Edition #14

26 May 2009

The Australian dollar, US dollar and commodity prices

Key points

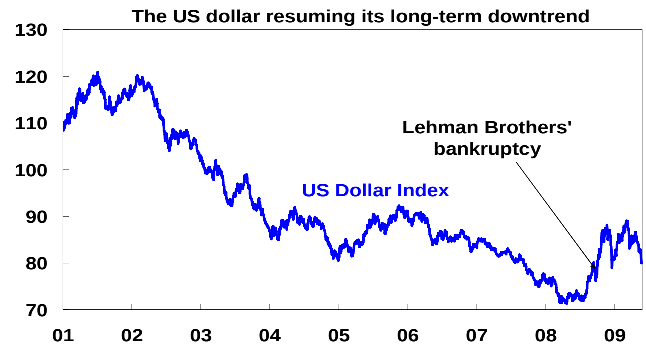
- The rebound in the $A reflects a combination of renewed $US weakness, stronger commodity prices and the relative strength of the Australian economy.
- Commodity prices seem to be recovering earlier than normal in this cycle reflecting the role played by China, infrastructure projects and supply cutbacks. The commodity super cycle looks to be alive and well.
- While the $A is due for a correction, in the absence of a major setback in the global economic outlook the broad trend is likely to remain up.

Introduction

A big surprise this year has been the strength of the $A. It has now recovered nearly half of its global financial crisis driven plunge. Several factors are at work: renewed weakness in the $US, the recovery in commodity prices and the relative strength in the Australian economy. The big question is - can the strength in the $A be sustained?

Reason #1 - Renewed $US weakness

As is often the case, the latest strength in the $A is partly due to renewed $US weakness. From mid last year to early March – which was the weakest period in global share markets – the $US actually rose in value by an average of about 25% against major currencies. See the chart below.



Source: Bloomberg, AMP Capital Investors

In fact, as is often the case during global economic slumps, the $US actually rises in value. During crises the $US is seen as a safe haven – US investors bring their money back home and, reflecting its reserve status, demand for the $US goes up. This is what happened during the second half last year. Now with the financial crisis abating the $US is retreating with other factors also playing a role:

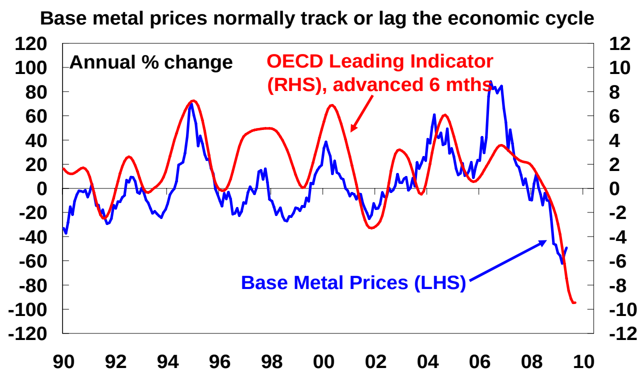
- As confidence in some sort of economic recovery and financial conditions have improved, the need to hold US dollars and demand for it as a safe haven has declined.
- The fall in risk aversion is seeing a resumption of the carry trade (where investors borrow cheaply in low yielding currencies and invest in high yielding currencies). The $US, with near zero interest rates, seems to have taken over from the Japanese Yen as the key funding currency for such trades. High yielding currencies such as the $A are clear beneficiaries.
- There is increasing concern about the US budget deficit, fears of a ratings downgrade for US public debt and worries about the direction of US economic policy.

It's doubtful that this is the start of the $US crash that has been long feared by many. It's hard to find any better alternatives to the $US. Europe and Japan are in worse shape than the US, have similarly eased monetary policy and have similar or worse public debt levels. While a fall in the value of the $US will actually help the US economy, it will be bad news for Japan and Europe and is likely to be met with increasing resistance the further the $US falls. The Chinese Renminbi is not really an alternative to the $US as an international reserve currency because it's not even fully convertible and lacks anywhere near the liquidity of the $US. And Chinese authorities are unlikely to sell or stop buying US bonds because such action would push up the Renminbi versus the $US (and damage their exporters), the very thing they have been trying to prevent.

But while a $US crash is unlikely, a recovering global economy is likely to see further US dollar weakness on the back of declining risk aversion and the resumption of carry trades. A reasonable expectation is that the $US index in the first chart will fall back to last year's lows, which would amount to a further fall of 10% or so against major currencies. This is likely to be positive for the $A.

Reason #2 - Commodity price recovery

Industrial commodity prices have had solid gains from their lows late last year and this has also helped drive up the $A. Oil is up 95%, base metals are up 35% and gold is up 34%. Commodity prices usually track or lag the global economic cycle, as evident for base metal prices in the next chart.



Source: Bloomberg, AMP Capital Investors

However, apart from contract iron ore and coal prices which always lag, traded commodity prices now appear to be leading the global economic cycle. There are several reasons for this changed relationship.

Firstly, commodity prices are also being pushed higher by the falling $US. This partly reflects the fact that most commodities are priced in US dollars and so when the latter goes down the natural tendency is for them to go up.

