



Platform

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Independent Insight in an Uncertain World

PLEXUS

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ZAR - Déjà VU ALL OVER AGAIN!

During the tumultuous years of the 2007/2008 credit crisis culminating in the eventual failure of Lehman Brothers and some other financial services giants, the South African rand (ZAR)* weakened by 48% (best to worst rate) against the US dollar (USD) and 47% against the euro (EUR). The mechanics that led to the ZAR's depreciation were not unique to South Africa and quite simple.

Markets severely spooked by unfolding events swiftly sold off anything that was liquid (easily convertible to USD or EUR) or perceived as risky. Capital sought refuge behind the world's largest balance sheets, specifically short-dated US Treasuries and German Bunds. Since these assets are denominated in USD and EUR respectively, most other assets and currencies saw scary losses relative to these 'safe harbours'. Emerging-market currencies were particularly hard hit in this process.

Developed-world governments have increasingly assumed the role of capital market guarantors. Markets have begun to digest the consequences of their policy responses and actions. Massive increases in national debt burdens lead to heightened debt-servicing costs, rising inflation expectations and lower real long-term growth rates. In the developed world these challenges are compounded by other problems, including deteriorating national demographics (ageing populations), unaffordable social welfare burdens and medicare systems. Symptoms of the above conditions will be poor real returns on assets and systematic currency depreciation of the major currencies to help inflate their sovereign debts away over time.

Emerging markets – particularly the well-run and fiscally conservative countries – do not generally have these same challenges. Generally they have low debt levels, strong foreign reserves, improving national demographics and are without expensive and inefficient welfare systems. In aggregate, one can say their long-term prospects for growth look good, particularly as their domestic middle classes emerge from poverty to become consumers. One could argue whether South Africa fits into this category of countries or not.

The point is that the global crisis expedited the unmasking of the duality that had been developing in global economics for some time. Markets began to recognise the stark differences of these parallel economic worlds, and as global conditions began to ease in 2009, emerging-market assets and currencies began to recover as they are superior on several fronts. To illustrate this point, over this time the ZAR strengthened from its weakest point of 10,67 to 6,62 against the US dollar – an appreciation of 38%.

The global financial crisis didn't go away in 2009. Its spectre has been

looming in the shadows ever present. National solutions have all too often been the equivalent of placing Band-Aids over gaping wounds that need surgery. The market's intense focus on the European banking system has singled out the weakest members of the herd. Greece, Ireland and Portugal are slowing the herd down, making them vulnerable to predators. Whether the herd's alpha males (Germany, France and Sweden) can save them is becoming questionable and whatever the outcome it is probably not that relevant. The inevitability of Greece's upcoming default is there for all to see.

The recent spate of risk aversion that commenced in July and will last until Greece (and others perhaps) defaults is in many ways reminiscent of 2008. Déjà vu – investors are scared again! They are rushing for the safe havens, causing severe liquidity-driven losses in the perceived risky assets. The ZAR has depreciated by 21% against the USD since May 2011.

These losses may still intensify when Greece breaks. But investors cannot stay in the USD for long. US interest rates are near zero and negative real returns are being experienced. Yield-hungry investors will again be forced to look elsewhere in the world for positive real returns. We would expect the ZAR and other emerging-market currencies and assets that offer better prospects, to recover much of their recent losses when this reality bites.

* Note: All currency calculations done on 27 September 2011 data using average daily spot rates.