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FX 2011

CURRENCY COMPASS

REDBACK RISING

HEDGING - MASTERING UNCERTAINTY

RISK-ON, RISK-OFF DOMINATES MARKETS

In association with CommonwealthBank

EDITOR'S LETTER

To hedge, or not to hedge:
that is the question,
Whether 'tis nobler in the mind
to suffer the slings and arrows
of currency fluctuation,
Or to take arms against a sea
of losses,
And by hedging, avoid them.

With due apologies to Shakespeare and Hamlet, to hedge or not to hedge is the question most often posed in this supplement, even if implied, and the answer from our experts has been a resounding yes.

How the Aussie dollar has become the world's fifth most traded currency since it was floated is a compelling question.

It obviously reflects Australia's affluence and massive trade in goods and services. Investment in mining, energy and agriculture must account for a lot of it too.

Some of that turnover, a good deal of it, must be trade in the currency itself. Why not? It is backed by a stable economy and government, liquid markets, and offers the nimble operator a useful degree of volatility.

About a year ago Insto ran a preview of the 2010 G20 Summit, setting the scene for a possible confrontation between the US and China over the Renminbi. The tussle has continued this year with US threats and legislative stunts not making that much difference.

What has surprised us though is the speed at which China has internationalized the RMB through its CNH currency. Experts are saying that the full flotation process could take five to 10 years, instead of the decades previously imagined. Officials are heard suggesting that capital account convertibility could occur by 2015 – a rhetorical flourish, one suspects.

Least expected is the nonchalance with which experts discuss the RMB's ascendance in opposite step with the dollar's decline, as they see its dominance begin to slowly fade.

Regards,
Eric Meijer, Editor

AUSSIE RIDES HIGH ON ASIA WAVE

Asia's vast demand for resources has ushered the Australian dollar into a new epoch that could last for decades, writes **Colin Packham**

THE AUSTRALIAN dollar's wait to reach parity with the US dollar after flotation in 1983 was a long 28 years. The Aussie had flirted with parity before, but it finally broke through on 15 October 2010. After slipping back almost immediately, the Australian dollar settled above parity during early 2011.

A glance at the economic fundamentals shows how Australia's currency managed to reach this strength. While many nations had been forced to keep interest rates hovering around zero, Australia's high interest rates offered a great return. The size and scope of the Australian economy caught the eye of central banks keen to acquire Australian dollars to diversify away from weak US dollars. Hot-money demand and the high prices fetched by coal and iron ore exports drove the terms of trade to levels not seen since the 1970s.

The Euro storm

While the Australian dollar continued to perform strongly during 2011, the European debt crisis began to bite hard in the later half of the year and the Australian dollar slid to below parity. For Jonathan Cavenagh, senior FX strategist for Westpac, the fall was caused by waning confidence in the global economy.

"What drove the Aussie dollar down to the lows was the concern by the market that the world was on the cusp of another global financial crisis," Cavenagh says. "The market was getting very bearish, there were concerns coming out of the US that growth was slowing down, commodities were coming down, and there were concerns that the Asian economies – which have been a real driver of global economic activity – were also cooling, so the dollar fell to a low of 93 cents."

The downward trend did not last and parity was soon restored. So what happened? Tim Waterer, CMC Markets foreign exchange dealer, said the recent commitment from the European leaders to tackle not only a potential Greece default but also the long-term funding needs of European banks, has reassured the market that a spread of contagion need not occur. Better-than-expected US retail spending and job creation numbers did the rest. Waterer describes the Australian dollar as the "confidence currency" – when the outlook is good, the dollar appreciates, when bad, it depreciates.

Bumps in the road

How the Australian dollar fares is very much down to how financial markets react to proposed solutions to the Greek debt crisis.

Should the recovery plan fail to win market confidence and the EU falls into recession, a global slowdown including China looks almost inevitable, with a matching fall in commodity demand spreading to Australian economic growth and employment.

Reduced demand for export commodities which are also earning lower prices would be offset by a weakening in the Australian dollar, provided the Reserve Bank does not need to keep interest high to contain inflation.

Westpac's Cavenagh believes the Australian dollar is likely to fall again in coming months. "In the near-term, I suspect it can continue to push higher in the next few weeks. However, as we move into 2012, I suspect there is more downside risk than there is upside risk." Cavenagh says.

"I do think the global economy is still cooling, China is slowing, commodity prices are coming off the boil, the RBA will more than likely cut interest rates, and that combination of events will send the Aussie down through the parity level to the low 90 cent region."

CMC's Waterer, however, is bullish for the next few months. The trader believes news from China will be less negative than many are forecasting. His 2012 A$ forecast is an average of US$1.05.

CBA's Capurso says his bank's model tests two scenarios: "Europe muddles through, or it doesn't." If the European Union reaches a reasonably durable agreement, he sees the Australian currency reaching US$1.05. Without a lasting agreement, the Australian dollar will go "lower, well lower."

A new normal

While the near future is a topic of debate, there appears to be an emerging consensus that in the long term the Aussie dollar will remain at higher average levels against the greenback, although analysts differ on the range of this "new normal."

The logic is not difficult to follow. Given Australia's position as a supplier to the Asian economies and the region's phenomenal growth, the Aussie should stay strong on the terms of trade alone.

The difficulties that China and India have faced with inflation as their economies have grown has prompted varied policy measures to curb price growth, but few analysts question the vast economic potential of China and to a lesser extent India. Cavenagh concludes that both countries may experience cyclical waves but that demand for Australian commodities is still "very much likely to be there".

HSBC estimates that Australia will have the fourth-fastest rate of trade growth in Asia over the next 15 years. Trade will increase by about 130 percent by 2025, nearly double the pace of world growth and easily outpacing Asia's average over the same period. Australia will be the world's second-fastest growing exporter and the seventh-fastest growing importer, HSBC said.

Cavenagh believes the Aussie dollar may have reached a new epoch, with an average value between 80 and 120 US cents over the next decade.

For CBA's Capurso "the re-emergence of China and India as world economies has led to a structural step-up in commodity prices, and in turn that has led to a structural step-up in the Aussie dollar. The dollar will still move in a range of 15-20 cents a year, but the average level of the Aussie dollar will be higher in the future." (CBA's model puts the dollar average in the 85-90 cents range.)

Asian not-so-minors

While the Australian dollar is likely to appreciate against the US dollar, emerging market currencies economies are mixed.

Capurso says generally emerging Asian currencies such as the Malaysian and Indonesian rupees track the movements in the dollar. CBA forecasts that the emerging Asian economies will grow faster than Australia, leading to an easing of the dollar against currencies of that type.

"Over the medium term you are likely to see the Aussie dollar weakening against emerging market currencies," concurs Cavenagh. ■

PRESSURE GRADIENT

The volatile Australian dollar has been portrayed by the media and financial analysts as hurting trade, but in reality the news is good as well as bad. **By Joseph Capurso**, currency strategist, Commonwealth Bank.

THE AUSTRALIAN dollar trading at parity and above against the US dollar is not always a bad thing for Australian companies. Although exporters can be negatively impacted by a high Australian dollar – and a volatile currency market can create uncertainties for companies trading overseas – the Australian dollar's current strength has a positive effect on importers. The Commonwealth Bank's *Aussie Dollar Barometer* looks at how the strong Australian dollar is affecting Australian small and medium enterprises (SMEs), and what they are doing to protect their business in an uncertain market.

Potential impact of the high Australian dollar

Australian economists have made much of how the country is in the grip of a two-speed or multi-speed economy and often blame the high Australian dollar for what they see as a significant disparity.

Indeed, for some Australian organisations, the high Australian dollar has had a negative impact on profits. The recent annual reporting period highlighted several high-profile cases where the strength of the Australian dollar was blamed for disappointing earnings.

Previous editions of the *Barometer* have shown that most exporters believe they become uncompetitive when the Australian dollar moves into the US$0.90 to US$1.00 range. Indeed, this edition reveals that the high Australian dollar is encouraging about 54 percent of exporters to consider cutting jobs. However, the news is not all bad. About 42 percent of exporters and three-quarters of SMEs involved in both exporting and importing say the high dollar has had no effect on their workforce plans.

In addition, about 75 percent of SME importers say the high Australian dollar has no effect on workforce size. In fact, 17 percent of importers said the high Australian dollar has actually encouraged their plans to increase jobs. With 25 percent more importers than exporters in the SME sector, these statistics suggest that the potential fall in SME employment is likely to be modest.

The *Barometer* also reveals that smaller businesses are better placed to deal with a high Australian dollar. Only 19 percent of businesses involved in international trade with annual turnover of A$5 million to A$25 million plan to cut jobs due to the strong dollar. By contrast, that number rises to around 30 percent of businesses with annual turnover of A$150 million to A$500 million. Although the net effect on workforce numbers appears to be negative for businesses involved in foreign trade, most Australian businesses neither export nor import, so the impact on the Australian workforce should not be significant. In fact, jobs in the Australian economy are increasing at a fast enough rate to keep unemployment at only 5.2%.

US dollar exposures

Understandably, importers are currently increasing their US dollar exposure, reflecting a potential expansion in business. However, the *Barometer* indicates that in fact most businesses expect to increase their US dollar exposure in the next three months.

Almost 89 percent of importers expect to increase their US dollar exposure, with an average increase of 48 percent. These high figures further suggest that importers' businesses are in good shape and are benefitting from the Australian dollar's strength.

Of course, the situation for exporters is very different. Only 30 percent expect to increase their US dollar exposure, with the average increase falling to 13 percent from over 50 percent at the beginning of 2010.

However, 80 percent of businesses that both import and export expect to increase their currency exposure, with an average expected increase of 22 percent. These statistics suggest that overall, most SMEs expect the high Australian dollar to result in better business conditions.

Managing currency risk

Whether business is booming or you are looking for ways to reduce costs, it makes good sense to protect your business against currency fluctuations. However, this doesn't have to mean cutting your workforce. Making changes in the way your company operates to ensure processes run more efficiently can keep profits healthy without the need to lose staff.

Hedging currency exposure is another way of managing adverse currency changes. The *Barometer* shows that a growing number of importers are hedging their exposure to lock in the benefits of the Australian dollar before a possible fall.

The *Barometer* reveals that 68 percent of importers plan to hedge their US dollar exposure over the next three months. This is a significant increase on last year's results, where only 40 percent planned to do so, reflecting the increased uncertainty in the dollar's position. The *Barometer* also shows that these importers plan to hedge 64 percent of their US dollar exposure.

