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The dollar and your shares

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PORTFOLIO POINT: How will the sagging US dollar affect your portfolio?

The US dollar is in terminal decline, experts say. Warren Buffett, Jim Rogers, Bill Gross, George Soros and Dimitry Medvedev have all recently and emphatically stated that the US dollar is going lower – a lot lower. So what does that mean for your share portfolio?

The current circumstances are as much due to the supply of dollars and the need for the US to inflate its way out of its mire, as it is a need to correct the deficit/surplus imbalances that exist between the US and, well, virtually everyone in Asia.

Quite simply, if you are the US and you owe everyone else billions of US dollars you can make the repayments cheaper by allowing the value of your currency to decline. Who needs tanks when you can steal by printing copious quantities of the object of your liabilities.

More immediately, the US dollar will also face pressure as the global economy begins to recover but US officials keep interest rates near zero.

Countries with poor economic management often rely on a declining currency to boost export demand and bring some order to their deteriorating balance of payments. Their standard of living, however, declines in tandem as the country's constituents work not only for the repayment of the debt but increasingly for the benefit of the foreign owners of the property on which they work.

Faced with this prospect, the United States has several options. The first is to accept the decline in the dollar; the second is to find alternative sources of finance; and the third is to adjust government policies to improve confidence in US assets among its creditors.

While the US currently enjoys a legacy safe-haven status due to "geostrategic" tension elsewhere, this is now less so. Consequently, its domestic and foreign policies need to be modified to meet new creditor expectations. This creates a risk that the US could face a foreign policy and financial crisis simultaneously.

Amid the global currency realignment now under way, international investors search for a safe haven for their money. And amid a belief that China's demand for commodities will continue to increase, Australia looks, to currency traders and investors, like a geological welcome-mat at the door of Asia. Keep this in mind when fearing currency-related losses of our exporters. More on that in a moment.

A weaker US dollar against what was only recently referred to endearingly as the "Australian Peso" or "Aussie Ringit", has an impact for Australian company balance sheets and profit and loss statements. These outcomes are often exaggerated because the Australian dollar is the popular kid in the foreign exchange playground as China's demand for Australian minerals booms again and the Reserve Bank keeps its finger on the interest rate trigger.

Before I mention some of the Australian companies impacted, it is important to remember that currency movements don't occur in a vacuum. If all that changed was the currency, your job would be a lot easier. The rising Australian dollar will mean lower prices for commodities such as base metals in Australian dollar terms, but rising demand from China should ensure demand for those same commodities. And just as the falling US dollar mimics the state of that country's economic performance, it also increases safe-haven buying of precious metals too.

Further but perhaps not finally, the rising Australian dollar may produce earnings headwinds but it also means that those companies with cash for acquisitions will be able to buy them more cheaply.

If it all seems too hard there is always the option of buying domestically based businesses with no currency exposure (see Alan Kohler's column, *Bank stocks recovery is for real*, page 2).

A rising Australian dollar simply means Australian companies can buy more foreign currency, and companies importing products or components also benefit. Conversely, exporters of Australian manufactured products that requirement payment in Australian dollars suffer the most because their products are now more expensive for overseas, particularly US, buyers.

Suppose you are a mining company selling iron ore overseas in US dollars. When you get paid, you get US dollars. You then convert the US dollars into Australian dollars. If the Australian dollar rises, you will get fewer of them than before.

Mining companies and other exporters such as agricultural companies suffer from a rising Australian dollar: their products are more expensive, making them less competitive. Australia's biggest exports are minerals and fuels (coal and iron ore), followed by services (education and travel), more minerals and fuel (gold and crude petroleum, aluminium

and natural gas) and then manufacturing and rural exports (beef followed by wine, then wool, wheat and other meats).

In Australia you may think of Foster's, CSL, BHP Billiton, Rio Tinto and Woodside but remember diversification of operations and rising commodities offset the effects of the declining dollar. Other companies with a local currency cost base but revenues in US dollars include Amcor, Iluka Resources and Energy Resources Australia (where a US1¢ change in the exchange rate has a $7 million impact on underlying earnings. To see more of this modeling see *Winners and losers*, page 8).

Companies with operations in the US suffer the same impact. As they repatriate their US dollars home, and translate their offshore assets into the local currency they are worth less. In this space, think Macquarie Infrastructure Group, Westfield, James Hardie, QBE Insurance, Sonic Healthcare, Computershare, Billabong, ResMed, Aristocrat and Lend Lease.

If you import goods, however, they will now cost less because it will take fewer Australian dollars to pay for them. Importers such as Wesfarmers-owned Bunnings, Coca-Cola Amatil, Pacific Brands, The Reject Shop, Supercheap Auto, Nick Scali and Fantastic Furniture should also see cost benefits in the immediate future from the stronger Australian dollar, although in the longer term all bets are off if the Chinese currency floats.

While I maintain my distaste for airlines, Qantas and Virgin Blue, benefit from a US dollar decline, because jet fuel is priced in US dollars; however this would be offset by a rising oil price. Goodman Fielder would also benefit from lower costs for wheat, which is also priced in US dollars.

Residing on a remote island virtually guarantees foreign currency exposure for all of us. In valuing companies I don't worry overly about the short-term impact of currency changes on earnings; instead, I consider the long-term effects that permanent shifts in the reserve currency status of the US dollar have on returns and returns on equity. You should do likewise. ◆

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