Rands and Sense

Managing currency risk in turbulent markets

Morningstar Investment Management South Africa

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Sean Neethling
Senior Portfolio Manager
Morningstar Investment Management
South Africa

For Financial Advisors and their Clients

The relaxation of Regulation 28 constraints over the last year has increased the ability of domestic fund managers to allocate up to a maximum of 45% offshore. While markets have been relatively volatile over that period, the rand has contributed positively to total returns on local currency portfolios. The currency has depreciated by almost 20% against an especially resilient US dollar and has become an increasingly more meaningful consideration in managing investment risk in Regulation 28 affected portfolios.

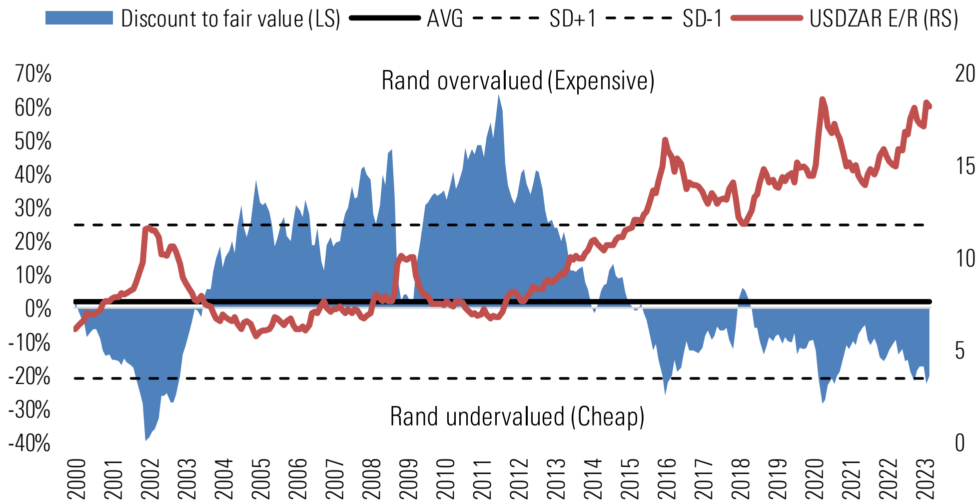
The currency dilemma

Given the currency gains that have accrued in local portfolios, the question confronting investors is "when to take profits from offshore positions". Investors are not usually directly invested in the currency, with the entry point into offshore markets usually being through a dedicated allocation to equity or fixed income. Disentangling the currency from the underlying asset is an especially important consideration, as these can often move in opposite directions (as evidenced in 2022 when global assets were heavily sold off). Unwinding offshore exposure could therefore result in investors giving up potential long-term asset growth for short-term currency gains.

Currency fair value

Currencies can trade well outside fundamentally derived fair value estimates for extended periods of time. The graph below shows the deviation of the rand from its purchasing power parity (PPP) derived fair value against the US dollar over the last 20 years.

Exhibit 1 | Purchasing Power Parity (PPP) - Relative ZAR valuation versus USD



Source: Refinitiv Datastream, author calculations. Data as at 28 February 2023. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

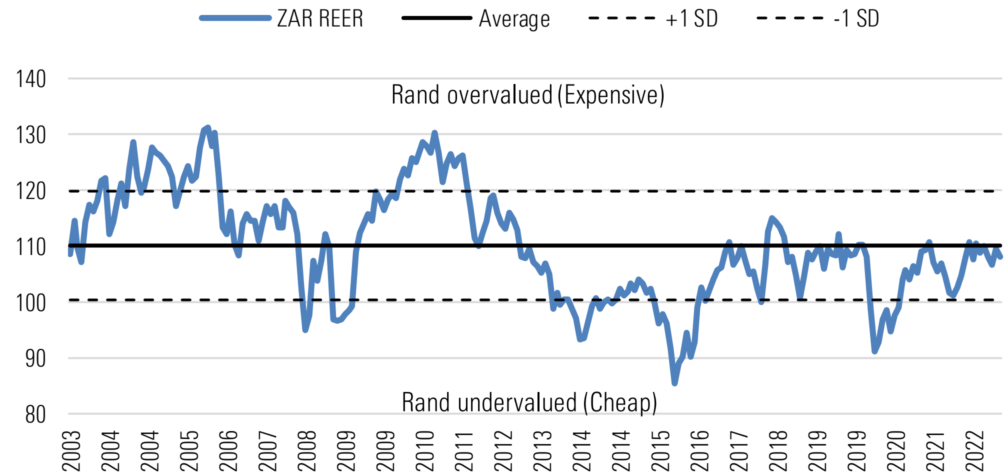
Theoretically, exchange rates are determined by fundamentals, such as economic growth, inflation, and interest rates. Purchasing power parity, or PPP, is one of the most popular theories. It states that countries with higher inflation should see their currencies depreciate over time. But because not all currency participants are profit-seekers, exchange rates can deviate from their theoretical fair values.[1]

