The outlook for the Australian dollar amid a slowing resources sector

Marcelle Murphy, Economist at Advance assesses the factors that are affecting the dollar to try to determine its most likely path over the coming year.

The strength of the Australian dollar in recent years, largely reflecting the resources sector boom and record high terms of trade, has negatively impacted unhedged investment returns for investors. More recently, our terms of trade have started to decline in line with slowing global growth and softer commodity prices. Traditionally, this would be reflected in a weaker exchange rate. However, the Australian dollar has remained persistently high.

The value of the Australian dollar (AUD) has always been a hot topic as it impacts decisions across the business, investment, tourist and retail environments. Given its persistent strength in recent years, discussion has become even more intense due to the contractionary influence it has had on some major sectors of our economy, as well as its impact on investor returns.

If we look at where the AUD is currently valued in an historical context, its stellar and persistent rise in recent years is a clear stand out. Chart 1 shows that at the time of writing, the AUD was valued at USD1.04. This is 38% above its post December 1983 float average of almost USD0.75, and only 5% below its record peak of USD1.10 reached in mid-2011. Moreover, it has remained consistently well above its average for the longest period since the float. Compared to what is generally considered its “fair value”, the AUD is also considered much overvalued, with most estimates of fair value at around USD0.79.

Chart 1 – The Australian Dollar

Source: Datastream and Advance Asset Management
The AUD is traditionally viewed as a commodity currency

The persistent strength in the AUD is because the AUD is traditionally viewed as a commodity currency, with fluctuations in base metal prices in particular, ultimately manifesting in movements in the AUD exchange rate.

As such, the boom in commodity prices since the GFC on the back of China’s ferocious demand for Australia’s key exports of iron ore and coal, and the resulting record high in Australia’s terms of trade, have well supported the AUD as shown in chart 2.

In recent months, it has become evident that our terms of trade have likely peaked, with prices of iron ore and coal falling sharply. Slower global growth in general, but more specifically, much weaker growth in China, has seen the demand for our commodities decline, resulting in lower prices.

What other factors are driving the AUD’s value and will they continue to support the AUD?

1. Differences in interest rates and growth

Differences in interest rates and growth between Australia and the US are often seen as key influences on the AUD exchange rate, and it is likely that the wider differences in both has been a factor that has supported the AUD. Interest rate differences were fairly closely aligned with trends in the AUD in the lead up to the GFC, but that relationship looks to have become less intense in recent years. Indeed, the spread between US and Australian official interest rates was as wide as 4.5% in 2011, and is now only 3% as a result of the 1.5% cut in rates by the RBA since then. Despite this, there has been no corresponding decline in the AUD, suggesting that at 3%, the differential is still relatively quite high from an historical perspective and is therefore still reasonably supportive for the AUD.

It also implies that there are other factors driving the AUD’s strength.

Similarly, the Australian economy has been outperforming the US, with GDP here exceeding that of the US by an average of 1.4% over the past year alone. Prior to this, except for some underperformance when the RBA started raising interest rates in 2010/1 whilst the US Fed began its second round of quantitative easing, Australia had outperformed by an average of 4.4% during 2009. This coincided with the upward trend in the AUD from that time.

2. Australia’s credit worthiness is also playing a role

Australia is one of only a handful of countries in which the sovereign credit rating is still at a stable AAA rating (see table), so from a safe haven point of view, the AUD is considered a very attractive investment. Add to this the fact that within that small group of AAA nations, Australia’s interest rates are also fairly attractive; and our net government debt to GDP ratio is very low compared to the others, it makes sense that demand for the AUD and AUD assets is very strong. Indeed, the most recent data from the Reserve Bank (RBA) shows that foreign holding of AUD sovereign bonds is currently at a record high, which has obviously helped support the currency (see chart 3).
The strength of this demand is implied in trends in the foreign exchange reserve holdings of central banks over recent years. Traditionally, the USD has been the major currency held on reserve by central banks, accounting for close to 70% of total FX reserves. Since 2009, that level has dropped closer to 60%. In contrast, the proportion of total FX reserves held in “other” which includes the AUD, has increased from around 1.5% to an all time high of 5.5%. (See chart 3)

What is the outlook for the AUD?
As is evident, falling commodity prices and interest rates have had some dampening influence on the AUD, but Australia’s strong credit standing and low debt levels, when combined with still high interest rates relative to key counterparts, have been the predominant driving forces recently. A change in any of these factors has the potential to see the AUD move sharply from current levels.

The AAA rating of Australian government debt appears solid for now. The Government remains firmly committed to returning the budget to surplus by June 2013, recently announcing further spending cuts and measures to increase revenues. The risk here is that the economy could slow much further than the government is expecting over the coming year (3% GDP forecast for 2012/13), which will threaten the government’s projected surplus outcome.

This is a reasonable risk, given the precarious outlook for the global economy, and the domestic economy’s still struggling non-mining sector. However, we believe, a sharp slowing in the Australian economy will likely only occur alongside a sharp deterioration in the global economy. The Australian government’s debt position will worsen, but so too will the debt position of other key economies. As such, in relative terms, Australia’s position will still be quite favourable.

In terms of interest rates, there is no doubt that Australian rates are heading lower, given the soft outlook for the economy in 2013. Our current expectation is that the Reserve Bank will cut official rates by at least a further total of 0.5% over the coming year. This would obviously narrow the rate differential between Australia and other key economies and place downward pressure on the AUD. However, in historical terms, our interest rate differential with other countries will still be quite attractive, so the negative impact on the AUD may be less severe.

In essence, we anticipate some downward pressure on the AUD during 2013, but expect that this will be limited. We also note the IMF’s recent announcement that it plans to add the AUD to its official currency reserve list, which already hosts USD, Euro, GBP and Yen, will only provide support for the AUD over the long term.