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US dollar breaking down, Australian dollar breaking higher

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Key points

- The Australian dollar (A$) is continuing to push further above parity against the US dollar (US$), reaching a 29-year high. This reflects a combination of strong commodity prices, US$ weakness and high Australian interest rates.
- Unless the global economy slides back into recession, which appears unlikely, the A$ is likely to average above parity over the next few years on the back of strong commodity prices and relatively high Australian interest rates. Expect US$1.10 by year end.
- On balance, a strong A$ is positive for the Australian economy and is part of the adjustment made necessary by strong demand for Australian raw material exports.

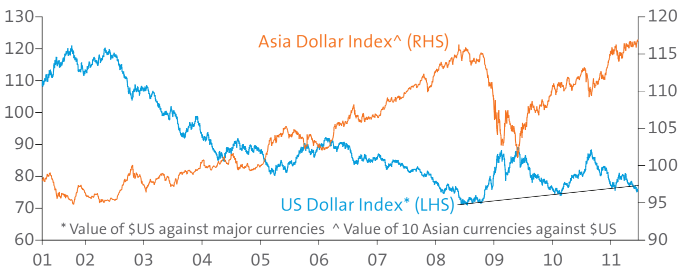
Introduction

After being stuck in a narrow range around parity against the US$ since last October, the A$ has reached a new 29-year high. The strength in the A$ reflects renewed US$ weakness, strong commodity prices and relatively high Australian interest rates. My view for some time has been that having breached parity against the US$, the A$ would head to US$1.10. Allowing for usual currency volatility, this still seems on track.

The bigger picture – a falling US dollar

A major part of the A$'s strength over the last decade has been the downtrend in the US$. After a pause this appears to be resuming.

The US$ appears to be resuming its downswing, Asian currencies continue to rise



Source: Bloomberg, AMP Capital Investors

Further US$ weakness is likely. The US Federal Reserve (Fed) is signalling no urgency to raise interest rates at a time when other central banks are either lifting interest rates or contemplating lifting them. In addition, rising global investor confidence is reducing demand for the US$ as a "safe haven". The converse of US$ weakness is renewed strength in a range of other currencies:

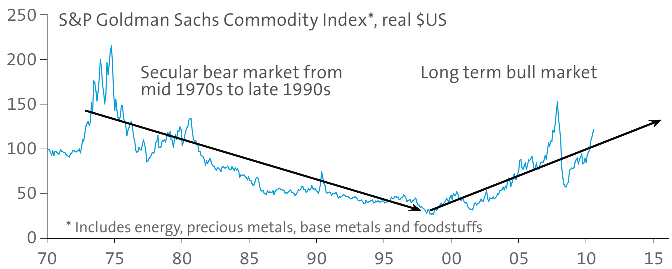
- The euro is looking stronger on the back of European Central Bank (ECB) talk of a rate hike and confidence that European authorities are confining sovereign debt problems to Greece, Ireland and Portugal.
- Asian currencies have risen to the top of their recent range against the US$. With the Renminbi steadily appreciating against the US$ and interest rates still rising across Asia, it's likely Asian currencies - including the Korean won, Taiwan dollar and Singapore dollar - have more upside.
- The Yen strengthened after the Japanese earthquake. This has since been short circuited by G7 intervention, confusing the outlook for this currency.

A weaker US$ is also likely to coincide with a stronger A$.

Strong commodity prices

Despite a brief dip as a result of the Japanese nuclear crisis, commodity prices have shown renewed strength. This reflects strong growth in Europe, expectations of rebuilding demand for raw materials from Japan, turmoil in the Middle East and North Africa boosting energy prices, and expectations that Japan's nuclear crisis will add to demand for oil, gas and coal. With the industrialisation process in China and other emerging countries likely having much further to go and supply likely to continue to struggle to keep up, the uptrend in commodity prices likely has years to run. And, of course, a weak US$ is also positive for commodity prices as they are priced in US$.

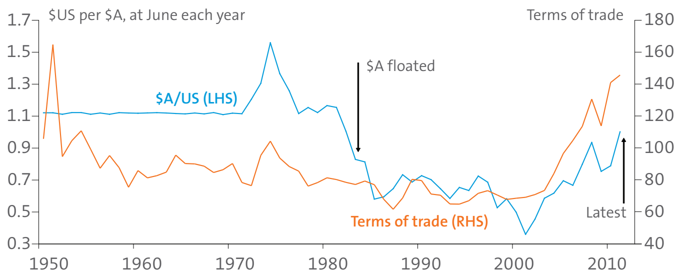
Commodity probes are in a long term uptrend



Source: Thompson Financial, AMP Capital Investors

Australian commodity exports such as iron ore, coal and liquid natural gas are all key beneficiaries of this. Commodities make up around 70% of Australian exports, so the strength in commodity prices has seen the ratio of Australia's export prices to import prices, or the terms of trade, rise to its highest level since the early 1950s and it is continuing to surprise on the upside. As can be seen in the next chart the A$ has tended to lag the strength in the terms of trade. The last time the terms of trade was this high, in the early 1950s, the equivalent of one Australian dollar bought US$1.12.

