Australia's Thunder From Down Under

A news item scrolled by the other day on a multi-decade high for the Australian dollar (AUD); my first reaction was to toss it on the pile of other currencies gaining against the greenback. But then I thought to take a look at what's going on "down there."

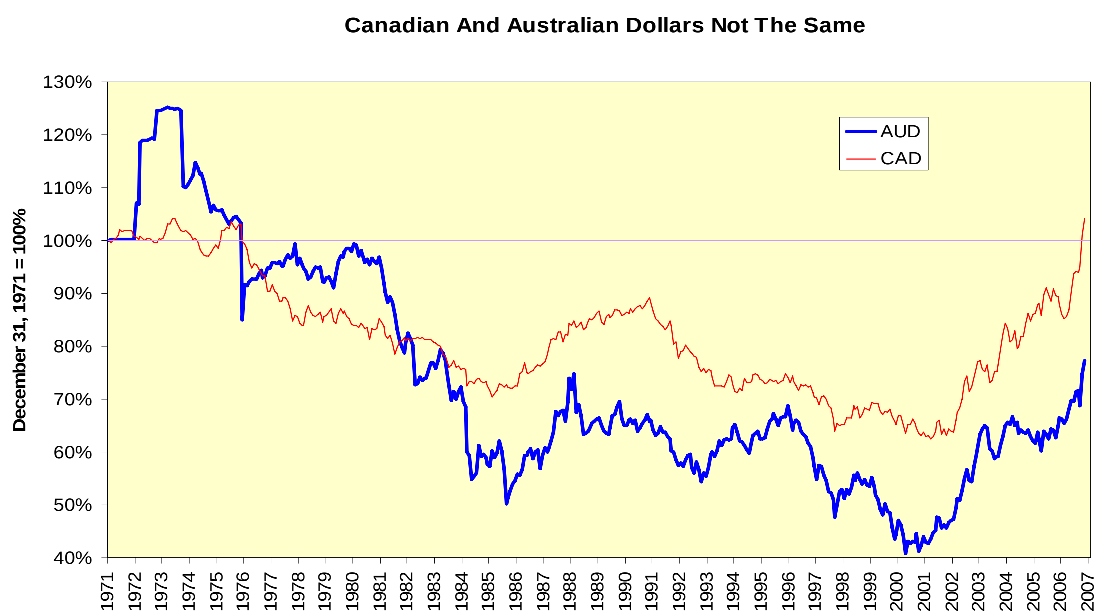
Australia is a pretty unique place, no doubt about it, and in ways that extend beyond its geography and exotic ecosystems. Back in the days when we still were numbering worlds, (First World for capitalist countries, Second World for communist countries, Third World for the remainder) Australia was accorded First World status. However, its economy increasingly has taken on the resource-export and commodity-price dependencies commonly associated with Third World countries.

Regardless, it has been making a pretty good living in recent years as a resource supplier to its Asian neighbors, China in particular but also Japan, Taiwan and Korea. And American investors in Australian stocks, represented here by an iShares ETF on the Morgan Stanley Capital International Australia index (EWA), have done very well, too. The question, as always, is can it continue?

