AUSTRALIAN DOLLAR OUTLOOK

The AUD – Still finding support

Tuesday, 10 July 2012

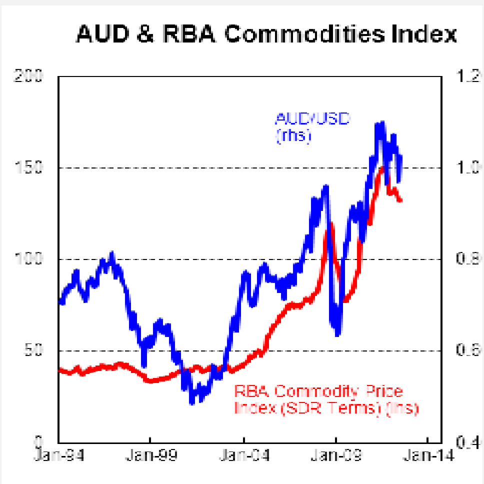
- **Concerns regarding global economic growth have pushed commodity prices and the AUD lower since edging above $US1.08 in January. This downside risk will remain for the remainder of the year unless decisive stimulus activity is undertaken in the major economies.**

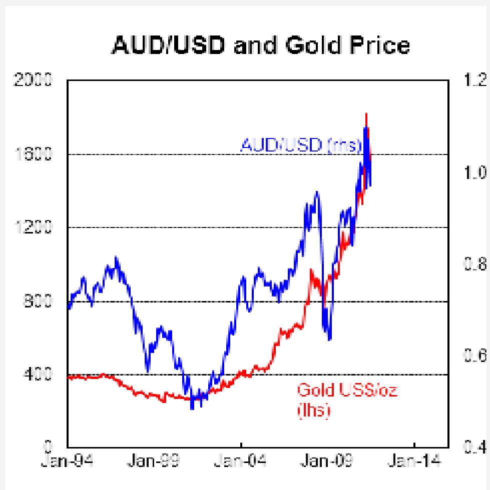
- **It is a widely held view that Australia's terms of trade have peaked. As the terms of trade move lower the AUD is likely to come under downward pressure.**

- **Australia's interest rate structure sits above those of the major economies. Combined with its AAA credit rating this lends support to the currency. While the RBA cash rate is expected to move a little lower, we still expect Australian interest rates to remain above those of the major economies thus the AUD is still expected to receive support from relatively high interest rates.**

- **A multitude of X factors need to be hurdled before we reach year end. The US elections, various European bond auctions, possible European banking crises, ongoing flare-ups in the Middle East and the US fiscal cliff to name a few. Each has the potential to undermine currency forecasts.**

- **We expect the AUD to end this year at around 1.01 and sit at 1.03 by end June 2013.**





Introduction

Since floating in December 1983, the AUD has seen an average rate against the US dollar (USD) of 0.7472 with a high of 1.1081 in July 2011 and a low of 0.4776 in April 2001.

In this note we look at what has driven the AUD higher in recent years and assess the risks of it moving significantly in either direction over the next 12 months.

The candidates for examination are not new. China, interest rates, commodity prices, inflation, GDP growth rates, sovereign debt ratings and liquidity all come into play, but the influence of each is variable over time. It is the changing landscape of influences that makes medium term forecasting the AUD a very subjective and complex task and a potential headache for businesses with exposure to a variable currency.

Commodity Prices and Global Economic Growth

As a major producer and exporter of commodities, both Australia's economic growth and the AUD are affected by movements in commodity prices. The rise of commodity prices since the mid-2000s has been associated with a rise in the AUD.

The rise in commodity prices over the past decade has been associated predominantly with growth in the Chinese economy. However, broad commodity prices are also influenced by the outlook for economic activity in the US and Europe.

The link between commodity prices and the AUD was clearly seen during the global financial crisis as fears of a global recession saw commodity prices and the AUD tumble. As it became apparent that the Chinese economy was still expanding rapidly – due to its urbanisation and industrialisation, plus some stimulatory government activity – commodity prices rose and the AUD followed suit.

More recently, in the face of weak economic activity in Europe and the US, both major purchasers of Chinese goods, and a modest slowdown in Chinese economic growth, commodity prices have again declined and again the AUD has followed them down.

When considering the medium term outlook for the AUD, a view of commodity prices and the pace of economic growth in China, the US and Europe is essential. In addition to the medium term demand for commodities it is also important to keep an eye on supply. High prices lead to increased supply and while new mines or major expansions of existing mines take many years to come online, eventually supply is increased. An increase in supply can depress prices and potentially lead to a lower AUD.

