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FINANCIAL NEWS, DATA & ANALYSIS

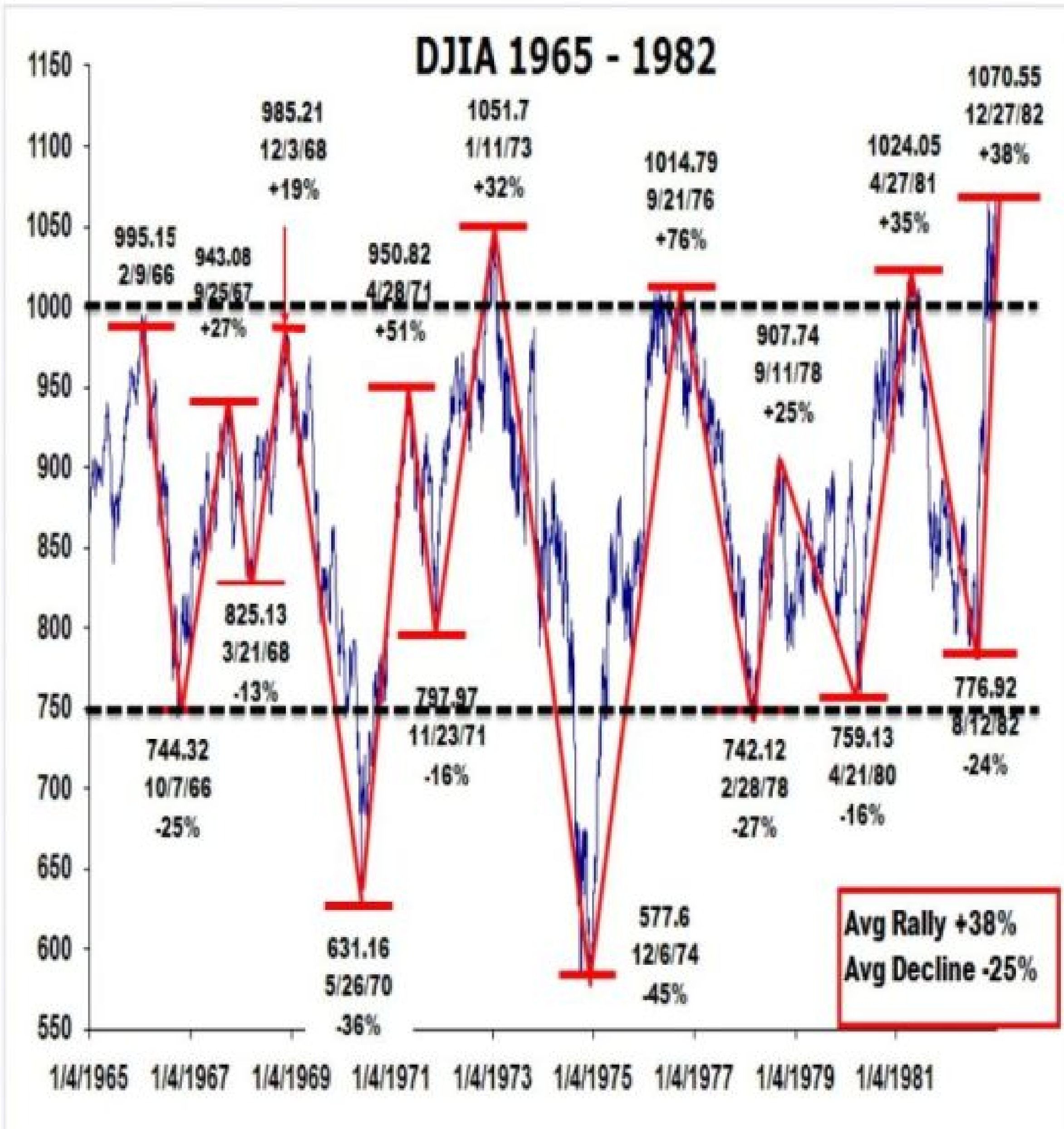
The AUD and the Australian Share Market

July 2013

Prologue

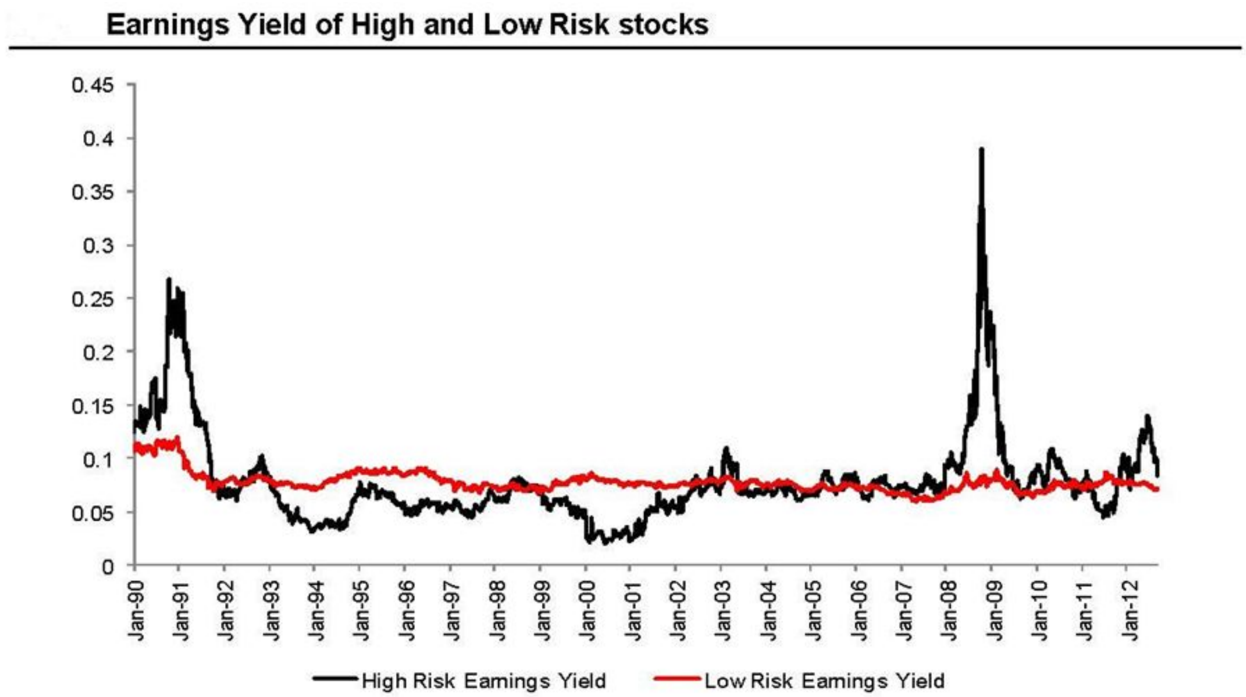
Every time I undertake an in-depth analysis on a given theme, I find that one crucial chart perfectly illustrates what it is all about.

During my earlier analyses of the Bear Market, back in 2007-2008, it was the chart below that immediately showed investors what they should expect:



Charts: Bloomberg and WJB Capital Group, Inc.

During my research for "Make Risk Your Friend. Finding All-Weather Performers"(*) it was the chart below that best showed how investors consistently reward earnings certainty and performance reliability.



Source: Macquarie Research, October 2012

Most investors would interpret the red line on the Macquarie chart above instinctively as "share prices moving sideways", but that's not what is on display here.

What the chart shows is a direct communication between Mr Market and listed companies, whereby Mr Market conveys the all too clear message: if you consistently perform, and I can trust you and rely upon you, then I will reward you with the valuation premium you deserve.

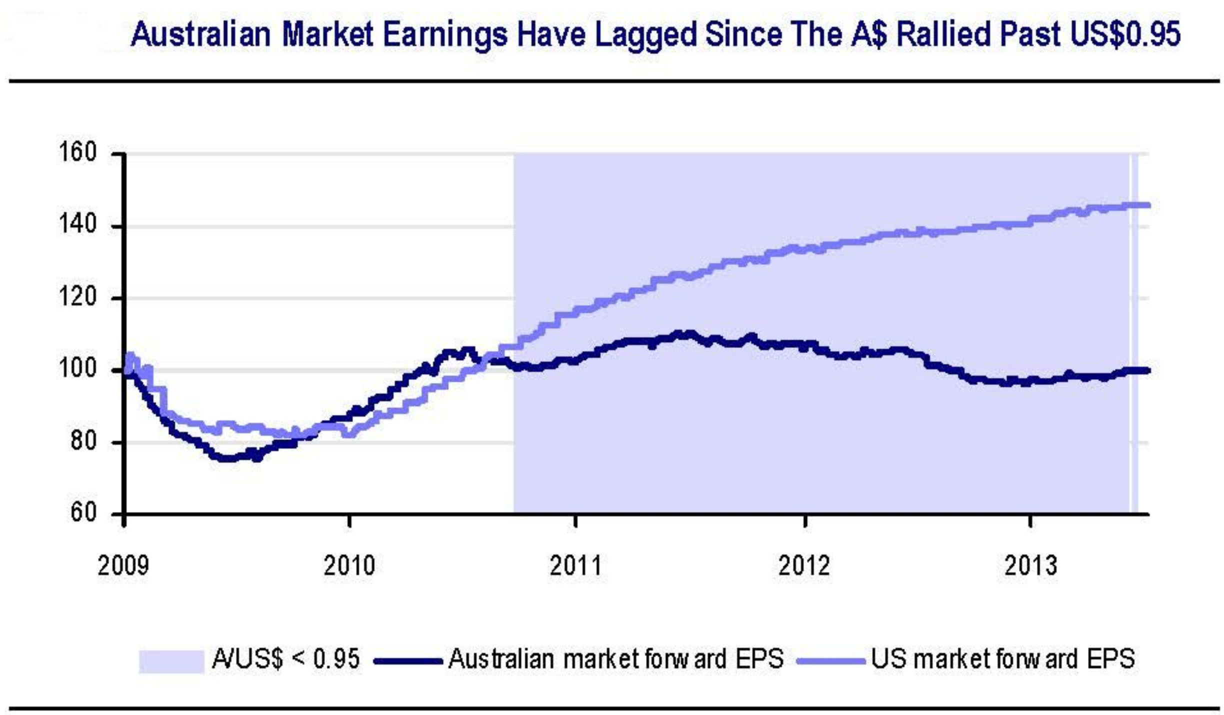
What the red line indicates is that once Mr Market feels comfortable with a given company's growth profile and with performance reliability, the share price will virtually match the growth in earnings. Profits up by 10%? So goes the share price. Profits up by 30%? Same.