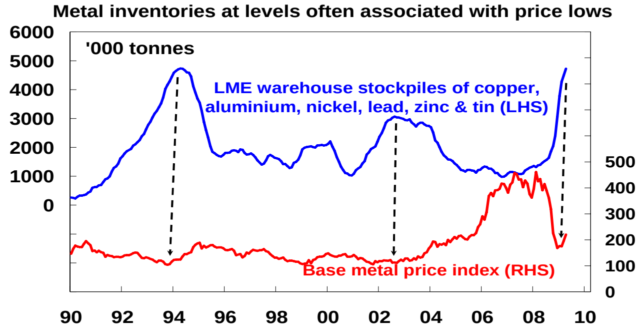
Secondly, investor demand for commodities may be on the way back up being given an added impetus by the desire to find a hedge against the uncertain outlook for most key paper currencies and the risk of increased inflation.

Thirdly, and more fundamentally, the greater importance of China in commodity demand is playing a role in commodity prices more pre-emptive nature. Since 2000 China has accounted for virtually all the growth in global copper consumption and now accounts for 35% of global copper demand. The recent rise in Chinese economic indicators has coincided with a sharp upswing in Chinese metals imports. This is due to China taking advantage of cheaper global metals prices to add to its stockpiles, the decline in the competitiveness of domestic metal producers and increased infrastructure spending in China.

Fourthly, increased infrastructure spending globally is also positive for commodity demand.

Finally, falling mining sector profits and tighter financing has seen numerous mining projects cancelled. This is at a time when commodity inventories have reached levels normally associated with bottoming commodity prices.

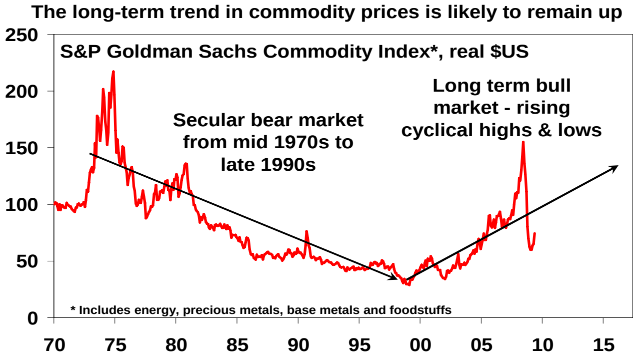
Metal inventories at levels often associated with price lows



Source: Thomson Financial, AMP Capital Investors

These considerations suggest that it's quite likely that commodity prices have turned the corner, and barring a renewed sharp setback in the global growth outlook, look like they are embarking on a new cyclical upswing. This is all consistent with the commodity super cycle being alive and well and having just gone through a temporary pause over the past year.

The long-term trend in commodity prices is likely to remain up



Source: Thomson Financial, AMP Capital Investors

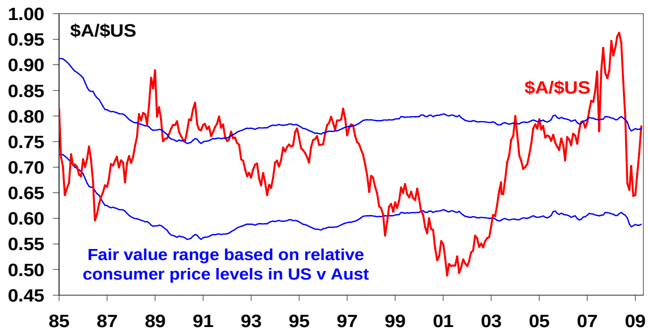
Reason #3 - Australian economy is relatively strong

Finally, thanks to a range of factors the Australian economy is relatively strong. The Australian economy is estimated to have fallen 0.5% over the year to the March quarter, compared to slumps of 2.6% in the US, 4.6% in Europe and 9.7% in Japan. Australian interest rates are likely to remain well above those in the US, Europe and Japan. On top of this, Australia is seen as relatively attractive to the extent that it's leveraged to strength in China. All of this makes Australia reasonably attractive for foreign capital, and sees Australia as a key beneficiary of carry trades.

The $A – vulnerable to a correction but trend likely up

Our measure of fair value for the $A, based on the assumption that the exchange rate should move to equate average price levels across countries, suggests a fair value level of around $US0.70. See the next chart.

The $A is back to the top end of its "fair value" range



Source: Thomson Financial, AMP Capital Investors

So at US0.78 the $A is at the top of its fair value range. However, as we saw over the last few years such fair value measures can be wrong for long periods, particularly when commodity prices are strong. It's probable that the $US0.80 level will provide some resistance and periodic concerns regarding the global growth outlook will create set backs. However, with the $US likely to see further downside, commodity prices on the rise again (from a point which will have left Australia's terms of trade still 40% above its long term average) and the Australian economy providing a relatively attractive investment destination it's likely the upswing in the $A has further to go. A rise to around $US0.85 by year end is now quite likely.

Implications of a rising $A

From an economic perspective the rise in the Australian dollar is a mixed bag. To the extent that it's a positive sign regarding the global growth outlook and that it will reduce the cost of imported goods to Australia and hence inflation, it's good news. But it's bad news for companies with exposure to trade or with offshore sourced earnings. So in this sense it may be a bit of a dampener on the Australian economic recovery and on profits. With 30% or so of listed company earnings sourced overseas, the 16% rise in the $A from its average December quarter level will mean that earnings will be 5% lower than would have been the case if the $A had stayed at its December quarter average.

For investors, a rise in the value of the $A may not be good news because it will reduce the value of offshore investments, unless they are hedged. Global bond and property funds are usually hedged back to $A to remove the currency impact. But global equity funds are usually unhedged, because the $A normally moves in line with share markets and so tends to smooth out their volatility. However, fully hedged equity funds are available. With the $A likely to see further gains as the global recovery comes through, there is a case to consider investing in hedged international equity funds as opposed to unhedged funds.

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