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The Australian dollar – still more to fall

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Key points

> The rising tide in favour of the $A has well and truly reversed with further downside likely in the years ahead, particularly against the $US and Euro.

> The commodity price boom has faded in response to a moderation in Chinese growth as commodity supply increases, the US is slowing its quantitative easing program and rate cuts have reduced the attractiveness of the $A all at a time that it remains above levels that offset relatively high costs and prices in Australia. Expect it to fall to around $US0.80 in the next few years.

> For Australian investors, this means less need to hedge global exposures back to Australian dollars.

Introduction

Over the last year the $A has fallen from around $US1.05 to around $US0.89 – a fall of 15%. In fact the $A is down nearly 20% from its 2011 high. The drivers of the slump have been a combination of lower commodity prices; increasing evidence that Australia is not competitive internationally; a deterioration in Australia's relative growth outlook; falling Australian interest rates; and more recently the Fed's move to slow down its monetary stimulus. RBA "jawboning" has also helped. Despite periodic bounces, like that in the last few days, our assessment is that more downside lies ahead.

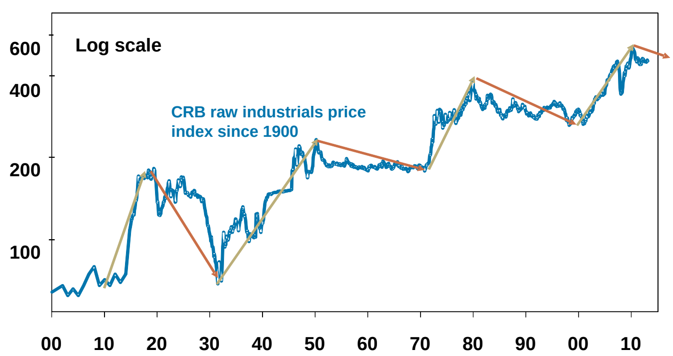
The big secular picture

The big swings in the value of the Australian dollar line up well with key long term swings globally:

- In the 1980s and 1990s the $A fell as commodity prices softened on stronger supply, global investor sentiment shifted in favour of the US and Australia was seen as "old economy". As a result the $A fell to $US0.48 in 2001.
- In the 2000s the $A surged as commodity prices rose (driven by China and the emerging world and weak commodity supply), the US and Europe hit hard times, Australia was seen as being in good shape and the $US generally fell. The $A peaked in 2011 at $US1.10.
- Now the secular picture is turning again: the US, Europe and Japan seem to be tracing out a renaissance of sorts at a time when parts of the emerging world seems to be running difficulties; slower growth in the emerging world led by China at a time of increased commodity supply is weighing on commodity prices; as a result the $A is trending down as the $US trends back up.

Central to these long term swings as far as the $A is concerned is the commodity super cycle. This is because 70% or so of Australia's exports are commodity related. Raw material prices over the past century have seen a roughly 10 year secular or long term upswing followed by a 10 to 20 year secular bear market. This can be seen in the next chart.

The long term cycle in commodity prices



Source: Global Financial Data, Bloomberg, AMP Capital

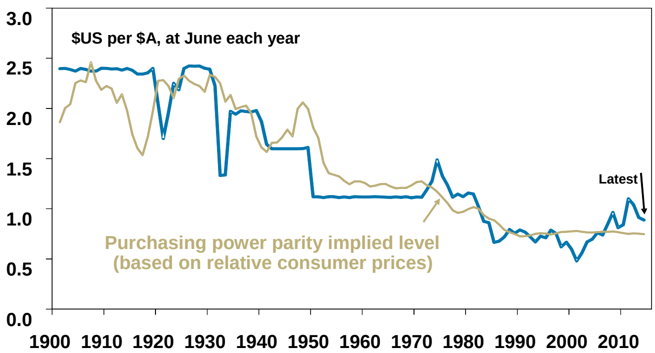
The upswings are usually driven by a surge in global demand for commodities after a period of mining underinvestment. The downswings come when the pace of demand slows but the supply of commodities picks up in lagged response to the previous price upswing. The last commodity super cycle that got underway around 2000 looks to have run its course. Growth in China remains strong but it has slowed from 10% plus to 7 to 8% at a time when the supply of commodities is surging after record levels of mining investment globally. And a basing in the $US is also not helping as commodities tend to be priced in US dollars.

Just as the upswing in the $A lasted a decade the downswing could last as long. But how far will the $A fall?

Purchasing power parity & hamburgers

A good place to start is with what economists call purchasing power parity, according to which exchange rates should equilibrate the price of a basket of goods and services across countries. A rough guide to this is shown below 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.

The $A is still overvalued based on relativeprices



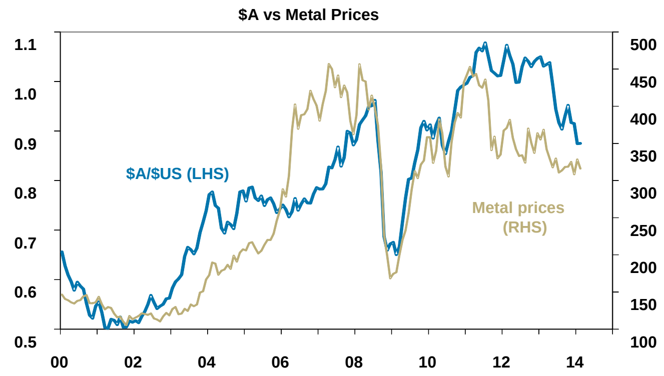
Source: RBA, ABS, AMP Capital

Purchasing power parity doesn't work for extended periods. In fact the commodity super cycle and the key long term global swings noted earlier play a big role in the long term swings in the $A around the level suggested by purchasing power parity, ie rising above it during 1970s, falling below in the 1980s & 1990s before rising back above it into 2011.

