Australian Dollar Outlook

The Resilience of the Aussie Dollar

- **We have revised up our Australian dollar forecasts to US$0.9300 by the end of this year and to US$0.9100 by the end of next year.**
- **USD strength is unlikely to materialise in a hurry and excess liquidity around the world combined with an appetite for risk will help keep the AUD elevated.**
- **We expect the RBA to start its tightening cycle before most of the G10 economies, keeping interest-rate differentials supportive of the AUD.**
- **The environment is more likely to shift unfavourably for the Australian dollar when the US Federal Reserve gets closer to tightening monetary-policy settings next year.**

Summary

We are upgrading our forecasts for the Australian dollar. We now expect the Australian dollar will end this year at US$0.9300 rather than US$0.8700 (previous forecast in place since the start of this year). This revision higher in the AUD is also one of the key factors behind our recent decision to push back the first timing for the RBA rate hike to the first quarter of next year.

The AUD should be underpinned into early next year by from the favourable risk environment and the incentive for global investors to continue with the carry trade. The AUD should also continue to receive support from interest-rate differentials and the improving economic growth outlook. While commodity prices are a drag on AUD, this will be offset by stronger export volumes. The China story also is unlikely to shift the AUD substantially lower. USD strength is not likely to materialise until the Fed gets closer to tightening monetary policy. The RBA's tightening cycle will already be underway by then. But, volatility and the risk environment could shift unfavourably towards the Australian dollar when the monetary policy regimes of the major central banks get closer to shifting. By the end of 2015, we expect the AUD to be at US$0.9000.

US Dollar and the Federal Reserve Outlook

The US Federal Reserve last week tapered by a further US$10 billion to take its bond-buying (i.e. quantitative easing) program to US$35 billion per month. The Fed's accompanying statement reiterated the previous wording that rates will stay low for a considerable period after the bond-buying program concludes.

We expect the Fed to conclude its bond-buying in October this year and for the first rate rise to materialise in June next year. Our forecast is slightly sooner than consensus. Consensus expects it to occur in the September quarter of 2015. We expect that as US growth picks up, after the harsh winter, the risk of the market pricing in earlier and more rate hikes next year will rise. If this scenario comes to fruition, it would push up US interest rates at the shorter end of the curve, such as US one-year and two-year swap rates. However, fairly benign inflation means that the tightening cycle is still a considerable time away.

This outlook for Fed policy suggests that a sustained appreciation in the USD will not occur until US rate hikes are closer. The Fed outlook will become increasingly data dependent as the first US rate hike draws near. Most likely the USD will begin an upward trend in 2015 in the lead up to the start of the Fed's tightening cycle. The appreciation of the USD will begin modestly because the tightening cycle should start off slowly.

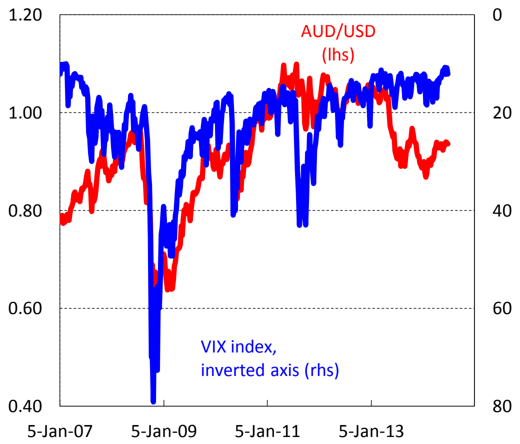
Risk Appetites

The Australian dollar tends to be firmer in an environment where appetite for risk is high and volatility is low. This is the mix of conditions prevailing in foreign exchange markets. Very low benchmark rates in all major economies combined with quantitative easing in some has contributed to these conditions.

