Data Snapshot

Monday, 19 August 2013

Bank of Melbourne

AUD – Losing Some Lustre

- **We have revised our forecasts for the Australian dollar lower over the next twelve to eighteen months. We expect the AUD to end this year at USD0.8700 and next year at USD0.8300.**
- **A range of fundamental factors are becoming less favourable for the AUD and we believe these will spur softer demand for the AUD over the forecast period. These factors include a narrowing in Australia's interest-rate differentials with the US, a softer domestic economic outlook, a weaker terms-of-trade outlook and shifting dynamics in China and the Asian region.**
- **The approaching tapering of the US quantitative easing program is also likely to support a stronger US dollar. It could begin as soon as next month.**
- **Japan's aggressive policy to reflate the economy is also producing weakness in the Japanese yen and carries implications for growth in the Asian region.**
- **But there are significant event risks in the next 1-2 months that are likely to produce choppy trading conditions in fx markets. Near the top of the event risk list is the possibility of another showdown in US Congress over raising the debt ceiling.**

The Australian dollar has generally been trending lower since April this year when it had struck as high as 1.0582. The AUD/USD hit a near three-year low of 0.8848 on 5 August, but has since recovered modestly to be back above 0.9000.

The global themes that have dominated currency markets this year include market expectations that the US Federal Reserve will soon start tapering its quantitative-easing program and a weaker Japanese yen from Japan's aggressive stimulus strategy.

On the domestic front, one of the key themes has been the Reserve Bank's cuts to interest rates. The recent rate cut from the RBA took the cash rate to 2.50%. We now expect the RBA to cut once more later this year, taking the cash rate to 2.25%.

We have also revised our forecasts for the AUD slightly lower over the next eighteen months. We expect the AUD/USD to end this year near 0.8700 and finish 2014 at 0.8300. These are end-point forecasts and between these times we can expect the Australian dollar to continue to trade with volatility. It's not an unusual occurrence for the AUD/USD to trade in wide ranges. Indeed, last year the trading range was around US 12 cents and this year it has been close to US 17 cents.

Interest-Rate Differentials

One of the prime reasons why we anticipate the Australian dollar will be lower over the forecast period relates to interest rates. The interest-rate structure in Australia is still attractive to foreign investors but it is much less compelling. It is because the outlook in Australia is for further

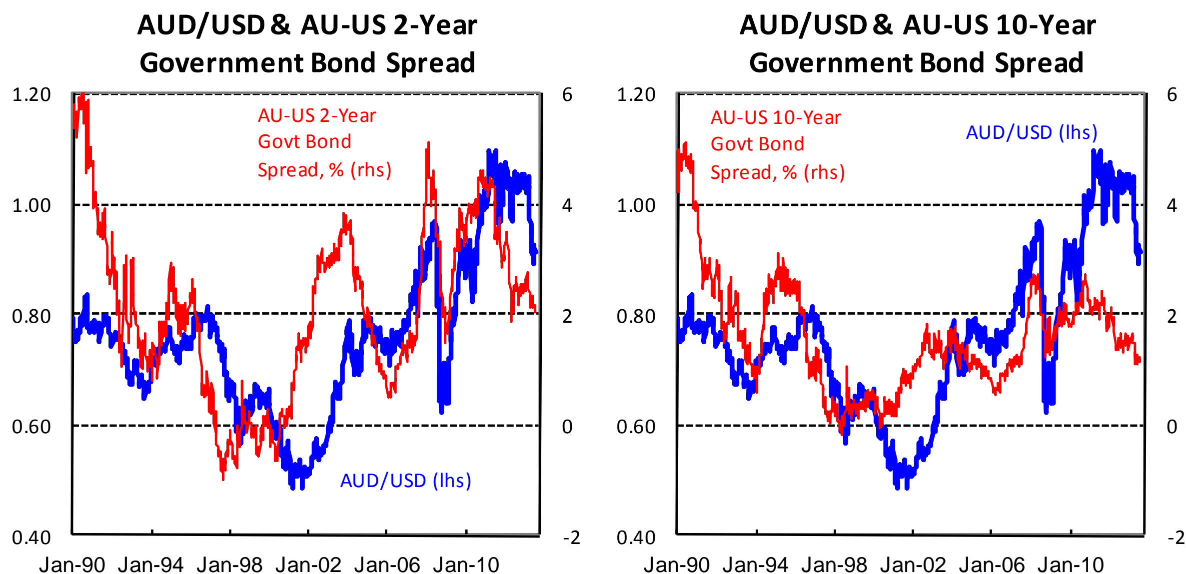
stimulus from policy makers. In comparison, US markets are anticipating a shift in policy, namely the scaling back of the Federal Reserve's bond-buying program.

