

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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EXCHANGE RATES: WHAT TO DO?

As the Australian economy has become more sophisticated, the winners and losers from an exchange rate appreciation are harder to fathom.

The conventional view is that exporters lose and importers gain as the Australian dollar rises. An investor should be aware of the exposures which are faced by companies in which he is invested to avoid the balance of his exchange rate exposure biasing his portfolio performance in one (perhaps unknown) direction.

The impact of a currency appreciation can vary from a large loss of profit to a large profit rise depending on how the company organizes its activities.

The Australian dollar has fluctuated by up to 30% against its rolling five year average value during the past five years and is near its peak variation now.

For investors, one choice might be to ignore the fluctuations and look at the longer term – that is, act as if there is no significant trend in the exchange rate.

This might be a reasonable course for an investor with a longer time horizon since the performance of the

Australian economy, especially in terms of the key inflation indicator, is now more closely aligned with the rest of the world. It is only when Australia's inflation performance has been out of line with inflation rates in the rest of the world that there has been pressure for a trend change in the direction of the exchange rate.

An investor with a shorter horizon might consider selecting stocks with an eye to what effect the next exchange rate fluctuation might have on the return performance of the portfolio.

One simple way of monitoring the position is to categorize companies in a portfolio in one of five ways.

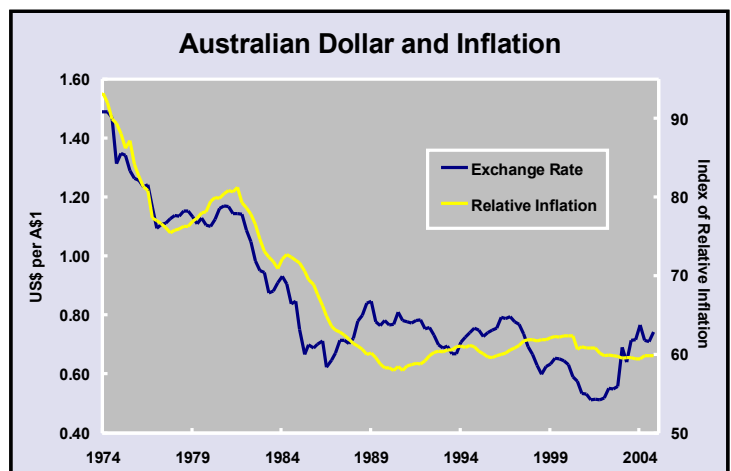
How a 10% currency appreciation affects profits*

- Type A No change
- Type B Down 67%
- Type C Down 4%
- Type D Up 34%
- Type E Down 10%

* using a simplified example with revenue of 100, costs of 85 and 30% tax

Type A is a wholly domestic company. All of its revenues are generated in the local market and all of its costs denominated in Australian dollars. A service provider, property developer or smaller consumer goods distributor are likely examples of this type of company. There is no direct exchange rate impact from a currency move.

Type B is a company whose production is

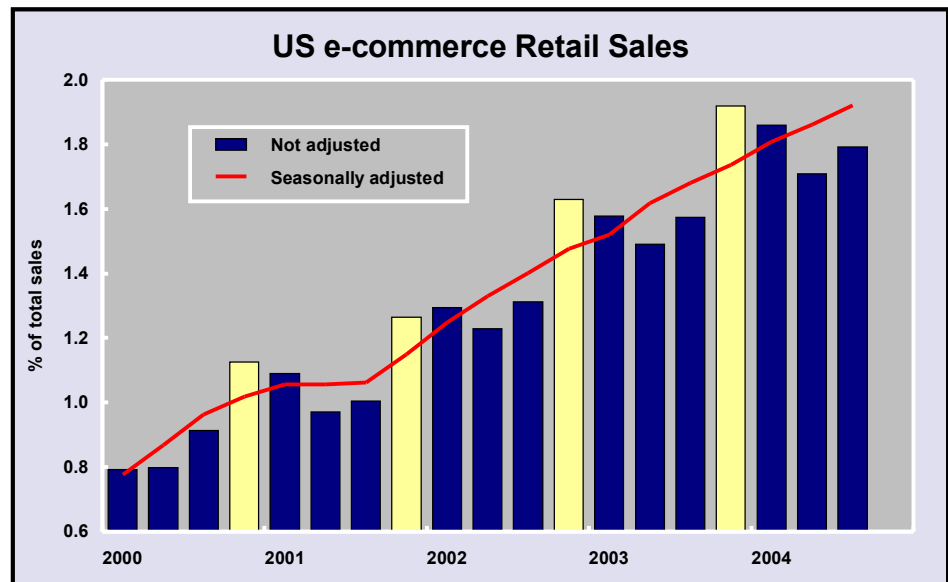


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THE WEEKLY CHART SPOT

The US Department of Commerce has begun publishing seasonally adjusted statistics (shown in the red line) for its e-commerce retail sales series. The most recent data, for the September quarter, again shows little change in the penetration of retail e-commerce.

