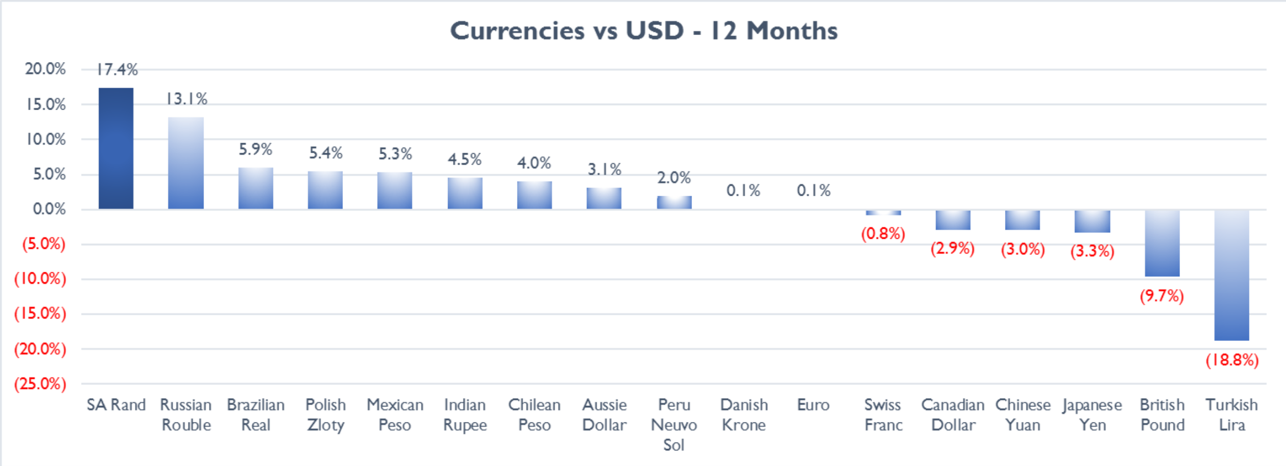
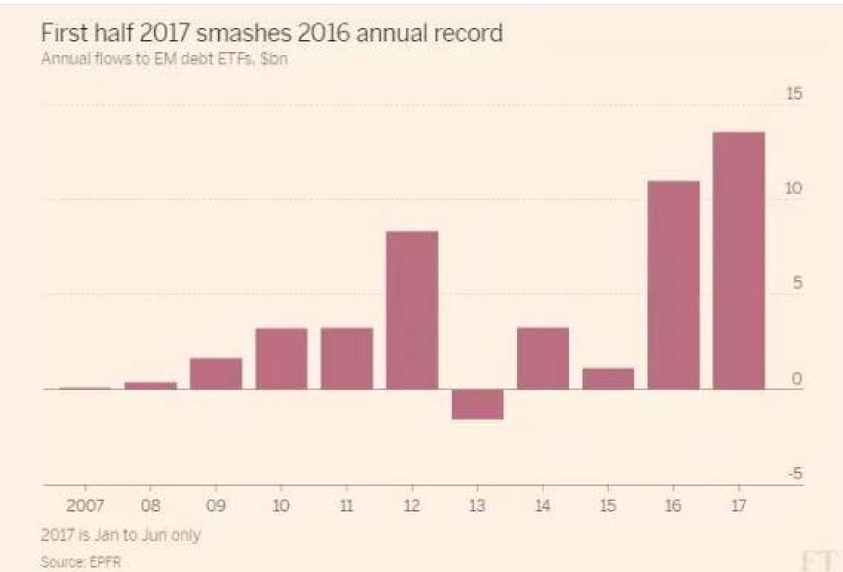
Why is the Rand so strong?



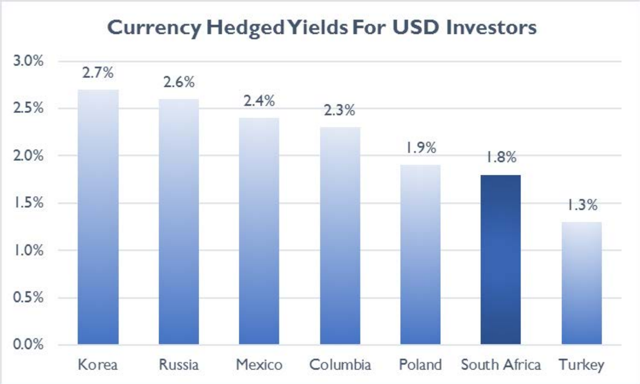
Weakening economic fundamentals, high unemployment and politics that reads like a story book – how is it that the Rand has managed to shrug off what seems like constant negative news – and more importantly, does this continue?

