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The Australian dollar - the best is behind it

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Oliver's Insights



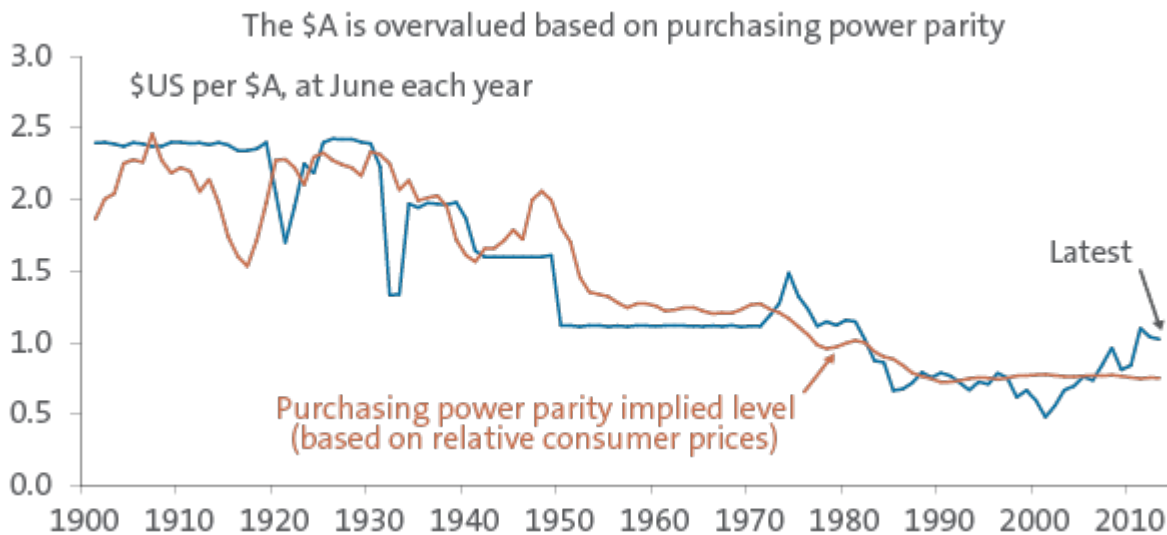
Introduction

The last decade saw a huge surge in commodity prices on the back of rapid growth in demand, as China industrialised, and as the supply of commodities was constrained. This hugely benefitted assets geared to commodity prices including emerging market shares in South America, resources companies and of course the A\$, which were all star performers.

For the A\$ it meant a rise from a low in 2001 of US\$0.48 to a high in 2011 of US\$1.10 and a 70% gain on a trade weighted basis. However, since 2011, the outlook for the A\$ has become more confused: commodity prices are high but have been sliding recently; monetary easing (particularly money printing) in the US and Japan is positive for the A\$ but has been blunted slightly by rate cuts in Australia and the chance of more to come; safe haven flows from central banks looking to diversify have helped support the A\$ but they are late to the party and some would question Australia's safe haven status; and the damage to Australia's international competitiveness has become more evident.

Purchasing power parity

One of most common ways to value a currency is to compare relative prices. According to purchasing power parity theory, exchange rates should equilibrate the price of a basket of goods and services across countries, such that A\$100 would buy the same basket of goods in other countries as it does in Australia when translated into their currencies. A rough guide to this is shown in the following chart, which shows the A\$/US\$ rate against where it would be if the rate had moved to equilibrate relative consumer price levels between the US and Australia over the last 110 years or so.



Source: RBA, ABS, AMP Capital

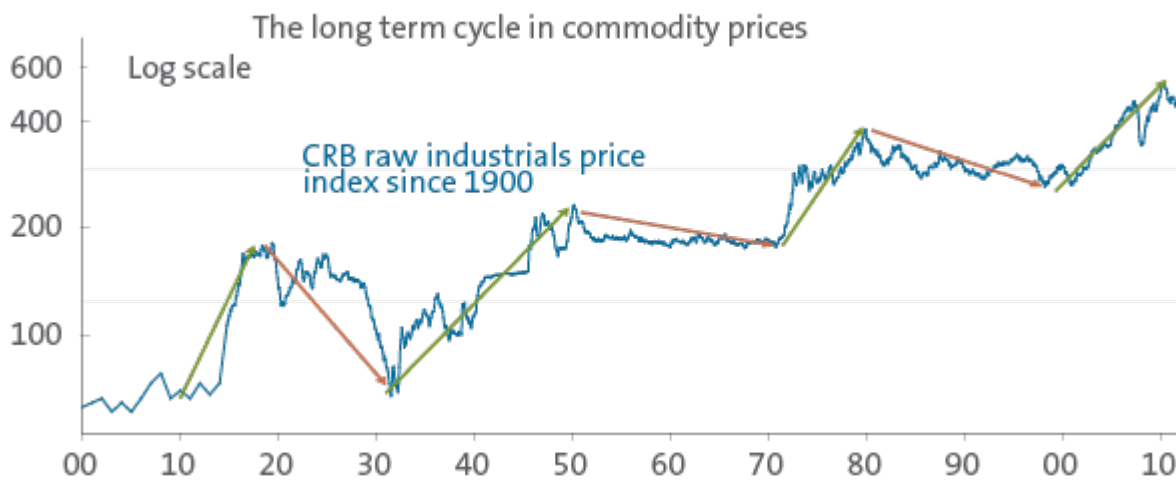
Quite clearly purchasing power parity doesn't work for extended periods with huge divergences evident at various points in time when the A\$ was fixed such as in the 1950s and 1960s and/or when other factors come into play. In fact, the A\$ has gone from being dramatically undervalued in 2001 to similarly overvalued now on this measure. However, it does provide a guide to where exchange rates are headed over very long periods of time. Such an approach has been popularised over many years by The Economist magazine's Big Mac index.

