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The Alchemist

Buoyant commodity prices not enough to keep AUD afloat

Resilience in commodity prices has not been enough to prevent the Aussie dollar from being one of the worst-performing developed economy currencies of 2018

INTRODUCTION

RFC Ambrian monitors the relationship between commodity prices and exchange rates. The relationship can be valuable in providing context for exchange rate movements as significant deviations in the relationship may indicate that factors other than commodity prices are having a stronger pull on the exchange rate

The Australian Dollar has slid over the last year from a high of $0.81 USD in January 2018 to $0.71 USD one year later, making it the second worst-performing currency amongst developed economies for 2018.

This depreciation has been widely attributed to 1) a reversal in interest rate differentials between Australia and the US, and 2) global macroeconomic and political tensions.

This report reviews this trend in the AUD/USD exchange rate in the context of the Alchemist's commodity price-based exchange rate model, a model based on the historical relationship between the Aussie dollar and the RBA's Index of Commodity Prices (ICP).

COMMODITY PRICE-BASED EXCHANGE RATE MODEL

- Given the significance of commodity exports to Australia's economy, it is not surprising that exchange rate movement in Australia has historically maintained a strong correlation to commodity prices, as can be seen in the chart below
- At US$0.71/A$, the Aussie dollar sits well below the range expected from a purely commodity-based modelling perspective
- According to a purely commodity-based exchange rate model, US$0.819/A$ to US$0.885/A$ would reflect a more fairly valued exchange rate at current commodity prices
- The current difference between the commodity-based exchange rate and the actual exchange rate is historically significant
- Over 2018, the actual exchange rate was, on average, within A9.27¢ of the predicted price, compared to an average of A4.60¢ over the period from 2005 to present
- Figure 1 shows the progress of large historical deviation events, in absolute terms, from the start to the peak for each event
- The ongoing run beginning in January 2018, while not as pronounced as the deviation seen during the GFC, has already become the longest significant deviation since the early 2000s