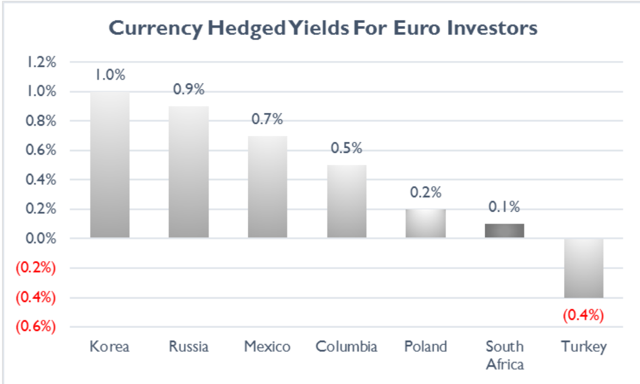
The short term direction of the currency is inherently difficult to gauge – having experienced by and large most of the 'triggers' that many predicted would cause a weakening in the currency, which has yet to happen. South Africa's equity and bond markets, as well as the Rand and other emerging market (EM) currencies, are at the mercy of the broader global market sentiment toward emerging markets rather than SA-specific factors. This sentiment generally tends to swing with commodity prices, as many emerging markets are inextricably linked to commodities. An example of our global link was on display post the Pravin Gordhan firing. In the two weeks that followed his recall from an investor roadshow in the UK, foreign investors purchased more than R20bn ($1.4bn) worth of SA government bonds – since then we have seen more of the same and foreign holders of our Government bonds are now at record levels, above 40%! Historically, the Rand tends to trade in line with other emerging market currencies, the bulk of which are driven by the resource cycle – many of these EM's are resource based economies. *This link with the commodity cycle seems to have broken down recently, particularly true for the Rand, and replaced by the significant flow of international funds into our bond market.*



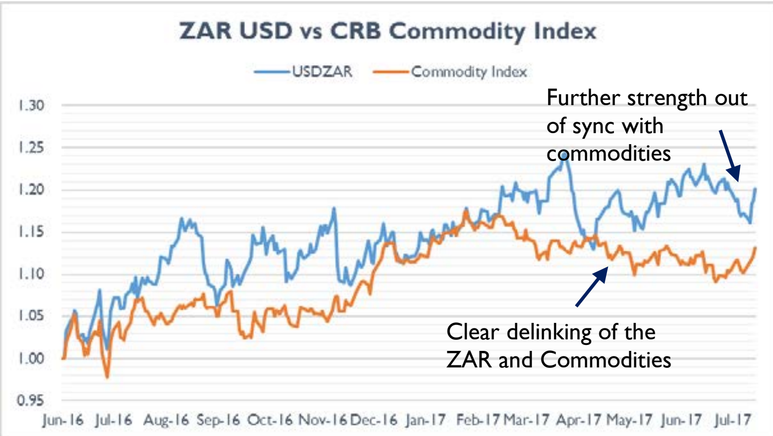
As discussed above, the Rand has managed to stay strong mainly as a result of the significant inflow of foreign money. This flow is clearly outlined in the graph alongside, where the period January to June 2017 has seen more funds flowing into emerging markets than was the case for the entire 2016 year! Foreign investors can borrow at very low rates in the developed world and are able to buy our government bonds on which the yield alone is around 9% - *not a bad return for a developed market investor where inflation is close to 0% and you can borrow at anywhere between 1% and 3%!*

Why is the Rand so strong? (Continued)





The catch comes in here – some of these investors would be hedging the currency, which comes at a cost, to ensure they are able to earn an 'almost' guaranteed return for the amount of time they have their money in our bonds. Based on a BCA Research report published recently, this 'hedged' return that foreign investors are now getting on SA bonds is not as attractive as it once was – meaning that it is either costing them more to lock in that hedge or they are only able to lock in a Rand rate higher than what they were previously – *clearly not as attractive as some of our peers and maybe political risk starting to rear its ugly head?*



Historically a tell-tale sign of emerging market activity are resources. January 2016 saw a major positive move for resources, as did the Rand, and the thinking is that emerging markets are able to export more, making our current account look good and this feeds into the general positive sentiment around EM's. Again, as indicated, there is a clear 'de-link' between the Rand and the CRB Commodity Index, a composite used to depict commodity prices. The picture tells the story – *we either see the commodity index tick up and 'join' the Rand again or the Rand turns down and follows the index?*

Lastly, and a topic spoken about ad nauseam by many, are our ratings. Fitch and S&P reaffirmed their credit rating for South African debt with Fitch having junk-rated both SA's foreign and local currency rating, while S&P kept SA's domestic currency rating one-notch above junk. Moody's has downgraded its rating by one notch, keeping SA's credit at the lowest investment grade rating. For South African government bonds to no longer be eligible for inclusion in the Citi World Government Bond Index, both S&P and Moody's need to downgrade SA's local currency credit rating to junk. The risk of further downgrades has now essentially shifted into the second half of this year and will therefore depend on the outcome of the ANC elective conference in December – unless there is a 'blatant' negative even between then and now, which will cause the agencies to move sooner than planned.

Inflation pressures have been receding, as the country recovers from the drought-related food price increases in 2016, with the current maize crop estimate for 2017 being one the highest on record and more than double 2016's harvest. Despite the pull-back of headline inflation into the SARB's 3%-6% target band, ongoing political uncertainty has thus far prevented the SARB from cutting interest rates. The door has, however, been left open for an interest rate cut in 2017 – *let's hope it comes later this week!*