A few things are worth noting from the graph in exhibit 1:

- The first is that the rand has historically traded well outside its estimated PPP fair value with a relatively wide standard deviation of approximately 20%. The rand is shown to rarely trade in line with its fundamental fair value. This would suggest that it is nearly impossible to time the currency, as mean reversions to fundamental fair values occur relatively infrequently and over extended periods of time.
- The second notable takeaway is that, while the rand has been both cheaply and expensively priced against the US dollar since 2000, the more recent history (since 2015) shows that (on average) the currency has been approximately 10% undervalued. At the current spot rate of around R18 to the US dollar, the rand is about 20% undervalued and is trading at a 1 standard deviation discount from where fundamentals suggest it should be trading. Other recent examples of rand depreciation to these extreme levels coincide with Nenegate in December 2015 and the COVID-19-induced market sell-off in March 2020.

Another way to consider currency valuation is to use a Real Effective Exchange Rate (REER) approach. This is slightly less intuitive than PPP but still considers the valuation of a reference currency against a basket of currencies made up of the reference country's main trading partners.

Exhibit 2 | ZAR Real Effective Exchange Rate (REER)



Source: Refinitiv Datastream, author calculations. Data as at 28 February 2023. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

[1] Source: http://advisor.morningstar.com/uploaded/pdf/Alt_CurrencyCategory.pdf

An important observation from the graph above is that while the rand is screening as slightly undervalued relative to its long-term average, it is not trading at the extreme levels indicated using a PPP approach. PPP shows that when compared only to the US dollar, the rand is especially cheap and trades at a 20% discount to fair value.

REER shows that, when comparing the rand relative to currencies of South Africa's main trading partners, it is priced approximately in line with fair value at a slight 2% discount. This would suggest that the depreciation of the currency over the last year is relatively more attributable to US dollar strength as opposed to rand weakness. When compared to the currencies of South Africa's main trading partners, the rand is trading relatively consistently with the peer set average.

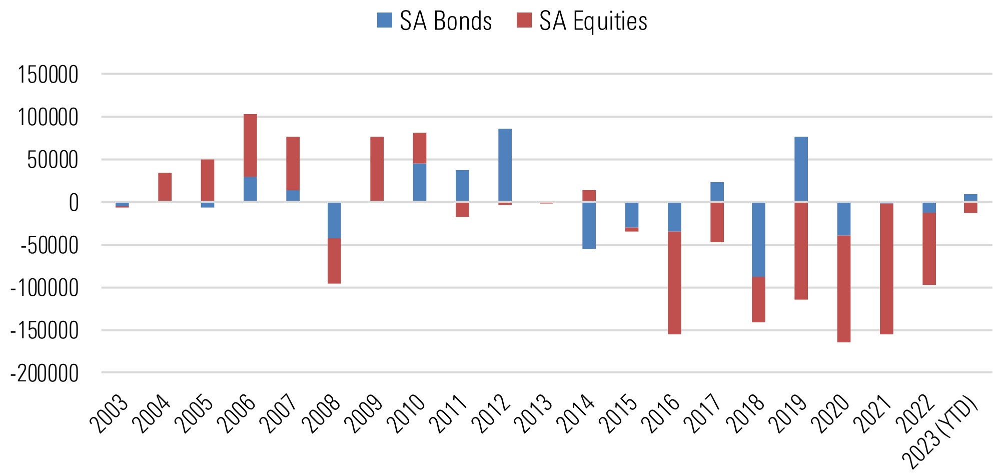
Foreign demand

Another good way to sense check the direction of travel for the currency is to simply follow the money. The graph below shows non-resident investment in South African government bonds and equities over the last 20 years.

Non-residents have been net sellers of local equities since 2015 and while flows into government bonds have been relatively varied, foreigners have also been net sellers of the asset class over the last eight years. That period is consistent with the undervaluation of the currency seen on a PPP basis.

Between 2015 and 2022, the rand depreciated by a staggering 50% against the US dollar. While the trend of non-resident selling does not fully explain rand weakness over the last eight years, foreigners being consistent net sellers of local rand-denominated assets would be especially negative for the currency.

