

Australian Dollar Outlook

Still a Slippery Slope

- The Australian dollar slid sharply over the first couple of weeks of this year, and hit new seven-year lows. Risk aversion once again escalated amid Chinese concerns and renewed falls in commodity prices.
- While worries regarding China continue to pose downside risks for the Australian dollar, we maintain that risks to the real economy have not taken a significant turn for the worse. Nonetheless, the AUD will likely remain volatile while these worries linger.
- The uncertain outlook for commodity prices is another key downside risk for the AUD outlook, as commodity prices tend to be a key determinant of the AUD over the longer-term. However, a relatively resilient domestic economy and our view for a steady cash rate for all of 2016 should limit further falls in the AUD.
- We expect that the AUD will trade close to US 70 cents over the first half of this year, notwithstanding some volatility while markets remain on edge. In the near-term, weakness in commodity prices and fragile market sentiment are likely to continue to provide some downside risk. Nonetheless, we do not expect the Australian dollar to sustain falls substantially below 70 cents unless RBA rate cuts become a strong possibility or the global outlook takes a significant turn for the worse.
- We expect the currency to begin appreciating in the second half of the year, as a recovery in the domestic economy takes hold. Our end of 2016 forecast for the AUD is US\$0.74.

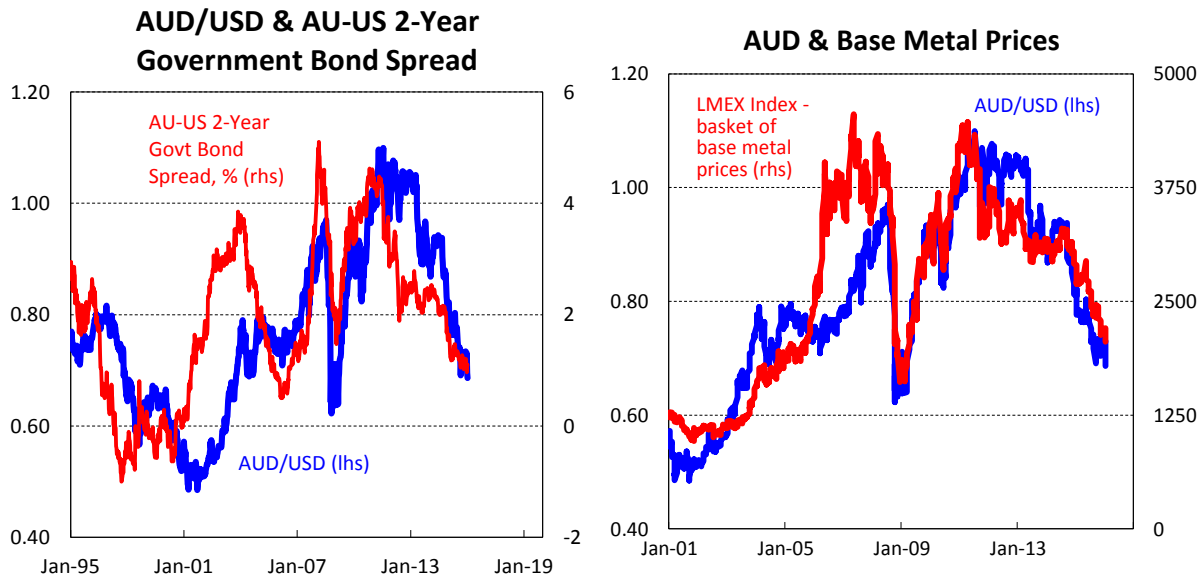
A Recap

The Australian dollar has had a volatile few months, mostly trading within a US\$0.69-0.74 range since September. After touching a low of US\$0.6896 on 7 September, the Australian dollar ended 2015 at US\$0.7286, in line with our long-held forecast of 73 US cents.

