

Economic Strategy

Why is the Australian dollar so strong?

Aggressive rate cuts by the Fed led the US dollar to fall and Australian dollar to rise.

In recent days, some of you have asked me 'why is the Australian dollar so strong'? From a level of US65.5 cents at the end of July 2019, the Australian dollar had fallen to a low of US55.08 cents in March 2020. From that level, it rose to a peak of US70.65 cents in June. At the time of writing, it has eased slightly to US69.3 cents on 24th June.

The answer to why the Australian exchange rate is so strong can be found by looking at floating exchange rate theory. This is one of the few occasions in economics, where what you would expect to happen in theory, actually happens in practice. What matters to the level of a floating exchange rate, is determined by the relative level of prices in the two countries, setting their exchange rate and the relative level of bond yields in each of the two countries. We can adjust the level of the nominal exchange rate, by the ratio between the two price levels.

By adjusting the nominal exchange rate by the ratio of prices in both countries, we are able to calculate what is called the real exchange rate. The real exchange rate of the Australian dollar can be expected to go up when Australian bond yields are rising, relative to US bond yields. The Australian dollar can be expected to go down when Australian bond yields are falling, relative to US bond yields. So, what has been happening over the period of this financial year?

Back at the end of July 2019, when the Australian dollar stood at US68.48 cents, Australian 10-year bond yields were 1.184%. US 10-year bond yields were 2.015%. This means that Australian 10-year bond yields were 0.83% below US bond yields. In that circumstance, we would expect the Australian dollar to fall, and the US dollar to be stronger. This process was triggered when we got into the pandemic crisis, which hit financial markets in March 2020. The flight to quality, out of all international assets into the US dollar, drove the US dollar up and the Australian dollar down.

In response, the US Federal Reserve made aggressive cuts in the US Fed funds rate. The Federal Reserve database tells us that the effective Fed funds rate fell from 2.4% at the end of July 2019, to 0.05% in March 2020. It has remained at that level ever since. The result was that US 10-year bond yields fell dramatically from 2.015% at the end of July 2019, to 0.659% at the end of March 2020. This was a decline of 1.36%. Australian 10-year bond yields fell from a level of 1.184% at the end of July 2019, to 0.758% at the end of March 2020. This was a decline of 0.43%.

Importantly, US bond yields had fallen by 0.93% relative to Australian 10-year bonds. This big move in relative interest rates, in favour of the Australian dollar, set up the rally that was to follow. As a result of this dramatic cut in US interest rates, the Australian dollar began to rise.

Over the next month, Australian 10-year bond yields rose further, and US 10-year bond yields fell further. Australian 10-year bond yields rose by 0.14% to 0.89%. US 10-year bond yields fell slightly to 0.64%. **This meant that Australian 10-year bond yields had risen by 1.08%, relative to US bond yields, since the end of July 2019.** This led the rise in the Australian dollar to accelerate. This larger difference between the bond yields was the final factor driving the Aussie dollar up to US70.65 cents. Since that time, the difference in bond yields has declined slightly, and so has the level of the Australian dollar.

A model containing variables, including those above, explains 87% of monthly variation of the Aussie dollar exchange rate. Fair value of such a model currently stands at US69 cents. It is possible for the Australian dollar to rise further, but the rally caused by the drop in US interest rates is already fully absorbed by the price.

Conclusion

The rally in the Australian dollar between March and June 2020, demonstrates that sometimes things in economics can work exactly the same as they do in theory. The aggressive cuts in the Fed funds rate by the US Federal Reserve, have led to a situation where US bond yields fell dramatically, relative to Australian bond yields.

This yield advantage then caused the rapid recovery in the Australian dollar which has occurred since March. This rally now seems to be followed by a pause.

Michael KNOX

T (61) 7 3334 4876

E michael.knox@morgans.com.au

Queensland

Brisbane	+61 7 3334 4888
Stockbroking, Corporate Advice, Wealth Management	
Brisbane: Edward St	+61 7 3121 5677
Brisbane: Tynan	+61 7 3152 0600
Partners	
Brisbane: North Quay	+61 7 3245 5466
Bundaberg	+61 7 4153 1050
Cairns	+61 7 4222 0555
Caloundra	+61 7 5491 5422
Gladstone	+61 7 4972 8000
Gold Coast	+61 7 5581 5777
Holland Park	+61 7 3151 8300
Ipswich/Springfield	+61 7 3202 3995
Kedron	+61 7 3350 9000
Mackay	+61 7 4957 3033
Milton	+61 7 3114 8600
Newstead	+61 7 3151 4151
Noosa	+61 7 5449 9511
Redcliffe	+61 7 3897 3999
Rockhampton	+61 7 4922 5855
Spring Hill	+61 7 3833 9333
Sunshine Coast	+61 7 5479 2757
Toowoomba	+61 7 4639 1277
Townsville	+61 7 4725 5787

