Cry, The Beloved Currency

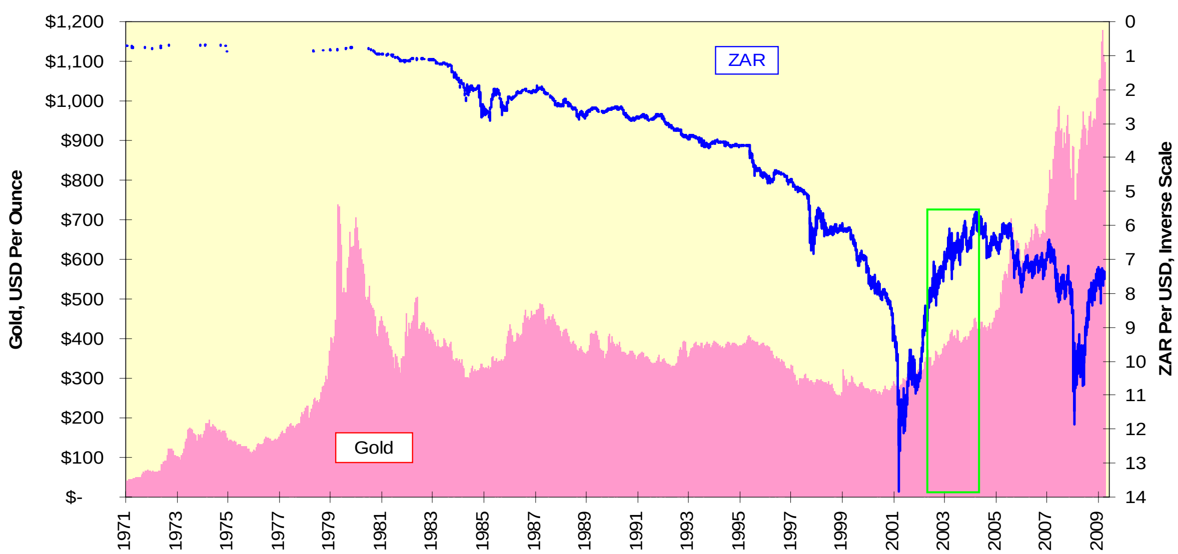
There was a time, not too long ago, when it would have been impossible to write anything on South Africa for fear of treading upon apartheid-era sensitivities. Those days are mercifully in the past, and while South Africa still has its problems, including an extraordinarily high crime rate and one of the world's highest incidences of AIDS, it is no longer an international pariah.

If we were to play any sort of word association game these days with South Africa, "gold" might come to mind. South Africa, along with Australia, central Canada and western Siberia has one of the world's greatest concentrations of mineral wealth. If we may take a foray into geology, all of these regions are on continental cratons, or original continental rock. The mineralization of these rocks may extend all the way back to asteroid impacts cracking the earth's early crustal shell and allowing hot, mineral-laden water to seep into the fractures and produce veins of ore.

Put Gold On Hold

The link between gold and South Africa is so strong that most people assume without examining the data the rand (ZAR) has to rise and fall therewith. It should surprise all and sundry to learn the long-term correlation between gold and the ZAR is slightly negative. The only time the two markets moved in synch with each other was the two year period 2003-2004, highlighted in the chart below.

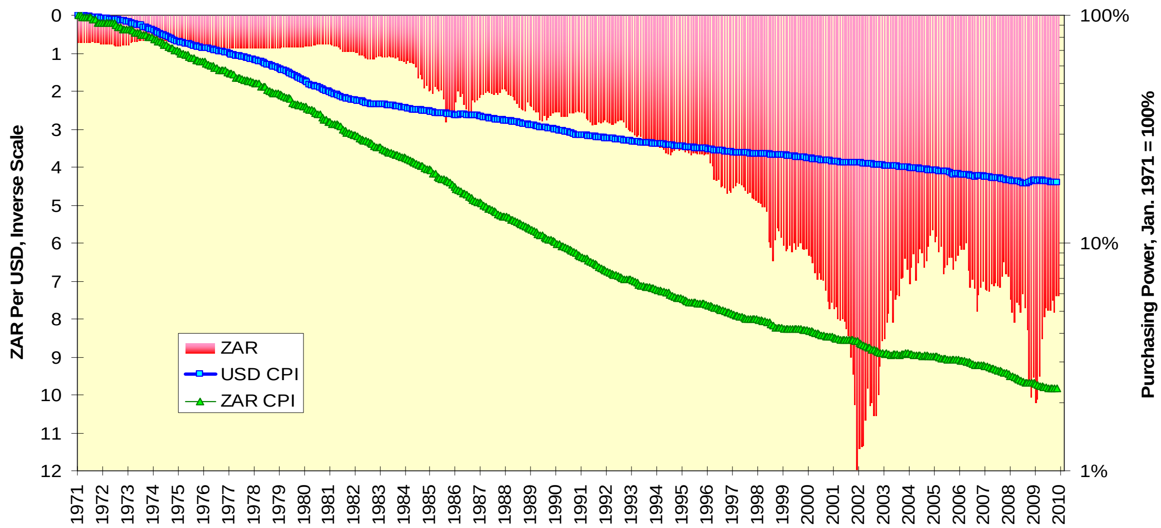
The ZAR Is Slightly *Negatively* Correlated With Gold