Our forecast was based on the notion that markets had taken an overly pessimistic view on the outlook for China, the domestic economy and domestic interest rates, as stated in our AUD outlook published on 14 September. Since then, the run of domestic economic data has been relatively upbeat, and market pricing for further reductions to the RBA cash rate has pared back. Evidence of the Australian economy's resilience, along with a rebound in risk appetite has provided support for the Australian dollar, and outweighed downward pressures from weak

commodity prices.

Nonetheless, we also stated in September that we did not expect any sustained rally in the Australian dollar. Lower commodity prices, and ongoing uncertainty regarding the global economy and developments in China, could continue to weigh on the Australian dollar. More recently, the Australian dollar slid sharply over the first couple of weeks of this year, and hit a seven-year low of US\$0.6827 on 16 January as risk aversion once again escalated amid Chinese concerns and renewed falls in commodity prices.



Where to Next for the AUD?

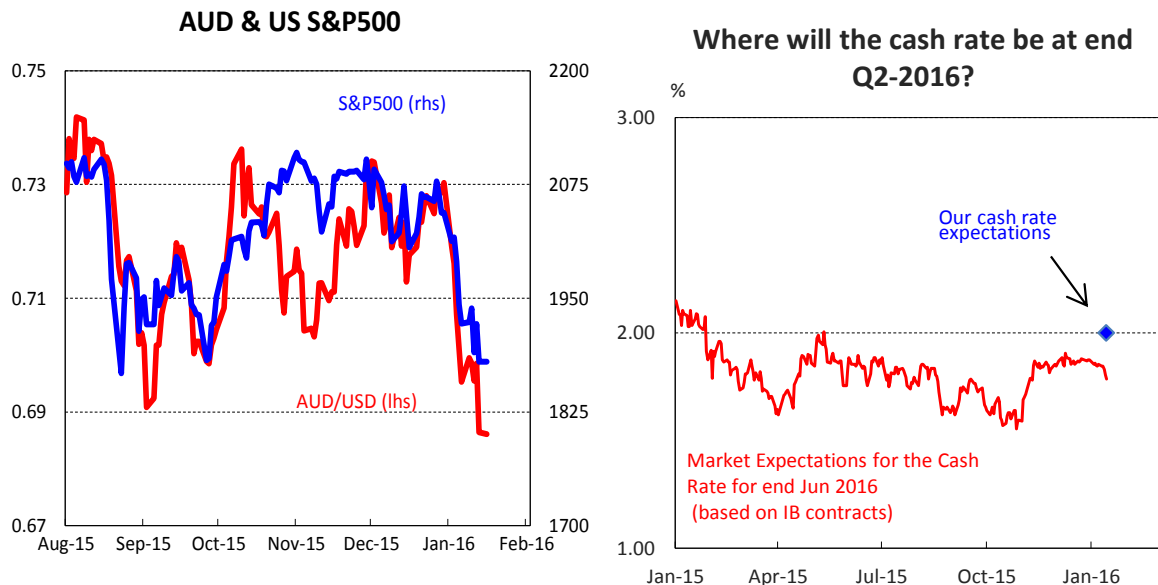
The balance of risks suggests to us that the AUD will mostly trade near 70 US cents over the first half of the year unless developments diverge significantly from our expectations.

Worries regarding China continue to pose downside risks for the Australian dollar, as the Chinese economy slows and continues to undergo its transition towards more market-driven financial markets. These concerns could result in further market ructions over the coming year. However, we maintain that risks to the real economy have not taken a significant turn for the worse. This would suggest that the events over the past few weeks should have limited implications for our forecasts over the coming year. Nonetheless, the AUD will likely remain volatile while these worries linger.

The commodity price outlook is also a significant risk for the currency outlook. Further falls in commodity prices remain a distinct possibility, and commodity prices tend to be a key determinant of the AUD over the longer-term. However, substantial falls from current levels in the prices of commodities such as oil and iron ore, would be unlikely sustainable over the long-term. Further, commodity prices are also not the only driver for the Australian dollar. The growth outlook for Australia and interest rates also plays a part.

