

Commodity Prices, Gold and the Aussie Dollar

In June of last year, we set out our rationale for believing that the Australian dollar had bottomed and why we thought we would see a USD/AUD of 65-70 on a one-year view.¹ Almost 12 months on, the AUD has belatedly started to move up albeit not at the speed or to the extent we had envisaged at the time. Nevertheless, we continue to believe that the Aussie still has a lot further to go over the coming year for most of the same reasons we presented in 2001. And given that we spent much of last week down under, now seemed an opportune time to restate our arguments. So with the blood having drained back down towards our feet...

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To recap, our thesis for being long the AUD and by implication other commodity currencies is predicated on both monetary and real economy arguments. In essence, we continue to believe that two factors will drive a major shift in relative prices over the next year or so – the internal devaluation of fiat currencies and supply imbalances resulting from an extended period of investment flow distortions.

Nevertheless, we still see a USD/AUD of 65-70 on a one-year view

We begin with a spot of monetary history. Ever since coinage first appeared in Sumeria *circa* 3700 BC, the sanctity of monetary standards has been reliant on the underlying hard backing for the unit of exchange. The general empirical experience has been that commodity standards have been abandoned either when leaders have wished to finance major expansions in public expenditure (which pre-twentieth century normally meant the desire to go to war), or when the pressures to mitigate the deflationary consequences of the hard asset backing became too acute. Either way, the experience was almost always uniform; the value of fiat devalued in relation to the underlying physical asset.

Monetary policy conduct during the period since the 1970s has been an historical aberration

Set against the history of the previous 5700 years, the period since the 1970s has been an aberration. It started off in a pretty classic manner. Richard Nixon's devaluation of the USD relative to gold in 1971 and his subsequent abandonment of the gold standard in 1973 were implemented for the good old-fashioned reason of military campaign funding. The Yom Kippur war in October 1973 then served to drive inflation even higher setting in motion a massive rise in the price of gold both in absolute terms and relative to paper assets. Enter one Paul Volker in 1979 with a mandate to crush inflation; a monetary stance that was reflected at the central banks of the world's second and third largest economies, Japan and Germany. And for the next

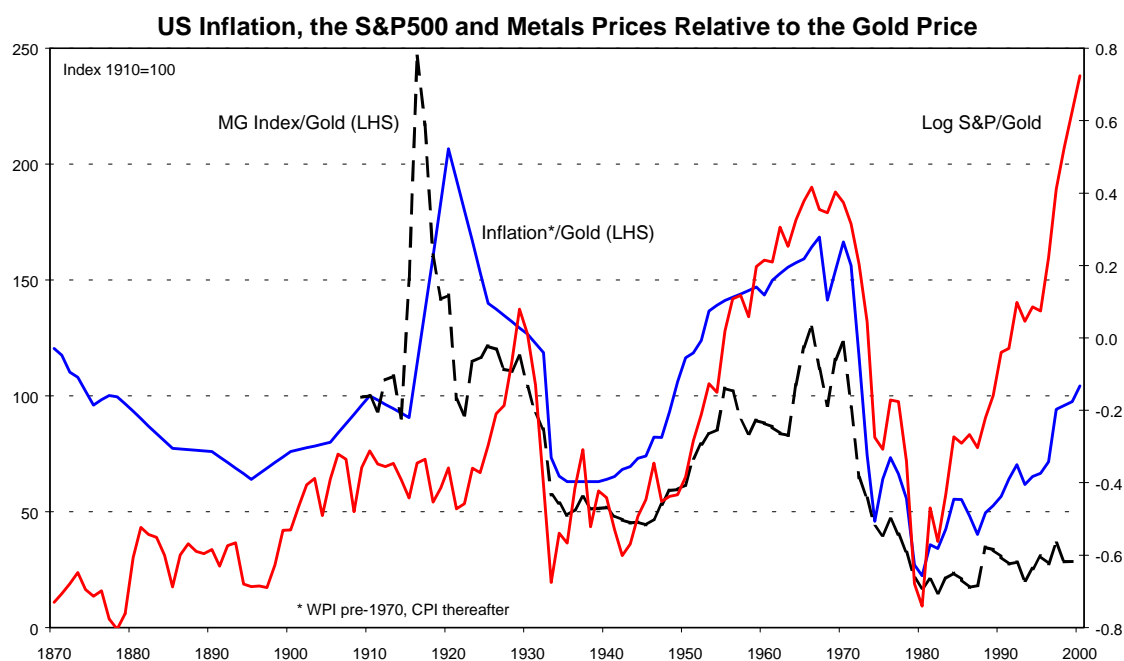
Price rises were tamed under a fiat monetary standard...

