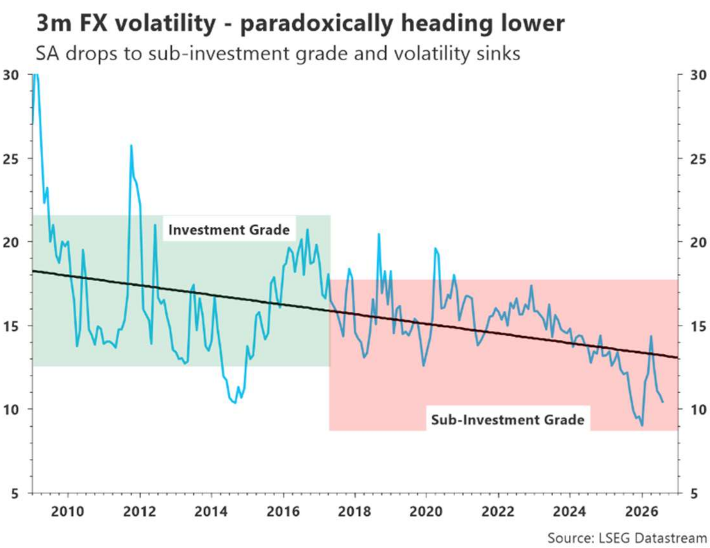
Viewpoint: Unpacking the ZAR's reduced volatility

Key points

- ZAR realised volatility has trended lower for almost two decades despite worsening fiscal fundamentals. A key explanation is reduced foreign participation after South Africa lost investment-grade status. Lower spot turnover and fewer short-term portfolio flows mean fewer abrupt reversals, reducing the hot-money dynamics that historically amplified currency volatility significantly.
- Foreign disengagement is evident across several measures. South Africa's net international investment position shifted from debtor to creditor status, while foreign ownership of government bonds fell from roughly 42% to below 25%. Regulation 28 changes also encouraged greater offshore investment by local institutions, reinforcing the shift towards becoming a creditor nation, which is counterintuitive for a capital-scarce country like SA.
- The external backdrop has also become less supportive of persistent USD strength. Reserve diversification, weaker demand for US Treasuries, poor US fiscal dynamics, unpredictable monetary policy and trade tensions all challenge the dollar. However, stretched US equity valuations could still trigger a risk-off episode and temporarily revive ZAR volatility materially.

BASELINE VIEW: Lower ZAR volatility appears structural, reflecting reduced foreign ownership and thinner hot-money flows, but this should not be confused with lower underlying risk. With the ZAR below 16.00/USD and stronger than recent terms-of-trade dynamics imply, the currency remains vulnerable to a relatively sharp corrective move from current levels.

3m realised volatility has steadily trended lower for almost two decades

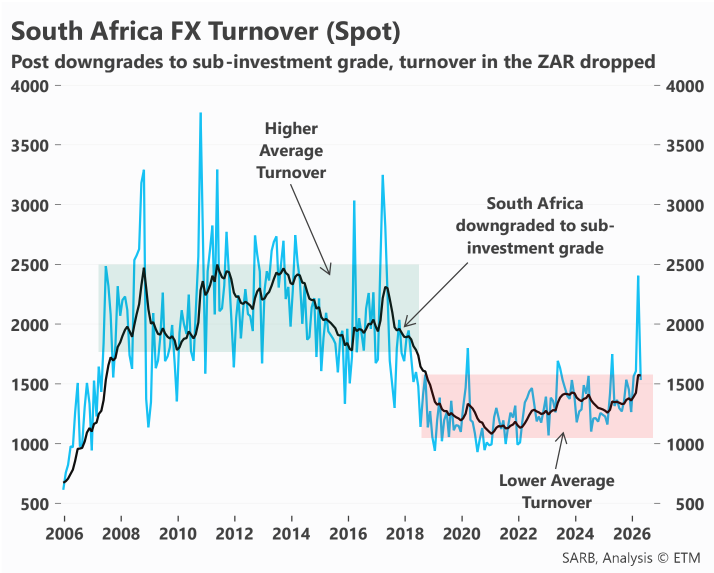


It may surprise readers, but through the past two decades, there has been a clear moderation in the ZAR's measure of volatility. The accompanying chart reflects the historical three-month realised volatility, and it is striking that the trend has been downwards.

Many readers will likely consider this finding to be counter-intuitive. After all, the SA economy has struggled in recent years, and if anything, the behaviour of the bond market shows that there is more risk priced in now than there was during SA's golden period of between 2005 and 2008.