Australia's bond yields at the shorter part of the curve are anticipating a lower cash rate. Financial markets have another RBA rate cut fully priced before the end of this year. At the longer end of the bond curve, Australian yields are moving higher because they are heavily influence by US yields. But Australian yields at the longer-end of the bond curve are not moving up by as much as US bond yields. It reflects Australia's weaker economic growth outlook.

So Australia's interest-rate differential with the US across the bond curve is shrinking.

The Australian-US 10-year bond spread, which is influential on the direction of the AUD/USD over time, has narrowed from as wide as 275bp in late 2010 to a low of 103bp recently. It currently sits at about 120bp but we can expect the spread to narrow further over the next 12-18 months.

At the shorter part of the bond curve, the Australian-US two-year bond spread is watched closely. It too has shrunk and should narrow further, as the RBA cuts rates again later this year. This spread has narrowed from 360bp from when the RBA started its easing cycle in November 2011 to as low as 190bp recently, although this spread has been choppy. The size of the spread is still attractive to investors but it is lending less support to the Aussie currency than what it was.



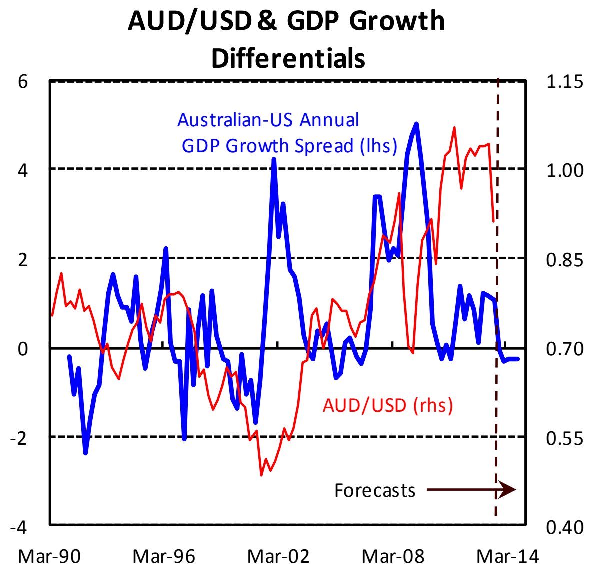
Economic Growth Outlook

The widening Australian-US interest-rate spreads reflect the divergence in the monetary policy outlooks for the two economies but it also reflects the divergence in the economic outlooks.

Over the past two years the Australian economy has been growing at a faster pace than that of the US economy and this has lent considerable support to the AUD. However, economic activity as measured by GDP is growing below trend in Australia and we do not expect growth to return to trend until the second half of 2015. US GDP is also growing below trend but activity has been improving since the recession of 2007-08. Moreover, US GDP is expected to return to its long-term trend much sooner than Australia. So the gap between the respective growth rates looks set to close thus withdrawing a source of support for the AUD.

Each economy is, of course, not without its challenges. For Australia, significant challenges lie ahead with the peaking of mining investment and the need to transition smoothly from an economy that has been driven by mining to one that is being led by the non-mining sector. The Reserve Bank Governor Stevens said on 30 July in a speech that the big rise [in resource sector investment] is now over, and a fall is in prospect...it could be quite a big fall in due course."

For the US, its key challenges to growth going forward are the strong headwinds created by current federal fiscal policies.



USD Outlook

The US Federal Reserve has held the Fed funds rate at a record low for more than four years and embarked on three rounds of quantitative easing. Quantitative easing involves the Federal Reserve purchasing longer-term Treasury securities (US$40bn per month) and agency mortgage-backed securities (US$45bn per month) to put downward pressure on longer-term interest rates, support mortgage markets and help make broader financial conditions more accommodative. It has also helped keep the US dollar low by in effect debasing the currency.

Recent economic data and remarks from Fed officials have led market participants to anticipate that the US Fed may begin to start scaling back on its bond purchases. These expectations have been a key catalyst for the decline in the Aussie dollar this year.

A poll taken by Reuters on 15 August shows the consensus is for this tapering to occur in September. The Fed has been at pains to point out the pace of any tapering or withdrawal of monetary stimulus would be undertaken at a measured pace such that it would not undermine recovery in the economy. Consensus expects the tapering would involve reducing asset purchases by US$15bn per month initially. Quantitative easing is not expected to completely end until mid next year.