¹ See "Australia – Digger's Revenge", June 4th 2001.



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twenty years, price rises were tamed under a fiat monetary standard overseen by generally competent central bankers. The result was that gold's lustre as a store of value diminished while paper assets under the backing of a 'hard' fiat standard saw a massive revaluation.



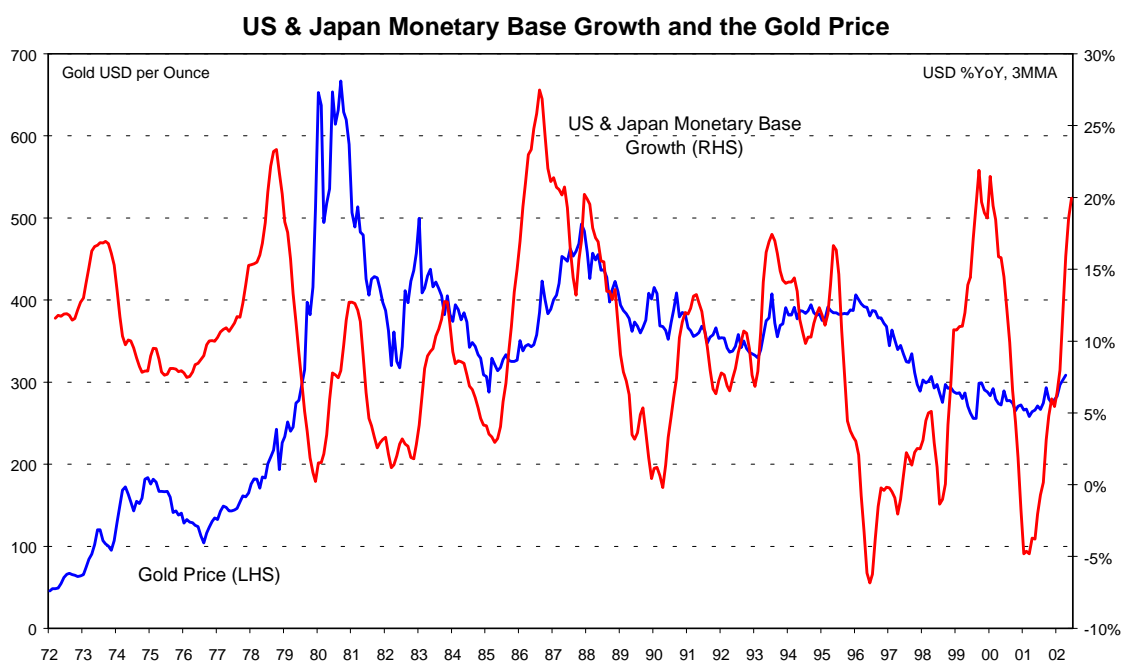
The long-term chart above illustrates many of these trends. First note the great deflation of the post Civil War 1800s which we have written at length about in the past.² With a few interruptions, the US economy was on a gold standard during this period and this helped accommodate a high 4.5% average annual rate of real income growth and steady stock market gains, albeit with considerable volatility. World War I caused a massive spike in inflation but as this subsided so stocks took off only to land with a bump in the 1930s. Partly as a result of huge negative output gaps at the start of World War II, the late 1940s inflation was less severe than after the previous conflict and the monetary stability re-established in 1948 set the stage for a period of sustained growth and stock market appreciation through to the late 1960s.

...thus gold's lustre as a store of value diminished

² See for example: "The Price is Right – Disinflation Versus Deflation", April 17th 2001.

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Finally, post the traumas of the 1970s, the 1980s and 1990s saw trust in central bankers as the guardians of price stability build and build with the result that gold started to behave like other physical metals. So while the real price of gold has reverted to its long-term average, its value relative to paper assets has fallen to historically unprecedented levels.³



The second chart above shows the gold price's response under discretionary monetary policy as proxied by USD base money growth in America and Japan.⁴ Note how gold's responsiveness to base money volatility has diminished in the 1990s again suggesting that the financial markets have come to trust the central bankers more and more. (The Y2K spike was

Gold's value relative to paper assets has fallen to historically unprecedented levels

³ See also: Tim Lee, "The Global Financial Adjustment is Far From Complete", *DSGAsia*, October 10th 2001.

