South Africa: All That Glitters Is Not Gold

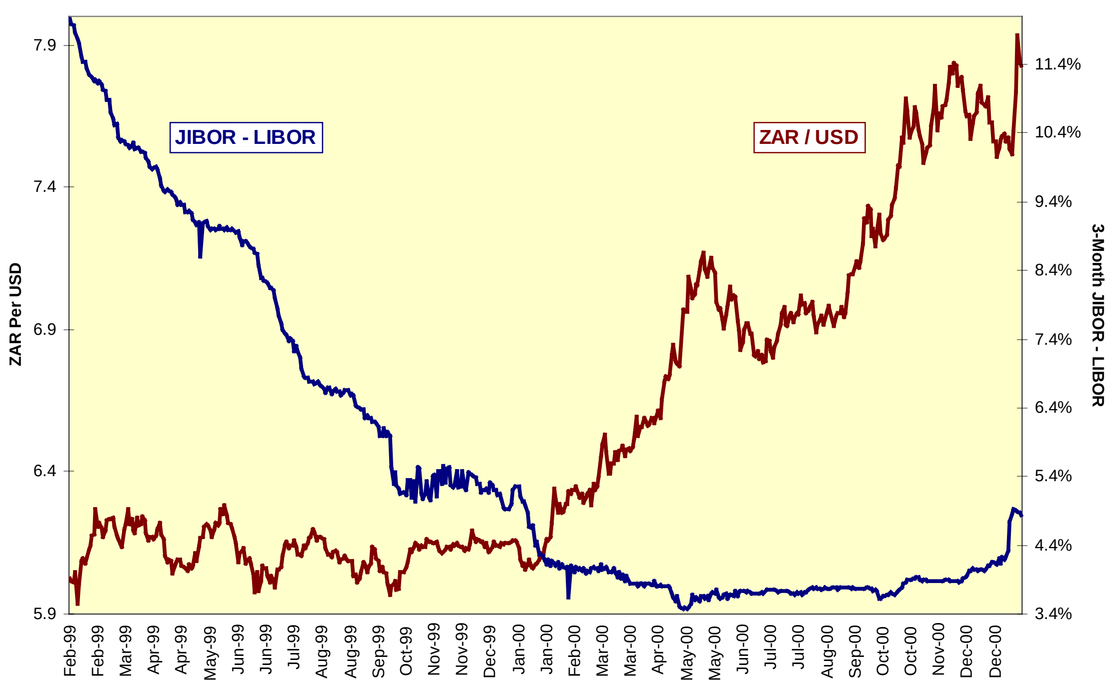
In a week beginning with Martin Luther King Day and in a world still torn by never-ending sectarian strife, the present state of the Union of South Africa stands as a blessed anomaly. The country could have botched its transition from apartheid and lapsed into the combination of civil war and kleptocracy that characterizes so much of the African continent.

But enough of the civics lesson: Let's see how South African markets have been doing and how we can profit therefrom. The answer, in brief, is this is not your father's South African stock market anymore.

A Rand-y Walk Down Wall Street

South African investments are denominated in the rand (ZAR), which, like so many other currencies worldwide weakened significantly over the past two years against the U.S. dollar (USD). However, the trend in the exchange rate has been a function of both USD strength and not ZAR weakness, and of declining interest rates in South Africa. The gap between 3-month Johannesburg interest rates (JIBOR) and 3-month LIBOR declined precipitously from the start of 1999 through the middle of 2000. The ZAR weakened only after the gap stopped narrowing, which is the foreign exchange market's way of saying higher interest rates are needed in South Africa.

