LightHouse
INVESTMENT SERVICES

"When ten people would rather talk to a dentist about plaque than to the manager of an equity mutual fund about stocks, it's likely that the market is about to turn up. When the neighbours tell me what to buy and then I wish I had taken their advice, it's a sure sign that the market has reached a top and is due for a tumble."

Peter Lynch (on his "Cocktail Party" theory of market forecasting)

Over the past couple of years one of the strong themes that have influenced our investment decisions has been the strength of the Australian dollar. Ever since the dollar appreciated above the mid US$0.80 level we have treated it as an opportunity to use its enhanced purchasing power to buy assets with an exposure to non-Australian dollar currencies. In doing so we are expecting to profit from higher prices and income if and when the Australian dollar returned to more "normal" levels. This exposure can be achieved by buying offshore equities directly on foreign stock exchanges, buying listed investment companies or managed funds that invest in such assets (and do not hedge their currency exposure) or buying Australian businesses that earn a large part of their income in foreign currencies. Around a quarter of our overall holdings are currently in securities that will directly benefit from a weaker Australian dollar.

With the dollar currently hovering around parity with the US dollar this is clearly a strategy that has not yet borne fruit. But does this therefore make it a poor investment decision, or even one that ought to now be reversed?

The strength of the Australian dollar is largely due to:

- Chinese demand for commodities,
- the interest rate differential between Australia and the rest of the developed world, and
- the United States' "quantitative easing".

We are now seeing some cracks in the Chinese economy. Chinese property prices have begun to decline and with property developers reportedly sitting on almost two years' worth of unsold inventory in both Beijing and Shanghai (let alone "ghost cities" like Ordos in Inner Mongolia) it is not difficult to see that trend rapidly accelerating. The Reserve Bank began to lower the Australian cash rate on Melbourne Cup Day, taking it from 4.75% to 4.25% over the December quarter. The market consensus is that it is likely to lower it by a further 0.75% over the course of 2012. With the US cash rate "in a range between 0% and 0.25%" the US Federal Reserve does not have the luxury of being able to lower its cash rate and so the interest rate differential should continue to narrow, making it less attractive for global institutions to hold cash in Australian dollars. The US economy has begun to show signs of gradual but steady recovery further reducing the likelihood of a third round of quantitative easing (QE3).

We are also seeing many global businesses (as well as Australian currency-exposed businesses) trading at historically low earnings multiples. If you were not to take advantage of the strong purchasing power of the Australian dollar to buy these businesses now, when would you?

I would argue that, far from invalidating the case for investment in non-Australian dollar assets, recent events have strengthened the case for holding a meaningful portion of your portfolio in assets that will benefit from a lower Australian dollar.

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