SA's fiscal metrics have deteriorated markedly over that time, resulting in two distinct phases, also reflected in the accompanying chart: the first was SA when it was still an investment-grade destination, and the second is when SA's credit rating fell into junk status.

Average FX daily turnover slides on SA's fall out of investment grade

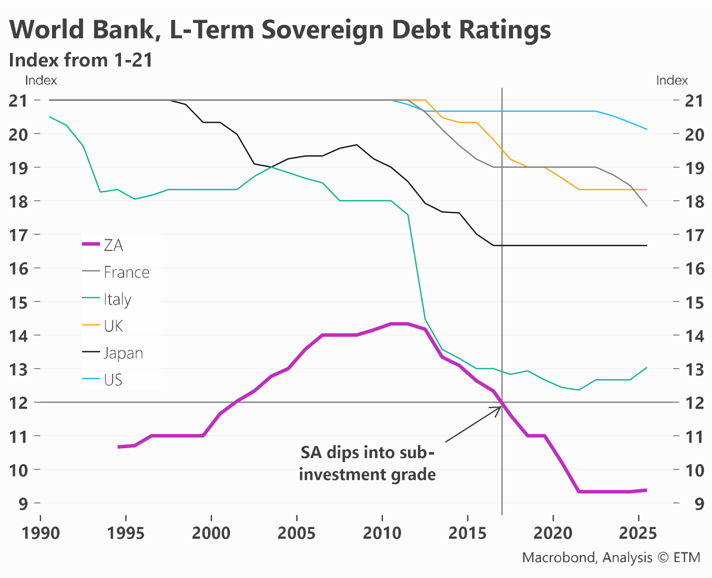


One hypothesis to test is whether foreigners have withdrawn from the SA economy, and whether the reduced volatility is simply due to lower participation in SA's markets. Less participation implies less propensity to withdraw funds should SA experience difficulties.

One possible barometer to test this is the average daily turnover in SA's spot market. Turnover takes a distinct dip that directly coincides with SA's loss of its investment-grade credit rating. Mechanically, many fund managers whose mandates dictate that they can only invest in investment-grade countries are forced to retreat to the sidelines and not commit any further funds to the countries that have fallen out of favour.

The result is reduced interest, and through that reduced interest, comes the reduction of the hot money flows that historically were major drivers of volatility.

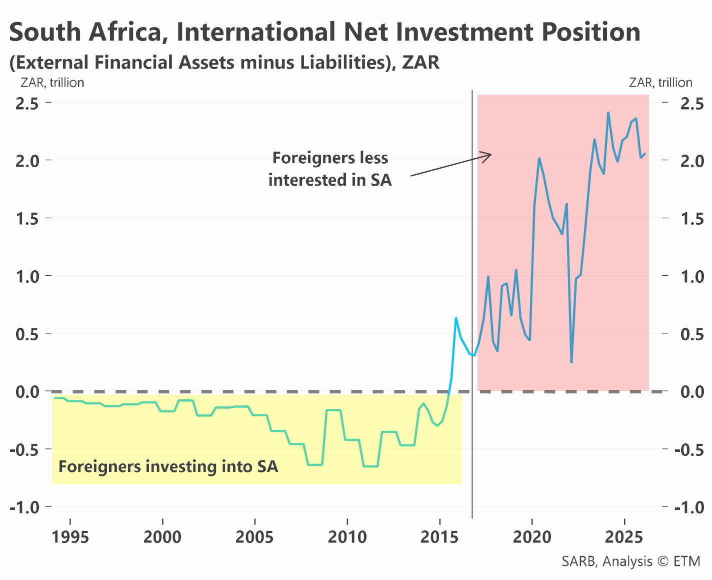
SA not alone in its credit rating downgrades, but junk status hurts



One counterargument is that other countries also experienced credit rating downgrades. That is true; many did. Most downgrades followed the Global Financial Crisis of 2009, when many governments delved into their fiscal arsenal to push back against a collapse in the banking system and attempted to pump-prime their economies through fiscal stimulus.

SA did the same, but the main difference, as reflected in the accompanying chart, is that while many other countries stabilised their credit rating within investment grade, SA's credit rating continued to slide. SA's fiscal authorities lost the ability to live within the country's means, and the result was a steady build-up of debt and debt service costs that far exceeded the initial forecasts made either by National Treasury or the private sector ratings agencies that were looking for signs that SA would get to grips with its rapidly deteriorating fiscal position.

