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Appreciating the art in forex

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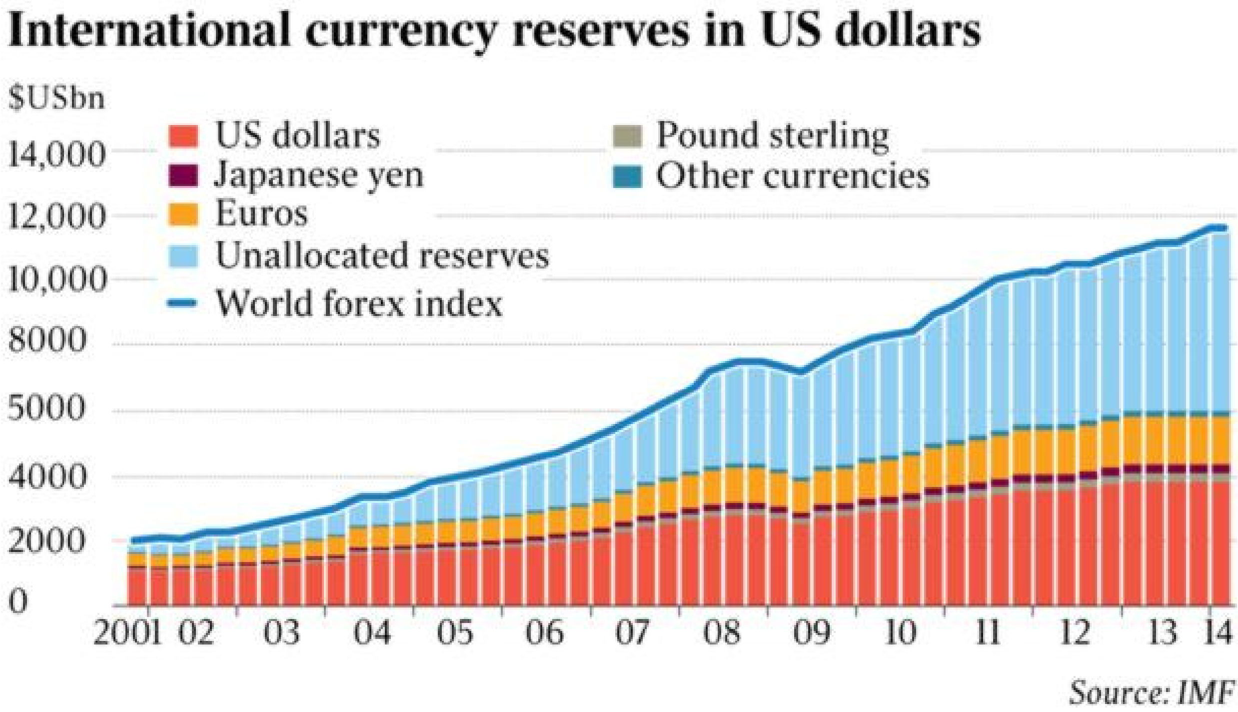

Currency reserves. Source: TheAustralian

LAST month, the iron ore spot price, our largest bulk commodity export, suffered its biggest one-day price fall in more than four years.

Then a curious thing happened. Our dollar nudged higher, not lower. Conventional wisdom would have it the dollar should have fallen, given the supposed importance of iron ore to the Australian economy.

It appears that many ultra-high-net-worth investors have enjoyed timely advice surrounding these events and positioned accordingly, while many other investment communities have not.

This is partly due to the legacy of merchant banking in Australia. This legacy saw today's institutions inherit their current grasp of these flows from the era when both Australia's terms of trade relied on wool and grain exports and when our dollar was pegged to the US dollar.

Even in light of the fact our dollar was freely floated in 1983 and our terms of trade have significantly shifted, this understanding has not kept up with the times.

There remain practical ways whereby we can better monitor these flows and make smarter trading and investment decisions.

We can also better understand why we are seeing the dollar strengthen as we are told it should be weakening.