The chart has since featured prominently in my presentations around the country. I usually attach the advice: print out and hang on the wall above your pc. At times of doubt, revisit. If the paper turns brown, print out again.

This is the one chart investors want to keep in sight at all times! It is why All-Weather stocks seldom trade on genuinely cheap valuations.

During the research and preparations for this eBooklet, I discovered the chart on the next page which instantaneously explains many of the questions that have been plaguing investors in Australia, including:

- Why has the Australian share market not been able to keep pace with US equities?
- How come operating in the world's most resilient economy has not allowed local businesses to show healthy growth in profits?
- Why does the RBA stick to the view the AUD is not yet stimulatory, even after a big fall of more than US10c in Q2 2013?
- Why is the outlook for corporate profits in Australia now improving, but only slightly so?



Source: I/B/E/S, Datastream

I could probably travel through the country from now onwards and simply put up the above chart and talk for an hour (or two) about all the conclusions we can draw from this one chart. Thinking about it, this might actually not be such a bad idea!

There's a saying that a well chosen chart is worth more than a thousand words. I think the three charts above are all worth a thousand books each on their own merits.

I hope the remaining pages and charts will assist investors with figuring out some of the details that come with assessing the interaction between AUD and the Australian economy and the share market.

If my hunch is correct, then the currency might play an even more prominent role in the years ahead than it already has during the years past, just not in the same way.

The research for this eBooklet is based upon my own market observations and analyses and incorporates many reports and research efforts published by the following eleven share market experts: BA-Merrill Lynch, CBA, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Goldman Sachs, Macquarie, Morgan Stanley and UBS.

Specific sourcing and attributes can be found throughout the chapters of this publication.

Thanks to Greg Peel, Andrew Nelson and Eva Brocklehurst for proofreading my initial writings.

I hope this publication will prove to be a valuable tool for investors in the years ahead.

Rudi Filapek-Vandyck

July 2013

(*) "Making Risk Your Friend. Finding All-Weather Performers" was published by FNArena in January 2013

The AUD and the Australian Share Market

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The AUD and the Australian Share Market

By Rudi Filapek-Vandyck, Editor FNArena

It may be hard to imagine today, but ten years ago virtually nobody in the share market paid much attention to forecasts for the Australian dollar in the year ahead.

When pressed about the issue, many a stockbroker would quote the former chairman of the Federal Reserve, Alan Greenspan: "Forecasting exchange rates for major currencies is as accurate as forecasting the outcome of the flip of a coin".

It was only sensible not to spend too much time on what can essentially not be forecasted in an accurate manner.

Times have changed, however, and quite dramatically so. Currencies have moved to the forefront of global market action, not in the least because of central bank policies to help out clueless governments in dealing with heavy financial and economic stresses. As a result, the past decade has seen some big moves in FX crosses, often showing swings in weeks or even days (if not hours) which used to develop over months or even years in the preceding era.

All of a sudden, it doesn't seem that smart anymore to ignore movements and forecasts for FX crosses. In particular because big currency moves are likely to have a significant impact on economies, on central bank policies and on corporate profits. And all of these factors ultimately feed back into direction and trends for listed equities.

Australian investors have experienced this change, and its consequences for the domestic share market, from the front row post-2008. Whereas the years leading up to the GFC seemed to be all about the awakening of China and a new paradigm for financial risk, the years following the corporate collapse of Lehman Brothers have been dominated by an unusually strong Australian dollar, which shed its previous derogative label of "Pacific Peso" and turned into a global high yielding, safe haven currency.

It meant that Australians could now travel abroad and live through the experience as if the world had gone in permanent discounting mode. Alas, for investors in the Australian share market, it also meant that most listed companies were struggling to grow their profits at a meaningful rate. So much for safe haven investing in the world's healthiest and best economy!

All that has changed in 2013 and the process only took a few weeks, starting in April and accelerating into May and June. Now everybody, from politicians to economists, to traders and investors, to forecasters and business leaders, is convinced the only way is further down for the Australian dollar. Given the (corporate) hardship caused by the currency when it was consistently trading at elevated highs, surely the effect now will be one of incredible benefits? Finally, Australian equities will have the chance to catch up with peers in Japan and in the US!

Alas, the matter is a little bit more complicated than that, as we will explain and explore in this eBooklet.

First up, Australian exporters who bring home a lot of sales in foreign currencies stand to automatically benefit as they receive a free boost to the translation of these foreign sales, profits and dividends into Australian dollars for Australian shareholders. For all others, including the Australian economy in general, we must restrain our enthusiasm. Instead of simply focusing on the weaker Aussie, it is much smarter to zoom in on **the reasons behind the currency's devaluation**.

These reasons will in large part define who is to benefit from a weaker AUD, and who is not.

Take the past years as an example. Throughout the post-Lehman disaster years of global turmoil, the Australian dollar turned into a safe haven currency, resulting in a high positive correlation with global risk appetite. This meant that when investors were optimistic and hopeful, the AUD would surge and stay at elevated levels. But at times when worries took over and global risk appetite turned into general risk aversion, the AUD would struggle and sell off.

As a result of this, defensive, safe haven equities in the Australian share market developed a high positive correlation with the Australian dollar, even if these companies enjoyed no immediate benefits from a weaker AUD to their bottom line. Such stocks include Telstra ((TLS)), Woolworths ((WOW)), Spark Infrastructure ((SKI)) and CFS Retail Trust Group ((CFX)).

From a pure currency viewpoint, it makes no sense at all to buy Woolworths shares when the AUD is in freefall --one could even argue its margins might be negatively impacted-- but if we expand the observation to what was causing the AUD's weakness, it all of a sudden makes perfect sense. When the world runs scared, investors seek shelter behind the sustainable and solid cashflows of Woolworths' liquor and supermarket operations in Australia. The same principle applies to other defensives in the Australian share market that have equally developed a close correlation with the currency.

Rule Number One becomes thus: don't just focus on the AUD's move, but try to establish what causes the move up or down instead.

The reasons behind FX movements are at least as important as the currency move in itself. As we will explain later, resources companies traditionally do not benefit from a weaker AUD. But this time they almost certainly will.

The ever-so-crucial question thus becomes: what is causing the Australian dollar to weaken and why is (almost) everybody now predicting further Aussie weakness in the years ahead?

Economists at UBS summed it up as follows:

Factors to negatively impact on AUD from now onwards:

- A stronger US economy
- A trend rise in bond yields globally
- Weakening commodity prices
- Increasing near term risk to domestic economic growth
- More domestic rate cuts
- The prospect of a more competitive and balanced local corporate sector over the medium term

Combine all of the above and the most logical conclusion is to seek benefits from a weaker Aussie through companies with a lot of exposure to the improving domestic economy in the US. This is exactly what equity strategists at various stockbrokerages and investment banks have been advocating and investors have responded accordingly.

Witness recent share price moves for the likes of **James Hardie** ((JHX)), **Brambles** ((BXB)), **Amcor** ((AMC)), **Computershare** ((CPU)) and **QBE Insurance** ((QBE)). James Hardie has significant operations in Australia and, contrary to widespread market misconception, it benefits only in minor fashion from a weakening AUD, but a revival in the US housing market is bound to perform miracles for the company's bottom line. Both Computershare and QBE have the extra bonus in that they also benefit from rising yields in the US bond market (more important for QBE than AUD weakness).

What about the Australian share market in general? Is it not true that, after years of underperformance and disappointments, confidence is now on the rise for profit forecasts for FY14 and FY15, with stockbroking analysts in the process of lifting expectations?

A little bit of restraint is necessary here too. One of the reasons the Australian dollar is weakening is because overall momentum for the domestic economy has now reversed from a solidly growing, resources capex-fueled, China-levered world class economy to a transitioning and weakening economy in need of a fresh engine for growth. The RBA has been cutting the cash rate in order to provide monetary stimulus to the non-resources parts of the domestic economy, but such transitioning does not suddenly occur overnight.

Both a weaker Aussie and lower interest rates should eventually support momentum for the domestic economy, but both impacts take time to materialise. On Macquarie's calculations, a 10% fall in the Aussie dollar is likely to boost economic growth by 0.25 ppt after one year and somewhere between 0.25-0.50 ppt in the second year.

On an individual company level, the impact might in some cases materialise faster, but there are in most cases also other moving parts that dilute the overall impact from a weaker currency. Factors investors should consider include debt (both in foreign currencies as in AUD), FX hedging programs in place and whether costs are impacted too.

Most of all, **a weaker Aussie can never be the panacea that cures all ailments for sectors or companies that are structurally or operationally in Struggle Street**. At best, a weaker Aussie might bring temporary and minor relief for companies and sectors battling with a structural downtrend. Some parts of the Australian economy will not benefit at all from a weaker AUD and might well experience headwinds in the short to medium term. The most obvious candidates to experience margin pressure from a weak AUD are bricks and mortar retailers. Many of them source products from offshore suppliers (higher input costs). Discretionary retailers in particular might feel the pinch as consumer spending power reduces and not only because gasoline prices are likely to rise.

Economists at CommBank have been pointing out that a weaker Aussie means import prices will rise and this effectively represents a **cut to real incomes for Australian consumers**.

The other obvious negative consequence from a much weaker AUD is that it might feed into **higher price inflation**. Rising inflation will by default pull the RBA back into action, but this time interest rates will rise, which will act as a lid on domestic growth momentum.