The Inflation Connection

As many well-accepted economic theories do not hold up well on examination, we tend to be surprised when they in fact do work. One of these is linked to the theory of purchasing power parity we can demonstrate to be a poor indicator of currency movements (see "A Parody Of Purchasing Power," December 2009). If we map the purchasing power of both the USD and the ZAR going back to 1971, we find the dollar has lost 81.6% of its value while the ZAR has lost 97.7%, a rate of loss 8 times as great. The ZAR is worth only 9.6% of its 1971 exchange rate relative to the USD, an 10.39:1 loss. The ZAR's loss of international purchasing power is greater than its loss of domestic purchasing power, assuming you can believe either country's inflation data.

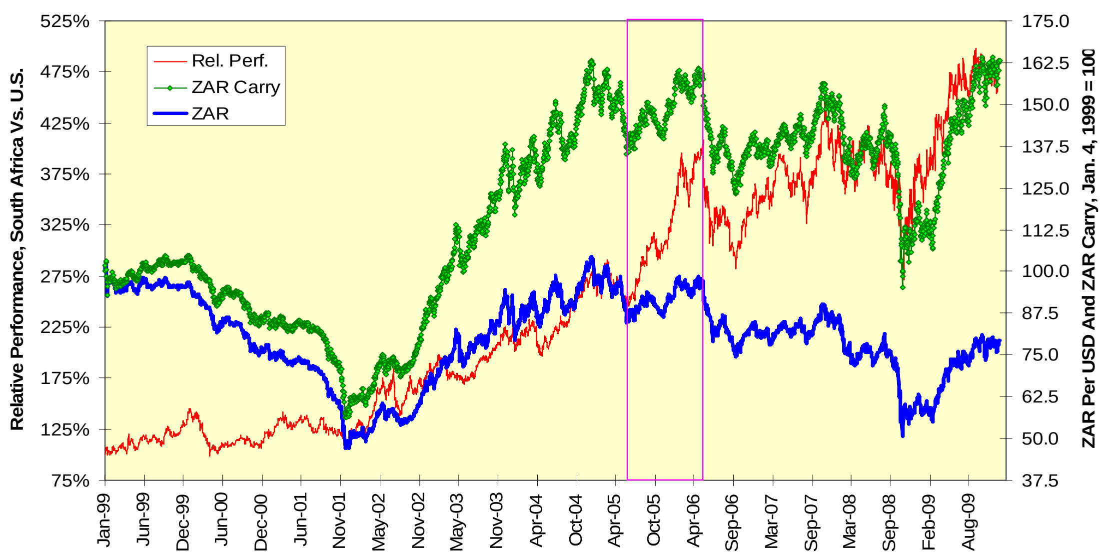
Rand Has Weakened Along With Relative Purchasing Power



Stocks And Carry Returns

The ZAR has tended to yield more than the USD over the years. These interest rate returns can exceed spot rate losses (see "The Short, Awful Life Of The Dollar Carry Trade," August 2008) and make holding the ZAR a profitable venture even when the spot rate slides. If we map the spot rate of the ZAR and its carry return on an index basis going back to the January 1999 advent of the euro, we find a very substantial difference in the two series. The spot rate of the ZAR is 20.7% weaker now than it was in January 1999; the carry return against the USD has been 63.06%.

Trade The Stock Or Lend The Currency?

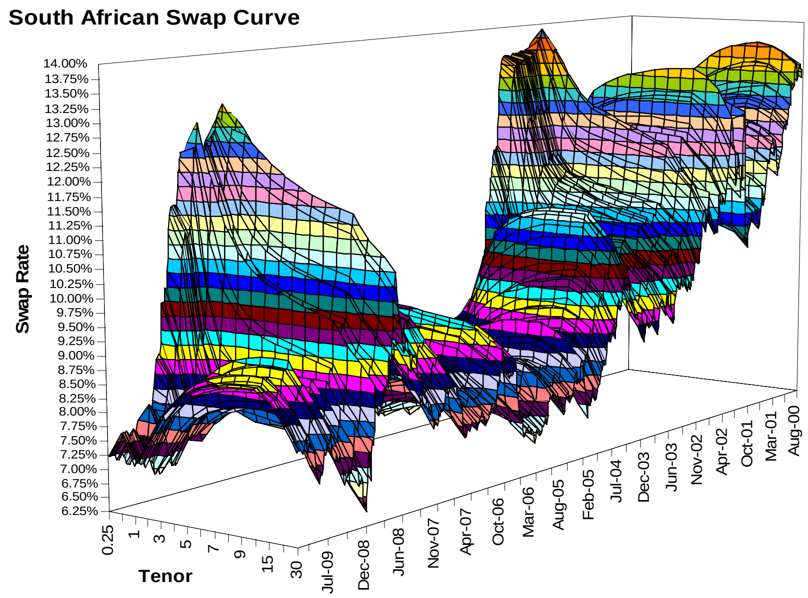


We can add an additional concept here, and that is the relative stock market total returns in USD terms. Between December 2001 and May 2005, the relative performance of the South African stock market had moved closely in parallel to the spot movement in the ZAR. Then between May 2005 and May 2006, highlighted on the chart above, relative performance had no close link to either the ZAR's spot rate or to the carry index. After May 2006, the relative performance of the two stock markets stated to move in increasingly close alignment with the carry index.

