The tail wagging the dog - how politics is driving the value of the rand

By Bianca Botes

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Over the past few years, investors have proved that regardless of the economic soundness of a particular nation, political stability is now a crucial determinant of sentiment and, consequently, capital flows to that country. Just consider the effects of Nenegate, Brexit and, of course, the presidency of Donald Trump.

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These events demonstrate that in the new normal, one cannot simply value a country and its currency based on the prevailing economic indicators, and one can no longer simply use standard economic models to forecast these indicators – a political element also needs to be factored into them.

Further fuelling market uncertainty, the line between what is real and what is merely political noise has become blurred, with official presidential media releases and Twitter feeds alike dictating the direction of currency movements and eventual economic performance.

Given US President Donald Trump’s reliance on Twitter as his preferred method for communication, there is now substantial evidence that his tweets have both short and long-term effects on the value of the dollar. One particularly famous incident saw the dollar’s value plunge immediately after he had tweeted to complain about its strength.

Ultimately, as Professor Adrian Saville from GIBS is fond of saying, "Politics doesn't matter until it does". And with this in mind, it is worth pausing to reflect on some of the landmark political events of 2018:

- In February we saw a change in the South African presidency from Jacob Zuma to Cyril Ramaphosa, hopefully beginning the process of bringing the policy uncertainty of the Zuma years to a close.
- The US played an extended game of cat and mouse with North Korea over its nuclear weapons programme before finally meeting in June. But despite the newfound 'love' between US President Trump and North Korean Supreme Leader Kim Jong-Un, US sanctions are to remain in place until North Korea achieves total denuclearisation.
- The US and China have been entangled in a trade war for the better part of the year, with each country introducing tariffs on goods traded with the other. Although this trade war began on a relatively small scale, it seems to have escalated as each month has passed, with many other countries becoming caught in the crossfire as a result of the spill-over of trade tensions.
- Europe has been impacted by a wave of political instability as populist, anti-establishment parties have resonated with voter bases negatively impacted by globalisation.
- Already on shaky ground, diplomatic relations between Turkey and the US further deteriorated in August with the implementation of sanctions against Turkey over the detention of US pastor Andrew Brunson, but later thawed after the cleric was released in October.

These and other such events have continued to overshadow key economic data on an almost daily basis, perhaps the most recent example of which is the Q3 2018 local unemployment stats.

Stats SA figures revealed that the local unemployment rate had risen to 27.5% in the third quarter of this year, while the expanded unemployment rate (which includes people who have become discouraged), had reached an overwhelming 37.3% – the worst level since the survey began in January 2008. Yet despite another significant blow to South Africa's hopes for a speedy economic recovery, investors remained focused on the US/China trade war, and the rand barely reacted to the news.

This does not mean that economic data should be discounted, however, but rather that political information is equally important and one cannot just focus on the numbers.

So, with a flexible exchange rate regime, the key focus for South Africa moving forward is sentiment, which in the new environment will be driven by two elements:

- the numbers, or the economic data, and
- the people in charge, or government and its respective policies.

After all, you can have the best horse in the race, but if the jockey is not sure how to ride a horse, the chances are it isn't going to win. The same principle can be applied to countries: unless the country is well managed with appropriate policies in place, then it's unlikely that it will perform well on the world stage in spite of its underlying advantages.

This said, it is also worth noting that there are two major political risks that will continue to overshadow economics in the medium to longer term, namely:

- The local national election to take place in May 2019; and
- The ongoing trade war between the US and China, as well as the knock-on effect on other emerging market countries.

And while we will never rely purely on political or economic factors, a combined approach will remain essential. Ultimately, this new normal sees political analysis as vitally important for asset managers, not only to understand political risks, but also to price for key political risks in their investment models and economic forecasts.

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