Dramatic reversal in SA's Net Investment Position

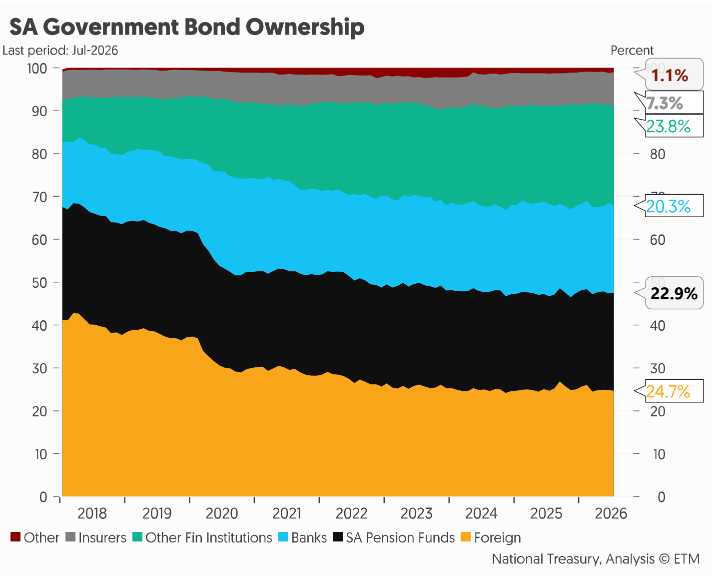


The net international investment position (NIIP) is the total value of foreign financial assets a country owns abroad minus the total value of domestic assets owned by foreigners. It acts like a country's financial balance sheet with the rest of the world at a specific point in time.

Sentiment toward SA shifted dramatically. Shortly ahead of the credit rating downgrades to junk, it was clear that SA shifted from a debtor nation where foreigners own more assets in SA than SA investors own abroad, to a full-blown creditor nation.

It is a great barometer of the impact that sub-investment-grade status had on the economy, but it also clearly confirms that foreigners are participating less in SA financial markets, which would go a long way toward explaining why spot turnover has subsided and why general volatility is also lower.

Dramatic reversal in SA's Net Investment Position

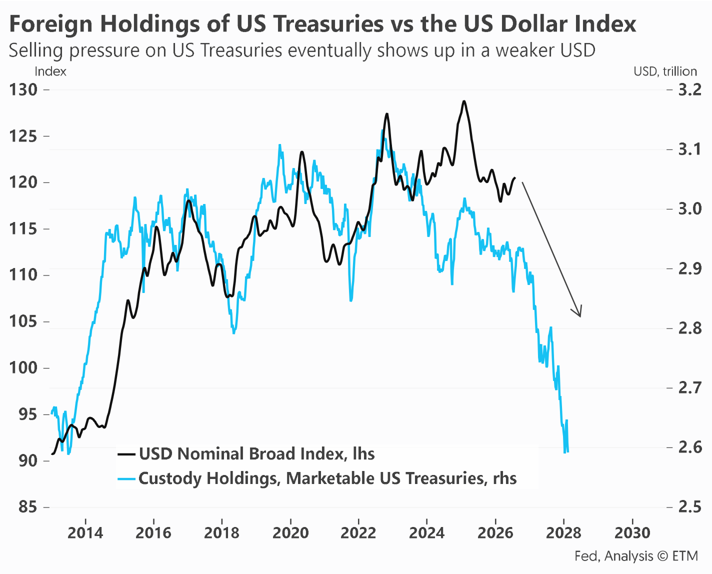


Similar confirmation can be obtained from the National Treasury bond ownership stats, which show that as a percentage of total issuance, foreigners own substantially less than they used to. Whereas they used to own as much as 42% of all issued debt, that has now fallen to below 25%.

While that does not necessarily represent an actual outflow of funds, it certainly reflects less support for the SA bond market and helps explain why SA bond yields are higher. They must be higher to attract foreign capital. This offers clear insight into the causality of how SA bond yields rise as foreign inflows dry up.

Changes to Reg 28 also impacted portfolio flows, as it allowed local fund managers to invest a greater proportion of their portfolios abroad. That contributed to the reversal in the Net International Investment Position, but it also contributed to a lower proportion of bonds held.

