MARKET MATTERS

ANCHORS AWAY

DAVE MOHR AND IZAK ODENDAAL | OLD MUTUAL MULTI-MANAGERS
24 MAY - 28 MAY 2021

Last week the rand broke decisively through the R14 to the dollar level, confirming its ability to surprise massively. In fact, when it gets going in either direction, the rand has the ability to move much further than most people (including economists and fund managers) can imagine. Certainly, a year and a bit ago when the exchange rate hit R19 to the dollar, few would have imagined we'd be here today. Similarly, at the start of 2020, when the rand was trading around R14 to the dollar, few imagined the epic collapse the next few months would bring.

How should we think about the current level of the rand-dollar exchange rate? Is it too strong now? Let's first take a detour through behavioural economics. By now most readers will be familiar with the various cognitive biases identified in the field developed by Nobel laureate Daniel Kahneman and others over the past 50 years.

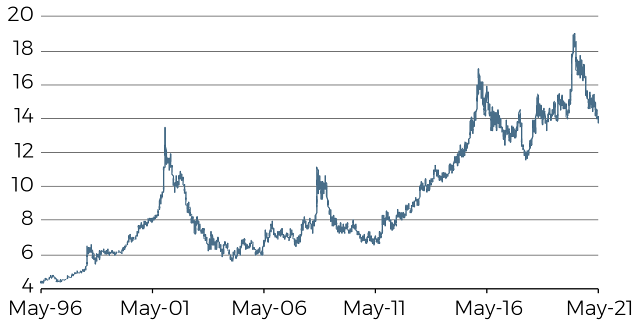
One of these is the *anchoring bias*, or how reference points impact decision-making. For instance, if the first bottle of wine on the menu costs R500, the second bottle at R300 will look much more reasonable. However, if the first bottle costs R100, the R300 bottle will seem expensive. The starting point matters. Kahneman's studies show than even completely unrelated reference points can influence how people think and what they do. In one study, Kahneman and his late colleague Amos Tversky asked people how many African countries were members of the UN. But before they answered, participants had to spin a wheel to receive a number between 0 and 100. Those who spun a higher number – completely randomly – on the wheel subsequently estimated a higher number of countries, while those who spun a lower number guessed a lower number.

Investors often do the same. When looking at financial variables, we are often influenced by starting points and their suggestibility.

BE CAREFUL WHERE YOU ANCHOR

If we anchor off the R19 to the dollar level hit in late April 2020, the rand will seem very strong today. Investment decisions made on this basis are likely to be very different if using a different period as a reference point, say three years ago, when the exchange rate was below R13 to the dollar. Compared to May 2018, the rand is weaker. Compared to two years ago – May 2019 – the rand is basically unchanged. Nobody thought it was too strong back then. In other words, anchoring off a given level can get investors into trouble.

CHART 1: RAND DOLLAR EXCHANGE RATE



Source: Refinitiv Datastream

IN CONTEXT

It is therefore important to place exchange rate movements in context, understand the underlying driver and get a sense of where fair value lies before making investment decisions related to the exchange rate.

Therefore, to begin with, it is important to remember that most of the gains in the rand over the past year or so largely represent the recovery from that collapse, though there are other factors that we'll get into below.

Such massive collapses of 30% or so in the currency have occurred before, in 1998, 2001, 2008 and 2015. What these episodes have in common is a global or emerging market financial crisis, meaning that the sharp decline in the rand was driven largely by factors emanating from outside South Africa, usually coinciding with a spike in the US dollar. What these episodes also had in common was a strong recovery in the rand once global risk aversion abated.

The pandemic panic was just such an external episode, and it was completely unpredictable. When it turned out that the worst financial fears of Covid-19 would not materialise, the rand started recovering.

The big behavioural risk at that point would have been to extrapolate from the R19 per dollar level and assume the rand would only weaken further, and therefore increase offshore exposure. From April 2020 to now, South African equities have beaten global equities by around 30%, local bonds have beaten global bonds by 40% and local property beat global property by 30% in rand terms.

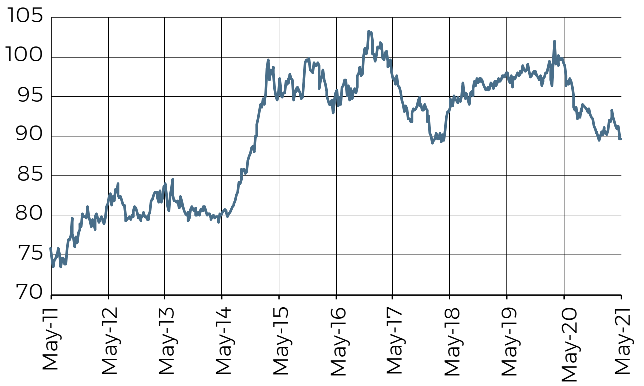
The worst behavioural mistake would have been to take money offshore and then, being afraid of equity markets, hold them in dollar cash. While lagging local equities, global equities still returned 20% in rands. A dollar money market fund, on the other hand, would have lost around 20% in rand terms.

