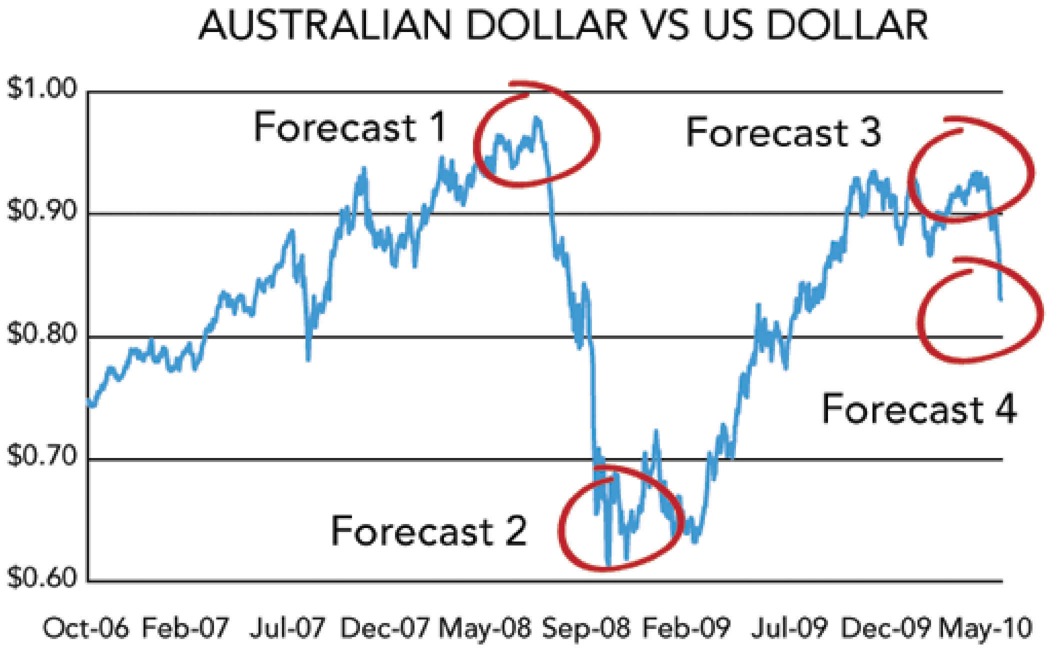
Dollars to Donuts

Anyone who still believes that you can make money consistently by forecasting market movements might want to interview clients of US investment bank Goldman Sachs.

According to Bloomberg, seven of Goldman's nine recommended top trades for 2010 had been losers for clients as of mid-May. These included 14 per cent losses by buying the Polish zloty against the Japanese yen and nearly 10 per cent trading the British pound against the Kiwi dollar.[1]

The Australian dollar was not mentioned as a 'top trade', but judging by the recent run of media commentary, pundits trying to anticipate the Aussie's movements in the past two years might be licking their wounds as well.

Indeed, forecasts have been so bad they have almost proved to be a contrarian indicator of the currency's actual direction, as the chart below of the past three and half years of the $A's movements shows.



Source: RBA

Back in mid-2008, the Australian dollar reached more than 98 US cents, its highest levels since it was floated in the mid-1980s. Economists were quoted as saying the currency would "match the greenback cent-for-cent by Christmas, if not within months".[2] That is shown above as 'forecast 1'.

No sooner had the parity parties been called than the $A fell spectacularly out of bed, crashing more than 40 per cent in the space of three months to a five-year low just above 60 US cents. This was during the worst period of the global financial crisis when risk appetites shrank dramatically.

By October 2008 (forecast 2), economists were saying the $A was on a one-way ride to below 60 US cents and to the levels prevailing during the tech boom 10 years ago when Australia was judged to be an "old" economy.[3]

But hold off on the last rites. As risk appetites revived in March 2009, the Australian exchange rate took off again and, within just over a year, had appreciated all the way back to nearly 94 US cents.

So what did the economists say this time? You guessed it: The little Aussie battler was on its way back to parity (forecast 3).[4]

Well, talk about tempting fate. Sure enough, no sooner had this call been made than the currency turned tail again and sank more than 10 per cent in the space of a couple of weeks. The trigger, said analysts, was a global unwinding of so-called "carry trades" as Europe's sovereign debt crisis sparked a sudden aversion to risk.

True to form, economists responded by warning of more of the same, calling for the currency to drop to 77 US cents and lower (forecast 4).[5]

It should be evident from all of this that pundits have a knack for turning what has *already happened* into a forecast. In other words, predictions of a currency's decline seem quite feasible when it has just dropped 10 per cent.

But the market tends to be always a couple of steps ahead of the professional forecasters, so that the trigger for any turnaround is the capitulation phase when everyone is jumping on the same bandwagon.

The Australian dollar is such a good example because it is often seen these days as a kind of canary in the coal mine of global investor sentiment. Despite Australia's relatively small economy (18th in the world in size), its currency is the sixth most traded globally, behind the US dollar, Euro, Japanese Yen, Pound Sterling and Swiss Franc.[6]

Depending on circumstances, the $A is perceived, rightly or wrongly, as a yield play, a China proxy, a commodity proxy, a signaller of market expectations for global growth and as a barometer of risk appetites.

What this means is that people who try to forecast the Aussie's movements must be able to get all of these perceived drivers right, as well as correctly anticipating the traditional currency influences of trade and investment flows.

What are the odds of them calling it all accurately? Judging by the above examples, you would have to say dollars to donuts.

[1] 'Goldman Sachs Hands Clients Losses in Top Trades', Ye Xie, Bloomberg news, May 19, 2010
[2] Courier Mail, July 28, 2008
[3] Australian Financial Review, Oct 21, 2008
[4] The Sunday Telegraph, April 11, 2010
[5] Aussie outlook marred, Reuters, May 21, 2010
[6] BIS Triennial Central Bank Survey

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