BetaShares
Exchange Traded Funds

Is the $A too high? An update on our currency valuation models

BY DAVID BASSANESE | 26 July 2017

SHARE

The Australian dollar has recently broken above the top-end of its previous year-long range against the US dollar. In light of this event, this note updates our $A valuation models. While the models suggest the $A could remain north of US70c over at least the coming year, they do suggest limited further upside unless iron-ore prices continue to rise.

Firm commodity prices support the $A

We have previously considered (see here and here) the question of the real $A's 'fair-value' using several valuation models. The first model only considers relative real interest rates and the terms of trade (similar to that most favoured by the RBA), while the second model also incorporates changes in the real $US – which has tended to produce a better historic fit with actual results, though with notable under prediction of the $A during the recent few years of general $US strength*. The results from these valuations models are detailed in the chart below.

Bassanese Bites

CPI/Lowe to confirm rates on hold

US Earnings to the Rescue?

Central Banks Bark

Popular Articles

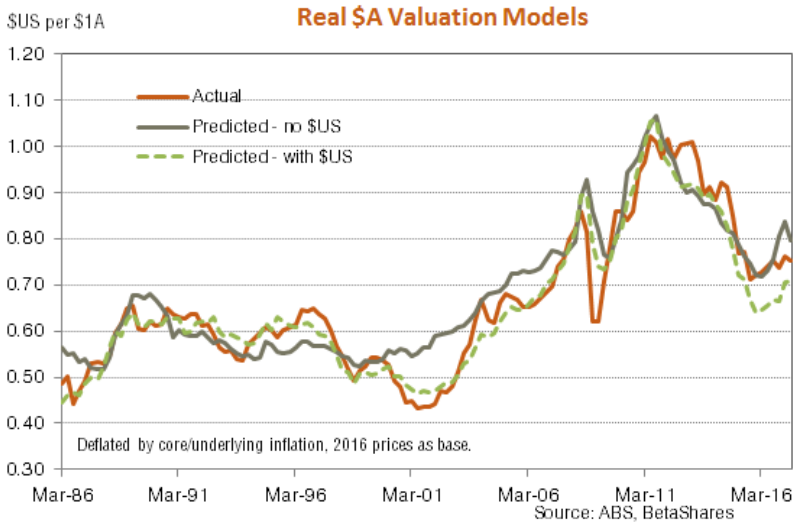
ETFs: sorting fact from fiction (Part 1)

Is the $A too high? An update on our currency valuation models

ETFs: sorting fact from fiction (part 2)

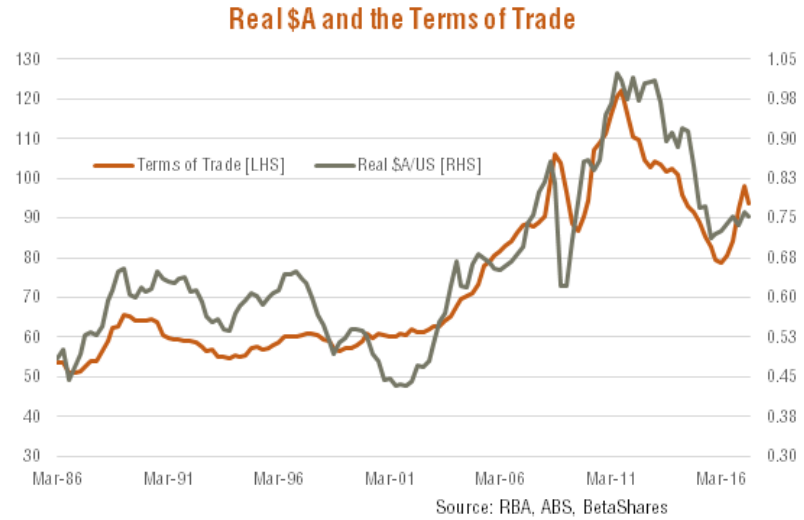
Look at total returns for the true picture

BetaShares Australian ETF Review – Half Year 2017

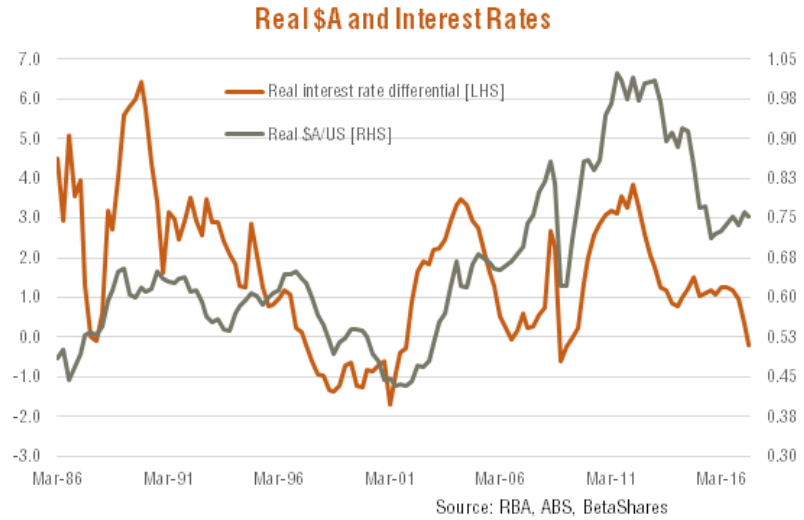


As evident in the June quarter last year, these models predicted an $A fair-value of US73c and US66c respectively, or an average of US69c (lower than the actual quarterly average of US74c). By the June quarter of this year, however, fair-value under both models had increased to US80c and US71c respectively, **or an average of US75c –** which was equal to the actual average in the quarter**. With the $A currently around US79c, these models suggest the currency is at worst only at the top-end of its fair-value range – and therefore it is not obviously over valued.

