MARKET MATTERS

RUNNING WITH THE RAND

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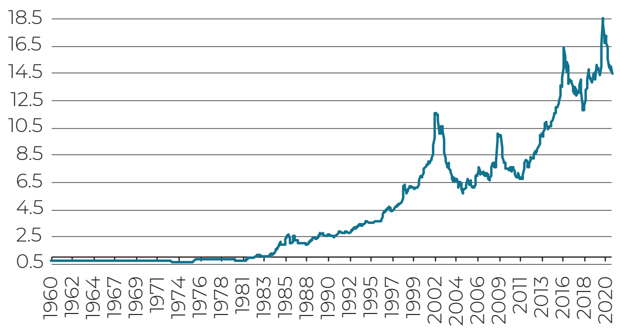
The rand turned 60 this year. It was introduced in February 1961 as a decimal replacement for the South African pound, which operated on the pounds, shillings and pence system. Named after the gold-rich Witwatersrand, the rand had a pretty sheltered childhood, until the early 1980s, mostly pegged against the US dollar and the UK pound. It was cut loose around the time of adulthood, and as a free-floating currency it's had a pretty wild existence ever since.

In fact, it is widely considered one of the most volatile currencies. South Africa's large and deep capital and derivative markets give it liquidity compared to other emerging countries with very little control over foreign participation. However, it lacks a massive and diversified economy behind it to give it stability. South Africa's level of foreign exchange reserves is also quite low relative to the size of the economy and imports, which probably makes it a more attractive target for speculators.

CHART 1: LONG-TERM RAND-DOLLAR EXCHANGE RATE



Source: Refinitiv Datastream

The Bank for International Settlements (the central banks' central bank) has a triennial survey of daily foreign exchange turnover. At $72 billion per day on average, the most recent survey (2019) puts the rand ahead of the currencies of Poland, Brazil and Turkey and only slightly behind Russia, even though they are all much larger economies.

Nonetheless, the rand is highly correlated with other commodity-linked emerging market currencies, which tend to rise and fall together with the commodity cycle, global investor risk appetite and major US dollar trends.

CLASSIC CYCLE

The past 18 months have of course seen a classic rand cycle. It blew out completely when global markets panicked about the Covid-19 pandemic in March and April of 2020, falling to record lows against the stronger dollar.

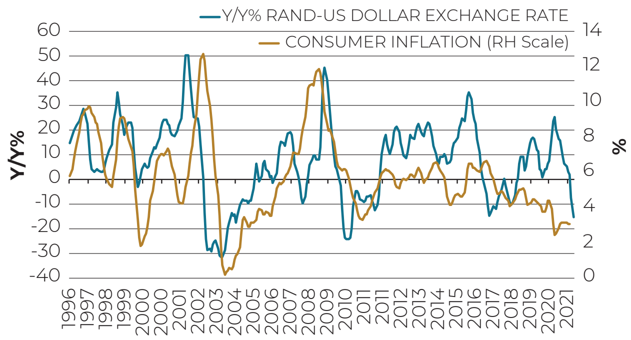
The recovery was almost as swift as the sell-off was brutal. Eventually it becomes too cheap to ignore, and investors start piling in as soon as the worst of the market anxiety passes. And once it gains momentum, traders smell a trend and it just snowballs.

This particular cycle has seen a massive boost in the form of commodity prices, particularly platinum group metals and iron ore. This impacts the currency directly through flows of higher export earnings, but also indirectly because the currency is so closely associated with commodities.

RAND RETURN BOOST

Local investors can benefit from the rand's volatility. Given South Africa's higher inflation and lower competitiveness compared to other major economies, one would expect the rand to weaken over time, boosting offshore returns. In fact, over the long term, it has weakened by about 1% per year more than inflation differentials imply, boosting the real rand returns on global assets.

CHART 2: EXCHANGE RATE VOLATILITY AND ITS DECLINING INFLATION IMPACT



Source: Refinitiv Datastream

Meanwhile, the impact on local inflation of rand weakness has declined over time and is currently estimated by the SA Reserve Bank to be around 10%. In other words, a 1% depreciation adds 10 basis points to inflation but 1% to offshore returns, all else being equal. Therefore, rand depreciation tends to boost real returns of local investors from offshore assets in the short to medium term as well. And since local investors, pension funds and corporates have more foreign assets than total foreign debt, national net wealth is also boosted.

But all else isn't always equal. One of the biggest headaches for local investors is that the same conditions that cause the rand to rally also cause global investments to rally: risk appetite, global economic and profit growth, and rising commodity prices. The converse is also true. The rand often falls with global markets, as we saw in March last year, cushioning the blow for local holders of offshore equities.