It would be another behavioural mistake to assume that the rand can only strengthen from this point. It can, for reasons discussed below, but the current momentum can also reverse. Diversification and balance are therefore always important, and investors shouldn't be scared of global exposure now that the rand has appreciated.

TAILWINDS

So what has been driving the currency forward? Firstly, the recovery largely represents global investors exhaling after a period of intense financial stress, and this has resulted in the ultimate safe-haven currency, the US dollar, retreating. Beyond that, we've also seen commodity prices rise strongly.

CHART 2: TRADE-WEIGHTED US DOLLAR INDEX



Source: Refinitiv Datastream

Ever since the big pandemic scare on financial markets in March and April last year, the dollar has been losing ground. It rallied again in the first quarter of this year as investor worries about inflation increased, leading to expectations that US interest rates would have to rise. However, the great inflation scare seems to have faded as market participants appear to have come round to the view of the Federal Reserve and other central banks that inflation will be temporary. The dollar therefore lost further ground in the second quarter.

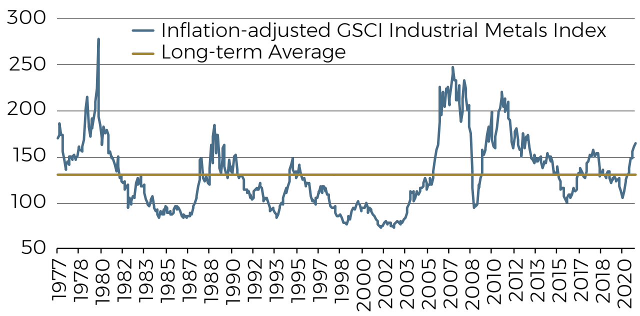
Viewed longer-term, the dollar is still quite strong on a trade-weighted basis, suggesting that there is scope for downside. Proponents of a weak dollar view will point to massive fiscal and current account deficits in the US. If it was any other country, these twin deficits would have put massive pressure on the currency long ago. But the dollar remains the global reserve currency, the status that should diminish only gradually over time, the main medium of exchange in global commerce and the ultimate safe haven for investors and businesses. If US growth keeps outpacing other major economies, it could also support the greenback as interest rate differentials will remain large in the US's favour. Interest rates are still negative in Europe and Japan, after all. The dollar's next big move is therefore by no means a clear-cut case.

COMMODITIES

The global economy has roared back to life after last year's pandemic-induced collapse. The latest round of purchasing managers' indices indicate that current business conditions for manufacturing and servicing firms in the major economies are exceptional. Amid fears that mines would not be able to respond to this rise in demand, commodity prices have shot up over a broad front. This has benefited South Africa tremendously by pushing exports to record levels and raising government tax revenues.

The longer-term outlook for many commodities still seems favourable, though calling it a supercycle would be overdoing it. The transition to green energy and transportation is expected to keep demand for certain key minerals at elevated levels for some time, but eventually supply will respond, which should moderate prices.

CHART 3: INDUSTRIAL METALS INDEX, DELATED BY US CPI



Source: Refinitiv Datastream

Individual commodities will of course always be volatile. Iron ore prices fell over the past week after warnings from Chinese regulators that they will not tolerate speculative activity in commodity markets. Since China is the largest consumer of most raw materials, it has the most to lose from rampant price increases, though their impact is offset somewhat by the appreciation of the renminbi. Indices of baskets of real commodity prices such as the one above still look reasonable compared to long-term averages, though no longer cheap.

In terms of determining a fair value for the rand, analysts use various models, including purchasing power parity models that compare the exchange rate to the inflation differentials of the US and South Africa. No one model can give a definitive answer, but generally speaking the rand seems close to its implied fair value. It has not massively overshot yet, which it has a tendency to do. If the dollar keeps falling, and commodities enjoy further gains, the rand should continue to benefit.

SLOW BUT STEADY

There is another element that may have played a role in the rand's recent gains. It appears global investors' views of South Africa have improved from terrible to merely average for a developing country. Government debt and slow progress on economic reforms continue to be seen as problematic, but the boost from commodity prices can paper over many cracks, and the recovery in the local economy has been better than expected. Instead of contracting, it now seems likely that the SA economy posted decent first quarter real economic growth. The third wave of Covid-19 infections seems unlikely to derail this recovery, but can, of course, deal another blow to the hospitality sector.

On the reform side, somewhat ironically, investors want both change and continuity, change from existing policies that constrain growth, such as monopolising electricity production in a single inefficient parastatal. Changing the mix of government spending away from salaries towards growth-supporting investment spending is also important. But continuity of leadership is necessary so that plans can actually be implemented and so that there is a degree of certainty regarding the regulatory landscape in the future. The current mix of change and continuity is promising. Developments within the ruling party strengthen President Ramaphosa's position and make it likely he will serve a second term and see through the economic and governance reforms that are slowly taking place. Domestic politics play a far smaller role in the level of the exchange rate than is commonly believed, but it does help when both local and global factors are supportive.