On this front, the domestic economy is performing relatively well given the income squeeze from falling commodity prices. This is in part due to solid growth in export volumes, but also because there are signs of recovery in non-mining sectors of the economy which are not as affected by movements in commodity prices. These are sectors which have supported strong growth in jobs and will support the case for the RBA to leave rates on hold. Our view for a steady cash rate for all

of 2016 should limit further falls in the AUD, although some chance of a rate cut is likely to remain embedded into market pricing while inflation remains low, growth remains below trend and global growth concerns persist.



Currently, markets are close to fully pricing in a rate cut from the RBA by June this year, although this is less than the two rate cuts priced in some months ago. This suggests that the AUD could lift if the RBA leaves official interest rates unchanged, particularly towards the end of the year when we expect to see further signs of growth picking up towards trend. Hence, we expect the AUD to begin appreciating towards the second half of 2016, with an end of year target of 74 US cents.

Risks and Uncertainties

We see the risks to our AUD forecasts as being mostly balanced. The key risk remains the uncertain outlook for commodity prices. The AUD has also been moving closely with equity markets and risk appetite, which have been volatile of late (see chart above left).

Another factor that could influence the currency is the outlook for the Federal Reserve. The US central bank finally kicked off its tightening cycle in December last year. As we expected, this resulted in limited market reaction given the move was widely telegraphed. We expect a further three 25 basis point increases this year, which should give the US dollar support (downward pressure on the AUD). However, the risk is that the Fed will lift rates at a slower pace given the weak inflation outlook. This would limit any further appreciation of the US dollar.

The domestic economy may not pick up as soon as expected, and delay the expected AUD appreciation towards the end of the year. However, once there are stronger signs of recovery in the domestic economy, and markets begin to get a sense that an RBA rate hike is on the horizon, the AUD could lift quickly over a short period of time.

Summary

We expect that the AUD will trade close to US 70 cents over the first half of this year. In the near-term, weakness in commodity prices and fragile market sentiment are likely to continue to provide some downside risk, and could keep the currency volatile. Nonetheless, we do not expect

the Australian dollar to sustain falls substantially below 70 cents unless RBA rate cuts become a strong possibility or the global outlook takes a significant turn for the worse. We expect the currency to begin appreciating in the second half of the year, as a recovery in the domestic economy takes hold. Our end of 2016 forecast for the AUD is \$0.74.

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Please see detailed forecasts below

EXCHANGE RATE FORECASTS

End Quarter Forecasts

	Mar-16	Jun-16	Sep-16	Dec-16
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USD Exchange Rates

AUD-USD	0.7000	0.7000	0.7200	0.7400
USD-JPY	122.00	122.00	120.00	119.00
EUR-USD	1.0800	1.0800	1.0900	1.1000
GBP-USD	1.4800	1.5000	1.5200	1.5400
USD-CHF	0.9900	0.9900	0.9800	0.9800
USD-CAD	1.4000	1.4000	1.3500	1.3300
NZD-USD	0.6600	0.6600	0.6700	0.6800
USD-CNY	6.5500	6.5500	6.6000	6.6000
USD-SGD	1.4200	1.4200	1.4400	1.4200

AUD Exchange Rates

AUD-USD	0.7000	0.7000	0.7200	0.7400
AUD-EUR	0.6480	0.6480	0.6610	0.6730
AUD-JPY	85.40	85.40	86.40	88.10
AUD-GBP	0.4730	0.4667	0.4737	0.4805
AUD-CHF	0.6930	0.6930	0.7060	0.7250
AUD-CAD	0.9800	0.9800	0.9720	0.9840
AUD-NZD	1.0610	1.0610	1.0750	1.0880
AUD-CNY	4.5850	4.5850	4.7520	4.8840
AUD-SGD	0.9940	0.9940	1.0370	1.0510

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

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