An obvious problem with such measures is that they can give different results depending on the estimation period and the types of prices used. The relative consumer price measures used in the chart above would suggest that the A\$ is currently around 35% overvalued, whereas according to the Big Mac index it is only about 12% overvalued.

However, the broad impression is that the A\$ is overvalued on a purchasing power parity basis. This is consistent with current perception and news stories about how Australia has gone from being a relatively cheap country a decade ago when the A\$ was much lower, to an expensive country today. This suggests the A\$ could face downward pressure if some of the factors that have been holding it up reverse. The major factors on this front are commodity prices, relative monetary policies and perceptions of Australia as a safe haven.

Commodity price boom starts to fray

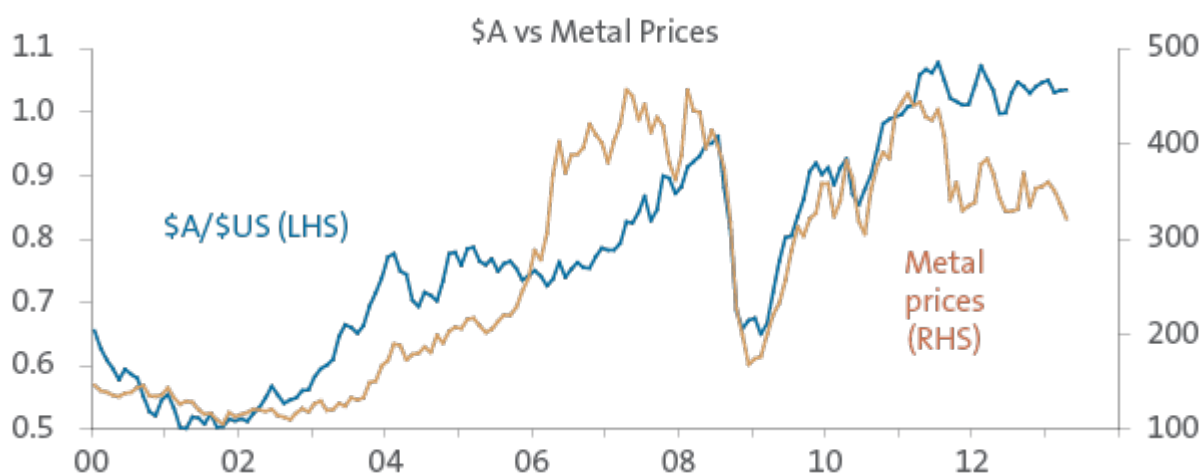
Over the last forty odd years, swings in commodity prices have been perhaps the main driver of the big picture swings in the A\$. Rising commodity prices helped the A\$ into the mid 1970s, falling commodities correlated with a fall in the A\$ until around 2000 and over the last decade rising commodity prices explained the huge surge in the A\$. The logic behind this is simple. 70% or so of Australia's exports are commodities and moves in commodity prices are key drivers of our export earnings. However, the commodity price story is starting to fray at the edges. The pattern for raw material prices over the past century or so has seen roughly a 10 year secular or long-term upswing followed by a 10 to 20 year secular bear market, which can sometimes just be a move to the side.



Source: Global Financial Data, Bloomberg, AMP Capital

The upswing is normally driven by a surge in global demand for commodities after a period of mining underinvestment. The downswings come when the pace of demand slows but the supply of commodities picks up in lagged response to the price upswing. After a 12 year bull run since 2000 this pattern would suggest that the commodity price boom may be at or near its end. Specifically, growth in China remains strong but it has slowed a bit (from 10% plus growth to 7 to 8% growth) just at the time when the supply of commodities is about to surge after record levels of mining investment globally. And a basing in the US\$ is not helping: the falling US\$ has helped boost commodity prices from around 2002 as they tend to be priced in US dollars. Now with the US\$ looking a bit stronger this effect is fading.

The chart below shows an index of prices for industrial metals such as copper, zinc, lead, etc. against the A\$ and suggest that they have gone from a positive influence, leading on the way up last decade, to potentially a negative.



