# Australian Dollar Outlook

## Turning Points

- We now expect the Australian dollar to end this year at US$0.8500 and finish next year at US$0.8200. Downside risks to the Australian dollar have grown.
- USD strength has materialised, as the Fed's bond-buying program concludes and the market focuses on when the first rate rise will occur. We expect the Fed to begin tightening monetary policy in June, but would not rule out an earlier move.
- We expect the RBA to start its tightening cycle around the middle of next year, before most of the G10 economies, keeping interest-rate differentials relatively supportive of the AUD.
- Weaker commodity prices and a softening in the Australian terms of trade should deliver a softer profile for the AUD over the medium term.

Summary

We now expect the Australian dollar to end this year at US$0.8500 and finish next year at US$0.8200. Downside risks to the Australian dollar have grown. A break under the key support level overnight of US$0.8660, could signal further medium-term weakness.

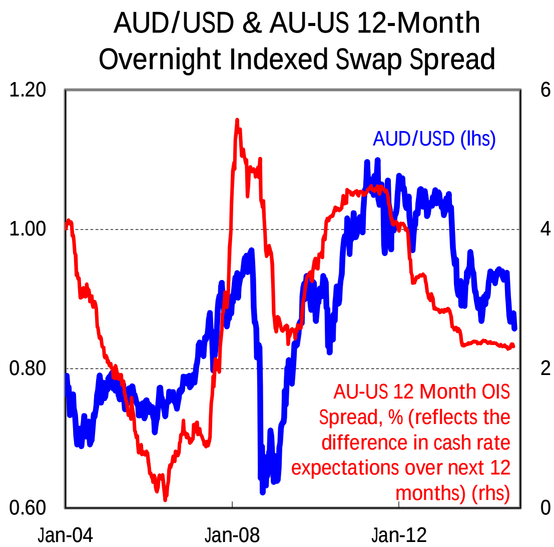
US Dollar and the Federal Reserve Outlook

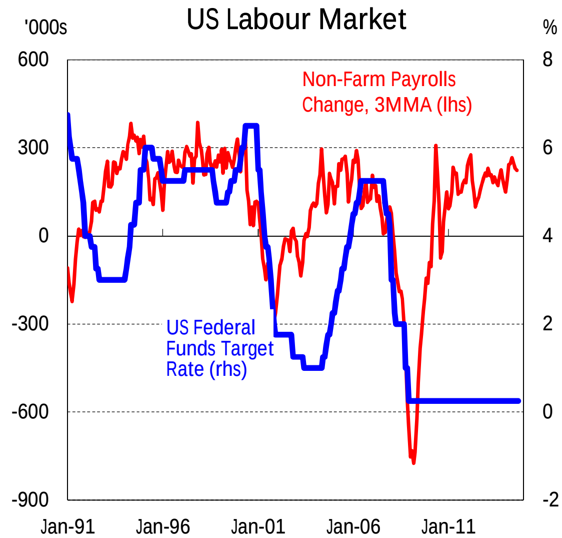
The US Federal Reserve last month announced the conclusion of its bond-buying (i.e. quantitative easing) program. The Fed's accompanying statement carried a more hawkish flavour, particularly on the labour market. The Fed upgraded its language on the labour market from concern about "significant underutilisation" to acknowledging "gradually diminishing underutilisation".

Now that quantitative easing is over, financial markets will focus increasingly on when the Fed will start raising rates. We expect the first rate rise to materialise in June next year. Our forecast is slightly sooner than consensus. Consensus expects the first rate hike to occur in the September quarter of 2015.

We expect that as US economic activity continues to expand, 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 (particularly wage pressures) suggests that the tightening cycle is still some months away at least.

The USD overnight hit a 5-year high against a basket of currencies. This outlook for Fed policy suggests that the USD will continue to face upward pressures, especially against the EUR and JPY where policy is still tilted towards easing.




## Risk Appetites and Carry Trades

The Australian dollar tends to be firmer in an environment where appetite for risk is high (i.e. volatility is low). A widely-watched measure of global risk appetite is the VIX index. The VIX index, a measure of volatility, has lifted from record lows around the middle of this year.

The Australian dollar benefits from the 'carry trade'. It involves investors borrowing funds at low interest rates in low-yielding currencies and then investing these funds in higher yielding Australian investments. In a low-risk environment, the lure of the carry trade rises.

