Currency spike can offer buying opportunities

RICHARD HEMMING

The Australian dollar eclipsed the US80c mark this week in what has been a spectacular run since early May, having appreciated almost 10 per cent against the greenback.

Currency is one of the great known unknowns in the investing world. Or is it unknown knowns? One factor in US dollar weakness is definitely that Donald Trump's agenda — which would have seen literally trillions of dollars flowing into the country — has been delayed, and possibly might not happen at all.

It is also noteworthy that the Aussie dollar has also appreciated against the euro and against the pound stirling, indicating a stronger outlook for commodities than previously anticipated (the iron ore price hitting $US70 a tonne might have something to do with that).

What does this mean for Australian companies? Or more to the point, are there any buying opportunities that have arisen out of this sharp, unexpected change in relative values?

Many analysts, including us, work on the assumption of eliminating the currency effect to establish what the "real" or "underlying" earnings of a company are, which is why companies often cite sales result comparisons with prior periods on a constant currency basis (using the same exchange rate for each period).

But this doesn't work for the small caps. Big companies are called multinationals for a reason. Companies like BHP and Rio Tinto have assets all around the world, which creates an effective hedge against currency movements.

The stocks that stand to be most affected are much smaller and are exporters in the true sense of the word, because they don't have the same opportunity to diversify their production as well as their sales.

These companies create products or services here, so have fixed costs in Australian dollars, but generate significant sales from offshore. It's also worth noting that the effect of sharp changes in exchange rates often takes longer to play out on companies that are genuine small caps. That's because these companies are less scrutinised by the market; often the effect of an exchange rate move is only known when they report, leading to a surprise (positive or negative). Share prices move big time when there are earnings revisions.

Finally, because these changes happened mainly in the new financial year, after June 30, in the upcoming reporting season the outlook statements will be one key; the other important factor is the amount of hedging the company has taken on. If a company hedges its foreign exposure, then it's possible that any change in gross profit margins in Australian dollar terms will not happen for a year (assuming exchange rates remain at current levels), when it has to roll over those hedges.

Companies to watch out for that could be in the firing line include the education providers Navitas and IDP Education, which rely upon a competitive Australian dollar to attract offshore students

> Companies that could be in the firing line include Navitas and IDP Education, and Nanosonics and Ellex Medical Lasers

. Another that should be affected is the car parts catalogue publisher Infomedia, which services auto dealer networks around the world. The high-flying software services group Integrated Research could see its wings clipped.

In the past few weeks I have been working with my colleague at Under the Radar, Tim Boreham, with feverish intensity on a series of reports on biotechnology, focusing on the medical technology space. Some of these companies are in the firing line and have been sold off in advance partly because of their exposure to an appreciating Aussie dollar owing to their global customer base. These include the sterilisation specialist Nanosonics and the ophthalmology technology group Ellex Medical Lasers.

Richard Hemming is an independent analyst who edits www.undertheradarreport.com.au. He does not own shares in any of the stocks mentioned.

Aussie dollar's trajectory in doubt

A fall in the current account deficit changes the game

DON STAMMER

With strong exports — partly from mining and energy — and soft imports, the external deficit could be just $12bn this year and next

When this year began, the dominant expectation in foreign exchange markets was that the US dollar would appreciate against most other currencies, including the Australian dollar.

The Trump reforms were expected to boost the US dollar by raising the pace of US economic growth — and encouraging American companies to return to the US a lot of their cash hoarded abroad.

It was also thought that money would flow to the US as the Fed further raised the US cash rate; the euro would weaken because of stagnant growth and likely wins by populist parties in the Dutch, French and German elections; Japan would continue trying to cheapen the yen; the yuan would fall as the Chinese economy stumbled and capital flowed out; and the Australian dollar would sink as China's imports slowed and our cash rate was cut.

All the ducks seemed in a neat row — but it turned out they were swimming the other way. As I write, the US dollar is 7 per cent lower against the average of its trading partners' currencies than at the start of the year, and the euro, yen, Aussie dollar and (even) the renminbi have gained against the US currency. Forecasting exchange rates is, most times, a hazardous activity; risk management is always important.

Here's a quick summary of the likely main influences on the Australian dollar/US dollar exchange rate in the coming 12 months, including the current account deficit, which seems to have been ignored.

$US v other currencies

Significant moves in the US dollar against the other major currencies can affect the Australian dollar/US dollar exchange rate. The weakening of the US dollar versus the euro (because of Europe's improving economy and politics) and the yuan (because of the resilient Chinese economy and lessened capital outflows) contributed to the current strength of the Aussie against its US counterpart.

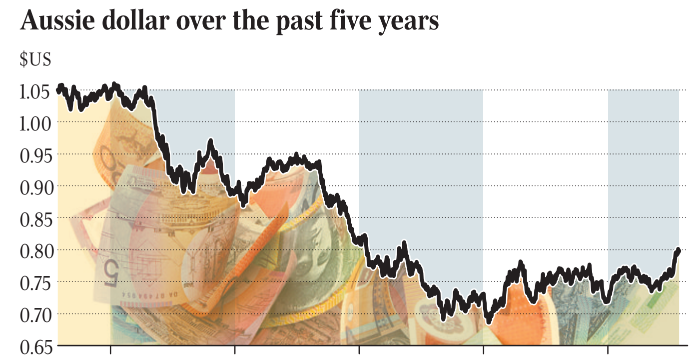
Commodity prices

Whether we like it or not, our dollar is seen as a commodity-based currency, and commodity prices fluctuate widely.

