When Currencies Are Resourceful

"You can observe a lot just by watching" -- Yogi Berra

Too much of what passes for wisdom in financial markets is classified best as urban legend, which is a shame because the wealth of data available for true analysis should make guessing unnecessary. But, market analysis is at least as much of an art as it is a science, which is why those content to draw simplistic conclusions are doomed to failure. As an example we need look no farther than the truth held to be self-evident by so many only a year ago that the Fed could make stocks rise by making short-term interest rates fall.

Another urban legend, and the subject of today's toiling in the vineyard, is the notion that certain currencies are linked to the prices of commodities prominent in their country's export mix. This declaration bears two characteristics of the finest nonsense: It sounds good and it is difficult if not impossible to test thoroughly. Some countries are highly dependent on the price of a single export, such as cocoa for the Ivory Coast, sugar for Cuba, crude oil for Gabon, and an assortment of, um, botanical products for Colombia (that ain't anthrax on your C-note, mister). In all of these cases the higher commodity price / stronger currency link makes sense, but since none of these country's currencies are traded widely and freely, how can we be sure?

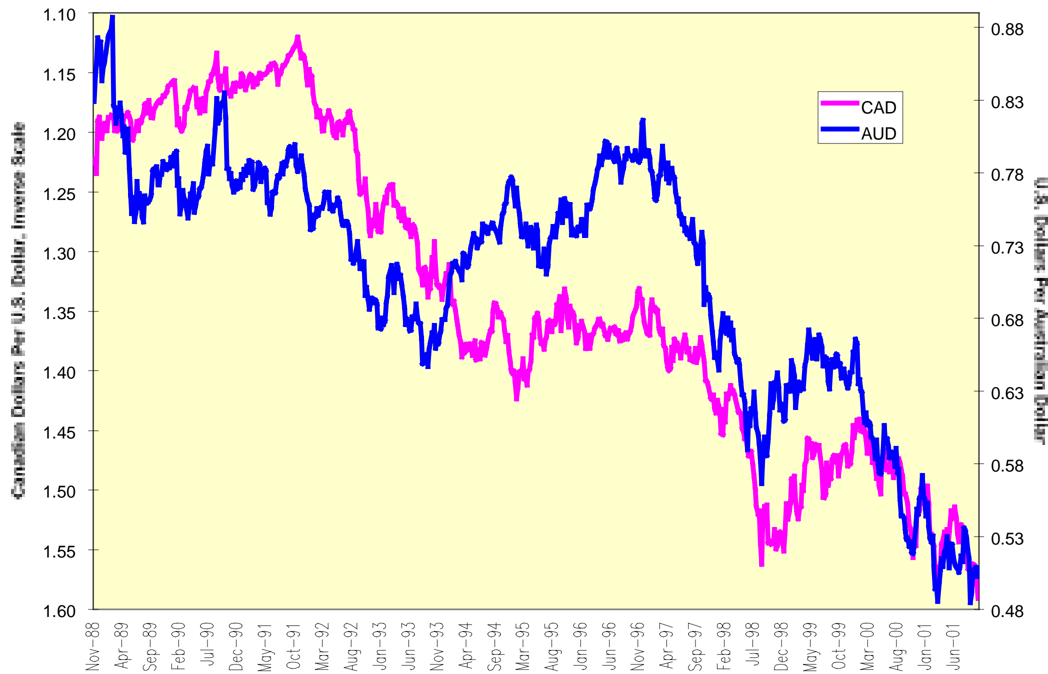
They Speak English And Use Dollars

Both the Canadian and Australian dollars are mentioned frequently as "resource currencies," and for plausible reasons. Both countries supply much larger economies' appetites for these resources, the U.S. for Canada and Japan, China, and an assortment of declawed and neutered Asian Tigers for Australia. Politically, both countries are struggling with the vestiges of British socialism. Australia is home to the world's most poisonous reptiles, while Canada has the Quebec Separatists.

Both countries are large producers of energy resources, and both base and precious metals. Oil & gas production is the second largest sector in the Australian All-Share index, with a 13.3% weighting, and mining accounts for another 2.4%. Comparable figures for Canada's Toronto Stock Exchange 300 index are 13.4% for oil & gas, 4.6% for metals and mining, and 4.1% for gold & precious metals.

Resources are not resources; this has been a great year for gold miners such as Australia's Delta Gold and Lihir Gold and Canada's Glamis Gold and Goldcorp. Miss triple-digit returns, do you? Three of these firms have them so far in 2001, and Lihir is up 92%. Base metals producers such as Australia's Anaconda Nickel and Canada's Inco are on the downward side of the ledger. This bifurcation (is this a cool word, or what?) is consistent with recent observations in this space that precious metals will benefit from lower interest rates while base metals are still suffering from the global manufacturing recession.