> The Barometer shows that SMEs expect the Australian dollar to remain well north of parity against the US dollar for 2012, and to reach new highs in this period.
>
> Joe Capurso

By comparison, 53 percent of exporters plan to hedge their US dollar exposure, a small increase compared to *Barometer* results in April. However, those exporters plan to hedge a significant 74 percent of that exposure.

Businesses that both import and export remain the most willing to hedge their US dollar exposure. Of these businesses, 69 percent plan to hedge and on average will be hedging 74 percent. Hedging plans also differ significantly between businesses of different sizes. Businesses with annual turnover of A$150 million to A$500 million plan to hedge 80 percent of their US dollar exposure. In contrast, businesses with annual turnover of A$5 million to A$25 million plan to hedge only 32 percent.

Aussie dollar predictions

The *Barometer* shows that SMEs expect the Australian dollar to remain well north of parity against the US dollar for 2012, and to reach new highs in this period.

Understandably, importers are the most optimistic, expecting the Australian dollar to peak at US$1.23 by the end of 2011. Exporters expect the Australian dollar to peak at a lower, but still very strong, record of US$1.17 by the end of 2011. Businesses that both export and import expect the Australian dollar to peak at US$1.19 by the end of 2011.

The dollar's recent volatility means it is difficult to predict the next six months with any certainty, so it makes even more sense to put practices in place to protect your business. The *Barometer* clearly illustrates that the high dollar is a double-edged sword, and while there are certainly those who are struggling to maintain profits, the dollar's strength can have a positive impact as well. ■

ABOUT THE BAROMETER

The Commonwealth Bank's Aussie Dollar Barometer has been published every three months since the beginning of 2010. The survey work is conducted by market research and advisory firm East & Partners. For the August 2011 edition, on which this article was based, East & Partners interviewed more than 600 businesses with a turnover of A$5 million to A$500 million per year. East & Partners surveyed businesses from 1 to 11 August 2011. The average value for AUD/USD during the survey period was US$1.05.

The next report will be released on the 30th November 2011. Visit www.commbank.com.au/CorporateFX for more details and to view all the latest reports.

REDBACK **RISING**

Chinese authorities have quickened the pace of Renminbi internationalisation with some bold new moves, writes **Eric Meijer**

WHEN CHINA began the process of internationalising the RMB in earnest it was seen as likely to follow the usual cautious path taken by the authorities to economic reform. But since the campaign began in July last year, the volume of offshore trading and deposits has soared and regulatory changes are being implemented more rapidly.

Hong Kong was the obvious choice for China to begin the internationalisation process, which had begun in part by allowing mainland tourists to draw small daily allowances in Hong Kong.

HSBC says the RMB deposit base in Hong Kong has risen by 80 percent since December last year, and CNH deposits now account for more than 10 percent of the island's foreign currency reserve, taking market share from the traditional US dollar and Euro holdings.

Turnover in the spot CNH market has grown to about US$1.5 billion a day, while the forwards, swaps and options market is seen at US$2.7 billion a day. These are, of course, trivial sums in the context of a US$4 trillion a day global currency market, but they reflect a rapid acceleration from the US$400 million and US$1 billion recorded in early 2011.

Much of the growth in deposits and swaps would have been based on the simple imperative of expected RMB appreciation, seen by financial markets as essential for China to curb inflation, and by some American politicians as crucial to balance the countries' trade positions.

The development of the Dim Sum bond market in Hong Kong has definitely boosted the use of CNH-denominated funds for investment, currency analysts believe.

So far this year Dim Sum bond issuance has reached around RMB140 billion (A$21 billion), more than three times last year's amount. The 2011 year-to-date total includes RMB20 billion issued by mainland China's Ministry of Finance across a range of maturities to promote the market and create a benchmark yield curve.

Until last year, the only offshore RMB hedging tool was a non-deliverable forward contract that settled in US dollars.

For currency strategists, the rate of growth in trade and deposits appears

to portend an acceleration in the internationalisation process, with the RMB now set on a much more rapid trajectory to full convertibility and even reserve currency status.

But for that process to even begin to happen, investors will need access to deep and liquid hedging mechanisms. The forwards market now exists in three forms – onshore deliverable (CNY DF) which began in 1996, offshore non-deliverable (NDF), and offshore deliverable (CNH DF), which were introduced a year ago. Currency analysts say each curve behaves somewhat differently, but they are part of an interconnected system.

The onshore CNY DF market is restricted to onshore corporates hedging with documentation. The onshore banks have limits on their forward FX positions and external debt quotas.

The incumbent RMB market, the offshore non-deliverable forward, is restricted to offshore corporates, institutions and banks. It has provided a simple forward transaction reflecting interest rate differentials between the RMB and US dollar and settles in dollars. Currency strategists say it is influenced by arbitrage with the new deliverable forward market and will become less liquid and more volatile over time as it loses ground to the more dynamic deliverable.

"While CNH options only account for just under 50 percent of NDF liquidity, the market has grown from less than a tenth of the size of the NDF options market since the start of 2011, a phenomenon we see continuing as more investors look to use the offshore CNH market," HSBC said.

At this point, the only bank outside mainland China authorised to clear CNH transactions is the Bank of China, Hong Kong, which it does in tandem with the Hong Kong Monetary Authority, which works closer than a full arm's length from the People's Bank of China.

The HKMA's Treasury Markets Association has commissioned a daily CNH fix, which is calculated by Thomson Reuters from data supplied by 15 banks. Reports suggest that Asia-Pacific countries with currencies normally marked against euro and US dollars are gravitating towards the CNH and its daily fix, and a belief that the CNH will become an Asian currency anchor as China's wealth and power increase.

Chinese authorities, their confidence possibly bolstered by the CNH's successes in Hong Kong, have revealed an intention to expand the CNH market to Singapore and possibly London, still the world's most important currency centre.

The IKON Group, a federation of companies in the trading and software sphere, announced it had formed a strategic alliance with the northern Chinese city of Tianjin, to develop the Financial Electronic Communication Network Exchange, a project it says is worth more than US$3.2 billion.

Whether this strategic alliance eventually bears fruit is currently moot, but it is an interesting occurrence in the development of Tianjin as the next major Chinese financial centre, as mandated by Beijing.

HSBC strategist Daniel Hui told Insto he believed the internationalisation of the RMB was at a point comparable to the European Union in 1991 when it settled the Maastricht Treaty, and brought the Euro into circulation in 2000.

He acknowledges that there are differences in history and politics, but maintains the economic significance is similar.

"The comparison is basically the quality and magnitude of the impact, rather than drawing a close parallel to the process. The impact, what it means for reserve managers, what it means for people who trade in good and services, what it means for capital markets, that's where I want to draw the parallel."

In a follow-up interview, Hui said that 18 months ago the process of taking the RMB to internationalisation; then to capital account convertibility; to first being recognised as a marginal alternative to the dollar; and finally being a core reserve currency, would have been seen taking at least a decade or more.

"Whereas now people are talking about it in terms of five to 10 years, rather than 10 to 20 years. And you have some officials on the mainland suggesting that capital account convertibility could happen by 2015, which is very, very close."

The US Senate has passed legislation that would tackle what it sees as RMB undervaluation. Most analysts do not believe that the bill will be passed by House of Representatives, but it does add a measure of uncertainty to the RMB internationalisation process.

For Hui, however, the message to the bill's supporters is 'be careful what you wish for, you may just get it'. He sees the rise of the redback as more in China's interest than in the United States's because it would be part of the US's need to manage what HSBC sees as the decline of the dollar in international importance.

"The internationalisation of the RMB has longer-term implications for the US dollar that will present somewhat of a challenge for the US in the long term as they seek to manage a gradual decline of the dollar from its position as the pre-eminent reserve currency. The decline of the dollar is part of a much broader secular trend that we expect to play out over the next couple of decades.

"Internationalisation of the RMB by China as a way to strategically position itself against this backdrop of gradual dollar decline is very clearly in China's own interest," he said.

Whether or not the over-rapid internationalisation of the Chinese currency is in the rest of world's best interests is another matter. The flow of news – political, economic, strategic and diplomatic – is an integral part of the headline-driven currency markets. China's central control of major media and censorship of the rest may not retreat as fast as its currency advances.

Combine that information vacuum with China's aggressive attitudes towards Taiwan and Tibet, plus its unfortunate tendency to form alliances with international pariahs, and the potential for complex and unpredictable shocks to a core reserve currency may be much greater than markets would like. ■

