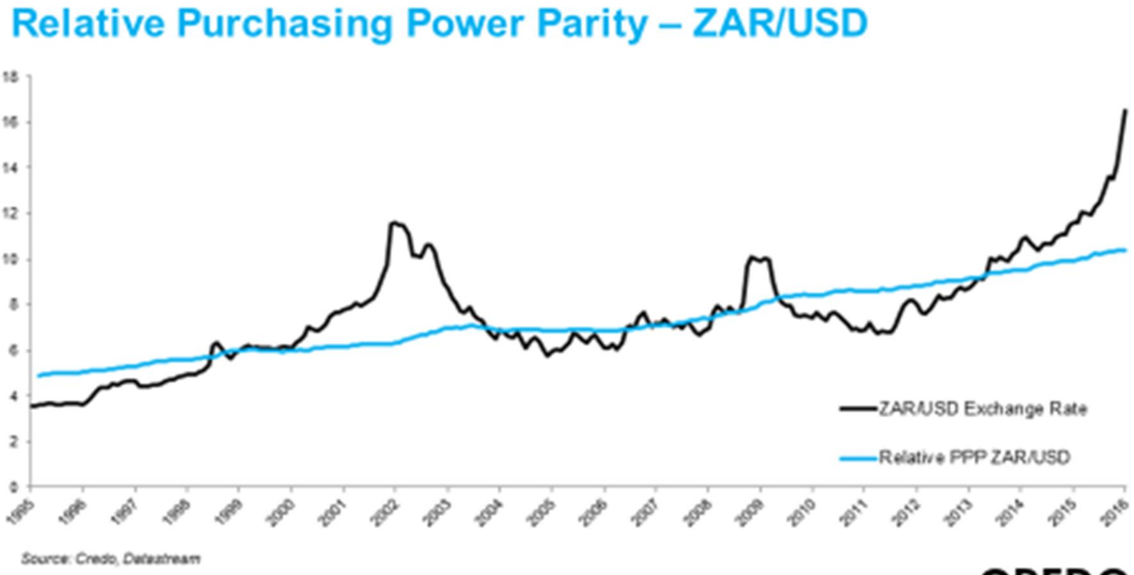
galileocapital
Challenging Conventional Wisdom
NEWSLETTER
Constantly investigating new posibilities

THE WORLD IS FALLING APART…AGAIN

I have spent half of every investment meeting in the last six weeks, discussing the firing of Nene and Gordhan's reinstatement as Finance Minister. The bulk of the conversations start with people asking me, "what was Zuma thinking?" "what was the REAL reason he did this?" followed by "what will stop him from making another harmful decision like this again?" Inevitably, the conclusion from these investors is that nothing will stop him from doing something equally destructive again – the majority of these investors will only reconsider SA as an investment destination when Zuma is no longer in charge. It is as simple as that.

Fortunately for Zuma, global markets have been so volatile in January that some attention has been drawn away from his serious error of judgement in firing Nene. I think Zuma has caused irreparable harm to South Africa's reputation as an investment destination but it is also equally clear that the volatility we have seen since the start of January is not purely related to South Africa's issues. The world is in a major state of flux and I have not seen many optimistic forecasts from respected analysts about global growth prospects for 2016. As an investor, I am becoming increasingly comfortable with the state of local and international equity markets. Valuations of companies are becoming more reasonable and many investors are starting to forecast "the end of the world" scenarios. This means that we are starting to see opportunities to buy quality assets at good prices again. This was certainly not the case at the start of 2015 when markets were near their long term highs while the global economic situation was rapidly deteriorating.

In times like these, it is important to remember that the markets always look forward and some investors will be in a perpetual state of gloom as they believe things are going to get much worse. It is easy to see why they believe this and many such investors will have really intelligent reasons for their predictions. Similarly those of us who believe in mean-reversion will be criticised as unrealistic optimists who are smoking some really good stuff. Naturally we will be similarly criticised when we start to become bearish in good times. In simple terms, believing in mean-reversion is a bit like believing in gravity – what goes up must come down. If something goes up for too long then the likelihood of a significant correction increases. If you were to graph the rand/$ since 2011, you would see that it has moved in a nearly straight line upwards. This means the potential for a reversal of this trend is increasing. That is not to say that the rand will recover to R5.00/$ but a significant recovery from R15.85 is likely. You will note from the graph below (courtesy of Credo Wealth), that the rand is on a long term decline against the US Dollar but current levels are simply overdone.



This does not mean that the rand will start recovering immediately, there are still some significant events such as the National Budget, Municipal elections and potential ratings downgrades that might impact the rand in the near term. However, one should not invest all your assets as if the rand is only a one way bet. If you get it wrong and the recovery is of the same size and duration as in 2002, you could be in for a torrid time.

WHAT DRIVES THE RAND?

RMB Global Markets did some research on the factors affecting the rand. They found there are three broad categories: US$ strength, Commodity effects/global risk appetite and SA specific issues. My interpretation of "SA Specific issues" would be domestic politics, economic policies, corruption etc. RMB found that since July 2011, SA specific factors account for 41% of the rand's move i.e. R3.45 at current levels. Over longer periods i.e. since the year 2000, SA factors have accounted for 42% of the rand's moves. Commodity and risk issues account for 27% and US$ strength (or weakness) account for the remaining 31%. As RMB says, when we think about the rand we should give a 60% weighting to international factors and 40% to local factors.

At present, it would seem that many investors are allocating 80% or more to local factors which could be detrimental in the long term. While many of us have changed our long-term offshore allocation strategies, one needs to be careful of taking big decisions in the short term.