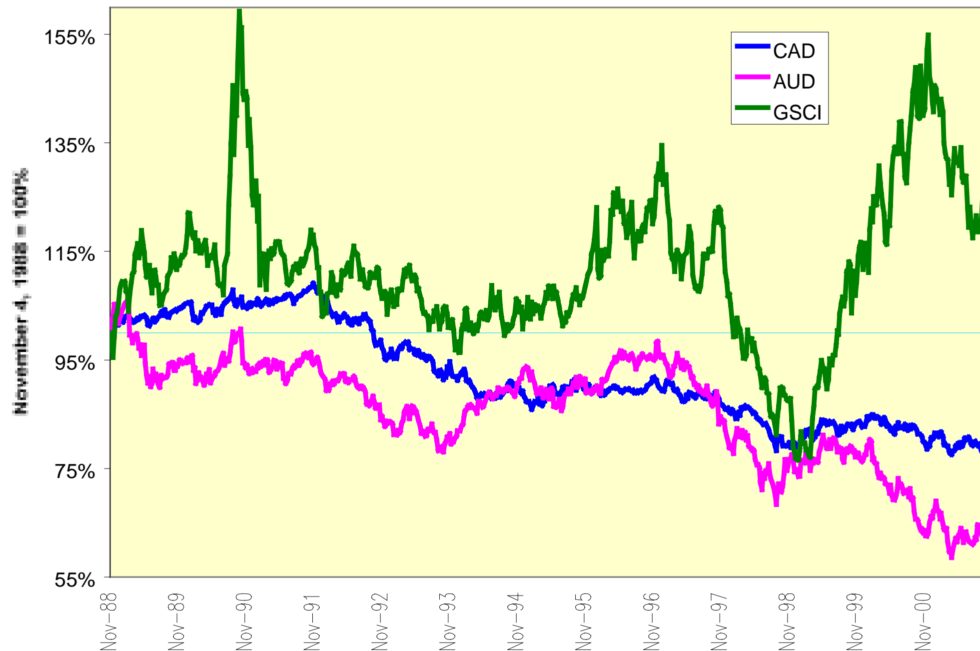
Their currencies have both paralleled and diverged from each other in recent history. Over the past two years, the relationship has been very parallel in a weakening direction. The Australian dollar (AUD) reached its all-time low of .4775 USD per AUD this past April. The Canadian dollar (CAD) hit its all-time low of 1.597 CAD per USD this past week.



Pieces Of The Puzzle

We now have two pieces of information, one that these two currencies have been getting pounded, and two that commodity prices are in what is probably the end stages of a very long-term bear market (see "Just What Are Commodities Good For," October 23, 2001). But if the two currencies' movements are tied to those of commodity prices, it certainly isn't apparent from the chart below. The Goldman Sachs Commodity Index, more weighted to energy and metals and thus more representative of the Canadian and Australian economies, is about the same level it was in November 1988. The two currencies ignored several intermediate rallies in commodities, including the 1999 - 2000 spike in energy prices.

You Call This A Relationship?
Goldman Sachs Commodity Index Vs. Canadian & Australian Dollars



If It's Not The Resources...

... Then what explains the long-term weakness of the AUD and CAD? The monetary policies of the two countries, Canada especially, are not vastly different from those of the U.S., even though traders of Australian Bank Bill futures on the Sydney Futures Exchange have to endure far higher volatility than their American counterparts.

The real difference, as we have seen for nearly three years in the dollar-euro rate, is expected return on capital. So long as investors believe they have a better chance of capital preservation and long-term growth in the U.S. than in either Canada or Australia, capital will flow into the U.S. regardless of our interest rates, our trade deficit, or any other macroeconomic measure you can mention.

Don't take my word for it, though, just take a look at the relative performance of both the Australian and Canadian stock indices relative to the S&P 500 converted back to USD. Take away Canada's brief Nortel and JDS Uniphase boomlet, as many Canadian investors would like to do, and we find a consistent outperformance by the American market during both bull and bear phases.

Currency Adjusted Performance Relative To S&P 500

Those who continue to cling to the notion of resource currencies should remember that the most important resource any country can have is its people. The return on human capital can be far greater than the return on any resource extracted from the ground. Those countries who confuse their, say, oil money for real wealth, and who ignore their human capital (yes, we're thinking of the same gang of worthies) will always come up a day late and a dollar short. A U.S. dollar, preferably.