The Index Down Under

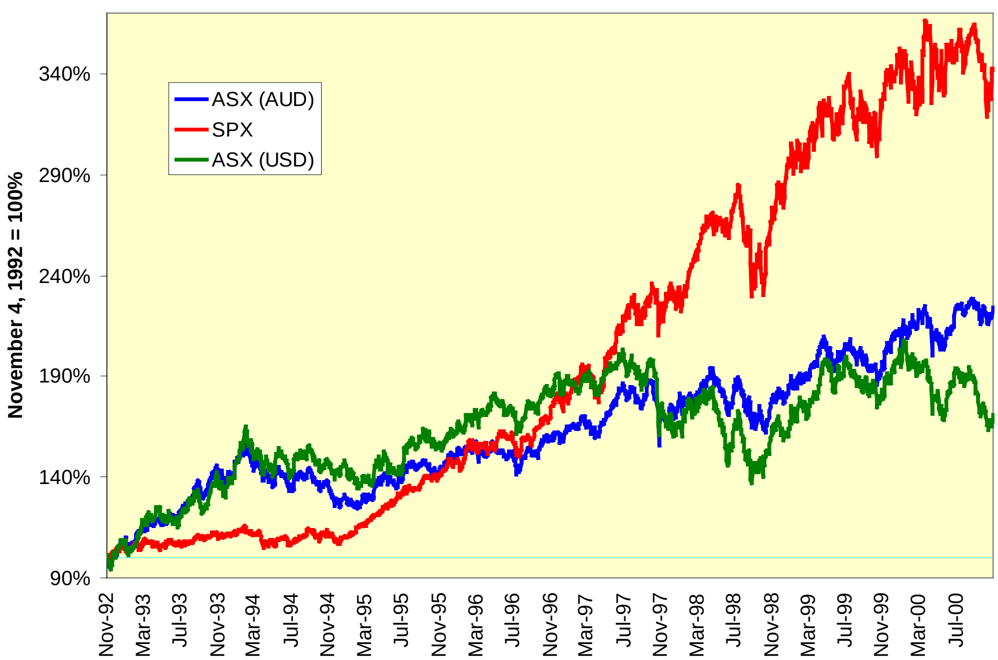
Americans seem to have a natural affinity for Australia. We regard the island continent as a repository for amusing characters like Steve Irwin or Paul Hogan, as the home for exotic fauna such as kangaroos, wombats, and Elle McPherson, and as the font of brilliant innovations such as the 25-ounce beer can.

This affinity ends, however, when it comes to financial markets. Every shoeshine boy knows of the euro's travails, but how many of us know the Australian dollar (AUD) is trading at an all-time low as well? Does this weakening currency create an opportunity to buy Australian assets cheaply under the frequently discredited buy low / sell high theory of investing?

In the near future, maybe, but not now.

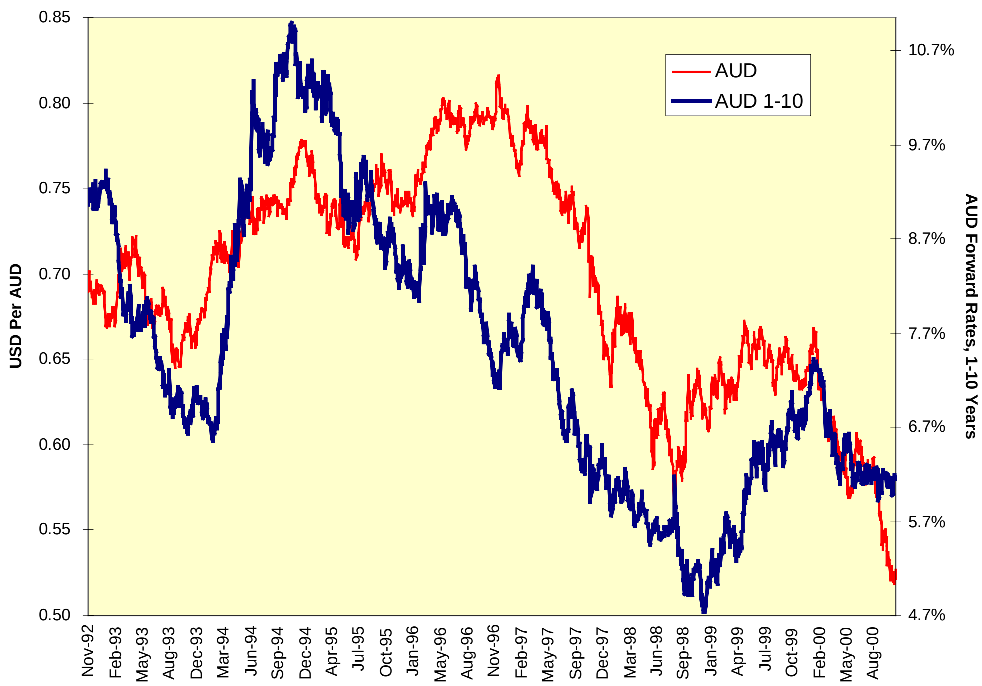
Not Common, Ordinary
The 510-issue benchmark Australian All Ordinaries Index (ASX) is a rarity among world markets so far in 2000: It shows a gain on the year of more than 5% in local currency terms. The largest issues are not in Australia's vibrant resource sector, rather in financial firms such as National Australia Bank or Commonwealth Bank, telecommunications firms such as Telstra, or in global media combines such as Rupert Murdoch's News Corporation. The relative dearth of high technology firms made the ASX a laggard performer during the 1990s global bull market. Not only has the ASX underperformed the S&P 500 (SPX) in local currency terms, it has barely budged in USD terms: After currency conversion, the ASX is no higher now than it was in February 1996.

