The View From The Outer

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The Australian dollar needs to fall further

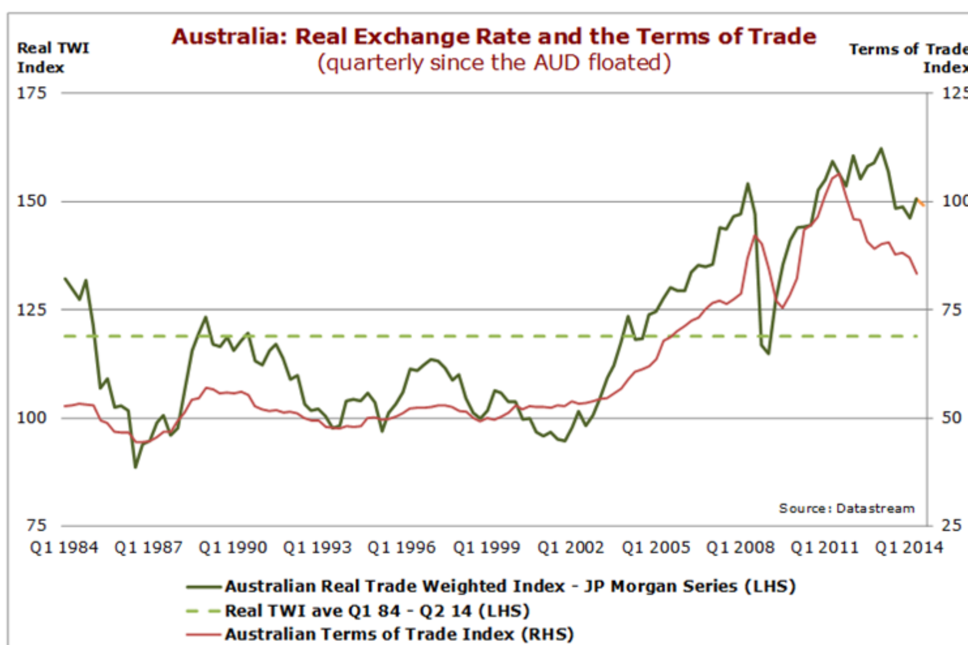
Synopsis: A significant proportion of the recent decline in the AUD/USD is due to US dollar strength. The recent decline in the Trade Weighted Index remains relatively moderate. While Australia's competitiveness issues are manifest, a substantial real depreciation of the Australian dollar is still required to support the rebalancing of Australian growth.

Below we include two quotes from the Reserve Bank Governor; the first on 3 July and the second on 7 October, 2014.

"When judged against current and likely future trends in the terms of trade, and Australia's still high costs of production relative to those elsewhere in the world, most measurements would say it is overvalued, and not by just a few cents. Of course, we live in unusual times, with interest rates at the 'zero lower bound' in several major jurisdictions. Nonetheless, we think that investors are underestimating the likelihood of a significant fall in the Australian dollar at some point." Glenn Stevens, Governor Reserve Bank of Australia. Speech to The Econometric Society Australasian Meeting and the Australian Conference of Economists Hobart - 3 July 2014

"The exchange rate has declined recently, in large part reflecting the strengthening US dollar, but remains high by historical standards, particularly given the further declines in key commodity prices in recent months." Monetary Policy Decision 7 October 2014 – Statement by Glenn Stevens, Governor RBA

We note that between the Governor's more extensive speech in Hobart on 3 July and the media statement after the Reserve Bank Board meeting, the Reserve Bank's TWI had only fallen by 3.8%. This is not a fundamental shift in competitiveness. It might feel like the Australian dollar has been very weak of late, but that is because we normally view the currency through the prism of the AUD/USD, which fell by 6.6% over the same period.



To assess longer term valuation, economists typically look at real effective exchange rates (the value against a range of relevant currencies adjusted for changes in relative inflation rates or unit labour costs) or purchasing power parity. The chart (left) shows that in September, the Real TWI (the real effective exchange rate) was still some 25% above its average level since the float in December 1983.

Of course currencies may remain substantially over or undervalued on this basis for years for a range of reasons.

In Australia's case, it is well understood that sustained over or undervaluation is often due to swings in the commodity price cycle driving Australia's Terms of Trade. This relationship is obvious from the chart on page one, particularly once allowance is made for the lag between spot prices and prices received by exporters, reflected in the Terms of Trade.

The period following the peak in the Terms of Trade in the September quarter of 2011, however, requires further explanation. As the chart on page 1 shows, the real Trade Weighted Index continued to rise, making a new post float high in quarterly terms in the March quarter 2013, despite the sharp decline in the Terms of Trade.