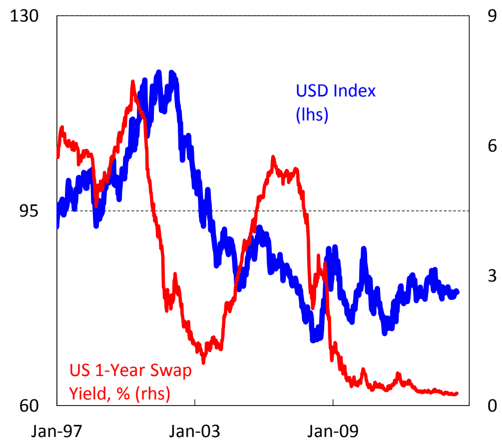
A widely-watched measure of global risk appetite is the VIX index. On 20 June, this index dropped to its lowest level since February 2007. It has since risen from this level on the back of Middle-East tensions, but remains relatively low and supportive of the AUD.

Volatility is likely to remain low until major central banks get closer to lifting their key policy rates. Hence, risk and carry trade should continue to perform well until then. We suspect that once the Fed, and possibly the Bank of England, get closer to changing their monetary-policy settings, volatility will be stirred.

AUD/USD & Risk Appetites



USD Index & US 1-Year Swap Yield



Carry Trade and the Chase for Yield

Demand for the Australian dollar is also being underpinned by the attractiveness of the 'carry trade'. International investors are borrowing funds at low interest rates in their local currency and then investing these funds in higher yielding Australian shares and fixed interest investments. In a low-risk environment, the lure of the carry trade rises.

With Australia as one of the few countries to be in the elite AAA sovereign-rated club, there is global demand for Australia's higher-yielding government bonds. There is also global demand for other Australian assets, such as equities and commercial property. This global demand is underpinning the AUD.

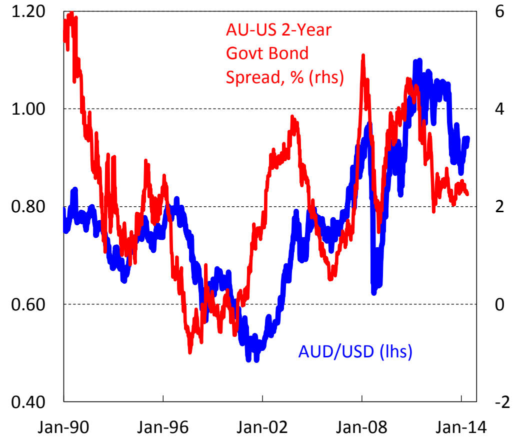
We do not expect the Reserve Bank of Australia (RBA) to cut the cash rate again in this cycle. The next move in the cash rate should be a hike, but not until next year. Moreover, the RBA is likely to start raising rates before most of the economies in the G10, including the US, Eurozone and Japan. The exception is the UK.

The UK's buoyant economy suggests it is only a matter of time before the Bank of England (BoE) starts raising rates and a move in December this year cannot be ruled out. We are lifting our GBP forecast profile to reflect the stronger underlying fundamentals in the UK economy.

The GBP/USD recently reached a five-year high of near 1.0740. Given how much of a favourable outlook for the UK economy is already priced in by markets, we expect that future GBP gains will be more modest in nature. The growing current account deficit will also remain a handicap for the pound.

Looking at interest rates in the yield curve beyond cash, Australian-US interest-rate differentials are unlikely to change in a meaningful way until later this year. However, US interest rates at the short end of the yield curve (for example, 2 years) have potential to shift and adjust higher because in our view current market pricing on the US is too dovish. US rates could correct higher later this year, after a period of ongoing improvement in the unemployment rate and inflation.

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



Central Bank Rates
Australia & G10 Economies

	Key Interest Rate	Current Rate	Median Market Expectation for End 2014
Australia	Cash Rate	2.50%	2.50%
Canada	Overnight Lending Rate	1.00%	1.00%
UK	Bank Rate	0.50%	0.63%
US	Federal Funds Rate	0.25%	0.25%
Euro Zone	Refinancing Tender	0.15%	0.13%
Japan	Overnight Call Rate	0.10%	0.10%
Switzerland	3-Month Libor Rate	0.00%	0.00%

Source: St.George, Bloomberg

Global Liquidity and Quantitative Easing

The carry trade is also being spurred by the world being awash with liquidity. The Bank of Japan, the US Federal Reserve and the Bank of England have quantitative easing (QE) programs in place. While the Fed is now cutting back on its QE program, it has not stopped yet. The European Central Bank (ECB) may also embark on its own version of QE later this year and there are risks the Bank of Japan will accelerate its QE program in October.