These processes do not take place in a hurry. They take time. According to the abovementioned Macquarie economists, a 10% fall in the AUD might boost growth by 0.25ppt after twelve months, but --

all else being equal-- it should also boost inflation by 0.50 ppt. That's double the boost economic growth receives.

According to a paper released by the RBA in September 2011, "The Exchange Rate and Consumer Prices", the boost to inflation from a sharply lower Aussie dollar is likely to build further beyond the first twelve months. RBA modeling suggests a 10% fall for the AUD adds 0.50 ppt to consumer price inflation in year one and then another 0.50 ppt in the two following years. This means a full 1% (100 ppt) rise in inflation over three years.

A weaker Aussie thus really is a double-edged sword as it is likely to force the RBA to step on the brakes much sooner than anyone wants it to.

Still, a weaker Aussie will leave long-lasting benefits for many companies in Australia through **increased competitiveness** for domestic import-competing companies as well as for their exporting peers. On top of these easy to identify benefits comes the complex potential from a non-identifiable positive multiplier benefit for the economy as a whole.

There are no two economists in the country that fully agree on the how, what and why of those multiplier benefits for the economy and for corporate profits, but one only has to look at the healthy gains that have been achieved by companies in the US since 2009 as opposed to what has since happened to corporate profits in Australia. There are many other factors co-responsible for this, but the divergence in currencies has without the slightest doubt played a major role in this process.

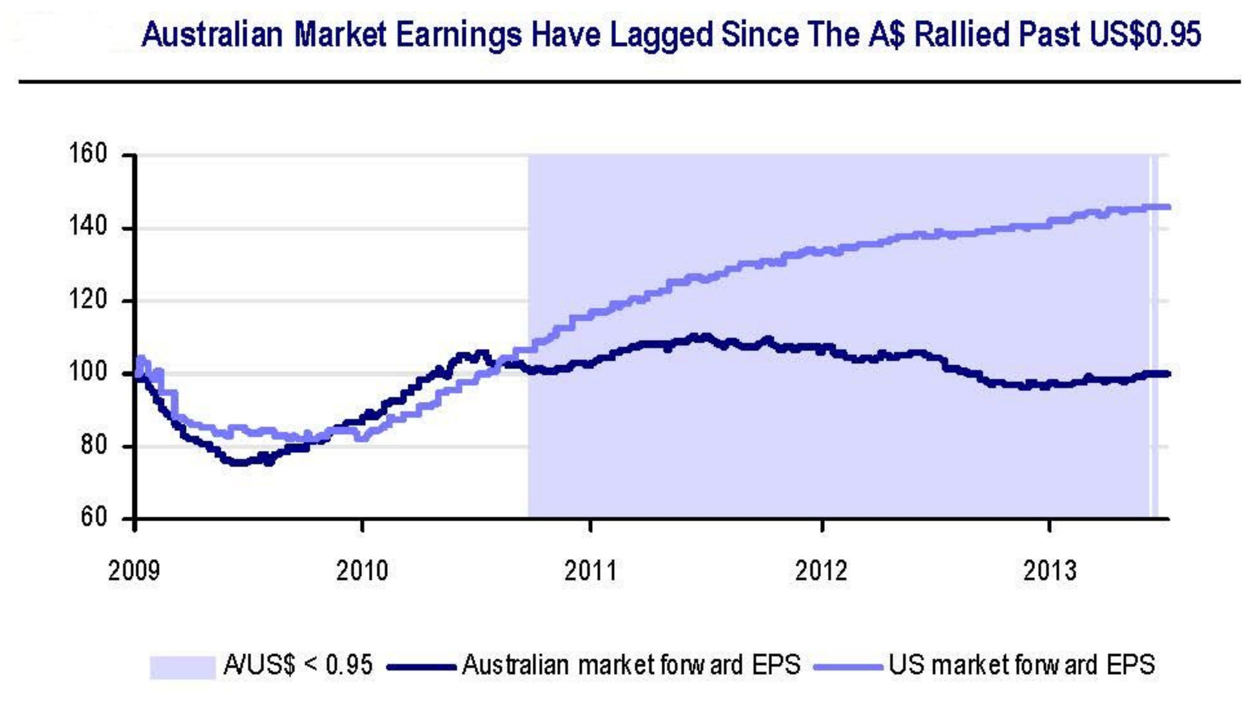
It might take a while, but, assuming an orderly re-adjustment and, of course, on the premise that current expectations for a weaker AUD prove accurate, both the Australian economy and Australian companies stand to benefit in the years ahead.

By how much exactly is yet to be determined.

One of the reasons as to why a weaker currency takes time to make its benefits visible is because businesses are more impacted by long to medium term average values than by daily movements. It takes time to pull down the average from AUDUSD above parity to well below parity. Secondly, businesses only make investment (and other) decisions when they feel that a sustainable trend is in place. It takes time to build such confidence.

Another important factor is that, while the overall trend is important, of equal importance is the actual value of the currency. The latter is something that is too often ignored by all and sundry. It is a characteristic that also typically applies to the price of oil. A rising oil price usually coincides with healthy economic growth, but there is a cut-off point where further price rises become a threat to economic growth. In other words: depending on the actual price level, movements to the upside or downside can cause much greater impact or rather minor additional impact.

The importance of the AUD at elevated highs has been perfectly captured in the chart below. It clearly shows that corporate profit growth in Australia diverged from profit growth in the US after AUDUSD reached 95c and moved higher.



Source: I/B/E/S, Datastream

The sobering observation thus far is that even with an unexpectedly sharp sell-off for the Australian dollar, AUDUSD above 90c is still in the vicinity of 95c (filling the gap might only require a three-day rally). Also, the average AUDUSD value for the year to date (as at the beginning of July) is still around parity; it will take many months to pull the average into the low 90s.

When we take into account that the average value of AUDUSD was no more than 67c in the ten years preceding the GFC, it is clear that present weakness has brought some relief, but from a very high level. In order to become truly stimulatory, the Aussie dollar needs to fall further.

Economists at CommBank believe the **ideal range for AUDUSD is between 70-80c**. Inside this "sweet spot" range, everybody would be happy, claim the economists, regardless whether the trend is up or down. Trading above 90c, the currency remains well above this range.

This won't prevent analysts and investors getting excited about improving profit prospects well in advance. The current estimate is the AUD's fall since April will boost corporate profits in Australia for FY14 by between 2-4%. But that's just an average for the bulk of ASX companies in general.

There are individual companies that will benefit a lot more even without taking into account more potential weakness for the currency (others will face headwinds).

Citi analysts explained recently why securities analysts tend to underestimate the full impact from a weakening AUD. The easy part is to focus on AUD values for offshore revenues and earnings and for imported costs. What is more difficult to assess is by how much sales volumes might increase as companies become more competitive vis-a-vis foreign peers.

Maybe the correct way to look at future earnings estimates is to reverse what has happened over the past years when analysts found themselves continuously on the too optimistic side of corporate profits in Australia. The fact that profit forecasts needed to be cut, and cut again, and cut even further, has been a major contributor to the downward pressure on share prices in Australia.

Maybe this time the pressure will work the other way around? If true, then analysts will find themselves behind the curve in a positive manner and catching up from now onwards means having to lift forecasts. This should translate in a positive undercurrent for the Australian share market.

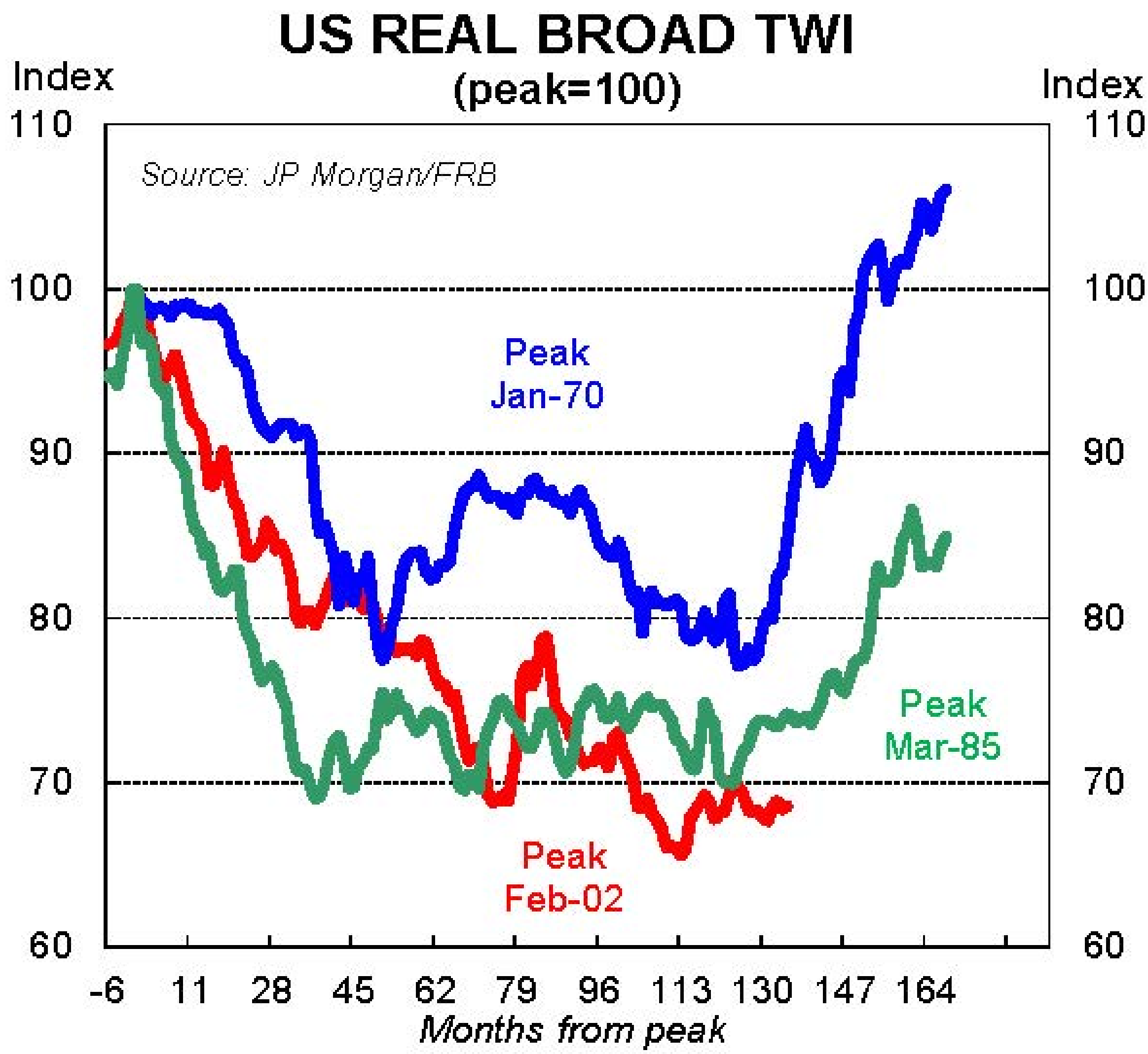
Recent analysis by UBS economists supports this thesis. On UBS' assessment, 15 out of 19 sectors in the Australian economy have been running on profit growth below historic averages in the past three years, with mining and mining related sectors running above their historic norms. The AUD has not been the only factor in this scenario, certainly not, but a weakening AUD and the principle of "mean reversion" suggest those 15 sectors (or most of them) should now have a much better prospect in front of them.