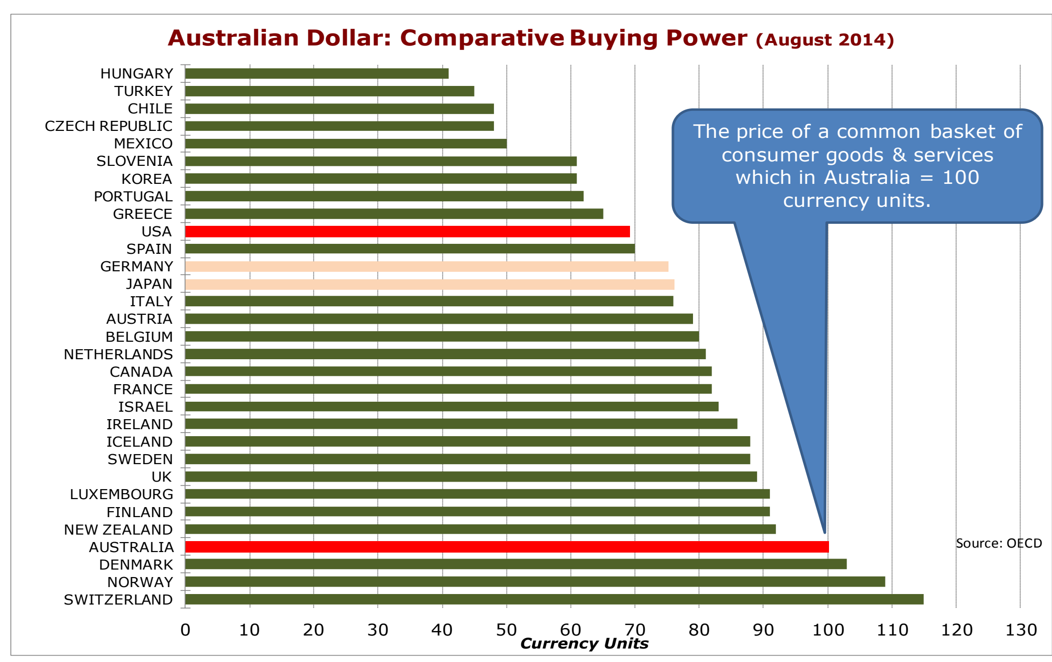
Near zero official interest rates in much of the developed world, quantitative easing and ballooning central bank balance sheets drove the global "reach for yield." By June 2012, the US 10 year Treasury bond yield fell below 1.5%; apparently an all time low. Fear of a break-up of the Euro and European sovereign debt concerns made AAA rated Australian Government paper all the more attractive. Australian 10 year Government bond yields fell below 3% as foreign investment flooded into our bond markets.

Subsequently, Mario Draghi's apparent assurance in his speech of 26 July 2012 to do "whatever it takes" calmed markets. As extraordinary as it seems reflecting back upon it, for a while it appeared as though good and bad global news both supported the Australian dollar. The Australian dollar remained overvalued through the worst of the Euro crisis; yet as we exited it, the renewed appetite for risk encouraged the "carry trade" of which Australia was a prime beneficiary. Seemingly, lower commodity prices were being ignored in pricing the dollar. Reality can hit home quickly, however. By way of example, note the initial sharp fall in the AUD/USD from above parity commencing in April 2013.

Renewed volatility in currency markets can lead to the rapid unwinding of the carry trade; as sudden sharp weakness in the Australian dollar has been testimony to on numerous previous occasions. This is why we encourage investors to focus their investment strategies upon where the longer term value lies.

In the recent episode of Australian dollar weakness starting in early September, the catalyst appeared to be confidence in strengthening growth in US bringing forward the timing of a lift in the Fed Funds Rate alongside weakness in China refocussing attention on the magnitude in the fall in the spot iron ore price.

Together with a growing view that a more aggressive pace of monetary easing will be required in the Euro zone and Japan as their growth prospects slip away led to a stronger US dollar and renewed market volatility as markets focus on divergent monetary policies between the Fed and the ECB and BOJ.



Frankly, over the preceding twelve months markets had become complacent, lulled into a false sense of security by abnormally low volatility.

This is the mindset that encourages the carry trade in ever greater magnitude, which helped support the Australian dollar in the face of the near 40% decline in the iron ore price so far in 2014.

So where to from here for the Australian dollar?

