Economic Update Newsletter – April 2021

IS THE STRENGHTENING OF THE RAND AGAINST THE US DOLLAR SUSTAINABLE IN 2021?

The sharp weakening of the rand against the US dollar in the first half of 2020, when the rand reached a low of R19.42, was followed by a sustained strengthening of the rand to the current R14.30 level. As mentioned in our September 2020 newsletter, the focus of the daily comments in the media on the rand's future value and movement towards the US-$, was only centred on the negative influence of the domestic political and economic policy framework.

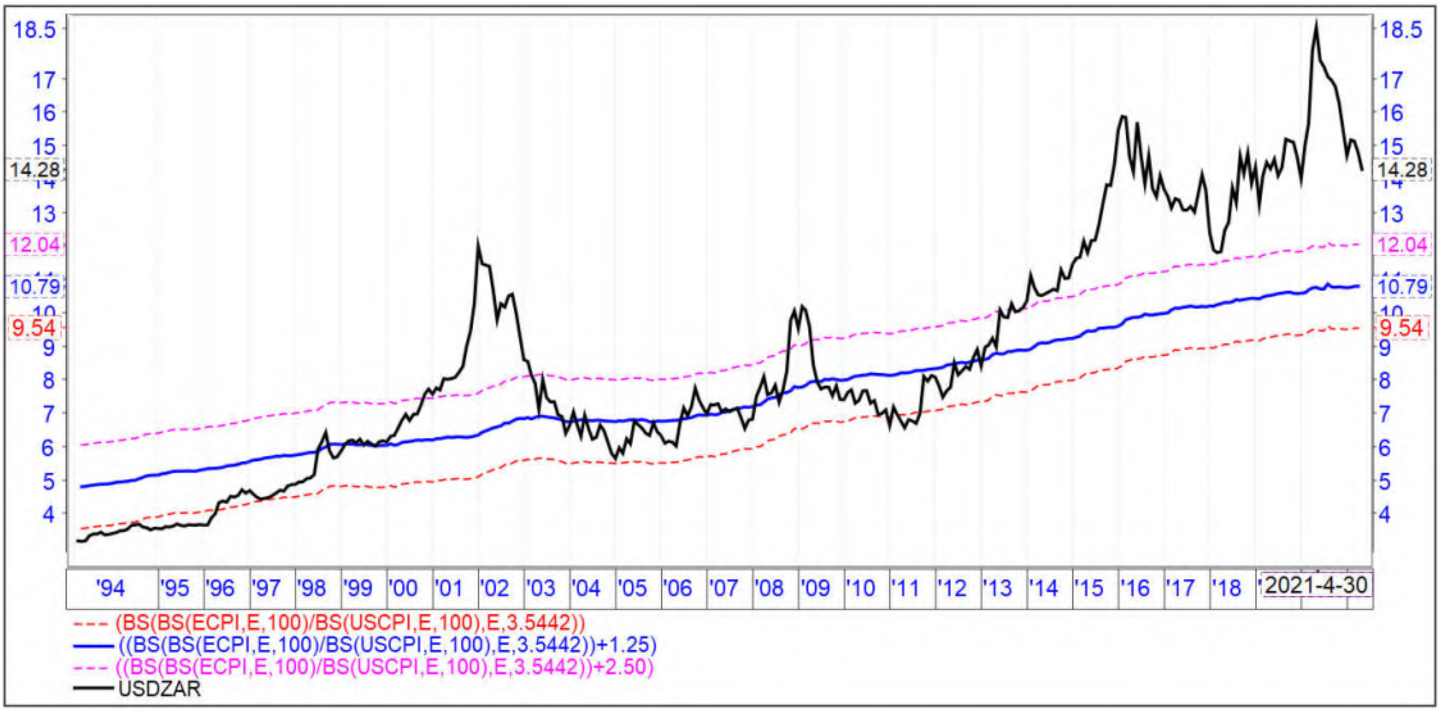
In this newsletter, we will briefly look at the drivers that are currently influencing the value of the R/$ highlighting the most important drivers and providing guidance to clients regarding rand levels where they can convert rand to US dollars.

