# Perennial Perspective

**Frank Uhlenbruch**
Investment Strategist

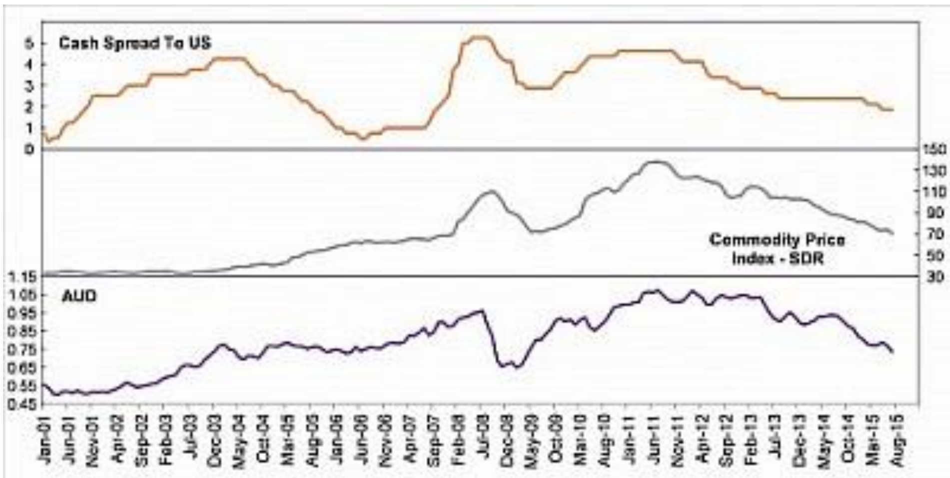
## Aussie Battler Battered

It's been some time coming, but it looks as though the currency is finally catching up to fundamentals. It was price signals from commodities that triggered the mining investment boom and helped push the currency up and now as the supply of these commodities is increasing, the price for many is falling.

Typically, as commodity prices fall, so does the Aussie dollar. However, this cycle has been a little different with falls in the currency lagging falling commodity prices. This has created significant problems for the Reserve Bank who were looking for a weaker currency to help the economy find alternative sources of growth as it went over the so called "capex cliff".

As the chart of cyclical exchange rate drivers below shows, most of the exchange rate fall has come more recently. There was a period between the second half of 2011 and early 2013 when short term interest rate differentials with the US were narrowing and commodity prices were falling, yet the Aussie dollar remained largely range bound. It's only since the second half of 2014 that the Aussie dollar has made a more decisive move lower.

**Cyclical Exchange Rate Drivers**




Source: RBA, Bloomberg, Perennial

Since their peak in mid-2011, commodity prices in SDR (or currency weighted) terms have almost halved. The Aussie dollar, which peaked in August 2011, is now around a third lower. Of that fall, most occurred from the second half of 2014 onwards. The latter move is important because it is beginning to take some pressure off the Reserve Bank of Australia (RBA) who are worried that monetary policy is carrying a disproportionate load of the economy's adjustment task.

**So where to from here?**

We expect that the currency still has further to fall but that a large part of the downward adjustment has already occurred. Our AUD targets for the end of 2015 and 2016 are 0.72 and 0.69. For the economy, the latest leg down in the exchange rate should add to both growth and inflation. RBA modelling suggests that a 10% fall in the exchange rate boosts GDP by 0.5% to 1.0% over two years and boosts inflation by 0.25% to 0.5% over each of the following two years. We suspect that the RBA is reluctant to ease further, cognisant of the limitations of monetary policy, but prepared to do more if forced. The recent battering the Aussie battler has taken makes it more likely that investors will be faced with a 2% cash rate until 2017. By then, the worst of the capex fall should be behind us and public sector infrastructure and non-mining investment should be recovering.