One exception was 2002, when the rand recovered sharply from an earlier blow-out just as the dotcom bubble was deflating and corporate scandals rocked markets. Rand returns from global assets were decimated, soon after many South Africans invested abroad for the first time following the easing of exchange controls.

IS THIS A GOOD TIME?

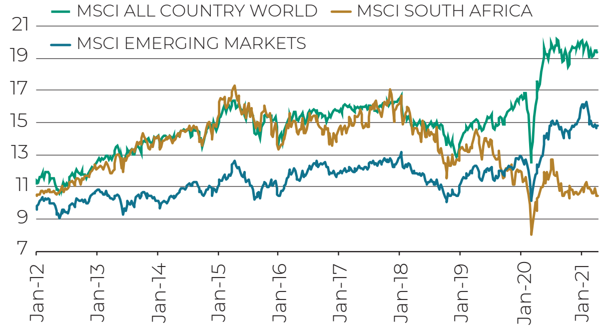
Many investors are wondering whether it is a good time to increase offshore exposure. Firstly, trying to time investments, whether equities, bonds or currencies, can do as much harm as good. If an individual's long-term financial plan or pension fund's strategic asset allocation requires offshore exposure, then don't worry about the currency too much.

Secondly, getting a handle on whether the rand is cheap or not usually involves a lot of guess work. Rather than looking for specific levels, investors should think about broad ranges. Based on inflation differentials (purchasing power parity theory), the rand looks fairly valued around R14 to R15 per dollar.

Thirdly, as mentioned above, waiting for a strong rand to take money offshore often also means buying into more expensive investments on the other side. That might very well be the case now. The rand has gained 27% against the dollar over the past year, but global equities have gained 48% in dollars. Global equity valuations have increased from an attractive to reasonable over this period, with the US now expensive.

At the end of April, MSCI put the forward price: earnings ratio for the world market at 18 times, the highest since 2002, while SA equities traded at 10 times forward earnings. Similarly, the South African 10-year government bond yield is double the Reserve Bank's 4.5% inflation target, while the US equivalent is still below the Federal Reserve's 2% target. This implies positive expected real returns from SA bonds and negative real returns from US bonds. While local cash returns are not as juicy as they once were, they might keep up with inflation while developed market central banks have all but promised negative real rates for the foreseeable future.

CHART 3: GLOBAL FORWARD PRICE: EARNINGS MULTIPLES



Source: Refinitiv Datastream

DIVERSIFICATION AND SOURCES OF RETURN

So why invest offshore at all? The answer remains diversifying to reduce exposure to SA-specific risks, and adding valuable and extensive sources of investment returns that are not available locally.

Yes, global equities are more expensive in aggregate, but among the thousands of listed companies there are those that are cheap relative to their fundamental value or growth prospects. In contrast, a big part of why South African equities trade on low valuations is because of high commodity prices boosting prospective earnings.

These prices might stay high, but they might not. If they decline, it is a risk to local investments. Apart from mining, the JSE is simply very concentrated, with a single underlying exposure (Tencent) accounting for 15% to 25% of the overall market, depending on the benchmark. If we look at the FTSE/JSE All Share Index, 60% of its market cap is contributed by the top 10 shares. For the MSCI All Country World Index, the largest 10 of the 2 974 constituents only make up 15% of the total market cap.

Emerging market equities in general trade at cheaper levels than developed markets. Local investors might shun emerging markets because South Africa is one, but we have a very different profile to the more dynamic East Asian countries with scores of innovative world-leading companies.

In terms of local fixed income, the bond market is dominated by the government and its state- owned enterprises (virtually all junk status) and the money market by the big four banks. By contrast, the global fixed income universe is massive, spilt roughly half-half between sovereign and corporate (and other private) borrowers, and across all imaginable regions, maturities, credit ratings and currencies.

Local property is heavily exposed to offices (at risk from the shift to working-from-home) and shopping malls (ecommerce), as well as Eastern Europe. Global property is an extremely diversified asset class, including sectors that barely feature on our market, such as data centres, various residential options, hospitals, laboratories and communications facilities. Global property is not overvalued by any standard metric.

HOME BIAS

Home bias is common, even in countries where there are few or no restrictions like Regulation 28. People tend to invest in what they know, whether it's the savings account of a local bank or the shares of the brand names they consume every day. But it's a big world, and home bias can mean missing out on opportunities not available locally.

For many South Africans, their biggest assets are probably their company pension fund and their home. Some own businesses. The more affluent might have a holiday property. That means they are overexposed to the domestic economy and its cycles.

Therefore, there is a strong case to be made for investing a significant portion of discretionary money offshore. The size of the allocation of course depends on individual circumstances.