The Currency Connection

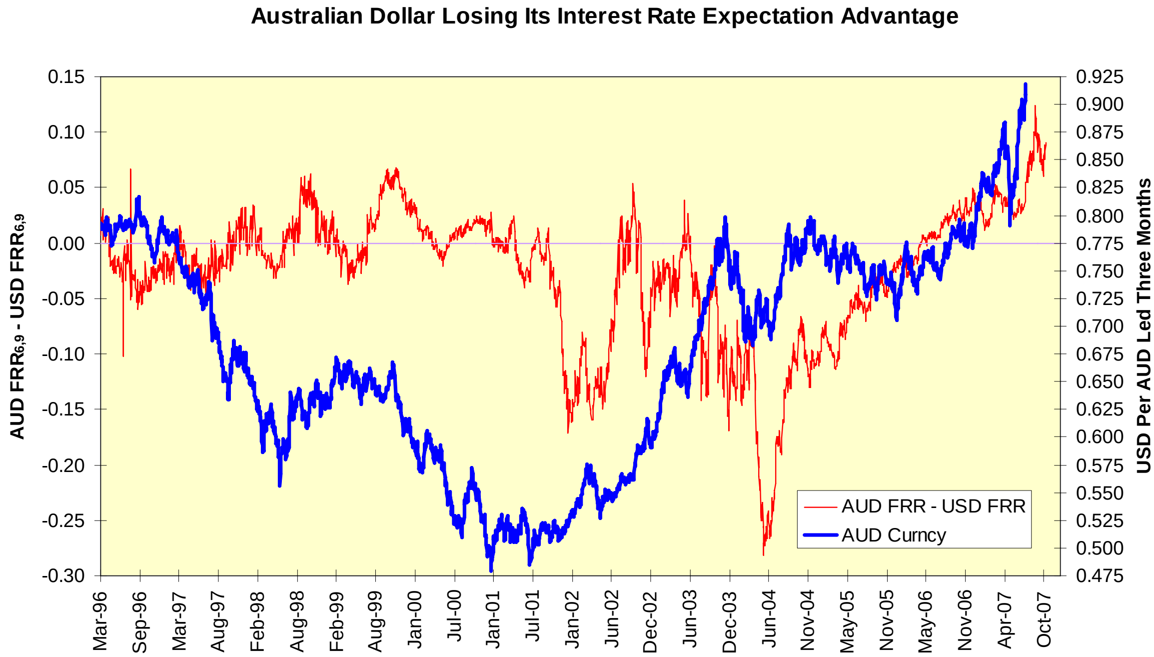
First, the dual bull market in the Australian and Canadian (CAD, last visited here in August) dollars reinforces the notion the two units are naturally correlated; I last addressed the relationship between the two dollars and their commodity linkages four years ago. But over the entirety of the floating exchange-rate era, the AUD has underperformed the CAD significantly and has done so with greater volatility.

If you were viewing the two dollars as investment assets, you would choose the CAD as the "stochastically superior" asset. The average daily return of the CAD has been .0004% with a standard deviation of .3036%; comparable figures for the AUD are -.0028% and .6221%. The r-squared, or percentage of variance explained, for their two return series is only 6.69%. Will these calculations stop currency pundits from treating them as equivalent units? Not a chance.



One of the factors driving the AUD higher is the relative short-term interest expectations between Australia and the U.S. The other two factors, noted in a recent Columnist Conversation, are prospective returns on assets and actual physical flows.

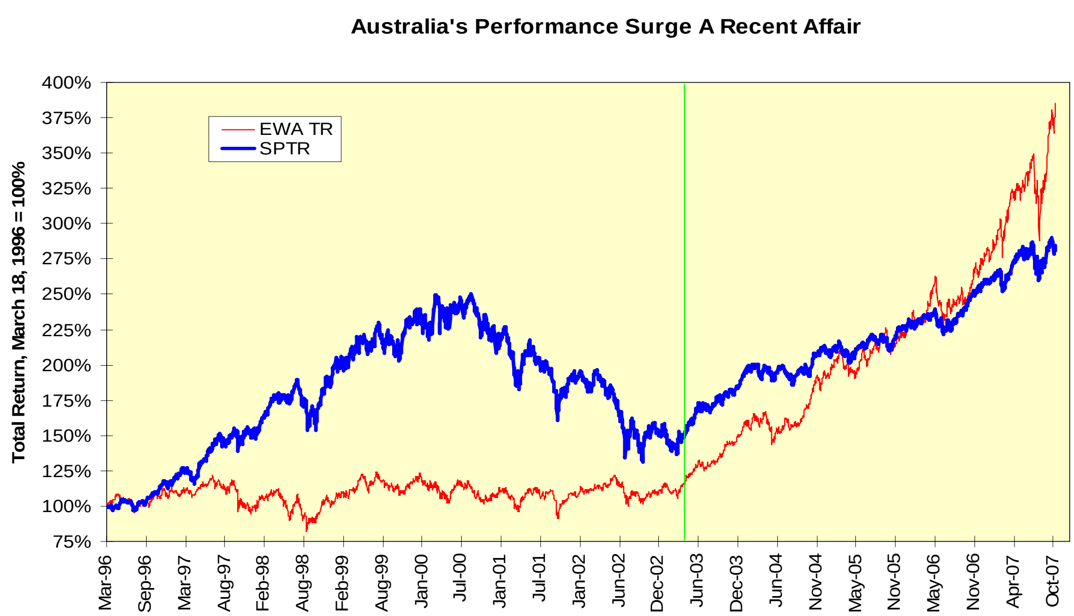
We can measure these relative short-term interest expectations by calculating the forward rate ratios (FRR) between six and nine months. This is the rate at which you can lock in borrowing for three months starting six months from now divided by the nine-month rate. The more this ratio exceeds 1.00, the steeper the money-market yield curve and the stronger the expectation for higher short-term interest rates in the future. The difference between the AUD and USD FRRs leads the movements in the AUD by three months on average. It peaked in mid-September, which suggests the AUD is losing its interest rate expectation advantage. This could change in a heartbeat if either the Federal Reserve or the Reserve Bank of Australia changed course, which has been a regular occurrence amongst central bankers this year.