Volatility is unlikely to return to new lows with geopolitical tensions high and the possibility nearing of a US rate hike.

However, with Australia as one of the few countries to be in the elite AAA sovereign-rated club, there will remain some 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 will ensure the AUD maintains some resilience in the face of upward pressures for the greenback.

## Interest-rate Differentials

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 June next year. Business investment in Australia has continued to fall from its late 2012 peak, as the investment phase of the resources boom unwinds. Non-mining investment is rising, but the increase is only partly offsetting the fall in mining investment. There are tangible signs that non-mining business investment will grow at a modest pace in 2014-15 and in 2015. If firms' willingness to take on risks improves, investment could easily be firmer. As the RBA has recently remarked, it's always hard to know if and when such a change in sentiment might occur. But we expect that by the middle of next year, the conditions will be ripe for the RBA to begin normalising monetary policy.

Central Bank Rates

Australia & G10 Economies

| Variable | Key Interest Rate | Current Rate |
|---|---|---|
| Australia | Cash Rate | 2.50 |
| Canada | Overnight Lending | 1.00 |
| Euro Zone | Refinancing Target | 0.05 |
| Japan | Overnight Call | 0.06 |
| Switzerland | Target | 0.00 |
| UK | Bank | 0.50 |
| US | Federal Funds Target | 0-0.25 |

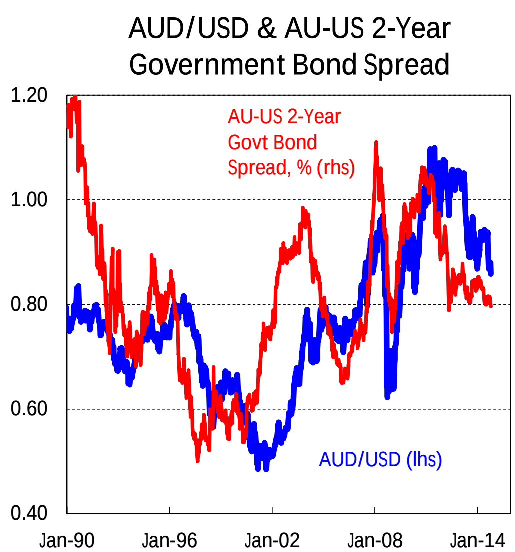
*Source: St.George, Bloomberg*

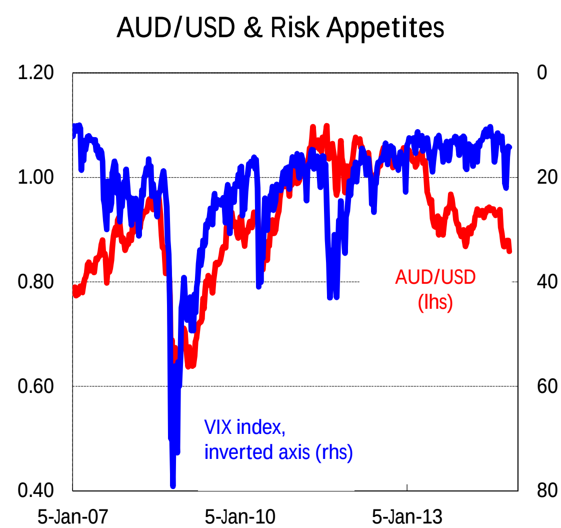
Therefore, the RBA is likely to start raising rates before most of the economies in the G10. The exception is the UK and possibly the US because there is some risk the US will need to move sooner rather than later.

The UK's buoyant economy suggests the Bank of England (BoE) will start raising rates next year. But recent UK economic data has disappointed and there are few signs of inflationary pressures, suggesting rates might be on hold for longer than previously thought. We expect the Bank of England will now raise rates in Q2. We are maintaining relative strength in our GBP forecast profile to reflect the still relatively buoyant underlying fundamentals in the UK economy relative to most other advanced economies.

The GBP/USD recently reached a near six-year high of near 1.7192 on July 15. It has since fallen back towards 1.5900 with a rising USD and some evidence of a softening in the UK economic expansion responsible for much of the depreciation. Jitters surrounding the Scottish referendum on independence in September also hurt the pound. We expect 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 underestimating the risk of Fed rate hikes for the first half of 2015.