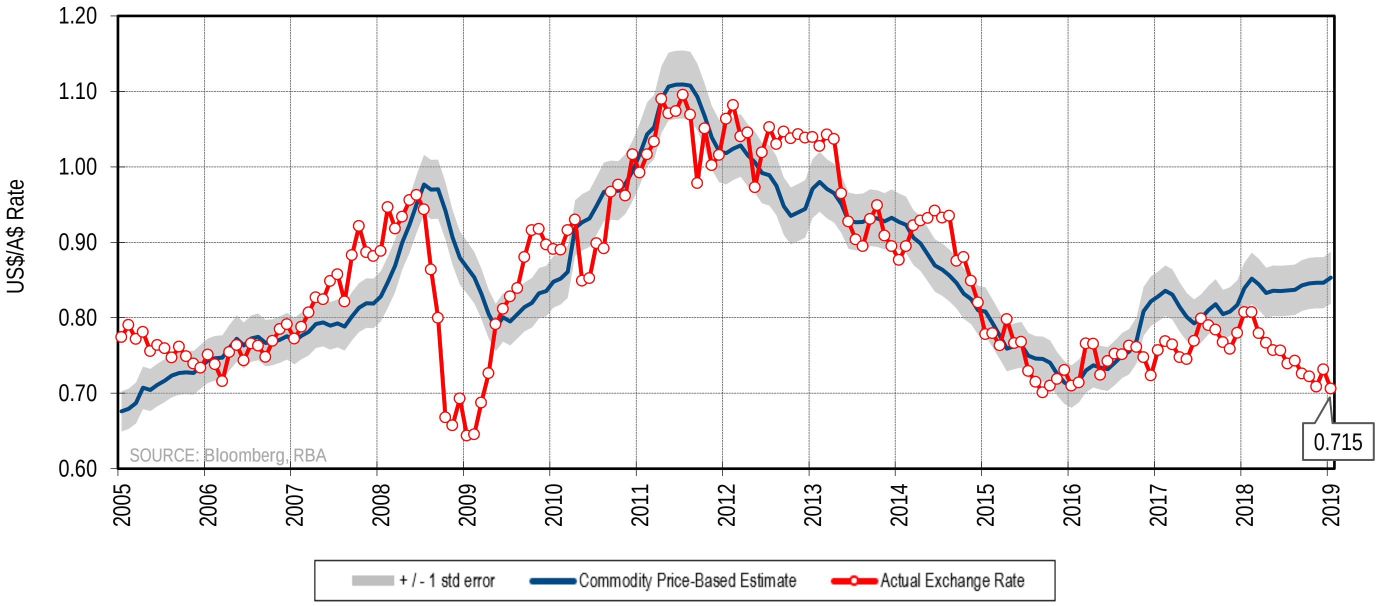

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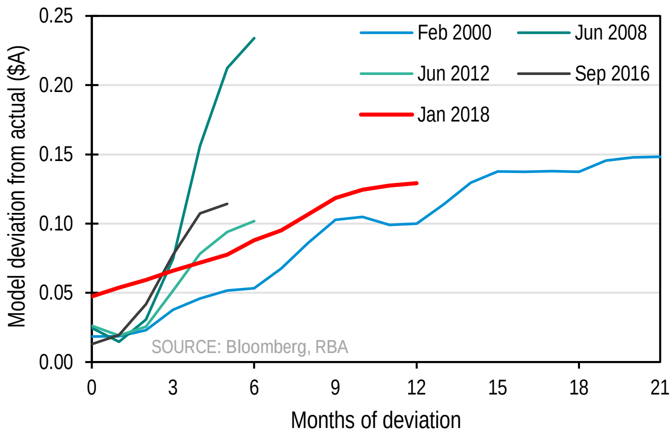
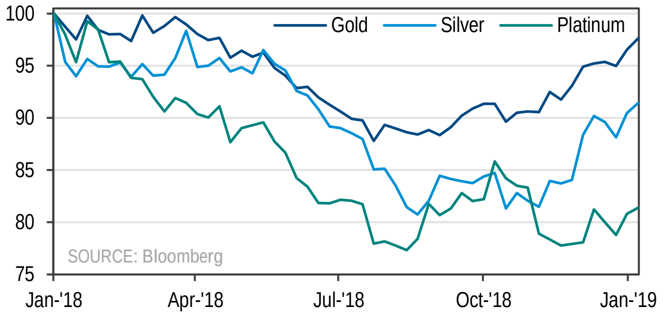
Figure 1. Past deviations between model and actual exchange



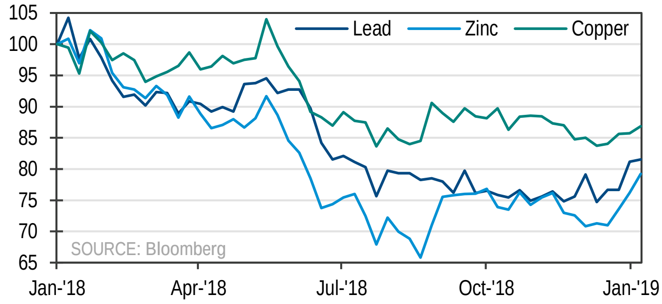
RECENT TRENDS IN COMMODITY PRICES

- The changing relationship between commodity prices and the AUD/USD exchange rate raises the question of whether commodities are becoming a less significant contributor to the Australian economy
- Despite any shifts in the importance of various drivers of the AUD/USD, the importance of mining in Australia has not taken any hits. Mining has continued to grow steadily as a percentage of GDP, rising from 5.2% in mid-2004 to 7.8% in September 2018, the largest contribution since the RBA began collating mining industry data in 1974
- Furthermore, mining as a proportion of value of physical exports has grown from 27.4% in June 2004 to 59.5% in December 2018
- Over 2018 there were some winners and some losers amongst the commodity groups, but a systematic lock-step movement such as that seen in the 2012-2015 commodity downturn was absent
- Price changes in energy and bulk commodities (which comprise the majority of the Aussie commodity basket) gained 2.59% and 1.53% respectively in the twelve months to February 2019
- Precious metals ended 9.86% lower over the period, although gold (the only precious metal substantially weighted in the basket) ended only 2.37% lower
- Comprising around 5% of the basket, base metals closed out the same period 17.47% lower than the open

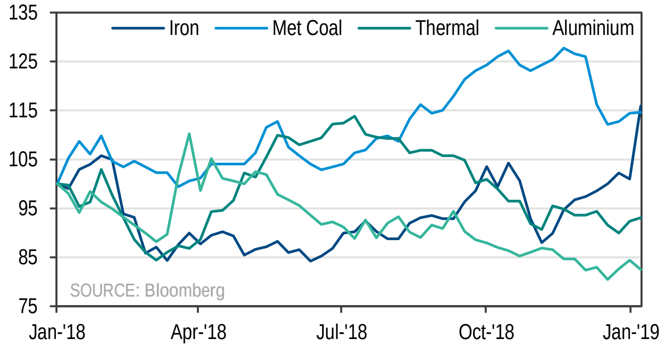
Precious metals (USD Prices)



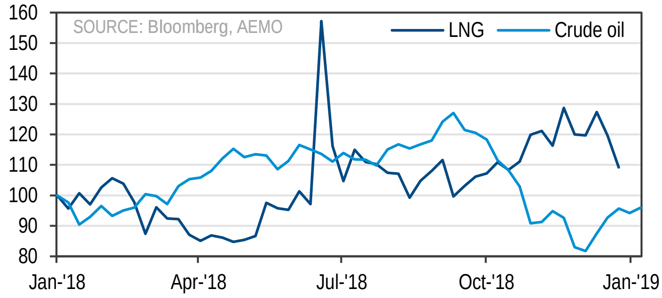
Base metals (USD Prices)



Bulks (USD Prices)



Energy (USD Prices)



CONCLUSION

- The exchange rate is now significantly disconnected from, and undervalued compared to, commodity prices
- Commodities appear broadly stable (in their own way), so it is apparent that other factors have dominated the exchange rate paradigm
- It is not clear whether this represents a fundamental change in the FX/commodity relationship, or if it is just an extended deviation
- It seems that the historic reversal of the interest rate differential between US and Australia is set to continue, with both the RBA and the Fed appearing to hold interest rates steady for the time being
- Either way, the current foreign exchange environment makes now a good time to be an Australian commodity exporter

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