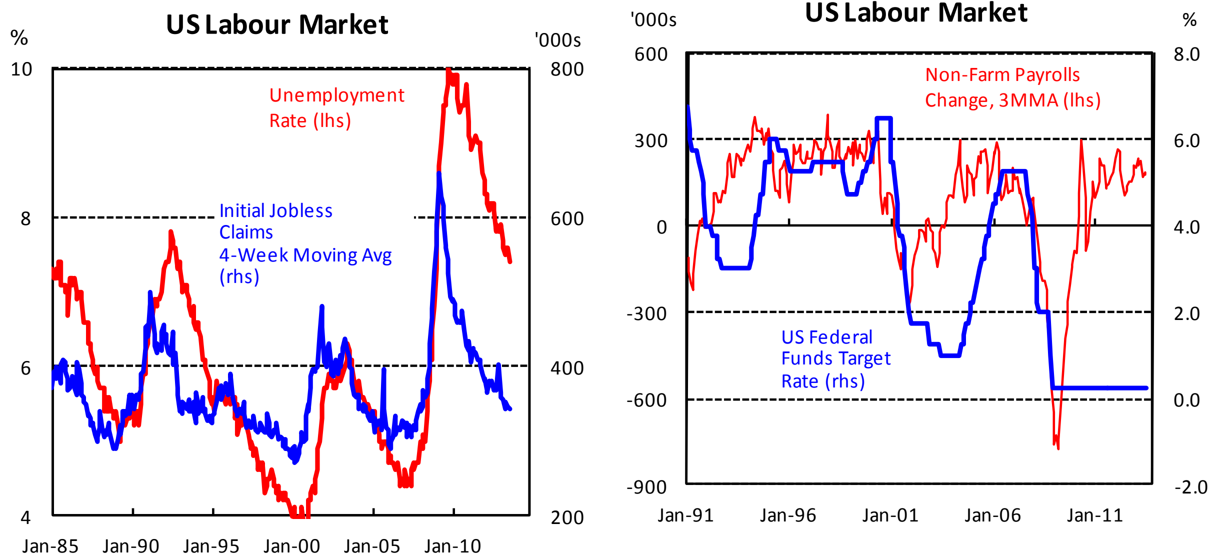
The FOMC highlighted that for tapering to begin it is essential that incoming economic data is broadly consistent with its forecasts on a number of key variables, particularly those for the labour market. The Fed has indicated when asset purchases come to a complete end, the unemployment rate would likely be in the "vicinity of 7%". The Fed's unemployment rate forecasts for this year are 7.2-7.3%. On a change to interest-rate settings, the Fed has indicated an unemployment rate of 6.5% or lower is required.

The current US unemployment rate is 7.4% and non-farm payrolls have averaged 175,000 over the past three months to July. Assuming this jobs growth continues, and other variables like the participation rate and population growth rate hold constant, the US unemployment rate would fall to 7.3% in two months and fall to 7% in around eight months. It supports our view that a tapering of quantitative easing will begin before the end of this year.

The prospect of a change to the quantitative-easing program has already pushed up long-term interest rates. The yield on ten-year Treasuries has risen to 2.82% from a low of 1.60% in May. As

yields rise, capital is attracted to America from riskier parts of the world. That in turn should help push up the US dollar.

We expect the US dollar to appreciate over the forecast period but we expect there will be volatility, especially next month where there is a lot of event risk.



Near, if not at, the top of the list for event risk is the possibility of another showdown in US Congress over raising the debt ceiling. The debt ceiling, the legislated borrowing limit of the US government, was suspended earlier this year, to prevent financial market instability and the possibility of default by the US government. However, the suspension merely delayed the issue, and inaction by Congress resulted in the debt ceiling being reinstated at US$16.7 trillion on May 19.

Since then, US Treasury has undergone “extraordinary measures” in order to be able to pay its financial obligations. As in the past, the US Department of the Treasury has stated that there is considerable uncertainty as to when the extraordinary measures will run out, but that they would not be exhausted until after Labor Day, 2 September. Some reports have suggested that US Treasury may not hit its borrowing limit until October or November.

A major issue is the ongoing brinksmanship within US Congress and the failure to resolve much to date. Additionally, there may be limited time for negotiations given members of Congress will be on recess until 9 September.

Although financial markets appear to be unperturbed at present, these concerns surrounding fiscal policy could escalate within the next few months, or even weeks. These worries might result in a wobbly period for the USD and the AUD/USD should see some pockets of strength.