The ECB recently cut its benchmark refi rate to 0.15% and imposed an interest rate of minus 0.10% on reserve balances that banks hold at the central bank. These cuts were undertaken to stimulate growth and combat deflationary pressures. These actions should spur the attraction of the EUR as a funding currency in the carry trade strategy. Moreover, if the fight against slowing inflation is not won with these measures, QE draws nearer for the Eurozone. In this event, there would be a baton change from the USD being a funding currency to the EUR.

The European Union (EU) is the top investor in Australia, at $716.0bn in 2013. This ranking suggests Australia is a favoured destination for EU investors, so QE in Europe could spur greater flows to Australia. These flows would encourage further demand for the AUD. However, while we expect the EUR/USD to soften, we are not as pessimistic on the EUR outlook as consensus. It is because we believe the Eurozone's widening current account surplus helps negate some of the downward forces on the EUR. The Eurozone's current account surplus could widen to as much as 2.6% of GDP next year, from 1.4% last year. In comparison, the US runs a current account deficit, which is likely to be at 2.2% of GDP in 2015.

Emerging Markets

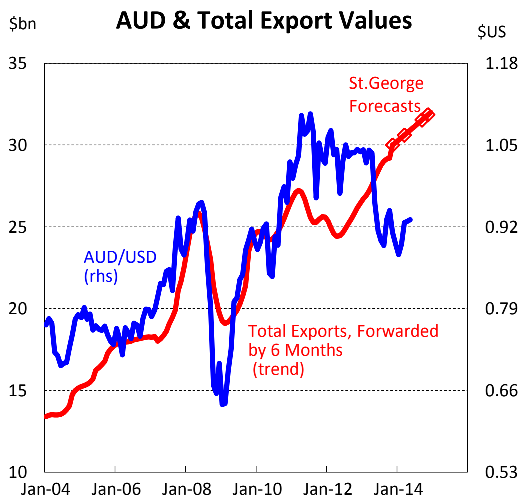
The current conjecture of low volatility in foreign exchange continuing creates the potential for an abrupt shift in financial markets. We would expect the currencies of emerging markets, the so called risk-sensitive currencies, to feel such a shift the most.

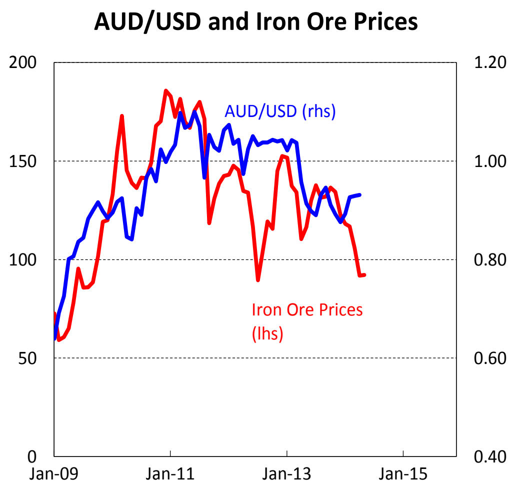
The 18th of June last year marked the "temper tantrum" emerging markets threw in response to a possible paring back of the Fed's QE program. It proved to be a dress rehearsal, as the Fed did not start cutting back on QE until the start of this year.

Another temper tantrum cannot be ruled out in the lead up to the US Fed raising rates next year. We expect the AUD to come under pressure when the US Fed starts its tightening cycle or signals strongly that the tightening cycle is near. While the AUD might not be as hard hit as currencies in emerging markets, it will not be immune. It was not completely immune last year when the "temper tantrum" occurred.

Commodity Prices

The Australian dollar is also not immune to the outlook for commodity prices due to Australia's role as a large commodity exporter. Recent remarks from Reserve Bank officials have stressed the AUD remains high by historical standards, particularly given the decline in the prices of commodities relevant to the Australian economy. Indeed, iron ore prices recently fell to their lowest level since the middle of 2012.





There is a mixed outlook for commodity prices, largely reflecting shifting demand dynamics within China and also supply excesses in the production of certain commodities. However, the outlook of Australia's largest exports, coal and iron ore, is one of further downward pressure on prices.

