

The Australian dollar and Europe

Oliver's Insights



Key points

- > In the short term, the Australian dollar (A\$) remains vulnerable to global growth worries stemming from Europe where the risks have increased dramatically with Italy now in trouble.
- > However, strong commodity demand and relatively higher interest rates in Australia are likely to see A\$ remain strong over the medium term.

Introduction

A year ago I thought the A\$ would head up to around US\$1.10. Having done that, it has been messy since mid-year, falling just below US\$0.94 in September before recovering back above parity in October. Where to from here? Is the upswing from US\$0.48 in 2001 now over?

The A\$ moves with other growth trades

In recent years, short-term swings in the A\$ have become highly correlated to other growth-oriented risk assets like shares. This is clear in the chart below which shows the A\$ against the US share market.

The A\$ and shares



Source: Bloomberg, AMP Capital Investors

While the longer-term trends in each differ (up for the A\$, down for US shares) each time shares have taken a decent hit, so too has the A\$ – falling 39% during the global financial crisis, 13% during last year's double-dip worries, and 14% recently.

There are three key reasons for this sensitivity. Firstly, because 70% of Australia's exports are commodities the A\$ is seen as a commodity currency. Whenever there are concerns about global growth and shares take a hit, commodity prices also take a hit and so too does the A\$.

Secondly, in times of economic uncertainty investors unwind so called 'carry trades'. These involve borrowing in Japanese yen or US dollars at near-zero interest rates and parking the money in higher-yielding currencies such as the A\$. When they are reversed during times of uncertainty, it pushes the A\$ down.

Thirdly, the US dollar (US\$) is seen as a safe-haven currency (perversely given America's debt problems). Since a big chunk of global trade and lending is conducted in US dollars, demand for the currency goes up in times of uncertainty. The US\$ strength in times of stress also pushes commodity prices down as most are priced in US dollars which in turn weakens the A\$.

If anything, this correlation with shares for the A\$ may intensify as more investors cotton on to the importance of macroeconomic issues in driving global investment markets and so see investing

in terms of 'risk on' (buy shares, commodities and commodity currencies in good times) and 'risk off' (do the opposite).

Europe is getting worse

It is likely the A\$'s vulnerability will remain high for some time. Europe looks terrible, with any relief provided by the European Union's (EU) latest policy response now being blown apart by political instability in Greece and Italy. While the EU's latest response to its debt problems – if implemented – may help head off a worst case financial blow-up, it does nothing to break the vicious spiral of fiscal austerity, economic contraction, budget blowouts, market panic, more fiscal austerity, etc. Current indications are that Europe is on track for recession. But it's also driving social and political dislocation on an immense scale, as seen recently in Greece and Italy. **Italy's slide into the abyss since July is particularly worrying as it accounts for 17% of Euro-zone gross domestic product (GDP) and 23% of its public debt, and European banks have a near US\$800 billion exposure to it** (as opposed to a US\$130 billion exposure to Greece). Italian elections will only lead to more uncertainty and delay. Italian bond yields have now reached levels that, if sustained, will turn its problems into a solvency crisis just like Greece. They have now surged past the levels that forced Ireland and Portugal to seek assistance. The crisis is creeping further and further into the core of Europe with France also coming under pressure. The best way out of this would be for the European Central Bank (ECB) to commit to unlimited bond buying and significant monetary easing, but it is still not prepared to do this. What's more, there is increasing talk of a break-up of the euro. All of which means continuing volatility out of Europe for some time to come, with an obvious threat to global growth, commodity prices and the A\$.

From the short to the medium term

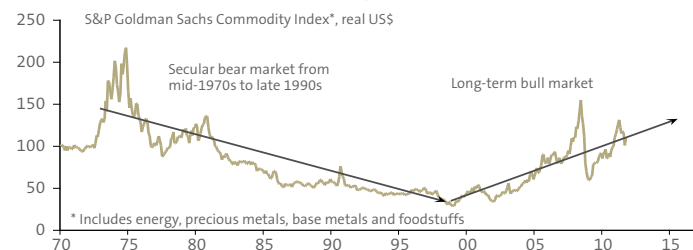
Pulling back from the myopic focus on the tragic soap opera unfolding in Europe and the short-term vulnerability this implies for the A\$, the medium-term outlook for the A\$ remains strong. This reflects two key forces – long-term commodity demand out of the emerging world and ultra-easy monetary policy in the US, Europe and Japan.

The commodity story remains alive and well

While commodity prices have fallen sharply over the last few months, the longer-term trend remains up. Rising supply is likely to slow the uptrend in real commodity prices in the years ahead, but, abstracting from cyclical fluctuations, demand is likely to be strong, driven by rapid industrialisation in emerging countries.

Emerging countries are now passing through the US\$3000-10,000 per capita income range that normally sees a sharp spike higher in demand for consumption goods. Last year, 50% of the population in emerging countries fell in this range.

Commodity prices remain in a long-term uptrend



Source: Thomson Reuters, AMP Capital Investors