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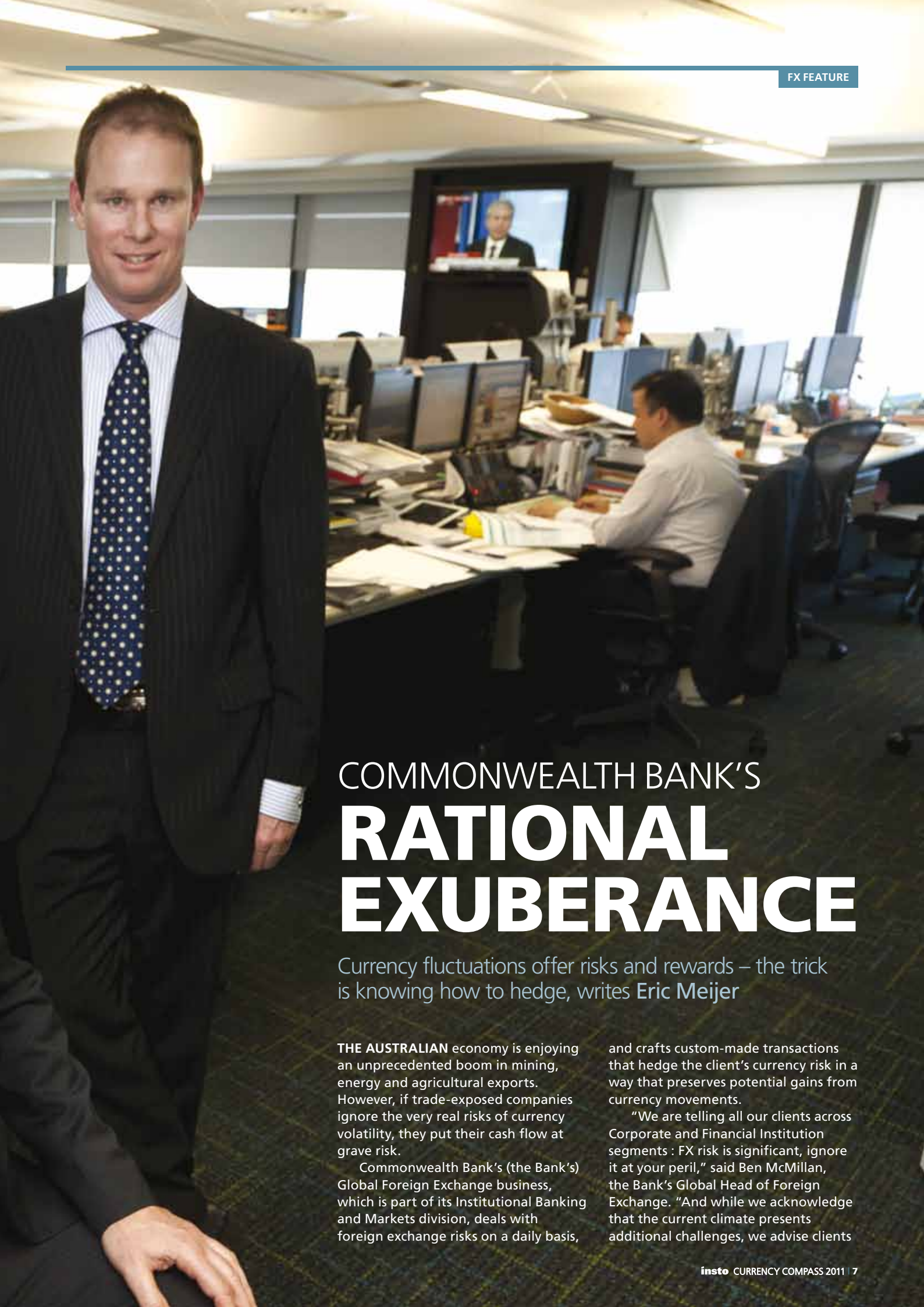
>
> Daniel Hui

FROM L-R: Ben McMillan, Global Head of Foreign Exchange, Michael Sarpi, Head Corporate and Institutional Sales, Richard Grace, Chief Currency Strategist.



COMMONWEALTH BANK'S RATIONAL EXUBERANCE

Currency fluctuations offer risks and rewards – the trick is knowing how to hedge, writes **Eric Meijer**

THE AUSTRALIAN economy is enjoying an unprecedented boom in mining, energy and agricultural exports. However, if trade-exposed companies ignore the very real risks of currency volatility, they put their cash flow at grave risk.

Commonwealth Bank's (the Bank's) Global Foreign Exchange business, which is part of its Institutional Banking and Markets division, deals with foreign exchange risks on a daily basis, and crafts custom-made transactions that hedge the client's currency risk in a way that preserves potential gains from currency movements.

"We are telling all our clients across Corporate and Financial Institution segments : FX risk is significant, ignore it at your peril," said Ben McMillan, the Bank's Global Head of Foreign Exchange. "And while we acknowledge that the current climate presents additional challenges, we advise clients

FROM L-R: The Strategic Solutions Group's Stephen McCabe, Head of Analytical Risk Management, Shane Sentence, Executive Manager Analytical Risk Management, Tom Holt, Analyst, Project Infrastructure.

where we think it's going to impact them and what they can do, what their risk is, and how to hedge it."

"We are seeing volumes in the global foreign exchange markets increase significantly. Even after 2008 they kept going up. A lot of it is driven by algo-trading, which is not fundamental-driven volume. Even so, offshore investment is standard these days, pension funds are still going up, so cross-border flows will continue to increase significantly."

Daily spot trading in Australia has grown by more than 300 percent in the 2007- 2010 period, according to the Bank for International Settlements' (BIS) research, which also found that most of this growth was driven by speculation as well as investment and trade.

In the experience of Michael Sarpi, the Bank's Head of Institutional and Corporate Sales, the increase in domestic foreign exchange volumes is partly driven by the mining boom:"Increased demand for our commodities and higher prices is driving up the demand for Australian dollar. From corporate Australia we are seeing genuine flows," said Sarpi.

McMillan believes separating currency flows is difficult because investors' motives are not always clear.

"It's hard to break it down and see exactly what's driving people's investments at any point in time. I would say we have less speculative flow than other banks, and that we are an investment-focused bank.

"What we have seen recently is sovereign central bank interest in Australian dollar. Now that's obviously not speculative, that's real investment and it's significant," he said.

Sarpi notes: "The increased liquidity in Australian dollar has made the currency attractive, and central banks globally are building up reserves in Australian dollar and diversifying out of US dollar."

"I think we are in a transition period because historically the Australian dollar was seen as a high-risk currency," said McMillan. "Relative to other currencies, it's quite volatile. In the past, when international crises have erupted, the Australian dollar sold off very quickly because of perceived risk. Currently, we're in a transition where the Australian dollar is potentially going to go from a very risky to a very safe currency. We're somewhere in between now."

For McMillan and Sarpi, the Bank's currency services are primarily about managing that risk for their clients, first by avoiding losses and then by positioning clients to profit from currency movements. They take a 'know-your-client' approach and analyse each customer's business individually.

The Institutional Banking and Markets' Strategic Solutions Group combines hedging with accounting and tax insights to create optimum rather than generic solutions to the challenge of uncontrolled risk. This is crucial for a currency that still has 15 to 20 percent volatility over a year.

For Sarpi, the team's strength is in its detailed analysis of the client's business.

"When we measure a client's risk, we use the same risk analytics that we use when assessing risk for ourselves. We look at a probability of outcome and through that we offer the client a hedging solution subject to the risks of their business.

"Every client has its own unique needs. A client might experience volatility through currencies or interest rates or commodities. If a corporation needs to pay a big dividend it might need more hedging than a client whose share price can take the volatility. It's not a straightforward or simple process.

"For example, a client we were working with had been doing only forward exchange contracts for the last 15 to 20 years. Recently, when a new treasurer came on board and wanted to examine the

hedging to see how effective it had been, we back-tested the last 20 years and then we projected forward, taking into account the different types of hedging solutions.

"As a result of our research, that client has adjusted its strategy of vanilla forwards to collars because the collars come out as more efficient for them. The treasurer is still providing a hedge for the business but due to our research, has a strategy in place with the potential for a much better outcome than previously. That's a great example of how our clients work with us," said Sarpi.

Investing in hedging tools such as options can even benefit businesses that are indirectly exposed to a currency risk, the tourism and education sectors for example.

The Bank offers a comprehensive foreign exchange product suite, including spot, forwards, options, and tailor-made derivative products, apart from foreign currency accounts and foreign currency term deposits. These products are offered in most currencies, with particular focus on Asian currencies. The Bank recently started offering trading in offshore deliverable Renminbi, further emphasizing its focus on Asia. Its leading CommBiz Markets platform is designed for businesses that make regular foreign exchange transactions with a full straight-through-processing functionality and linkage to its payments system.

The Bank is leveraging its own and Australia's reputation to grow its share of the global foreign exchange business. The Bank has AA, Aa2 and AA ratings from Fitch, Moody's and S&P respectively, as well as enviably stable positions in the rankings of the world's largest and safest banks.

"We have always had 24-hour trading operations in foreign exchange, and mostly viewed our London and New York trading centres as an added service for our Australian customers. Recently, we have been focused on growing our London and New York operations, and are seeing increasing interest from overseas clients as a result of our stability and credit rating," said McMillan.

"It's a great spot for us because European and American banks are not attractive, from a risk point of view, and if you're an overseas investor looking for a safe counterparty there isn't much to choose from.

"Our pitch to clients is our credit rating, and the service we provide, with a focus on Australian dollar and Kiwi first, and secondly on our proximity to Asia. Our research is important, and we back it up with our product and technological capability", added McMillan.

The Bank's global reach is strong with FX dealing rooms in Sydney, Melbourne, Brisbane, Adelaide, Perth, Auckland, Hong Kong, Tokyo, Singapore, Shanghai, London and New York.

Its presence in all the major financial centres across the globe, and its growing regional presence add heft to its already renowned currency research capability, which supports the Bank's own market view and the expertise offered to clients.

At the same time, its domestic strength puts it in a unique position at the centre of an open economy dominated by international trade and financial services, a mix that magnifies the risks presented by currency fluctuation to its clients.

The Bank's Project Falcon is a major technology program designed to deliver lightning-fast data and high-order functionality for clients. When Falcon's final element goes live next year it will complete a three-year campaign to match the Bank's technological sophistication with its global foreign exchange capacity and leadership in the Australian market.

"Project Falcon represents a significant investment by the bank in the technology that powers our foreign exchange business globally," said McMillan. "It entails upgrading the entire front-to-back system, from electronic trading systems, order management systems, and FX options systems in the front office, to our core booking system for trades in the back office.

Fully implementing Falcon will completely transform our business by adding significant scalability to operations and achieving efficiencies through straight-through-processing. That means customers get faster pricing, an increased product set, and more ways to trade with us," notes McMillan.

The CommBiz Markets platform ensures client convenience is a valuable competitive advantage through Falcon, in this highly-contested market.

"CommBiz Markets is linked to our payment system so if the client has foreign currency to buy or sell, he simply enters the details of the transaction and gets a live rate fed in through our systems. The payment is made automatically by the client to his supplier, offering front to back straight-through-processing," Sarpi told Insto.

The BIS calculates global daily currency market turnover at about US$4 trillion, up from US$2.3 trillion estimated in the BIS's 2007 study. Much of that growth stems from the increased use of electronic dealing.

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>
> Ben McMillan

"Over the last 10 years the biggest trend in foreign exchange has been electronic dealing. The banks have invested heavily around developing foreign exchange capabilities through technology. Australia has lagged on that, but it's catching up pretty quickly," said Sarpi. "At Commonwealth Bank, 50 percent of our domestic FX is done electronically – we're ahead of the domestic market."

The Bank is now first among the major domestic banks in foreign exchange volume, excluding in-house transactions, according to the latest Australian Financial Markets Association (AFMA) report. It was also first for FX options without an Australian dollar leg, and leader among the domestic majors for options with an Australian dollar leg. ■

MEASURING & MASTERING UNCERTAINTY

When management needs to avoid FX, interest rate or commodity risk without losing potential upside, Commonwealth Bank's Strategic Solutions Group crafts the optimum solution.

