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Dollar madness

Should the United States of America decide to increase the country's interest rates, it could have a dire effect on the interest rates of emerging countries like South Africa.

It is often asked why South Africa and the rest of the world are so obsessed with the interest rates of the Federal Reserve Bank of America (Fed). According to economists it is all about dominance. Globally the US is the most powerful economy, the US dollar the most dominant currency and the Fed the dominant central bank.

If the Fed raises interest rates (currently 0.25%), the dollar will likely strengthen. This will lead to an increase in borrowing costs for most emerging countries that borrow in dollars.

Economists predict the Fed will raise rates on 13/14 December. After the election of Donald Trump as US President, the yields of the US ten year Treasury bills increased sharply. This indicates that the rise in US interest rates in December could be repeated twice in 2017.

Janet Yellen, Fed chair, said the body's decisions on interest rates were not influenced by politics. Yet it is well known that she's a Democrat supporter and Trump criticised her for helping Hillary Clinton during the election. Yellen said, however, that she would stay on in her position until the end of her term in 2018, unless Trump decided to appoint someone else.

It is expected that under Trump's leadership fiscal policy (decisions in parliament on spending or taxes etc to influence the economy) will be relaxed significantly. While this may be good for the US economy, the Fed will have to balance it out by increasing interest rates.

Trump is particularly opposed to the Dodd-Frank financial regulations which were introduced to prevent financial crises similar to the crisis in 2009. He says it restricts the economy and should be removed. Yellen on the other hand, insists the regulations are essential to protect the economy from downswings.

The relaxation of fiscal policy and the strengthening of monetary policy (action by the central bank to adjust the money supply and/or interest rates to achieve stable prices/growth/employment) mean the currency is likely to strengthen.

But a strengthening dollar can be painful to the rest of the world. As the global trading currency, a firming of the dollar will have an especially negative effect on emerging countries that export goods to the US.

There are several historic examples of economic crises in emerging countries that coincided with the strengthening of the dollar. Just think of Brazil/Argentina in the early eighties, Mexico in 1994 and the Asian crisis in 1997.

What does this mean for South Africa? As in the past, the SA Reserve Bank will not intervene to protect the rand. The currency acts as the mechanism that absorbs the shock of global economic events and protects the economy.

However, the Reserve Bank will address the resulting secondary impact of a weakening rand — like the rising inflation rate. If inflation increases, the domestic interest rates will increase, or existing rates will remain at the same level for a longer time. We will simply have to take the pain associated with a stronger dollar, and likely higher interest rates.

Higher local rates will further suppress economic growth and will not necessarily restrain inflation. Clearly, this is not good news for our economy!

Politics rattle the markets

Emerging markets, like South Africa, were in turmoil after Donald Trump's election as the new President of the USA. For investors, the results altered their risk exposure.

For South Africans in particular, there is uncertainty and concern about potential increases in US interest rates and the ongoing threat of a credit rating downgrade to junk status. If the downgrade happens, whether now or later, it could take South Africa many years to recover.

Political shocks introduce significant risk because it brings uncertainty to the global economy. Markets need time to process the changes in government leadership.

In anticipation of running losses South Africans are investing less and have even begun to withdraw existing investments. The annual results of fund managers support this notion. For example, Coronation, which is one of the biggest fund managers in South Africa, saw their assets under management decrease by about 2% to R599 billion for the year up to September. This is the first time since the financial crisis in 2008 when Coronation experienced a net outflow from its unit trusts. Investors have redeemed R18 billion more than the amount invested during the last year.

Ironically, just as with Brexit, the polls about the election outcome were completely off the mark. It appears that despite all the information at our disposal, we still don't know enough to predict the markets.

This is why investing can be difficult. There are almost 400 listed shares and 1 200 unit trusts in South Africa. The question is: "How do you know which to choose?" Will your fund manager at least know how to make good choices? Unfortunately, research from the US has shown that 98% of top fund managers have also been among the worst performing over a three-year period.

Even though some fund managers succeed at outperforming the market, statistics show that no-one can do so all the time.

The JSE's all-share index reached a record level of 55 188 points in April last year. It has since dropped to below 50 000 points. Many analysts believe that this is alarmingly high. At these levels, the capital and total return indices are at record levels and the market overvalued.

The new risks and the fear of the unknown have already caused some wary investors to take steps to protect their investments. For example, some have a renewed interest in fixed average yield investments which are not exposed to market fluctuations.

Should you switch to the money market?

The money market yield is often lower than inflation and should only serve as a temporary investment. The money market is not guaranteed and banks, for example, ABSA charge an initial and annual cost. The benchmark for such an investment must be availability and not yield.

What about bricks and mortar?

A property boom can only occur if the economy enters a bull phase, which is unlikely to happen within the next few years. Moreover, property investments involve too much cost and time.

Choose equity

Equity as an asset class has on average outperformed all other asset classes over the past decades. It is also important to stay in the market and not to move from one asset class to another. Continued investment in equities provides the best returns over the long term.

What type of shares are the best?

Here investors have a choice between direct share investments, unit trusts, index tracking funds and preference shares.

To buy shares directly is risky. Buying a few shares might not add enough diversification to a portfolio and an investor could be at risk to lose capital.

Unit trusts are managed by fund managers, offering a more favourable spread of risk. The fund manager aims to capitalise on market fluctuations to achieve better returns than the market average. Timing is imperative and they try to predict the market. Given the new uncertainties in the world markets, they are likely to be wrong more often than right.

For the investor, there is an added risk which is related to costs. Regardless of performance, the fund manager will charge a fee and there are upfront and annual costs payable to a financial advisor.

Many people fear the risk and cost related to unit trusts and prefer to invest in market indices like the JSE's Top Forty Index where the risk is spread among the forty largest JSE-listed companies by market capitalisation. It involves only a fraction of the cost and the aim is to deliver average returns.

But what happens if the stock market takes a tumble and even your indices underperform? Your index funds are still exposed to market fluctuations and sentiment.

Consider preference shares

Go one step further and look at preference shares. Certain preference shares offer a conservative, but fixed, rate with fewer fluctuations and lower costs.

The same principle of unit trusts (trading in shares) and indices (investing in shares but not actively trading in individual shares) are combined in preference shares. However, with preference shares you get a fixed rate which is not affected by the sentiment or fluctuations in the JSE.

They are listed shares, affording you all the protection of the JSE. You know exactly what the return will be. Ecsponent Class B capital growth shares offers, for example, a fixed annual rate of 11,2% and the investor receives a 100% capital allocation.

With these preference shares you eliminate risk factors of global markets (such as Donald Trump and new trade agreements) and local markets (President Zuma and junk status).

With Ecsponent preference shares you have peace of mind and can enter the New Year without worrying that political changes may sabotage your money.

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