Domestic Event Risk

There is also political event risk locally in September with the Federal Election on September 7. Elections represent uncertainty and markets typically do not like uncertainty, so it implies it would apply some downward pressure to the AUD (ceteris paribus). However, any impact the election will have on the Australian dollar, if any, will be short-lived.

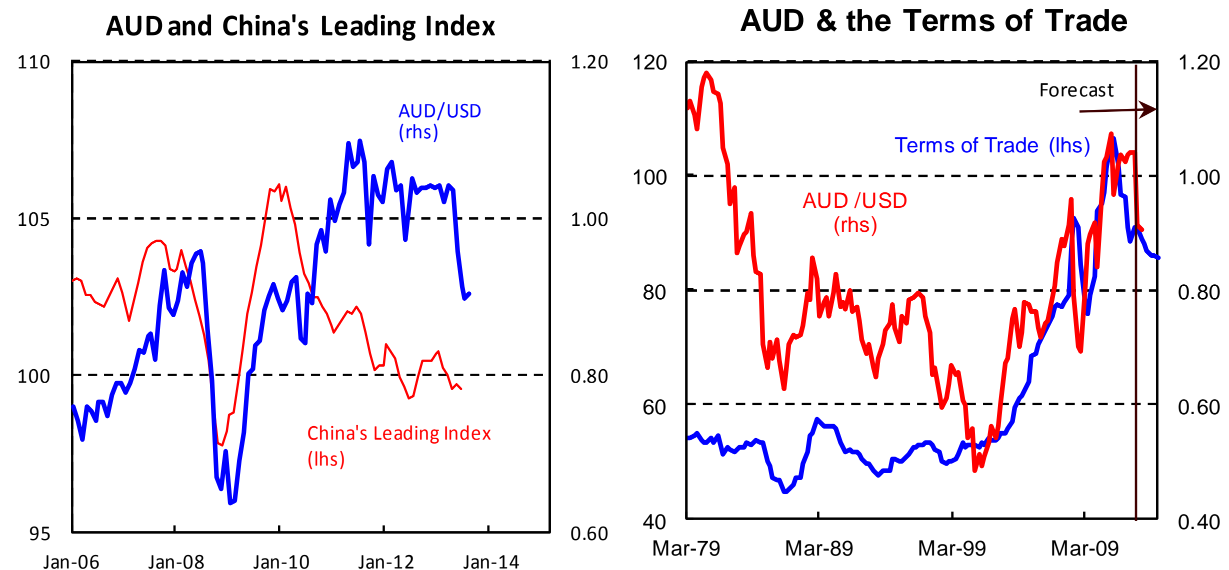
China

A longer-lived impact on the AUD comes from the impact of the Chinese economy. There is a new shift occurring in China and the rest of Asia and that shift is that these economies are no longer growing at the frenetic pace that we have become used to over the past decade.

GDP growth has slowed considerably in China. Real GDP slowed to a four-year low of 7.5% in the June quarter compared with 7.7% in the March quarter. It compares with 7.8% in calendar year 2012 and 9.3% in 2011. We expect economic growth this year to average 7.5%, a more subdued rate compared with recent years. China's forward-looking economic indicators, such as the purchasing managers index (PMI) and the leading index, are consistent with this outlook.

Much of China's slowdown has been intentionally engineered by government authorities and policy makers. China's new government, appointed in March, is intent on achieving long-run structural reforms and a re-balancing of the economy. It is less focussed on short-term cyclical growth outcomes that are fuelled by fixed asset investment and monetary and fiscal stimulus.

While slower Chinese growth removes some support for the AUD, the Chinese government is unlikely to tolerate growth falling below 7%. So any concerns about a hard landing in China are overdone. The Chinese government has a GDP growth target of 7.5% for the next five years.



Terms of Trade and Commodity Prices

China's growth over the past decade contributed heavily to a sharp rise in Australia's terms of trade. The AUD has a strong positive correlation to the terms of trade over a longer-run timeframe. The term of trade is the ratio of Australia's export prices to import prices. It peaked in the second half of 2011 and it is forecast to continue to decline gradually over the next few years as the global supply of bulk commodities increases. That spells downward pressure on the AUD.

Over the next few years, however, the terms of trade is still expected to be at a level that is high on a historical basis, and that means the AUD should also trade higher than historically is the case. It should, therefore, give underlying support to the AUD above the AUD/USD's long-run (or 20-year) average of around 0.7600.

