Print this report

"A Strong Rand means a Strong Economy"

... OR DOES IT?

Many persons have been ecstatic at the performance of the Rand over the past few years, based on the assumption that a strong Rand means a strong Economy, but

DOES IT REALLY?

Have the actual effects been researched? Well, let us do so for you. . .

February 2007

Revised and Expanded

Extracts of a study researched, compiled and updated by

Dynamic Outcomes

Specialist Rand Market Analysts

www.DynamicOutcomes.co.za

"A Strong Rand means a Strong Economy"

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Executive Summary

The following report is an executive summary of the full Study, originally undertaken during 2004 to research the above question looking at the Rand from an historical point of view using base fundamentals.

Let's start with what is generally known:

1) HOW HAS THE RAND PERFORMED?

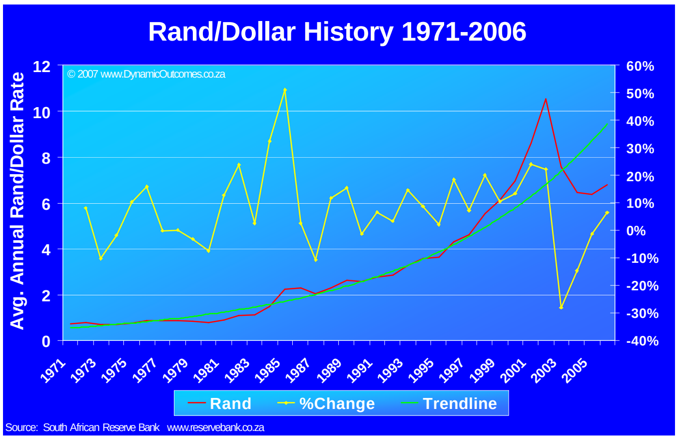
The following is the historical performance of the Rand since 1971 and its more recent performance since 1995.

35 Year History	
1971 - 2006 Trendline	6.6% p.a.

10 Year History (since abolition of apartheid & Financial Rand)	
Feb 1995 – Feb 2007 Trendline	4.4% p.a.
Feb 1995 - October 2001 Trendline	11.3% p.a.
"Floor Rate" Trendline	10.6% p.a.

Let's take a look in some detail.

The graph below shows the **Rand's actual performance from 1971 to 2005**, reflecting the *average annual* exchange rate by year, and the trendline for the period, as well as year over year percentage changes.



Taking a look at the long term history of the Rand provides some indication as to what we can expect in the future. So, what can we learn from this?

- The average depreciation per annum is **6.6%** for the period 1971 to 2005. This means that the currency has had to adjust by an average of 6.6% each year for South African goods to be competitive.
- The Trendline from 1971 to 2005 shows the undervaluation of the spike in late 2001 and overvaluation extent of the counter movement since mid-2003.
- This long-term Trendline indicates that the average rate for 2005 should have been **R9.00/$** – compared with an actual rate of R6.36/$.

However, this period could be seen to be too long a view considering the considerable structural changes that have taken place over the past 10 years – abolition of apartheid, establishment of a democratic government, scrapping of the Financial Rand and reduction of import duties.

So let's look at the period since the Financial Rand was discontinued in February 1995 and ceased to exercise an abnormal influence on the Rand currency market.

This graph shows the **performance of the Rand since February 1995**, reflecting the daily rate since that date as well as three trendlines computed from this daily rate, based on different scenarios:

Feb 1995 – Feb 2007 Trendline A **(Red)**

- The Rand trendline since February 1995 to date has been **4.4%** per annum. This takes into account both the decline in Q4 2001, culminating in the 2 day spike above R13/$ in December 2001, and the recent extended overcorrection below R7.00/$ and excursion below R6.00/$.
- This trendline indicates that the Rand should presently be **R8.10/$**

