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Investing from within the Fragile Five Club

South Africa's trade and current account deficits widened significantly during 2013, creating a twin-deficit problem, while government finances reflected a persistently wider deficit. Numerous countries have this same problem; but five countries, namely India, Indonesia, Brazil, Turkey and South Africa, have unusually large twin deficits. Dubbed the 'Fragile Five', this dubious distinction has important investment implications.

It is important to note that none of the Fragile Five faces sovereign bankruptcy and there is no prospect of a Greek-style meltdown. In Greece's case, the sovereign was essentially bankrupt and required a bailout from the European Union and other global agencies such as the IMF. It was also a special case. It was participating in a common currency and did not have the tax base to meet its obligations in the form of political promises to its electorate. In the case of the Greek crisis, there was no place to hide regarding its financial markets, as all asset classes were hammered. The country's stock market lost more than 90 per cent from its 2007 peak to the low in 2012. Greek bonds fared similarly and property was also sold down significantly, pushing the banking system into insolvency.

The Fragile Five do not face a similar fate. The deficits reflect a high degree of vulnerability that manifests mainly in the weakness of their currencies. The Rand (nominal effective exchange rate), for example, weakened by 18.4 per cent in 2013 and has slumped further in 2014. However, the JSE has risen to fresh all-time highs in Rand terms. Bonds have weakened on prospects of higher inflation and fears that interest rates might rise as a consequence. This is a typical market reaction to macroeconomic imbalances affecting the currency.

However, there is never simply a single factor at work. Last year, the Fed escalated its QE programme to monthly asset purchases of $85 billion. The 2014 intention is to taper this amount and the Fed planned to begin doing so at the end of January. In 2013, the massive QE programme signalled 'risk-on' and this was reflected in global equity markets, which ended the year at record levels. The tapering decision has resulted in weaker equity markets. However, the risky currencies of the Fragile Five weakened in 2013 during this period of risk-on when they should have strengthened. Financial markets will probably remain in a 'risk-off' mode while the Fed tapers, which implies the Fragile Five's currencies will experience accelerated weakness.

In South Africa's case, the JSE will prove an appropriate haven for protection against a weaker Rand despite weaker global stock markets. But not all sectors will be strong. This scenario will be unkind to sectors such as financials, which do not have Rand-hedge characteristics and will fall in sympathy with global markets. The Rand-hedge industrials will probably hold up in Rand terms but not in Dollar terms, as they are already quite expensive. These were the momentum stocks of 2013. The Rand-hedge and Rand-leverage resources will probably be the winners, as they are the cheapest part of the JSE at the moment.

This means that under the scenario of Fed tapering and financial markets moving to risk-off mode, the Fragile Five's currencies are expected to come under even more severe pressure. The dogs of 2013 might end up the winners of 2014.

It is essential to understand that while the Fragile Five are not countries facing a sovereign default, they have developed macroeconomic imbalances. This means their financial markets will be volatile, but there will be assets that will provide protection and opportunity. However, assets such as bonds and non-hedge shares will carry danger for the investor. The key is to understand how the different asset classes and instruments behave when the currency becomes the most important driver of financial-market performance.