Japan and the Japanese Yen

The Bank of Japan (BoJ) announced a new era of quantitative easing in April designed to reflate the economy. The BoJ has pledged to double the size of base money to JPY270 trillion in two years, boosting base money as a percentage of GDP to 60% in 2014 from 30% in 2012. This ratio is well above the ratios prevailing in the US and Europe of 20-30%. The BoJ will also lengthen the average duration of its JGB holdings to seven years from less than three years.

This more aggressive strategy of creating inflationary pressures and boosting domestic demand in Japan is causing the USD/JPY to rise (ie JPY to weaken).

Many Asian countries have hard or soft pegs with the USD. South-East Asia competes with Japan and China, but many economies in South-East Asia have soft or hard pegs with the USD. It means if the USD turns higher as we expect it to, it could make Asia more vulnerable to a weakening yen. A more vulnerable Asia suggests a softer AUD ahead.

While we expect the JPY to weaken further (ie USD/JPY appreciate), we believe that any rise would not exceed 110.00. Earlier this year, Prime Minister Abe's economic adviser Koichi Hamada suggested that USD/JPY around 98-100 was the appropriate level for the USD/JPY and levels above 110 are problematic. Our forecasts for USD/JPY are 102.00 by year's end and then a further drift higher next year. Note that the large-scale quantitative easing in Japan is encouraging Japanese money outflows, some of it to Australia. That is providing support to the AUD, but the weight of other factors pressuring the AUD lower means we still expect the AUD to edge lower in the coming year.

Europe

EUR/USD in recent months has largely consolidated in a range of about 1.2800 to 1.3400 for much of this year. The Eurozone economy continues to struggle and growth is weak. GDP contracted in Q1 and grew only modestly in Q2 while inflation is well below the target set by the European Central Bank (ECB). Unlike the Fed and BoJ, it is difficult for the ECB to introduce quantitative easing to spur growth. The benchmark rate is low at 0.50%, providing little room for the ECB to add significant more stimulus to the economy.

Sentiment, however, has improved from a year ago. Fears that the European Monetary Union (EMU) might crumble have waned. A few other factors have also helped sentiment improve. First, government bond yields of struggling EU countries have fallen back to pre-crisis levels. Second, Portugal has successfully returned to the bond market for the first time since its bailout. Spain and Italy are also attracting firm demand for their bond issuance. Against a backdrop of a stronger USD, we think EUR/USD will end this year at 1.2800 and AUD/EUR at 0.6800. A further modest decline for each exchange rate pair is in the profile for next year.

Our Forecasts and Consensus

A poll of 52 banks around the world taken last week by Reuters shows the consensus is for the AUD to end the year at US$0.9000, however, the range of forecasts is very wide at US$0.85000-US$1.0000. In twelve months time (ie by the middle of next year), consensus sits at 0.8800 and the range is 0.7500-1.000. We sit below consensus for the next 12-18 months for the end-point forecasts. Please refer to the next page for a detailed table of our house forecasts.

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

Our Forecasts:

	End Quarter					
	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
USD Exchange Rates						
AUD-USD	0.9000	0.8700	0.8400	0.8200	0.8250	0.8300
USD-JPY	100.00	102.00	103.00	104.00	105.00	105.00
EUR-USD	1.2900	1.2800	1.2700	1.2600	1.2500	1.2400
GBP-USD	1.5400	1.5200	1.5100	1.5000	1.5100	1.5300
USD-CHF	0.9600	0.9700	0.9800	0.9900	1.0000	1.0100
USD-CAD	1.0500	1.0600	1.0700	1.0800	1.0800	1.0800
NZD-USD	0.7900	0.7800	0.7700	0.7600	0.7500	0.7500
USD-CNY	6.1200	6.1000	6.0800	6.0700	6.0600	6.0500
USD-SGD	1.2700	1.2700	1.2700	1.2700	1.2650	1.2600
AUD Exchange Rates						
AUD-USD	0.9000	0.8700	0.8400	0.8200	0.8250	0.8300
AUD-EUR	0.6980	0.6800	0.6610	0.6510	0.6600	0.6690
AUD-JPY	98.17	90.00	88.74	86.52	85.28	86.63
AUD-GBP	0.6860	0.5840	0.5720	0.5560	0.5470	0.5460
AUD-CHF	0.9890	0.8640	0.8440	0.8230	0.8120	0.8250
AUD-CAD	1.0600	0.9450	0.9220	0.8990	0.8860	0.8910
AUD-NZD	1.2450	1.1390	1.1150	1.0910	1.0790	1.1000
AUD-CNY	6.4700	5.5080	5.3070	5.1070	4.9770	5.0000
AUD-SGD	1.2920	1.1430	1.1050	1.0670	1.0410	1.0440

* 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

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