



WILSONS

Is the Rising A\$ a Threat to the Australian Equity Market Outlook?

Our weekly view on Australian equities.

21 January 2021

A\$ Responds to Risk-On Mode in Markets

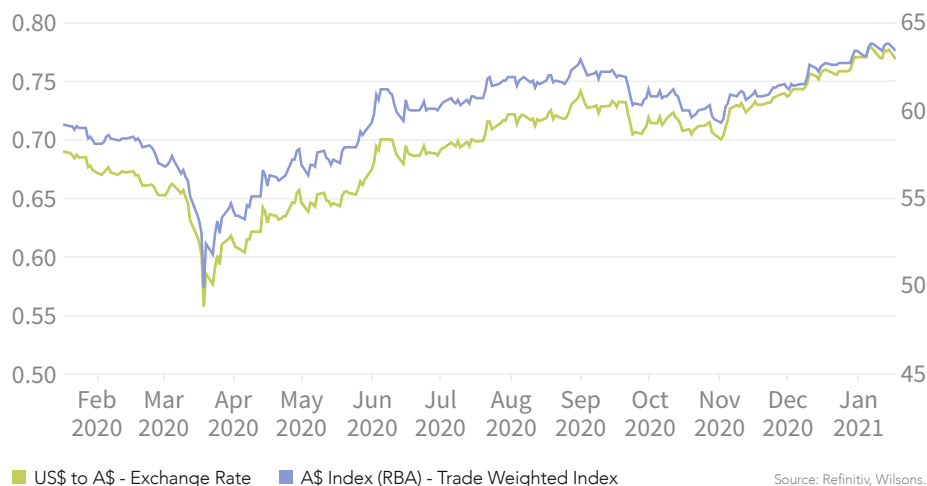
Global markets over the holiday period have been in a risk-on mode as investors look through rising COVID-19 cases and lockdowns and instead focus on a vaccine-led economic re-opening, and the prospect of further fiscal stimulus – particularly from the new Biden Administration in the US.

The A\$ has responded to this risk-on mode, rising almost +12% over the past 12 months, and appreciating faster than the Australian equity market over the past 3 months and during the holiday period.

The strength of the A\$ has arguably been a dampener on local equity performance over the past month, with the S&P/ASX 200 +1.3% in local currency versus +2.6% in US\$ terms. This compares to global equities (US\$) +3.5%, and European and US equities being between 2-4% respectively over the past month. The A\$ has risen 2.2% against the US\$ over the same time.

This has led investors to question whether a stronger A\$ could threaten the market recovery in 2021?

Exhibit 1: The A\$ has risen more than 10% during 2020 relative to the US\$ and Trade-Weighted Index (TWI)

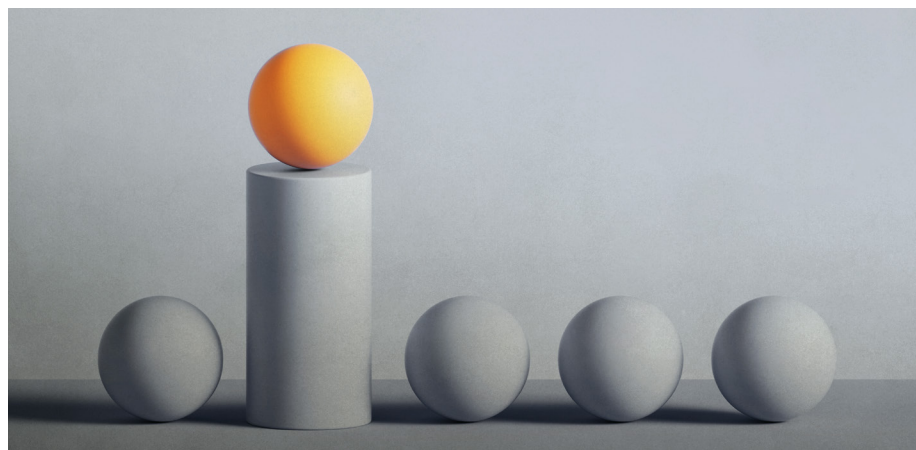


Rising A\$ Impacts Sectors Differently

Within the equity market, sectors sensitive to the A\$ have posted dramatically different performance. Energy and material sectors – where a rising A\$ is generally viewed as positive – have risen +8% over the past month.

The healthcare sector – dominated by non-cyclical US\$ denominated earnings from CSL (CSL), Cochlear (COH) and ResMed (RMD) – has underperformed the market, falling by more than -6% during the past month.