Adjusted for the 'Christmas shopping effect', e-commerce retail sales account for 1.9% of total retail sales activity.



Source: US Department of Commerce

HOW MISLEADING IS UNEMPLOYMENT? CONT'D

than the 57.8% employed in the third quarter of 1981 when the cycle was at its previous peak.

While overall employment conditions have clearly been improving, the rate of full-time employment (shown in the yellow line) is barely different to what it was in the early 1990s. On that measure, the recession delivered a one-off change from which Australia has never recovered.

The supposed improvement in labour market conditions has been driven by higher rates of part-time employment.

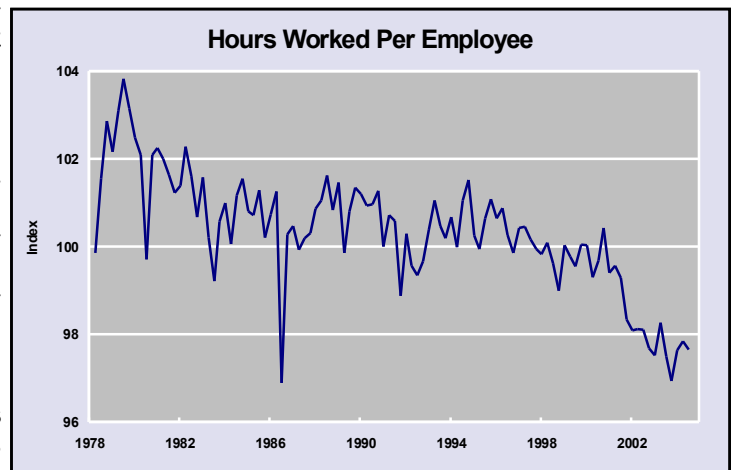
Some would say that the more extensive use of part-time employment reflects welcome flexibility for both employers and employees. However, the other view is that employed people are still not getting as much employment as they would like.

On this view, it would be wrong to say that Australia's labour market conditions are as good as they have been over the past 25 years. Two part-time workers could be putting in half the number of hours of a full-time worker and the unemployment rate would be showing a fall.

The third chart showing an index of the

number of hours worked per employed person illustrates the important change which has been occurring since 2000. Although the number of people who have been given employment of some form has risen, the nature of that employment has changed considerably. On average, people are working fewer hours than they had been working prior to 2000.

Despite no single statistic being able to



represent accurately the prevailing conditions, the evidence is clear on one point. Labour market conditions have not improved so much that there has been any noticeable improvement in full-time employment. Greater preparedness of employers to take on full-time workers would be one of the clearest indicators of better labour market conditions. ■

EXCHANGE RATES: WHAT TO DO? CONT'D

(Continued from page 1)

wholly located in Australia but whose entire output is sold in foreign markets at prices denominated in US dollars. This is similar to the typical Australian resources company.

Type C is a company with a substantial part of both its production and markets located offshore. We assume, in the example cited below, that it has 40% of its revenue and production costs in an offshore location. Examples of this type of company would include some of the larger Australian firms such as Amcor, National Australia Bank and Foster's Group.

Type D is where all the revenues are generated in the domestic market but a substantial proportion of the costs are in foreign currency. We assume for the example that 60% of the costs are denominated in a foreign currency. Local manufacturers which import materials for their production processes or companies which have offshore production centres for the fabrication of goods which are to be sold in the domestic market are examples.

Type E is where the local company has all its revenue and a predominant portion of its costs (say 80%) denominated in foreign currency. Some of the biotech companies whose markets are entirely offshore and whose costs reflect the overseas market development activity which is necessary to build alliances and take a product to market could be characterized in this way.

To illustrate the currency impact, the table uses a simple model of a company with a revenue base of 100 and a pre-tax profit margin of 15% facing a 10% currency appreciation.

At face value, Type B companies are clearly the big losers from currency appreciation. However, a strengthening Australian dollar might reflect more favourable international growth prospects. For a commodity producer selling US dollar denominated raw materials, demand might be rising at the same time, more than offsetting any adverse currency impact.

Moreover, US dollar denominated prices of internationally traded commodities tend to rise with a weaker US dollar. In part, raw material users in non-US dollar regions bring the prices back to their previous non-US dollar values pushing the US dollar prices higher.

For exporters of commodity raw materials typically priced in US dollars, the disadvantage from an Australian dollar appreciation might be negligible.

Conversely, a weaker Australian dollar is not an unambiguous advantage. Investment markets do not usually accord a profit change from a currency fluctuation the same value as one from an operational or commodity price change. A very weak Australian dollar, for example, has rarely implied buoyant resource stock prices.

Despite the apparent financial exposure, an appreciating currency might still be the preferred scenario.

In evaluating export oriented companies, a distinction needs to be drawn between commodity producers with prices set in international markets and exporters whose sales are priced in Australian dollars or other non-US dollar currencies.