## Global Liquidity and Quantitative Easing

While the US and UK are looking ahead to tighten policy next year, Japan and the Eurozone remain far from it. Japan now has the largest quantitative easing program in place and the European Central Bank (ECB) has recently started its asset-backed securities purchase program. There is speculation the ECB will eventually have to adopt full-blown QE to fight deflation and weak growth prospects, but we do not think there is yet enough pressure on the ECB to act further. Moreover, there are hurdles.

Markets are all hoping for a European version of quantitative easing (QE) similar in scale to Japan or the US previously. But there is a problem. In the US, UK and Japan, quantitative easing is relatively straight forward. The central banks just add a couple of extra zeros to their balance sheets and then buy the country's debt. The ECB has no such luxury. If the ECB wanted to do quantitative easing, it would have to buy the debt of its members. This might be exceptionally difficult. It is unclear how the ECB would decide how much of its member's bonds to buy. If it bought bonds relative to output, it would buy mostly German bonds. Since the German 10-year bonds are already under 1%, it is doubtful that further buying will have much of an effect.

Buying other Eurozone sovereign bonds entails a large credit risk. Many of the countries are deeply in debt.

Greece has already had a technical default. Ireland, Portugal, Greece and Cyprus have had bailouts. Italy's bonds are rated Baa2, two levels above junk, as are Spain's bonds.

It is not only the credit risk that a Eurozone QE would entail. There are also large political hurdles. So rather than attempt to tackle the political issues surrounding a full-blown QE, the ECB opted for purchasing ABS. Asset-backed securities are loans made by banks and other financial institutions, which then are sliced and repackaged as bonds with various risk levels and resold to investors.

For now, the ECB is in wait and see mode. They are likely to wait until it gets a clearer view of the impact of its asset purchases before adding further stimulus, including taking on new measures.

The ECB last cut its benchmark refi rate in August, to 0.05%, and imposed an interest rate of minus 0.20% 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. These events in the Eurozone might mean there is a baton change from the USD being a funding currency to the EUR. The AUD should still benefit from inflows, but more so against the EUR (and JPY).

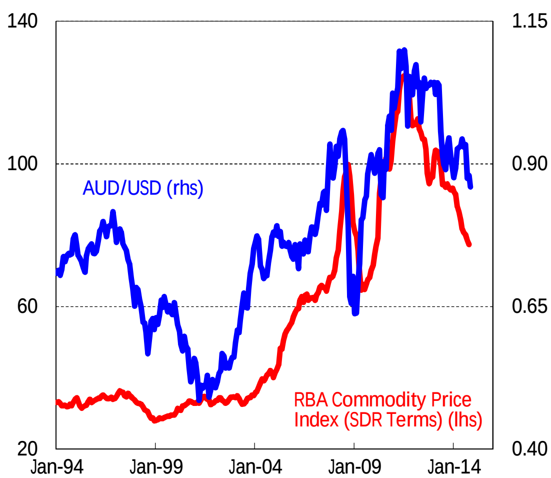
We remain bearish on the EUR and believe any rallies will be short-lived and opportunities to sell the EUR. As for the JPY, outward foreign direct investment is likely to continue, underpinning our bearish outlook on the JPY.

Commodity Prices

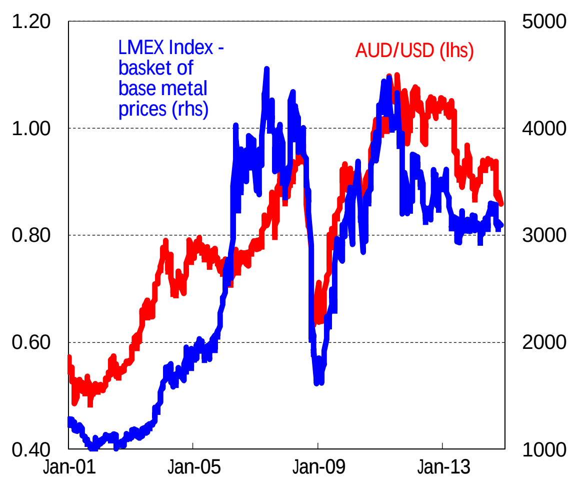
The Australian dollar is also not immune to the outlook for commodity prices due to Australia's role as a large commodity exporter. There is a mixed outlook for commodity prices, largely reflecting shifting demand dynamics within China and also supply excesses in the production of certain commodities. 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. 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 7% per year from 2013-14 to 2018-19.