Feb 1995 - October 2001 Trendline B **(Green)**

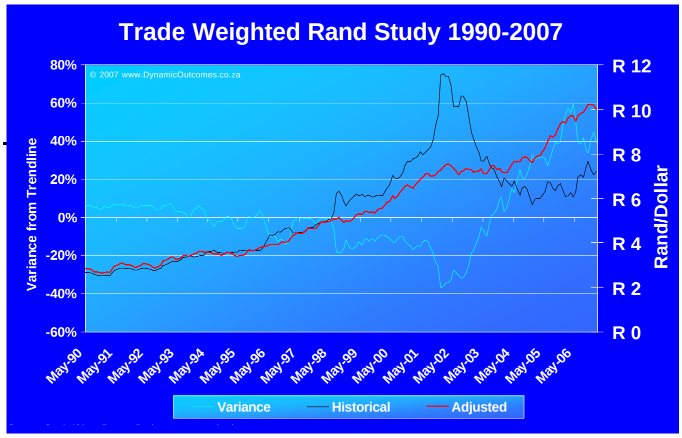
- Excluding the period of above-mentioned aberrations following October 2001, the trendline depreciation has been **11.3%** per annum.
- This extrapolated trendline indicates the Rand should presently be **R12.00/$**

"Floor Rate" Trendline C **(Yellow)**

- The absolute "floor rate" trendline (based on strongest Rand levels over this period as Trendline C above (Feb 1995 to October 2001), and excluding the present aberration), gives average depreciation of **10.6%** per annum.
- This extrapolated trendline indicates the Rand should not be stronger than **R10.80** to the Dollar at present

2) "BUT IT'S DOLLAR WEAKNESS" – OR IS IT?

There is a large contingent out there saying that the Rand's present strength is purely due to Dollar weakness – let's analyse this argument, by looking at the **Trade Weighted Value** of the Rand.



The above graph reflects the following:

- The actual Dollar/Rand exchange rate from 1990 to date (**Black Line**)
- The Deviation of actual Trade Weighted Value from regressive trendline Trade Weighted Value over the same period (**Blue Line**)
- An adjusted Rand exchange rate, computed by taking the actual exchange rate and adjusting it by the Deviation factor (referred to above), determined on a Trade Weighted Index basis (**Red Line**).

By applying this Deviation Factor to the actual Rand exchange rates, we can establish what **the Rand's trendline rate would be** for the period from 1990 **based on international competitiveness with trading partners**, that is, recognising currency movements of *all* the economies of South Africa's trading partners in relation to the Rand. The revealing results are:

- the Rand has been overvalued since July 2003 when it moved stronger than the Trade Weighted rate of R7.60/$
- the Rand should be **R10.00/$** on a Trade Weighted basis as at January 2007.

3) THE BURNING QUESTIONS

The initial questions to answer and investigate are:

- What are the actual factors that have caused the Rand to depreciate during the long term, at an average annual rate of 6.6% since 1971?
- How have these factors changed over the past years, and especially more recently?
- What can be expected for the future?

4) WHAT IS AN EXCHANGE RATE?

To try and investigate these questions, let's first ask: "What is an Exchange Rate?" Why does a currency appreciate or depreciate? This is an essential baseline to any currency study.

Fundamentally, an exchange rate is the ***adjusting factor (an economic mechanism)*** between a domestic economy and that of its trading partners, so that ***exported goods and services exported remain competitive and goods produced for local consumption are not threatened by cheaper imports*** - the exchange rate compensates for product cost differentials, and other factors that affect international trade competitiveness.

5) INTERNATIONAL COMPETITIVENESS

The Domestic Supply Chain Cost of any product and its ultimate Value Added can be reduced to its essential elements - **Labour Cost** and **Productivity**

If there are differentials in underlying Labour Cost and Productivity between two countries producing the same product, the essential adjusting mechanism to enable these countries to continue to trade (whether export or import) at competitive prices is ***the exchange rate***. International trade succeeds or fails through this essential gear working efficiently, or not!

