

The Canada-Australia Cross-Rate

It almost sounds like a bad Vaudeville joke: What do you get when you cross Canada with Australia? Several things come to mind, actually, and this is where that line of thinking shall end. We have looked at the CAD separately (see “Canadian Dollar: Remember The Forgotten Currency,” February 2006) and as a cross-rate to both the euro and the yen (see “Canada On The Cross-Rates,” May 2010). Australia has been addressed both by itself (see “What’s Down With The Australian Dollar?” March 2008) as a spread to the New Zealand dollar (see “Getting Carried Away With The Kiwi,” July 2008 and as a factor in the Indonesian rupiah (see “Indonesian Rupiah: River Deep, Bali High,” March 2011).

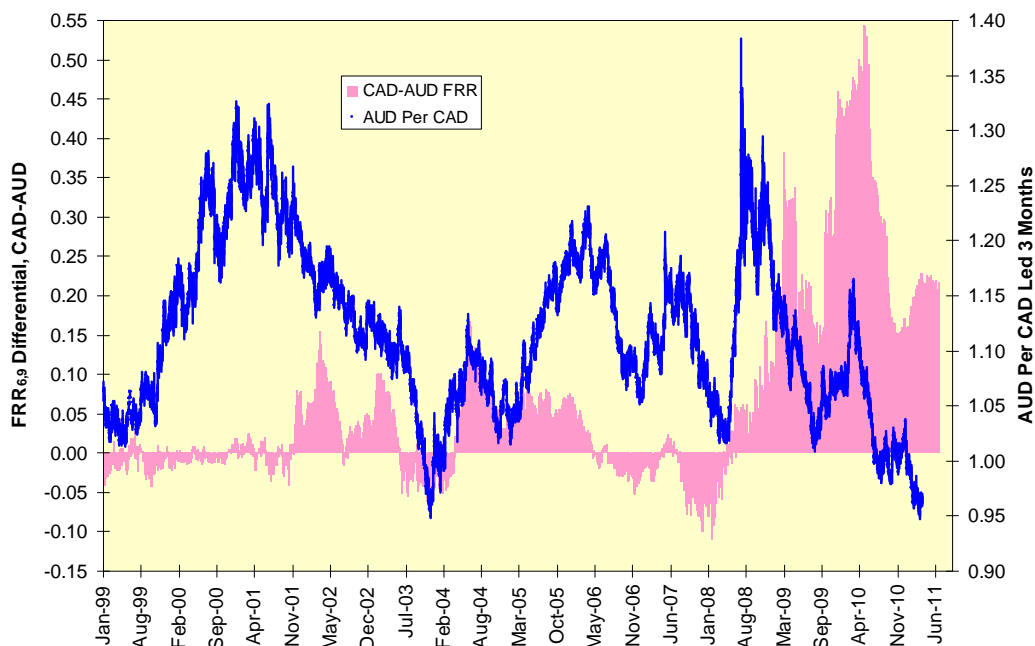
Both Canada and Australia have large resource sectors, and both have very large customers in their neighborhood in the United States and China. Both countries suffered less in the 2007-2009 global financial crisis as their banks did not go overboard on the sort of egregious risk-taking seen in the U.S. and in Europe, although this may be an artifact of Canada’s protected status for its banks more than anything else. Australia was one of the first G-20 countries to raise its short-term interest rates, in October 2009, to slow its growth rate and inflationary pressures. Canada, a member of the more exclusive G-7, became the first country in that group to raise its short-term interest rates at the start of June 2010.

A Well-Behaved Cross-Rate

The financial crisis of 2007-2009 and the free-money responses to it undertaken by most of the world’s central banks had the nasty side-effect of placing many short-term interest rate markets in a state of “perma-expectations,” the belief while short-term rates are quite low now, they must rise and rise soon. This would have been a nicer theory if it had been supported at all by any actual evidence, but such has not been the case. Japan has demonstrated “perma-expectations” can last longer than you may care to play the game of waiting for rates to rise, and the U.S. seems destined to follow this path as well.