Exhibit 3 | Non-Resident Investment (shown in ZAR Billion)



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Re-thinking volatility

The rand is a highly liquid currency that often trades with high volatility. This volatility is not necessarily a bad thing. While the fluctuations in the rand can be difficult for consumers, they are good for investors, as the spot price is usually a reliable indication of where buyers and sellers are willing to trade.

This is important for maintaining market structure and integrity and providing credibility to both the currency and institutions that facilitate market making and trading. This can be contrasted with currencies in other emerging markets where liquidity squeezes can make it difficult for investors to exit markets without incurring significant costs to unwind trading positions. The fact that foreign investors can transact in SA bonds and equities without having to be overly concerned about functioning capital markets is positive for the currency.

Portfolio considerations

So, given existing levels of rand volatility, how should investors be thinking about managing currency risk in the current environment?

1. **Understand currency extremes**
   Using a reliable measure to estimate fair value is a useful starting point. However, what's relatively more important is understanding extremes, both on the upside and downside, in terms of the extent to which a currency deviates from that fair value estimate. The base case should be that the rand will *not* trade at its calculated fair value against the US dollar. Having a framework for thinking through extremes and the range of potential outcomes that are linked to those extremes is relatively more important than fixating on where the currency should be trading.

   History suggests that investors could be waiting a long time for that to happen. We use a blended approach that combines PPP with other metrics to gauge when the rand trades significantly above or below our fair value estimates. At a fair value of around R14.30, it should be evident that R18 is especially cheap (undervalued) while R12 is particularly expensive (overvalued).

2. **Pay attention to the mandate**
   Offshore allocations bring additional currency volatility to portfolios. Currency exposure should therefore be considered relative to the objectives and constraints of investors, specifically with regard to their ability and willingness to take risk.

   For more cautious, income-oriented investors focused on capital preservation, we manage offshore exposure more conservatively at 25%. This is to mitigate the potential risk of currency moves detracting significantly from the more stable yield contributions from SA government bonds and other fixed income assets in these portfolios.

For relatively more aggressive investors, our Balanced and Adventurous portfolios are managed at an allocation to offshore of between 30% - 35%. For aggressive mandates not constrained by Regulation 28 restrictions, the currency is less actively managed. We manage offshore exposure levels in these mandates by allowing portfolios to drift to predetermined threshold levels.

It's worth highlighting that we do not take direct currency bets in portfolios. Our drift management process evaluates the benefits of selling down offshore asset exposure to unlock currency gains against the costs of potentially giving up long term returns by selling those assets too soon. In more aggressive growth mandates, we are mindful not to take currency profits too soon if the underlying assets have underperformed.

3. **Use a deviation framework to control risk taking**
   Asset allocation explains around 90% of the variance in fund performance over time and is an important component of managing risk in multi-asset portfolios. Employing sensible deviation guidelines to manage tolerance levels above or below target asset allocations provides a useful framework for allowing underlying assets to drift based on both underlying asset class and currency conviction views.

   Constructing multi-asset portfolios that maintain control over the underlying asset class building blocks is likely to become more important in a Regulation 28 world where managers have more flexibility to allocate capital offshore.

4. **Consider the nature of the risk**
   Separating idiosyncratic SA-specific risk from the broader market or global risk is particularly challenging in the current environment. The first quarter of 2023 saw the country being grey-listed as well as having its long-term foreign-currency rating lowered to BB-, three notches below investment grade.

   While it is not especially important to attribute currency moves to specific events, understanding the extent to which currency moves are affected by local or global factors helps shape forward-looking expectations in terms of the general trajectory of the currency. Quantifying those expectations through a fundamental PPP or REER lens is important to control behavioural biases being overweighted in the investment process.

In conclusion

It may be useful to think about the currency as the hypothetical share price of the country. By that measure, the recent rand weakness would suggest that global investors have severely downgraded South Africa’s investment and economic prospects. This outlook does, however, appear to be priced in by global investors, as evidenced by consistent net outflows from equity and bonds markets, as well as a currency that has depreciated by 50% and has been trading at a 10% discount to fair value over the last eight years.

At R18 to the US dollar, the rand has sold off to relatively extreme levels, which is largely supportive of our most recent portfolio actions of taking profits from offshore and bringing mandates in line with target asset allocations.

At Morningstar, we follow a fundamental, long-term investment approach that prioritises building robust, holistic portfolios that are aligned to investor objectives and constraints. Managing currency risk in the context of client mandates and applying sensibility checks to protect downside risk without compromising potential upside participation is an important part of constructing robust client portfolios.

+ t: (0)21 201 4645 + e: MIMSouthAfrica@morningstar.com + 5th Floor, 20 Vineyard Road, Claremont, 7708.