Below is a summary of the yardsticks whereby we can compare **South Africa's competitiveness with its trading partners** - broken down into Quantifiable, Semi-definable and Indefinable Effects:

	Annual Differentials		
	1981-2004	1996-2004	Future
Primary Factors (Quantifiable Effects)	**21.6%**	**8.5%**	**8.0%**
Labour Cost	13.9%	6.7%	6.0%
Productivity	7.7%	1.8%	2.0%
Secondary Factors (Semi-definable Effects)		**2.0%**	**5.0%**
AIDS Pandemic			?
Black Economic Empowerment			?
Emigration of Skilled Labour/Professionals			?
Structural Factors (Indefinable Effects)		**1.0%**	**2.0%**
Infrastructure Inefficiencies (Transportation/Energy)			?
Crime and Security Factors			?
Immigration Burden Costs			?
Illiteracy			? ?
Unemployment Burden Costs			?
Delivery Costs (remoteness from major markets)			?
Total		**11.5%**	**15.0%**

6) THE RESULTANT GEAR

The above table reflects the competitive situation that impacts on the Rand Exchange Rate using data that we have gleaned for the South African economy and its trading partners. It reflects the average annual performances for 1981 through 2004:

- SA labour cost has increased at a higher rate than its international trading partners – **13.9% annually** for 23 years.

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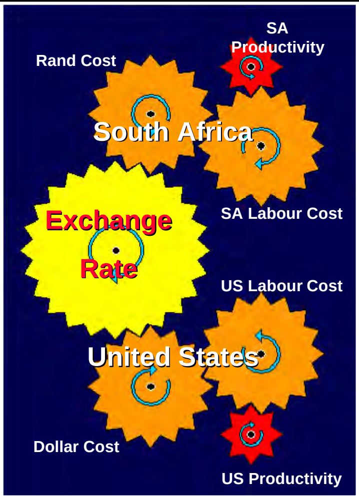


- SA productivity has reduced while increases were achieved by its trading partners – a differential of 7.7% annually for 22 years.

What is the essential compensating mechanism for the SA economy to remain competitive? What can be done to offset these higher costs? *The Exchange Rate!* Without this gear reacting regularly, SA exporters would not be competitive overseas, and local manufacturers serving the domestic market would not be able to compete with imports from other countries.

With respect, the Governor's use of the Rand in recent years to reduce imported inflation, so that he meets his 3-6% inflation target, was a misuse of this economic mechanism. An exchange rate is to adjust the pricing of exported and imported products and services between one country and another – not the domestic pricing of products and services!

South Africa	(Illustrative data used)	United States
R 900	**Domestic Price** (Base Rate of R9.00/$)	**$100**
108%	**Labour Cost Index**	102%
	+	
97%	**Productivity Index**	105%
	=	
11.0%	**Change in Product Cost**	-3.0%
	Local Price	
R 999	adjusted change in costs	$97
	Export Price Scenario	
R 999	@ Base rate of R9.00/$	$111
R 999	@ Strong rate R6.50/$	$154
R 999	@ Realistic rate R10.30/$	$97

But how important are exports to the South African economy? And how is the economy affected by the Exchange Rate?

7) A SIMPLISTIC VIEW OF ECONOMICS

Firstly some background:

When looking at the performance of an economy, economists speak in terms of Trade Account, Services Account, Current Account, Net Capital Inflows, etc. But what do these terms and numbers actually mean? Can we relate these numbers to an ordinary business, and if so, how?

Well, consider this: If South Africa had NO trade or business transactions with any other country, would there be a necessity for an exchange rate? NO. Would the Rand have an external value? NO.

Since 1992, South Africa is NOT a closed economy (not one which has no external trade transactions), but is heavily dependent on foreign trade, the simplistic viewpoint set out hereunder helps to explain a complex situation:

Consider South Africa to be a very large business venture, a very large public company, called Republic of South Africa (Pty) Ltd

- All persons in employment are the employees of RSA (Pty) Ltd
- There are various departments in RSA (Pty) Ltd making up the supply chain so that ultimate finished goods are sold to other companies, that is, exported to other countries.
- The interdepartmental transfers, although value added, do not assist RSA (Pty) Ltd's turnover and profits, it is the finished goods when sold, and sold at profit that achieve turnover and profits.
- The economic data relating to South Africa's foreign trade can be restructured in a form which suits this simple Company viewpoint, per the Table below:

