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Global commodities and African stocks: insights for hedging and diversification strategies

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1. Introduction

Most African countries are still poor, and financing domestic expenditures is often constrained by inefficient and narrow tax bases. Consequently, financing development has often concentrated on domestic and/or foreign borrowing. While the former has severe implications of crowding out investments among other distortions, the latter is either subject to sudden reversals or comes with strings attached, and at times does not find most African countries as a conducive environment to thrive. At the same time, evidence suggests that well-functioning stock markets can help mobilise capital for domestic firms. They can also help inject more liquidity into national economies to enhance growth and development. Research on the role of Africa's domestic stock markets in contributing to the continent's growth spurt is, however, very harrowing. This deficiency may be due to the relatively small size of some of the markets and lack of information on the relative potentials of African stock markets in general. This article is a contribution to the role of African stock markets as hubs for portfolio diversification, both in tranquil and turbulent times. To the extent that the study reveals the strength of African stocks in cushioning international portfolio investors in a mean-variance stand-point during market crashes, the paper helps to decay all doubts in the minds of investors on the perceived lack of capacity of the continent's stocks to yield higher expected risk-return trade-offs during global market crashes. In all, 11 of the largest stock markets in Africa (South Africa, Egypt, Ghana, Botswana, Tunisia, Mauritius, Morocco, Namibia, Kenya, Cote D'Ivoire and Nigeria) and spot prices of five (5) important global commodities (gold, oil, silver, platinum, and cocoa) are covered in this study.

2. Key results and implications.

The main conclusion from this study is that African stock markets provide decorrelation from commodity markets during extreme market conditions. Of all the commodities analyzed in the study, diversification or hedging opportunities into Africa's equities are noticed to be more achievable for investors in the gold and oil spot markets. Essentially, the results generally show that international oil and/or gold investors holding or seeking to hold equities in Africa, may have to allocate on average, about 50:50 weight each to an African stock and a commodity to be able to maximize their risk-return trade-off. It follows that, all stock-oil or stock-gold hedged portfolios with less than 50% African stock components do not offer effective hedges. We identify the Bourse Regionale Des Valueurs Mobilieres (BRVM) market in Cote D'Ivoire as best in terms of offering effective hedge for commodity shocks. The results further show that global commodity

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investors react differently towards investment potentials in Africa during market calmness and crisis. Finally, it is obvious from the mean-variance standpoint that including African equities in a diversified portfolio has the effect of lowering risk whiles simultaneously increasing expected returns. That said, although the markets in South Africa, Egypt, and Botswana present mean-variance optimized diversification opportunities for cocoa, platinum, and crude oil investors respectively, the risk-mitigating capacity of the Botswana stock market for international crude oil investors is highly remarkable.

The implication of the study is that given the recent history of commodities, fund managers around the world seeking viable alternatives to compensate for losses from commodity shocks through uncorrelated markets may consider the equity markets in Africa, albeit on account of volatility persistence, present and past market conditions, markets stability, as well as size and liquidity issues. Advisedly, the proportion of portfolio investments may have to be increased (decreased) in bullish (bearish) markets. The implication of the stronger diversification properties of the African market is that, investors who purchase African stocks during periods of crisis in the global commodity markets are compensated for loses from commodity shocks through positive returns. With this, governments in Africa can work towards increasing the flow of investment capital into their economies by enhancing the performance of the domestic stock markets. This will ultimately reduce over-reliance on domestic and foreign borrowings which have the corollary ramifications for crowding-out private businesses; compromising the objective of fiscal consolidation and debt sustainability; destabilizing economic fundamentals among others.

3. Concluding thoughts

The conclusions from this paper suggest that despite the seeming uncertainty that surrounds the relative capacities of emerging markets to provide appropriate shields for international portfolio investors, especially during extreme market conditions, African stock markets can be excluded. The findings of the study may provide useful evidence to augment efforts of policy makers at promoting Africa as a hub for certain kinds of international investments.