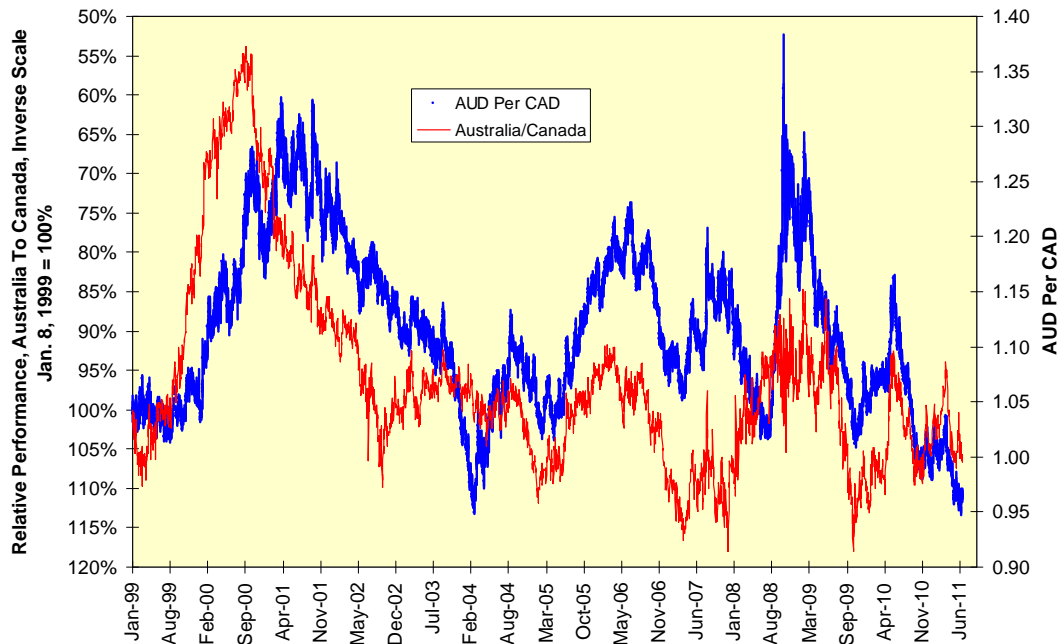
The CAD-AUD cross-rate is something of an exception, perhaps because neither central bank turned on the printing presses just to see what would happen. If we take the forward rate ratios between six and nine months ($FRR_{6,9}$) for both currencies, the rates at which we can lock in borrowing for three months starting six months from now divided by the nine-month rate itself, we see the CAD-AUD $FRR_{6,9}$ differential led the cross rate by the expected three months into the start of 2011. If the market expected Canadian short-term rates to start raising faster than their Australian counterparts, the CAD firmed against the AUD and vice-versa. After the start of 2011, this relationship and most others of its kind started to weaken as artificially low short-term interest rates and money-printing around the world distorted many market signals.

AUD/CAD Cross-Rate And Expected Interest Rate Differentials



This relatively neat and tidy behavior (yes, we must appreciate the irony here as neither country's self-image is very big on the "neat and tidy" quotient) extends to the very investable relative stock market performance of the two countries. If we map the relative total returns of the Canadian and Australian stock markets in USD terms inversely to the cross-rate, we find a very strong contemporaneous correlation between the two markets. As the CAD strengthens on the cross-rate, Canadian equities will outperform Australian equities, and vice-versa. Once again, this is a demonstration of how much international equity diversification has turned into nothing more than an expensive way to trade currencies.