Income Statement for RSA (Pty) Ltd

Ordinary Description	Technical Description	2002	2003	2004	2005
Sales	Exports	333 251	291 434	310 525	347 673
Cost of Sales	Imports	(283 004)	(264 752)	(311 759)	(359 678)
Gross Profit/Loss	Trade Balance	50 247	26 682	(1 234)	(12 005)
Other Revenue	Offshore Services	53 314	64 131	62 526	70 492
	Offshore Investment Interest/Dividends	19 897	18 442	17 958	25 402
Expenditures	Foreign-sourced Services	(69 141)	(75 055)	(83 662)	(94 543)
	Foreign Investment Interest/Dividends	(46 803)	(50 961)	(43 053)	(53 720)
Net Other Revenue	Services Account	(42 733)	(43 443)	(46 231)	(52 369)
Total Net Income	**Current Account**	**7 514**	**(16 761)**	**(47 465)**	**(64 374)**
Cash outflow requiring short-term funding:					
Bank Overdraft/Loans	Foreign-sourced Loans	0	(16 761)	(47 465)	(64 374)

As can be seen from the above, RSA (Pty) Ltd had a good year in 2002, recording a Gross Profit (Trade Surplus) of R50.2bn and a Net Profit (Current Account Surplus) of R7.5bn.

But since then, what has happened:

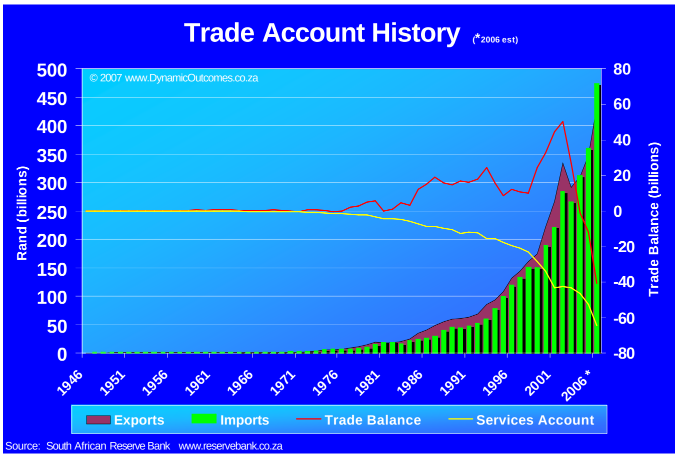
- In 2003, Gross Profit was down almost 50%, and Net Other Revenue also made a bigger loss, resulting in a Total Net Loss of R16.7 billion.
- In 2004, previous Gross Profit had reversed into a small Gross Loss, while Net Other Revenue loss had also increased, resulting in a worrying R47.5 billion Total Net Loss.
- In 2005, the Gross Loss had sliden to it's worst level ever, and the Total Net Income now stood at R64.4 billion loss.

Is this a good performance? Should the "directors" feel happy with the performance of the company? Well, they seem to be, only because their bankers are still happy to finance this increasing loss. But who are these bankers? Mostly, short-term investors, seeking higher yields. But just like any short-term financier, at the first sign of trouble, what will they do? *Recall their loan or investment.*
So, are these signs of trouble, or has the situation improved in 2006?

8) EXPORTS AND THE TRADE ACCOUNT

As can be readily seen from the above illustration, it is imperative that South Africa maintains a positive Trade Balance (Exports exceeding Imports), to offset the Services Account, which always run in negative territory.

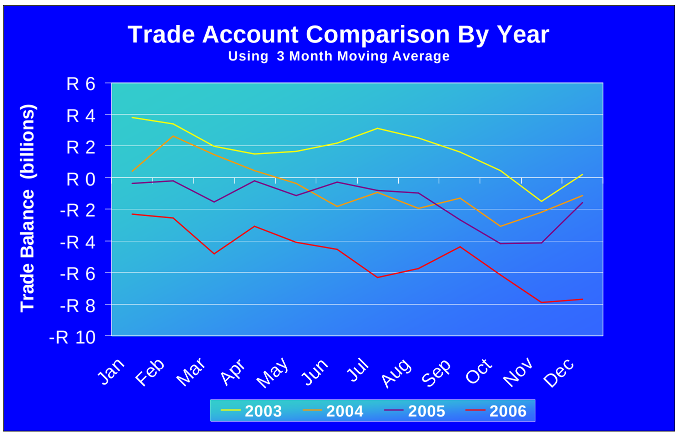
So let's have a look at the history.