1. **Purchasing Power Parity Theory (PPP) of the R/$**

   Economists use the PPP to calculate a fundamental value of the rand against the US dollar. In short, it comes down to the calculation of inflation differentials between South Africa and the USA, which means that when SA's inflation rate is 5% per annum and that of the USA is 2% per annum, the rand will lose 3% of its purchasing power in US-$ per year. If the annual differentials are then represented in a graph, we get a valuation line for the R/$ against which we can assess the prevailing R/$ exchange rate in the foreign exchange market. In the chart below, the valuation line is represented by the blue line in the middle and the prevailing R/$ exchange rate is represented by the black line. The valuation line (blue line) indicates that the fair value of the R/$ should approximately be in the R11 - R12 range. According to the PPP, the rand is currently trading (R14.30) R2 to R3 below its fair value which is approximately a 16% undervaluation of its fundamental value.

   The critical question is, what is the invisible rand value of the country risk premium (CRP), that is priced into the R/$ exchange rate? The CRP is the additional rand premium demanded by foreign investors to compensate them for the additional geopolitical and economic risks in a country. We know that there are many such risks in South Africa. It is our opinion that the CRP in South Africa is approximately R2.50. If you take the PPP's present fair valuation of R10.79 and you add the R2.50, we end up with a rand value of R13.30. Many market participants reject the PPP as old fashioned, but usually do so over the long term at their own expense. The key principle of the PPP remains that if domestic economic policy in South Africa does not cause sharp rises in inflation or create hyperinflation, there will be no free fall of the rand against the US dollar.

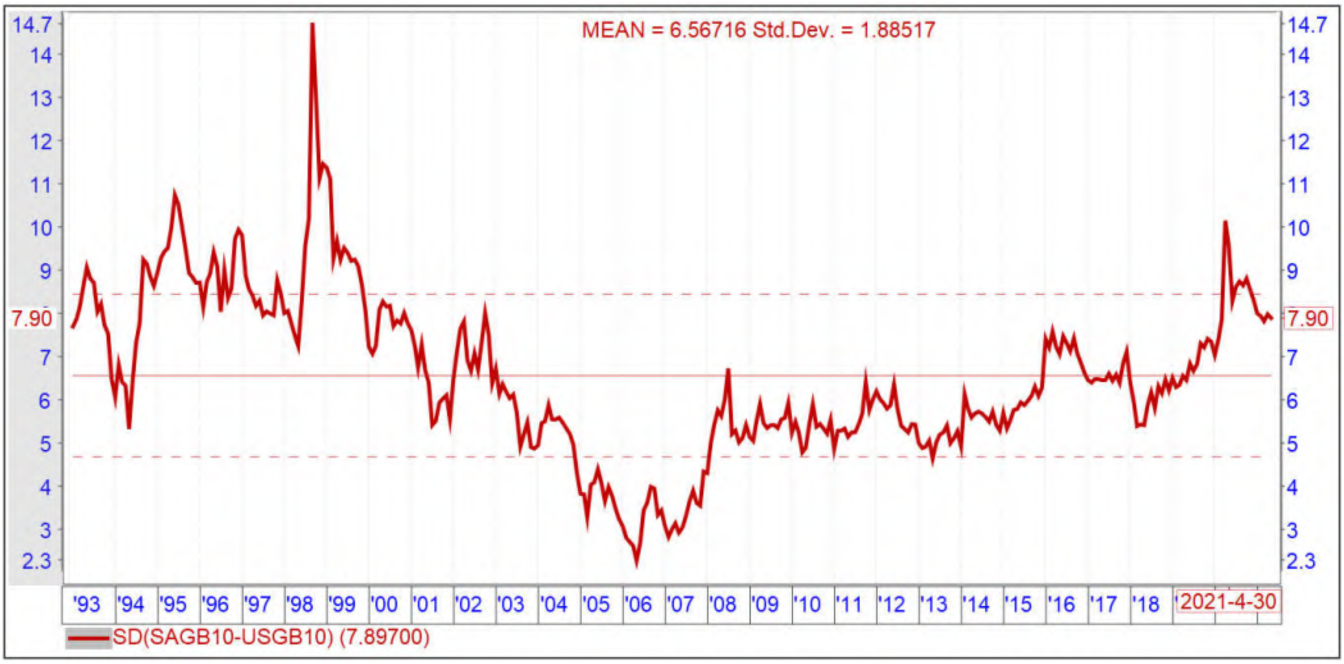
Purchasing Power Parity of the R/$



2. **Interest rate differential RSA vs USA**

Interest rate differentials between South Africa and the USA will not give us a fair R/$ value level but will rather give us an indication of the global attractiveness of the South African capital market. In other words: The higher the differential between RSA and the USA, the greater the likelihood that international capital can flow to our domestic capital market. The graph below indicates the rate differential between the 10-year government bond of RSA and the USA. The South African government bond is currently 7.9% higher that its US counterpart and 1.33% higher than the 6.56% long-term average of the differential. Despite our government debt rated at junk status, the interest rate offered by our 10-year government bond is attractive to foreign investors. Over the last three months we have seen a decline in the net sales of South African government bonds by foreigners.

