Greenback regains place at the top of the currency pile

By **Stirling R Larkin**

IT is important to recognise that the Australian and US dollar pairing is changing not because of a shift in the commodities complex or “carry trade” but because the greenback, is rediscovering its rightful place at the top.

Understanding why is as important as contemplating where that pair may be headed.

For sophisticated investors, such as the Australian ultra high net worth investment community, currency speculation is a “fool’s errand” and trying to pick movements, moment by moment, is considered futile, dangerous and statistically hazardous.

Contrary to the mass opinion that our dollar was remaining resiliently high, when compared to the US dollar, because of iron ore exports or the interest rate arbitrage trade (known as the “carry trade”), the reality has proven to be something quite different.

Such arguments have had a coach and horses driven through them as our currency has remained relatively high at above $US0.70c during a period where iron ore spot prices have plummeted and domestic interest rates have fallen.

Also, commentators who suggest that the greenback is strong and on a bull run, albeit observationally correct, are missing the point regarding what is, in fact, actually currently afoot.

Taking a step back and seeing the forest for the trees, a clear picture now presents itself.

Guessing where currencies are headed is inadvisable but appreciating the forces at work influencing them is an important process for any sophisticated investor to pursue.

Looking at it by and large, what appears to have happened is that the US dollar, the stalwart reserve currency of the world since the “Nixon Shock” of 1971 — when president Richard Nixon unexpectedly unpegged convertibility of the greenback to gold bullion — was artificially repressed during the years of quantitative easing in the US.

Such suppression led to what appeared to be a weaker greenback.

The logic behind this is very easy to follow: quantitative easing, crudely referred to as “printing money”, diluted the US money supply and such dilution weakened the relative value of this currency.

With the end of US unconventional monetary programs in October of last year, what appears to have happened is that the US dollar, no longer being subjugated, returned to its natural position in the global currency mix.

Needless to say, this position was one where the greenback was naturally stronger than where it had been during the years of unconventional monetary programs.

Currency pairings are, at the end of the day, a representation of relative value between two countries’ currencies.

So during early 2015, when we saw a rising greenback vis-a-vis other currency pairings, it would be narrow minded to view this as a US dollar rally, as much as it was a re-emergence of the world’s dominant reserve currency, returning from a subdued state.

When reflecting upon why our dollar has not moved due to its own natural dynamics (referred to earlier), it is important to truly grasp how significant and omnipotent the greenback really is in the global economy.

A persuasive argument could well be mounted that the resilience of the Australian dollar around its current levels exists because our currency is considered one of a small batch of reserve currencies sitting behind the ultimate reserve currency, the US dollar.

In other words, the Australian dollar could well be considered a “back-up” or second deviation reserve currency, a gold and green coloured “golden greenback”.

Such a hypothesis is supported by the continued evidence, as the graph illustrates, of the AUD v USD pairing since the end of our last recession in Australia in 1993.

What ultimately drives our dollar, is its relative value, at any point in time, to the value of the US dollar.

Such congruity is accepted by both global institutional and UHNW investment communities.

By no means a "Faustian pact", this relationship is rooted in the acceptance that the Australian dollar sits alongside the Japanese yen, Canadian dollar, euro, sterling and Swiss franc. Proof of this was seen in October of 2012, when the 45-member exchange rate and international monetary stabilising institution, commonly known as the IMF, added the Australian dollar to their highly regarded Composition of Foreign Exchange Reserves report.

The importance of the COFER report stems from the fact that it gauges the currency reserves of central banks around the world and has done so since 1947.

Niney-five per cent of those reserves have traditionally been held in just five currencies: US dollars, euros, sterling, Japanese yen and Swiss francs.

This recent IMF decision galvanised the Australian dollar's place within this mix and acknowledged the fact that foreign ownership of Australian bonds has grown to a record 76 per cent, more than double the levels seen a decade earlier.

The RBA only keeps partial data on which particular countries hold its sovereign debt and currency reserves and the increase in foreign investors has led to justifiable calls for a more comprehensive register.

Figures released by the Australian Office of Financial Management show that Asian countries are the biggest buyers of Australian bonds, followed by Europeans and North Americans (especially Canadians).

If we respect the principle of "Occam's razor", which states that among competing hypotheses, the one that makes the fewest assumptions should be selected, it makes good sense to suggest that the level of our Australian dollar in relation to the greenback, has more to do with a recognition by central banks around the world that Australia has, for now, a significant role in the rise of China, rather than it being solely a currency in play when commodities and bond yields shift.

As Leonardo da Vinci said, simplicity is the ultimate sophistication.

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