In contrast, some of our emerging market peers are experiencing political difficulties. Although India's devastating Covid pandemic is unlikely to cost Narendra Modi his job it has certainly dented his image. Progress with fiscal reform in Brazil has stalled, and it appears the incumbent Bolsanaro will be running against left-wing hero Lula da Silva in a tight presidential race next year, increasing policy uncertainty. Colombia had to backtrack from key tax reforms after massive street protests. A recent election for the constitutional assembly in Chile has been dominated by radicals and independentsin an unexpected rejection of the market-friendly political establishment. Turkey's economy continues to be at the mercy of Erdogan's whims. He fired the deputy governor of the central bank last week, not long after replacing the governor with a more pliable candidate. In contrast to the rand, the Turkish lira trades near all-time lows.

ASSET ALLOCATION IMPLICATIONS

Finally, with a view to portfolio construction, there are three additional points to bear in mind. Firstly, given the rand's inherent volatility and ability to surprise, basing an asset allocation view on a currency forecast is risky. You can take a view with a greater amount of certainty when the rand is very weak or very strong, but most of the time its short-term moves are unpredictable.

Secondly, when thinking about global allocations, investors should spend more time looking at the valuations and return prospects of the underlying asset classes than trying to gauge if the exchange rate is favourable for shifting money abroad or bringing it back.

Finally, the ideal level of rand hedge exposure will depend greatly on individual circumstances. This includes the overall exposure to the SA economy through other assets such as residential property or business interests, but also on whether the investor or fund is accumulating capital or drawing an income from that capital. For a South African investor drawing a regular income from an offshore portfolio, bouts of rand appreciation can cause serious anxiety and longer-term financial damage.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US$	2 979.0	1.22%	1.36%	10.74%	38.69%
United States	S&P 500	US$	4 204.0	1.15%	0.55%	11.93%	38.75%
Europe	MSCI Europe	US$	2 060.0	0.83%	3.88%	11.96%	38.16%
Britain	FTSE 100	US$	9 965.0	0.34%	3.50%	12.87%	30.04%
Germany	DAX	US$	1 778.0	1.08%	3.67%	1.47%	44.20%
Japan	Nikkei 225	US$	265.3	2.06%	0.66%	-5.98%	30.28%
Emerging Markets	MSCI Emerging Markets	US$	1 361.0	2.33%	0.96%	5.42%	47.14%
Brazil	MSCI Brazil	US$	1 929.0	3.99%	9.23%	2.83%	42.57%
China	MSCI China	US$	108.4	2.15%	-0.89%	-0.01%	36.58%
India	MSCI India	US$	756.2	2.19%	7.73%	12.03%	67.31%
South Africa	MSCI South Africa	US$	527.0	3.13%	5.61%	17.11%	56.85%

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	67 555.0	1.99%	0.92%	13.71%	31.46%
All Share	All Share (Total Return)	Rand	10 687.0	1.99%	0.95%	15.32%	34.87%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	26 922.0	2.26%	2.29%	16.12%	37.32%
TOP 40/Large Caps	Top 40	Rand	9 656.0	1.88%	0.43%	14.38%	32.60%
Mid Caps	Mid Cap	Rand	18 025.0	4.09%	6.12%	18.84%	43.09%
Small Companies	Small Cap	Rand	22 747.0	3.01%	3.50%	32.47%	86.74%
Resources	Resource 20	Rand	4 822.8	-1.29%	-3.44%	18.02%	45.92%
Industrials	Industrial 25	Rand	17 654.0	3.48%	1.14%	12.15%	23.08%
Financials	Financial 15	Rand	8 569.0	4.76%	9.13%	13.54%	37.21%
Listed Property	SA Listed Property	Rand	1 427.5	2.00%	-2.29%	16.06%	36.60%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
US Aggregate Bond Index	Bloomberg Barclays	US$	544.5	0.26%	0.73%	-2.54%	4.60%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	785.6	0.49%	3.39%	3.51%	10.54%
Government Bonds	BESA GOVI	Rand	775.9	0.48%	3.31%	3.46%	10.43%
Inflation Linked Bonds	BESA CILI	Rand	296.0	1.62%	3.28%	9.22%	15.95%
Cash	STEFI Composite	Rand	471.5	0.07%	0.28%	1.49%	4.16%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US$	68.7	3.43%	2.57%	32.15%	96.34%
Gold	Gold Spot	US$	1 896.0	1.01%	7.00%	0.11%	10.30%
Platinum	Platinum Spot	US$	1 182.0	-1.50%	-1.58%	10.47%	40.88%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	13.78	1.28%	5.17%	6.58%	27.04%
ZAR/Pound	ZAR/GBP	Rand	19.54	1.13%	2.51%	2.76%	10.44%
ZAR/Euro	ZAR/EUR	Rand	16.79	1.34%	3.78%	6.93%	15.57%
Dollar/Euro	USD/EUR	US$	1.22	0.00%	-1.48%	0.16%	-9.02%
Dollar/Pound	USD/GBP	US$	1.42	-0.28%	-2.75%	-3.45%	-13.32%
Dollar/Yen	USD/JPY	US$	0.01	0.86%	0.51%	6.36%	2.09%

Source: I-Net, figures as at 28 May 2021

Old Mutual Multi-Managers is a Division of Old Mutual Life Assurance Company (South Africa) Limited.
A licensed Financial Services Provider and Life Insurer.