Monday, 10 October 2016

Australian Dollar Outlook

Steady as She Goes

- **The Australian dollar has shown resilience over the past year. After some volatility in early 2016, the AUD has traded within a narrow band over the past three months. While the AUD has traded a little higher than we had anticipated, it remains close to the mid-70 cent range where we had expected it to stay for the remainder of this year.**

- **Stronger-than-expected commodity prices are the major factor keeping the AUD elevated. Monetary and fiscal stimulus in China has driven a resurgence in Chinese demand creating key support for commodity prices and the Australian dollar.**

- **We do not expect a significant appreciation in the US dollar, and that it will track broadly sideways over the next year. The outlook for a steady US dollar suggests that commodity prices are not expected to undergo large swings. That said, a sustained rally in commodity prices is unlikely.**

- **Our expectations are for the RBA to cut official interest rates by a total of 50 basis points before mid-next year, which is more than markets are currently anticipating. However, rate cuts from the RBA have taken a backseat in determining the Australian dollar outlook.**

- **Over the near-term, we expect the AUD to trade near its current range and we have maintained our year-end forecast of 74 US cents. We expect it will trade within the US 70 cent range over the coming year.**

The Australian dollar has shown resilience over the past year. After some volatility in early 2016, the AUD has traded within a narrow band of between US$0.7462 and US$0.7703 over the past three months. It is currently trading at close to 76 US cents.

Stronger-than-expected commodity prices are the major factor keeping the AUD elevated. In particular, coking coal prices have surged nearly 150% since the beginning of June to over $200 a tonne. Iron ore prices have also been elevated, but are off their highs hit in April of this year.

Monetary and fiscal stimulus in China has driven a resurgence in Chinese demand creating key support for commodity prices and the Australian dollar.

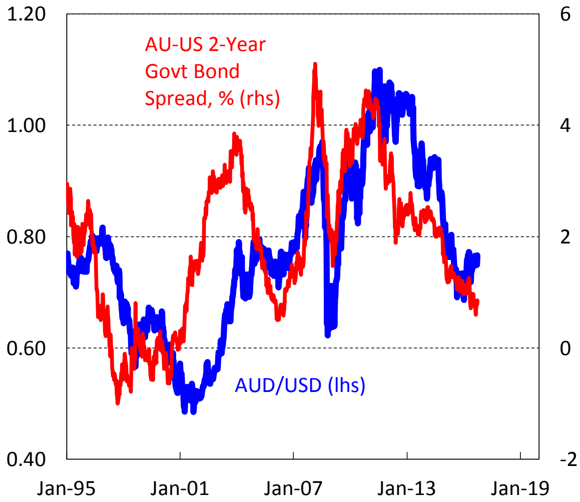
Higher commodity prices have been the overriding factor in determining the value of the Australian dollar. The currency is well up from its January lows, when it hit US$0.6864, and comes despite the fact that the RBA has lowered official interest rates by a total of 50 basis points over

May and August. It does not appear that lower official interest rates have had much of an impact in keeping the AUD under downward pressure, although lower interest rates may have had the impact of keeping the AUD lower than it otherwise would have been.

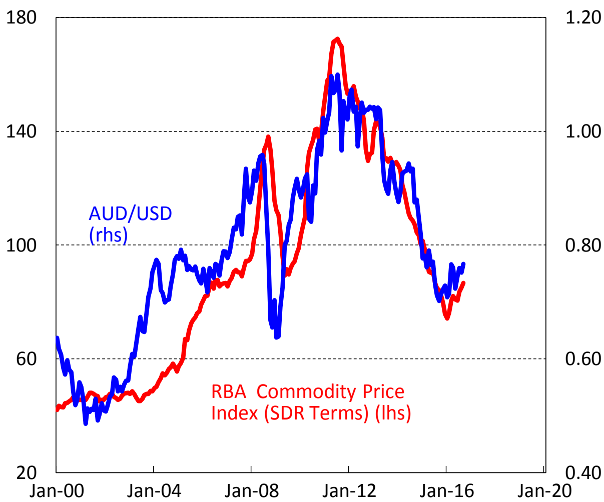
Another factor supporting the AUD (or keeping downward pressure on the USD) has been the scaling back of expectations of Federal Reserve rate hikes. So far this year, the Fed has not lifted its Fed funds rate and this follows earlier Federal Reserve forecasts of up to four rate hikes in late 2015.