The Rand As A Function of Interest Rate Differentials



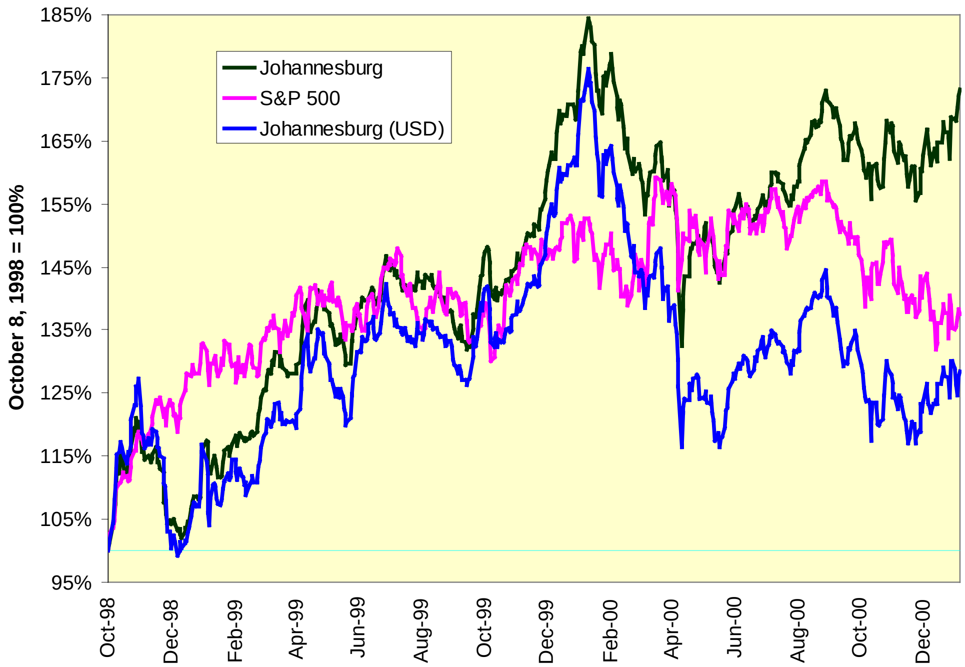
The weakening ZAR does not yet appear to be a source of imported inflation or a matter of concern for Reserve Bank Governor Tito Mboweni. Consumer inflation is presently running at an annualized rate of 7.7%, and Mboweni has repeatedly called for a decline to the 3-6% range by the end of 2002. And, contrary to those who still believe a weakening currency will lead to a trade surplus, the narrow South African trade surplus swung to a deficit of $568 million in November.

Given these conditions, it would be prudent for investors in South African securities to hedge their ZAR exposure. Not only can this be done in the interbank market, but the Chicago Mercantile Exchange has thinly-traded (open interest of 1,653 contracts at present) futures on the rand.

Johannesburg: Resourceful And Rising

Since the general market low of October 8, 1998, the 534-member Johannesburg All-Shares index has outperformed the S&P 500 on a non-currency adjusted basis, and has underperformed the U.S. benchmark only slightly on a currency-adjusted basis. Given the ease of ZAR hedging, however, we should look more at the unadjusted comparisons, particularly in light of Johannesburg's strong relative performance since September 1, 2000.

