Australian Dollar Outlook

Going Out of Style?

- **An intensifying of concerns regarding the outlook for China has resulted in the Australian dollar falling below our end of year forecast. Commodity prices have fallen, and markets have moved to fully price in a rate cut from the RBA in the first half of next year.**

- **In our view, markets have taken an overly pessimistic view on the outlook for China, the domestic economy and interest rates. Our expectations of the broader outlook for the Australian economy are not materially different from a few months ago. We continue to expect the RBA will leave rates on hold until late 2016.**

- **We therefore see a risk that the Australian dollar will partly rebound. We are maintaining our end of year forecast at 0.73 US cents, but we recognise that downside risks exist for our forecast while sentiment remains fragile. Volatility has escalated and there remains more uncertainty than usual surrounding our forecast.**

- **We do not however, expect a sustained rally in the Australian dollar. It will likely come under downward pressure over the course of 2016, as the tightening cycle of the Federal Reserve takes hold and we expect the AUD to track close to 70 US cents throughout early next year.**

The Australian dollar has come under pressure over the last few months. It has fallen over 12% from a recent peak in May against the US dollar and on On 7 September, the AUD hit a six-year low of 0.6896.

Some downside risks have escalated, including uncertainty regarding the Chinese outlook, the global economy and the domestic economy. However, our view is that the broader outlook for the Australian economy is not materially different from a few months ago. We continue to expect the RBA will leave rates on hold until late 2016. While the latest GDP growth results for the June quarter were somewhat disappointing, the outlook for growth to remain a bit below its long-run average over the next year or so remains unchanged.

We view much of the recent fall in the Australian dollar as being largely reflective of the large downturn in sentiment, triggered by the sharp drop in the Chinese stock market and the devaluation of the Chinese currency. However, these movements in markets are probably more due to a range of regulatory changes to liberalise its financial markets and less representative of the state of the Chinese economy.

That being said, challenges remain for China, as it undergoes a transition from investment to consumer-led growth, and to a more market driven economy. Moreover, the Chinese economy is continuing to slow from the rapid pace of growth in earlier years. However, these risks have not significantly increased as a result of the recent developments in the share market and the currency. Further, authorities continue to have significant firepower to do more to support China's economic growth. While the government is willing to tolerate a slower pace of economic growth, it would not want to let growth collapse.

The increased concern about the outlook for Australia's largest trading partner however, raises downside risks for commodity prices, and these have a strong relationship with the Australian dollar. Indeed, the prices of oil, base metals and iron ore have fallen in recent months. There is a risk that commodity prices could fall further, but the AUD has now fallen more than what the current drop in commodity prices implies.

Another factor which is currently placing downward pressure on the Australian dollar is the expectation that the RBA will cut official interest rates again. Markets have moved to fully price in a 25 basis point rate cut from the RBA by May next year. This is contrary to our view that the RBA will leave rates on hold until late 2016.

These developments would suggest that markets have taken a more pessimistic view on the outlook for China, the domestic economy and interest rates, in comparison to what we expect.

The US Federal Reserve, however, remains a key downside risk for the Australian dollar. While the odds of a Federal Reserve official interest rate hike in September have lessened, we continue to expect the Federal Reserve will lift rates once before the end of the year. The prospect of a Fed rate hike in 2015 is only partially priced into markets, and suggests there is a strong risk the US dollar will spike if the Fed raises rates as we expect. However, we sense that the path of future rate increases beyond the first move will be more important for the medium-term direction of the currency. Therefore, if the Fed decides to hike rates once before the end of the year, but emphasises a very gradual path of monetary tightening, then any appreciation of the US currency for the remainder of this year could be limited.

Finally, the pessimism regarding the Chinese economy could persist into 2016 as economic growth is likely to slow. Uncertainty could remain for some time regarding the ability of authorities to deal with the challenges it faces.

In summary, we see a risk that the AUD will rebound in the near-term, thus **we have maintained our end of year target at 0.73 US cents**. However, we recognise that downside risks exist for this forecast while sentiment remains fragile. Moreover, we do not expect a sustained rally in the Australian dollar. It will likely stay under downward pressure over the course of 2016, as the tightening cycle of the Federal Reserve takes hold, and we expect the AUD to track near 70 US cents throughout early next year.

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Please see detailed forecasts on following page.

EXCHANGE RATE FORECASTS

	End Quarter Forecasts			
	Sep-15	**Dec-15**	**Mar-16**	**Jun-16**
USD Exchange Rates				
AUD-USD	0.7100	0.7300	0.7000	0.7000
USD-JPY	122.00	125.00	127.00	130.00
EUR-USD	1.1300	1.1100	1.0900	1.0800
GBP-USD	1.5500	1.5600	1.5700	1.5800
USD-CHF	0.9700	0.9800	0.9900	0.9900
USD-CAD	1.3100	1.3000	1.3000	1.2900
NZD-USD	0.6300	0.6400	0.6100	0.6100
USD-CNY	6.4000	6.6000	6.7000	6.7200
USD-SGD	1.4000	1.4000	1.4100	1.4200
AUD Exchange Rates				
AUD-USD	0.7100	0.7300	0.7000	0.7000
AUD-EUR	0.6280	0.6580	0.6420	0.6480
AUD-JPY	86.60	91.30	88.90	91.00
AUD-GBP	0.4580	0.4680	0.4460	0.4430
AUD-CHF	0.6890	0.7150	0.6930	0.6930
AUD-CAD	0.9300	0.9490	0.9100	0.9030
AUD-NZD	1.1270	1.1410	1.1480	1.1480
AUD-CNY	4.5440	4.8180	4.6900	4.7040
AUD-SGD	0.9940	1.0220	0.9870	0.9940

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

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