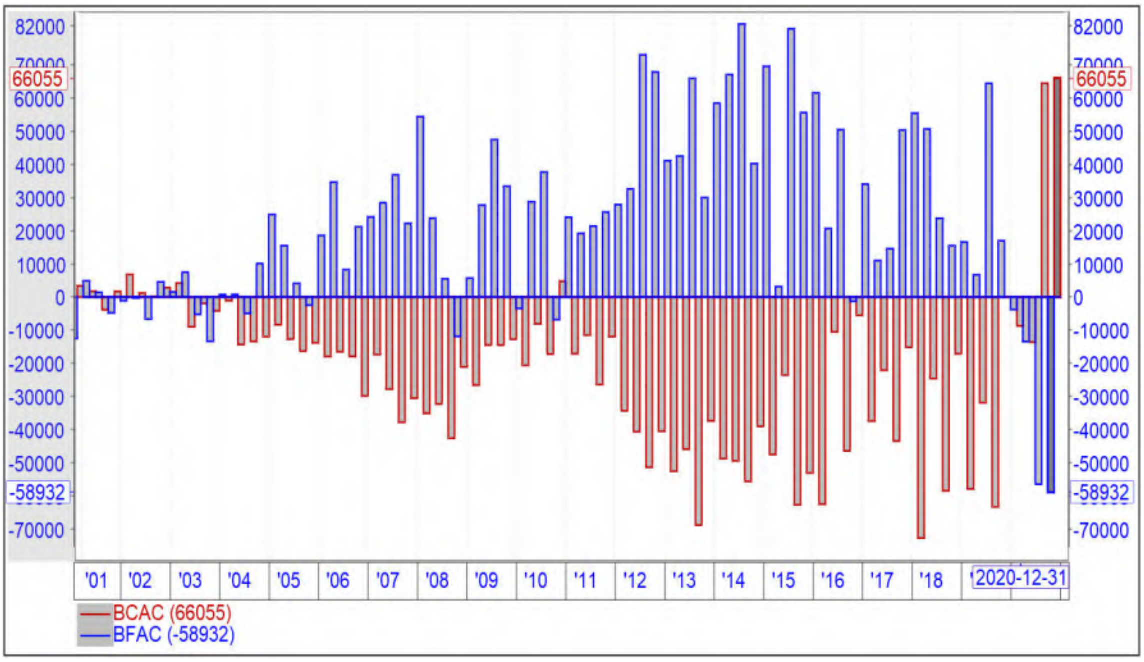
RSA 10-year government bond minus USA 10-year government bond - %



3. **Balance of payments**

The balance of payments, which includes both the current account and the financial account, is also a good indicator of global cash flows to a country. The balance on the current account is calculated by deducting the value of the import of goods and services from the value of the export of goods and services. For the last two quarters of 2020, the current account balance was positive. This was mainly due to lower imports resulting from the sharp decline in private consumption expenditure during the lockdown and a sharp rise in exports due to the weaker rand and rise in the dollar prices of commodities. The negative financial account was mainly due to high net sales of South African shares and government bonds. The sum of these flows in the current- and financial account was a balance of payments surplus for the last two quarters of 2020.

RSA balance of payments – R billion



This positive balance on the balance of payments supported the rand to strengthen further against the US dollar.

