Resource Currencies: Gilt By Association?

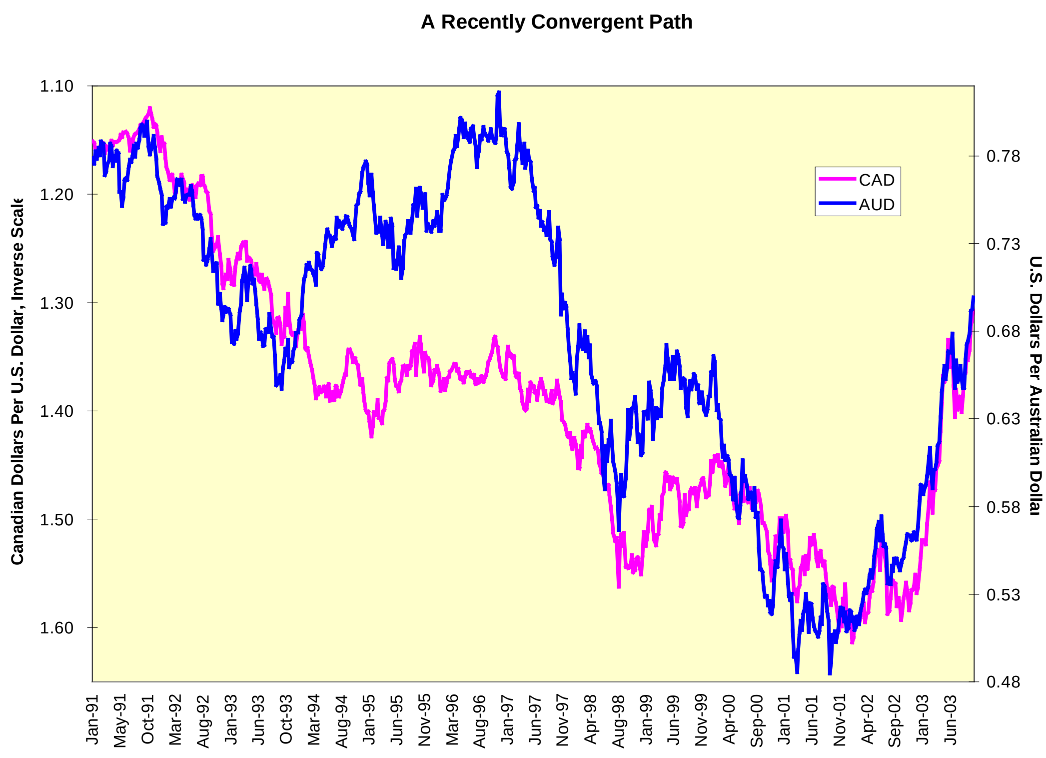
Fewer topics in finance provide more fertile fields than spurious correlation. While the more doctrinaire behavioral analysts may weigh in with a different insight, I think most of these alleged relationships are born in a single Pavlovian instant. Once upon a time, gold rallied in response to every global hiccup - the Russians invaded Afghanistan? Buy me some gold! - and that led to years of one-day wonders in the gold market until people finally realized the trade simply had no merit.

My personal favorite trade of this class is the selloffs in live cattle futures that often accompany stock market swan dives. If anyone, anywhere, can demonstrate an instantaneous drop in beef consumption linked to a negative wealth effect linked to a selloff in the stock market not offset by that other knee-jerk reaction, a flight to quality in Treasury bonds, a lifetime subscription *to The Journal of Irreproducible Results* awaits. Or a sitcom scene: "No, Bobby, we're not having steak tonight because your daddy (glaring) didn't know when to get out of Kodak."

Canada And Australia

The mind craves a linkage between these two countries. Both are English-speaking after a fashion, both use a currency called a dollar, both are sparsely populated with that population concentrated geographically and both are major producers of various minerals and energy commodities. As a result of the last attribute, they are referred to as "resource currencies," a label not given to more deserving currencies such as the South African rand, Russian ruble or Saudi Arabian riyal.