HEDGING CAN provide certainty in uncertain times, but inefficient hedging strategies cost companies millions of dollars a year. And it's a cost that's largely hidden, as companies never know what they're missing out on because they don't analyse hedging strategies retrospectively.

Treasurers will always look at the dollar cost (i.e. upfront premium or margin) of different hedging methods but will rarely analyse the impact of the expected outcomes on net profit, debt covenants or a project's internal rate of return. For example, the upside lost in using swaps and forwards, the two most common hedging methods, is rarely analysed and often excessive.

The Strategic Solutions Group, within the Commonwealth Bank's Institutional Banking & Markets Division, analyses clients' treasury risks by using mathematical and quantitative modelling to assess the impact of uncertain price movements – the same risk management techniques the bank uses to analyse its own financial market exposures.

The models use historical data to assign probabilities to the exposure (of say, FX rates) at a future date, and use that information to determine the likely levels of key company metrics such as free cash flow, net profit or the internal rate of return on a project.

The team also provides tax and accounting insights in its hedging propositions, allowing the Bank to provide more comprehensive and tailored solutions. This is a core element of the Bank's mission to deepen its trusted advisor relationship with clients.

Over the past 18 months, the Group has helped an energy company identify that its swaps strategy was costing significant upside; uncovered the hidden costs in a forward hedging strategy used by a resources company, and modelled competing hedging strategies on a company's net profit and debt covenants.

To illustrate by example: Company X had US dollar income but was planning a large Australian dollar capital expenditure programme. It was committed to A$100 million capital expenditure in Australia over the next 5 years. The company wanted to minimise its exposure to FX changes during the building phase, whilst the project was not generating positive cash flows.

In this case, the Bank analysed the impact movements in FX rates could have on management's projections for the project's key metrics. This article shows the impact that FX had on net present value (NPV) but equally other important metrics such as internal rate of return (IRR) and minimum cash balances could have been analysed. One of the strengths of this analysis is that it can be applied to any metric used by the business.

Chart 1 shows the distribution of potential project NPVs from our FX rate simulation. The analysis shows in the absence of hedging, 50 percent of the time the net present value (NPV) was lower than management's forecast US$44 million, and 6 percent of the time (equivalent to a 1 in 16 chance) it was less than US$25 million. This is the level management considered to be the minimum NPV required for this project. The team then analysed the impact of hedging 75 percent of the company's FX exposure using two hedging strategies considering the resulting changes to NPV.

Forward exchange contract

The market price for the AUD/USD forward exchange contract was US$0.95. While spot prices were US$1.04, the interest rate differentials meant that the forward looked considerably more attractive than spot, enabling Company X to lock in US$0.95 for the period of the capex spend. But the forward did not allow Company X to benefit from any depreciation of the Australian dollar (below the forward rate), which if it did, would have made the capex cheaper in US dollars.

Collar

A collar strategy bought protection against rates rising but at a price. To reduce the cost, Company X sold some of its upside had the Australian dollar depreciated significantly. It was possible to set the collar boundaries at US$1.05 and US$0.68 without paying a premium for the hedge. That meant Company X was protected if the spot rate increased above US$1.05, or 1 percent from the spot rate, and participated in the upside all the way down to US$0.68. Company X had the view that the Australian dollar was extremely unlikely to trade below 0.70 during the capex spend. This analysis assessed the validity of that view indicating that the probability of an effective AUD/USD rate of lower than 0.70 during the hedging term was 0.8 percent (equivalent to a 1 in 125 chance). From a practical perspective, Company X's management did not believe it was giving away any real upside by entering into the collar, and the analysis supported this view.

Impact of hedging

The results of the hedging strategies on the simulated NPV of the project are best shown by charts 2 and 3.

Chart 2 shows the distribution of Project NPV from the FX rate simulation for two of the scenarios (no hedging and zero cost collar).

Chart 2 shows that the collar strategy significantly reduced the chance of achieving a low NPV for the project. The chart shows there was a negligible chance that the NPV was below US$27m. This is above the minimum level management considered

necessary to proceed, demonstrating that suitable FX hedging can significantly increase the economic viability of the project. In addition the reduction of NPV on the upside was minimal.

An alternative way of showing the data in chart 2 is to look at a box plot of the key confidence intervals. This is shown in Chart 3 for all three strategies (the two hedging strategies and no hedging). This representation allows quick estimation of the benefit from hedging and the associated cost. For example looking at the forward strategy, the 95th percentile confidence interval indicates a NPV of US$49m compared to that of US$58m unhedged. This indicates an opportunity cost of US$9m and is shown in Chart 3. The benefit is seen from looking at the change of the 5th percentiles, that moves to US$40m from US$24m (a change of US$16m).

Hence the forward strategy can be thought of as protecting US$16m of NPV at a cost of US$9m at the 95th percentile confidence interval. The equivalent numbers for the collar are protection of US$11m of NPV at a cost of US$1m. This method has therefore allowed the numerical estimation of the benefit of hedging compared to its lost opportunity cost

Conclusion

The Bank's analysis enabled Company X to determine the impact FX risk had on a project. It identified the magnitude of the unhedged risk and easily demonstrated how hedging using two potential strategies impacted on the NPV of the project. The forward-based strategy offered greater certainty of cashflows but allowed very little participation in any upside resulting in a potential opportunity cost, whereas the collar based strategy had less certainty in the cashflows but allowed greater participation in the upside (while limiting any potential downside). Analysis of this type allows quantitative measures to be placed on potential hedging strategies giving a clear estimation of risk and reward.

This allowed Company X to better analyse the risk and reward profile of the hedging strategies, and ultimately allowed an informed decision on which hedging strategy is better suited for the project. Management could therefore make a more informed hedging decision based upon the probability distribution of the key business metrics expected from the hedging strategy it chose.

Critically, the most effective strategy available is often never identified. You can't manage what isn't measured, yet people do it all the time, but it's not very effective. ■

– Stephen McCabe, Tom Holt CFA, Shane Sentance.

CHART 1: DISTRIBUTION OF PROJECT NPV – FROM FX RATE SIMULATION

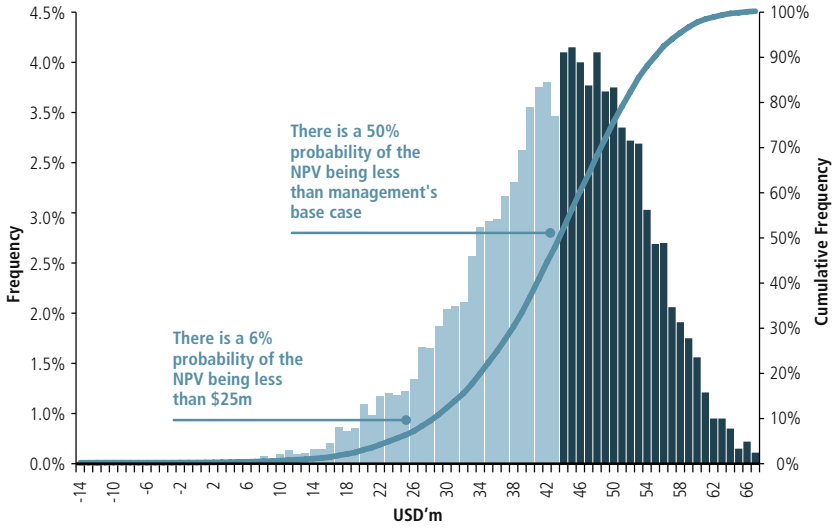


CHART 2: DISTRIBUTION OF PROJECT NPV

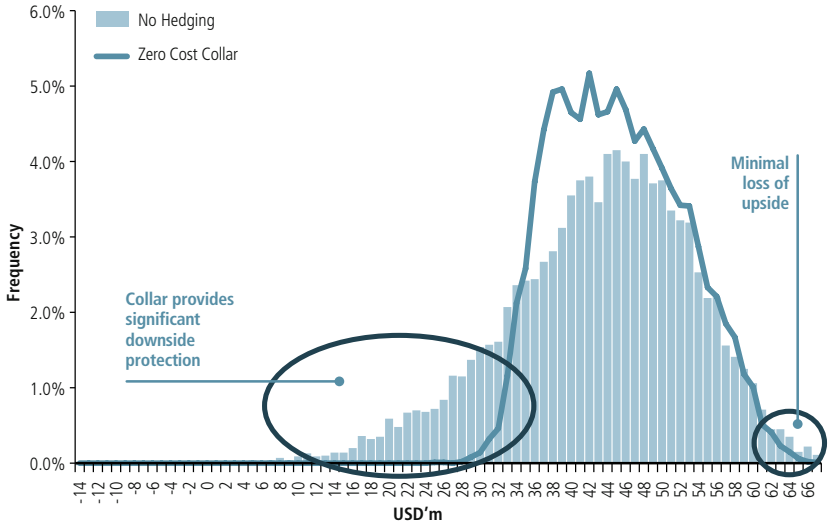
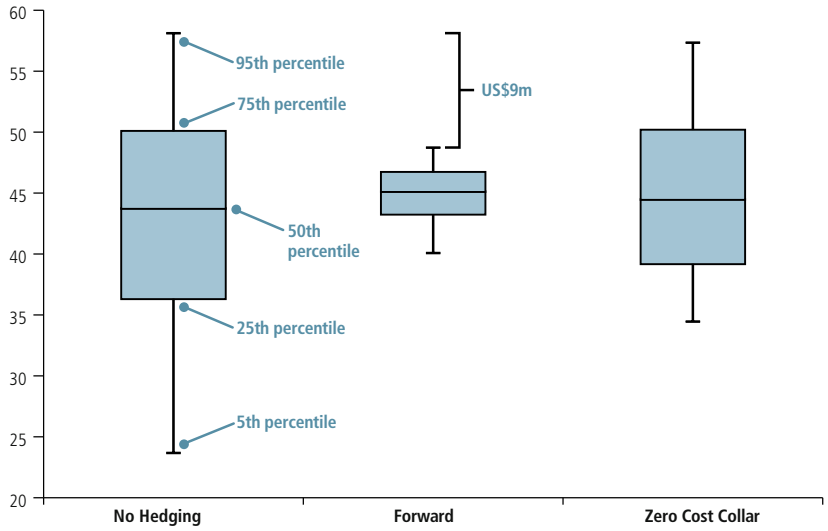


CHART 3: BOX PLOT OF SIMULATED PROJECT NPV (USDm)



HEDGE CLIPPER

A new accounting standard supposedly making it simpler to understand hedging policies is in the works, writes **Winnie Choo.** But will it clarify or confuse?