The first step is to avoid "Pamplona" herd behaviour, which will see us running with the bulls. Too many investment communities base their decision-making on consensus that can also be referred to as "groupthink".

This groupthink has been helpful for those who make reactive decisions but ineffective for those who try to pre-empt the future.

The second and most important step is respecting the fundamentals of monetary economics — all that is currently being faced has been experienced before and much can be taken from those experiences, such as last week's "Abenomics" example.

Both Keynesian and Hayekian schools of economics respect the important role the monetary base plays in all markets and it is front and centre in Friedman's monetarist theory.

In 2014 this conversation has centred on the unorthodox monetary easing policies known as "quantitative easing" or "money printing" throughout much of the world and its impact on others.

Even though foreign exchange appears, at times, to be allergic to reason, the global investor respects that there are sound economic principles at work.

The third step is a good understanding about the role and limitation that a central bank can have.

The Reserve Bank of Australia, our central bank, has been effective on many fronts but has had little influence over the flow of the Australian dollar.

This limit to efficacy is thanks to two equally important realities.

One is that the tools it has, namely those controlling interest rates, have been proven to have limited influence over currency flows. Coupled with this, the RBA itself acknowledges that its other primary currency tool, known as "foreign exchange market intervention", also suffers inherent limitations.

The other reality is that the depth and scope of other central banks' unorthodox monetary policies, namely zero interest rate policies and quantitative easing, have led to currency devaluation wars that Australia is not partaking in — and cannot.

Australian UHNW investors have received the advice that the decisions made at the US Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan have far more direct impact on Australian dollar flows than anything else.

This conflicts with the heavily institutionalised advice afforded by the consensus that our currency is high because of the influences of international interest rate arbitrage opportunities (known as a "carry trade") and our link to commodity markets, namely iron ore.

But the consensus analysis has been flawed. When the RBA has named successive interest rates cuts over the past two years, again our dollar moved contrary to what one would expect if it were high due to carry trades.

UHNW investors have placed more credence towards the advice grounded in economic fundamentals than that advocated by the popular consensus. They know to pay more attention this year to the events of the global currency devaluation wars than anything else. For all Australian investment communities, there are more ways than ever before to trade and invest in the Australian dollar.

Currency pair trades — in which you buy and sell two different currencies and arbitrage the spread — are not new but have enjoyed increasingly popularity.

This is because transactions can now be executed using a broader array of instruments than have been previously available.

These include quoted trading warrants, over the counter products and even bespoke exchange traded funds that have encapsulated both legs of these transactions in one tradeable parcel.

A topical pair trade has been the Australian dollar and South African rand spread on the back of the David Jones bid.

A derivative product known as a dual currency deposit has also seen a recent resurgence thanks largely to the continued expansion of the currency devaluation wars. A DCD is a money market-linked deposit that attempts to attract higher yields in another jurisdiction.

The managing director of the SILC Group, Koby Jones, says they are also seeing more foreign investors, particularly from Southeast Asia, undertaking off-market transactions on a direct, syndicated and fund basis.

"There is no reason why more Australian investors cannot also participate in these transactions," he says, and goes on to say "Today we have far more Australian dollar hedging options than ever before."

UHNW traders saw this first-hand when in November 2012 the International Monetary Fund announced that the Australian and Canadian dollars would be included in the Currency Composition of Official Foreign Exchange Reserves report.

After this inclusion the Australian dollar has been an increasing part of many central bank portfolios.

This inclusion meant they had to rebalance their portfolios on a daily or weekly basis to keep the value of their portfolios within the risk limits prescribed by their mandates.

So in practice, if the Australian dollar went up, they sold and if it went down, they bought. This therefore compresses the price action within the fluctuating range and is often referred to as "top and tail".

UHNW traders closely monitor these central bank portfolios and include this information in their future Australian dollar decisions.

There is legitimacy in the belief that foreign exchange is more art than science and respecting this helps us connect to our investments and the world.

Larkin Group is a wholesale wealth advisor focusing on high-yielding regional investments.

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