New South Wales

Sydney	+61 2 9043 7900
Stockbroking, Corporate Advice, Wealth Management	
Sydney: Grosvenor	+61 2 8215 5000
Place	
Sydney: Reynolds	+61 2 9373 4452
Securities	
Sydney: Currency	+61 2 8216 5111
House	
Armistdale	+61 2 6770 3300
Ballina	+61 2 6686 4144
Balmain	+61 2 8755 3333
Bowral	+61 2 4851 5555
Chatswood	+61 2 8116 1700
Coffs Harbour	+61 2 6651 5700
Gosford	+61 2 4325 0884
Hurstville	+61 2 8215 5079
Merimbula	+61 2 6495 2869
Mona Vale	+61 2 9998 4200
Neutral Bay	+61 2 8969 7500
Newcastle	+61 2 4926 4044
Orange	+61 2 6361 9166
Port Macquarie	+61 2 6583 1735
Scone	+61 2 6544 3144
Wollongong	+61 2 4227 3022

Victoria

Melbourne	+61 3 9947 4111
Stockbroking, Corporate Advice, Wealth Management	
Brighton	+61 3 9519 3555
Camberwell	+61 3 9813 2945
Domain	+61 3 9066 3200
Geelong	+61 3 5222 5128
Richmond	+61 3 9916 4000
South Yarra	+61 3 8762 1400
Southbank	+61 3 9037 9444
Traralgon	+61 3 5176 6055
Warrnambool	+61 3 5559 1500

Western Australia

West Perth	+61 8 6160 8700
Stockbroking, Corporate Advice, Wealth Management	
Perth	+61 8 6462 1999

South Australia

Adelaide	+61 8 8464 5000
Exchange Place	+61 8 7325 9200
Norwood	+61 8 8461 2800
Unley	+61 8 8155 4300

Australian Capital Territory

Canberra	+61 2 6232 4999
----------	-----------------

Northern Territory

Darwin	+61 8 8981 9555
--------	-----------------

Tasmania

Hobart	+61 3 6236 9000
--------	-----------------

Disclaimer

The information contained in this report is provided to you by Morgans Financial Limited as general advice only, and is made without consideration of an individual's relevant personal circumstances. Morgans Financial Limited ABN 49 010 669 726, its related bodies corporate, directors and officers, employees, authorised representatives and agents ("Morgans") do not accept any liability for any loss or damage arising from or in connection with any action taken or not taken on the basis of information contained in this report, or for any errors or omissions contained within. It is recommended that any persons who wish to act upon this report consult with their Morgans investment adviser before doing so. Those acting upon such information without advice do so entirely at their own risk.

This report was prepared as private communication to clients of Morgans and is not intended for public circulation, publication or for use by any third party. The contents of this report may not be reproduced in whole or in part without the prior written consent of Morgans. While this report is based on information from sources which Morgans believes are reliable, its accuracy and completeness cannot be guaranteed. Any opinions expressed reflect Morgans judgement at this date and are subject to change. Morgans is under no obligation to provide revised assessments in the event of changed circumstances. This report does not constitute an offer or invitation to purchase any securities and should not be relied upon in connection with any contract or commitment whatsoever.

Disclosure of interest

Morgans may from time to time hold an interest in any security referred to in this report and may, as principal or agent, sell such interests. Morgans may previously have acted as manager or co-manager of a public offering of any such securities. Morgans affiliates may provide or have provided banking services or corporate finance to the companies referred to in the report. The knowledge of affiliates concerning such services may not be reflected in this report. Morgans advises that it may earn brokerage, commissions, fees or other benefits and advantages, direct or indirect, in connection with the making of a recommendation or a dealing by a client in these securities. Some or all of Morgans Authorised Representatives may be remunerated wholly or partly by way of commission.

Regulatory disclosures

Analyst owns shares in the following mentioned company(ies): N/A

Recommendation structure

For a full explanation of the recommendation structure, refer to our website at morgans.com.au/research_disclaimer

Research team

For analyst qualifications and experience, refer to our website at morgans.com.au/research-and-markets/our-research-team

Research coverage policy

For an overview on the stock selection process, refer to our website at morgans.com.au/research-and-markets/company-analysis/Research-Coverage-Policy

Research independence statement

morgans.com.au/Research-Independence-Statement

Stocks under coverage

For a full list of stocks under coverage, refer to our website at morgans.com.au/research-and-markets/company-analysis/ASX100-Companies-under-coverage and morgans.com.au/research-and-markets/company-analysis/EX-100-Companies-under-coverage

morgans.com.au

If you no longer wish to receive Morgans publications please contact your local Morgans branch or write to GPO Box 202 Brisbane QLD 4001 and include your account details.