However, it does provide a guide to where exchange rates are headed over very long periods of time. A popularised version of purchasing power parity is The Economist magazine's Big Mac index, which works on the principle that exchange rates should adjust until the Big Mac costs the same in any two countries. Such measures can give different results depending on the estimation period and the types of prices used. Right now after the sharp fall of the past year the Big Mac index suggests the $A is fair value. By contrast the relative consumer price measure used in the chart above suggest the $A is still 15% overvalued, with fair value around $US0.75-0.80. The broader approach also lines up with anecdotes of high prices and labour costs in Australia compared to many other countries. This suggests the $A could at last fall to $US0.80 in the years ahead.

Other drivers

But the last chart above also suggests there is a good chance of an overshoot. Several other factors also point lower for the $A. The major factors on this front are commodity prices, relative monetary policies and changing perceptions of Australia. First, as already noted commodity prices are in a secular downswing. The chart below shows an index of industrial metal prices against the $A, showing they have gone from a positive influence to a negative.



Source: Bloomberg, AMP Capital

Second, monetary policies are now working against the $A with the RBA cutting interest rates since late 2011 which has reduced the interest rate differential favouring the $A when the US Fed is slowing its quantitative easing program.

Finally, perceptions of global investors about the $A appear to be changing. Over much of the last decade it was positive reflecting Australia's favourable fundamentals tied to growth in the emerging world and more latterly as a AAA rated safe haven against turbulence in the US and Europe. Now there is a bit more wariness as emerging markets have gone out of favour and Australia's budget deficit has deteriorated.

While the RBA appears to have relaxed its efforts at jawboning the $A lower this may simply reflect the extent of the fall that has already occurred. Coming at time when short positions in the $A are extreme the change in the RBA's stance could see a further short term bounce in the $A as short positions are unwound. However, it doesn't change our broader assessment that the trend in the $A will be down.

Implications for investors

Changes in the value of the $A can have a big impact on the return Australian based investors receive from international investments. This can be seen in relation to international equity returns in the next table. The first column shows the return from global shares in local currency terms, the second shows the return in Australian dollars (if foreign currency exposures are not hedged back to Australian dollars), the third column shows the difference which is the change in the $A on a weighted basis and the final column shows the return to global shares if hedged back to Australian dollars.

Impact of $A moves on international equity returns

Year	Local currency return, %	Return in $A, %	Change in $A, wgted, %	Hedged return, %
2001	-14.5	-10.0	-4.5	-13.6
2002	-24.3	-27.4	3.1	-22.5
2003	25.2	-0.8	26.0	29.1
2004	11.0	9.9	1.1	15.3
2005	15.6	16.8	-1.2	18.9
2006	15.4	11.5	3.9	17.8
2007	4.4	-2.6	7.0	6.7
2008	-38.7	-24.9	-13.8	-36.4
2009	25.4	-0.3	25.7	26.7
2010	10.4	-2.0	12.4	13.1
2011	-5.3	-5.3	0.0	-1.9
2012	15.5	14.1	1.4	18.7
2013	29.2	48.0	-18.8	32.3

Source: Thomson Reuters, AMP Capital Investors

In years when the $A falls like last year it boosts investors' returns from global shares. But when the $A rises as was the case for much of the 2002 to 2011 period it reduces returns from international shares. As can be seen in the last column the return from global shares when hedged back to Australian dollars is usually a bit higher than the local currency return because investors also receive the difference between Australian and foreign interest rates.

Over the 2001 to 2010 period unhedged international shares lost an average 3% pa whereas hedged international shares returned 5.5% pa. The difference largely reflects the rise in the $A (+6% pa), but also the interest rate differential between Australia and the rest of the world (+2.5% pa).

Most global investments offered by fund managers come with a choice of being unhedged, ie exposed to fluctuations in the value of foreign currencies, or hedged, where the value of the investment is locked back into Australian dollars.

There are essentially three key drivers of the decision to hedge or not when investing offshore:

- The outlook for the $A. When it is rising it is best to be hedged, but best to be unhedged when it is falling.
- Whether an investor is "paid" to hedge or not – this is determined by relative interest rates. Most of the time Australian interest rates are above average global rates so investors are paid to hedge into Australian dollars.
- The diversification benefits of foreign currencies. Having an exposure to foreign currency means not keeping all your "currency eggs" in one basket. At times the $A can be pro-cyclical, rising in good times and falling in bad, so it can smooth out swings in global shares.

Right now the broad trend in the $A remains down and investors are getting "paid" less to hedge as the RBA has cut interest rates (2% pa compared to around 3.5% pa 3 years ago). As a result it makes sense to take advantage of the diversification benefits of other currencies by having a greater unhedged exposure than a decade or so ago.

The one major currency where this may not apply is the Yen where further weakness against the $US is likely.

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