New way of looking at pricing the Aussie dollar

The first step lies in understanding why currency and foreign exchange are different compared with other asset classes.

Stirling Larkin Columnist
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Central to successful ultra high net worth wealth management is a cool-headed and controlled approach to maintaining currency exposure and not falling foul of the temptations, as Margaret Thatcher noted, of treating exchange rates as a virility symbol.

What continues to anchor our Australian dollar has been grossly misunderstood by institutional experts. Unsurprisingly, their explanations have failed to make sense of why our dollar versus the greenback and other leading currencies has continued to fall below the 69¢ bottom range floor.

Unlike other asset classes, currencies do not enjoy a microstructure back-end, which makes their exchange a price-setting auction.

Before unpacking why these institutional experts and members of our Reserve Bank Board have significantly misread the tea leaves and what may come next for our currency, it is imperative to understand why currency and foreign exchange are different compared with other asset classes.

The traditional assumption at the heart of institutional experts' arithmetic assumes that during periods of currency weakness, the sharemarket tends to rise in local currency terms and, conversely, when the exchange rate appreciates, equities usually underperform government bonds.

Before our dollar was floated on December 12, 1983, such arithmetic and related assumptions may have been valid. But since then, all (including those within the monetary arms of our government) have maladministered its stewardship.

And that is because, in essence, our Australian dollar has been presumed to behave like any other comparative asset class – such as equities, bonds, commodities, real assets and property – with a market architecture behind it.

Seminal research

The answer to why these assumptions have been misleading and providing false signalling may be found in a seminal research paper published by Professor Maureen O'Hara, of Cornell University, in 1999, titled Market Microstructure Theory.

Market microstructure refers to the study of the process and outcomes of exchanging assets under a specific set of rules and, while much of economics abstracts from the mechanics of trading, microstructure theory focuses on how specific trading mechanisms affect the price formation process.

What this theory ostensibly exposes is that unlike equities, bonds and other asset classes, currencies do not enjoy a microstructure back-end, which in effect makes their exchange – for instance, exchanging our Australian dollar for a US dollar – a price-setting auction. This is a polite way of saying it is nearer to glorified bookmaking than it is to exchanging assets that rely on fundamentals to discover their value or price.

Market microstructure theory has been further tested after the Great Recession by the advent of high-frequency trading (HFT) and O'Hara and others have extended the frameworks that help explain optimisation of exchange between all assets in an HFT inclusive and exclusive environment.

As O'Hara noted in April 2014: "Markets are different now in fundamental ways. HFT has clearly made things faster, but viewing the advent of HFT as being only about speed misses the revolution that has happened in markets. From the way traders trade, to the way markets are structured, to the way liquidity and price discovery arise – all are now different in the high-frequency world. What is particularly intriguing is the new role played by microstructure. One might have expected that when things are fast the market structure becomes irrelevant – the opposite is actually the case. At very fast speeds, only the microstructure matters."

Professors Yin-Wong Cheung and Menzie David Chin in 2001 published a supporting paper, "Currency traders and exchange rate dynamics", which surveyed US foreign exchange traders and found that in recent years electronically brokered transactions have risen substantially, mostly at the expense of traditional brokers. Because of HFT and the change in currency microstructure, half or more of market respondents believe that large players dominate in the US dollar-sterling and dollar-Swiss franc markets and, as a consequence, exchange rate predictability is viewed as fairly low to impossible irrespective of whether those views were intraday or as far out as six months.

For UHNW wealth management, speculation pales in comparison or priority behind exchange rate dependability. For those who accept that currency exchange is a unique asset class that identifies price formation by ways of deep liquidity opposed to the traditional assumptions of price reflecting an asset's intrinsic value, different variables become material when predicting where our Australian dollar exchange rate is heading.

QT news

One such variable that was missed or under-reported in recent weeks was the news that not only had the US Federal Reserve cut short-term interest rates by 25 per cent but it had also halted its program of quantitative tightening, or "QT", effective immediately.

Admittedly QT, under which the Federal Reserve has been shrinking its balance sheet by not rolling over some $US35 billion of its maturing holdings of debt securities each month, only had a further two months to run. But the decision to end the program early cancels an expected additional $US70 billion contraction in the supply of US dollars, and means $US70 billion more demand for US treasuries over the next two months, relative to earlier expectations.

This represents a significant easing and a material *downward* influence over the value of our Australian dollar and alternatives such as Australian government bonds.

Temptations abound but, as Thatcher also taught us, "one way to destroy functional markets is to devalue a currency".

Stirling Larkin is chief investment officer of [Australian Standfirst](www.australianstandfirst.com) (www.australianstandfirst.com).

Stirling Larkin writes on global investing and ultra high net worth wealth. He is chief investment officer of investment manager Australian Standfirst.