AUD & RBA Commodities Index

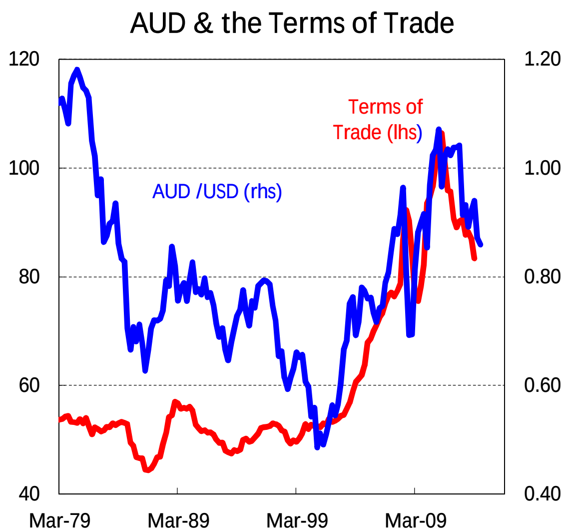


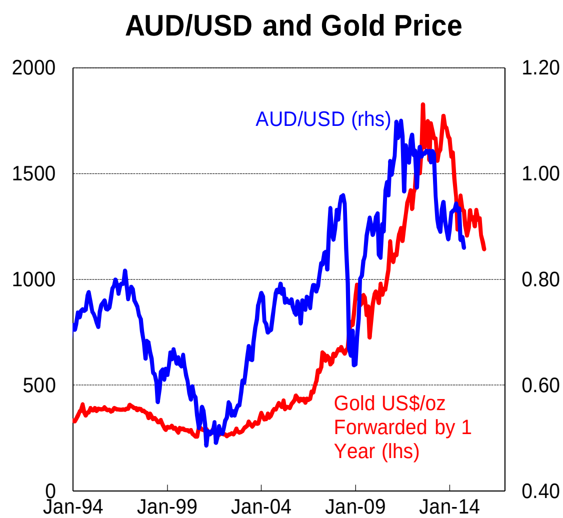

AUD & LMEX Index



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.

One of the tightest positive commodity correlations the AUD holds is with gold. The fall in the price of gold has been less pronounced than in many other core export commodities. Any further falls in gold are likely to be modest. A fragile Eurozone economy, simmering geopolitical tensions and a seasonal upturn in Indian demand should offer some near-term support. A vote in Switzerland to boost gold reserves at the end of this month could also support the gold price. But with inflation expectations well contained and US monetary policy set to be tightening in 2015, the outlook for gold is muted.




## 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 called the terms of trade. It has fallen in three of the last four quarters and is likely to keep declining. The decline represents a net transfer of income from Australia to the rest of the world, thus weighing down on the AUD. 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 the medium to long term.

## Economic Growth

The terms of trade until late 2011 had been rising. With the peak in 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 against the likes of the US and UK. For this reason, we think the AUD will struggle against these currencies.

Still on the topic of economic growth, the AUD is typically a barometer for world economic growth. We have recently lowered our estimate for global GDP growth in 2014 and our forecast for 2015. Europe is at the heart of the latest global slowdown. The 28 members of the European Union, in total, represent just under one-quarter of global GDP, so the rest of the world is not immune.

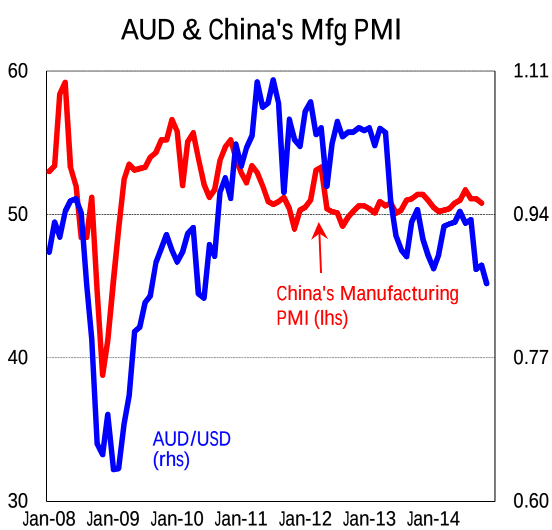
Global growth worries and market volatility have been another source of support for the USD. The US economy, still the world's largest, is enjoying what appears to be a durable recovery.