The above chart shows clearly that from 1970 until 2002, exports exceeded imports, and the resulting Trade Surplus more than offset the Services Account deficit, which has steadily increased year on year.

However, since 2002 the situation has reversed dramatically, with Imports outstripping Exports to such an extent that from a record Trade Surplus that year, we tumbled to a Trade Deficit in just 2 years, and this trend has continued with **2006 forecast to exceed R40bn loss!** And this is conservative, as Trade Statistics released by SARS show an accumulated deficit of R67bn!

Let's have a closer look at the last 4 years' performance, based on the data released by SARS.



The above chart compares the 3 month moving average for each month, with each year represented by a different line.

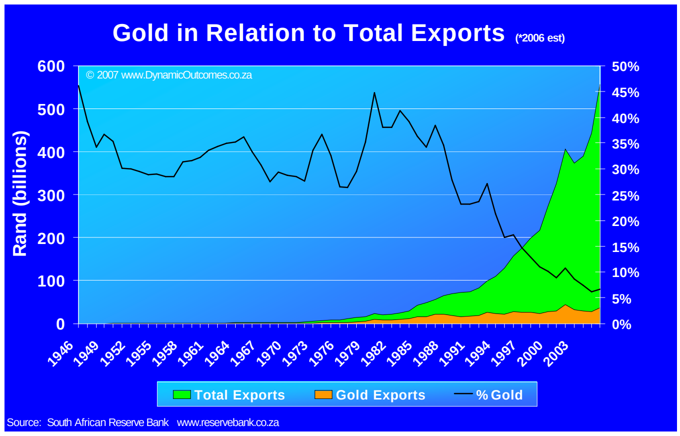
This tells its own story. As can clearly be seen, the Trade Account has shown steady deterioration year on year, with only the period June to August 2005 showing any improvement over previous years.

But 2006 (red line) has been a shocker, despite a more competitive exchange rate than the couple of years previous.

9) HAVE WE HAVE BENEFITTED FROM GOLD?

This study would not be complete without addressing Gold.

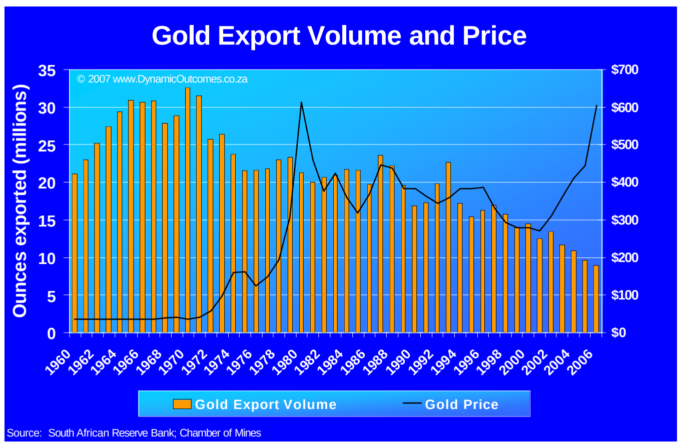
What about the bullishness of gold and other commodities – is this the reason for the Rand's recent strength and, more importantly, will this not support the Exchange Rate and the economy going forward? Let's take a look at this argument.



The above graph tells us the following:

- From 1946 to early 1970s, Gold Exports represented around 30-35% of Total Exports.
- By the time the Gold price peaked in 1981, Total Exports had increased more than seven times and Gold Exports by more than eleven times, Gold now making up 45% of Total Exports!
- Since the mid-1980s, Total Exports have steadily increased in Dollar terms
- Over this period, however, Gold Exports have **steadily decreased** to just **7%** of Total Exports – and this, despite the Gold price (in Dollars) having *more than doubled* in the last 6 years!