While a weaker AUD should ultimately work to the benefit of Australian companies and their shareholders, investors should also understand the currency will not turn today's operationally challenged corporates into tomorrow's modern, super-growth machines. Strong companies that benefit will simply become a little stronger and if they are on the wrong side of the ledger, the currency will prove a headwind only.

Weak and vulnerable companies will receive some relief, but they will still be weak and vulnerable. Depending on how much support is forthcoming from a weakening AUD and how much their business model has been challenged in years past, the difference can nevertheless turn out to be significant, over time.

Lastly, if there's one factor that should be a worry for every investor, it is that since the AUD's reversal of fortune in April-June, virtually every expert has now decided that the only way forward is for a much weaker currency. Financial markets have a habit of surprising the majority, especially when general opinion turns so overwhelmingly into one direction.

There is, however, one broader view around the USD that supports a weaker AUD in the years ahead. This view is based upon the fact that USD seems to go through broad and extended cycles post 1970. Two of those cycles have been captured in the chart below. If USD is currently bottoming in its third cycle, which the analysis below suggests, this would imply strength lies ahead for many years into the future. This should add extra support to prospects for a weaker AUD.



Let's recap the main focal points as to what a weaker AUD might mean for investors in the Australian share market in the years ahead:

1. Absolute AUD level is as important as the trend

The AUD has fallen significantly in a few weeks only between April-June 2013, but the currency remains well above its average values pre-GFC.

This probably means a weaker AUD has brought some relief for Australian businesses and the economy in general, but more weakness is needed for the AUD to become truly stimulatory. In other words: the next pull-back, if it eventuates, will be more important than the pullback that has occurred thus far.

Also, because average FX values are more important than daily movements, it will take time to pull the average AUDUSD back from parity to a level well below parity.

2. The reasons behind AUD weakness will determine who is to benefit, and who will not

In years past, the AUD had developed a close correlation with global risk appetite, which meant that equities benefiting from a weaker AUD were not necessarily enjoying direct financial benefits. The link was between risk aversion and reliable, defensive, less risky business profiles.

In recent times it appears AUD is now developing a close correlation with growth in developed economies (negative for AUD) and an early slowdown in the domestic Australian economy (another negative for AUD), while bond yields in developed countries are on the rise (yet another negative for AUD) and the US Federal Reserve might be looking at winding back its unprecedented monetary stimulus experiment, which is yet another negative for AUD (because positive for USD).

All this means that a weaker AUD should now benefit equities other than the beneficiaries from the years past. Obvious candidates are companies that benefit from a softer AUD and that have a positive correlation with at least one of the factors that is acting as a major negative for the Aussie.

3. Currency movements create both winners and losers

The obvious winners from a weaker AUD are companies with large offshore sales and operations. In the domestic market, those companies producing for exports and having to compete with foreign imports should benefit too.

Obvious losers are companies that buy in from overseas and companies that are directly exposed to consumer spending and to crude oil (all else being equal).

4. A weaker AUD is not a panacea for structurally challenged sectors and companies

A weaker AUD can translate into improved competitiveness or into lower costs, but it doesn't necessarily change the underlying dynamics for structurally challenged industries.

Traditional media companies still have to find an answer to the emergence of the Internet, mobile and a plethora of new technologies.

Bricks and mortar retailers will continue to face the threat from online and from offshore competitors setting up shop in Australia, while supply-demand balances will always prove more important for commodity producers than any FX relief.

Mining services providers will remain victims of an ever shrinking pool of available projects. It is important for investors to understand that any benefits from a weaker currency do not compensate for these broader, longer-term, structural challenges.

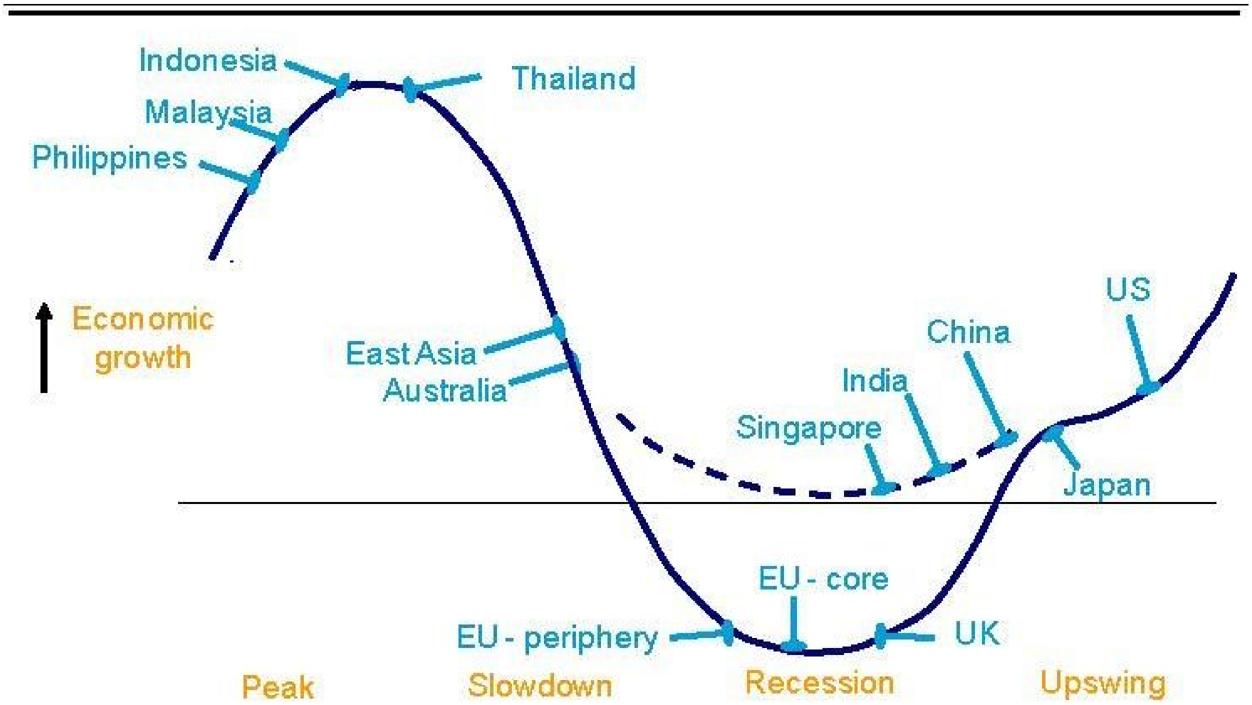
5. AUDUSD is not the only cross that counts

The US dollar, also known as the "greenback", remains the world's reserve currency and many listed companies on the ASX have sales in the US or report their financial results in USD. There's a general tendency to always compare AUD against the USD, but for some companies AUDUSD is not the main denominator. Given AUD has weakened against every other currency between April-June, such an eye for detail has not been necessary, but this will not always remain the case.

Casino operator Crown ((CWN)) is one of the main operators in Macau, offshore mainland China. Any sizeable movements in AUD against RMB will thus impact on the valuation of Crown shares. This is but one example. Make sure you understand which FX crosses are important for your own portfolio of equity investments.

Likely scenario as at mid-to-late July 2013: A Two-Tiered Impact

Economic data and forward indicators as at the start of July are signalling a divergence seems to be opening up between Australia domestically (slowing down with challenging times ahead) and developed economies where economic growth appears to be solidifying and becoming more sustainable. This divergence has been captured in the graph below (thanks to Macquarie).



Source (for all above): RBA, IRESS, Macquarie Research, June 2013

Were these trends to continue, it is well possible that domestically oriented companies in Australia will first have a battle at hand with the slowing economic momentum. The good news is that by the time the domestic economy regains its mojo, extra benefits will be derived from a weaker AUD and from lower interest rates.

As such it seems very likely that the present down trend for the Aussie dollar will result in a two-tiered impact for Australian companies and for the share market: at first, strong exporters and global manufacturers will enjoy benefits from the softer currency at home, later on it will be the turn for domestic businesses to ride the next economic upswing with much improved competitiveness and with the prospect of higher profit margins.

A few things to keep in mind:

- this eBooklet has been written from the viewpoint that the Australian dollar is likely to weaken further in years ahead. As such it lines up winners and losers, while explaining impact and leverage from a weaker AUD. Should the opposite occur: read everything in opposite terms

- What the currency giveth, it can also easily taketh away!

Healthcare sector and AUD

Australia's healthcare sector is often viewed as the easiest and the most logical sector to play for AUD benefits or headwinds. At face value, this makes perfect sense as many of Australia's most successful business stories from the past decades are located in this sector and companies including CSL, Cochlear, ResMed, Ramsay Healthcare, Sonic Healthcare and Ansell are today global players in their field, with sales and operations spread across the world.