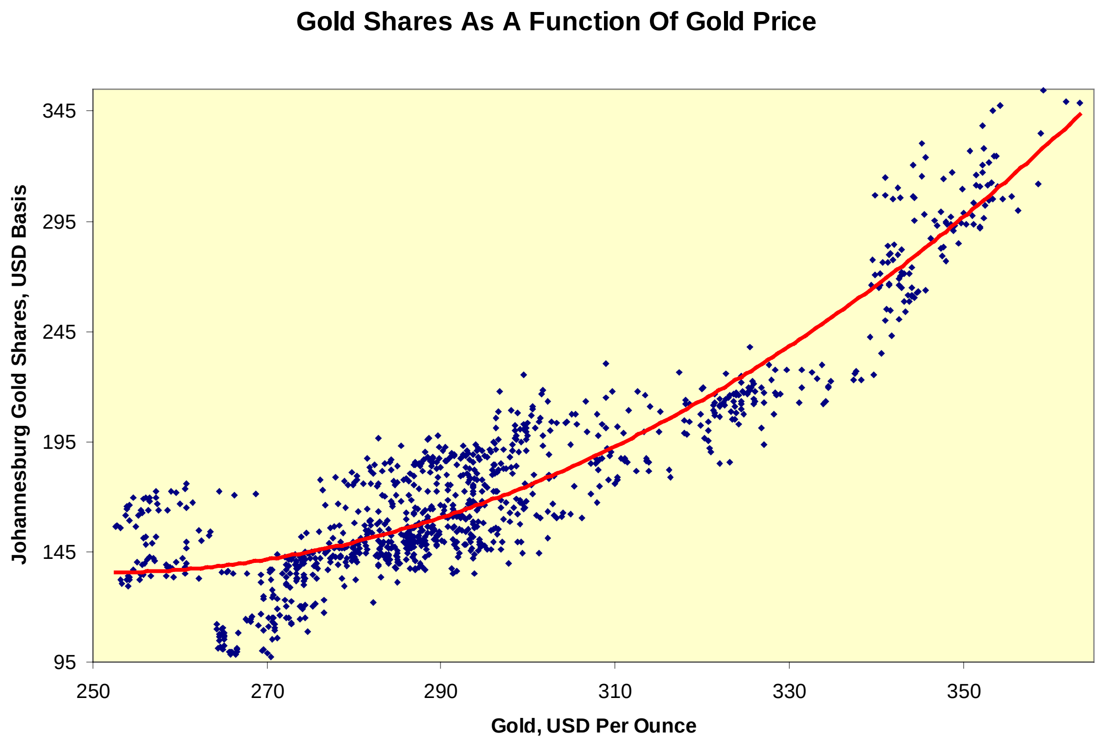
Relative Movements: Johannesburg All-Shares And S&P 500



Any word-association game with "South Africa" would lead quickly to "gold" in response, and it is true that many of the larger issues in the All-Shares, such as Anglo American PLC and Gold Fields Ltd., are gold-linked. However, the price of gold has been going nowhere but down for over two decades, and it has lost 12.5% in price since October 1998 alone. But as we have seen elsewhere in this series, the valuation of commodity producers' shares is largely immune to declines in the price of the commodity. Once we convert to Johannesburg Gold Shares Index to USD from ZAR, we get the classic quadratic relationship between equities and commodities:

$$\text{Gold Shares} = 1173.1 - 8.27 * \text{gold} + .017 * \text{gold}^2, \; r^2 = .8631$$

This relationship suggests a trade parallel to one suggested for platinum miners (see "Platinum And Palladium, Catalysts For Change," December 20, 2000) of buying the South African miners, selling the ZAR forward, and then hedging the gold price component with put options. The metal will fall faster than the stocks, and the stocks will rise faster than the metal.



An interesting implication of this quadratic relationship can be inferred from the Johannesburg Diamonds "index;" as much as a three-member group in which one company, De Beers Consolidated Mines, accounts for 98.7% of the weight, can be termed an index. De Beers has policed the international diamond trade with an iron hand for years, much to the benefit of other diamond sellers, cutters, and merchants, all of whom have profited from the restricted supply. As an aside, social economists may note that consumers, who treat jewelry as a superior good, one whose demand rises with price, benefit psychologically if not financially from the higher price. While diamonds are not traded freely, De Beers is, and the 1.2% drop in USD price over the past four years suggests a rather static global diamond price as well.

A Changing Market

While we cannot suggest the All Shares index has broken its resource link – the top performing issue over the past year with a 166% gain was Trabex Exploration – we can note changes in weights. For example, the second largest stock is luxury goods retailer Richemont, and the sixth largest is Old Mutual, a financial services holding company. Others in the top ten include Dimension Data, a networking firm whose shares only lost 1.17% in the past year, FirstRand, another financial services provider, Standard Bank, and Nedcor, an investment manager.

It has become too fashionable to write off the entirety of sub-Saharan Africa as having missed the tide of history. While there is much to lament over the continent's woes, many of which have been self-inflicted, South Africa's determination to shed the worst parts of its past and move forward deserve our applause and quite possibly our investment dollars.