To further highlight, we attach another Chart which shows the actual volume (not value) of Gold exported by year.



The above chart tells its own story.

- Actual volume of Gold exported has reduced substantially the past 30 years – from over 30 million

Troy ounces in the 1970's to below 10 million the past couple of years.

- And noticeably, despite the Gold price having more than doubled since 2000, this trend has continued.
- And in 2006, with the Gold price at its best levels for over two decades, South Africa exported the smallest volume in living memory – just 9 million ounces!

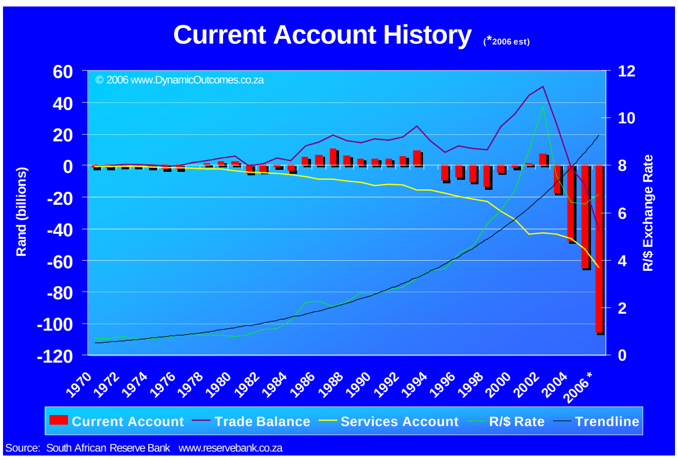
So what effect does Gold have on our total economy? The truth is that, apart from lingering remembrance of a commodity-based economy – VERY little!

Furthermore, have these casualties of a strong Rand escaped worthy attention: the alarming extent of closure of gold mines and precious metal mines in recent years? And, as concerning, the abandoning of plans to proceed with new metal exploitation ventures?

10) CURRENT ACCOUNT BALANCE WORSENING!

Having now seen how the Trade Balance (Gross Profit/Loss) has turned to a deficit (loss) as a consequence of declining exports (and of escalating cheaper imports challenging domestic manufacture), how has this affected the Current Account (Net Profit/Loss)?

Here's Part 1 of the real shocking news as to where the South African economy has been heading:



The above graph reflects historical Annual Trade, Services and Current Account data in Rand from 1970 through to 2006 (est), plotted together with the Rand/Dollar Exchange Rate, and its long-term trendline.

What does this tell us about the economy's performance?

- From about 1990 through to 2003 the Trade Account was in surplus reaching a peak in 2002.
- During this same period the Current Account has fluctuated between R10bn surplus and R20bn deficit.
- Since 2003, when the Rand fell below it's Trendline, the situation has steadily deteriorated – at an increasing rate.
- The last 2 years have seen increasing record Trade deficits, with 2005 full year being the worst ever to date!
- And, based on preliminary data (see next section for more details) full year 2006 is estimated to record a **deficit of at least R105bn**, **possibly higher** which is a massive 63% increase over 2005!

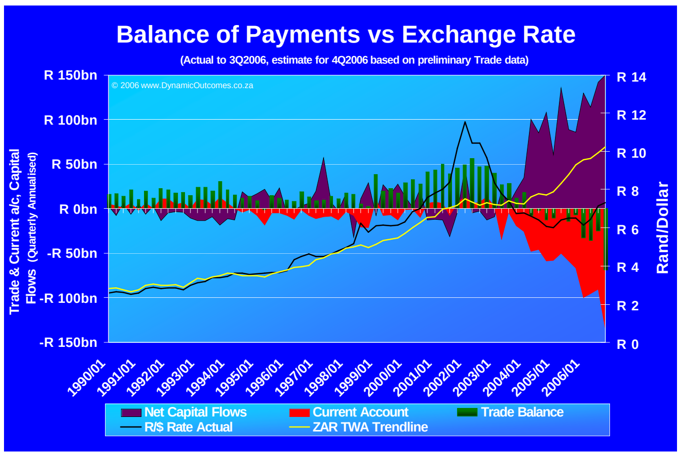
Recognizing that many export contracts are negotiated annually, the full effects of "the strong Rand" are now starting to filter through. Furthermore, many companies have lost long term contracts to other economies, perhaps never to regain them, with resultant closure of many SA export manufacturing facilities.

