THE ALTERNATIVE VIEW

AURORA FUNDS MANAGEMENT

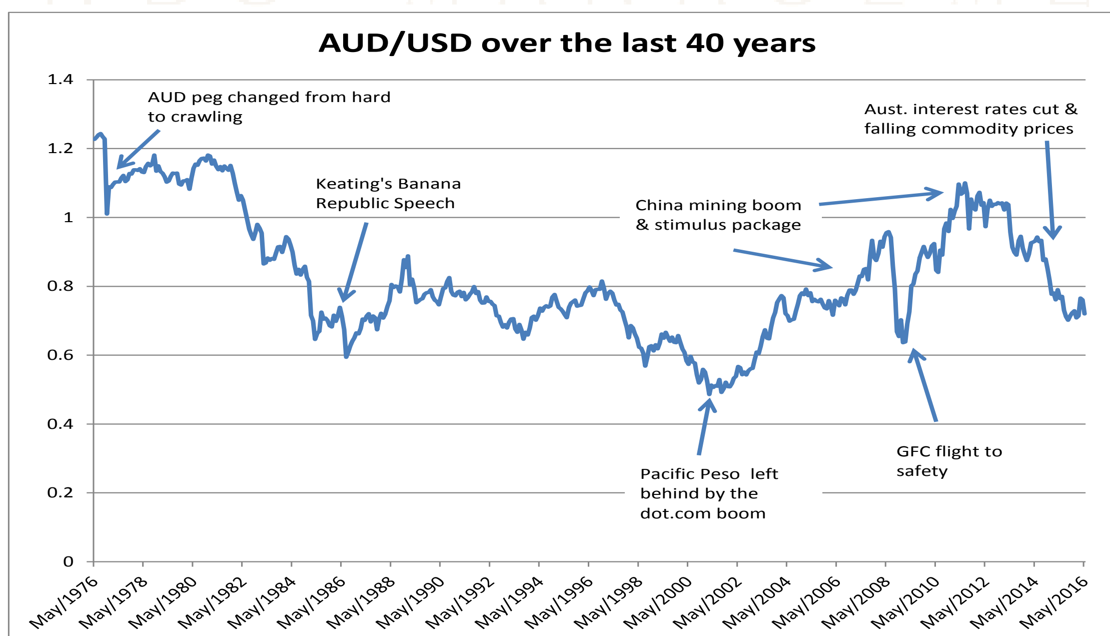
By Hugh Dive **27th April 2016**

Currency Wars

Over the last month we have seen the AUD fall 8% vs the USD, continuing the volatility in the AUD in 2016 which started the year off at 0.72, then fell to 0.68 mid-January before recovering to over 0.78 in mid-April. The fall in May sparked research that was released on Wednesday from ANZ Bank's foreign exchange strategy team stating that the AUD was overvalued, and could head towards US50¢ as it loses its de facto safe-haven status. In the press large movements in the Australian dollar are often erroneously presented in the press as a vote of confidence in Australia as a nation or the management of our elected leaders. A falling Australian dollar is often viewed as a negative event, raising the cost of online purchases, imported cars and overseas travel. In this week's piece we are going to look at the AUD and in particular the winners and losers from currency movements.

History

When the Hawke government came into power in 1983, one of their first decisions was devalue the AUD by 10% and float the Australian dollar, assuming that this action would cause the AUD to fall and improve our international competitiveness and stimulate the export sector. Before 1983, the value of the AUD was set each day by the Reserve Bank of Australia (RBA) and the Federal Government and either directly pegged to the foreign currencies such as the GBP or USD or pegged to a trade-weighted basket of currencies. Corporations had to apply to the RBA to buy foreign currencies to buy imported goods or make investments offshore. A senior market participant informed me this morning that prior to 1983; two floors of the RBA Building in Martin Place were occupied by Exchange Control staff whose job was to made it hard and discouraging for Australian businesses and investors wanting to invest offshore. Whilst this may be an example of coercive paternalism, most investors can quickly think of twenty poor offshore investments made by Australian companies that might have been avoided by bureaucratic obstruction.



