Canada, Australia And Diversification

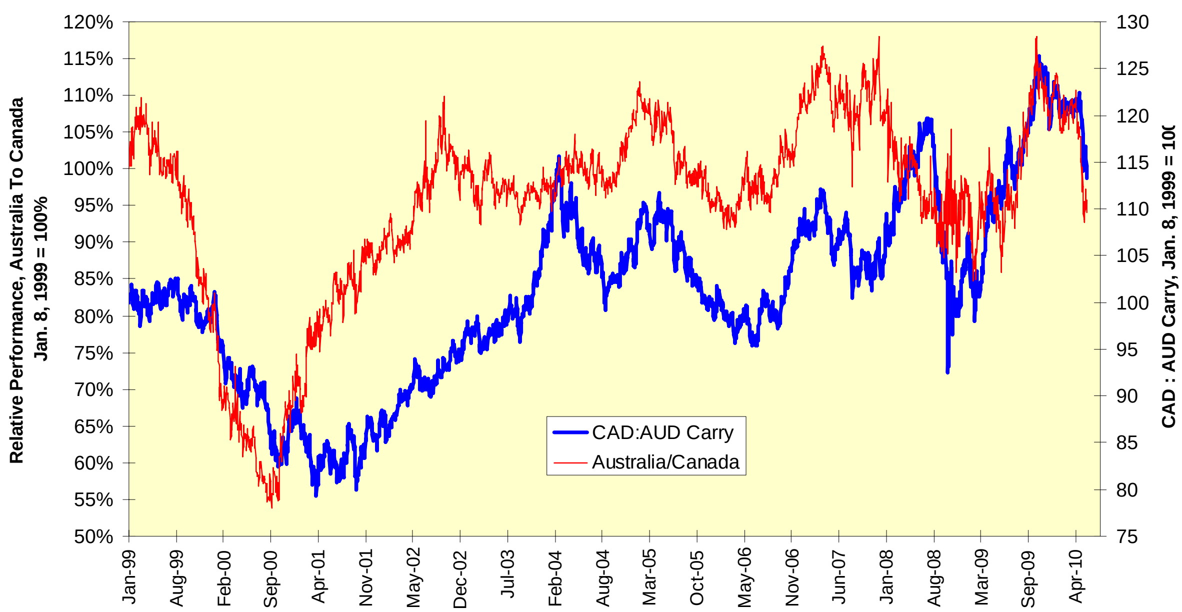
Our neighbors to the North – and let the record show that not only have I been in Saskatchewan, but I have been there in mid-December – became the first member of the G-7 to raise short-term interest rates this past week. Australia, which is only a member of the G-20 and therefore has to climb over the backs of at least a dozen G's to get into the G-7, has been raising rates since October 2009.

As the two members of the British Commonwealth, a designation that once meant something but now serves mostly as an excuse to start drinking at cricket matches or going to golf tournaments with lots of players named "Nigel," have structurally similar economies and large resource-export sectors, what has the impact been of their respective rate-hike decisions on their currencies and relative equity markets?

Stocks, Carry And Currencies

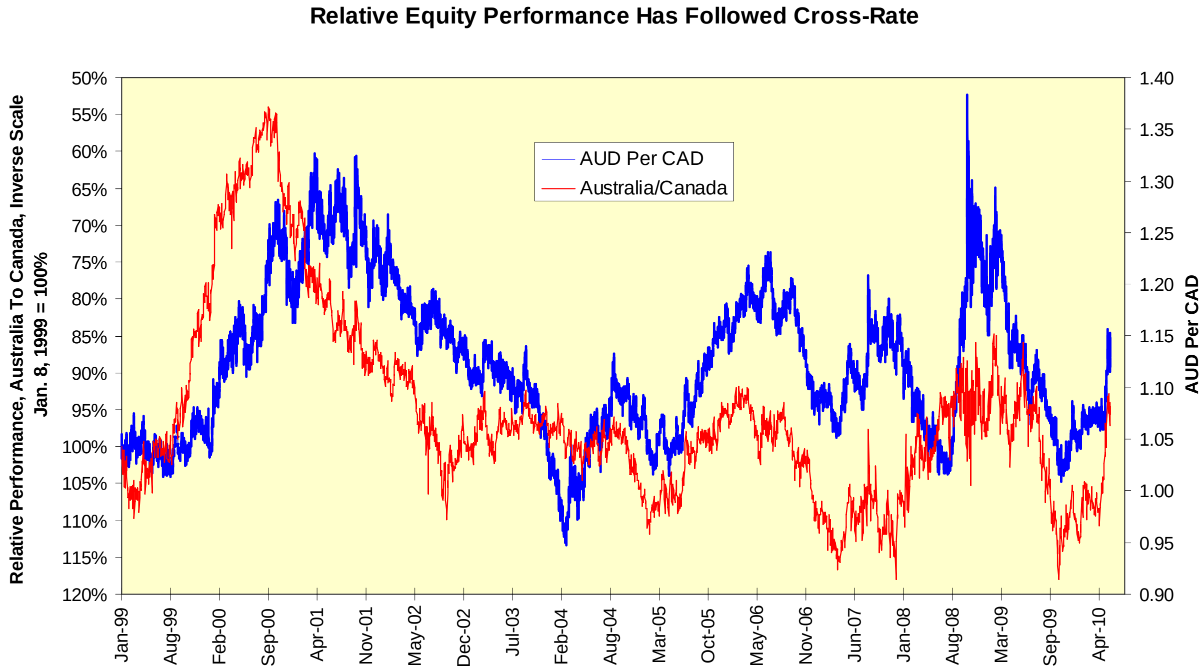
We noted yesterday the general relationship between carry trade returns between two currencies and the relative performance of the respective equity markets was upended in the case of Hong Kong. Be at peace with the working order of the universe when it comes to the relationship between Canada and Australia. Here if we map the relative performance of Australia vis-à-vis Canada against the return for borrowing CAD and lending AUD, we find the two have moved hand-in-hand, especially since the financial crisis prompted a round of global interest rate cuts in 2008.

Relative Equity Performance Linked To Carry Return



In an analysis not displayed here, the interest rate markets are expecting Canadian short-term interest rates to start climbing faster than their Australian counterparts. A glance at the chart above reveals this would reduce the carry return from CAD to AUD and therefore argue in favor of Canadian equities outperforming Australian equities.

If we strip away the total carry return from the analysis above and display the much simpler cross-rate of AUD per CAD, we get the same general answer: As the AUD weakens relative to the CAD, Australia's relative performance, here displayed inversely to highlight the relationship will deteriorate.



Going Forward

Central banks had been in unusual lockstep for most of the past decade; how do you think we wound up with such a bubble-and-bust cycle globally? This was especially true after 2008, and it does explain why diversification, long hallowed by investment professionals as the most important aspect of this whole sordid business, failed when needed most. This is highlighted in the first chart by the close relationship between relative equity performance and net carry returns.

If we start to see central banks peel away from the herd, the opposite should occur: A greater diversity of policies and therefore a greater diversity of returns. For all of those who have been wishing for such a development, remember the warning about being careful for what you wish as you just might get it.