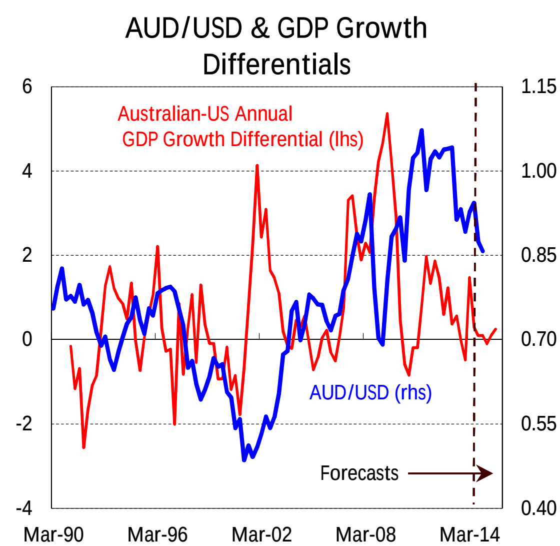
Chinese Outlook

Of course, Australia's growth performance and AUD is also tightly tied to the fortunes in China, especially as the AUD is often viewed as a proxy for the performance of China's economy. China's economy remains a beacon, but one that is shining less brightly.

The Chinese government 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.

China's annual economic growth rate slowed to 7.3% in the September quarter this year and partial economic indicators in this quarter have been mixed. We expect Chinese economic growth will slow from 7.3% in 2014 to 7% in 2015. The pace is still reasonable but slower than in previous years.




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

## Forecasts:

| End Quarter Forecasts | | | | | |
|---|---|---|---|---|---|
| | Dec-14 | Mar-15 | Jun-15 | Sep-15 | Dec-15 |
| **USD Exchange Rates** | | | | | |
| AUD-USD | 0.8500 | 0.8400 | 0.8400 | 0.8300 | 0.8200 |
| USD-JPY | 113.00 | 114.00 | 115.00 | 116.00 | 117.00 |
| EUR-USD | 1.2300 | 1.2100 | 1.2000 | 1.1900 | 1.1800 |
| GBP-USD | 1.6100 | 1.6300 | 1.6500 | 1.6300 | 1.6200 |
| USD-CHF | 0.9500 | 0.9600 | 0.9700 | 0.9800 | 0.9900 |
| USD-CAD | 1.1300 | 1.1300 | 1.1300 | 1.1400 | 1.1400 |
| NZD-USD | 0.7700 | 0.7700 | 0.7500 | 0.7500 | 0.7400 |
| USD-CNY | 6.1100 | 6.1000 | 6.1000 | 6.1100 | 6.1200 |
| USD-SGD | 1.2800 | 1.2800 | 1.2800 | 1.2900 | 1.2900 |
| **AUD Exchange Rates** | | | | | |
| AUD-USD | 0.8500 | 0.8400 | 0.8400 | 0.8300 | 0.8200 |
| AUD-EUR | 0.6910 | 0.6940 | 0.7000 | 0.6970 | 0.6950 |
| AUD-JPY | 96.10 | 95.80 | 96.60 | 96.30 | 95.90 |
| AUD-GBP | 0.5280 | 0.5150 | 0.5090 | 0.5090 | 0.5060 |
| AUD-CHF | 0.8080 | 0.8060 | 0.8150 | 0.8130 | 0.8120 |
| AUD-CAD | 0.9610 | 0.9490 | 0.9490 | 0.9460 | 0.9350 |
| AUD-NZD | 1.1040 | 1.0910 | 1.1200 | 1.1070 | 1.1080 |
| AUD-CNY | 5.1940 | 5.1240 | 5.1240 | 5.0710 | 5.0180 |
| AUD-SGD | 1.0880 | 1.0750 | 1.0750 | 1.0710 | 1.0580 |

* 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

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