A CHANGE to the hedge accounting standard is long overdue and its critics have been vocal. Their biggest gripe? It simply doesn't reflect how hedging works. Cue the IFRS 9 Financial Instruments, a new international accounting set to appease the critics and make the decision to hedge a whole lot easier.

The International Accounting Standards Board (IASB) is introducing IFRS 9, known as AASB 9 in Australia, in response to criticisms that the hedge accounting rules in IAS 39 are too complex, creating a gap between financial reporting outcomes and the economic rationale of hedging.

Users of financial statements want to understand the risks a company faces, understand the hedges in place to manage those risks and then decide whether whether the hedge is likely to be effective.

Under IAS 39, some hedging strategies were excluded from hedge accounting, obscuring the whole picture of a company's risk management. In some cases, it has deterred companies from hedging altogether as the accounting rules of recognition of ineffectiveness and fair value can create fluctuations in reported profits.

Holding an option for instance meant companies had to mark to market even though the option hadn't been exercised.

Daniel Morgan, a resources analyst at UBS names an option held by Fortescue Metals, where it borrowed A$100 million and paid 4 percent of its iron ore revenue as interest, as an example of an option that artificially affected the company's financial reporting outcomes.

The fair value of the option changed depending on the iron ore market, resulting in profits that were counter-intuitive to the company's underlying performance.

Morgan said that hedge accounting rules needlessly complicate financial statements.

"When we look at dissecting profit and loss statements for example, in the last half, I had to try to work out what the hedge accounting impacts were and try to strip that out or reverse it from the P&L," said Morgan.

This is hardly the kind of feedback you want when accounting standards are meant to improve the usefulness of financial information.

The hedge accounting phase of IFRS 9 is still in project phase with the International Accounting Standards Board (IASB). An exposure draft (ED) was released in December 2010. The new standard will be effective from 1 January 2013 though the IASB is proposing to move the date to 1 January 2015 to allow more time for the transition process.

So what are the changes under IFRS 9?

Risk components

IAS 39: Risk components of financial items can be hedged items
IFRS 9: Risk components of financial and non-financial items that can be identifiable and measured can be hedged items

Non-financial items

IAS 39: Permitted as hedged item for foreign currency risk or in its entirety for all risks
IFRS 9: All risk components of non-financial items, e.g. crude oil component of jet fuel, are allowed as hedged items

Time value of options

IAS 39: Option must be recorded at fair value on balance sheet and the change must be posted to P&L
IFRS 9: The ED proposes two types of hedged items; transaction related (e.g. a call option) and time period related (e.g. hedging a commodity against price changes) and different methods of accounting for them

- **Transaction related** – cumulative change in fair value of the option will be deferred to other comprehensive income and recognised against the option as a cost
- **Time period related** – the premium is amortised to profit and loss over the life of the option

Net position hedging

IAS 39: Does not permit net positions as hedged items
IFRS 9: Net positions can be hedged provided gross amounts are eligible hedge items.

Fair value hedge mechanics

IAS 39: A gain or loss from recording a hedged item at fair value is recognised in P&L. A gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying value of hedged item and be recorded in P&L
IFRS 9: Fair value changes will be isolated in other comprehensive income and ineffectiveness will be posted to P&L

A cumulative gain or loss on the hedged item will be presented on the balance sheet as a separate line item and will not affect the carrying value.

Hedge effectiveness assessment

IAS 39: The 80-125 percent hedge effectiveness test, where a hedge is deemed effective if the correlation between the hedged item and the hedging instrument is high or the ratio of change of the hedged item to the hedging instrument is wthin 80 to 125 percent
IFRS 9: IASB has eliminated the test instead requiring a prospective assessment of a hedge at the beginning of the hedging contract and on a regular basis.

Derivatives

IAS 39: Derivatives not permitted as hedged items.
IFRS 9: Hedged items can include combinations of derivatives and non-derivatives.

New disclosure requirements will help users to get a clearer idea of a company's risk management strategy as it must explain the hedging position for each risk exposure and how it will reduce risk. More disclosures might re-frame hedging as a legitimate business strategy rather than a speculative activity to shareholders.

Mark Shying, senior policy adviser at CPA Australia said that determining whether users will respond favourably to IFRS 9 is like looking into a crystal ball.

While isolating fair value changes in other comprehensive income will reduce some volatility in profit reports, a plus for companies that are hesitant to hedge, Shying says other comprehensive income shouldn't become a castaway category.

"It's just a number that is a conglomerate of a number of different things which in at least one level of reading doesn't have any particular relationship other than they get put under other comprehensive income." ■

RORO COASTER

The risk-on/risk-off paradigm spares no one, write **David Bloom**, HSBC Global Head of FX Strategy, and **Paul Mackel**, HSBC Head of Asia Currency Research

ALMOST ALL markets are now heavily influenced by one factor, namely shifting market perceptions about whether the future prospects are good, in which case risk is on, or bad, in which case risk is off.

In the market, this phenomenon is called "risk on – risk off" (RORO). The RORO paradigm continues to be an overriding force in financial markets and the European crisis has caused RORO domination to increase to almost preposterous levels.

The HSBC RORO Index tracks the strength of this RORO paradigm. When this index is high it means that the RORO factor is dominating price moves and all asset prices are highly correlated. Our RORO Index is now at all-time highs., and cross-asset correlations of such intensity have never been seen before.

This is not only the case with cross-asset correlations. The HSBC Equity RORO Index, which tracks the strength of intra-asset-class correlations between constituent equities in the S&P 500index, is also at all-time highs. So, not only are there extremely strong correlations between many different asset classes, now there are extremely strong correlations within the quintessential 'risk on' asset class of equities.

This has not always been the case. The RORO Index has been generally high ever since the start of the financial crisis whereas there have been occasions during this time when the Equity RORO Index was not high. The current combination of the RORO Index and the Equity RORO Index both being at all-time highs intensifies the perception that the RORO paradigm is dominating asset prices.

The intense correlations we are now seeing are a sign of extreme market stress. Everybody has the same exposure, regardless of what positions they actually hold. This means that the RORO factor is driving assets to the exclusion of other forces.

This lack of discrimination between different assets ignores the fact that individual assets do have their own idiosyncratic value. This must mean that some assets are being mispriced. While the RORO factor dominates, such mispricing will continue.

Whilst asset prices are currently dominated by the RORO factor, it makes sense to identify situations where the price level is particularly out of line with economic fundamentals. Once the RORO paradigm weakens, as it eventually must, the valuation of these currencies will once again become important.

Seeing the index level fall will give us an early warning sign that valuation and economic fundamentals will become more important once again.

Two currencies particularly dominated by the RORO factor are the Australian dollar (A$) and the South African rand. They also provide interesting, and opposite, examples of mispriced currencies.

Both rand-US$ and A$-US$ have both been strongly positively correlated with the RORO factor for some time (chart 5). In other words, the A$ and the rand are both highly risk-on currencies – they will perform very well when the market thinks the world is moving in a positive direction, and will sell off aggressively when the market's view turns negative.

The very high correlations mean that the price action in these currencies is completely dominated by the RORO factor, rather than being determined by macroeconomic fundamentals. These two currencies will continue to move together until the RORO paradigm dissipates.

What would happen if the markets settled down, we moved out of the RORO paradigm and fundamentals came back into play? We believe the implications for the two currencies would be very different. We would still expect the A$ to retrace, as it is highly overvalued on many measures. In contrast, we believe the rand has room to strengthen on a valuation basis.

For much of the past two years, the strength of the rand caused many to worry that it was overvalued. But from a macro fundamental standpoint, the currency appreciation was justified by the improvement in South Africa's terms of trade, largely caused by the global economic upturn triggering a surge in demand for commodities.

Following the recent sharp weakening of the rand, it is now implausible to consider the rand to be overvalued. The nominal effective exchange rate depreciation of more than 8.0 percent since July, one of the sharpest falls among emerging markets, has caused important changes and distortions in valuation: The terms of trade gains have run of out of steam but have been largely offset by the recent strong fall of the REER.


David Bloom


Paul Mackel

Assuming that terms of trade stabilise, if anything the rand appears to even be slightly cheap. On a valuation basis there is no reason for the rand to weaken further and may even look attractive at current levels.

Currency valuation is a permanent dilemma for policymakers. The South African Reserve Bank seems to prefer a stronger currency, The government has indicated that further weakening of the rand is not desirable and direct intervention in the FX market may even be envisaged.

Officially, the target of such an action would be to ease volatility in the FX market; however, the real aim is to limit the pass-through effects that a too-weak rand may have on inflation.

As long as policymakers at the South African Reserve Bank refrain from using radical monetary policy to try to stabilise the currency, the RORO factor will continue to dominate the rand. Despite this, once the violent storm currently sweeping across financial markets calms, the rand is attractive on fundamental grounds. At such a time the rand will outperform the A$. ■

RISKY BUSINESS

The Australian dollar has hovered comfortably around US$ parity for some time, but it is still prone to volatility. Insto's expert panel assesses the issues.

Participants (from left in picture)

Richard Grace, Chief Currency Strategist, Commonwealth Bank

Michael Lyttle, Group Treasurer, Sucrogen

Chris Ellis, Division Director, Fixed Income and Currency, Macquarie Funds Group

Michael Sarpi, Head Of Corporate and Institutional Sales, Commonwealth Bank

Chris Loong, Head Of Australian Institutional FX Sales, Commonwealth Bank

Uri Gordon, Deputy General Manager Treasury, Incitec Pivot

Joe Capurso, Currency Strategist, Commonwealth Bank

Andy Ji, Currency Strategist, Commonwealth Bank (in Singapore)

Moderator: Eric Meijer

Eric Meijer: Quite a few of you were at our last FX roundtable and the issues are similar but they've become much more intense. The stakes are much higher, the risks that were alluded to – problems with the US, European debt and so on – those things have become so much more acute. We're seeing increased volatility in some markets and stasis in the debt capital issuance market in particular. Richard, how do you see the Australian economy that's being described as two-speed or multi-speed and what's driving the Australian dollar in that context?