In recent years, the Australian dollar has shown some resilience, despite the fall in commodity prices. For example, from around the middle of 2012 to early 2013, the Australian dollar largely held its head above parity against the US dollar at a time when bulk commodity prices were on a downward trend.

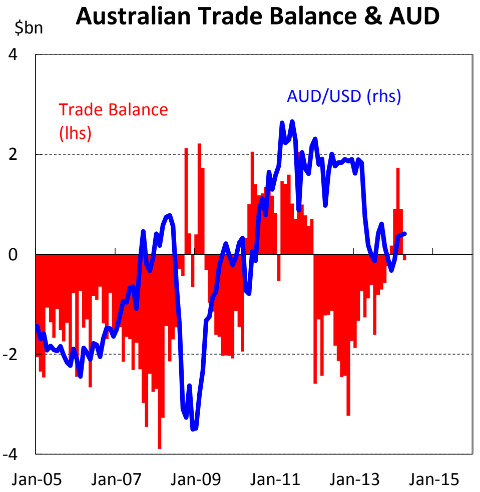
A possible explanation for the divergence between commodity prices and the Australian dollar could reflect the ongoing strong growth in export values. Despite falls in commodity prices since their peak in 2011, growth in export volumes have been very strong, thanks to large increases in production capacity. The Bureau of Resource and Energy Economics (BREE) estimates that earnings from resources and energy commodities to increase at an average rate of 8% per year from 2013-14 to 2018-19.

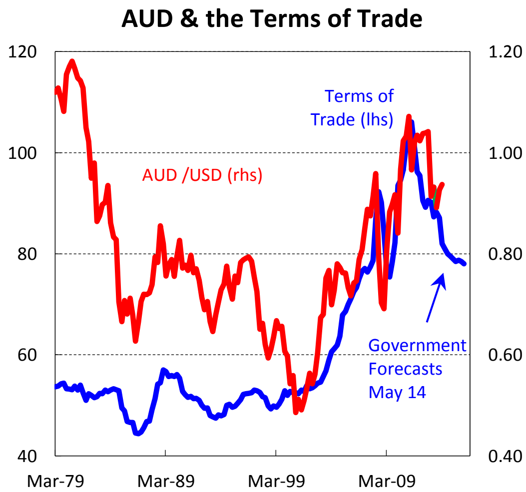
Strong growth in export values should provide some support to the demand for Australian dollars, even though commodity prices most relevant to Australian exports are set to fall further.

Terms of Trade

Commodity prices also heavily influence Australia's export prices and Australia's term of trade. The ratio of export prices to import prices produces the terms of trade ratio. It is now falling, representing a net transfer of income from Australia to the rest of the world. We expect it will continue to fall over the next few years.

The terms of trade is a strong influence on the Australian currency over a medium to long-term framework, so we would expect the AUD to adopt a softer profile over a longer period of time.