While currency is a noteworthy factor in this relative sector performance, it is also reflective of the differential in earnings momentum – broad sector-based earnings upgrades for energy (rising oil price) and materials (rising commodities prices) during the past month. In contrast, healthcare earnings are facing pressure from translation risk given the A\$ appreciation.



What's Behind the Strength of the A\$?

Three factors behind the strength of the A\$ in the 2H20 have remained in play in early 2021.

1. A falling US\$ in response to weak COVID-19 control, soft US GDP growth, and expectations of large scale US Government bond issuance. The US\$, measured in broad trade weighted terms (DXY), has fallen almost 10% over the course of the last year.
2. Global reflation expectations have been reinforced with recent above-market Chinese economic data, additional fiscal stimulus in the US, and the early roll-out of the vaccine. Coupled with rising commodity prices, reflation has been a powerful influence on the A\$.
3. Australia's strong COVID-19 response and economic performance versus the rest of the world has also helped the A\$. The +10% appreciation of the Australian Trade-weighted Index (TWI) reflects both the health and economic outcomes.

How Far Can the A\$ Rally?

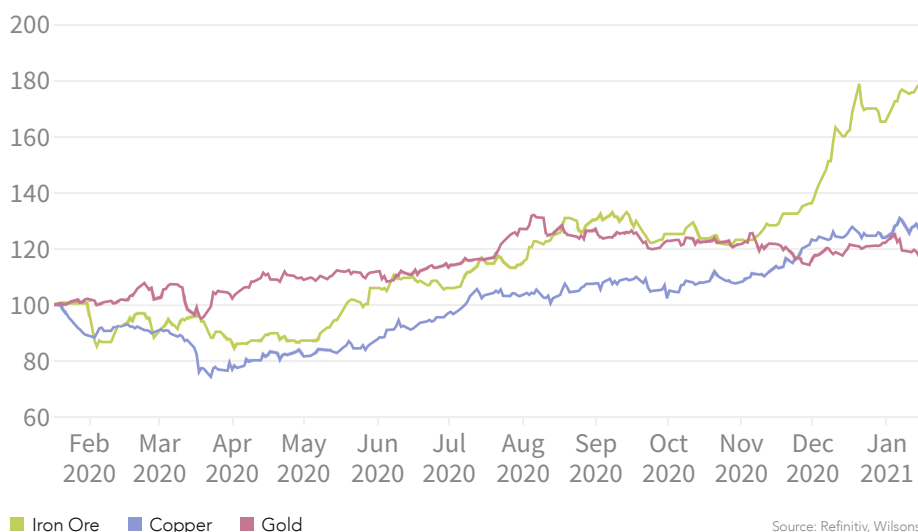
The A\$ appreciation since the depressed low in March 2020 is now almost +40%. While we do not see a significant risk of A\$/US\$ rallying through 0.80 in the near-term, momentum in currency markets can be powerful. Our sense is that pricing risk for the A\$ still resides to the upside.

Our spot valuation model (interest rate differentials and commodity prices) of A\$/US\$ currently sits at ~0.80, with the currency modestly below that at 0.77 at present. This was a similar trait to what we saw in 2020, which is likely best explained by the RBA's QE program influencing the A\$.

The current scenario is unlike the 2010/11 backdrop when the A\$ went to parity. Back then we had both strong commodities and a large positive interest rate differential behind the A\$, which is unlikely to be a factor this time.

It is also not out of the question that iron ore begins to mean revert during 2021 given a number of one-off factors continue

Exhibit 2: Commodity prices have risen strongly through 2020



to impact both demand and supply. A potential lower iron ore price later in 2021 would take pressure off the A\$.

Read our [December expectations for the A\\$ into 2021](#).

How a Higher A\$ Impacts Equities?

A rising A\$ typically has a mixed impact on the Australian equity market depending on the investment narrative of the day.

A global reflation narrative can see the \$A rise and the Australian market outperform, boosted by higher commodity prices and cyclical earnings acceleration. We saw these conditions in the commodity super-cycle of the mid-2000s and now again in 2021.

In contrast, a period where the currency is rising due to increasing Australian inflation expectations versus the rest of the world can see equity investors become concerned about rising local interest rates, slowing earnings growth. We saw this scenario in the 1990s, and more recently after the GFC (2010-2012) when local inflation expectations accelerated.

The A\$ sector impact varies considerably. In Exhibit 3 we have ranked the sectors by price correlation to the A\$ from most negatively impacted to most positively impacted.