Richard Grace: First – what's driving the Australian dollar – it is always a number of factors. But you could summarise them by saying it is a combination of the US dollar and Australia's terms of trade (that is export prices divided by our import prices). Some 65 per cent of Australia's exports are commodities. High terms of trade feeds income into Australia's economy, generating economic activity and keeping the economy well stimulated. Australia's relatively high interest rate levels reflect the activity of the local economy, and provide a base of support for the Australian dollar.

With regard to a two-speed economy, a high terms of trade tends to generate an investment boom. The consumption side of the economy has been quite flat, but not disastrous, as the latest June quarter national accounts indicate. But from a macroeconomic management point of view, that's not terrible, because you don't want both the investment side and the consumption side firing at the same time because it is

too inflationary. But a two-speed or multi-speed economy is not unique to Australia, nor is it worse than elsewhere. For instance, observe the unemployment rates in the Euro zone or among different states within the US, and you have much wider unemployment rate differentials than you do between the states within Australia.

Eric Meijer: You've got 20 percent unemployment in Spain and 3 percent unemployment in Germany, or something like that.

Richard Grace: Germany is about 7 percent, but even on that basis you're talking about a 13 percent differential. We don't have a 13 percentage point differential between any of the states in Australia. So while there is the perception of a two-speed economy – and the reality is there is – how wide, how much of a differential, is open to some debate.

Eric Meijer: In terms of decoupling, would you say that perhaps the concerns about problems in Europe particularly, and maybe the US, are overdone in this market – that Australia's trading partners and domestic economy are strong enough to withstand contagion?

Richard Grace: It's a good question. In terms of the real economy – yes, I'd say the concern is overdone, but in terms of the financial effects, this is the way financial markets work, so you may not come to the same conclusion. The US and Europe remain the major financial centres, so stress is there. You'll see how it's impacted on the confidence measures. If you look at where the difficulties reside and that is the CDS spreads in Europe and the ability of European banks to access US dollar funding – if you take those same comparisons and put them in an Australian context, Australian banks are not having notable trouble accessing overseas funding. So the financial effects are all interlinked, but there are differences. The real economic effects suggest that Australia should be somewhat insulated unless we see the real economies in the US and Europe enter recession. But that's not our base case, even though the risks of a double-dip recession in the US and Europe are growing.

Eric Meijer: Just to clarify – you see potential for a double-dip in the US, or low potential?

Richard Grace: Yes, there is potential. I think the risk is around 30 percent of the US going back into recession and if the US goes into recession there's a good chance Europe will follow. Already there have been downward revisions to GDP forecasts in both economies by their respective central banks and I think you can't ignore those risks. Financial markets are toying with the risks of those developments occurring.

Eric Meijer: Ben Bernanke referred to the "Fed toolkit" – from my layman's perspective, that toolkit seems rather empty and worn…

Richard Grace: Yes, but the Fed still has a few things up its sleeve. We believe there are at least three policy measures left. One is what we term "Operation Twist,"* where the size of the Fed's balance sheet is left unchanged, but the Fed extends duration – selling securities at the short end, purchasing securities at the long end in an effort to drive the long end of the curve lower. That would probably be the first tool they would employ and it would be somewhat effective given that the majority of household mortgages and a lot of business loans are written or priced off the long end of that curve.

Second, the Fed could cut the interest rate paid on deposits held at the Fed (ie. on reserves). Hopefully, it would encourage banks to lend more into the economy, rather than banks simply depositing money with the Fed, where they're picking up 25 basis points on an overnight rate per annum basis. To put that into perspective, banks have to go out more than two years along the US government curve to pick up 25 basis points. So in many ways it's relatively risk-free and a good return for the banks to leave money deposited with the Fed. So if that rate were cut, the incentive would be for banks to start lending in the economy. But the problem is that demand for loans is still very weak in the US.

The third policy tool that the Fed has left is additional quantitative easing. That would increase the size of the Fed's balance sheet, whereas the other two policy measures wouldn't.

Eric Meijer: Uri Gordon, you're involved in industry and dealing with the real economy, how is the Aussie dollar environment affecting your business?

Uri Gordon: Well, it's not helping. I guess that's obvious. Incitec manufactures products, whether it's fertilisers or explosives, that operate in US dollars, and we've got Dyno Nobel, which operates in the US, all its earnings are in US dollars. All our sales, all our earnings, have to be converted back into Australian dollars. As the Australian dollar appreciates obviously the conversion rate worsens. The one benefit is that there is some correlation between the product we sell, the commodities, and those dollars. Unfortunately, there is a much bigger lag between the price of fertilisers and the dollar itself. The price is a lot more dependent on seasonality and the effects of supply and demand. The way it affects us means that we view the currency change – in the past we saw the Aussie as a 70 cents currency. Whether it's parity, $1.10 or 90 cents, it is a 95 cents currency, which is significantly higher. We went back into the business and started looking at how we're doing things to reduce our overall exposure to currency.

Eric Meijer: At this meeting last year, you said you had a competitive advantage in the sense that making fertiliser overseas and shipping it here is not competitive with Incitec – is that still the case?

Uri Gordon: Australia is far enough away from the rest of the world, which is good, it definitely is a freight advantage. But saying that, we still have to compete at arm's length. We expect the fertiliser market in Australia will become a lot more competitive next year, next season, with the change in ownership from AWB to AGU. We've definitely seen increased presence of other manufacturers coming into Australia. So while we have a freight advantage, if the Aussie dollar continues to increase, that advantage gets eroded, which brings us back to making sure that we supply our clients the right fertilisers at the right time and the right quality, and hopefully that will do the trick.

Eric Meijer: You refer to the Aussie dollar going from a 75 cents currency to more like 95 cents. To throw this open, the dollar has historically been described as walking slowly up the stairs, if you like, and then coming down via the lift. Is that still the case?

Chris Loong: I think that is still the case in a sense from an investment point of view, especially investors who attempt to take advantage of the interest rate differential. This strategy works when you have a relatively stable currency with that differential maintained, but you're at risk of giving back all those gains quite quickly if you do have a sharp depreciation and you can't wear that capital loss in the short-term. There are potentially a lot of short-term or leveraged positions in the currency based on the interest rate differential that may be quick to be reversed – hence the analogy.

There are also a lot of systematic investors, where some factors may be favouring the Australian dollar, such as interest rates and commodity prices. But

there are also variables such as market volatility that may quickly turn their models away from buying the Aussie, and indeed to even selling it. That's why we still have a high correlation with a lot of other market indicators such as equity prices, equity market volatility, certain interest rate spreads, etc. Hence, a slow grind-up in the Australian dollar can often be corrected by a more rapid decline.

Richard Grace: I'd add that I don't think the term for the Australian dollar of "slowly up by the stairs, down by the elevator" will ever be completely shaken. But one thing we have noticed is that the effect on the Australian dollar from spikes in global financial market volatility has been reducing over time. I use the example of the global financial crisis in 2008-09, where the Australian dollar volatility, as measured by the one-month option, spiked higher than the VIX volatility index on the S&P 500. But within the three major financial market episodes we've had since the 2008-09 crisis, the spike in volatility has been less than the spike in the VIX.

Michael Sarpi: Richard, would you say that is because of the buyers of the Australian dollar?

Richard Grace: Yes, I would. I think it's becoming clearer to us through our activities at Commonwealth Bank that central banks are a big buyer on dips. Central banks are attracted to Australia's AAA sovereign rating and the highest interest rates in the AAA-rated spectrum as they run through their diversification process. We're also seeing exporters take advantage of any dips to buy Australian dollars and real funds come in and adjust hedge ratios.

Michael Sarpi: So potentially some of those big drops we've seen historically could be taken away simply by the nature of the buyers in the marketplace?

Richard Grace: That's right. It's probably important to add that since the GFC we haven't had a major threat of the global economy going into recession. We've had concerns, we've had downward revisions to global growth, but we've never had the global economy severely tested like it was during the crisis, which would inevitably see commodity prices collapse and the Australian dollar go down in a sharp fashion. So until we revisit that scenario we won't know for sure, but most certainly in the three major financial market episodes we've had, and most of those have been related to the European sovereign crisis, the volatility in the Australian dollar has been much less than the volatility in the stockmarket.

Chris Loong: To reinforce that, at least in the short-term, where else is capital going to go at the moment even if we see this volatility? Even if investors want to move capital to the traditional safe haven currencies such as the Swiss franc or yen, their respective authorities are fighting that, so that's a limitation. There are worries about the Euro and there are worries about the US dollar, so in some ways investors have chosen the relative strength of our economy and stability of local markets. Historically in other crises there were more alternatives, at least from a currency point of view.

Michael Lyttle: I think you've seen a few other alternatives, of people going into Singapore dollars and other currencies as new safe havens.

Eric Meijer: The BRIC-type countries that are attracting hot money, do they have the depth and sophistication of market to handle these volumes? It's much more turbulent there, isn't it? Indonesia, for example, has had to impose capital controls. So the Aussie has a natural benefit from the sophistication of this market and its ability to absorb vast amounts of hot money.

Joe Capurso: Australian financial markets are quite deep and sophisticated. Another attraction is the Reserve Bank of Australia is quite happy to not intervene in the currency market. By contrast, a lot of the emerging market central banks intervene heavily in their currency markets and in their financial systems more generally, such as directing lending. That sort of intervention can distort financial markets. Another issue that gives a lot of assurance to market participants is Australia's Asia exposure. The resilience of Asia to the slowdown in Europe and the US, at least so far, provides a lot of resilience and support to the Australian dollar.

Richard Grace: Yes, and just reflecting on those BRIC countries that you mentioned, China has capital controls so that's not even an option. Brazil has recently introduced macro-prudential measures to discourage the flows, and the level of sophistication in the Indian markets is not there in enough depth. In Russia, there are other issues.

Andy Ji: I think it is a question of the sophistication of the market, the depth of the market. The trading volume of the Aussie is about the same as the Asian

currencies combined, that's why Aussie is certainly a proxy for Asian and Chinese currencies. Also, to have safe haven status you need a global trading currency. The Singapore dollar and other smaller Asian currencies are not even close in that regard.

Eric Meijer: Isn't there a potential disadvantage from becoming a safe haven reserve currency like the Swiss franc, which is traditionally overvalued by PPP.

Richard Grace: Yes – the Australian dollar is good in the sense that it works for the benefit of the Australian economy. When the Australian economy is doing pretty well the dollar tends to appreciate, when the global economy is above trend the dollar tends to appreciate, but if the Australian economy takes a rapid downturn the dollar tends to depreciate, which is very, very helpful for the management of the economy.

