JMME

CURRENCY WARS

with Cameron Diffey - Director, Financial Advisory

The Australian dollar has risen 10% in 2016 to date, countering the strong downtrend that commenced in April 2013. The Reserve Bank of Australia (RBA) is comfortable with a lower $A in order to keep interest rates steady, and to restore competitiveness to sectors of the economy that need to provide jobs and production, now that the resources boom and associated capital investment is over. They call it rebalancing the economy.

One of the key factors in the global financial economy has been the rise of the $US, and its recent consolidation phase and current downward move. The strong $US along with ample supplies are the major reasons why commodity prices across energy, metals and grains are lower. The lower commodity prices have hurt the growth prospects of commodity exporting countries. China pegs its currency to the $US, and as a result the Chinese currency has been strong relative to other Asian export competitors, having the effect of lowering Chinese exports, and thereby reducing demand for Chinese imports of raw materials to produce goods to export. A vicious cycle!

The stronger $US has now started to hit the profits of the large multi-national companies listed in the US, providing a headwind for the US sharemarket. The various policy initiatives from the Bank of Japan and the European Central Bank add to the volatility of currency markets. Volatile currency markets make it more costly for business to hedge their purchases and sales, and as a result trade activity can slow, some are calling it the peak of globalisation.

The chart of the US Dollar index below illustrates the recent consolidation phase, no country wants a strong currency. The US Dollar is still regarded as a safe haven asset, it rallies in uncertain economic times and on a view of rising US interest rates. The views on further increases in US interest rates

are now mixed given some weakness in recent economic data, so markets will remain hostage to the commentary and actions from central banks.

The US Federal Reserve had projected 4 quarter point rate rises over 2016, increasing the US Fed Funds base rate from 0.50% to 1.50%. They have recently revised the projection to 2 quarter point increases over 2016. US economic growth has been below average in this economic recovery phase and many don't expect the US Fed to follow through on above, prompting short term weakness in the $US. Simply the $US will remain strong if US interest rates increase.

If the recent rally in commodity prices holds, and prices don't resume their downward trend this would signal to the market increased confidence that the demand side of the global economy is resilient, and lend support to the $A.

Over last 20 years the mid-point range for the $A is US70-80 cents. It is currently trading around US75 cents. It is difficult to forecast a scenario where the $A trades back towards US90 cents over the coming years as the capital investment boom is over. For the $A to trade below US65 cents we would require either a domestic or global recession, or quicker than expected increases in US interest rates which will only happen if US economic growth surprises to the upside and inflationary expectations rise.

The declining $A over past 18 months has provided a buffer for our exporters against declining commodity prices, has boosted domestic tourism, and has provided some relief for our manufacturing sector.

**Charts courtesy of Fuller Treacy Money (UK)*