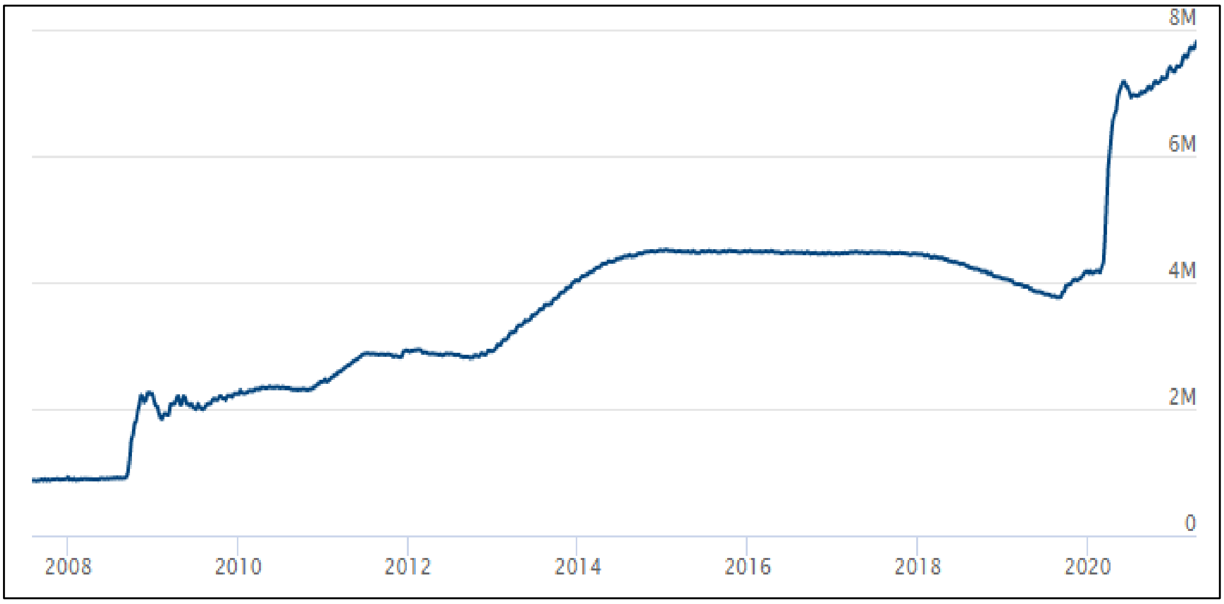
4. **<u>US $ strength/weakness against the Euro (€)</u>**

At a time when the US dollar is strengthening against the Euro, prices of precious metals and bulk commodities are decreasing, which indirectly puts downward pressure on the rand. The opposite is also true. In short, the weakening or strengthening of the US $ against the Euro will indirectly determine the direction of the rand against the US $.

€/$ (red line) vs R/$ (blue line)

The red line is the R/$ and should be read on the left-hand axis. The blue line is the €/$ and should be read on the right-hand axis. From the beginning of 2020, the US $ ($1.12) strengthened to $1.08 against the Euro at the end of May 2020. Thereafter, the US $ weakened from $1.08 to $1.21 against the Euro. This sharp weakening of the US dollar against the Euro was mainly due to the Federal Reserve (Fed) pumping $4.5 trillion liquidity into the foreign exchange markets by expanding their balance sheet. This stimulation was also supported by the $3 trillion fiscal simulation initiatives from the US Treasury. See the chart below. We knew that the Fed and Treasury would stimulate, but its size and scope surprised us. As a result, the rand strengthened sharply against the US dollar from R19.00 to R14.30.

Federal Reserve's asset expansion on its balance sheet



To put the $4.5 trillion stimulus in context, it must be noted that the nominal GDP of the USA is approximately $22 trillion. This stimulus is at least 3 to 4 times greater than that of the stimulus during and after the sub-prime financial crisis of 2008. The Fed has speculated that they may start phasing out their stimulus and quantitative easing in 2023. If the US economy recovers faster than the markets expect, the phasing out will commence sooner. The US 10-year government bond is 1.82% higher than the European Union's 10-year government bond which will place a limit on the extent to which the US dollar will weaken further against the Euro. At the beginning of 2021, the differential was only 1% in favour of the US 10-year bond.