The strong Rand has been a double-edged sword, damaging manufacturer's export *and* domestic markets. True that this state of affairs forces innovative reductions in costs, but when these have been exhausted, the economic mechanism – the Rand exchange rate – is needed to maintain secondary sector business, so essential to this economy.

But this has failed, through the Authorities' stated support of a "strong Rand" thereby stimulating foreign inflows with a view to lowering inflation to meet their 3-6% target range.

11) ACHILLES HEEL – BALANCE OF PAYMENTS

Part 2 of the real shocking news is shown in the following graph – a deteriorating Balance of Payments:



The above graph gives a more detailed snapshot of the more recent history – Quarterly Balance of Payments data in Rands – Trade Account, Current Account, **plus Financial Inflows** data – from 1990 through 2005, plotted together with the Rand/Dollar Exchange Rate, and the **Trade Weighted Average Trendline.**

Again, we see the relatively healthy state of affairs until the Rand fell below its Trendline in 2003, with the Trade Account falling into deficit and the Current Account deteriorating rapidly, with Q1 to Q3 2006 notching up record deficits over R90bn (quarterly annualised)! **So what can be expected for the balance of 2006?** Based on preliminary data available:

- Based on preliminary data released by SARS, Q4 2006 Trade Account has recorded a **R100bn deficit**!
- However, there are leads and lags between the Trade Statistics released by SARS, and the data released by the Reserve Bank, and so we will use more conservative data as stated by the Governor in his MPC statement this month, which indicated that the Quarterly Bulletin would show a **R69bn deficit**, still a 280% increase over Q3 2006!

- If 4Q 2006 Services Account deficit remains the same as the previous quarter, this economy is likely to have sustained a 4Q 2006 Current Account deficit of **R134bn** (quarterly annualised) – **double Q4 2005!**
- This forecast deficit would represent around **7.4% of GDP** – very alarming for any economy; and certainly quite unsustainable by this one!

Let's look at this from an RSA (Pty) Ltd perspective, and update our Income Statement:

Income Statement for RSA (Pty) Ltd					
Ordinary Description	**Technical Description**	**2003**	**2004**	**2005**	**2006**
Sales	Exports	291 434	310 525	347 673	432 735
Cost of Sales	Imports	(264 752)	(311 759)	(359 678)	(473 297)
Gross Profit/Loss	Trade Balance	26 682	(1 234)	(12 005)	(40 561)
Other Revenue	Offshore Services	64 131	62 526	70 492	79 520
	Offshore Investment Interest/Dividends	18 442	17 958	25 402	43 829
Expenditures	Foreign-sourced Services	(75 055)	(83 662)	(94 543)	(112 188)
	Foreign Investment Interest/Dividends	(50 961)	(43 053)	(53 720)	(75 642)
Net Other Revenue	Services Account	(43 443)	(46 231)	(52 369)	(64 481)
Total Net Income	**Current Account**	**(16 761)**	**(47 465)**	**(64 374)**	**(105 042)**
Cash outflow requiring short-term funding:					
Bank Overdraft/Loans	Foreign-sourced Loans	(16 761)	(47 465)	(64 374)	(105 042)

This does not show a pretty picture, with 2006 Current Account deficit likely to be as much as the two previous years' "losses" combined.

The Capital Account inflows to fund increasing deficits have been sufficient to date, but based on preliminary data the past 3 months from the share and bond market, there is a serious risk of this comfort having evaporated.

The financing of the potentially large Current Account deficit is cause for great concern, especially in that the Authorities have until recently referred to it as "a healthy state of affairs."

The fact is that it is presently being funded by "foreign call funds", and these offshore investor funds (in the bond and money markets particularly) can and will be recalled immediately the Rand depreciates to any extent! From where will the long term funding be secured thereafter, and how will its incremental interest cost burden be met?