Exhibit 3: Ranked sector correlation to the A\$ (negatively impacted to positively impacted)

Rank	Sector
1	Healthcare
2	Consumer Staples
3	Utilities
4	Communication Services
5	Real Estate
6	Financials
7	Consumer Discretionary
8	Industrials
9	Information Technology
10	Energy
11	Materials

Source: Refinitiv, Wilsons. Monthly sector excess return versus the A\$/US\$ 2001-2021.

The reason the energy and materials sectors do well under a rising A\$ is that it is commonly associated with increasing oil and commodity prices driving an earnings upgrade cycle in the sector(s).

In contrast, there is little to offset currency impacts on the healthcare sector from either a revenue or cost perspective. Consumer staples and utility sectors typically see investors rotate out of defensive earnings streams into cyclical sectors in response to the factors driving the A\$ upwards.

How Investors Should be Positioned with Regards to the A\$

Over the long-term, the currency impact on Australian equity returns is negligible.

1. Unlike currencies, corporate earnings have the ability to compound over time.
2. The A\$ tends to mean revert to the long-term average in the A\$/US\$ 0.73-0.75 range.

In the short-term, currency fluctuations can profoundly impact equity returns, particularly on specific stocks.

With a relatively subdued view around the outlook for the A\$ into 2021, we think there is low probability of the A\$ going into the 0.80-0.85 range for a sustained period of time. The currency forms an input for consideration rather than dominating our thinking around stock selection for the Wilsons Australian Equity Focus List.

The prospect of a global reflation-led corporate earnings recovery far outweighs the impact of a potentially higher A\$. This is the case for both domestic and globally-focused companies in the Focus List, with the List continuing to outperform the index through the Nov 20 - Jan 21 period.

Focus List A\$ Exposure

The Focus List has a slight bias to the US\$. By weighting, 54% of the Focus List has a negative correlation to the A\$ from a historical price return perspective. Healthcare names and offshore earners like Aristocrat Leisure (ALL), Appen (APX), James Hardie industries (JHX), and Macquarie Group (MQG) are all represented given the above market global earnings growth prospects these companies offer. We have ranked each stock by A\$ sensitivity in Exhibit 4. Broadly we see our exposure to a rising A\$ as relatively balanced.

Exhibit 4: Focus List correlation to the A\$

Stock	Correlation to AUD	Focus List Weight
WorleyParsons (WOR)	High Positive	3%
OZ Minerals (OZL)	High Positive	3%
BHP Billiton (BHP)	High Positive	10%
Northern Star Resources (NST)	High Positive	3%
Seven Group (SVW)	Low Positive	4%
Reliance Worldwide (RWC)	Low Positive	3%
Santos (STO)	Low Positive	4%
Appen (APX)	Low Positive	3%
ANZ Banking Group (ANZ)	Low Positive	7%
Aventus Retail Prpty (AVN)	Low Positive	4%
Super Retail Group (SUL)	Low Positive	3%
Aurizon (AZJ)	Low Negative	3%
Commonwealth Bank (CBA)	Low Negative	7%
National Aus. Bank (NAB)	Low Negative	5%
Xero (XRO)	Low Negative	4%
Telix Pharmaceuticals (TLX)	Low Negative	2%
Goodman Group (GMG)	Low Negative	3%
News Corp (NWS)	Low Negative	2%
Macquarie Group (MQG)	High Negative	6%
ResMed (RMD)	High Negative	2%
Aristocrat Leisure (ALL)	High Negative	4%
Transurban Group (TCL)	High Negative	4%
James Hardie Industries (JHX)	High Negative	3%
CSL (CSL)	High Negative	7%
EML Payments (EML)	High Negative	2%

Source: Refinitiv, Wilsons.
Monthly stock excess return vs the AUDUSD 2001-2021.

While we have not explored the earnings sensitivities to a higher A\$, recent guidance from Appen (APX), EML Payments (EML), and Worley (WOR) has all been currency dependent. CSL (CSL) providing earnings on a constant currency basis – which strips out the impact of FX movements – does not change the fact that translated US\$ earnings into A\$ do come under pressure as the A\$ rises.

The upcoming reporting season is likely to see the A\$ feature in a number of company outlooks, given the ~10% appreciation since last season – albeit with most of the appreciation happening in the last two months of the reporting period (Nov/Dec). The impact on reported numbers should therefore be relatively modest, given the A\$ averaged 0.72 over the 2HCY20 period.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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