

Australian dollar parity – is it sustainable & what is the impact?



Key points

- For the first time in 28 years the Australian dollar (A\$) has spiked above parity against the US dollar (US\$), highlighting the culmination of a long, hard slog back to form for the Australian economy. In a longer-term context, it is the last 28 years below parity that is the aberration.
- While the A\$ is vulnerable to a correction having risen so fast since late August, unless the global economy tanks again it is likely to average above parity over the next few years on the back of strong commodity prices and the relative strength of the Australian economy. Probably at around US\$1.10.
- While the high A\$ will make life tough for trade-exposed companies without a natural hedge, on balance it is more of a positive for the Australian economy. It is unambiguously positive for consumers and will help limit the extent to which interest rates have to rise.

Introduction

Well it's taken a bit longer than I first thought, but the A\$ has finally broken through to parity against the US\$. This raises several questions: How did it get here and is it sustainable? And what does it mean for the Australian economy and investors?

How did we get here?

The move through parity reflects a range of factors including downwards pressure in the value of the currencies of the major advanced countries led by the US\$, strong commodity prices, a widening interest rate differential and strong economic fundamentals.

The global financial crisis (GFC) has exposed a fundamental imbalance in the global economy and that is a high level of consumption and/or public debt in major advanced countries in contrast to low consumption and low debt in emerging countries. A necessary part of the adjustment to rebalance the world is that currencies in the G3 (the US, Japan and Europe) need to fall relative to those in the emerging world. This has been led by the US\$ and British pound but the Japanese yen and euro will follow. Against the background of a falling US\$, the strength in the A\$ is being given added impetus by a combination of:

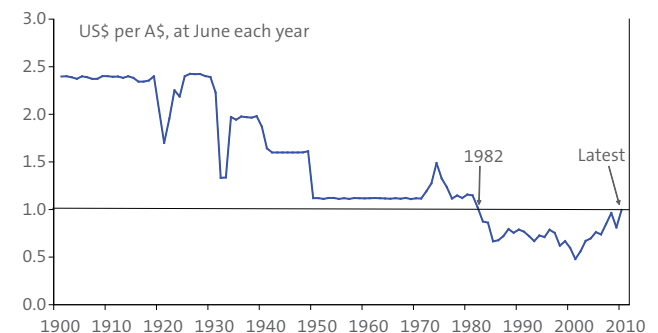
- Rising commodity prices – they usually move inversely to the US\$ and their longer-term trend higher is being driven by the commodity-intensive demand in the emerging world;
- While the US and other major industrial countries are moving towards more monetary easing, the Reserve Bank of Australia (RBA) looks set to raise interest rates, further widening the differential in rates with the US and other major countries; and

- The GFC has improved investor perceptions of Australia. It is the only Organisation for Economic Cooperation and Development (OECD) country not to have succumbed to recession through the GFC, it has zero net public debt and is seen as well managed, and is a relatively safe way to invest in the strong China story.

But is it sustainable?

Since the A\$ floated in 1983 the general perception was that fair value was around US\$0.70 and most fair value models for the A\$ constructed over this period confirmed this (as would be expected). However, it is likely this relatively narrow period of history misses the longer-term perspective and the changed reality facing Australia. Back in 1901 the equivalent of one A\$ bought US\$2.40 and for most of the last century the A\$ was above parity against the US\$. The long-term slide in the A\$ between 1901 and 2001 reflected a combination of soft commodity prices (which adversely impacted Australia's terms of trade) and a perception of Australia as a mediocre, inflation prone 'old' economy (see below).

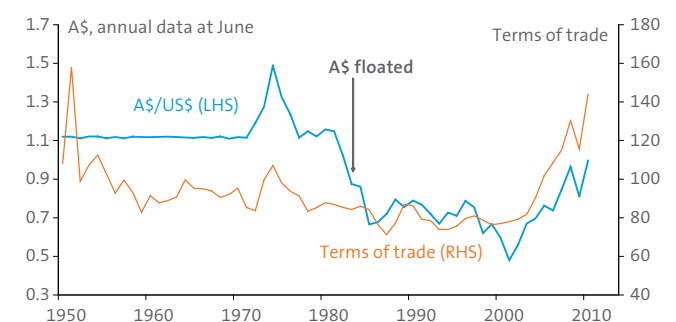
Above parity was the norm for the A\$



Source: Thomson Financial, AMP Capital Investors

However, these drivers have now all turned around. Commodity prices are in a long-term upswing, Australia is seen as well managed with inflation under control and interest rates are relatively high, in part reflecting a potentially higher return on capital. In fact, back in the early 1950s when Australia's terms of trade (the ratio of export prices to import prices) was around current high levels, the equivalent of one A\$ bought US\$1.12.