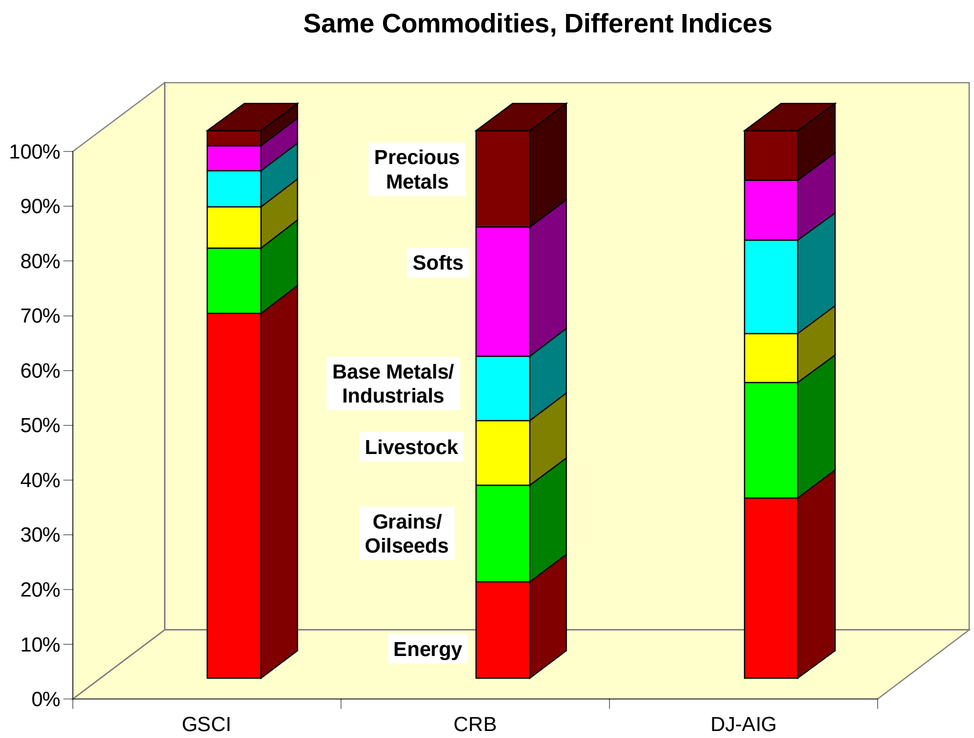
Compounding the problem is the near-identical paths the two currencies have taken over the past year and one-half. Never mind the divergent paths the Canadian (CAD) and Australian (AUD) dollars took between 1988 and 1998, a period during which the price trends of global commodities surely were the same for both. They are moving quite identically of late and this development will no doubt create a future generation of currency traders willing to trade one off the other.



Which Index?

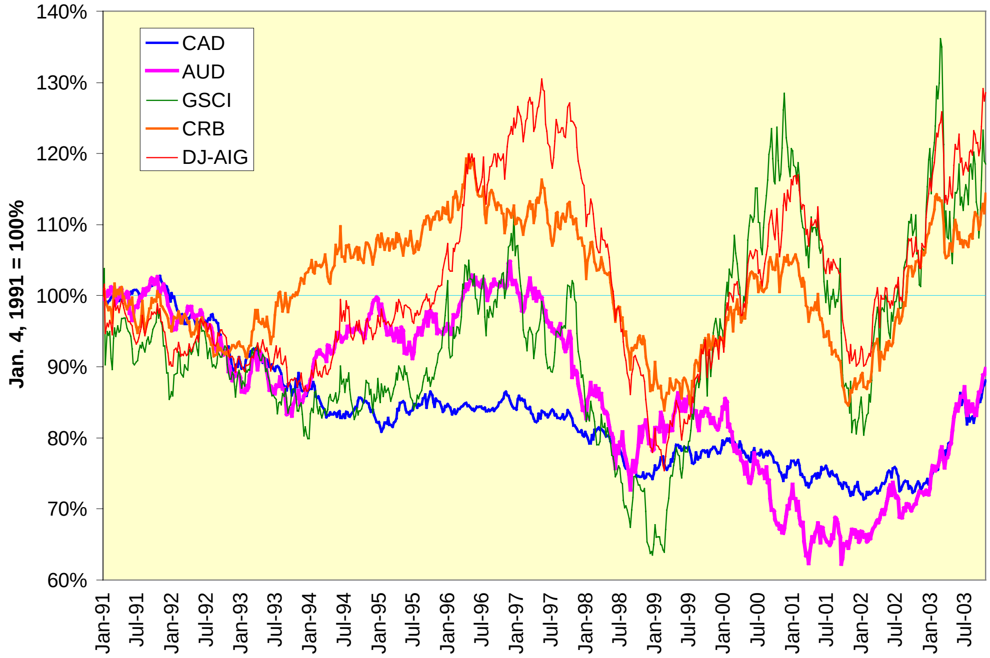
The linkages between currencies and commodities are dependent on which commodity index you use. The Goldman Sachs index (GSCI) is weighted by the economic importance of its members and as a result has a 66.69% energy weight. The GSCI's weights are very different from those of two other indices, the Commodity Research

