Less Commodity Thunder Down Under

One of the rules every rookie economist learns the hard way is if you have written about Canada one day, you have to write about Australia the next day. It is, as Abraham Lincoln said in another context, fitting and proper. Detours into the cross-rate between the Australian and Canadian dollars are permissible.

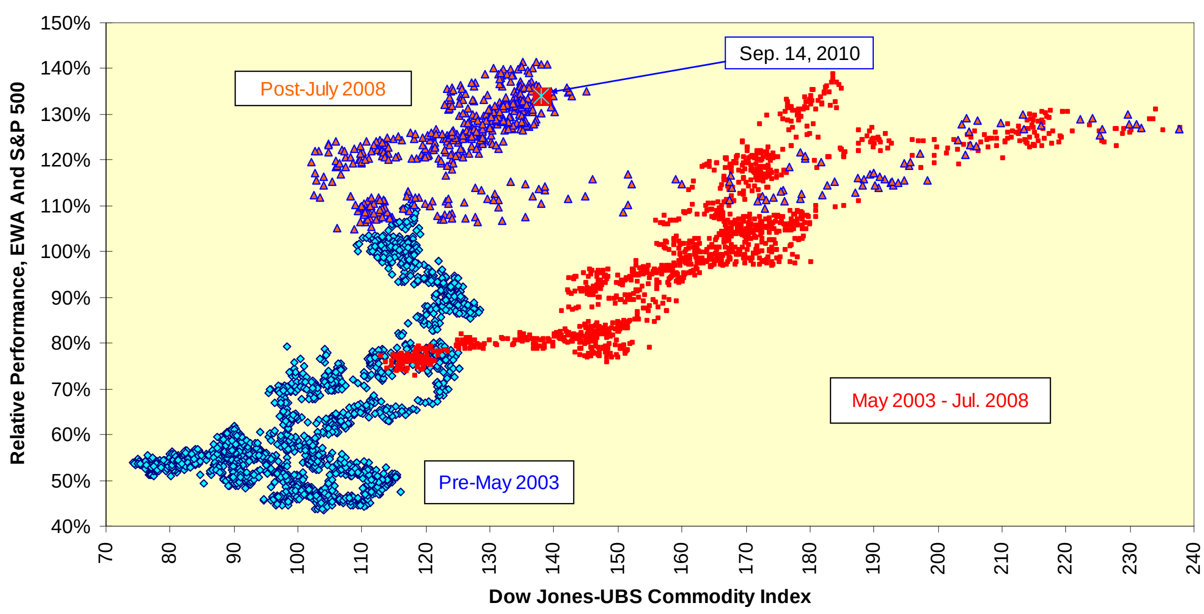
Australian equity markets, just like their Canadian cousins, used to be regarded as resource-dominated, and for good reason. The island continent is being dug up and transported to China and other Asian industrial giants one shipload at a time; this is why the Baltic Dry Freight index is so dominated by the Australia-to-China route.

In a related note, the Australian dollar, even though it is lumped in with other "commodity currencies," really is not; it is driven by its expected interest rate differentials vis-à-vis the Japanese yen. This is the sort of information that might earn you a Foster's Lager (a product of the cleverly named Foster's Group, we might add) at an appropriate establishment, but then again it might earn you an early exit to the sidewalk.

Another Link, Another Break

Just as we saw in the case of the Canadian markets, the world changed for Australian equities' commodity linkage after the July 2008 peak in commodity prices. But in an interesting twist, the change is a back-to-the-future sort of affair. If we map the relative performance of USD-denominated iShares MSCI Australia index ETF to that of the S&P 500 as a function of the Dow Jones-UBS commodity index, we see three distinct periods. The first, marked in turquoise extends to the Federal Reserve's first declaration of war on deflation in May 2003. The second, marked in red, occurred during the commodity boom extending to July 2008. We are now in a third zone, marked in blue-orange, that is really nothing more than an extension of the first period. The anomaly was the bubble, not the current zone. Regardless, the Australian market's relative performance has shed its May 2003-July 2008 commodity-dependence.

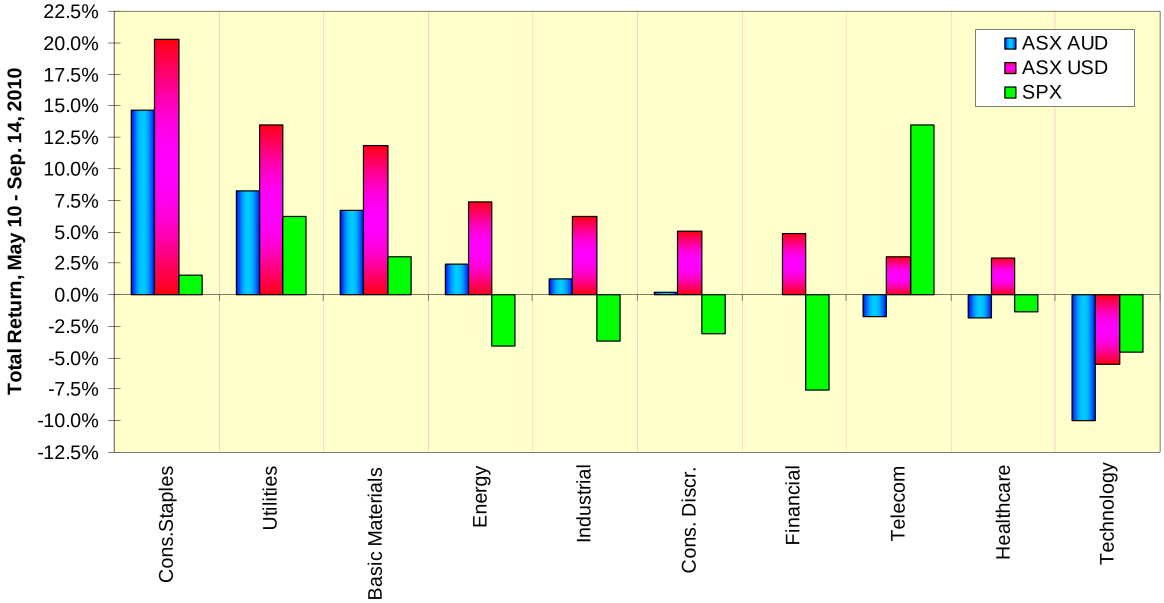
Australia's Relative Performance Shedding Commodity Dependence



Sector Performance

Now let's replicate the S&P economic sector performance chart produced yesterday for the Canadian markets. The sample will begin at the resolution for the time being of the Eurozone's sovereign debt crisis in May 2010. Just as we saw in the case of Canada, Australia has outperformed the U.S. in every sector but Information Technology and Telecommunications since May. Both of the resource-related sectors, Basic Materials and Energy, have performed well on both an absolute and a relative basis, but the real stars of the Australian market in recent months have been two sectors generally regarded as defensive, Consumer Staples and Utilities.

Comparative Economic Sector Performance



As a general comment, Australia is a great derivative play on the Asian growth story; it fits the old adage, "In a gold rush, sell shovels." But it is more than just a resource story and therefore has a more-than-fighting chance of avoiding a complete bust if and when raw materials demand slows.