

AUSTRALIAN DOLLAR DRIVERS AND THE IMPACT ON GRAIN PRICES

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Volatility in the Australian Dollar (AUD) has been a massive factor in grain prices over the last month. As a result, the Farmanco Marketing Team believes it is important to understand the major factors that influence the AUD/USD exchange rate. It is vital to have an understanding of the current situation and how this impacts the domestic price of grain for the remainder of the year.

In the last month we have witnessed the AUD against the US Dollar (USD) exhibit the kind of volatility not seen since late 2008 when the Global Financial Crisis first hit. While the falls haven't been as severe as 2008, there has still been some very impressive intra-week movements. At the height of the panic in 2008, the AUD dropped eight cents against the USD in a week. In the last month the AUD fell six cents in a week, which is nothing short of spectacular. About 5 years ago, before extreme volatility became the norm, a typical yearly trading range for the AUD was around ten cents. At the best of times predicting the direction of the AUD is fraught with danger.

We felt that it would be timely to touch on the broad factors that are affecting the AUD as the landscape has changed in such a short timeframe. In no particular order, the three key drivers for the AUD are as follows:

- Interest rate differentials between Australia, USA and Japan.
- Commodity prices.
- Global economic sentiment.

Earlier this year all three of these factors were quite positive. In the past month, however, uncertainty has returned to global markets.

INTEREST RATE DIFFERENTIALS

Over the last few years there has been a lot of talk about the 'carry trade'. The carry trade is where a person borrows money in a country where interest rates are low (USA or Japan) and invests in a country where interest rates are higher (Australia). The investor then picks up the difference. In this example, the investor is selling USD or Japanese Yen (JPY) and buying the AUD. This transaction puts downwards pressure on the USD and JPY and upward pressure on the AUD. Current interest rates in the USA are 0.25% and 0.10% in Japan, while interest rates in Australia are 4.50%. All things being equal, the investor is picking up the difference between the two official interest rates.

This is not a risk free strategy though, as the investor will be exposed to adverse movements in the exchange rate between the two countries (i.e. if the AUD strengthens the investor wins, if it weakens the investor loses).

At the start of the year the outlook for Australian

interest rates was that they would rise. Both Japan and the US appear to be reluctant to raise official interest rates, therefore, the interest rate differential was expected to widen. This has changed somewhat with fears of a widespread sovereign debt crisis in Europe. Because of the problems in Europe, the Reserve Bank of Australia (RBA) has signalled a pause in interest rate rises for the medium term. This has diminished the attractiveness of the carry trade as the interest rate differential is not widening out.

Investors are very nervous that the debt problems Greece is having could spread to other countries like Spain, Portugal, Ireland and Hungary. In this situation, they are less likely to invest in countries like Australia, instead seeking the 'safe havens' of Japan and the US. If this happens they will not participate in the carry trade – putting downward pressure on the AUD.

COMMODITY PRICES

The financial problems are not just confined to Europe. There is talk that China's economy appears to be slowing. If China's demand for raw materials slows then commodity prices are likely to come under pressure. Australia is very much a commodity driven economy, therefore movements in commodity prices will have a direct influence on the AUD. Chart 1 shows the strong correlation between the AUD and commodities (in this case copper).

China is in the process of attempting to slow its overheating economy without suffering a decline in growth. If China's economy experiences a marked slowdown, demand for raw materials will decline resulting in lower prices and downward pressure on the AUD.

GLOBAL ECONOMIC SENTIMENT

Finally, the AUD is seen as a barometer for global economic sentiment. When there is a perception that the global economy is performing well, investors have an appetite for risk and the AUD strengthens. When this perception changes, which can happen very quickly, market participants become risk averse and the AUD weakens.

The AUD is currently the sixth most traded currency in the world. This means a lot of liquidity that allows investors to get in and out in large volumes. Whenever sentiment turns sharply lower, like it did in August 2008, the AUD is capable of very impressive downward movements. On Monday 17th May the AUD touched a high of \$0.8684. On Friday 21st May it touched a low of \$0.8070 as news of the Greek debt crisis gathered momentum. This is a fall of over six cents which, from a historical perspective, is a very large weekly move. This is a good example of how a rapid change in sentiment adversely affects the AUD.