Relative Stock Performance

The relative total returns for the U.S. and Australian markets, as measured by the total returns on the EWA and S&P 500, respectively, show how the Australian market's outperformance has been a recent affair. It began shortly after the Federal Reserve's May 2003 declaration of war on deflation, marked with a green vertical line. As both the EWA and S&P 500 are denominated in USD no further currency adjustment is required.

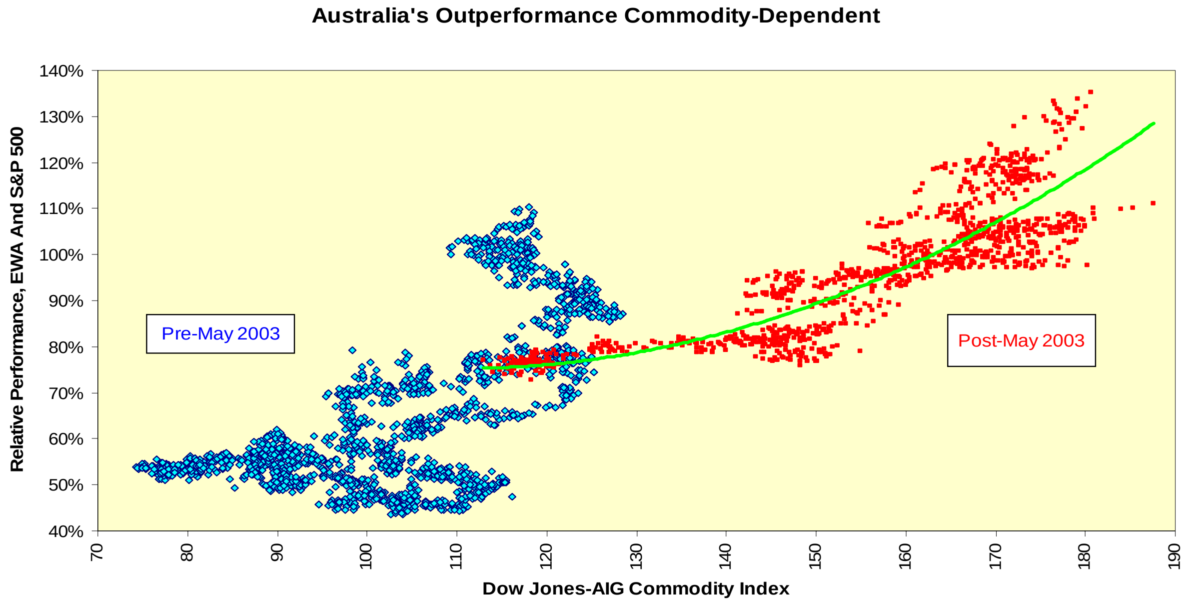
Please note how the EWA pulled back severely during the two episodes of yen carry trade unwinding in May-June 2006 and July-August 2007; I last discussed the yen carry trade in September. This is prima facie evidence of the liquidity-driven nature of the Australian market's rally and its vulnerability to any changes in Japanese monetary policy.