Our view is that strong demand from China will continue for at least a decade. At present, Australia is 'tooling up' for that expansion. This leads to the view that commodity prices – in particular iron ore and steaming coal will remain high by historical standards but somewhat lower than the highs seen in 2011. Likewise we expect the AUD to find broad support from commodity prices but not to the extent seen in late 2011 and early 2012. A softening of commodity prices is expected work against the AUD re-establishing its 2012 peak of US$1.08.

In the very short term it is the expectation of changes in commodity prices that affects the currency. These expectations change with the wind of daily economic news. Unlike the early 1990s, the AUD is now more sensitive to economic news out of the China rather than just Europe, the US and Australia.

In the current climate of global economic uncertainty we expect commodity prices to add a downside bias to the currency. However, commodity prices do seem set to remain high relative to historical standards and thus we expect the AUD to remain above its long run average.

Terms of Trade

Commentary on the currency from the Reserve Bank of Australia (RBA) often makes reference to Australia's terms of trade – the ratio of export prices to import prices. Clearly, Australia's export prices are dominated by commodities such as coal, gas and iron ore and have risen in recent years. At the same time, import prices have either remained stable or fallen. Import prices for footwear, clothing and electrical goods have all fallen in recent years.

The net effect of these changes has been a rise in the terms of trade that broadly mirrors the rise of the AUD. More recently, the fall of the AUD has reflected the fact that the peak in the terms of trade is now behind us.

Australia's terms of trade are expected to remain high by historical standards but possibly 10-15% lower than they currently stand. As such, they imply some downward pressures on the AUD.

Interest Rates

Interest rates and expected changes in interest rates play a part in the daily fluctuations of the AUD but have less of an impact on its medium term level. High interest rates do not necessarily imply a stronger currency.

The AUD moves when the market expects Australian interest rates to move relative to those of other nations. In the current environment, the market's expectation is for the RBA's cash rate to fall between 25-75 basis points before the end of the year. If this does not occur there will be some upward pressure on the AUD. It is also possible that as when the interest rate cycle reaches its nadir, thoughts will move towards the possibility of a move up in official interest rates. This could see the AUD come under upward pressure, depending upon what other central banks choose to do.

The influence interest rates on the AUD is made more complex by the fact that interest rates themselves embody or are affected by economic growth, inflation, job growth and a host of other economic indicators.

In economies where interest rates are close to zero, the authorities have taken to effectively 'printing' money. This is occurring in Europe and the US and is akin to reducing interest rates. To date, Australia has not engaged this tactic, however, when it is applied in the US and Europe it tends to weaken their currencies and provide a boost to the AUD.

We suspect the US will continue down the path of 'quantitative easing' which will put downward pressure on the USD. At the same time Europe can both reduce interest rates and engage in 'quantitative easing'. Both provide the AUD with some upside potential over the next 18 months.

Domestically we believe there is room for a 25 basis point cut in the RBA's official cash rate but, if the recent run of stronger domestic data continues, this may be taken off the table. Australia's relative economic strength combined with a relatively high official cash rate remains a positive for the AUD as capital is attracted to our shores.

Asset diversification and Sovereign Risk

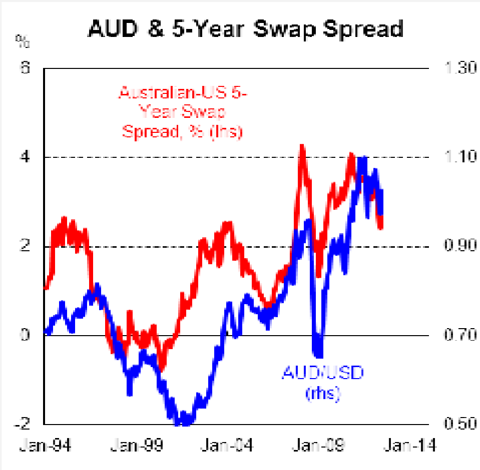
The role of the USD as a de facto global currency has come into question from time to time. While it is always likely to play a major role, its predominance has declined as institutions have sought to diversify their currency holdings. China has indicated it wishes to reduce its exposure to the USD and, by default, potentially lift its holdings of AUD. More recently it has been reported that Germany has shown an interest in purchasing Australian government bonds.

