

## Global reflation mark II, gold and the Australian dollar



### Key points

- The sub-par recovery in the US, Japan and Europe and constrained fiscal policy most likely means that we will see another round of global policy reflation, centred on quantitative easing (or printing money).
- This will be bad news for G3 currencies, but good news for Asian currencies and gold. It will likely also help stimulate the next asset price bubble.
- The Australian dollar (A\$) is likely to head higher as Japan and the US boost their money supplies and the Reserve Bank of Australia (RBA) continues to raise Australian interest rates.

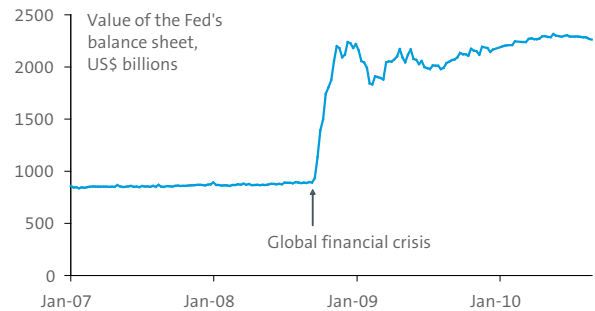
### Global reflation mark II

Another round of global monetary reflation is likely getting underway with the US Federal Reserve (the Fed) and the Bank of England indicating that they are now considering additional monetary easing and Japan undertaking its own easing in moving to push the value of the yen lower. This has major implications for foreign exchange markets, the gold price and the next asset price bubble.

**The key driver is the sub-par nature of the recoveries in the US, Japan and Europe and the inability of fiscal policy to respond further due to already high public debt levels.** With interest rates at or close to zero, central banks look to be turning to another round of quantitative easing. Technically this involves expanding the size of the central bank's balance sheet and basically involves using printed money to buy securities, thereby increasing the quantity of money in the system. Increase the supply of something and its price normally falls!

- Following its September meeting, the US Federal Reserve has indicated that it is considering more monetary easing if needed to support the economic recovery and push inflation back up to levels more consistent with price stability. And since the Fed funds rate is close to zero, this effectively means another round of quantitative easing (or QE2 as it has been called), which involves using printed money to buy Treasury bonds. With US growth now below the level necessary to stop unemployment from rising (which is at least 2.5% pa) and the Fed likely to revise down its 2011 growth forecasts, it is likely to engage in quantitative easing following its November meeting. Market speculation is that the Fed is considering undertaking another US\$1 trillion of asset purchases (which is equivalent to 7% of US gross domestic product [GDP]). Following on from the US\$1.3 trillion in Fed asset purchases in 2008-09 this would result in a further sharp rise in the size of the Fed's balance sheet (see the chart below) and another big increase in the supply of US dollars (US\$).

### The FEDs balance sheet looks set to expand further



Source: US Federal Reserve, AMP Capital Investors

Market expectations of QE2 in the US and a resultant increase in the supply of US dollars have seen renewed downwards pressure on the US\$.

- The Bank of England has also indicated that it is considering more quantitative easing.
- Tired of seeing the yen move ever higher in response to a weakening US\$, Japan has responded by starting to buy US dollars and leaving the increased supply of yen in the economy in what is called unsterilised intervention. As such it has essentially engaged in quantitative easing itself. Currently it has only spent ¥2 trillion but purportedly has ¥35 trillion available, which is about 7% of its GDP and hence roughly matches the potential US easing.
- So far Europe has merely complained about the Bank of Japan's intervention and it is still reaping the benefits of the weaker euro seen over the December to May period. But with the euro rising sharply again in response to a weaker US\$ and fiscal tightening likely to impact next year there is a good chance that it will also be forced into quantitative easing next year.

The end result is likely to be an increase in the supply of US dollars, Japanese yen, British pounds and euros and a race down in each of these currencies, with the US\$ leading the charge.

Such 'beggar thy neighbour' policies or 'competitive depreciations' will no doubt result in worries about all sorts of things, in particular inflation and trade tensions. Inflation is a risk but as with QE1 it isn't going to happen until people start spending and spare capacity, evident in circa 10% unemployment in the US and Europe and idle factories, is used up. Right now the bigger risk is deflation, so G3 central banks can afford to take risks with printing more money.

**Another obvious issue is will it work?** Quantitative easing operates by injecting more cash into banks, lowering mortgage rates and corporate borrowing rates (as government bond yields fall) and pushing the exchange rate lower (at least against countries not doing the same). But so far US banks have not lent much of the cash out from the first round of quantitative easing (i.e. the money multiplier remains low) and mortgage rates are already at record lows. The counter argument is that QE1 probably did prevent a worse outcome, banks will be able to further rebuild their

balance sheets, further falls in mortgage rates will allow more US homeowners to refinance their loans at lower rates and the US\$ will at least fall against non-major currencies providing a further boost to its exports. Also, Federal Reserve Chairman Ben Bernanke feels that he at least has to try!