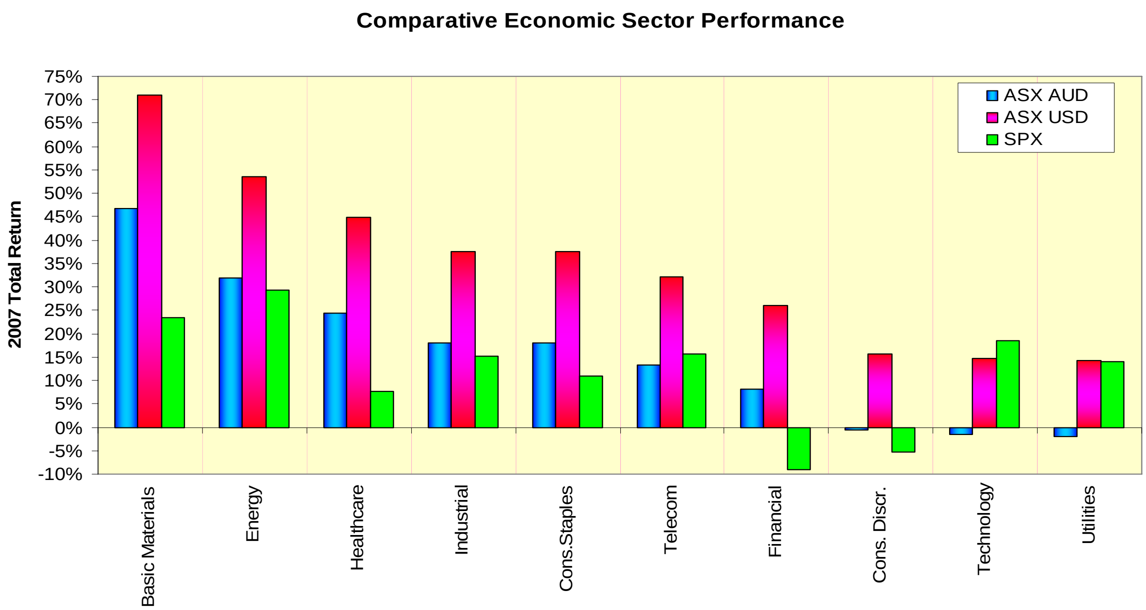
The Commodity Connection

Where there's liquidity smoke, there's commodity fire, and this is certainly the case with the Australian market. If we map the relative performance of the Australian and American markets pre- and post-May 2003, against the Dow

Jones-AIG commodity index, we see an accelerating outperformance after May 2003. The huge East Asian demand for raw materials has turned the Australian economy into a commodity boom town.



This is certainly obvious in the relative economic sector performances between the S&P Australian Stock Exchange 200 index and our own beloved S&P 500. The Australian market's Basic Materials and Energy sectors have returned 46.75% and 31.91% year-to-date in AUD terms and 70.97% and 53.68% in USD terms. The only sectors where the American market outperformed in local currency terms were Telecommunications, Information Technology and Utilities.



Now let's return to the question whether you should throw another stock on the barbie. The continued outperformance of the Australian market is linked to the global commodity boom, and while certain key commodities such as crude oil and gold are surging higher still, many of the key industrial metals such as copper, nickel and aluminum are showing signs of resistance. We have seen how the short-term interest rate expectations for Australia relative to the U.S. no longer are moving strongly in favor of Australia, and we have seen Australia's vulnerability to Japanese monetary policies.

The name of the game is "buy low, sell high," and that applies to the Southern Hemisphere, too. The time to go long Australia aggressively was more than four years ago, not today.