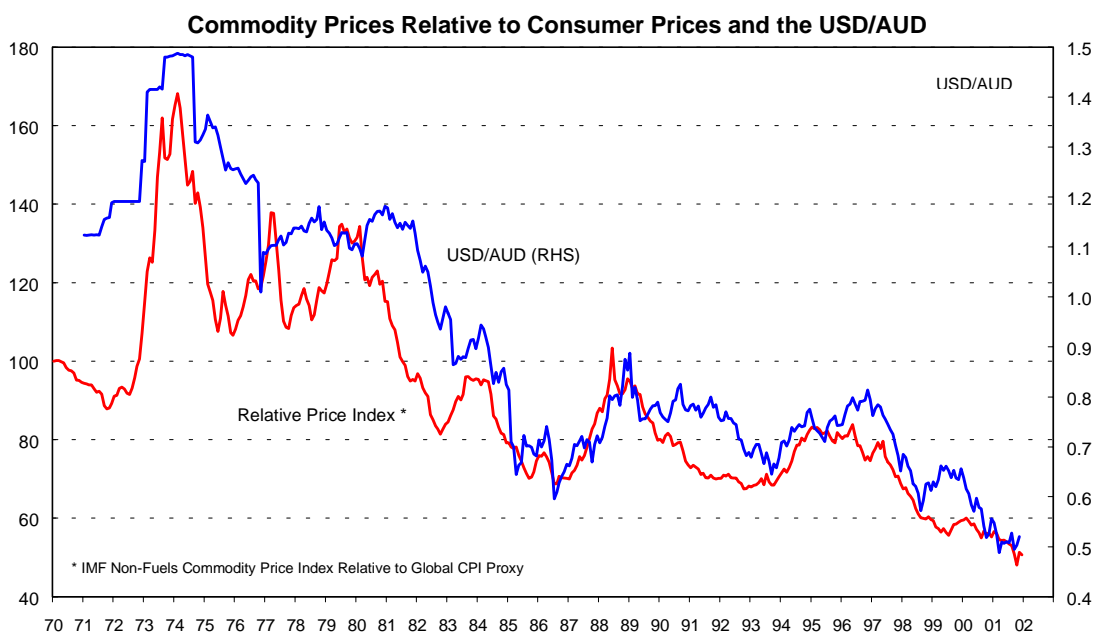
⁴ Interestingly enough, base money levels in Japan and the US are around the same now but the sputtering nature of the transmission mechanism in the former has resulted in broad money being half the level of that in the latter.

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interpreted as being temporary and was indeed reversed rapidly.) The recent surge in base growth is one to watch since we interpret this as the first leg of a sustained period of extraordinary liquidity creation. The Fed especially is attempting to bring paper asset valuations back nearer to reality by ensuring that prices do not collapse but values normalise via a prolonged sideways move, which allows underlying income streams to catch up.

While such trends should accommodate a rise in the gold price relative to the US dollar, US inflation and US assets, it should also be reflected in a rise in the relative prices of other commodities and thus drive a revaluation of commodity-based currencies. We reproduce below our chart of the USD/AUD plotted against an index of non-fuel commodities relative to global CPI. We would again stress that we are making a relative call here based on both monetary analysis and the idea that there has been substantial over-investment in manufacturing and technology, and under-investment in many extraction industries. This investment imbalance should serve to keep a cap on the ability of companies to raise prices at the retail level but should also accommodate slightly firmer resource prices on the assumption that underlying consumer demand will still be growing steadily.