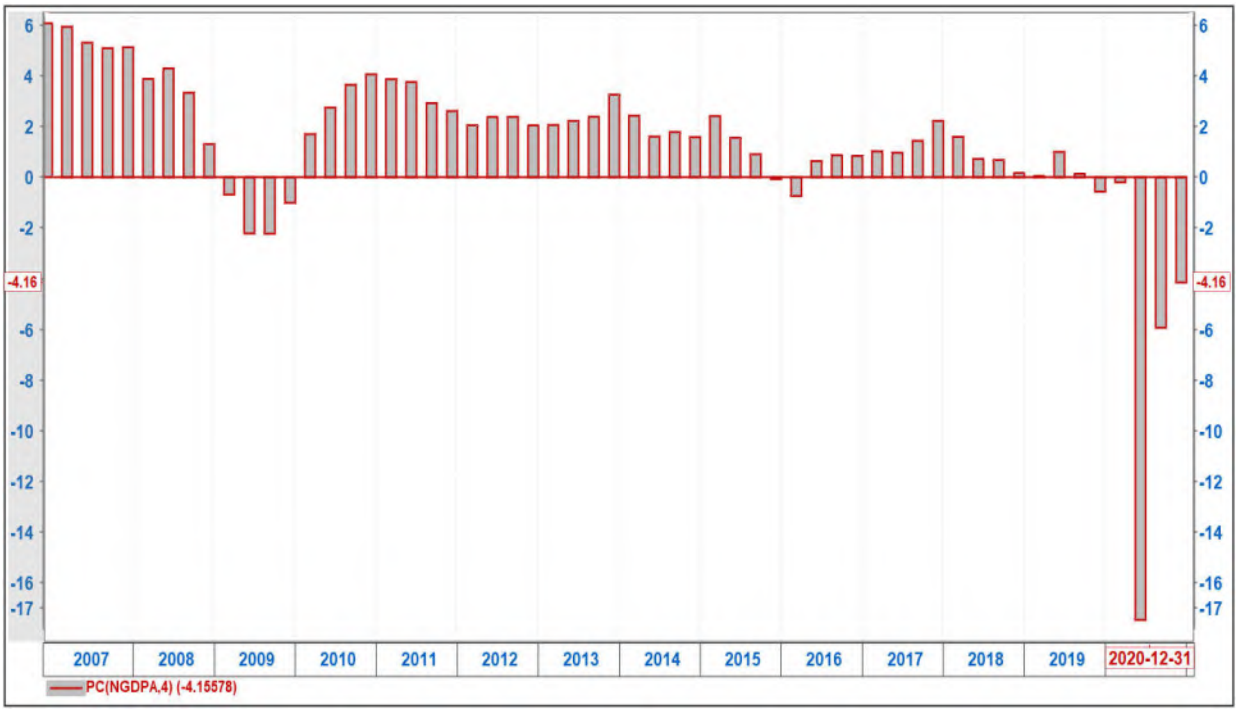
The weakening of the US $ against the Euro from May 2020 was undoubtedly the biggest driver of the rand strengthening we have witnessed.

5. **South Africa's economic growth**

Countries which economic growth rate outstrip their population growth rate over the medium- to longer term, are usually an attractive destination for international investment capital. As shown in the balance of payments graph above, capital flows to South Africa have been steadily declining since 2015.

The sluggish economic growth in South Africa over the last decade has been one of the main reasons for this. Long before the Covid-19 virus, South Africa's real economic growth dropped from an average of 4-5% per annum to a negative figure of -0.21%. The contraction of the South African economy in the last two quarters of 2020 and the first quarter of 2021, resulted from the destructive nature of the lockdown on the domestic economy which was already in recession. Few foreign investors will see opportunity for large-scale investment in such a low-growth environment. On the contrary, the low-growth environment has caused net outflows of capital.