This is a rather extraordinary relationship; it says for three years foreign investors in South Africa were rewarded equivalently for swapping USD deposits for ZAR deposits and for swapping American stocks for South African stocks. Sixty years of modern portfolio theory have told us investors in stocks assume greater risks and should expect to receive greater rewards than investors in short-term fixed-income instruments, but the in the South African case this is not at all demonstrable.

An Unstable Swap Curve

The strong returns for three-month ZAR deposits are even more remarkable when the term structure of South African interest rates is taken into account. If we map the swap curve across tenors from three months to 30 years over the past decade, we see some very wide oscillations in both the level of interest rates and in the way the yield curve changes. Yields more the most part have peaked on a ridge between six months and one year, with both the longest-term and shortest-term rates lower. The overall level of yields plunged between 2003 and 2006, the time when the ZAR entered a prolonged rally from nearly 12 per USD to fewer than 6 per USD.

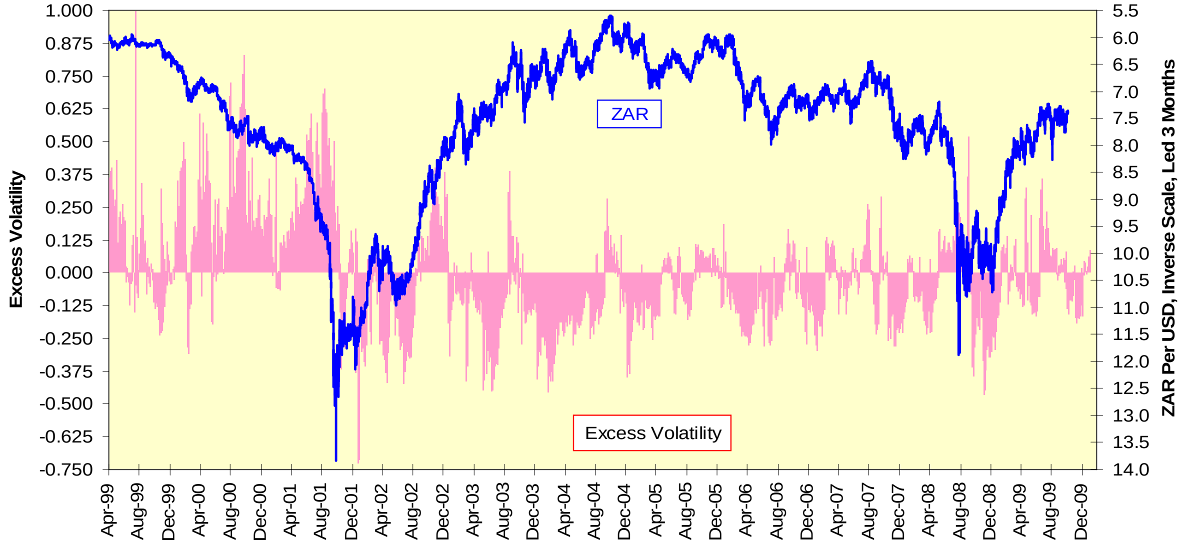


South African rates rose once again during the financial crisis of 2008 as higher yields were required to keep funds in the country. This is consistent with patterns seen elsewhere: While many central banks use higher short-term interest rates as a tool to “defend” their currency and many external investors have come to expect this reaction, the opposite often is true. The higher short-term interest rates are seen as unstable and short-lived instruments of economic damage, while the decision to abandon them as a tool is a signal the economy is about to grow again.

No Worries

An attribute that works frequently in currency markets is a fear gauge, in this case the ratio of implied volatility to high-low-close volatility minus 1.00. It is quite normal to expect a sharp selloff in a currency to be accompanied by rising demand for insurance against further declines. This has not been the case in the rand since 2001. Once the U.S. entered its prolonged period of low interest rates, insurance on the ZAR entered a prolonged period of being cheap. Even during the financial crisis of late 2008, excess volatility remained quite tame.

Insurance On A Stronger Rand Has Been Cheap Since 2003



We are left with the question of what is the primary driver of the ZAR? We know it sinks during financial crises, as do most emerging market currencies, and we know better than to treat it as a simple reflection of gold prices. The best indicator, paradoxically, seems to be South African interest rates and in a different direction than expected. When South African rates start falling, expect money to start flowing into South African equities and for the ZAR to tag along.