

China virus causes capital market havoc

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3 February 2020

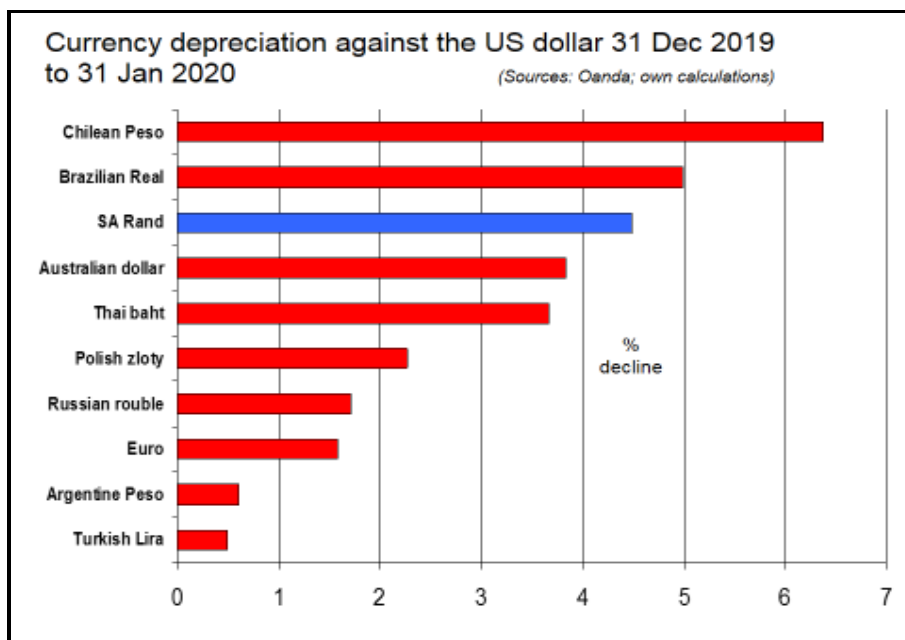
For several decades, the adage held that when America sneezes, the world catches pneumonia. Now that China has become a global superpower, this principle needs to be expanded.

During the last week of January 2020, most emerging markets were reeling from currency and equity market weakness imposed by the global health emergency originating in China. Although a variant of the coronavirus also caused a major scare 17 years ago, the role of China in the world economy has since increased by leaps and bounds.

The dichotomous nature of international market reaction to the health emergency is aptly illustrated by two different sets of data: Firstly, most commodity prices have already taken a beating since mid-January, with oil one of the most profound losers.

Markets are fearing a protracted slowdown of the rate of growth in China, which is bad news for commodity exporters, except for the ultimate safe haven investment (next to US bonds), namely gold. Although platinum almost matched the spectacular gain of gold between mid-2019 and mid-January 2020, its predominantly industrial application has caused a slide of almost 7% since then.

Secondly, the US and its largest regional trading partners have proven to be largely immune to the capital market contagion that has even affected the otherwise stable Euro area.



Due mainly to its proximity to and large degree of integration with the US, Mexico was one of very few economies of note that experienced currency appreciation during January. In contrast, countries that have strong economic and trade linkages with China have experienced an equity market sell-off and their currencies will remain under severe pressure until such time as fears over the spread of the virus have dissipated.

When countries start imposing travel bans on flights to and from the world's second most powerful nation, it is bound to have serious repercussions and February will probably be another testing month for emerging market economies.

After a stunning December, during which the rand strengthened by more than 4% against the US dollar, January saw this gain wiped out, with a further bout of depreciation during the first couple of days of February.

Change in the real effective exchange rate of the rand	
	%
April 2014 to January 2016	-17.9
January 2016 to February 2018	34.8
February 2018 to August 2019	-9.9
August 2019 to December 2019	5.6
December 2019 to January 2020	-3.8
Sources: SARB; own calculations	

The table tells an interesting tale of South Africa's recent history. The dramatic decline in the real effective value of the rand (trade-weighted against the 20 largest trading partners) between the second quarter of 2014 and the beginning of 2016 can be dubbed the "Zupta-effect", when the extent and costs of state capture became highly visible.

The following two years saw a systematic recovery of the rand exchange rate, culminating in the so-called "Ramaphosa-effect", with a fairly spectacular strengthening of almost 35%. Thereafter, a large degree of soberness returned to the market. Assuming that the January decline was mainly influenced by short-term global volatility resulting from the anticipated slowdown of the Chinese economy, the rand/dollar exchange rate could well recover to R14.50 by the second quarter.

The bright side for South Africa is that gold promises to move beyond \$1,600 per ounce. Furthermore, the slide of the oil price will hopefully mitigate most of the negative impact that a weaker currency will exert on fuel prices, thereby staving off any attempts by the SA Reserve Bank to counter inflationary pressures via a return to higher interest rates.