For example, since 2003 the average price of our commodity exports has ranged between 60 and 210 index points and traced out 2½ cycles.

Expectations of commodity prices — which are what really drive the Aussie dollar — seem to have varied even more.

Aussie dollar over the past five years



Source: Bloomberg

> 'The narrower current account deficit ... makes Australia less reliant on foreign financing. Australia funds a greater share of Australia'
>
> RESEARCH REPORT
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China's prospects

With Australia more affected by economic conditions in China than any other western country, forecasts for the Aussie dollar need to incorporate a sensible view on the Chinese economy and its appetite for imports. In recent years, the prevailing expectation in financial markets on China has generally been too gloomy; as a result, our dollar has mostly traded above predicted levels.

Capital flows

Forecasts for our dollar need to take a view on prospective capital flows — and, particularly, how these capital transfers might be affected by the differentials in short-term interest rates between Australia and other countries.

In 2011, our cash rate was 4.75 percentage points above the US cash rate. Since then, we've had our cash rate cut 12 times while the US cash rate has been raised five times. Currently, the differential between the two countries in short-term interest rates is a quarter to a half a percentage point.

A couple of months ago, foreign exchange markets decided the spread between the Australian and US cash rates would soon narrow further, or even turn negative. The line "the last time the interest rate spread was so narrow, the Aussie was worth only US50c" came into many conversations in foreign exchange dealing rooms.

In July, expectations changed again: at time of writing, the prevailing view is for rises in the US cash rate to be gradual and drawn out, and for the Reserve Bank to leave our cash rate unchanged for another 12 months.

What will likely happen to the Australian dollar against its US counterpart should the US cash rate rise above the cash rate here? A lot will depend on the new set of influences on our exchange rate — the sharp decline now underway in the current account deficit.

In 2015, our current account deficit was $75 billion.

With strong exports (partly from the mining boom), soft imports (because of weak domestic demand), higher receipts from exports of services (tourism and education), reduced costs on our foreign debts (low interest rates), and bigger returns on Australian investments overseas (including superannuation assets), the external deficit could be just $12bn this year and next.

A recent research report by Deutsche Bank highlights the likely implications: "The narrower current account deficit ... makes Australia less reliant on foreign financing. In other words, Australia funds a greater share of Australia ... It also means a collapse in the Australian dollar into the mid-60s (US cents) if US yields end up about the same level as Australian yields is much less likely."

My guess is the Australian dollar is likely to fall when the US cash rate first exceeds our cash rate — but not settle at the very low level generally predicted for it. But it's only a guess.

Don Stammer is an adviser to Altius Asset Management and Stanford Brown Financial Advisers. The views expressed are his alone.

How new super laws affect death benefit pensions and the transfer balance cap

MONICA RULE

Before May 22, some self-managed superannuation fund members who were receiving death benefit pensions were concerned about how they were going to reduce their retirement pension account to $1.6 million to comply with the transfer balance cap.

Under the new transfer balance cap rule, effective from July 1, an SMSF member is limited to a maximum of $1.6m in their retirement pension account.

This means any death benefit pension they receive, when combined with their own retirement pension, cannot exceed $1.6m. Exceeding the limit means they would need to either commute their retirement pension and transfer the commuted amount to their accumulation account, or commute the death benefit pension and pay the commuted amount out of their SMSF.

To pay the commuted amount out of their SMSF might mean needing to sell a SMSF asset, which is not always easy.

Under the old superannuation law, the spouses of deceased members did not have to do anything when receiving death benefit pensions, as there was no limit placed on pension accounts.

On May 22, the Australian Taxation Office released guidelines on commutation of a death benefit pension. They state the ATO will not take any compliance action if affected members commute their death benefit pension and retain the commuted amount in their accumulation account, instead of paying it out of their SMSF. This meant these members no longer needed to sell assets to remove the excess moneys above $1.6m from their SMSF's pension account. However, this treatment is allowed only if the surviving spouse commutes the death benefit pension prior to July 1, 2017, after having been in receipt of the pension for longer than six months from the date of their spouse's death or three months from the grant of probate.

> Under the new superannuation law, a death benefit must be paid either as a lump sum, a pension or a combination of both from an SMSF upon the death of an SMSF member

So anyone who received a death benefit pension on or after January 1 will not be able to meet the timing requirements. These people may need to remove some or all of the death benefit pension from their SMSF.

With regards to the surviving spouse retaining the commuted death benefit pension in their accumulation account as their own super savings, it also means the commuted amount (while remaining as an unrestricted non-preserved amount) loses its character as a death benefit.

This means when the money is eventually paid out of the surviving spouse's super account, it will be treated as a normal superannuation benefit and taxed accordingly. It will not receive the concessional tax treatment of a death benefit. Why has the ATO allowed surviving spouses to retain death benefit pensions in their accumulation accounts?

Well, it appears many in the superannuation industry misunderstood the ATO's intent when it released its publication "Taxation Determination 2013-13". This paper implied that death benefit pensions could be commuted and placed back into surviving spouses' accumulation accounts.

Under the new superannuation law, there is no misunderstanding. A death benefit must be paid either as a lump sum, a pension or a combination of both from an SMSF upon the death of an SMSF member as soon as practicable. The death benefit money cannot be placed into a surviving spouse's accumulation account.

Monica Rule is an SMSF specialist and runs SMSF seminars.

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