Relative Performance: S&P 500 And All Ordinaries



Of course, international investing involves acceptance of currency risk, so we must ask ourselves whether the AUD is nearing a bottom after its nearly 20% decline to-date in 2000. One school of thought, noting last week's unproductive intervention by the Reserve Bank of Australia (RBA) on behalf of the AUD, would say no. After all, interventions without either a reduction in the AUD money supply or a change in monetary policy are simply selling opportunities for those who wish to unload the currency. What has been the AUD's historical relationship to RBA policies, described herein as the forward rate between one-year and ten-year Australian government debt?

AUD As A Function Of Australian Forward Rates



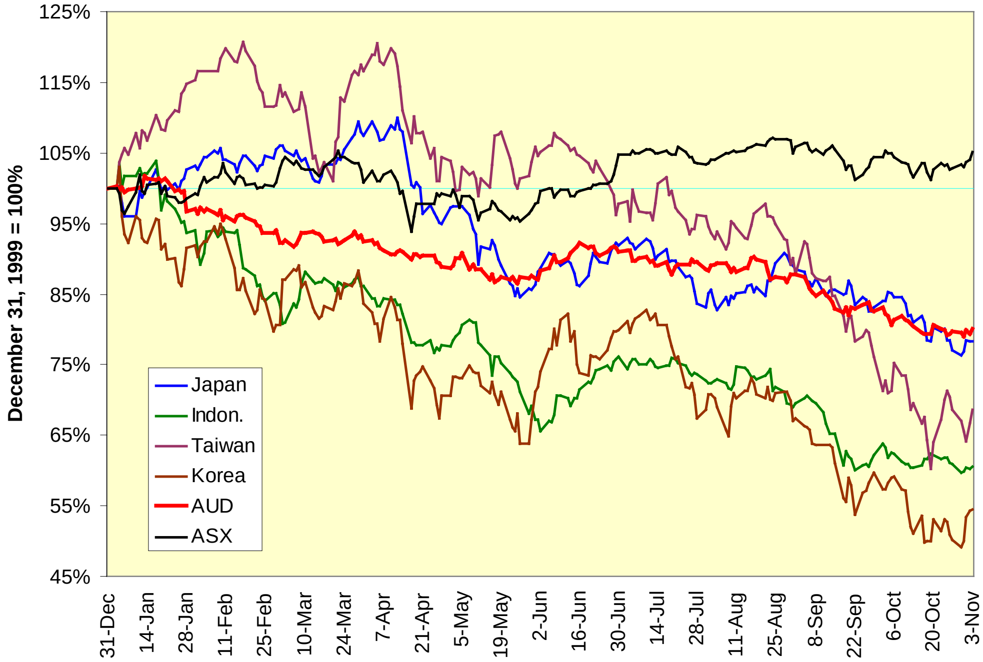
Unsurprisingly, the AUD and RBA policies are correlated with each other in broad fashion, but without a discernible lead-lag relationship. For instance, the AUD turned higher in both 1993 and 1998, and lower in 1999 well before forward rates declined, but a similar rally in 1996 did not lead to any upturn in Australian interest rate expectations. The present episode of AUD weakness is extending well beyond any concurrent fall in Australian forward rates, and this suggests other factors may be at work in the currency's weakness.

The Asian Connection

While Australia may consider itself and be seen by others as an outpost of Western civilization, geography says otherwise. It is an Asian country, and as such had to be affected for the worst by the region's devastating recession in 1997-1998. Weak commodity prices hurt its earnings from raw material exports to Japan, South Korea, and Taiwan, and its domestic manufacturers had to face deflationary competition from Asian exporters desperate for hard currency earnings.

While the worst of the Asian crisis may be behind us, the region's equity markets, with the notable exception of China's Shanghai and Shenzhen indices, have struggled mightily so far in 2000. Much of the problem can be traced back to higher interest rates in the U.S. and to the stronger U.S. dollar. If the Asian and Russian crises kept the Fed's policies easier than they would have been otherwise until May 1999, and this decision helped Asia avoid the abyss by exporting to the strong American market, this support is gone. The result has been a renewed downturn in the Asian markets and pressure on the AUD, as seen below.

The AUD, ASX, And Asian Bourses In 2000



The ASX' ability to outperform other Asian bourses so far in 2000 is attributable to the strong performance of the resource sector. Firms such as mining services operator Brandrill, Aquarius Platinum, Ashton Mining, Jubilee Mines, and Auiron Energy pepper the index' list of top stocks. For the sake of completeness, the worst performers include such New Economy names as Bmcmedia.com, Spike Networks, Kidz.net, and Adultshop.com.

A central theme of this series has been how difficult it is for primary commodity producers to enjoy pricing power over time. This suggests the strength of the Australian resource sector will be short-lived. It will take a more sustainable recovery of Asian economies in general to promote profitability in other sectors of the Australian economy. More importantly for non-Australian investors, it will take a firming of the now-cheap AUD to turbocharge portfolio returns. If the RBA persists in the strategy of intervention and higher interest rates to support the currency, both the AUD and ASX will remain weak. The best outcome will come from a relaxation of U.S. interest rates, which will both strengthen the AUD and improve economic conditions throughout Asia. Until such a policy change comes into view, however, there's no need to send your plunder down under.