



What does the rising \$A mean for investment markets?

The soaring \$A has reignited the speculation that the \$A will reach parity with the \$US in the near future. In this Point of View, AXA's Chief Investment Officer Mark Dutton looks at what's driving the \$A, and assesses the likely implications for investment markets.

In brief

- The recent strength in the \$A is being driven by Australia's higher interest rates, strong economic growth, high commodity prices and weakness among some other foreign currencies.
- Since floating in 1983, the long-term average for the \$A has been around US70c, while this year the \$A has traded at an average of \$US77c.
- It is extremely difficult to accurately predict short-term currency movements – Investors benefit from exposure to currency over the longer term, as it tends to act as a powerful diversifier.

A bumpy ride

The \$A has been through a bumpy ride over the past 18 months. After reaching a high of US97.48c in June last year, the \$A fell to as low as US61.01c in November 2008, before turning and soaring to a high of US93.38c in November this year – that's a 53 per cent increase within 12 months.

This fall and subsequent rise has been the sharpest reversal in the \$A since it was floated in 1983, as shown by figure 1 below, and has raised the possibility that the \$A may reach parity with the \$US in the near future.

Figure 1: The \$A against the \$US



Source: Bloomberg, daily data from 1 February 1982 through to 16 November 2009

The \$A is rising strongly relative to all major currencies, not just the \$US. According to the Reserve Bank of Australia's (RBA) Trade Weighted Index, which measures the \$A against the average of our trading partners, the \$A increased by 40 per cent over the same period.

The rise was 40 per cent against the Pound Sterling, 46 per cent against the Japanese Yen, and even 26 per cent against the relatively strong Euro.

What's driving the \$A?

The short-term influences on \$A currency movements can vary rapidly, but are typically a mixture of four key factors: interest rate differentials with other economies; economic and employment growth; inflation, and the strength of commodity prices.

At present, all of these drivers are aligned for the Australian economy, creating considerable positive momentum for the \$A.

In particular, stronger than expected economic recovery and early signs of inflationary pressures point to further increases in Australian interest rates, well before other economies begin their rate rises.

The rise in commodity prices is largely being fuelled by strong growth in China, which shows no signs of abating in the near term.

How much higher is the \$A likely to go?

Parity with the \$US cannot be ruled out, but no trend lasts forever, especially when markets still need to revert to a more stable, equilibrium state.

A clear example that markets have not yet reverted to an equilibrium level is the historically low interest rates of the major



overseas economies. An official rate of close to zero in the US is abnormal and cannot be sustained over the longer term. When growth re-emerges in the US and rates begin to increase, the \$A may come under some downward pressure.

What is fair value?

Determining the 'correct' value of a company share is difficult enough, but a currency has no absolute value. It represents an exchange rate relative to other currencies. Over long periods of time, the comparative buying power of currencies, measured by Purchase Power Parity (PPP), is a guide to fair value.

The slightly tongue in cheek version – the Economist magazine's Big Mac Index – looks at the relative price of a Big Mac in 120 different currencies. Recent calculations indicate an implied PPP Big Mac rate slightly above parity against the \$US.

Obviously this is a very narrow measure as fast food prices don't reflect all of the variables of the broader economy. Other more conventional models of PPP indicate that the \$A has less room to move.

What this means for investors

The RBA recently indicated that the rise in the \$A is in line with economic fundamentals, and is showing no interest in intervening. In contrast, the central banks of other resource based economies such as Canada and New Zealand have flagged their rising currency as a potential concern and may take actions to limit further gains.

The \$A ranks in the top 10 most actively traded currencies in the world. It generally trades freely, without intervention and is therefore able to act as a stabiliser as relative demand changes. This means that large swings in the value of the \$A can be expected to be an ongoing feature.

Generally speaking, a rising \$A benefits importers and disadvantages exporters, but it is too simplistic to extend this logic to company earnings.

Many Australian companies have developed sophisticated approaches to managing currency risks and some have natural offsets in their cost and revenue structures.

Returns to Australian investors in overseas asset portfolios are clearly impacted by currency changes.

An increasing \$A reduces the value of unhedged offshore investments, which has been the case for many portfolios since March this year.

On the flip side, the falling \$A helped cushion some of the losses during the Global Financial Crisis (GFC). From October 2007 through to March 2009, the fall in the global sharemarket was not nearly as severe in \$A terms compared to local currency.

Over the longer term, exposure to international sharemarkets and different currencies provides diversification benefits and this can help smooth out the ride.

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