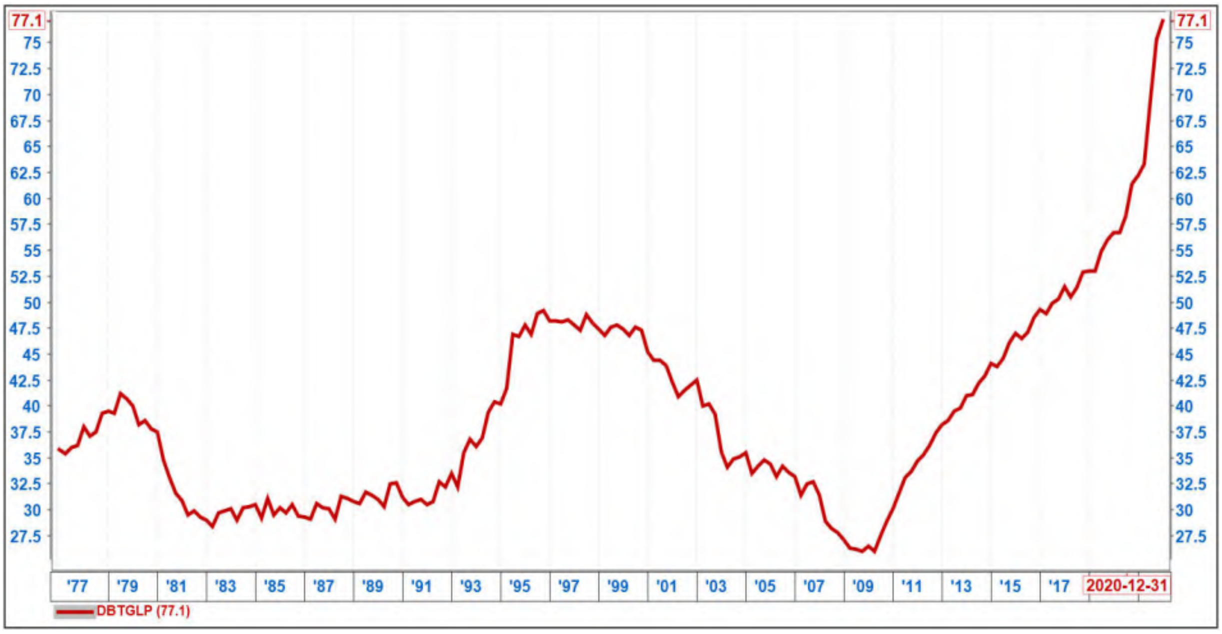
South Africa's real economic growth - %



6. **<u>Economic policy</u>**

The strong socialist element in South Africa's fiscal policy together with the exponential growth in government debt (see graph below), bankrupt state-owned enterprises such as Eskom and SAA etc., expropriation without compensation, fraud, state capture, theft, lack of expenditure on physical infrastructure and ignorance, creates an extremely negative CRP in the value of the rand. There are currently no positive fiscal policy initiatives that can turn the situation around.

