



## Currency Review

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### AUD...after the Sub Prime Mortgage debacle and what next?

The AUD has had a large fall since it peaked on the 25 July at US0.8870... many exporters thought that it would continue to trade onto US 1.00 and so did many advisors. We continue to support the view that the AUD trades up the stairs and down the escalator this has happened again. The key questions that many are asking is whether or not the low of US0.7697 is a low of magnitude and whether or not the AUD should trade higher from here. In this report we look at the Sub Prime, explain what happened and see whether or not it has changed the state of play for the AUD. We do however; conclude that we have in fact found an intermediate low of some magnitude and that buying the AUD at current levels does represent a good opportunity.

### Why did the crisis emerge?

The best way to work out why is to look at the main ingredients. Sub Prime means exactly that. They are mortgages granted to people who have poor credit ratings. These mortgages are then bunched together to form a mortgage backed security. As the securities are sub prime or just have higher risk they are hard to sell to investors. So in order to make them more attractive these securities are then further packaged together as the risk is then spread amongst many rather than few. This package is then split into tranches which attract different ratings. The credit rating of this new paper improves as the risks are categorised. This new product can then be more easily sold to investors as ratings of AAA+ to BBB- are achieved, higher the yield, higher the risk. In these offerings yields of between 5.45% through to 7.5% are achieved.

### What happened next?

As the Housing market in the US took a turn so did the ability of people to repay the loans. So these defaults/delinquencies increased on an alarming basis and the return on the lower rated paper was questioned. As it became increasingly difficult to value these investments credit markets tightened. As the risks started to blow out the cost of money for BBB- blew out, in the above example out to 30%. As a result Funds looked to exit their obligations and so bids/confidence in the sector deteriorated. As expectations on credit concerns escalated liquidity in the system dried up. The result was higher cost for money. This higher cost caused a domino effect in the asset market as bottom line returns were being questioned. As economic growth is af-

ected by the increased cost of money asset market re-aligned. Equity, commodity and foreign exchange markets spend time adjusting to the new regime.

### How has this affected the AUD?

It is interesting to note that when the crisis developed the market was extremely long carry trades. We suspected that if the volatility in the currency fell by the expected return of the carry then investors would flee in a hurry. This is exactly what has happened. Since this we have seen many exit their carries. The action by the Federal Reserve has dampened the enthusiasm for the trades however the returns are still there just 50bpts lower. In retrospect the yielding plays are still intact so once the dust settles we would expect to see investors back to the market.

### So what does this mean to AUD?

The AUD as mentioned in many of our reports and blerbs "goes up the stairs on down the escalator". As can be seen from the chart below this is exactly what has happened. However, it doesn't make our decisions to buy or sell any easier.

So what would we do if we were an export, importer or investor:



### As an exporter:

As exported if you have not covered any of your currency then the current levels represent good levels for the time being. We cannot guarantee that the AUD will not go any lower, however, given the last 12 months worth of trading it represents solid value. If you need currency then we would suggest putting some AUD on board. If you have currency in at higher levels buying some gives you the ability to average your receivables. Remember the yield will help any bad positions you have over time. If you do not wish to commit currency then look at some call options. At this stage we

feel it is better to have some AUD on board rather than none.

### **As an importer:**

As an importer if you have not hedged any currency then we would look to hold off for the time being. We feel that the AUD has the ability to edge higher from current levels and so would be cautious about taking any long term positions. If you are nervous the Sub-Prime Mortgage fallout will see investors back to the USD, like it did when it first emerged then look at purchasing AUD put options. This way you are protected if the AUD trades lower, however you can reap the rewards if it edges higher. Be cautious when you take on put options as the volatility in the options market is currently high. One solution here would be to buy puts and fund the purchase of these puts by selling calls of a higher strike. This way, if the currency trades lower the downside is covered and if it rallies then your call is exercised. You have sold AUD at a higher price than today.

### **As an investor.**

As an investor this is very interesting as the current level for the AUD represents good value. The yield play is still in tact against the USD and YEN. Given the nature of the commodities market perhaps the AUD has already adjusted to any potential slow down in economic growth. Remember the AUD is close to 14% off its highs... so it looks like good value when comparing from a month ago. If looking to invest in the AUD we would look at taking on small long positions at current levels as your stop on the position needs to be below US0.7650. Once the position becomes in the money then look to take on more. Remember the AUD has this ability to grind higher so if you take a small position the chances are that the position will be in the money over time and you can average higher from a position of strength.

Please do not hesitate to call concerning any of the above. I can be reached on direct call 1300 660 734.