Bureau (CRB) index, which is weighted far more heavily to the grains and to tropical soft commodities such as sugar and cocoa, and the more equally balanced Dow Jones-AIG index. The CRB has the greatest weight in precious metals, and the DJ-AIG has the greatest weight in industrial commodities.



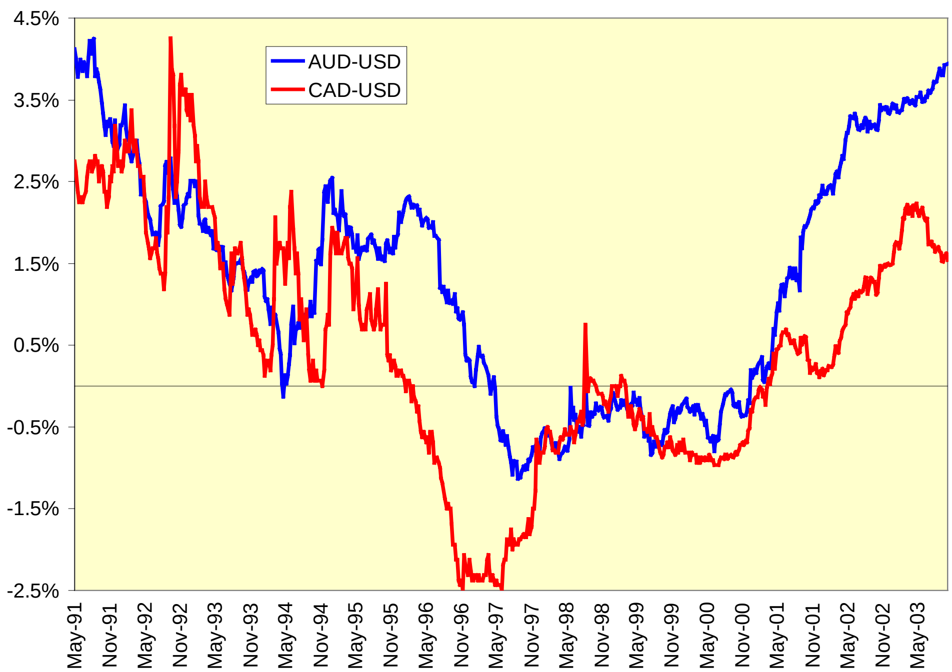
On balance, none of the three commodity indices have a strong coincident or leading relationship to either the CAD or the AUD. While it is true that both commodities and the two currencies have risen in 2003, both currencies managed to ignore a similar commodity price rise from mid-1999 through the end of 2000. Their simultaneous rise invites an incorrect Pavlovian response: Both countries have heavy resource sectors, so their currencies must be commodity proxies.

