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LESSONS FROM AN UNEXPECTED CONTENDER IN THE RAND'S BATTLE AGAINST ONGOING CURRENCY WEAKNESS

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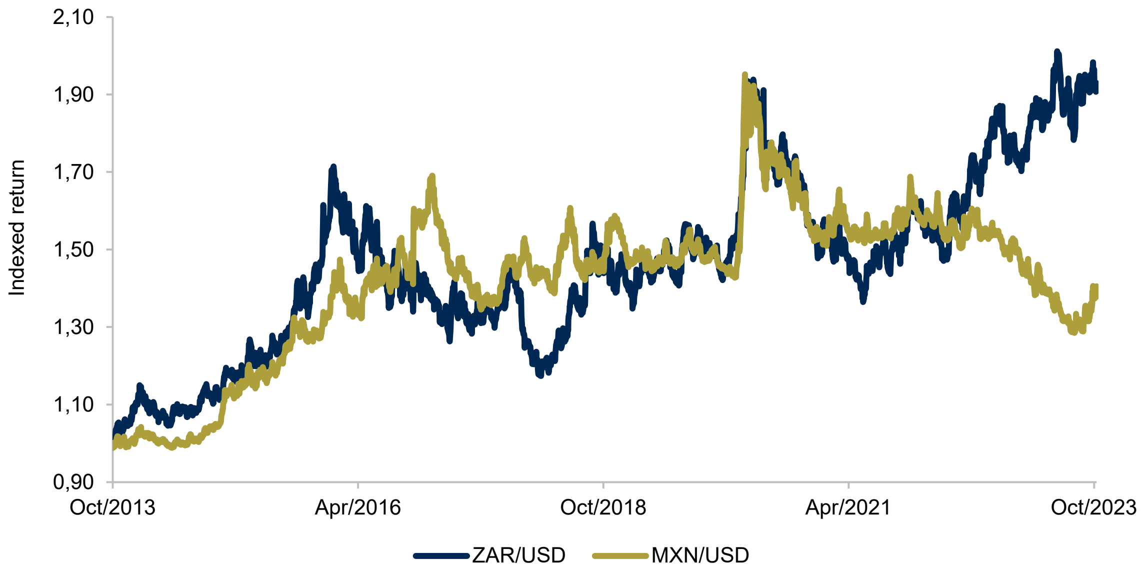
South Africa's rand has had an exceptionally volatile year, almost reaching R20 to the dollar in May before strengthening to about R17.27 in late July and then weakening again to trade between R18 and about R19.30 to date. Most notable about the domestic currency's weakness is that it has been weak on a relative basis compared with some of the other emerging market currencies and not just against the US dollar, which suggests that there are other forces at work.

Over the past two years, South Africa has not only weakened against the dollar, but it has come up against an unexpected contender: Mexico. The Mexican peso has performed much better than the SA rand against the dollar since mid-2022, when the peso decoupled from our exchange rate after closely tracking it for years. The chart below, which compares the performance of the two currencies relative to the dollar, shows the peso has strengthened over the period while the rand has weakened.

South African rand vs. Mexican peso: normalised returns



Source: Prescient Investment Management, Bloomberg (as at 18 October 2023)

So where has the rand's weakness stemmed from? The emerging markets, of which South Africa is one, are often viewed as a collective by foreign investors. Though diverse, these countries are generally considered to offer the prospective of relatively higher returns based on their faster economic growth rates and more favourable demographics than advanced economies that are aging fast.

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Thus, investors willing to take on the higher risks associated with emerging markets stand to benefit from the opportunities they offer. Their fixed interest yields ordinarily compensate investors for their risk by trading at a premium to developed market yields, particularly to US Treasuries, which are viewed as safe havens. Stock markets, like South Africa's JSE currently trades at a discount, with the US stock market currently trading above its long-term average after an extended bull market.

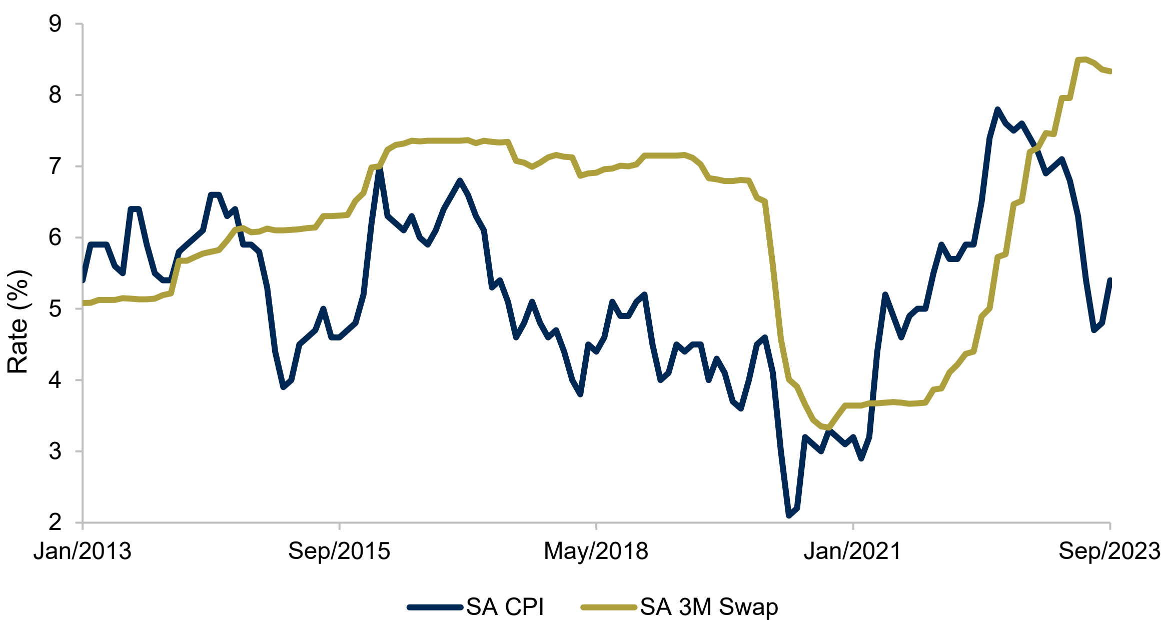
Emerging market financial markets and foreign exchange rates usually benefit during periods when investors have an increased appetite for risk, resulting in a weaker dollar when money flows out of the US and into emerging market assets, and lose ground when investors become risk averse and money flows back into the US, buoying the dollar.