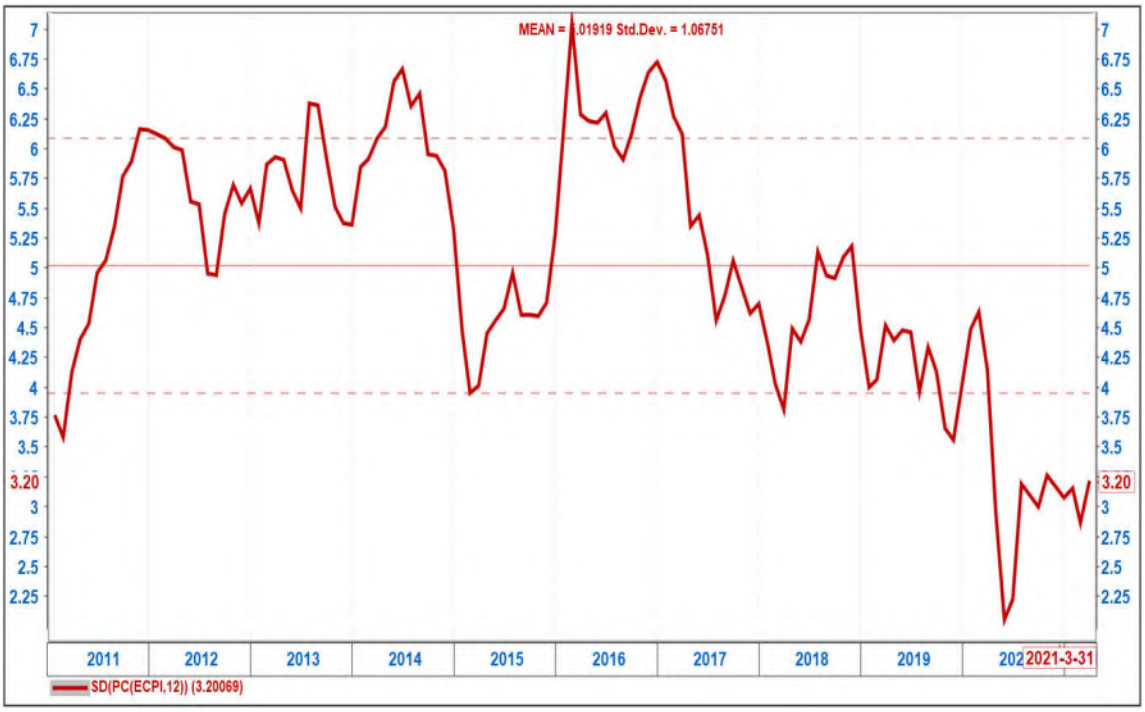
RSA Government Debt as % of GDP



Were it not for a disciplined conservative application of monetary policy by the South African Reserve Bank (SARB) over the past decade, South Africa would most likely have entered into the early stages of a Zimbabwe scenario, marked by a sharp rise in the inflation rate. The result of the sound monetary policy applied by the SARB, i.e., growth in money supply that is sufficient to satisfy the demand for money from the nominal economy without excessive price pressure, is a low average inflation of 5% over the last 10 years. This inflation rate is low is for an emerging country. Presently the inflation rate is a low 3.2%. See graph below for the average inflation rate over the past 10 years. The one leg of economic policy that prevented the South African rand from moving into a free fall, is monetary policy. This despite our poor fiscal policy that did not support monetary policy. The president of the SARB deserves recognition for his attempt to protect the value of the rand.

One of the major threats to our sound monetary policy is the large group of cadres within the ANC who are promoting the nationalisation of the SARB. Their main purpose is to establish a monetary policy that offers cheap money to the economy. There are plenty of case studies and examples worldwide that show us the results of such a cheap monetary policy - hyperinflation with the inevitable destruction of South Africans' wealth and prosperity.

South African Inflation - %



7. **<u>Credit rating of RSA's government debt</u>**

The creditworthiness of a country's government is simply its ability to meet its financial obligations regarding the repayment of government debt. As we already know, South Africa's government debt has been downgraded to junk status. Furthermore, two of the three credit rating agencies even assigned a negative outlook to our junk status. See table below for a summary of South Africa's credit rating of government debt by Moody's, Standard & Poor's and Fitch. When a country is downgraded to junk status, international capital will no longer flow to that country resulting in pressure on the country's currency.

RSA's Latest Credit Ratings

Moody's	S & P	Fitch	Meaning of the credit rating	Status
Baa1	BBB+	BBB+	Adequate solvency	Investment rating
Baa2	BBB	BBB		
Baa3	BBB-	BBB-		
Ba1	BB+	BB+	Solvency uncertain	Junk status
Ba2	BB	BB		
Ba3	BB-	BB-		
B1	B+	B+	Great uncertainty about solvency	Severe junk status
B2	B	B		
B3	B-	B-		

8. Summary

To make sense of the discussion of the factors that influence the value of the rand, we scored the various factors out of 10 in three categories, namely strengthened, neutral and weakened. This is summarised in the table below. The period under consideration is 6 months. The factors have not been weighed, but it gives a general indication that the rand may further moderately strengthen against the US $ over the short to medium term, as the total points in the left-hand column suggest. However, this is not cast in stone as the points for strengthening and weakening don't differ by much.

FACTORS THAT DETERMINE R/$	RAND STRENGTHEND	RAND NEUTRAL	RAND WEAKENED
PPP	7	3	0
INTEREST RATE DIFFERENTIALS	7	2	1
BALANCE OF PAYMENT	6	3	1
US $ STRENGTH	5	3	2
ECONOMIC GROWTH	0	2	8
FISCAL POLICY	0	2	8
MONETARY POLICY	9	1	0
CREDIT RATING	0	3	7
TOTAL	34	19	27

9. Technical analysis and recommendation

The foregoing factors are mostly fundamental in nature. For further technical guidance, we also provide a graph of CIB Nedbank's market research on the R/$ exchange rate levels and an indication of where clients may consider converting rand to US-dollar. The extreme level on the strong side is R13.20 and on the weak side R19.30. The two points remain in a rising channel. We would recommend that clients convert rand to US $ when the R/$ levels reach between R14.30 and R13.80. If they want to take more risk, wait for R13.50 and R13.20. Were it not for the extremely poor economic and political situation in South Africa, we would have advised its clients to wait for the R10.70 level. The risk to wait for the R10.70 level, however, is just too big. It is our opinion that approximately 85% of the rand strengthening is complete and that clients should now take the opportunity to convert rand to US dollar. This could very well be the last opportunity before the rand starts weakening again.

R/$ - Exchange rate

Regards,

Eben Smith.