### So what will it all mean?

There are several implications from another round of monetary easing.

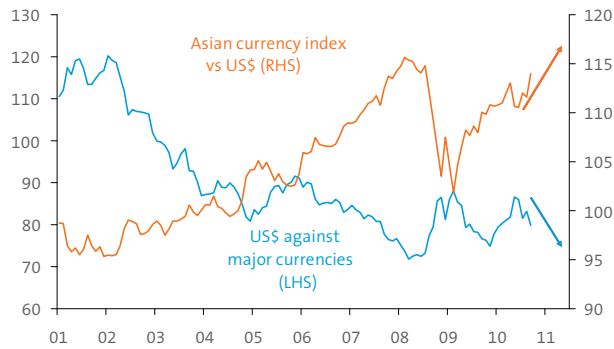
First, it means another boost to global liquidity which should at least support growth, if not provide an additional boost to growth going forward.

Second, it will likely be positive for share markets and other listed growth assets as it was through last year following QE1.

Third, it will be bad for G3 currencies – first the US\$, but also the yen and ultimately the euro as its economy lags the US and it is forced to do the same.

Fourth, Asian and other emerging market currencies are likely to remain key beneficiaries as their central banks engage in tightening and the relative supply of their currencies falls relative to US dollars, yen, British pounds and euros. China's move last week to allow a faster appreciation in the renminbi will likely help accelerate the rise in Asian currencies.

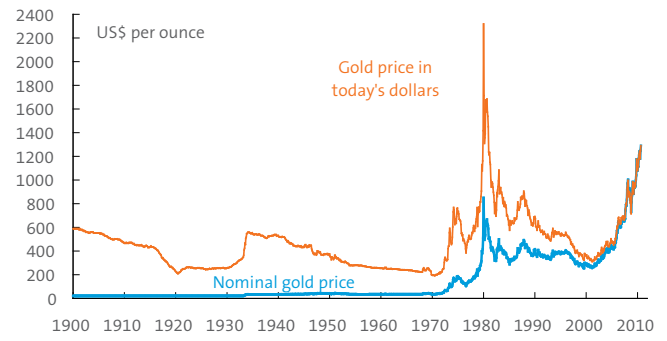
#### Expect Asian currencies to keep rising as the US\$ falls



Source: Bloomberg, AMP Capital Investors

Fifth, the increase in the supply of US dollars, yen, British pounds and euros (the latter next year) will be good for gold as investors seek a safe haven from falls in major paper currencies. This explains why gold has recently broken out to a new record high, even though inflation remains benign. The chart below shows that while the gold price has come a long way over the last decade it is still well below its inflation adjusted peak of 1980, when gold rose above US\$2,000 an ounce. It will likely head up to a similar level over the next few years.

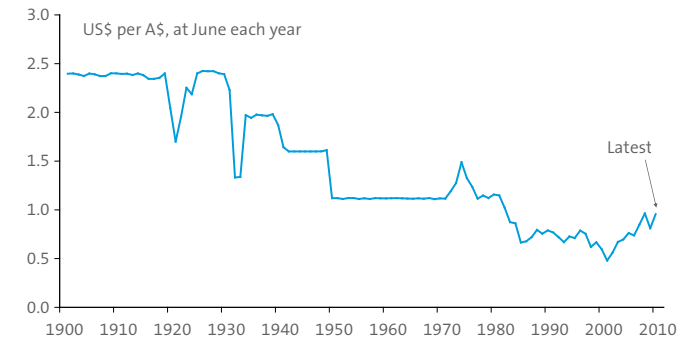
### More to go – the real gold price is still well below its 1980 peak



Source: Global Financial Data, AMP Capital Investors

Sixth, commodity currencies such as the Australian and Canadian dollars are also likely to be key beneficiaries. Talk of an additional boost to the supply of US dollars via quantitative easing is coming at a time when the RBA is signalling more interest rate hikes and commodity prices are strong all of which are positive for the A\$. All the talk of QE2 in the US is helping propel the A\$ back to parity against the US\$. The chart below showing the value of the A\$ since 1901 serves as a reminder that the post float period of the A\$ which saw it slip below parity was an aberration. The norm up until early 1982, was for the A\$ to trade above parity. This includes the early 1950s when the terms of trade was about as strong as it is now. Back then, one Australian dollar bought US\$1.12.

#### The norm for the A\$ over the last century was above parity with the US\$



Source: Thomson Financial, RBA, AMP Capital Investors

Finally, another surge in global liquidity will help fertilise the next asset price bubble, the seeds of which have already been sown in the bursting of the last. This could well be in emerging markets or commodities. And, to the extent that emerging market countries intervene to resist appreciation in their currencies, it will only add to the boost in global liquidity.

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