Special focus: Rand strength surprise

By Brian Kantor

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The market always expects the rand to weaken. The large spread between SA interest rates and US or other developed market interest rates indicates that the market expects the rand to weaken consistently against the US dollar and other developed market currencies. By the close on 18 July this difference between RSA and USA 10 year bond yields was 6.43%. To put it another way, the rand was expected to weaken against the US dollar at the average annual rate of 6.43%, from about R13 to R24 for a dollar delivered in 10 years time.

A US dollar to be delivered in three months or three years always costs more than a dollar bought today. The difference between the spot and forward rand exchange rate for a USD is always equal to the difference in interest rates in SA and the US, known also as the carry.

Someone who borrows dollars at a lower rate and lends rands at a higher rate, without securing the dollars to be repaid at a rate determined today, must be speculating that the rand will enjoy surprising strength. That is will weaken by less than the difference in interest rates. Or vice versa if you borrow rands, to lend dollars, without insurance, you would be speculating that the rand will have weakened by more than the difference in interest rates. What the market expects you to gain in higher rand interest income it expects you to have to give away as the rand weakens. Good luck to any speculator taking on the market.

This year, the daily interest spread between an RSA government bond and a US Treasury Bond of the same 10 year duration has varied between 6.4 and 5.94 percentage points while the USD/ZAR has varied between a most expensive R13.20 to a best of R12.42, using daily close rates of exchange. Yet while the interest spread- or expected exchange rate has had a narrow range - the two series move together. That is a stronger rand leads to less rand weakness expected (less of a spread) and vice-versa.

Another way of putting this point is that the weaker the rand the more it is expected to weaken and vice versa when the rand strengthens. It would seemingly therefore take an extended period of rand strength to improve the outlook for the rand, as indeed was the case between 2003 and 2006 when the ten year spread narrowed to about 2% with significant rand strength

The reality is that the behaviour of the USD/ZAR exchange rate to date has had much less to do with South African events and political developments and much more to do with global forces than is usually appreciated. And such global forces affect the exchange value of the rand and other emerging market currencies in similar ways.

The USD/ZAR exchange rate moves closely in line with those of other emerging market (EM) currencies. That is US dollar strength vs the Euro and other major currencies, is strongly associated with EM exchange rate weakness generally and also USD/ZAR weakness. The correlation since 2012 of daily exchange rates between the USD/ZAR and the trade-weighted dollar index is a very high (0.89)

US dollar strength after 2014 was closely associated with emerging market and rand weakness. Very recently, since June 2017, it is shown how a small degree of US dollar weakness has been associated with emerging market currencies and rand strength. Thus betting against the rand at current rates is mostly a bet on the value of the US dollar vs the euro and other developed market currencies. The reality is that the value of the ZAR has not been much influenced by South African events – even of the Zuma variety

Relatively slower US growth and a more dovish Fed could be very helpful to emerging market exchange rates (like the rand) over the next few months. The unexpected can happen. 19 July 2017

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