The currency leverage theme is further enhanced by the fact the healthcare sector enjoys by far the most regular sector updates by stockbrokers on the back of FX movements or changes to currency forecasts. In reality, however, playing AUD leverage through Australia's dominant (and popular) healthcare stocks is less straightforward than many investors would assume, not in the least because both ResMed and Cochlear have active FX cash flow hedging strategies in place, while most large cap healthcare stocks are reporting in USD (CSL is about to make that switch) and most have large operations overseas (meaning: large costs in foreign currencies) or a natural hedge/offset via debt in foreign currencies.

Look deeper into the subject, and pay attention to detail, and investors will find the most straightforward AUD leverage is not to be found among the usual suspects, but among small cap players in the sector instead.

Below is a brief summary of the main issues affecting benefits and/or headwinds from AUD movements for the main names in the Australian healthcare sector:

CSL

Until the present year, CSL ((CSL)) has been one of the most popular stocks in the share market to target strength or weakness from AUD movements. Note also that management would every year provide forward looking guidance on a "constant currency" basis, so investors and traders had an easy tool to benchmark against. This is about to change as CSL will switch to reporting its financial numbers in USD from the upcoming reporting season onwards. This automatically reduces its AUD-leverage because there no longer is a significant translation from foreign currencies into AUD, from which its profits should benefit. A weaker AUD will still be beneficial because of the dividends, but CSL never has been a typical yield stock (and is unlikely to become one any time soon given it tends to trade on high PE multiples and with ongoing strategy to consistently invest in R&D).

CSL is to remain one of the prime FX-affected stocks in the share market because of its large operations in Europe and because it owns large facilities in Switzerland. As such (and this has been the case for years, in fact), the currency movements that affect the business most are CHF against EUR, CHF against USD and EUR against USD.

What all this boils down to is that CSL is more a beneficiary from a stronger USD than from a weaker AUD. At times, both go hand in hand together, but this is not necessarily always the case. A stronger USD reduces costs incurred in CHF, in EUR and in AUD and thus it is beneficial for CSL's bottom line.

Cochlear

Cochlear ((COH)) should easily be one of the main beneficiaries from a weaker AUD in the share market. Most of its production occurs in Australia while 40% of all sales go overseas, mainly to Europe and the US, but Asian sales are growing fast. An Australian based cost in combination with significant offshore sales should easily translate in significant benefits from a softer AUD, were it not for the company's active hedging policy. It is because of these FX hedging programs that the company managed to grow strongly when AUDUSD was consistently trading above parity.

As a matter of fact, despite a consistently strong AUD in years past, Cochlear has managed to draw extra benefits through its FX hedging with profits from these programs directly contributing to its bottom line. Alas, this won't be the case this year. Cochlear is hedged around AUDUSD at parity and will now incur losses from its hedging. Were management to decide that hedging is no longer necessary, the company could --all else being equal-- turn into a major beneficiary from further AUD weakness in the future.

ResMed

ResMed ((RMD)) is essentially a US-listed company with Australian based manufacturing, R&D and admin operations. Its core financials are reported in USD and management deploys active FX hedging strategies. Regardless, ResMed remains to date the most AUD-leveraged large-cap healthcare stock in

Australia. In the short term, the company is likely to incur losses from its FX hedging due to the sharp fall of AUD over only a few week. Also, as the company is shifting more manufacturing into Asia, its FX sensitivities will be affected too.

At this point, with 50% of ResMed's costs of goods sold (COGS) and 75% of R&D denominated in AUD, ResMed remains a prime beneficiary of a softening AUD.

Ansell

Ansell ((ANN)) is an international player which reports in USD while investors tend to disregard its dividends. Same story as for CSL: the PE ratio can be quite high at times, while the yield is too low to genuinely attract attention. The company has manufacturing operations offshore and has been expanding into Asia. Benefits from a softer AUD tend to be small and almost negligible. Investors should watch movements between EUR and USD as Ansell is a major player in Europe (and reports in USD).

Sonic Healthcare

Sonic Healthcare ((SHL)) owns large operations in the US and in Europe, but that doesn't make the company automatically a natural AUD-play. Anything but, in fact. Operating in foreign countries means costs are in foreign currencies too and this mitigates any changes in FX values. In addition, the company carries debt positions in Europe and in the US, which act as yet another offset to currency induced volatility. Make no error: Sonic Healthcare is still deriving 50% of all revenues from Australia and this makes it a beneficiary of further AUD weakness (because of the other 50%), just not to the same extent as would be the case without the overseas offsets.

Ramsay Healthcare

Ramsay Healthcare ((RHC)) has been expanding overseas in recent years, but all in all the group still generates close to 90% of its earnings before interest and taxes here in Australia, so any benefits or headwinds from movements in AUD remain minor at this stage.

Sirtex Medical

Sirtex Medical ((SRX)) has only just started conquering the world with its newly developed liver cancer treatment, but with growing emphasis on large target markets offshore, such as the US, the company is also one of the main beneficiaries in the healthcare sector from a falling AUD. The combination of a firm cost base in Australia and a growing presence internationally forms the ideal cocktail to absorb as many benefits as possible from a weaker AUD. Sirtex shares have only just started to attract the attention of major stockbrokerages in Australia, but the stock has already been featuring at the top of FX-inspired sector updates from the stockbrokers who cover it.

Given Sirtex is only in the early stages of corporate development, both revenues and FX benefits should grow strongly in years to come.

Acrux

Emerging drug developer Acrux ((ACR)) is essentially in a similar position to Sirtex Medical. The company's cost base is in Australia while revenues and profits from across the globe should grow strongly in the years ahead. As a corporate minnow in only an early stage of its development, the combination of the two can make for a powerful cocktail in the years ahead.

Other healthcare companies such as Primary Healthcare ((PRY)), NIB ((NHF)), Australian Pharmaceutical Industries ((API)) and Sigma Pharmaceuticals ((SIP)) are predominantly Australia-based. Any impact from a weakening AUD is likely to be slightly negative, but probably negligible.

Australian Banks and AUD

Australian banks are increasingly looking offshore to expand operations and this suggests they are increasingly turning into beneficiaries of a softer AUD. This is probably true, but only in a marginal sense. Most banks still derive the majority of profits from lending in Australia. They tend to hedge FX exposures. To date, the currency that matters most is NZD. The main benefit from a weaker AUD is longer term through the banks' offshore funding needs: a weaker AUD means the banks need to fund less from offshore markets to satisfy their domestic lending requirements.

ANZ Bank

ANZ Bank ((ANZ)) has the largest exposure to foreign currencies with circa 18% of group earnings in NZD and a similar number (estimated 17% in FY13) in USD and Asian currencies. But any short term benefits should be minor as the bank is believed to be 70% hedged in FY13 plus nearly all of its NZD exposure for FY14. Bottom line: over time, the bank's profits stand to receive a nice bonus from a significantly weaker AUD, but as things are lined up right now, the benefits probably won't be seen in full until FY15, at the earliest.

UBS analysts recently projected the bonus gain for ANZ Bank's profits is likely to be around 3% in FY15. Hardly a number that attracts a lot of excitement, were it not for the fact that Australian banks are currently in a low growth environment while projections suggest the Australian economy in general is likely heading into more challenging times. Viewed within this context, an extra 3% to profits in FY15 might potentially transform ANZ Bank into the sector standout that year.

National Australia Bank

National Australia Bank ((NAB)) has sizeable operations in the UK, but there are no profits to be translated back into AUD. Any benefits from a softening in AUDGBP are thus likely to remain minor.

Both **Westpac** ((WBC)) and **Commonwealth Bank of Australia** ((CBA)) are beneficiaries from a softer AUDNZD, but equally so in a minor fashion. Regional lenders Bank of Queensland ((BOQ)), Suncorp ((SUN)) and Bendigo and Adelaide Bank ((BEN)) are focused on the domestic market.

Where all banks stand to benefit the most is through a recovering domestic economy on the back of lower interest rates and a weakening currency, as this is likely to boost demand for business lending and for mortgages, while a potential reduction in consumer spending potential should act as a tempering offset.

Macquarie Group

The Australian bank with the most FX leverage is not a commercial bank, it's an investment bank, but Macquarie Group ((MQG)) is once again re-inventing itself and it is doing so by taking on more traditional banking activities in Australia (such as mortgages) while at the same time acquiring operations in North-America and in Asia.

The result is that today a good 60% of Macquarie Group's operational income is priced in USD. What this means, the Board explained at the recent AGM, is that a 10% drop in AUDUSD benefits full year profits by 6%. That's a pretty high correlation/benefit by anyone's standard!

Building Materials sector and AUD

Australia's leading building materials stocks have significant operations offshore and as such they stand to benefit from a weaker AUD.

CSR

CSR ((CSR)) is the most leveraged to a weakening AUDUSD with analysts estimating every 1c move impacts CSR's earnings per share by 1.5%.

James Hardie

James Hardie ((JHX)) is a significant player in the US housing materials market and according to analysts' estimates, its earnings per share are impacted to the tune of 0.8% for every 1c move in AUDUSD.

Boral

Boral ((BLD)) has the least AUDUSD leverage among the big building materials stocks in Australia.

As a matter of fact, analysts in Australia are divided as to whether the company actually is a beneficiary from a weakening AUDUSD, with some projecting a minor positive impact but others suggesting the end impact is actually slightly negative for group earnings per share.

Adelaide Brighton

Adelaide Brighton ((ABC)) is domestically focused, but it sources clinkers from offshore and as such, a weaker AUDUSD acts as a minor headwind for the company.

Fletcher Building

Given its large New Zealand operations, Fletcher Building's ((FBU)) bottom line is more impacted by AUDNZD. A weakening AUD might act as a major benefit for shareholders in Australia, but the opposite is true for shareholders in New Zealand.