When a country has a fixed currency and faces adverse economic conditions, their treasury uses foreign currency reserves to prop up a faltering exchange rate, as investors seek to exit and sell the county's currency. A great example of this occurred in Russia in 2008, which saw Russia chew through US$200 billion in carefully hoarded

foreign currency reserves in a futile attempt to defend the value of the ruble. By allowing a currency to float freely a country obviously loses the ability to control its exchange rate, but it gains control of its monetary system. Prior to 2000 (when the Greek Drachma was fixed to the €), the current Greek debt situation would have arguably been much less painful to the Greek economy. The current Greek debt crisis would have seen the Drachma being sold down heavily, thus making summer holidays on the Aegean and Greek olive oil much cheaper than similar products offered by Italy or France.

Since floating in 1983 the AUD/USD has averaged 76c, however as one can see from the above chart the AUD was in a downward trajectory from 1983 to 2002. This was broadly due to Australia's higher relative inflation rate. The strength in the AUD over the past 10 years has been a result of China's industrialisation and its associated unprecedented explosion in demand for Australian minerals since China's integration into the global economy after joining the World Trade Organisation in 2001. More recently the interest rate differential between Australia and the US and Europe has boosted the AUD; though rate cuts since 2011 and the spectre of higher US rates in the near term has closed this gap. In the medium term, we would expect the AUD to move towards fair value based on purchasing power parity, which we estimate, is approximately US$0.66.

Carry Trade

Since the 19th April this year the AUD has fallen 8% against the USD, as the 'carry trade' (borrow cheaply in USD and invest the proceeds in higher yielding AUD securities) continues to unwind and foreign speculators flee back to US dollars. Whilst this move is negative for a government wanting to buy French submairines, the falling AUD benefits investors in the Aurora Dividend Income Trust, as under the recent enhancements to our investment strategy, we are now designed to benefit from a falling AUD.

Winners

The companies that are likely to benefit from a weaker AUD fall into four categories;

- Companies that produce something in Australia and compete with the now more expensive imports such as steel (***BlueScope***), fertiliser (***Incitec Pivot***) or tourism (***Crown***)
- Companies that have production costs such as wages in Australian dollars but sell a commodity globally like iron ore that is priced in USD (***Rio Tinto***). Here a falling AUD translates into higher revenue per tonne sold.
- When a falling AUD results in inflation, companies like ***Wesfarmers*** and ***Transurban*** should see an expanding profit margin. Here their products from cans of tuna to road tolls will increase with inflation, whilst a proportion of these companies' costs remain fixed, thus resulting in higher profits.
- The falling AUD also benefits companies with substantial offshore operations such as ***CSL*** and ***Westfield***, as their USD or Euro denominated earnings are worth more when translated back into AUD for Australian investors.

Losers

The companies that are typically hurt by a falling AUD are those that buy goods offshore for resale to Australian consumers such as retailers ***Myer*** and ***JB Hi-Fi***. Similarly, a falling AUD presents a challenge for companies like ***Qantas*** and ***Pacific Brands*** that earn revenue in AUD from domestic consumers, but have significant USD-denominated costs such as aviation gas and cotton. Further, companies that have significant un-hedged USD borrowings such as ***Boral*** will see their interest costs increase, especially when the company does not have USD earnings to service their debt. For example Boral's US building materials businesses last generated a full year profit in 2007, though generated US$6 million in 1st half 2016.

Hugh Dive
Senior Portfolio Manager

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AURORA FUNDS MANAGEMENT

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Level 4, 1 Alfred Street, Sydney NSW 2000
PO Box R1695, Royal Exchange NSW 1225
Telephone: +61 2 9080 2377
Visit:
Email:

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