Commodity Indices Vs. Canadian & Australian Dollars



The reasons behind the resurgence of the two resource currencies have little to do with gold or oil or wheat prices. The interest rate differentials between them and the U.S. dollar have grown, especially for the AUD, and this simply makes them more attractive to hold. Moreover, both central banks, like the Bank of England, have backed away from the open spigot policy of the Greenspan Fed. Gold could be back at $260 and we would see a strong AUD given this rate gap.

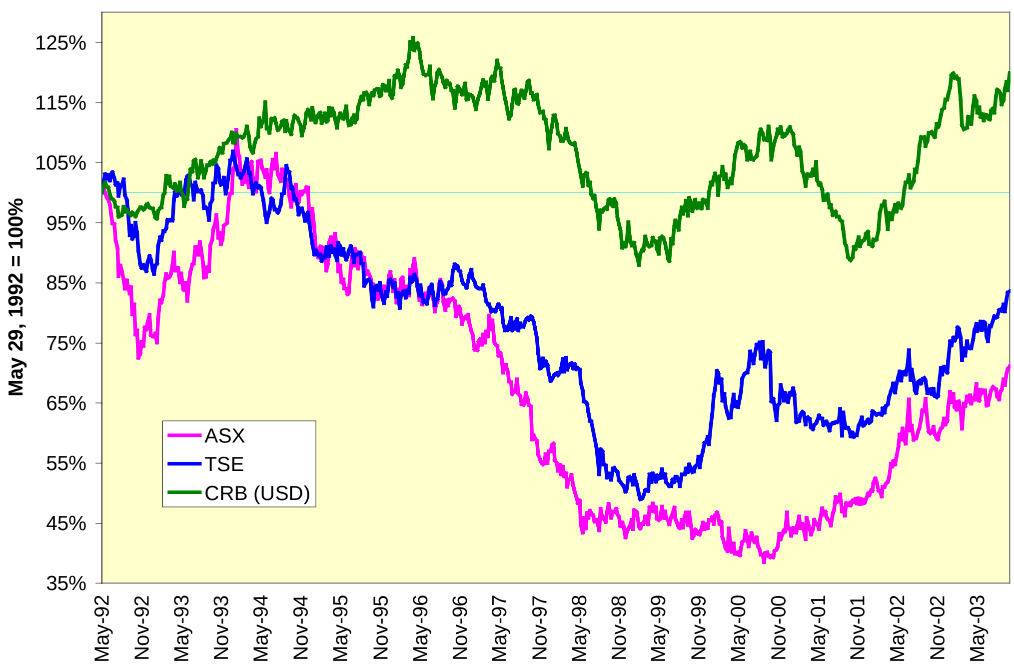
Interest Rate Differentials At Six Months



Stocks Strong, But Not Golden
If commodity prices are not moving the currencies, are they helping these two stock markets? They certainly are not hurting either. The S&P/ASX 200 index is up 21.9% so far in 2003 in AUD terms, but 32.7% in USD terms. The Canadian story is similar: The Canadian S&P/TSX Composite is up a pedestrian 15.1% in CAD terms in 2003, but a strong 38.3% in USD terms.

The information technology group in both stock markets, not the mining and energy groups, has been the top performer. This is a marked departure from 2001 and 2002, when various gold mining firms led both the Sydney and Toronto markets. Their stocks correctly anticipated the subsequent rise in bullion prices. And the connection between these two markets, adjusted for currency changes, and the CRB index is visible, if not particularly strong statistically. The Toronto market has miners such as Ivanhoe Mines, Bema Gold and Golden Star Resources among its leaders, and Sydney is being led by nickel miner Jubilee Mines.

Currency Adjusted Performance Relative To S&P 500



In the end, neither currency can be called a resource currency as much as an interest rate differential currency. And neither stock market can be called a resource market as much as a technology market; it was not too long ago that Nortel Networks so dominated the Canadian market that the index was referred to as the "TSE 1." All we can say is so long as American interest rates remain low and commodity prices remain strong, two trends that appear likely to continue in the near future, American investors can get a double kick out of buying these resource-related stocks.