Energy Companies and AUD

Oil and Gas companies in Australia can be significant beneficiaries in case of a much weaker AUD, but only if they report in AUD. As most oil and gas stocks report in USD, the overall impact remains rather muted. Given many companies in the sector are also involved in large capex programs, there is potential for additional impact from a weakening AUD. All in all, FX movements play second fiddle in the sector, as prices for crude oil and gas, together with investor risk appetite, remain the key drivers behind share price movements (apart from company specific developments, of course).

Most companies in the sector report in USD, which means companies such as Woodside Petroleum ((WPL)), Oil Search ((OSH)), Horizon Oil ((HZN)) and Roc Oil ((ROC)) are likely to only enjoy marginal benefits. However, with capex programs ending (Woodside) or about to end next year (Santos, Oil Search, Origin), some companies stand to reap additional benefits from, as one analyst described it, "annuity-like cash flows" primarily denominated in USD.

A sector report from UBS in late May identified Santos as the large cap with the highest prospective gains from AUD weakness, while Aurora Oil & Gas ((AUT)) was identified as the largest beneficiary among smaller companies in the sector. The same report suggests Drillsearch has potentially the highest leverage in the sector (among stocks covered by UBS). Drillsearch reports in AUD, as do many other smaller cap stocks in the sector, including Buru Energy ((BRU)), Senex Energy ((SXY)) and Nexus Energy ((NXS)); they all could see an additional boost to growth in the years ahead if the AUD weakens.

Note also that shareholders in companies reporting in USD are still receiving extra benefits through higher dividends.

Santos

Australian oil and gas producer Santos ((STO)) stands to benefit the most from a softer AUD among large cap stocks in Australia. Santos reports its financial results in AUD and is currently involved in some mega-investment projects that have suffered from project delays and cost over-runs, both for which a strong AUD has been a major contributor. As such, Santos could potentially become a significant beneficiary in the next few years if the AUD weakens a lot more, to the tune of 20% extra growth in earnings per share or more.

Also, Santos' exposure to USD-priced oil is growing, which enlarges the impact from a weakening AUD.

Woodside Petroleum

Woodside Petroleum ((WPL)) should enjoy lower costs in AUD and thus some benefit from a weakening AUD, but this is partially offset by the fact it also has domestic gas contracts priced in AUD. The board earlier in the year decided to put a halt to additional grand capex projects in Australia, so no benefits there either.

Oil Search

Oil Search ((OSH)) might indirectly benefit from a weakening AUD through the link with the PNG kina, which means operational costs might fall in USD terms. On top of this, lower AUD corporate overheads might add some extra benefits.

Caltex

Refiner Caltex ((CTX)) stands to benefit from the fact that regional refining margins are denominated in USD, so there should be a gain from the translation impact of a lower AUD. The always present danger is, of course, that a weakening AUD pushes up the price of gasoline a little too far in AUD, causing a negative response from Australian consumers.

Also, there is an immediate offset for the benefits from refining margins through USD denominated payables. All in all, Caltex's benefits in earnings remains dependent on the speed and volatility of changes in the AUD/USD; not easy to estimate thus.

AWE

Junior producer AWE Ltd ((AWE)) should be a beneficiary from a weakening AUD through its USD-denominated crude production but, longer term, its benefits should shrink as the company is increasing its exposure to East Coast domestic gas.

ROC oil

ROC Oil ((ROC)) reports in USD, but its headquarters are in Australia, so there should be a minor positive impact from a weaker AUD.

Beach Energy

Beach Energy ((BPT)) should benefit from a weaker AUD through USD-linked crude production, but the company is also investing heavily in the Cooper Basin.

Tap Oil

Tap Oil ((TAP)) might not benefit from a weaker AUD in the short term as its USD denominated construction costs at Manora will push up interest costs.

Carnarvon Petroleum

Carnarvon Petroleum ((CVN)) could become a major beneficiary from a weaker AUD as its USD revenues will enjoy higher translation into local currency.

Gaming sector and AUD

Australians have a natural appetite for taking risk, just ask the late Kerry Packer. It is no coincidence thus the Australian share market comprises of a handful of gaming and betting-related shares, many of which have expanded their corporate horizons well beyond Australian territory. As such, these companies stand to benefit from a weakening AUD.

Aristocrat Leisure

Aristocrat Leisure ((ALL)) is the world's third largest marketer and manufacturer of poker gaming machines ("pokies"). The company has significant sales in Japan and in the US and thus benefits on a simple translation of these revenues in AUD. USDAUD holds potentially the most important FX impact for Australian shareholders with analysts estimating every US1c move against the AUD impacts earnings per share (EPS) by 1%. This makes Aristocrat one of the highest AUD-leveraged stocks in the Australian share market.

Crown

Crown ((CWN)) has become one of the major casino players on Macau, offshore China, which has in recent years rapidly become the world's number one casino market. As the importance of Crown's equity stake in venture Melco Crown is likely to only grow further in importance, the valuation impact of RMB (or CNY) movements will grow in importance too.

As RMB still largely moves in tandem with USD (the Chinese currency is not free floating, it is "managed" by Chinese authorities), this usually translates into stronger USD against weaker AUD = positive valuation impact.

Crown also has a small exposure to GBP through the Aspinall's Club in the UK.

Ainsworth Gaming

Fast-growing poker machines minnow Ainsworth Gaming ((AIG)) is aiming at making big inroads into US markets, but those ambitions are supported by a low base in USD sales to date. The company is a beneficiary of AUD weakness but in the bigger scheme of things, any FX-related benefits are likely to remain marginal on a short to medium term outlook.

FX influences for other players Tatts Group ((TTS)), Tabcorp Holdings ((TAH)) and Echo Entertainment ((EGP)) remain negligible because international exposure for the first two remains benign, whereas Echo Entertainment remains to date a 100% Australia-focused operation.

Less Obvious Beneficiaries from a weaker AUD

One of the most highly leveraged companies to a weaker AUD in the Australian share market hardly ever features on investors' minds: **Macquarie Atlas Roads** ((MQA)). The toll roads operator generates revenues through two assets in France plus it owns additional assets in the US, the UK, and in Germany, which means it is highly leveraged to AUDEUR on a direct translation of cash flows, valuation and dividends for Australian shareholders.

One sector that has dropped off investors' radar in recent years is the domestic tourism and leisure industry, yet if a weaker AUD reinvigorates the attractiveness of Australia for foreign tourists, then companies in the sector stand to benefit. If at the same time Australians decide to stay more at home and seek leisure on domestic soil, this would also reinvigorate the sector.

One company in the sector, **Ardent Leisure** ((AAD)), will increasingly be investing in the further roll-out of its Main Event strategy in the US to secure future growth. If successful, this makes future growth increasingly dependent on the US operations, with additional benefits provided by a weaker AUD.

Companies in the Australian travel services industry have benefited from a push towards more outward bound travel on the back of a strong Australian dollar. It is easy to thus conclude this sector is likely to turn into a No Go Zone if the AUD weakens materially.

However, in a recent note on this matter, analysts at BA-Merrill Lynch state this should not apply for **Flight Centre** ((FLT)), one of the star performers in the Australian share market in recent years.

BA-ML analysts believe the Australian travel sector is likely to remain relatively resilient even with a slowing ahead for the domestic economy. Furthermore, note the analysts, detailed analysis of outbound destinations suggests a very tenuous link between FX-rates and destination choice: consumers tend to adjust their ‘in-destination’ spend as a result of currency rather than cancelling trips.

Flight Centre also stands out in the domestic sector because it derives circa 18% of earnings before interest and taxes (EBIT) from operations in overseas markets (predominantly the US and the UK) which means any slowing in Australia caused by a weakening AUD is likely to be compensated via international sales.

The latter argument gains in strength as overall activity for Flight Centre operations in the US and in the UK now seems on an upward path. This means that, contrary to general perception, Flight Centre may not turn into a victim of a weaker AUD, but instead could well benefit from it.

Other smaller cap stories that derive a significant portion of group sales from overseas markets include **Nufarm** ((NUF)), **Breville Group** ((BRG)), **BT Investment Management** ((BTT)), **Goodman Fielder** ((GFF)), **APN News & Media** ((APN)), **SAI Global** ((SAI)) and **Domino's Pizzas** ((DMP)). All these companies generate at least 40% of all sales from outside Australia.

The same applies for mining services providers such as Ausenco ((AAX)), Boart Longyear ((BLY)) and Cardno ((CDD)). However, this sector in particular may not necessarily see many benefits from a weakening AUD as two of the reasons for the currency's projected weakness are both firm negatives for the sector: falling commodity prices and a reduction in capex from the mining sector.

Note also, agricultural play **Select Harvests** ((SHV)) exports around 60% of its almond production and the world price is denominated in USD. Analysts at Goldman Sachs estimate a 5c fall in AUD/USD increases EPS by 9.2%, all else being equal.

In an update on Base Materials stocks and AUD, analysts at CIMB in June pointed out that fertiliser and explosives company **Incitec Pivot** ((IPL)) has the highest AUD-leverage amongst all the stocks under the stockbroker's coverage for the sector which also comprises of the likes of **Amcor** ((AMC)), **Orica** ((ORI)), Nufarm ((NUF)) and the main building materials stocks in the Australian share market.

According to the company's own indication, the impact of a one-cent change in AUDUSD impacts operational earnings (EBIT) for fertiliser by about A$8m, with an additional A$1m impact associated with translation of the group's DNA explosives earnings. That's an A$9m impact on a total group EBIT which is projected between $600-700m for FY14-15.

Amcor is one of the few truly global companies on the Australian share market. As such, it is easy to make the assumption the company is one key beneficiary of AUDUSD trending lower. In reality, however, the dominant currency for the Amcor group of operations is the euro. Analysts estimate that Amcor’s bottom line benefits to the tune of A$5m for every 1c the AUD softens against EUR. For every

1c the USD weakens against EUR the bottom line receives a bonus of circa A$3m.