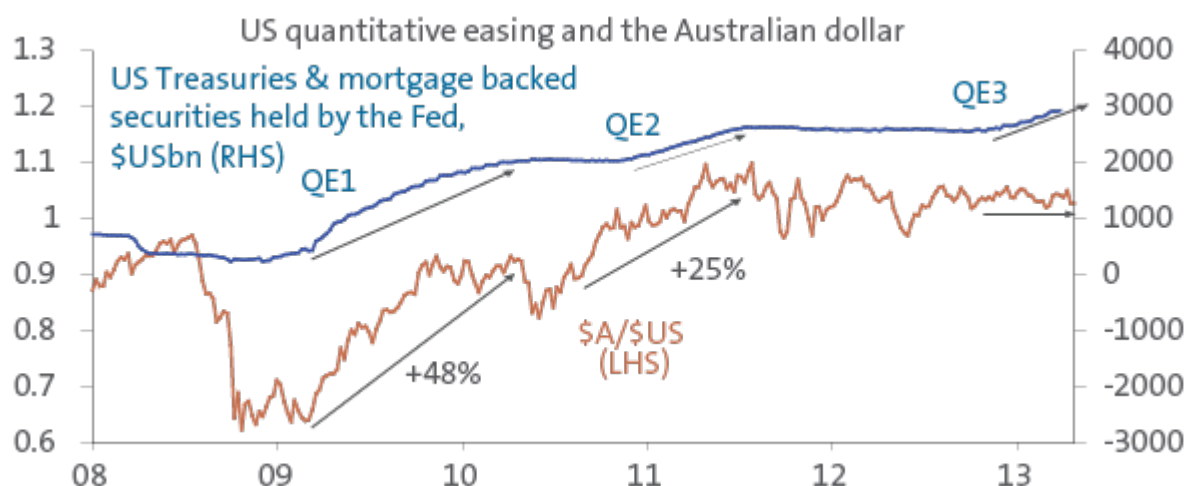
Source: Bloomberg, AMP Capital

Relative monetary policies

Quantitative easing (QE) in the US, Japan and elsewhere should be positive for the A\$ as it means an increase in the supply of US dollars, yen, etc, relative to the supply of Australian dollars. And indeed it

has been. Various rounds of QE in the US have been associated with A\$ strengthening, and the heightened efforts by Japan on this front have only added to this pressure and have helped to push the A\$ up 25% over the last six months and the trade weighted value for the A\$ up to its highest since early 1985. Our assessment remains that as the value of the yen continues to fall in response to aggressive monetary stimulus from the Bank of Japan, the A\$ will see further gains against the yen, taking it to around ¥110 by year end.

However, against the US\$ the impact of QE may be starting to wane a bit. As can be seen in the chart below, while the first two rounds of QE in the US were associated with strong gains in the value of the A\$, QE3 has just seen the A\$ continue to track sideways in the same US\$1.02 to US\$1.06 range it has been in since last July.



Source: Bloomberg, AMP Capital

This may be partly because QE3 has not seen a rise in commodity prices. But the main reason that the impact of quantitative easing may be starting to wane for the A\$ is that the interest rate differential in favour of Australia has fallen dramatically as the RBA has cut rates. With the Australian economy still struggling, there may be further rate cuts to come.

What about central bank buying and safe haven demand

Buying by central banks looking to diversify their foreign exchange reserves and by investors allocating to a diminishing pool of safe AAA rated countries have no doubt played a role in boosting the A\$.

However, one can't help but think that after a decade long bull market in the A\$ (or bear market in the US\$), central banks are late to the A\$ party. And with the fading of the mining boom and the government struggling to bring the budget back into surplus it has to be recognised that Australia is not without risk.

So my feeling is that this source of support for the A\$ will start to fade.

Implications for investors

The bottom line is the best has likely been seen for the A\$ and the risks are on the downside over the years ahead as the commodity price boom fades, allowing the A\$ to correct some of its overvaluation on a purchasing power parity basis.

Currency is very important for investors as soon as they invest in foreign countries. Most global investments offered by fund managers come with a choice of being unhedged, i.e. exposed to fluctuations in the value of foreign currencies, or hedged, where the value of the investment is locked back into Australian dollars.

Over the last decade, unhedged international shares returned 2.7% per annum (pa) whereas hedged international shares gained 9.5% pa. The difference largely reflects the rise in the A\$ (+4.4% pa), but also the interest rate differential between Australia and the rest of the world (+2.4% pa). But if the A\$ is likely to go sideways or down there is much less need to hedge and with the interest rate gap between Australia and the rest of the world narrowing there is much less incentive to hedge.

In other words the reward versus risk equation in favour of the A\$ is diminishing so it makes more sense for investors now to consider taking an exposure to foreign currencies (ideally with the exception of the yen) beyond the A\$ and obtaining the diversification benefits they provide.

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