.88%	50.92%
Gold	Gold Spot	US$	1 319.0	0.30%	0.15%	1.70%	7.67%
Platinum	Platinum Spot	US$	924.0	1.65%	1.99%	-0.65%	0.65%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	12.28	1.81%	1.50%	0.84%	8.90%
ZAR/Pound	ZAR/GBP	Rand	16.61	1.81%	3.25%	0.78%	3.67%
ZAR/Euro	ZAR/EUR	Rand	14.65	2.03%	2.72%	1.42%	-0.90%
Dollar/Euro	USD/EUR	US$	1.19	0.84%	1.51%	0.92%	-8.40%
Dollar/Pound	USD/GBP	US$	1.35	-0.11%	1.91%	-0.31%	-4.74%
Dollar/Yen	USD/JPY	US$	0.01	0.27%	0.04%	-2.92%	-3.75%

Source: I-Net, figures as at 11 May 2018

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ASSET MANAGER MOVEMENTS

There were no manager movements over the past week.

THE WEEK AHEAD

SOUTH AFRICA

- Retail sales
- Unemployment

US

- Retail sales
- Housing starts and building permits

EUROPE

- Eurozone inflation
- Germany ZEW Economic Sentiment Index

CHINA

- Fixed asset investment
- Industrial production
- Retail sales

JAPAN

- First quarter GDP growth
- Inflation

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