Australia's strong terms of trade supports the A$ above parity



Source: RBA, Thomson Financial, AMP Capital Investors

Relatively high interest rates

Australian interest rates at 4.75% are well above those in the US, Europe and Japan where the range is zero to 1%. While the ECB is likely to raise rates next month to 1.25%, there is unlikely to be much follow through and the Bank of Japan has been undertaking more (quantitative) easing. Meanwhile the Fed is likely to be on hold for some time. By contrast, Australian rates are on hold but the Reserve Bank of Australia's bias remains towards more tightening which we expect to occur during the second half as Australian economic growth rebounds on mining investment, Queensland production returns to pre-flood levels, flood-related rebuilding kicks in and as national income remains strong on the back of high commodity prices. By year end, the interest rate differential in Australia's favour is likely to have increased to around 5% against the US and Japan and 4% against Europe. This has the effect of attracting funds to Australia, which in turn pushes up the A$.

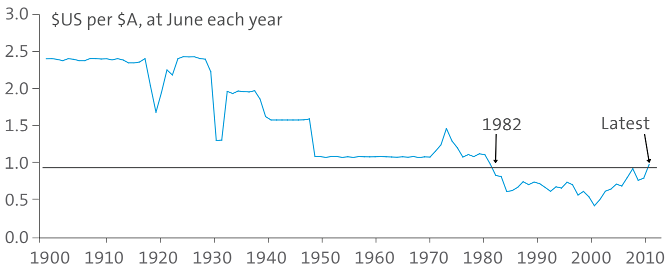
A longer-term perspective on the Australian dollar

The general consensus seems to be that the A$ is way overvalued and that parity and above is unsustainable. By contrast, we think parity and above is sustainable. There are several reasons for this.

Firstly, most fair value models for the A$ have been estimated over a relatively narrow period of history, i.e. the period since the A$ floated in 1983, but this misses the longer-term perspective and the changed fundamentals now facing Australia.

Secondly, most of the factors that drove the long-term slide below parity for the A$ have now reversed. In 1901, the equivalent of A$1 bought US$2.40 and for most of the last century the A$ was above parity against the US$. The long-term slide from 1901 to a low of US$0.48 in 2001 reflected a combination of soft commodity prices and a perception of Australia as a mediocre, poorly-managed, inflation prone "old" economy.

A$ back at more normal levels after a long slide



Source: Thomson Financial, AMP Capital Investors

These drivers have now all turned around. Commodity prices are in a long-term upswing and Australia is seen as well-managed with low public debt, inflation under control and relatively high interest rates.

Thirdly, the global financial crisis has exposed a fundamental imbalance in the global economy, which 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. Part of the adjustment to rebalance the world is that currencies in the US, Japan and Europe need to fall relative to those in the emerging world, and also against currencies that benefit from emerging world growth, such as the Canadian and Australian dollars.

In short, **it is likely the sub-parity period from the 1980s was an 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 expect an average around US$1.10 in the years ahead, unless the global economy collapses again. This would be consistent with the high terms of trade.

The impact of a rising Australian dollar on the economy and shares

The strong A$ is great news for Australian consumers as it will result in lower prices for imported 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 ultimately have to 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. With around 30% of listed company earnings sourced overseas, a 10% rise in the A$ will cut earnings by about 3%. This would suggest a rising A$ is bad for the Australian share market.

However, **the actual relationship between the A$ and the Australian share market is ambiguous**. In fact, over the last decade a strong A$ has gone hand in hand with economic strength and a weak A$ has correlated with economic weakness. The reason is, that while a rise in the A$ is a dampener for company profits on its own, it's normally associated with strong economic growth which is good for profits. Given the latest bout of A$ strength has been associated with renewed vigour in commodity prices and improved optimism regarding the global outlook, it's 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. However, the strong A$ could remain a drag on the relative performance of Australian shares against global shares.

From a longer-term perspective, the rise in the A$ will present challenges. It's helping to shift economic resources to the strongly-growing resources sector of the economy, which is appropriate from a technical economic perspective but such restructuring will invariably have significant social and regional consequences.

The strong Australian dollar and investors

For investors, a rising A$ reduces the value of offshore investments, unless they are hedged back to A$. Global bond and property funds are usually hedged to remove the currency impact. Fully hedged international equity funds are available. **With the A$ likely to see further gains over time, there is a case to remain biased towards hedged international equity funds as opposed to unhedged funds, although not as strong a case when the A$ was well below parity**.

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