The performance of some of the safe haven currencies is very unhelpful to the performance of their respective economies. I will use the example of the yen. The yen continues to strengthen despite Japan being in recession. The yen strengthens if the world economy starts to take a downturn. You have a similar story with Switzerland and the US.

Michael Lyttle: Do we build in a huge inflation risk if the dollar starts turning back down and we have a rapid depreciation in the Australian dollar?

Richard Grace: That would be the risk, yes, that inflation would rise. But I guess the thinking would be that demand would collapse if we see the Australian dollar fall and that would offset the potential inflation risk from imported inflation.

Joe Capurso: The exchange rate pass-through from a low Aussie dollar into consumer prices is much weaker than 20 years ago. Instead of prices moving up and down, retailers and wholesalers margins move up and down. That's because the Aussie economy is a lot more competitive than it used to be. Here we are talking about not just competition from imports, but also from foreign companies that have set up shop in Australia. More recently, we have seen competition from the internet with savvy consumers shopping online.

Eric Meijer: What sort of event do you think would cause this rapid depreciation, if there were to be one?

Richard Grace: I think it would mainly come from offshore, if the US went back into recession for instance. But the most likely catalyst for a large depreciation of the Australian dollar would be something coming out of China, which would impact severely on the Australian economy and cause the RBA to cut interest rates. You'd have that sort of combination occur.

Michael Sarpi: What about the reverse – the recovery of the US dollar, that's the obvious one that would affect the Australian dollar?

Richard Grace: Yes, that's right. If the US economy suddenly started to outperform and the Fed looked like it was going to lift interest rates you would see the US dollar strengthen and that environment would put downward pressure on the Australian dollar.

Chris Ellis: Mind you, the Aussie dollar would be falling against the US dollar, just like many other currencies in that environment.

Eric Meijer: So Chris Ellis, you would say that stairs-and-lift analogy is still valid?

Chris Ellis: Absolutely. I think everyone is very long and happy thinking the Australian dollar is bulletproof at the moment, but if things turn, and as you were saying China is probably the big one but there are other factors, things could turn quickly. When S&P downgraded US credit the Aussie dollar fell 10 cents in about eight days. It bounced back quickly because the market stabilised, but that just shows if there was something more dramatic then the Aussie dollar is susceptible.

Joe Capurso: It is important to remember that the Australian dollar is not a safe haven currency. There are a lot of supportive factors like high yields, links to Asia and commodity exposure. But whenever something goes awry overseas, the Australian dollar sells off, and often aggressively. The one thing going against the Australian dollar is that we are still a net borrower. We have a lot of foreign debt reflecting decades of current account deficits. During bouts of market panic, risk capital goes home. It also goes to the safe havens, whether that be Japan and Switzerland with their current account surpluses or the US with their deep government bond market.

Michael Lyttle: The big changes in the Aussie dollar aren't local issues anymore. Three, four, five or 10 years ago what was moving the Aussie dollar rapidly were local issues, like Keating making the banana republic statement and the Aussie dollar would move dramatically, whereas now the things that are changing it are French banks getting downgraded or Greece facing debt default.

Chris Loong: Yes, offshore developments are a much bigger factor…

Michael Lyttle: And much more likely to move the Aussie dollar than domestic factors. It would be hard to see an Australian announcement having a 10 cents movement in the currency prices.

Chris Loong: Unless it's a large and unexpected interest rate cut.

Michael Lyttle: Also in line with that, Australia is closely aligned to Asia and if Asia is going to be the dominant economy of the world and drive the world, we're closely linked to that as opposed to previously being linked to the US or Europe.

Eric Meijer: Michael Lyttle, from your point of view in an exporting industry related to fast-moving consumer goods, how are you finding the Aussie dollar environment?

Michael Lyttle: The Aussie dollar being strong doesn't help, but we've been quite lucky in some ways that commodity prices have held up. So we've had things balancing off a little bit. Previously we looked at trying to undertake hedging in an Aussie dollar commodity price basis, so we locked in commodity prices and foreign exchange to achieve a price. Now we look at commodities independently of currency and we are beginning to ask the question – we've got historically high commodity prices and they're very attractive to lock in, but perhaps locking in prices two and three years forward, are you really comfortable locking in Aussie dollar prices three years forward at 110 cents? I think that's a reasonably easy answer because there is going to come a point where the interest rate differential is going to come back down. The other thing you look at is can you denominate more of your costs in US dollars, can you try and match your revenues and your costs a little bit? It's not easy, but we've certainly looked at some of our funding based in US dollars rather than Aussie dollars to try and match that.

Eric Meijer: So you try to maximise your use of natural hedges, is that right?

Michael Lyttle: Yes, correct – absolutely.

Eric Meijer: Deloittes surveyed about 110 CFOs and found that 77 percent believe that the strong dollar was having a negative effect on their business or the economy. But asked what they proposed to do about it – 65 percent said no change; 20 percent would revise their hedging arrangements; 15 percent would increase their cost management; 10 percent saw the BlueScope option and would go for overseas expansion; 9 percent said offshore purchases; only 5 percent said increased forward sales. So how do you see hedging and derivatives helping in this high dollar environment?

Michael Sarpi: Well that's one thing about hedging, you can't look back and say I want to adjust my price, you have to look forward and see where your business is positioned and can we survive with a stronger currency? Over time if your costs get higher and higher it makes it a lot more difficult to survive, so you have to make some adjustments. As far as the hedging policy goes you have to position yourself from a risk management perspective, can we fund ourselves, can we meet our dividend payments? Most corporations in Australia have good hedging policies, but because of the big price adjustments, if the Australian dollar stays above parity for the next 10 years, for example, there's a lot of price adjustment to be had and that's the sort of discussion I think the corporations need to bring to me and make decisions around. Hedging is part of the solution but not the total solution. You can't hedge everything out of a business for the next 10 to 20 years, you can't make that sort of decision.

Eric Meijer: So these other options like cost control – it's pretty much management. Overseas expansion – do you see Aussie manufacturers in particular moving themselves overseas?

Michael Lyttle: With a strong Australian dollar it makes assets overseas a lot cheaper, so if you're looking to make some acquisitions a strong currency helps. That's the type of decision Australian corporations can make.

Chris Ellis: I question at what point this becomes an issue. You're saying people are looking at putting jobs or businesses overseas and all the issues with the Australian dollar costing jobs and hurting businesses – at what point does the RBA or the government step in – because currencies naturally will overshoot at times. There's a chance the Aussie will break at 110 and go to 115 or 120. Whether the RBA will act like a Swiss National Bank or a Bank of Japan and intervene and say this is not on, it's hurting our economy enough and we're putting the Aussie back at parity – I don't know whether they will. They've intervened on the downside in the crisis in '08 successfully ahead of 60 cents and held it. They weren't in control of the currency for a while when it freefell, so at what point is it considered a breaking point?

Richard Grace: The RBA has been asked this question before. Their view is that they won't intervene. The Australian economy will go through structural change. Their view is you can't stop structural change. You have to let it run its course. We've got inflation issues, and from that perspective the high currency helps manage inflation problems. The central bank is well aware that the history of commodity or terms of trade booms in this country is inflationary. So they wouldn't want to talk down or intervene to lower the Australian dollar when they know they've got an inflation problem on their hands.

Chris Ellis: If it started getting up to the 120s or 130s and it starts costing jobs and blowing up whole sections of the economy – I would have thought they would have to think about alternatives to bring the dollar back down to a level that isn't going to destroy the non-mining parts of the economy.

Richard Grace: Yes, but it is primarily offshore factors that are driving the Australian dollar, unless we get the case of an interest rate cut. If we had the scenario where the Australian economy was really bleeding, the RBA would cut rates and that would lower the value of the Australian dollar. But markets can do funny things – take New Zealand. New Zealand has a 2.5 percent official interest rate, same as it had during the crisis in 2008-09 and it was only a month ago that the NZ dollar was pressing fresh post-float record highs against the US dollar. So it's not always an interest rate story that drives exchange rates. But you would think that a cut by the RBA if the Australian economy was in trouble would generate some depreciation of the Australian dollar.

Chris Ellis: I think the RBA would have the attitude of not wanting to pick winners and losers to support certain sectors. So its main mandate is very macro and particularly based around inflation. I agree that it's definitely a policy issue and a political issue if nothing else. It's definitely going to be a political issue if current conditions are maintained and I guess it increases pressure on the government and possibly fiscal policy or Treasury policy to maybe support sectors if it wants to make that value judgement, but it's a tough one. I guess the question is how much do you want to redistribute the winners from the boom to the so-called losers?

Eric Meijer: OK, we still have to explore some hedging issues. Would you say that corporate Australia is sufficiently aware of

the benefits of hedging, particularly from derivatives rather than forwards?

Uri Gordon: I know within Incitec Pivot our policy is more options-based rather than forwards because, similar to what we said earlier, the risk that the currency does fall means that we want to make sure we do have the participation in place. In the past we were much more pure buyers of options. As we got a bit more comfortable or less worried about the risk of Aussie going one way completely from the best rate of 60 cents without stopping beforehand, we're happy to use more collars and other structures that limit our participation, but still give us enough participation in an area which we think is likely for the currency to move in.

Michael Sarpi: That's a trend we've seen in the corporate market in Australia – there's been a greater use of options and that's been driven also by the changes in accounting. So now your derivatives are on balance sheet you either have an asset or liability, depending on the currency move, through the hedge you've taken out. That's why there's been a big move into options, which gives you a lot more flexibility with capturing the downside of the Australian dollar.

Eric Meijer: Michael Lyttle – how do you see this going?

Michael Lyttle: We haven't done as much option-related trading as we probably could. In a lot of corporates you have to take people along a journey to understand the fundamentals of options. You have to be very passionate. I think there are occasions where that is warranted and we've certainly done that, but probably more in commodity prices than we have in the currency side of things. Certainly with the increased volatility out there options are always hard because the time when you really want the protection is when the volatility is the highest and they're the most expensive, which is a double-edged sword of options, but I guess you can always sell some volatility to try and recoup, but accounting standards make that hard as well.

Uri Gordon: That's what we're looking forward to do hopefully. The new IAS39 (IFRS 9) will definitely have an impact on the way we manage our exposures, not just on currency but also on rates and commodities. It does give you a lot more flexibility to use other options and other hedging tools and a lot more option-based strategies.