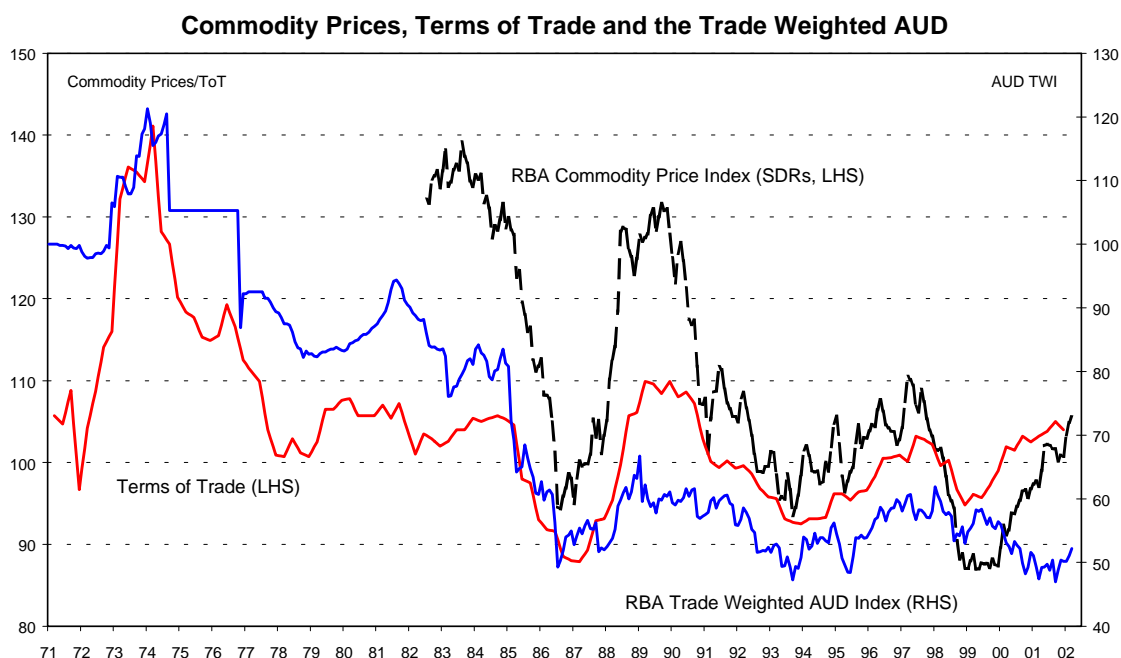
The recent surge in base growth is the first leg of a sustained period of extraordinary liquidity creation.



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While we are not looking for a relative price surge *à la* the early 1970s, such trends could easily drive the Aussie 20% or so higher on our opinion. Indeed as the chart below suggests, terms of trade improvements and commodity price rises over the last two years already suggest that the AUD is lagging behind fundamentals. Some of this was explained in 2000 by Australia's lack of 'sexy' investment stories, which was driving greater and greater superannuation and real money flows overseas. A lack of sexiness is sometimes a virtue though and a reassessment may be getting underway. Especially if tech continues to perform poorly as we believe it will do.

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The strong currency argument can be further reinforced by a number of additional factors. First, as we have been predicting for a number of months, the RBA has started to tighten monetary policy. Australia is probably operating nearer to full capacity than almost any other developed economy with all sectors of the economy performing strongly. Business and consumer confidence are rising, retail sales and corporate investment are humming along nicely, and rapid (though not broadly excessive) gains in

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property values seem likely to simulate consumer expenditures further.⁵ We suspect that the 0.25% move in the cash rate served up last week will not be the last by any means and that short rate differentials will move further in Australia's favour as the year progresses.

One area of concern is the current account deficit, which has widened again into Q4 2001 to 3.7% of GDP from 1.8% of GDP in the previous quarter. And while this seems likely to deteriorate further as Australian growth outstrips most of its peers, the deficit is a long way away from the 6.1% of GDP gap recorded in late 1999, and moreover should be easily financeable.

The current account deficit should be easily financeable

If we are correct on the relative attractiveness of the AUD and interest rate differentials, then the country should see incremental currency and bond inflows from international managers. We also suspect that while regional equity managers have been running down Australian positions to fund purchases elsewhere in Asia, this process is pretty much complete. And if superior growth continues to come through, then we may even see some additional 'safe-haven' allocations from larger international mandates. Finally, if the resource sector does turn out to be an outperformer as we believe, then we may also see direct investments going back down under. Shrimp on the barbie anyone?

Shrimp on the barbie anyone?

⁵ Australia's housing market has pockets of excess but the quality of local balance sheets is superior to those in America as fewer Australians have extracted equity from their houses to fund current consumption. See: "Assessing the Wealth Effect in Asia", February 19th 2002.



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