This is not about "fleeing" South Africa at all, or implying the country is falling apart. It isn't. Local politics may be as noisy as always, but there are signs of improved governance and key institutions acting against abuse and overreach. Local growth prospects are also improving on the back of a strong global economic recovery. It is rather about prudently spreading risk and widening opportunities to gain a better overall chance of generating inflation-beating returns, particularly through offshore growth assets.

Increased offshore allocation will also not starve the country of funds for development. Given our sophisticated financial markets and banking system, the biggest problem is not a shortage of funds, but difficulty in spending it properly. The answer to our developmental challenges is therefore not to force capital in a certain direction, but to build state capacity to spend it constructively and get the most out of every rand. Improvement in this direction will in fact attract foreign money.

Capital will always find its way to where the returns are. And as mentioned above, foreign assets build resilience for the local economy.

KEEP EMOTIONS AT BAY

However, as always, beware making decisions based on emotions. It makes sense to hedge against potential domestic political and economic instability, but the hedge also has to be proportional to the risk. The rand's behaviour will probably continue to belie its age, and we can expect it to continue jumping around like a teenager at a party to the hectic rhythm of global capital flows. This volatility means investors can burn their fingers if they respond reactively to episodes of weakness, rather than proactively diversifying.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 979.0	1.36%	1.36%	10.74%	47.04%
United States	S&P 500	US$	4 233.0	1.24%	1.24%	12.70%	46.93%
Europe	MSCI Europe	US$	2 036.0	2.67%	2.67%	10.65%	47.00%
Britain	FTSE 100	US$	9 974.0	3.59%	3.59%	12.97%	35.92%
Germany	DAX	US$	1 755.0	2.33%	2.33%	1.19%	58.82%
Japan	Nikkei 225	US$	270.4	2.60%	2.60%	-4.85%	46.03%
Emerging Markets	MSCI Emerging Markets	US$	1 349.0	0.07%	0.07%	4.49%	50.39%
Brazil	MSCI Brazil	US$	1 891.0	7.08%	7.08%	0.80%	70.82%
China	MSCI China	US$	106.9	-2.23%	-2.23%	-1.37%	34.23%
India	MSCI India	US$	718.1	2.33%	2.29%	6.38%	63.56%
South Africa	MSCI South Africa	US$	524.0	5.01%	5.01%	16.44%	69.03%

EQUITIES - SOUTH AFRICA (TOTAL RETURN 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	68 520.0	2.36%	2.36%	15.34%	36.99%
All Share	All Share (Total Return)	Rand	10 838.0	2.38%	2.38%	16.95%	40.53%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	26 918.0	2.28%	2.28%	16.10%	40.85%
TOP 40/Large Caps	Top 40	Rand	9 850.0	2.44%	2.44%	16.68%	39.20%
Mid Caps	Mid Cap	Rand	17 340.0	2.08%	2.08%	14.33%	41.19%
Small Companies	Small Cap	Rand	22 171.0	0.88%	0.88%	29.12%	78.68%
Resources	Resource 20	Rand	5 202.6	4.16%	4.16%	27.31%	66.67%
Industrials	Industrial 25	Rand	17 609.0	0.88%	0.88%	11.86%	24.14%
Financials	Financial 15	Rand	8 098.0	3.13%	3.13%	7.30%	31.48%
Listed Property	SA Listed Property	Rand	1 441.2	-1.37%	-1.36%	17.17%	39.78%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	544.0	0.63%	0.63%	-2.64%	5.44%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	776.8	2.23%	2.23%	2.35%	12.19%
Government Bonds	BESA GOVI	Rand	767.5	2.19%	2.19%	2.34%	12.11%
Inflation Linked Bonds	BESA CILI	Rand	286.4	-0.06%	-0.06%	5.69%	10.27%
Cash	STEFI Composite	Rand	470.5	0.07%	0.07%	1.28%	4.29%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	68.1	1.99%	1.63%	30.94%	134.79%
Gold	Gold Spot	US$	1 787.0	0.85%	0.85%	-5.65%	5.80%
Platinum	Platinum Spot	US$	1 230.0	2.41%	2.41%	14.95%	63.13%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	14.05	3.17%	3.14%	4.52%	32.27%
ZAR/Pound	ZAR/GBP	Rand	19.67	1.83%	1.83%	2.08%	16.88%
ZAR/Euro	ZAR/EUR	Rand	17.10	1.85%	1.85%	4.95%	17.75%
Dollar/Euro	USD/EUR	US$	1.22	-1.64%	-1.48%	0.16%	-11.48%
Dollar/Pound	USD/GBP	US$	1.40	-1.25%	-1.35%	-2.07%	-11.36%
Dollar/Yen	USD/JPY	US$	0.01	-0.68%	-0.68%	5.10%	2.18%

Source: I-Net, figures as at 7 May 2021