While the AUD has traded a little higher than what we had anticipated, it remains close to the mid-70 cent range where we had expected it to stay for the remainder of this year.

AUD/USD & AU-US 2-Year Government Bond Spread



AUD & RBA Commodities Index



Where to Next for the AUD?

Over the near-term, we expect the AUD to trade near its current range and we have maintained our year end forecast of 74 US cents. We expect it will trade close to within the US 70 cent range over the coming year.

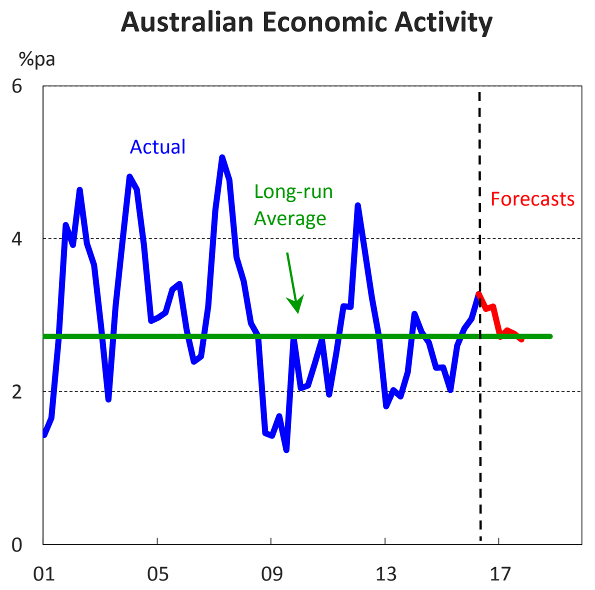
There is little on the horizon which suggests currencies will move strongly in any particular direction, with risks close to balanced.

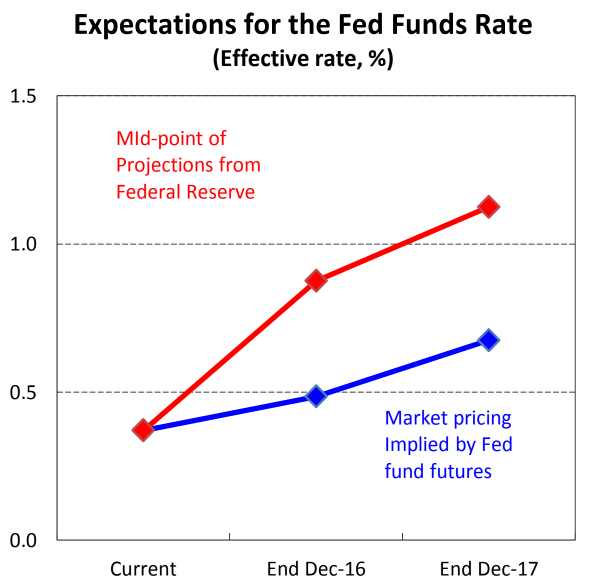
First and foremost, the outlook for Federal Reserve monetary policy will be the key determinant for currency markets. Financial markets continue to place a relatively low probability of Fed rate hikes over the coming year – only a “below 50%” chance of a 25 basis point rate hike by December and a 75% chance of a hike by 2017. We expect a larger, 50 basis points of hikes by the Fed next year, in line with the median estimate of Fed projections. While this is more than markets seem to be suggesting, the pace of expected rate tightening is extremely conservative. Consequently, we do not expect a significant appreciation in the US dollar, and that it will track broadly sideways over the next year.

The outlook for a broadly steady US dollar suggests that commodity prices are not expected to undergo large swings, given the US dollar is a key influence on commodity prices. Recent stimulus measures have boosted economic growth in China and helped to underpin demand for commodities, keeping prices stronger than expected. There is however, the question of how sustainable the recent pickup in commodity prices will be, as there continues to be issues of overcapacity in the Chinese steel sector. That would suggest that a sustained rally in commodity prices is unlikely.