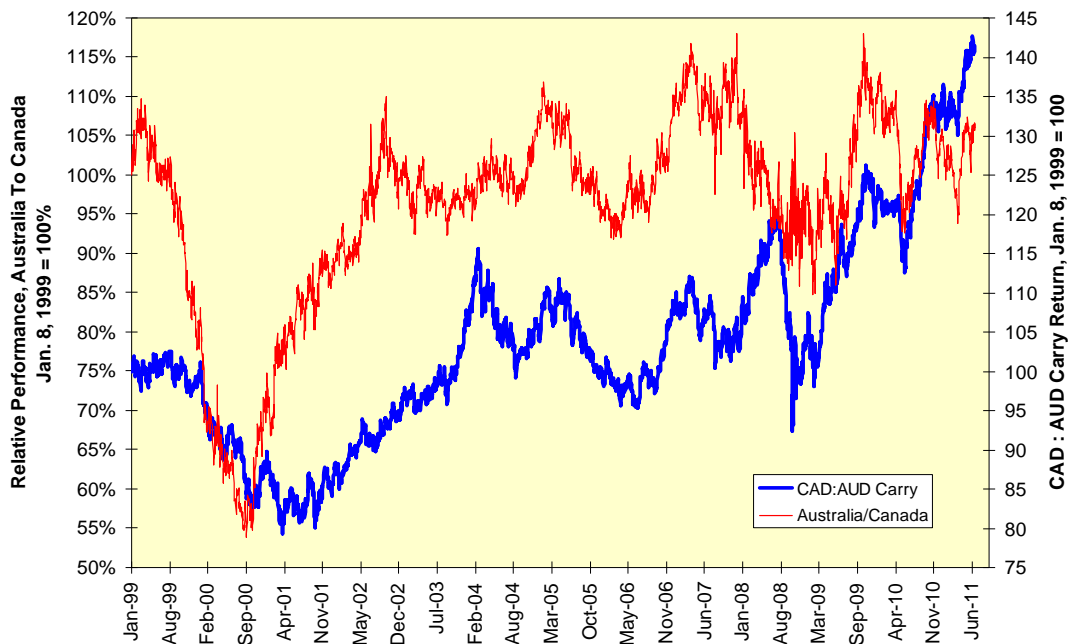
Relative Equity Performance Has Followed Cross-Rate



Carry And Volatility

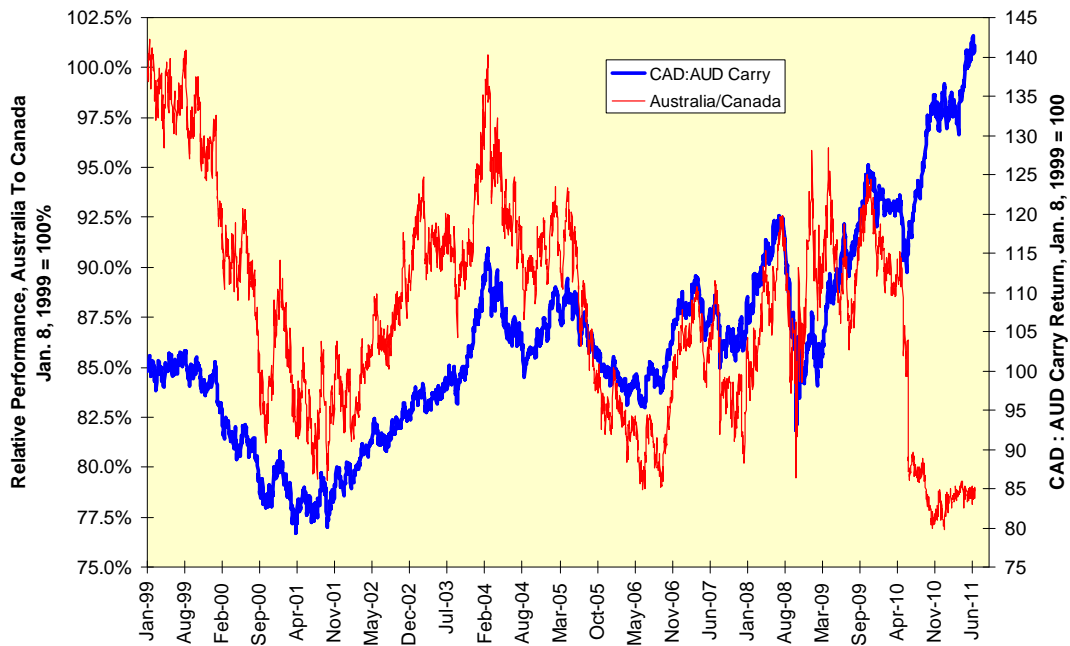
If international equity diversification is a closet currency trade, then all parties involved are getting a little more comfortable with that closet. If we map the excess return from borrowing the CAD and lending in the CAD against the relative equity market performance, we find the relationship became an extremely close one during the financial crisis of 2008 and remained that way into 2010. In a broader macroeconomic sense, we can say the policy responses to the financial crisis made both macroeconomic growth and the premia paid for risky assets beholden to artificially steep yield curves; as carry expanded, equity markets followed. It was not supposed to be this way, as the late Walter Cronkite might have said, "That's the way it is."

