Positive catalysts have caused the Australian dollar to rise strongly since early 2009

Australia’s currency has enjoyed strong gains over the past year (figure 1, below). The decision by the Reserve Bank of Australia (RBA) to begin tightening monetary policy in October 2009 (the first developed world central bank to do so), along with a strong recovery for its own domestic economy, has caused the currency to rally strongly. However, the strength of the currency also reflects the close correlation that the Australian dollar has to global risk appetite. Its strong rebound through much of 2009 (in an early economic cycle environment) has been very much a response to the rebound in Chinese demand and the resulting upgrades to commodity prices. These forces—rising interest rates, rising commodity prices, and a robust domestic economy—are still at play. However, the relative benefits of some may begin to fade, depending on how the global economy performs going forward.

Outlook: A mixture of factors may affect Australia’s currency going forward

Australia is extremely advanced (and anomalous) in this particular interest rate cycle, with most other developed markets maintaining a very loose monetary policy (figure 2, below). Benchmark interest rates are 4.5% in Australia, compared with just 0.1% in Japan and as low as zero in the U.S. This interest rate differential remains a significant positive for the Australian currency, although this may diminish as expectations for rate rises in the rest of the world gather momentum.

The rally in the Australian dollar throughout 2009 can also be attributed to the sustained depreciation of the U.S. dollar. However, there was evidence in the first quarter of 2010 that this had started to show some signs of reversal as U.S. economic data improved and yields on U.S. Treasuries rose. Markets started to consider the possibility of higher official interest rates and the reversal of the significant market liquidity programs.

Recently, however, indications that the pace of the U.S. economy’s growth has lost momentum this summer, while the rate of inflation has fallen sharply at the same time, have moderated these expectations. In fact, with the U.S. Fed stating that the outlook was “unusually uncertain,” consensus for the first interest rate hike has now been pushed out from early 2011 to the fall of 2011. If that prediction is accurate, we may continue to see a strong Australian dollar versus its U.S. counterpart.
We do, however, have to take into consideration that on an historical basis, the Australian dollar has been trading at the upper end of its trading band over the last year. This dovetails well with the upturn in equity prices and global risk appetite. With its peak in recent years being 0.9798 (15 July 2008), coinciding with the peak in equity markets, it can be argued that if we see both risk assets and equities prosper going forward, then there could be further upside for the currency. But if we encounter a period of uncertainty, then you could see the currency fall in line with sentiment.

Resurgence in domestic economic activity
Australia’s currency also has benefited from a resurgence in its own economy. Employment has rebounded strongly, rising job advertisements point to further gains in the short term (figure 3, below), and wage growth has returned to pre-crisis rates. Improved consumer confidence and the swing in Australia’s trade balance into surplus also have provided a fundamental flow of support for the Australian dollar. If this continues, it would provide a positive backdrop for the currency.

The outlook for commodities, and subsequently economic growth in China, are key factors for the Australian currency
Perhaps one of the most important factors to monitor in recent years has been the future of commodity prices. Using the Westpac Commodity Futures Index, a measure of futures trade commodities, we can see that the Australian dollar’s relationship with its U.S. counterpart is closely linked with the performance of commodities (figure 4, next column). Therefore, with China being the main driver of commodity prices in recent years, the outlook for the Chinese economy will be paramount in assessing the prospects for the Australian currency.

Current implications for Australian monetary policy
Following a period of unprecedented easing over eight short months, which brought official policy rates down to all time lows, the RBA has been one of the first central banks to tighten monetary policy. However, despite six rate hikes since October 2009, the current cash rate is still slightly below what historically has been considered neutral (figure 5, below).

Going forward, however, the RBA is maintaining a more cautionary stance. At recent meetings, the RBA intimated that Chinese economic growth was “moderating to a more sustainable rate as policies are now less accommodating,” indicating less chance of upward risk from China. With monetary policy close to more normalized levels, inflation “close to target,” and economic growth likely to be close to trend, policy should remain relatively stable in the short term. As for the crucial “medium-term,” the RBA has stated that inflation will be the crucial barometer to monitor.
How does this impact global equity investors?

For those investors who have sought to diversify their positions by allocating money to global equity markets, any increase or decrease in the value of the Australian dollar will have a respective negative or positive impact on investment returns. This would argue for a global portfolio to be hedged against any fluctuations in the value of the currency.

However, what investors should perhaps assess is how leveraged they wish to be to their own domestic economy. With Australian stock markets being predominately made up of financials and natural resources companies, China, and the prospects for its economy, plays an important role for many Australian stocks. A hedged global portfolio would only add to this bet. By contrast, an unhedged portfolio offers the opportunity to properly achieve those diversification benefits sought in the first place, especially when paired with a domestic equity allocation.

Adopting a 50/50 split between a hedged and unhedged portfolio could also prove beneficial for investors, especially when the currency is trading in a relatively small trading range. This would also allow for the flexibility to make a strategic tilt when parameters for the currency are close to being reached, have been reached, or have been breached. However, execution of this may prove difficult as currency markets can move very quickly. Therefore, choosing a global equity manager to manage these currency risks may offer the best option.

Importantly, however investors choose to invest, advisors should always remain fastidious in their duties irrespective of the economic climate and selection should always be based on a multitude of factors. Attributes such as durability of investment process, robustness and independence of fundamental research, quality of risk controls, consistency, etc., are very important to scrutinize in the selection process. Above all, however, advisors are supposed to be fiduciaries, they are guardians of a trust and should always put clients’ interests first.