Australia's strong terms of trade is consistent with the A\$ above parity



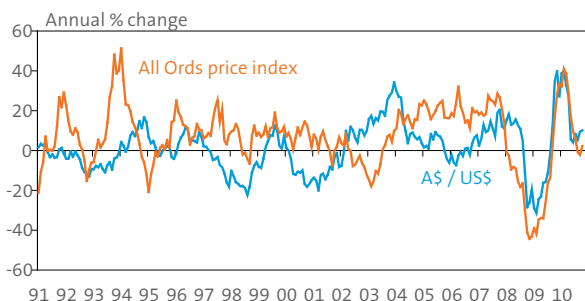
Source: RBA, Thomson Financial, AMP Capital Investors

In short, it is likely the sub-parity period from the 1980s was the aberration for the A\$, and the improvement in Australia's relative fundamentals suggest it is likely the A\$ is going to settle above parity against the US\$. Forecasting currency levels is an impossible task but I would suggest an average around US\$1.10 is likely in the years ahead, unless the global economy collapses anew.

The impact of a rising A\$ on the economy and shares

The strong A\$ is great news for Australian consumers as it will result in lower prices for imported items. Imports account for nearly 30% of consumption goods, notably items such as cars, clothing, petrol and many electrical goods. This in turn is likely to take pressure off inflation and reduce the extent to which the RBA will raise interest rates. For the broader economy and shares, a strong A\$ is often seen as bad news as export and import competing companies become less competitive. It is much easier to identify companies that will lose from a rising A\$ via the impact on their earnings (such as resource stocks, multinational industrials, steel makers and various health care stocks) than to identify companies that benefit because of lower import costs (such as some retailers and the airlines). With around 30% of listed company earnings sourced overseas, a 10% rise in the A\$ will mechanically cut earnings by about 3%. This would suggest that a rising A\$ is bad for the Australian share market. However, the problem with this approach is that historically, the actual relationship between the A\$ and the Australian share market is ambiguous (see the next chart). In fact, in recent times a strong A\$ has gone hand in hand with economic strength, e.g. over the 2003-2007 period, and a weak A\$ has correlated with economic weakness, such as in the second half of 2008.

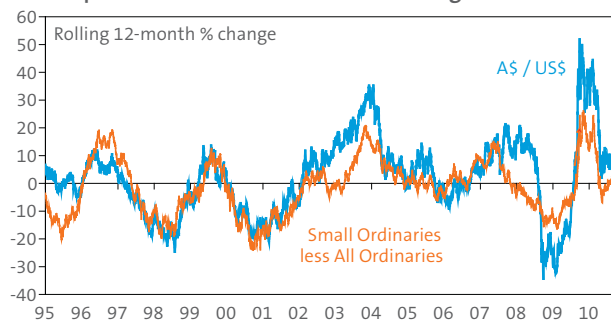
Historically there has been no clear correlation between the A\$ and Australian shares, but in recent times it has been positive



Source: Thomson Financial, AMP Capital Investors

The reason is because while a rise in the A\$ is a dampener for company profits on its own, it is normally associated with strong economic growth which is good for profits. This explains, for instance, why the performance of resource shares correlates strongly with the A\$, contrary to what an analysis of the A\$'s impact on their earnings suggests. It is also worth noting that periods of A\$ strength are normally positive for the relative performance of small caps because they are cyclical, have less offshore exposure and benefit more from lower import costs.

Small cap shares will benefit from the strong A\$



Source: Thomson Financial, AMP Capital Investors

Given that the latest bout of A\$ strength has been associated with renewed vigour in commodity prices, improved optimism regarding the global outlook and relatively stronger economic conditions locally, it is unlikely to cause major problems for the share market or the economy at an aggregate level. This is because the direct negative impact on profit growth from the surge in the A\$ should be largely offset by the positive impact from solid economic conditions. From a longer-term perspective though, the rise in the A\$ will present challenges. It is effectively helping to shift economic resources to the strongly growing resources sector of the economy, which is fine from a technical economic perspective but such restructuring will invariably have significant social and regional consequences.

The strong A\$ and investors

For investors, the rise in the value of the A\$ may not be good news as it will reduce the value of offshore investments, unless they are hedged. Global bond and property funds are usually hedged back to Australian dollars to remove the currency impact. However, global equity funds are usually unhedged, because the A\$ normally moves in line with share markets and tends to smooth out their volatility. In 2008 the fall in the value of the A\$ helped cushion the fall in international share markets for Australian-based investors in unhedged international shares; but in 2009 the rise in the value of the A\$ offset the recovery in global share markets. However, fully hedged international equity funds are available. With the A\$ likely to see further gains over time, there is a case to remain biased towards hedged international equity funds as opposed to unhedged funds.

Concluding comments

The breach of parity for the A\$ against the US\$ symbolises the improvement in Australia's fortunes over the last decade. With major advanced country currencies likely to remain depressed and commodity prices likely to remain high, above parity for the A\$ is likely to prove sustainable, albeit with the normal high degree of volatility that characterises exchange rate movements.

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