Currently the outlook for the global economy is unclear at best. The AUD will remain very vulnerable to bad news out of Europe. If the sovereign debt issues spread

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to other countries, in addition to Greece, then the AUD will weaken. On the other hand, the AUD will strengthen if these problems dissipate.

EFFECT ON GRAIN PRICES

It is this weakening of the AUD that has given prices a welcome lift and has provided clients the opportunity to start their sales program. Charts 2 and 3 show how the fall in the AUD has resulted in the price rise of wheat and barley.

We feel that this pullback in the AUD and subsequent rise in domestic cash prices represents a good opportunity to begin sales. The recent weakness in the AUD won't necessarily continue if the problems in Europe subside. With so many unknown variables affecting the AUD there is just as much chance of it being over \$0.90 at the end of the year as being under \$0.80.

TAKE HOME MESSAGE

Very large world wheat stocks and another large production year, coupled with a relatively high AUD/USD exchange rate, means it's unlikely that there will be significant upside in prices. This year's global wheat crop could be down 1% from last year, but it will still be the third biggest crop in history if realised – 672 million tonnes (mmt). This means that world stocks are likely to stay at a similarly high level to last year (09/10 = 193mmt, 10/11 = 198mmt). These numbers, in our opinion, make it difficult to see much upside in wheat this year. The big caveat on this, of course, is where the AUD trades over the rest of the year.

Predicting the direction of the AUD is a dangerous occupation. The driving forces are diverse and complex. For a farm business to risk the profitability of their enterprise on an assumption on the exchange rate is a gamble. Growers should view this as an opportunity to look at taking some price coverage, particularly on wheat, as the AUD above \$0.90 at the end of the year will be detrimental to price. 🌱

Chart 1: Relationship between copper and the AUD..

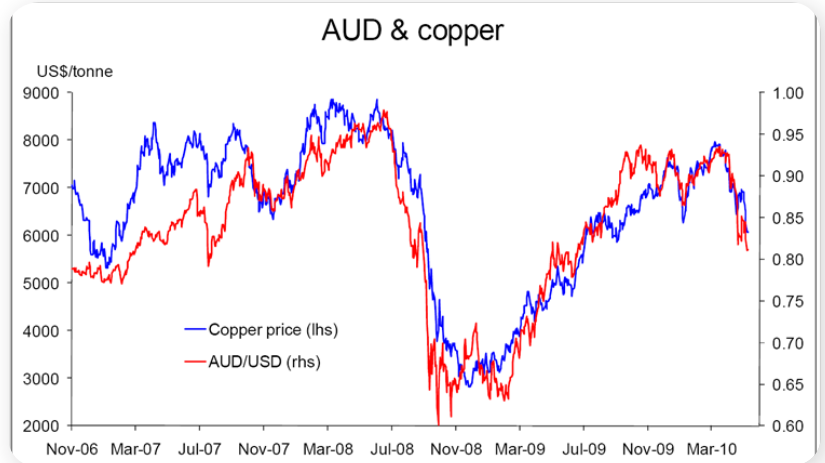


Chart 2: AUD Vs GA1 in Kwinana port zone.

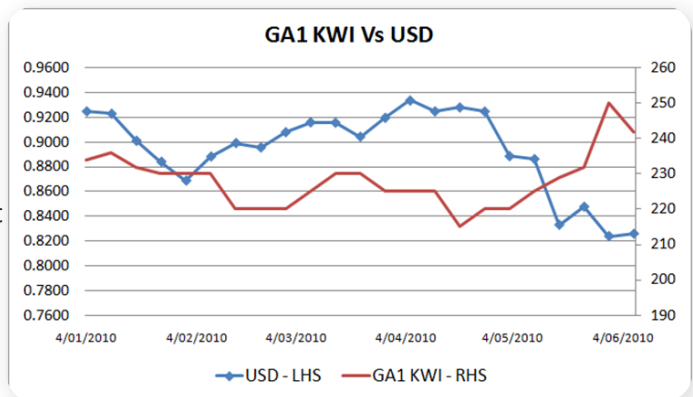


Chart 3: AUD Vs APW in Kwinana port zone.