Type D companies are the big winners. However, despite being a clear beneficiary of currency strength, there is a risk of the investment market discounting the benefit.

A currency-based windfall might be accorded a relatively low value if the market concludes that it is not sustainable, a likely conclusion given such a long history of Australian dollar weakness, the dollar trading at above average values and little fundamental analysis pointing to a permanent lift in its value.

While the sensitivity of Type E companies to currency appreciation is not apparently great, the impact might be significant enough to be of concern since early stage companies often have limited cash resources and might not have budgeted for a change in currency circumstances.

Seeking to minimize the currency impact on earnings would lead investors to Type C companies. Their relatively small profit sensitivity arising from geographic diversification of production and sales represents an inbuilt management of risk.

An alternative is to structure a portfolio so that the net effect on overall profitability of currency change is not significant.

Using the example here would mean having a portfolio comprising one-third Type B companies and two-thirds Type D companies to eliminate the impact on overall profitability of an exchange rate shift. ■

“An investor should be aware of the exposures which are faced by companies in which he is invested to avoid the balance of his exchange rate exposure biasing his portfolio performance in one direction.”

HOW MISLEADING IS UNEMPLOYMENT?

An employment rate is a more meaningful indicator of labour market conditions than the more frequently used unemployment rate which usually receives the headlines.

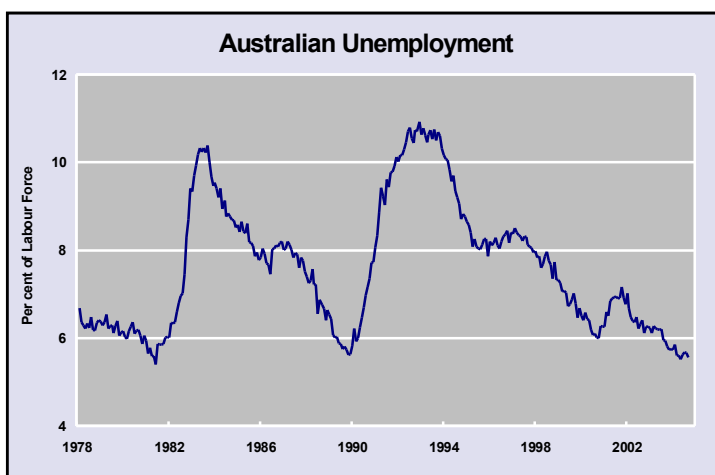
Australia's unemployment rate is as low as it has been for the last 25 years. While it might not have seemed so at the time, there has been more or less steady progress in reducing unemployment since the recession of the early 1990s. Measured conventionally, the unemployment rate has fallen from a high of 10.9% in December 1992 to 5.3% in October 2004.

Unfortunately, as a summary measure of labour market conditions, the much-quoted unemployment rate has some significant inadequacies.

One shortcoming is that it does not take account of the duration of unemployment. Unemployment with a strong chance of another job following within a few weeks is very different to unemployment which might mean permanent exclusion from paid work.

Another shortcoming is the tendency to understate the true unemployment rate

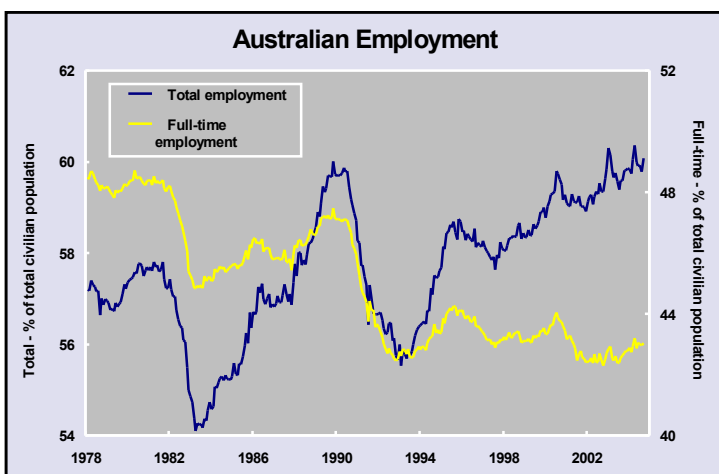
whatever the duration of unemployment. If labour market conditions are sufficiently poor that people give up hope of finding a job, they will cease to identify themselves as looking for work. That excludes them from the definition of the labour force so they are no longer part of the unemployment tally.



“...as a summary measure of labour market conditions, the much-quoted unemployment rate has some significant inadequacies.”

The rate of employment is little used in public commentaries but might go some way to giving a more accurate version of labour market conditions. The second chart shows employment as a percentage of the civilian population over 15 years of age.

The blue line which shows total employment suggests a similar pattern to unemployment. Labour market conditions have been improving steadily since 1997 and have reached a point which suggests that they are as good as they have been.



The same proportion of the working age population is employed today as was employed at the beginning of 1990 at the peak of the last cycle and before the onset of recession. The proportion of the population currently employed is some 2½ percentage points higher

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