The Macro Research Desk

Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

Responding rationally to rand and recession ructions

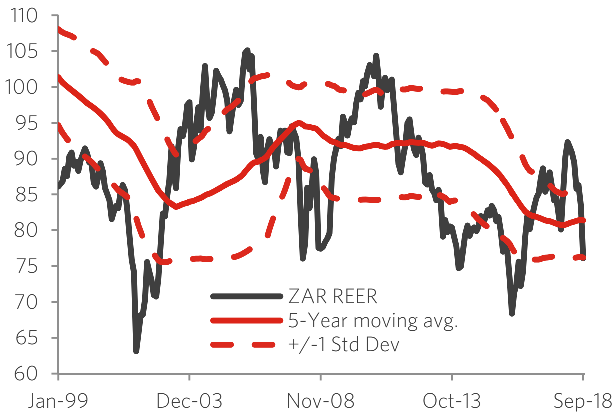
The reality of rand weakness and local recession

In recent months, the South African (SA) economy and financial markets have been continually buffeted by relentless rand weakness, with the local currency losing a quarter of its value since the inauguration of President Cyril Ramaphosa in mid-February 2018 (see chart 1). While the rand's travails have been predominantly driven by Turkey-inspired fears for emerging market (EM) contagion against the backdrop of tightening global liquidity conditions, with the US central bank's interest rate hiking cycle causing dollar strength, this was recently exacerbated by uncertainty about the final outcome of local land reform policy and, eventually, this week by news that the SA economy officially slipped into recession in the second quarter of 2018.

Chart 1: Rand/dollar weak during Ramaphosa era

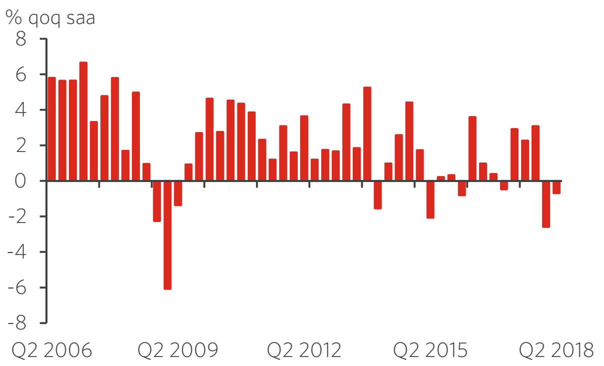
At the outset, it needs to be acknowledged that the rand is fundamentally a weak currency, reflecting the inability of SA to sustainably finance its perennial current account and budget deficits with foreign long-term capital due to relative unattractiveness of its low-growth economy. While the rand will portray interim strengthening characteristics during periods when it has been aggressively oversold (like now, in Momentum Investments' view - see chart 2) or when global liquidity is rampant, its prevailing trend over time will be to weaken in line with SA's long-term inflation differentials with the major global economies (estimated to be around 3.5%). To improve the fundamentals for the rand and, hence, ensure a less volatile and less weak local currency, it is thus essential for SA's policymakers to undertake the necessary policy reforms (on labour and product markets, for instance) to propel the SA economy to a higher growth plane to sustainably entice long-term foreign capital to finance the country's twin deficits on an ongoing basis.

Chart 2: Rand real effective exchange rate (REER) now undervalued



After poor SA growth in the first half of 2018 (with two consecutive negative quarters on a quarter-on-quarter seasonally adjusted annualised (qoq saa) basis- see chart 3 - and growth up only 0.9% for the first half of 2017), the base is probably now low enough to expect some positive rebound on a qoq saa basis in the second half of this year. Nevertheless, growth for 2018 is now likely to end up in the 0.5% to 1% range, rather than the 1% to 1.5% range previously expected. In this regard, President Ramaphosa's upcoming investment conference and jobs summit, the outcome of the land reform debate and the finalisation of the revised mining charter will be crucial in determining the longer-term outlook on SA's structural growth trajectory (and, hence, the country's fiscal and debt dynamics in coming years).

Chart 3: SA economic growth



As SA's (poor) economic growth trajectory has been one of the main focus points for the rating agencies in determining the country's fiscal sustainability, the weaker-than-expected growth outcome in the first half of 2018 should have negative implications for their fiscal projections for the country and, in turn, for SA's debt sustainability. As such, the probability for some negative rating action has no doubt increased due to the current weak growth environment. All rating agencies have SA on a 'stable' outlook, so any rating action will likely first be on the outlook, rather than on the rating itself. Nevertheless, if rating agencies believe there are positive developments on the policy reform front, they could again give the SA policy makers the benefit of the doubt and keep ratings unchanged.

In Momentum Investments' view, the South African Reserve Bank (SARB) will only react to rand weakness if second-round inflationary pressures become apparent and might view the current 'sacrifice ratio' for the economy (the negative growth effect of interest rate hikes) as too high to increase interest rates, particularly if they view the current rand weakness as transitory due to EM factors.

The rational investor response

Dealing with uncertainty and volatility is never easy. However, the prudent investor response would be to acknowledge that volatility is part and parcel of the behaviour of investment markets (and, hence, to accept volatility as part of the DNA of investing), to therefore always remain focused on the long-term investment goal, not to panic or behave irrationally, but to stay invested.

Momentum Investments has an investment team comprising more than 80 individuals that construct and manage client portfolios according to an outcome-based investing philosophy that incorporates the long-term goals of its clients, as well as their stated risk appetites. In this regard, the company continually ensures its portfolios are appropriately diversified across asset classes, investment strategies and mandates to smooth the investment journey to the company's clients' required outcomes as much as possible and to cope with the inevitable volatility that characterises investment markets from time to time. In addition, the incorporation of risk parameters in Momentum Investments' strategic asset allocation process ensures the drawdown risk within its investment portfolios is minimised over appropriate investment horizons.

Momentum Investments remains steadfast in its view that appropriately diversified portfolios that incorporate a well-constructed asset allocation process within a multi-asset, multi-strategy and multi-mandate portfolio framework remain paramount to maximising long-term financial wellness for the company's clients. As always, Momentum Investments also remains vigilant in identifying potentially lucrative opportunities from asset price weakness associated with any risk event to add strategic exposures to long-term portfolios if justified by an appropriate improvement of the risk-reward ratio, with the aim to increase portfolio returns for clients in the long run. In particular, the company's significant exposure to global asset classes should provide some protection for its client portfolios during periods of rand weakness.