Relative Equity Performance Linked To Carry Return



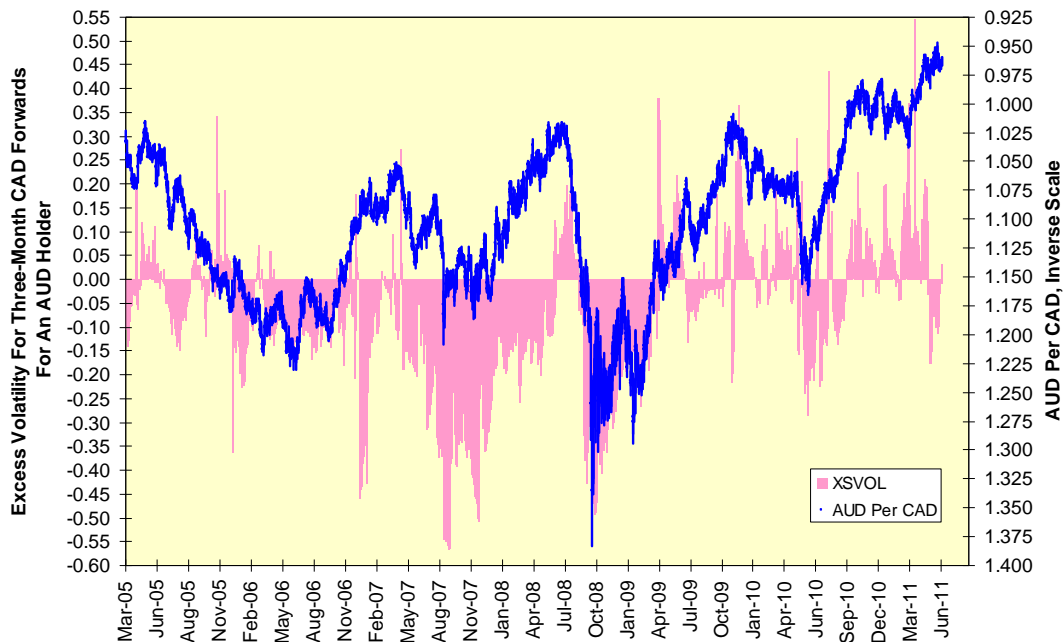
Longer-maturity sovereign bonds present a different look in time relative to the currency carry trade. If we map the relative performance of 7-10 year bonds for each country against the excess return on the currency carry trade, we see much greater convergence between the markets between 2001 and 2005. Canadian bonds have outperformed after 2005 largely as a function of a continued bull market in government debt in the United States. The net result is an investor now receives greater diversification for sovereign debt than for equities; equities are supposed to have greater specific risk and therefore provide greater diversification.

Relative 7-10 Year Bond Performance No Longer Linked To Carry Return



Finally, let's take a look at the cross-rate in terms of the insurance options traders are willing to pay. If we map the excess volatility of CAD forwards for an AUD holder, defined as the ratio between option implied volatility and high-low-close volatility, minus 1.00, we find it has tended to move inversely to the direction of the AUD per CAD cross-rate.

Excess Volatility Follows The Trend In AUD/CAD Cross-Rate



The Canadian dollar long has been one of the more straightforward markets for new currency traders as it tends to be one of the trendiest of the major currencies (see “Let The Trend Be Your Friend: The Majors,” January 2009). The Australian dollar was second in that ranking; given the presence of two trending currencies, should anyone be surprised their cross-rate is not only a trending market in itself but it flows directly from expected interest rate differentials and is linked directly to relative asset returns?

The only thing this cross-rate does not provide is a measure of diversification for global equity investors. That is a small price to pay; after all, when was the last time you heard a profitable trader talking about how well he or she was diversified?