The RBA outlook is the other factor which will influence the Australian dollar. Our expectations are for the RBA to cut official interest rates by a total 50 basis points before mid-next year, which is more than markets are currently anticipating. Interest rate futures are pricing in a 'near 70%' chance of a 25 basis point rate cut by mid-2017. Nonetheless, rate cuts from the RBA have taken a backseat in determining the Australian dollar outlook. Despite two rate cuts from the RBA this year, the Australian dollar is relatively unchanged from its value in April. This might reflect the fact that the Australian economy is growing at a relatively healthy pace. In the year to the June quarter, the economy grew at an above trend pace of 3.3%, and we expect economic growth to remain close to trend over the next year.

The Australian dollar's resilience in the face of RBA rate cuts may also, in part, reflect the very easy monetary policy stances of other central banks around the world. These include the Bank of Japan and the European Central Bank, although there are becoming increasingly limited options for monetary policy that these central banks are able to provide.





Risks and Uncertainties

In the near-term, the US presidential election could pose some downside risks to the Australian dollar. If the prospect of a Trump presidency increases, this would more than likely weigh on financial market sentiment and bring down the Australian dollar, although it would only have an impact over the short-term.

An uncertain outlook for China is the other major risk on the horizon. Chinese growth has received a near-term boost thanks to stimulus measures from authorities. However, this might give way to softer growth as the effects from these measures fade and as growth continues to rebalance towards a more sustainable growth path.

Risks run in both directions in terms of the interest rate outlook. There is the possibility that the US Federal Reserve would further delay raising official interest rates. Conversely, a faster pickup in US wage pressures and inflation could see the Fed raise rates faster than expected. The RBA may also delay reducing official interest rates which could help boost the AUD higher than expected, although RBA monetary policy appears to have had less of an impact on the currency of late.

Summary

We expect that the Australian dollar will trade not far from current levels over the next year. While the RBA is expected to lower official interest rates further, we anticipate that commodity prices and the Fed will be more important for the outlook for the Australian dollar.

Sluggish global demand and still ample capacity suggests that commodity prices are unlikely to rally substantially, but we doubt that commodity prices will fall back to their January lows. Expected rate hikes by the Fed and interest rate cuts by the RBA are expected to only place mild downward pressure on the AUD.

We have maintained our forecast of US$0.74 for the end of 2016 and expect US$0.76 for end 2017.

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Please see detailed forecasts on following page

EXCHANGE RATE FORECASTS

	End Quarter Forecasts			
	Sep-16	Dec-16	Mar-17	Jun-17
USD Exchange Rates				
AUD-USD	0.7664	0.7400	0.7300	0.7200
USD-JPY	101.35	100.00	100.00	100.00
EUR-USD	1.1235	1.1200	1.1300	1.1300
GBP-USD	1.2972	1.3000	1.3300	1.3500
USD-CHF	0.9714	0.9800	0.9700	0.9700
USD-CAD	1.3127	1.3000	1.3000	1.3200
NZD-USD	0.7286	0.7000	0.7000	0.6900
USD-CNY	6.6718	6.6000	6.6000	6.6000
USD-SGD	1.3631	1.3500	1.3500	1.3400
AUD Exchange Rates				
AUD-USD	0.7664	0.7400	0.7300	0.7200
AUD-EUR	0.6820	0.6610	0.6460	0.6370
AUD-JPY	77.70	74.00	73.00	72.00
AUD-GBP	0.5908	0.5692	0.5489	0.5333
AUD-CHF	0.7440	0.7250	0.7080	0.6980
AUD-CAD	1.0060	0.9620	0.9490	0.9500
AUD-NZD	1.0520	1.0570	1.0430	1.0430
AUD-CNY	5.1130	4.8840	4.8180	4.7520
AUD-SGD	1.0450	0.9990	0.9860	0.9650

* Note that the AUD cross exchange rates have been rounded.

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The Detail