Michael Sarpi: The accounting standard accounts only for the derivative, it doesn't account for the underlying. So the fact that you're going to have a negative in your derivative doesn't affect the positive in the underlying business. It is a bit one-sided.

Richard Grace: Do you think the new standards might address that imbalance?

Michael Sarpi: Yes, I think as analysts work with these accounting standards there'll be an improvement in the knowledge and understanding of how a derivative works when a client is placing a hedge to insure their business.

Eric Meijer: I was talking to a derivatives expert the other day who advocated something that was new to me – he said that corporates with a currency exposure should actually budget for taking out options – every year in their budgets put aside a little money for options, actually tell the board they need to do this every year, year in, year out, just like any other insurance policy. What do you think about that?

Michael Lyttle: It's not the worst advice I've ever heard.

Eric Meijer: He made the point that it's better than an insurance policy because there's an upside but also because there's no claims department to deal with. What do you think – pre-funded options?

Michael Sarpi: It makes a lot of sense and we're quite happy to lend our clients money to buy those options.

Eric Meijer: At a rate that makes the option worthwhile?

Michael Sarpi: Yes, absolutely – lowest rate possible. But it makes a lot of sense and it's a much cleaner way of medium exposure. For the exporters who are worried about the Australian dollar it's the most logical way to deal with it.

Joe Capurso: The idea that companies need to hedge their exposures is filtering down to the smaller corporates. We've seen, for example, companies with a turnover of say A$25-150 million, almost 70 percent of those companies now are thinking about hedging their exposures in the next three months. Compare that with beginning of 2010 when it was only about 40 percent.

Eric Meijer: Do you think the Federal Court's decision to hold Centro directors accountable for their decisions will make boards more diligent about understanding how their company's finances are managed and whether they could be more

effectively run? Any thoughts?

Uri Gordon: Over the last two years our board has definitely taken more interest in the activities of the Treasury and we've spent a lot of time with the board and explained to them not only our operation, but also where all exposures come within the business. I don't think it was a product of Centro as such, I think it was more our board being responsible and saying we have to make sure we understand.

Michael Sarpi: And if you think of the GFC when the Australian dollar went from 95 down to 60 cents, all of a sudden if you're managing a company and you've got assets overseas and costs in US dollars, that has a massive impact on your operation and if it happens that quickly, it's a massive part of their business.

Uri Gordon: It wasn't just the currency, it was also the actual funding in place. We saw during the GFC how many companies got caught with short-term funding because they thought the bank will always be there. So our board became a lot more conscious of how we fund the company, what is our liquidity cushion, are we having more diversified source of funding?

Chris Ellis: I just hope that because of that greater recognition of the personal risk for directors that they don't become more conservative about what derivatives they use, even when they do make sense. They may make it tougher to be convinced about using a derivative.

Michael Sarpi: But if you do nothing and it impacts your balance sheet, it impacts your ability to pay dividends because you haven't done anything, as a shareholder what are you going to say? So where's the alternative? To hedge or not to hedge is equally as bad. That's why it's important – and most top-end corporations in Australia have got a policy, and have made shareholders aware of it.

Chris Ellis: If you are going to have the issue where directors are liable then they have to be remunerated accordingly for that risk, so you need educated, qualified people, you can't just have lay people in that position because then why would you do it?

Michael Sarpi: I think it's a great idea.

Eric Meijer: Macquarie University is doing a corporate governance degree now, and the AICD has always been very active in this. Do you see them having to increase their level of financial education for prospective directors?

Group: Absolutely … (general agreement around table)

Eric Meijer: Before we move on to the rise of the redback, does anyone have any other comments to make?

Chris Loong: Just to generalise, we are seeing more isolated usages of options to hedge some of the growing offshore exposures that the larger funds have, whether it be via a currency manager or directly themselves for those funds that do execute themselves.

Eric Meijer: In terms of that, are funds attempting to use options for a bit of alpha, to generate extra profit, or is it just straightforward risk management?

Chris Loong: I think it's still more for protection, which is a good thing in that sense. If not, that is where investors may get into trouble, when they start coming up with something which may be more sophisticated to generate alpha.

Michael Sarpi: Also from a corporate perspective, when a client puts a hedge on now it needs to qualify, so they have to be a lot more measured in what they do. We've got a strategic solutions group that just measures that risk, so when you do put a hedge on it is managed against your exposure.

Eric Meijer: Andy Ji in Singapore, we're looking at a big issue for Australian business generally, the rise of the RMB. How do you see developments in the Chinese currency?

Andy Ji: The Chinese government is consciously trying to shift from the exchange rate to more interest rate-based monetary policy. That requires letting the CNY appreciate or depreciate according to market forces. At the current juncture, we're looking at significant undervaluation in the CNY. Over the next five years we're looking at steady appreciation until it reaches a fundamental valuation against USD. We still have a lot of missing steps in between. We do not have a very functional interest rate market, for instance, for the monetary policy transmission to work, so that's what the Chinese government is working on. It is a work in progress, it will take years, if not a decade, for it to actually achieve that final objective. Nevertheless, in the meantime we see CNY appreciation against most currencies but mainly against USD.

Eric Meijer: I would think that's still a fairly slow appreciation, right? The authorities will allow the CNY to only appreciate slowly, they're not going to let it react as quickly as it would if it was free floating?

Andy Ji: No, people have been talking about convertibility for CNY and that takes a lot longer than so-called CNY internationalisation, which is just a trade settlement regime and offshore CNY centres. For CNY to be fully convertible you have to have a financial system that is strong enough to cope with external shocks. The banking sector is not in such good shape, and that takes years to fix. China doesn't have a very deep and liquid equity and bond market. Even with the CNY internationalisation and trade settlement regime we still need a great deal of progress to be made in the domestic financial system to make the CNY fully convertible.

Eric Meijer: On the trade settlement front, is this a real development? Can importers really settle their debts in Renminbi or is it just a disguised US dollar play?

Andy Ji: No, it's the real thing. Importers/exporters are free to choose the denomination currency, so they can choose CNY if they agree as a trade settlement currency.

Michael Lyttle: We've actively approached a couple of our Chinese suppliers and offered them the ability to settle in Renminbi. No one has taken it up at this point.

Andy Ji: We also have to realise this is a function of CNY appreciation expectation because you don't want to hold CNY, you don't want to settle in CNY unless you think CNY is going to appreciate. So that's the whole gist of it and that's really driving the demand for CNH of offshore CNY.

Uri Gordon: Why are you offering your clients the ability to pay in RMB?

Michael Lyttle: I think it's just that if it's the natural currency of your client and your client would otherwise be taking US dollars and converting them into CNY – I'd rather manage the conversion ourselves than have the client do it and charge us for it.

Uri Gordon: We also offered it to a number of our clients and we haven't had a bite yet.

Michael Lyttle: No, nor have we – but we've offered it.

Richard Grace: I can see your point about the spread, but do you then take the currency risk?

Michael Lyttle: Generally I don't think we would. We only have a couple of

people who supply us out of China and we've approached them directly, it's just a settlement option. Generally I think we would look to hedge in position, we're not taking a currency view on Renminbi or anything like that, it's just a spread risk.

Eric Meijer: So Andy – we've got two sizeable Australian corporates here that have offered to settle trade debts in Renminbi and they haven't been taken up on it – why do you think that is?

Andy Ji: From the Chinese corporate perspective they also take a view on the USD/CNY, so I think in the long-term people realise that the CNY is going to be an appreciating currency, but in the short-term there's always a choice between holding USD and CNY. In a time of crisis for the Chinese they'd rather hold USD offshore than having CNY. We have seen companies move in and out, into CNY or USD offshore purely based on the prevailing expectation of CNY appreciation.

Eric Meijer: So in terms of Chinese demand for Australian resources – iron ore, coal, agricultural commodities – do you see current levels growing?

Andy Ji: Yes. It's really a structural shift, it's a level change for the Australian economy, so that also supports structural appreciation in the Aussie dollar. One thing is if you look at China or Asia, domestic demand is really rising. Monetary policy is still quite loose. Thus, we still have low interest rates. But I also see structural changes that shift the economy more towards domestic growth engines, here in Singapore and in China. That is partly why we're seeing high inflation rates. These changes are structurally good for commodity demand. In China's case we know that around 80 percent of Australia's exports are consumed in China. So given China's shift towards more consumption and a domestically-driven growth model, we expect the Australian economy will benefit.

Eric Meijer: Michael Lyttle, Andy sees domestic consumption rising and imports staying in the domestic market .

Michael Lyttle: Yes, I think we see global demand for a lot of agricultural commodities, and sugar particularly, growing steadily over the long-term future.

Eric Meijer: And Uri, you're tied to agriculture through your fertiliser business…

Uri Gordon: A big part of the company's strategy is exposure to China. It's indirect exposure because we don't export directly to China, but we do provide the fertiliser to grow grain because we believe that the diet in China will be a much higher protein diet as they organise their communities, they'll demand more, as a result they'll need more grain. Similarly, we'll provide exposure for mining activities for the BHPs and the Rios and others to provide whatever mills and coal required for the growth in China. We prefer to service those exporters that sell into China because we believe it is going to grow.

Eric Meijer: Michael, would you sum up?

Michael Sarpi: Well I've been in markets for over 25 years and it's always fun, something different happening every day, new challenges all the time. The nature of market remains the same but the things that trigger moves in markets change from time to time. But I think everybody is impacted by currency, the impact is being felt by even the man in the street.

Richard Grace: Probably just reflecting on the corporate governance issues you raised, I think that's going to be an increasing trend. And from what our "Aussie Dollar Barometer" is suggesting, participants are looking more towards increasing hedging strategies. I think this is going to be a trend going forward, particularly as the world becomes more international.

Uri Gordon: Other than encouraging people to use fertilisers … (laughter). The volatile environment means that as corporates we're adopting a much more active approach and ensuring we're not falling asleep at the wheel. We're taking Treasury operations very seriously, ensuring that the lessons we've learnt from the GFC are actually put in place to ensure that if the world comes to another recession we'll be in a much stronger financial position.

Michael Sarpi: If I could just add to that – the level of sophistication in the marketplace has grown. When I started 25 years ago the level of sophistication was next to nothing. When the Australian dollar first floated I worked in a corporation and the awareness of the impact of currency was not really known. Nowadays I think, even with training in universities, people coming into the business are a lot more aware of markets and the impact markets have on business.

Joe Capurso: I would say know your risk, measure it, and minimise it. ■