South Africa Shows Vulnerability To Carry Trade Unwinding

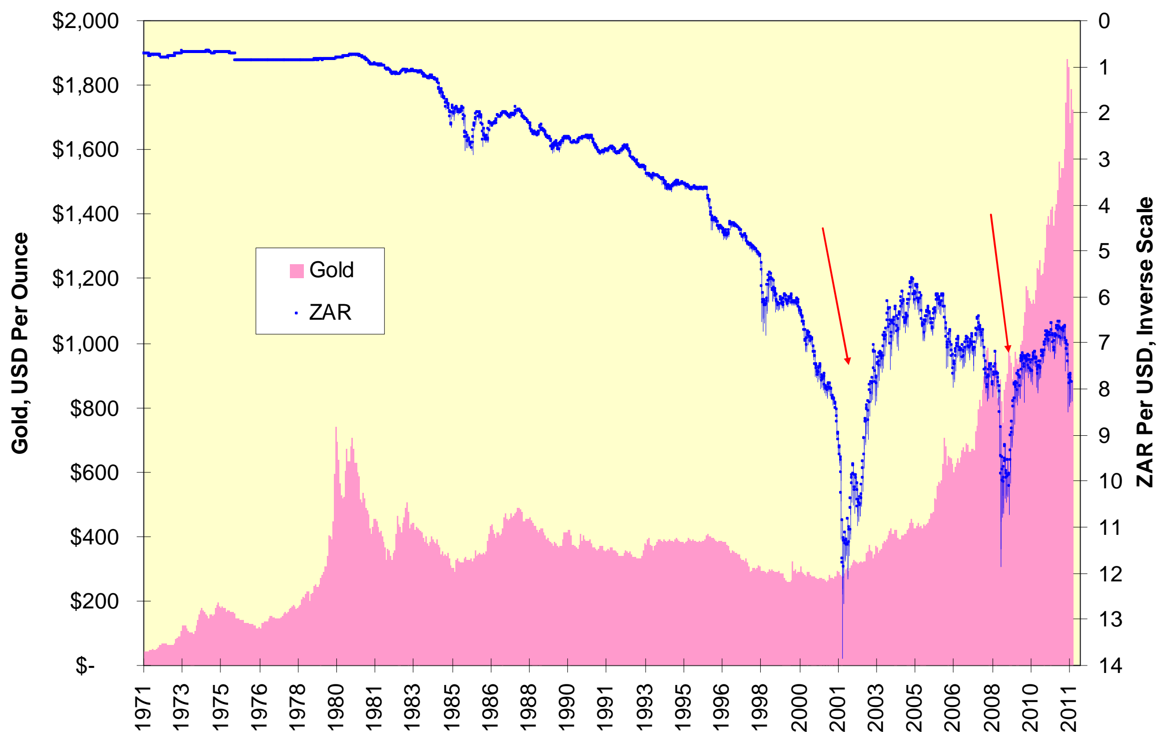
Its Markets Did Not Glitter Like Gold

Back in the days of real gumshoe journalism, when Scotch and cigars were considered two of the four food groups and tweeting was considered an unmanly act at best, there was an entity in Chicago called City News Bureau. Hard-bitten editors devoured soft-boiled eggs and advised their wet-behind-the-ears charges, "If your mother says she loves you, check it out."

This brings us to our topic du jour, different from yesterday, and that is why the South African rand (ZAR) should not be considered a proxy for gold despite the obvious word association between the metal and the country. South Africa is a major producer of platinum group metals, diamonds, coal, steel-making metals such as chromium and vanadium and exports a scad of white corn to Mexico for the production of tortillas. Seriously: I have a very handsome notebook holder made from Cape buffalo leather presented to me by a South African corn grower; his corn helped feed a production line that made (drum-roll, please) 17 million tortillas a day.

However, while gold has been on two tears since the floating exchange-rate era began in 1971, one during the late 1970s and one since 2001, there have been only two short-lived periods, marked with arrows below, wherein the ZAR rose along with gold prices.