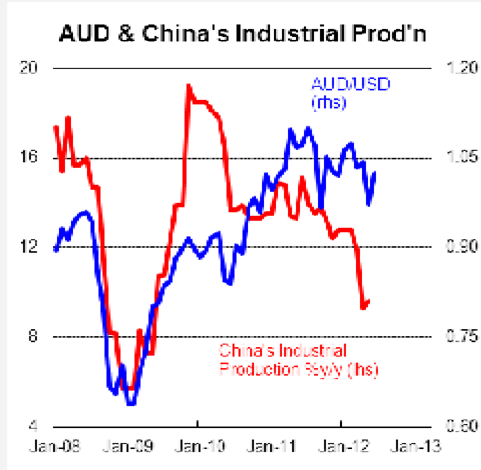
Australia's AAA standing is seen as a positive to those institutions wishing to diversify away from USD assets.

X-factors

Since it was floated, the AUD has been subject to a range of X-factors, usually of a political nature. The MX missile crisis of 1985 and the infamous 'banana republic' comments of 1986 come to mind. While the impact of these evens is often brief, other events, such as the Asian currency crisis and fallout from US sub-prime lending; have impacted negatively on the AUD over an extended period.

In the current climate we face events such as the US Presidential elections, the US 'fiscal cliff', ongoing European bond auctions, a possible European banking crisis and ongoing flare-ups in the Middle East.





Summary

In summary, we expect that over the next six months it will be difficult for the AUD to regain the $US1.08 levels it saw in earlier this year. Why? Commodity prices have weakened, the terms of trade have declined and domestic interest rates have fallen. These factors seem unlikely to change direction in the short term.

For the AUD to move significantly higher against the USD from where it stands today, we would need to see a stabilisation of Chinese economic growth at between 7-8%, lower official interest rates in Europe and further quantitative easings in the United States. Higher interest rates in Australia could also see the AUD move higher and while we do not expect this in the near term, it remains a possibility later in 2013.

Factors that could see the AUD move significantly lower would include severe financial disruption in European banking and financial markets and a sharp fall in Chinese economic growth.

The forecasts on page 5 reflect the range of influences discussed above and suggest that the AUD has most likely seen both the maximum and minimums of its trading range for the year. That said, the market will always display short term volatility and is never short of surprises.

EXCHANGE RATE FORECASTS As at 10 July 2012						
	End Quarter					
	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13
USD Exchange Rates						
AUD-USD	1.0238	1.0000	1.0100	1.0300	1.0300	1.0400
USD-JPY	79.790	82.000	82.000	83.000	84.000	84.000
EUR-USD	1.2667	1.2300	1.2200	1.2200	1.2200	1.2200
GBP-USD	1.5707	1.5700	1.5800	1.5800	1.6000	1.6000
USD-CHF	0.9485	0.9300	0.9400	0.9400	0.9500	0.9500
USD-CAD	1.0166	1.0200	1.0200	1.0100	1.0000	1.0000
NZD-USD	0.8013	0.7800	0.7900	0.8000	0.8100	0.8100
USD-CNY	6.3540	6.2000	6.1500	6.1000	6.0500	6.0000
USD-SGD	1.2651	1.2600	1.2400	1.2400	1.2600	1.2600
AUD Exchange Rates						
AUD-USD	1.0238	1.0000	1.0100	1.0300	1.0300	1.0400
AUD-EUR	0.8080	0.8130	0.8280	0.8440	0.8440	84.0000
AUD-JPY	81.70	82.00	82.80	85.50	86.50	86.5200
AUD-GBP	0.6520	0.6370	0.6390	0.6520	0.6440	0.6440
AUD-CHF	0.9710	0.9300	0.9490	0.9680	0.9790	0.9790
AUD-CAD	1.0410	1.0200	1.0300	1.0400	1.0300	1.0300
AUD-NZD	1.2780	1.2820	1.2780	1.2880	1.2720	1.2720
AUD-CNY	6.5050	6.2000	6.2120	6.2830	6.2320	6.2320
AUD-SGD	1.2950	1.2600	1.2520	1.2770	1.2980	1.2980

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

Hans Kunnen, Chief Economist
Ph: (02) 9320-5854

Contact Listing

Economics Group

Chief Economist	Hans Kunnen	kunnenh@bankofmelbourne.com.au	(02) 9320 5854
Senior Economist	Josephine Heffernan	heffernanj@bankofmelbourne.com.au	(02) 9320 5751
Economist	Janu Chan	chanj@bankofmelbourne.com.au	(02) 9320 5892