Citi released a general list of companies impacted by AUD in June, showing mining stocks, and smaller miners in particular, do have the highest leverage overall (see also pages 36-37). Below are a few stand-outs among industrials stocks from the Citi tables:

- Aristocrat Leisure ((ALL)) EPS estimates for next two years up by 6% and 9%
- Amcor ((AMC)) EPS estimates for next two years up by 5.5% and 9%
- Cochlear ((COH)) EPS estimates for next two years up by 4% and 15%
- Caltex ((CTX)) EPS estimates for next two years up by 6.5% and 4%
- Incitec Pivot ((IPL)) EPS estimates for next two years up by 9.5% and 14%
- Orica ((ORI)) EPS estimates for next two years up by 4% and 6.5%
- Treasury Wine Estates ((TWE)) EPS estimates for next two years up by 6% and 8%
- Westfield ((WDC)) EPS estimates for next two years up by 3% and 5%

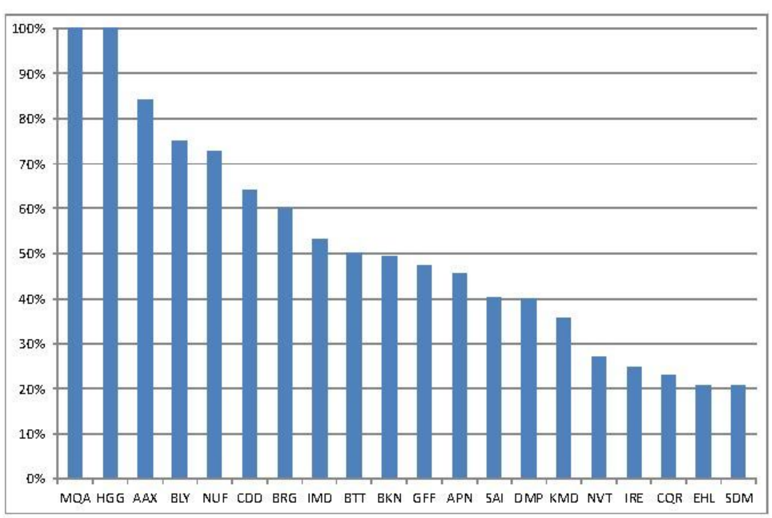
Consider also (from the same Citi tables):

- Ansell ((ANN) EPS estimates for next two years DOWN by 6% and 12%
- Myer ((MYR)) EPS estimates for next two years DOWN by 2.5% and 4%
- Qantas ((QAN)) EPS estimates for next two years DOWN by 72% and 72%
- Wesfarmers ((WES)) EPS estimates for next two years DOWN by 2.5% and 3.5%

Again, the exact impact will be determined by how far AUD might fall or rise, but these examples provide an indication about various (relative) exposures for Australian companies.

MQA, HGG, AAX, BLY and NUF generate >70% of sales from outside Australia

FY14E sales from offshore



Source: Goldman Sachs Research estimates, Quantum database.

Mining companies and AUD

The Australian dollar usually trades in close correlation with commodity prices; bulk minerals and base metals in particular. Thus when prices for copper, aluminium, coal, iron ore and the like are rising, an appreciating AUD reduces some of the upward impact on profits and valuations for Australian-based mining companies. But investors tend not to care, instead focusing on the commodity price movements behind the currency's strength, as that is much more important (backed-up by share price movements).

Somewhere along the upward path will come an adjustment for the currency, but nobody really knows when that'll happen, or how. There's so much inherent volatility in share prices of mining stocks, it makes it difficult to pinpoint exactly what the AUD's impact is during buoyant times.

Most traders/investors will stick to the observation that when commodity prices moves higher, share prices for mining stocks do the same. Here the currency should probably play a more prominent role, but it seldom does. And nobody really seems to care about it much.

During times when commodity prices are falling and AUD is dragged south, should investors then care?

That might be the $64m question for investors in the years ahead, as sector analysts and economists have turned increasingly more subdued in their forecasts and projections, but this should to a large extent be compensated for by equally subdued estimates for AUD.

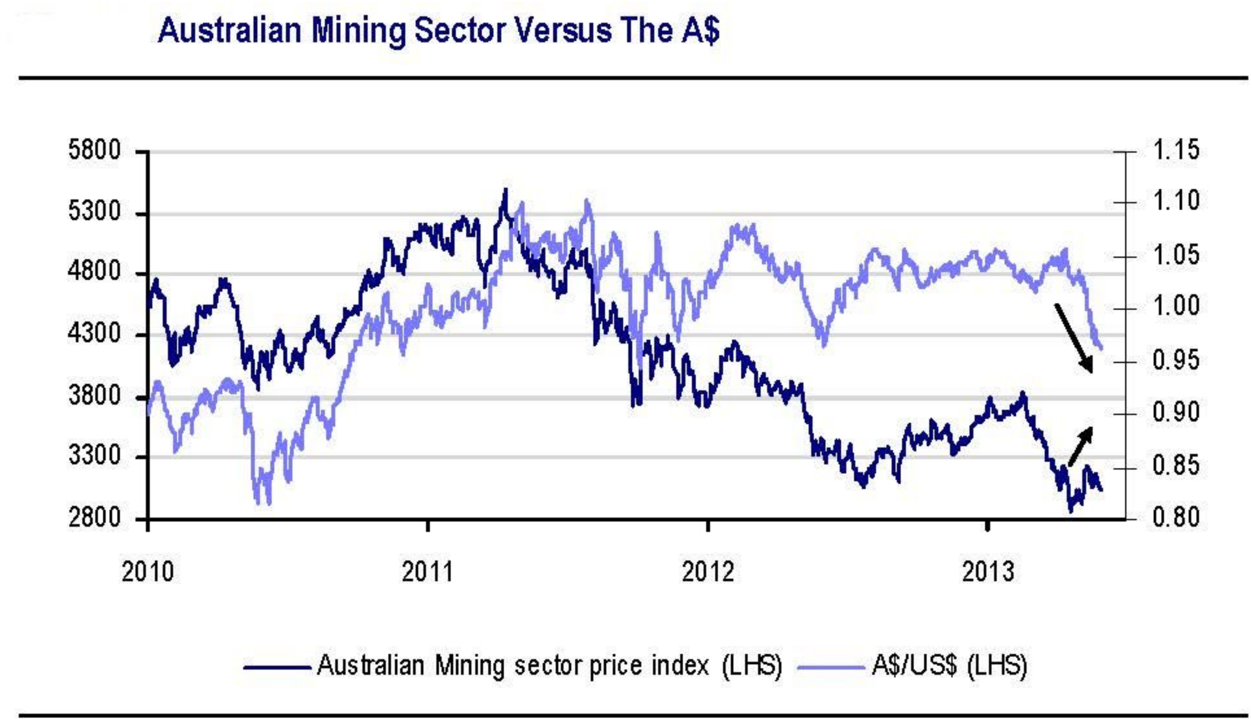
As a rule of thumb, mining companies reporting in USD won't feel much of an impact in their financial reporting, unless they have a significant cost base in AUD, but their valuations and dividends should still be positively impacted. Those most highly leveraged to a weaker AUD are companies with significant operations in Australia that also report in AUD because their sales will largely be in USD, thus boosting their margins and profits.

Movements in AUD essentially raise or lower the cost of production for mining companies in Australia. Some companies (a lot of them in dire times) would not be able to stay in business without extra support from a weaker AUD.

This also implies that when times are tough, and prices are low, a weaker AUD can have a significant impact on beaten-down, highly leveraged, operationally challenged mining companies. This is why a substantially weaker AUD can be a material factor (pun intended) for Australian mining companies in the year(s) ahead.

Investors seeking to implement strategies for AUD-leveraged mining stocks will need to keep a close eye on the interaction between commodity prices and AUD. As shown on the price chart below, in 2012 AUD temporarily decoupled from falling commodity prices, and remained above USD-parity, essentially exacerbating the impact from weakening commodity prices for Australian mining companies.

This is why, in the second quarter of 2013, a softening AUD turned into a positive factor for mining shares in Australia.



Source: Datastream

In essence, and under ideal circumstances, a softer AUD can have a significant impact on financial performances, in particular among the smaller companies in the sector, as illustrated by the following quote from a research report from UBS, released in late June:

"Earnings across our coverage universe are up anywhere between 10 and 300%, albeit the larger changes are on small earnings in absolute terms. In some instance, the weaker A$ is sufficient to see companies return to profitability".

A weaker AUD strengthens the market position of producers in Australia relative to their international competitors (as it lowers the costs of production for operations in Australia).

The ultimate outcomes of changing prices for commodities, AUD moves and responses put in place by management teams at mining operations remains very much a feast with many moving plates. Below are some examples I picked from broker sector reports. Note projected impacts are very much dependent on what prices and AUD-values are being used, so these examples should under all circumstances be treated with caution. They only serve as an illustration of the extreme leverage that can reveal itself under accommodative circumstances.