International factors also supporting ZAR resilience

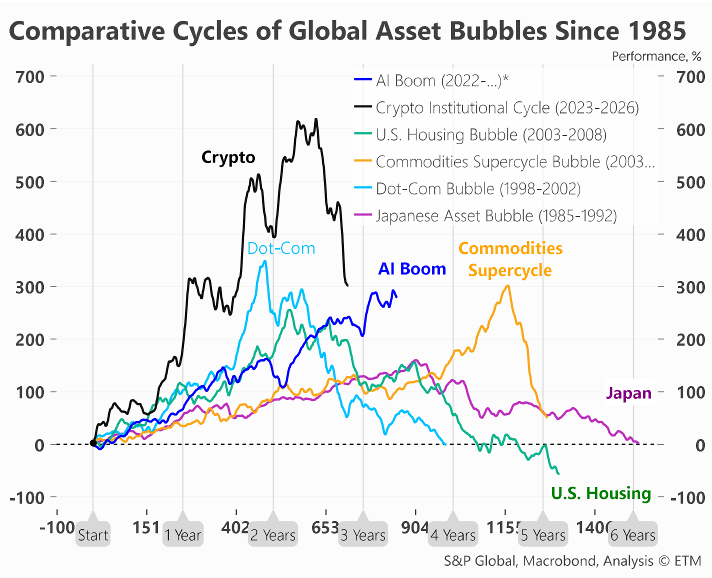


Not only is the USD considered overbought by many measures, both short-term and long-term, but some major central banks are also taking active steps to diversify their reserve holdings away from USD-denominated assets.

The very act of diversification helps to undermine the USD, and it is neatly reflected in the accompanying chart, which shows how the USD has performed in recent years and its relationship to that foreign demand for US Treasuries. The lower the demand for US Treasuries, the greater the probability that the USD loses some ground.

It is far from clear that the policy positions of the US are supportive of the USD these days. US fiscal policy is poor and unsustainable, monetary policy is currently unpredictable, the US is actively involved in two wars, and is attracting negative attention for its trade policies, including its stance on tariffs.

However, some risks still exist

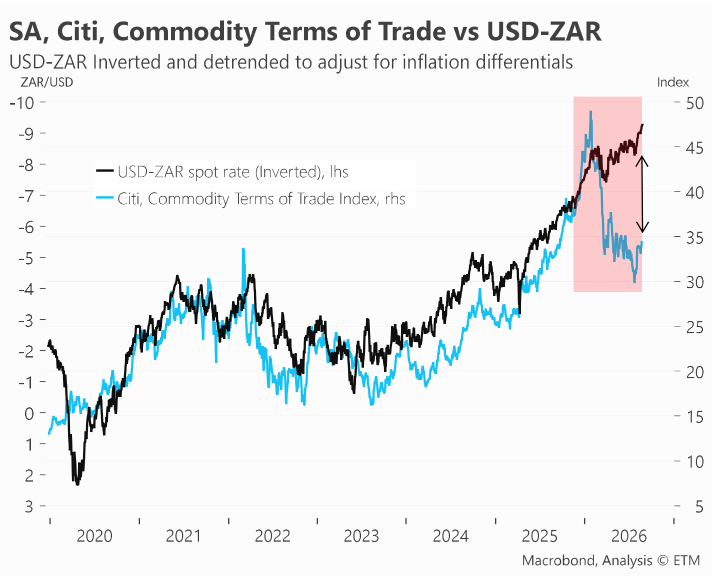


While there are very strong, structural reasons why the ZAR's volatility has subsided, one should not take it for granted that it will always remain that way. As business cycles wax and wane, so they bring different business cycle characteristics into play. One possible characteristic is a stock market correction.

That is currently relevant because of the impressive performance of US equities and the way that they have been driven by the extraordinary rise in AI-related stocks. The problem, if there is one, is that investors are now starting to compare the current rally in US equities with previous bubbles and questioning its sustainability.

One could argue that this time is different, but the hallmarks of a bubble are certainly evident, and so this is something that one cannot rule out completely. As valuations mount, so does the risk of a reversal, emphasising the need to remain cautious and vigilant.

Disparity between ZAR performance and terms of trade



Another short-term risk is the chasm between ZAR performance and its underlying terms of trade. Put simply, the terms of trade have not kept pace with what would typically justify the ZAR's performance. So, judging by this chart, one of two things needs to happen if this relationship is to reassert itself.

Either the ZAR will correct weaker, or the terms of trade will improve significantly. The combination of the surge in oil prices vs the retreat in gold and platinum was the main culprit. Oil prices may well retreat if the war ends. But whether the gold and platinum prices can reclaim their lost ground is debatable.

Therefore, this remains a risk to be aware of, as snapbacks can happen quickly and catch many off-guard. Once again, the point is made that there is no room for complacency and that importers should recognise the value on offer with the ZAR at current levels below 16.00/dlr.

Analyst(s):

George Glynos

Get in touch with us!

research@etmanalytics.com