The ZAR Has Not Reacted To Gold

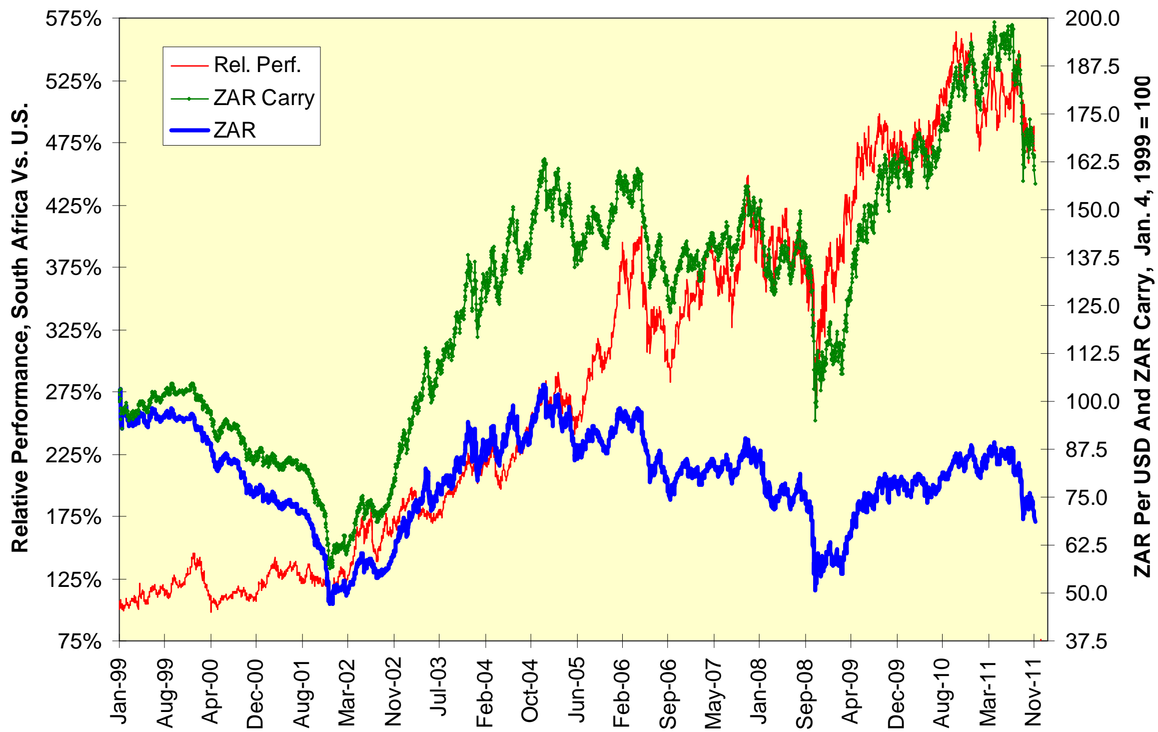


The Carry Trade

As I noted recently in Emerging Markets' Reliance On Cheap Dollars Is Growing, the ZAR has been one of the top five beneficiaries of the dollar carry trade since August 2007. As formerly hot countries such as Mexico prior to its December 1994 peso collapse or Thailand before its July 1997 crisis can tell you, being on the receiving end of carry trade inflows is a far more enjoyable experience than standing in the doorway and begging the funds to return once they have left. This is starting to occur in South Africa today.

If we index the performance of the MSCI-Barra total return index for South Africa, the basis for the iShares South Africa Index fund (EZA) to the U.S. total return index and map it against both the spot rate of the ZAR and the excess carry return for borrowing the USD and lending the ZAR, we see just how closely relative stock market

performance has followed the carry trade return; since July 2006, the r^2 or percentage of variance explained has been 0.757. If we simply focus on the post-July 27, 2011 period, though, a different story emerges: Here the excess carry return has declined 19.18% while the South African market has declined 9.64% relative to the U.S.



I entitled a September column Why the Dollar Carry Trade Could Unwind; in it I noted how a flight from risky assets could lead to a demand for dollars, which in turn would encourage those who borrowed them to close the carry trade loans and buy them back in a sudden and vicious cycle. We can see the start of that process, not only in South Africa but elsewhere. Do not fool yourself into thinking the country is a proxy for gold prices; no, it has been a proxy for hot money looking for a home.