From a sector report by UBS, 24 June, 2013: Projected changes to EPS after incorporating lowered prices for commodities and lowered projections for AUD:

- Atlas Iron ((AGO)) EPS estimates for next two years up by 95% and 63%
- BC Iron ((BCI)) EPS estimates for next two years up by 45% and 37%
- Mout Gibson ((MGX)) EPS estimates for next two years up by 89% and 86%
- Gindalbie Metals ((GBG)) EPS estimates for next two years up by 154% and 227%
- Grange Resources ((GRR)) EPS estimates for next two years up by 177% and 354%
- Bathurst Resources ((BTU)) EPS estimates for next two years up by 184% and 102%
- Whitehaven Coal ((WHC)) EPS estimates for next two years up by 115% and 358%
- Iluka Resources ((ILU)) EPS estimates for next two years up by 98% and 53%
- Western Areas ((WSA)) EPS estimates for next two years up by 343% and 108%
- Mincor Resources ((MCR)) EPS estimates for next two years up by 93% and 40%
- Panoramic Resources ((PAN)) EPS estimates for next two years up by 86% and 240%

Citi released a general list of companies impacted by AUD in June, showing mining stocks, and smaller miners in particular, do have the highest leverage overall, followed by oil and gas producers. A few extra stand-outs from the Citi tables include:

- Beach Petroleum ((BPT)) EPS estimates for next two years up by 27% and 32%
- Fortescue Metals ((FMG)) EPS estimates for next two years up by 8.5% and 15%
- Newcrest Mining ((NCM)) EPS estimates for next two years up by 36% and 46%
- OZ Minerals ((OZL)) EPS estimates for next two years up by 47% and 69%
- Regis Resources ((RRL)) EPS estimates for next two years up by 13% and 23%

- Santos ((STO)) EPS estimates for next two years up by 14% and 25%
- Woodside Petroleum ((WPL)) EPS estimates for next two years up by 5% and 9%

In comparison, consider some of the industrials stocks with the highest leverage from the same Citi tables:

- Aristocrat Leisure ((ALL)) EPS estimates for next two years up by 6% and 9%
- Amcor ((AMC)) EPS estimates for next two years up by 5.5% and 9%
- Cochlear ((COH)) EPS estimates for next two years up by 4% and 15%
- Caltex ((CTX)) EPS estimates for next two years up by 6.5% and 4%
- Incitec Pivot ((IPL)) EPS estimates for next two years up by 9.5% and 14%
- Orica ((ORI)) EPS estimates for next two years up by 4% and 6.5%
- Treasury Wine Estates ((TWE)) EPS estimates for next two years up by 6% and 8%
- Westfield ((WDC)) EPS estimates for next two years up by 3% and 5%

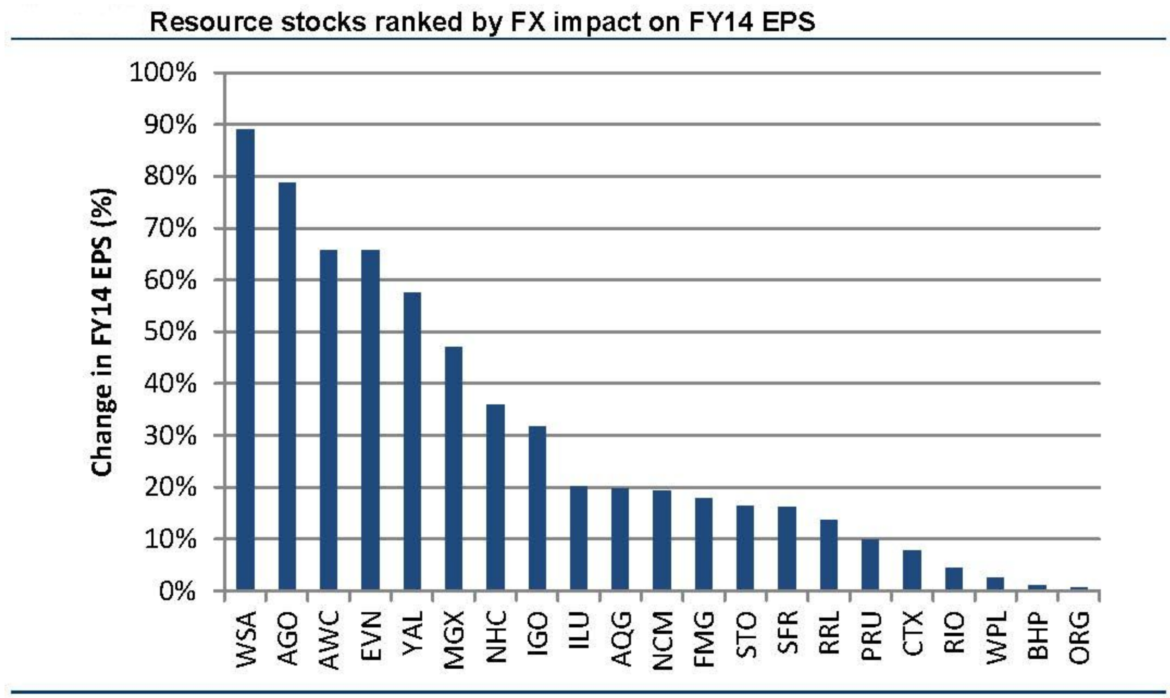
On June 20, Analysts at BA-Merrill Lynch published the following table illustrating AUD leverage in the sector for FY14:

Looking at FY14E EPS changes on a 10% lower AUD

Company	Base Case	10% Chg.	% EPS Chg.
ERA	(0.076)	(0.029)	NM
Intrepid	NA	NA	NA
Ampella	NA	NA	NA
Alumina Limited	-0.0049	0.026	618.8%
Kingsgate	0.0362	0.154	326.8%
Whitehaven Coal	0.032	0.104	221.8%
OZ Minerals	0.1591	0.381	139.4%
Atlas Iron Limited	0.050	0.119	137.2%
Yancoal	0.103	0.244	136.7%
Grange Resources	0.024	0.043	83.9%
Gindalbie Metals	0.037	0.065	72.5%
Western Areas	0.1939	0.322	65.9%
Evolution	0.1129	0.184	63.1%
Independence Group	0.1541	0.245	59.1%
BC Iron Limited	0.511	0.777	52.0%
Mount Gibson Iron	0.091	0.137	50.1%
Newcrest	0.6559	0.961	46.5%
Saracen	0.0523	0.066	26.2%
Iluka Resources	1.236	1.554	25.7%
Fortescue Metals	0.493	0.588	19.2%
Regis	0.3767	0.447	18.6%
Perseus	0.0768	0.089	16.4%
Rio Tinto Ltd	4.551	4.840	6.4%
BHP Billiton Ltd	2.643	2.730	3.3%
PanAust Limited	0.2113	0.214	1.4%
Alacer Gold	0.2098	0.212	1.1%
Paladin	0.063	0.063	0.0%

Source: BofA Merrill Lynch Global Research Estimates

And here's a similar exercise by analysts at Credit Suisse in late May:



Source: Credit Suisse estimates

Note: amidst all these hefty changes to forward projections, the two juggernauts in the sector in Australia, **BHP Billiton** ((BHP)) and **Rio Tinto** ((RIO)) have enjoyed single digit lifts to EPS estimates for the years ahead only. On UBS's assessment, BHP is slightly more sensitive to the AUD than is Rio Tinto.

Retail and AUD (Negative)

The impact of a weaker AUD on Australian retail companies is a dragon with many heads. On one hand, those companies sourcing a substantial part of their products from overseas will be faced with higher input costs and thus potentially shrinking margins.

On the other hand, the AUD remaining persistently above USD-parity is seen as one of the factors that has kept overall economic activity in the domestic economy outside the mining sector at benign levels in years past.

All in all, retail spending is likely to be most impacted by the AUD's contribution to the local unemployment rate and by its impact on property prices and on consumers' real spending power; all three link back to the RBA and interest rates and potential government actions.

Retailers that source between 60-90% of their costs of goods sold (COGS) in USD include (in declining order) **The Reject Shop** ((TRS)), **Pacific Brands** ((PBG)) and **Premier Investments** ((PMV)). They are all facing additional headwinds if AUD weakens further.

On the other hand, inflation is likely to make a come-back as a direct result of a cheaper AUD and this should be to the advantage of supermarket operators **Woolworths** ((WOW)) and **Wesfarmers** ((WES)).

The same should apply for department stores owners **David Jones** ((DJS)) and **Myer** ((MYR)). The latter two should also benefit from the fact that purchasing directly from foreign sources also becomes less attractive for Australian consumers.

Traditionally, retailers find it easier to grow sales and profits in an inflationary environment. Most retailers have been battling deflation for many, many years in Australia.

In a report on small cap stocks, published on June 19, analysts at Goldman Sachs highlight most companies in the retail sector appear to be negatively impacted by a weaker AUD because of the upward impact on costs from foreign imports.

However, the analysts point out, most of these retailers also have a hedging program in place, meaning they are largely insulated for the foreseeable future.

Special note: given the rapid decline for AUD it is possible most retailers will feel the pinch through their FX hedging programs. The August reporting season may well provide more clarity on the issue.

Already it has emerged (in July, ahead of the upcoming reporting season) that **GUD Holdings** ((GUD)) might well turn into one of the main victims of a softer AUD in the years ahead. For the short term, the company has hedged all FX exposures at AUDUSD 0.99, including for all of FY14.

Through its Consumer Products division, GUD has benefited from a strong AUD in years past. A weaker AUD is likely to change market dynamics on several fronts. It might narrow the price gap between GUD's products and "house brands", which is likely to translate into either lower sales, or into even more downward pressure on margins, or both.

It is not easy to assess the longer term impact, but if retailers and distributors pass on the declining AUD impact on sourcing costs to the consumer, there may be a combination of reduced headline demand and a mix-shift to lower price points. This could represent a double whammy for the company.

Steel Stocks and AUD

Steel manufacturers in Australia should be amongst the most obvious beneficiaries from a weakening AUD. Not only does it improve their competitiveness on international steel markets, it also improves their positioning vis-a-vis foreign imports into the Australian market for steel products.

Arrium (formerly OneSteel)

Arrium ((ARI)) might well be the largest beneficiary of AUDUSD weakness in the entire Australian share market. On estimates from Goldman Sachs, a 1c move in AUDUSD impacts Arrium's bottom line by no less than 6%. This currency impact even overshadows the impact from changes in the price of iron ore which Goldman Sachs estimates at 3% impact for every US1c price move for iron ore.

BlueScope Steel

Unlike Arrium, BlueScope Steel ((BSL)) does not have extensive iron ore operations. Its benefits from movements in AUDUSD stem entirely from the interaction with foreign competitors, both in offshore markets as well as in Australia.

Sims Metal Management

Sims Metal ((SGM)) is the world's largest recycler of metals and electronics, with extensive operations in the US and in other markets outside Australia. The company reports in USD and is as such a minor beneficiary only of a weaker AUD.

ALWAYS BEAR IN MIND:

AUD CAN NEVER BE THE SOLE FACTOR THAT DETERMINES THE FUTURE OUTLOOK FOR A GIVEN STOCK

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