Let us briefly review some of the main dynamics:

- The Terms of Trade is way above its long term average (see chart on page 1) and is expected to continue to decline. Commodity prices (broadly) are likely to continue to decline. Supply growth remains strong in key commodities. Intense downward pressure on costs of production will remain a feature of the industry in the years ahead. Growth globally is also becoming less commodity intensive (driven in large measure by China).

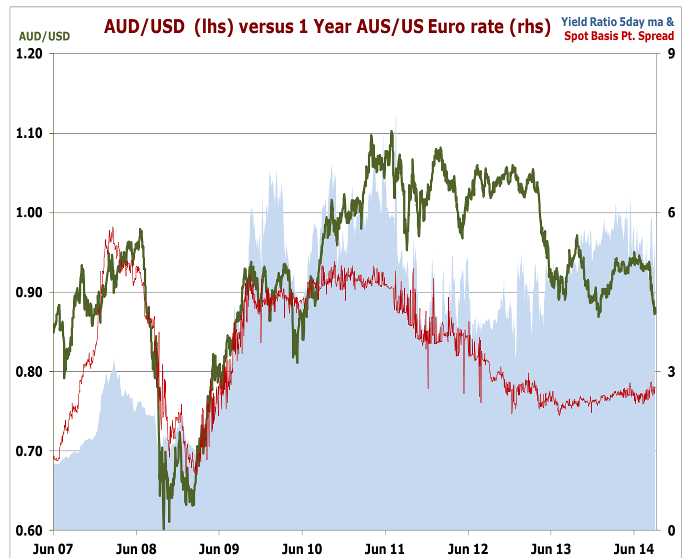
- We see no reason for Australian short term interest rates to increase until late 2015 at the earliest. (Further, that would likely only occur if Australian dollar weakness has been substantial enough to improve competitiveness and support non-mining business investment, as opposed to housing.) Australian inflation is unlikely to be a constraint – wages growth slowed significantly over the last two years. The RBA would also likely look through any temporary currency induced lift in inflation, so long as it did not feed into higher ongoing inflation expectations and wage settlements.

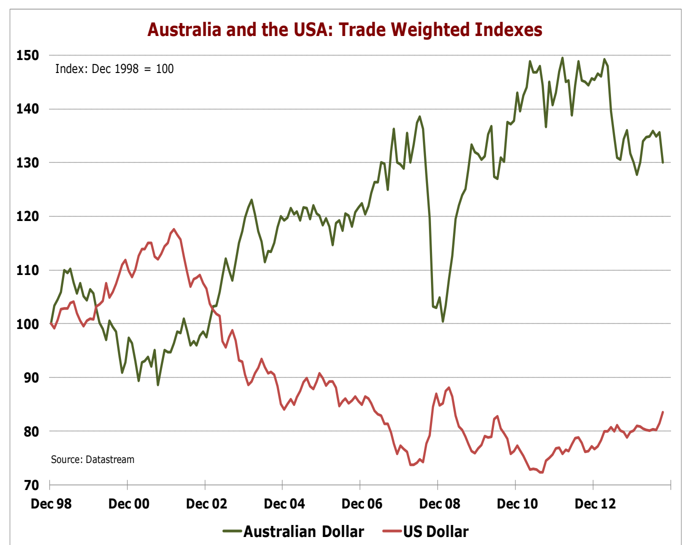
- The Fed is likely to start increasing the Fed Funds Rate at either the June, July or September 2015 meeting, and increase it in regular 25 basis point increments at each subsequent FOMC meeting. (Data dependent until policy settings are normalised.)

- The swing in the interest rate differential (which would be increasingly priced into the medium term sections of the yield curve) should weaken the Australian dollar. We expect the US Fed to begin lifting the Fed Funds Rate target before the RBA feels it is appropriate to lift the Official Cash Rate on domestic grounds.

- Finally, we believe the US dollar is still in the early stages of a substantial medium to longer term uptrend against most major currencies. (In particular the Euro and the Yen, much less so UK Sterling) The US economy is fundamentally stronger and demographics are more favourable. Productivity growth is stronger, there is a culture of innovation and manufacturing is extremely internationally competitive (low unit labour and energy costs help drive this).

- While the weakness elsewhere in the world may have taken the urgency out of the US tightening argument in the short term, this only underscores the medium to longer term argument in favour of a resurgent US dollar in the years ahead. This is occurring from a still relatively low base; note the chart contrasting the Australian and US Trade Weighted Indexes below.





- We expect the AUD/USD to fall to 75 US cents over the next one to two years.

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