Why is a stronger $A justified? As seen in the chart below, a major factor has been the relatively sharp rebound in the terms of trade, which in turn has reflected the sharp rebound in iron ore prices over the past year. The resilience of Chinese steel production in the past year – reflecting continued strength in home building and infrastructure projects – has been a major factor.



By contrast, it's notable that the $A has firmed over the past year despite the fact that short-term interest rate differentials between Australia and the United States have narrowed further, reflecting three interest rate increases by the US Federal Reserve. The $US has been a largely neutral influence – after initial strength in late 2016, the real $US has since declined to be broadly unchanged over the past year.



All up, the past year has only served to affirm the relatively dominant positive influence that the terms of trade tend to have over the real $A.

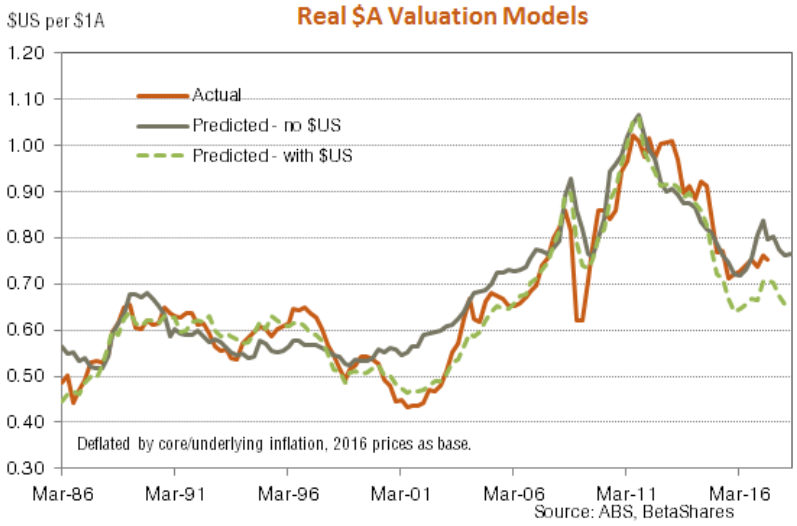
$A fair-value could hold above US70c for some time

Of course, all this begs the question: where to from here?

As should be evident from the above analysis, **it is the direction in commodity prices that seems to matter most for the $A.** Over at least the short-term, that makes forecasting especially difficult, given the volatility evident in iron ore prices – in part due to speculative activity in the iron ore futures market. That said, reflecting an expectation that iron ore supply will continue to rise while Chinese demand will moderate, recent official forecasts from the Department of Industry, Innovation and Science predict iron ore prices will average $US48 tonne in 2018 – compared with an average for the June quarter of $US61, and a recently quarterly average low of $US45.80 in the December quarter 2015.

Based on past statistical relationships, these forecasts suggest a further modest decline in the terms of trade by June next year, though to levels that still remain well above the historical average. At the same time, further, (modest) downward pressure on the $A is likely from an ongoing narrowing in interest rate differentials – assuming the Fed hikes rates at least twice more in the coming year, while the RBA remains on hold. Our projections also anticipate a rebound in the real $US to its recent average in the December quarter last year.

On the basis of these assumptions, fair-value projections using both models are provided in the chart below. As evident, the model incorporating trends in the $US continues to project a much weaker fair-value by the June quarter 2018 of US65c, while the alternative model predicts a fair-value decline to US76c – the average of the two models is around US70c.



All up, based on the key critical assumption that iron ore prices are more likely to weaken than strengthen over the coming year, there appears more downside than upside risk on

the $A given its current level of almost US80c.

Obtaining US Dollar exposure

Investors wishing to express a view that the $US will rise against the $A can do so using either of the BetaShares Fund's USD or YANK, the latter of which provides magnified 'long' exposure to the value of the $US relative to the $A. By contrast, investors who believe the $A will continue to strengthen in value against the $US may have an interest in the BetaShares Strong Australian Dollar Fund (hedge fund) (ASX: AUDS), which provides magnified 'long' exposure to the value of the $A relative to the US.

*The model incorporating the $US suggests a 1% increase in the real $US (all else constant) tends to push down the real $A by a notable 1.2%.

**Note these estimates even allow for an assumed 5% decline in the terms of trade during the quarter, based historical relationships given the near 30% slump back in iron ore prices.

CATEGORY MARKET INSIGHTS
AUTHOR DAVID BASSANESE, 26 July 2017

Leave a Reply

Message

Name

Email

I'm not a robot
reCAPTCHA
Privacy - Terms

SUBMIT

Previous post Next post

Subscribe for the latest industry news and tips

First name Email address SUBSCRIBE