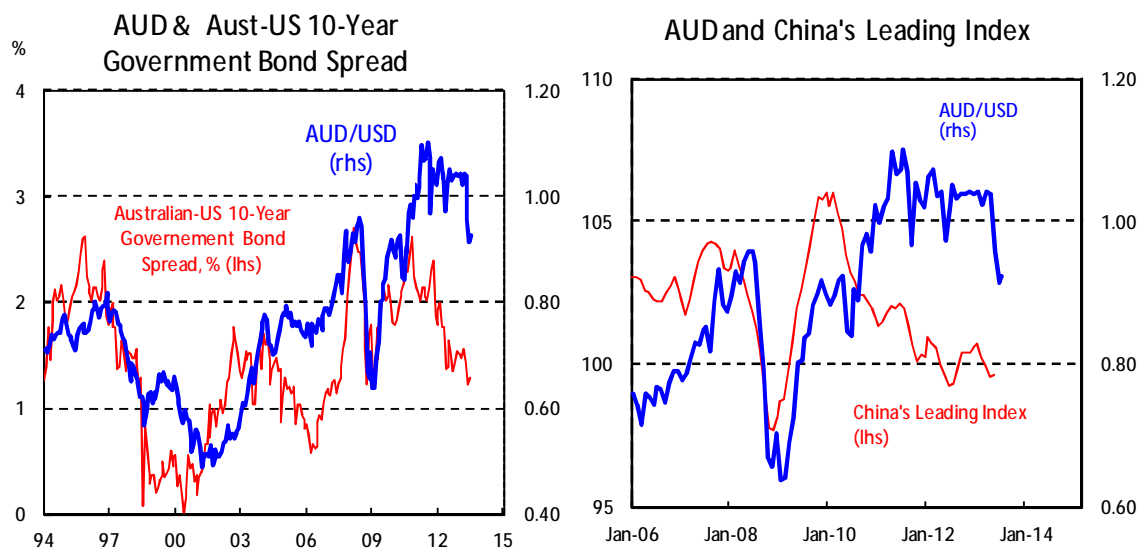


## AUD Leaning to the Downside

The AUD/USD has depreciated considerably in recent months. It has fallen from an exchange rate near 1.0600 in mid April to be as low as 0.8927 overnight. The price action in the AUD is also heavy on the crosses.



We believe the factors that have been supporting the AUD over the past two years are waning. The implication is that we expect the AUD to continue to remain under pressure over the year ahead. These factors include the following.

- The higher interest rate structure in Australia is now less compelling as our cash rate declines and as US bond yields rise. For example, the influential Australian-US 10-year bond spread has narrowed from as wide as 275bp in late 2010 to as low as 107bp. It is the narrowest interest-rate differential in 4½ years and is set to narrow further.
- Australia's AAA credit rating cannot improve, but those of other nations can.
- Diversification out of US dollars and euros by central banks appears to have peaked.
- US economic growth is improving while in Australia downside risks have risen. There are challenges ahead for the Australian economy and growth may be uneven. The mining investment boom is nearing an end and the Australian economy will have to successfully transition from an investment-led mining boom to one in which growth is driven more by the non-mining sector.
- Lower Chinese growth is also a concern, particularly for commodity prices.
- The US is readying the market for the withdrawal of quantitative easing (QE). Timing is

uncertain but 'tapering' could begin this year if the US economy performs to the expectations of the Federal Reserve. QE is keeping the USD 'artificially' low.

"Abenomics" – the affectionate term for Japan's aggressive three-pronged strategy to reflate its economy - is producing a sharp weakening of the yen. Many Asian countries have hard or soft pegs with the USD. The problems for Asian economies and the commodity cycle can come when the USD turns a corner, as it did in 1995-1998 that culminated in the Asia crisis. We do not expect a re-run of the Asia crisis but pegs to the USD make Asia vulnerable to a weakening yen at a time when the USD is set to turn higher. A vulnerable Asia is negative for the AUD because of Australia's close trading ties with Asia.

Our current view is for the AUD to sit near US\$0.8900 by the end of the year. The risks remain tilted to the downside. We are reviewing our forecasts and expect to revise our AUD forecasts lower for the year ahead.

In terms of consensus estimates, a recent poll of 52 banks around the world shows the consensus is for the AUD to end the year at US\$0.9200. However, the range of forecasts is very wide at US\$0.85-US\$1.06.

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## The Detail

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