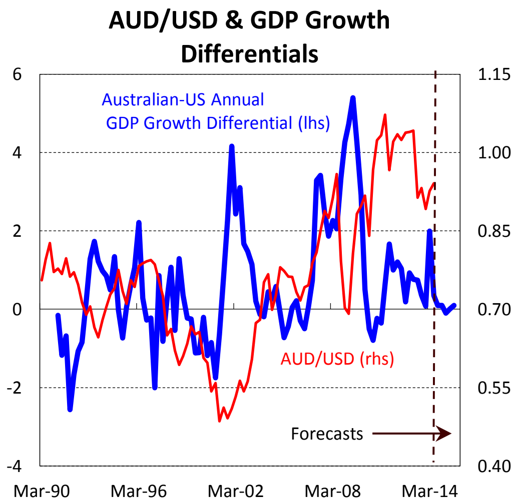


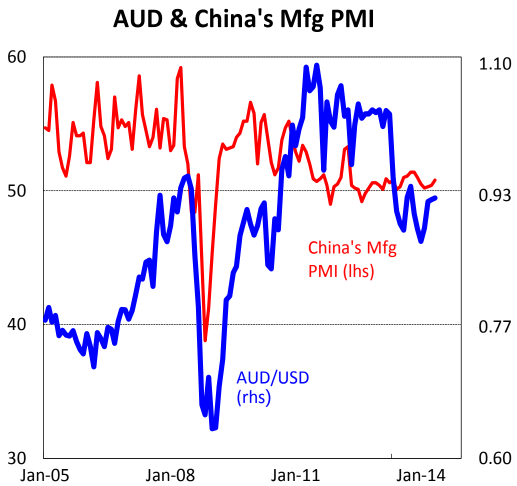


Economic Growth

The terms of trade until recently had been rising. With the peaking of commodity prices behind us, the terms of trade has deteriorated. The Australian economy is transitioning from the second phase of the resources cycle, the mining investment phase, to the third phase, the export production phase. This transition needs the non-mining sector of the economy to lift growth in order to ensure overall economic activity in the Australian economy does not sag.

In the past few years, Australia's relatively strong economic growth performance (compared with other developed economies in particular), has helped underpin demand for the Aussie currency. While Australia's growth performance is still expected to be stronger than many other advanced economies this year, the degree of outperformance is shrinking.





Chinese Outlook

The growth outlook of the Chinese economy is also very relevant for the Australian dollar because it is often viewed as a proxy for the performance of China's economy.

The Chinese leadership under Chinese Premier Li Keqiang is more intent on rebalancing the Chinese economy to sustain long-term growth. The government is moving ahead with important financial market reforms that will help the Chinese economy rebalance. It means they are accepting a weaker growth performance. However, the government has provided assurances that growth of at least 7.5% per annum will be achieved.

China's annual economic growth rate slowed to an 18-month low of 7.4% in the March quarter this year and partial economic indicators raised some concerns. However, the government has acted since then to steady growth through some focused measures such as instructing major banks to keep a fifth of their cash as reserves. There has also been a more targeted mini-stimulus package introduced to bolster growth. There are signs these measures might be working with official manufacturing and service sector surveys showing improvement in May. We expect the 7.5% growth target will remain achievable.

Besa Deda, Chief Economist
Ph: (02) 8254-3251

EXCHANGE RATE FORECASTS

	End Quarter Forecasts					
	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
USD Exchange Rates						
AUD-USD	0.9300	0.9300	0.9400	0.9200	0.9100	0.9000
USD-JPY	104.00	105.00	106.00	107.00	108.00	109.00
EUR-USD	1.3500	1.3400	1.3300	1.3100	1.3000	1.2900
GBP-USD	1.7100	1.7200	1.7300	1.7400	1.7300	1.7200
USD-CHF	0.9200	0.9400	0.9500	0.9600	0.9700	0.9800
USD-CAD	1.0750	1.0800	1.0900	1.1000	1.1100	1.1100
NZD-USD	0.8600	0.8650	0.8700	0.8600	0.8300	0.8100
USD-CNY	6.1800	6.1600	6.1400	6.1200	6.1000	6.0800
USD-SGD	1.2600	1.2700	1.2700	1.2700	1.2700	1.2700
AUD Exchange Rates						
AUD-USD	0.9300	0.9300	0.9400	0.9200	0.9100	0.9000
AUD-EUR	0.6890	0.6940	0.7070	0.7020	0.7000	0.6980
AUD-JPY	96.70	97.70	99.60	98.40	98.30	98.10
AUD-GBP	0.5440	0.5410	0.5430	0.5290	0.5260	0.5230
AUD-CHF	0.8560	0.8740	0.8930	0.8830	0.8830	0.8820
AUD-CAD	1.0000	1.0040	1.0250	1.0120	1.0100	0.9990
AUD-NZD	1.0810	1.0750	1.0800	1.0700	1.0960	1.1110
AUD-CNY	5.7470	5.7290	5.7720	5.6300	5.5510	5.4720
AUD-SGD	1.1720	1.1810	1.1940	1.1680	1.1560	1.1430

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

Contact Listing

Chief Economist

Besa Deda
dedab@bankofmelbourne.com.au
(02) 8254 3251

Senior Economist

Hans Kunnen
kunnenh@bankofmelbourne.com.au
(02) 8254 8322

Senior Economist

Josephine Horton
hortonj@bankofmelbourne.com.au
(02) 8253 6696

Economist

Janu Chan
chanj@bankofmelbourne.com.au
(02) 8253 0898

The Detail