We anticipate that when actual 4Q 2006 Balance of Payments data is issued on 22 March 2007, that the Rand will respond by weakening once again.

12) WHERE TO NOW? OUR CONCLUSION …

The purpose of this abbreviated summary (a portion of the extensive study on the Rand, which we originally researched during 2004 and is updated quarterly) is to indicate to readers the direction of thought, and appropriate weighting placed on basic fundamental economic data, in order to assess on a rational scientific basis where the Rand can be expected to move in the future.

Other valid factors that can affect the Rand, such as being an emerging market, do not form part of this study or its conclusions.

Our science is a collaboration of 3 sets of data:

- **Historical Trendline of the Rand since 1971**
- **Trade Weighted Value of The Rand since 1990**
- **Competitiveness of the South African economy**

All these indicate:

- *Intrinsic value* of the Rand in 1st Quarter 2007 is within the range **R8.11 - R12.00**, and
- Economic Factors will combine to force a correction of the Rand back to its intrinsic value indicated above, and
- The Rand will continue to depreciate for the foreseeable future at **minimum 4.4% annually** – and maybe as high as **15% annually.**

So now we have an indication of where the Rand is now and where it is most likely to go before equilibrium is reached. That still leaves one very big question:

13) CAN FUTURE MOVEMENTS BE FORECAST?

It's all very well knowing that the Rand is overvalued, but it has been so for several years now.

Has it bottomed out yet? If not, when is it likely to? How long is it likely to take to adjust back to realistic levels?

Is it likely to rise strongly or gradually, and by how much, and when? Or will we see another move down towards the R6.00 level first?

Is it possible to answer these questions?

We had not thought so, until in 2004 we discovered the most advanced forecasting technology available and started applying its uncanny abilities to the Rand.

> This technology is based on the Elliott Wave Principle, discovered in the early 1930s by Ralph Nelson Elliott: In essence this theory states that all liquid markets move in definable patterns, the result of mass human emotion, flowing from hope to fear, and back again. Given a set of data, the majority of a crowd would react in the same inexplicable but predictable way – not all, but most – a human herd instinct.

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Therefore, by knowing what likely pattern is in play and where one is in this pattern, you are able to determine the probability of future market movements. But, unfortunately, this theory - that made perfect logical sense - became unreliable in actual live markets, because the same human emotions were unavoidably engaged when determining what pattern was in play.

Well, the Refined Elliott Trader has all but removed this element, having a massive database of actual historical price movements of financial markets, all analyzed and catalogued in terms of Elliott Wave patterns.

Thus, now, you can compare a current market situation with hundreds of thousands of actual historical market movements and come up with the best fitting patterns, each providing the most probable completion of the current market pattern in both time and price, based on what similar identified markets had actually done.

We did extensive testing ourselves and we have become more and more confident in this software's ability to forecast market direction.

Since October 2005 we have been publishing these forecasts on a daily basis, and have managed to clock up an accuracy of over 80% over short medium and long term.

So what is Refined Elliott Trader telling us?

As can be seen from the above screenshot, RET shows us the following, based on previous market movements:

1. The Rand probably bottomed at the beginning of 2005, and
2. The Rand could be expected to rise for the foreseeable future, albeit in a zigzag fashion, probably above 11.50

This further confirms our fundamental view that the Rand was clearly overvalued and needed to revert back to the 8.10 to 12.00 area.

But where is it going in the short and medium term?

Why not test-drive our forecasting service today, and experience what it is like to become empowered through knowledge.

If you are affected by the fluctuations of the Rand in any way, and need to know where you are likely to be the next few days, weeks, or month – this will give it to you at a glance!

14 DAY FREE TRIAL

How would **you** like to know, at a glance, what the Rand is most likely to do the next few days, weeks, months and years. On your desk, every day!

If you're not getting our Daily Rand Forecasts, and you're perfectly happy to continue flying by the seat of your pants, and trading like the rest of the crowd, we won't waste your time – this is not for you.

But if you are tired of guessing where the market is going, and the stress involved in deciding when to trade (and when not to), then become empowered through knowledge.

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