Notwithstanding these opportunities, the US Federal Reserve's proactive stance on interest rates, outpacing counterparts like the Bank of England and the European Central Bank, saw the US dollar gain significant ground over the past two years, fortifying its position as the strongest currency globally. It has also confounded expectations that it will weaken this year in anticipation of the US's long-awaited recession. High interest rates have been expected to take their toll on the world's largest economy, but the economy has proved much more robust then envisaged.

Emerging market currencies, like the rand, typically face headwinds in the wake of a robust dollar. Yet exceptions to this trend exist. Notably, the Mexican peso has been remarkably and unusually resilient against the dollar. South Africans can glean invaluable insights from Mexico's experience, which can be attributed to the country's favorable economic conditions and inflation dynamics, but most importantly prudent central bank policies.

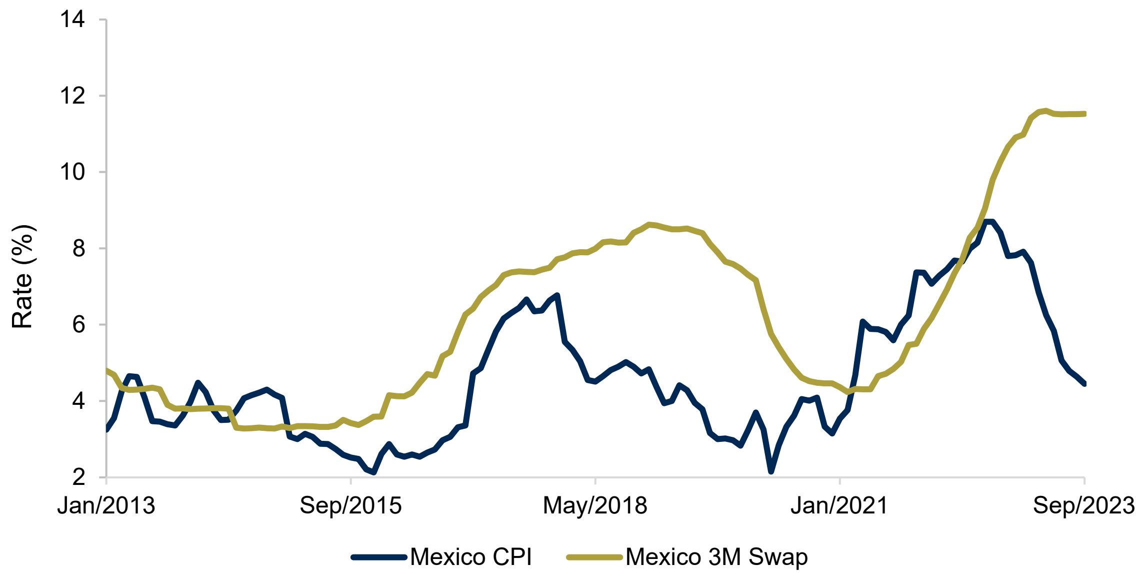
The peso has benefited from the Bank of Mexico raising rates in line with rising inflation. While the South African Reserve Bank (SARB) responded swiftly to the threat of inflation too, its approach has been more measured and this nuanced distinction has played a pivotal role in the divergence in the performance of the rand relative to the peso against the USD.

South African CPI vs. 3m swap



Sources: Prescient Investment Management, Bloomberg (as at 30 September 2023)

Mexican CPI vs 3m swap



Sources: Prescient Investment Management, Bloomberg (as at 30 September 2023)

It is crucial to recognize that currencies are inherently relative, reflecting disparities in economic fundamentals, inflation projections, central bank strategies, and interest rates between the countries against which they are measured. Exchange rates thus serve as the barometer of a nation's relative economic vitality on the global stage.

Real interest rates matter most in foreign exchange markets and explain why the Mexican peso parted ways with the SA rand last year. In 2022, the Bank of Mexico swiftly returned to positive real rates while the South African Reserve Bank allowed our currency to experience negative real rates at the front end of the curve for a slightly longer period.

Today, however, South Africa enjoys elevated real interest rates and inflation appears largely under control, bolstered by a central bank that remains steadfast in its fight against inflation. However, are rand remains starkly undervalued and most of our asset classes are trading at a discount globally.

To unlock SA’s exchange rate and foreign investment potential and return SA to favour with foreign investors, its paramount that government moves ahead with its structural reforms, facilitates robust infrastructure development and secures political stability. Addressing these crucial factors could set the stage for the rand to strengthen against the dollar to a point where it is fairly valued again, regaining its rightful place alongside other emerging markets, like Mexico.

In early November, the rand benefited from the US Fed’s decision to keep interest rates at current level and the subsequent weakening in the dollar. It also managed to withstand the disappointing news in the mid-year Budget that the budget deficit is going to be much higher than targeted, undermining National Treasury’s fiscal consolidation efforts. Disappointment on the fiscal front will need to be counterbalanced by progress on the other fronts if SA has any hope of regaining its lost ground against the dollar and recoupling with Mexico’s peso anytime soon.

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