

The rise and rise of the Aussie dollar

The strong performance of the Aussie dollar (\$AUD) over recent months has made front page news, with a focus on how well it's performing compared with the US dollar. But is it all good news? And when will values start to drop? In this month's *Investment Update* we explore the intricacies of currency value and how growth can bring both good and bad tidings.

Why does the \$AUD rise and fall?

Currency values rise and fall for many reasons. Underlying most of these is the simple principle of supply and demand. If there are more currency buyers than available dollars, the price of a currency goes up. On the flip side, if there are more dollars than buyers, a currency can weaken.

Factors that have recently contributed to strong demand for \$AUD include:

- strengthened Australian commodity prices (e.g. grains, fruits and vegetables, precious metals)
- Australia's relatively high interest rates compared with other countries, giving foreign investors more bang for their buck
- investors buying \$AUD as an alternative to investing in China, because \$AUD performance has closely mirrored the Chinese Yuan's performance, and investors can avoid the complexities of investing in tightly-controlled China; and
- investors diversifying away from the world's major currencies, many of which are currently under-performing – such as the United States, Japan, Greece and Ireland.

It's heartening to know that the Reserve Bank of Australia (Australia's central bank) closely monitors the \$AUD, taking action

where necessary when the dollar rises or falls dramatically. These actions include the RBA buying or selling \$AUD, foreign exchange intervention, and various other measures.

What's around the corner for the Aussie dollar?

Predicting currency movements is extraordinarily difficult – particularly during times of unprecedented growth or economic turning points. Currencies usually don't behave in expected (or even rational) ways.

One forecasting approach is to track the movement or 'trend' of a currency based on its past performance. The limitation of this method is that turning points – marked rises or falls – can't be predicted. That's where 'Purchasing Power Parity' (PPP) has advantages as a longer term forecasting method. PPP relates to the fundamental 'purchasing power' of a currency for a 'given basket of goods'. The percentage change in prices between countries is then compared and translated to depreciation or appreciation of a country's exchange rate. Some studies suggest that PPP will be correct around half the time in a five-year period.

Although no one can accurately tell how the Aussie dollar will perform in future, it's evident that today the \$AUD is well above its PPP: in other words, the \$AUD is overvalued.



What is hedging?

In investment terms, 'hedging' means paying for some kind of protection on an investment. It can help to think of hedging as similar to insurance. Like insurance, it's designed to reduce or eliminate financial risk. Hedging usually involves purchasing a related investment, for example hedging an investment in a foreign currency by buying or selling 'futures' in that currency.

Short supply

From a global point of view, investing in Australia is appealing. Our economy is strong, prospects are encouraging, the \$AUD is considered a terrific China proxy, our Government is trustworthy, and the \$AUD is currently returning one of the world's best interest rates. Even overseas central banks are diversifying their foreign exchange reserves from fundamentally weakened major currencies into currencies like the \$AUD.

The problem is that Australia is a tiny market compared with many of the markets people are trying to exit. And our Government bond market is particularly small, so even a small asset allocation shift can have significant implications. Our economy is about one twelfth the size of the US or Europe, with limited opportunities for investors to purchase Australian Government debt -- \$190 billion Australian Government debt compared with \$14,500 billion US. So although investing in Australia may be very appealing right now, the opportunities are in comparatively short supply.

The downside of a strong Aussie dollar

A stronger \$AUD is a good thing for foreign currency investors. It's also great for Australians travelling overseas or purchasing offshore goods online. But the news isn't all good.

The downsides of a strong \$AUD include:

- Australian exports cost more, making them less competitive
- local industries can be weakened, forcing them to move local operations offshore
- fewer tourists; and
- potential losses/lower gains from investments held in offshore assets.
- For example, suppose you had shares in Amazon (a US company), which are traded in \$USD. Imagine that Amazon's share price rose 15%, but the \$AUD rose 25% against the \$USD over the same period. In this example, Amazon's share price, when converted back to \$AUD would actually fall – despite its share price rise. For an Australian 'unhedged' investor, the return would be a disappointing -10% rather than the +15% for US investors.

On the other hand, if Amazon's share price rose 10% and the \$AUD fell 20% for the same period, an unhedged Australian investor would receive a return of +30%.

The movements of the \$AUD also affect returns from listed Australian companies, because a large part of the earnings of Australian-based companies are actually derived from overseas.

Action points

- Changes in currency value have many and varied effects on investments. You can find monthly performance of the NGS Super investment options on the "News" section of the NGS Super website.
- Read the **Investment** fact sheet for information about the NGS Super options and how they are invested. Go to the "Publications" page on the website.
- If you have questions about your NGS Super investment choices, you might benefit from the assistance of a financial adviser. You can make an appointment with an NGS financial planner by calling the Customer Service Team on **1300 133 177**. Remember your first appointment is free!

How to contact us

Visit our website www.ngssuper.com.au, or contact our Customer Service Team or your local relationship manager at any time. We're here to help you.

NGS Super Administration
Telephone: 1300 133 177

Phone number for callers outside Australia
+61 3 8687 1818

Fax: (03) 8640 0813

Email: administration@ngssuper.com.au

Web: www.ngssuper.com.au

Postal address

**GPO Box 4303
Melbourne VIC 3001**

Important information

This is general information only and does not take into account your objectives, financial situation or needs. Before making a financial decision, please assess the appropriateness of the information to your individual circumstances, read the Product Disclosure Statement for any product you may be thinking of acquiring and consider seeking independent advice from a licensed or appropriately authorised financial planner.

