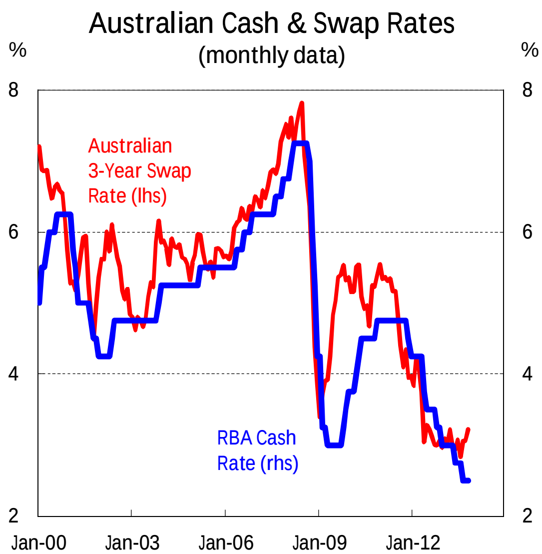
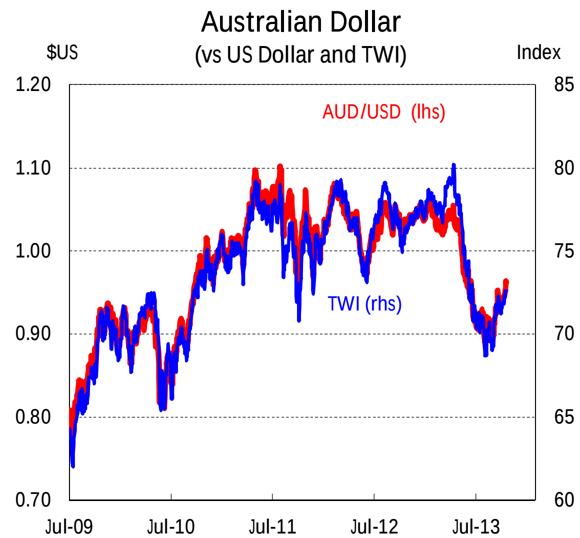
Wednesday, 23 October 2013

Cash Rate and AUD Forecast Update

Changing Tides

- Conditions in the Australian economy remain subdued. However there appear to be enough green shoots to keep the RBA in "wait-and-see" mode. Additionally, it is becoming increasingly likely that any tapering of the Federal Reserve's quantitative easing program will be delayed until next year. Recent economic data from China has also improved. These developments have had implications for our interest rate and exchange rate forecasts.
- As outlined last week, we expect that the RBA will keep rates on hold for the remainder of this year. While there remain downside risks in the domestic economy, we think that it would require a significant deterioration in the outlook in order to sway the RBA to cut rates again.
- We expect the RBA to leave rates on hold for an extended period of time to support growth.
- The outlook for a lower US dollar and our expectations for the RBA to remain on hold suggest that the Australian dollar is likely to be higher than what we previously thought. We still expect the Australian dollar will weaken modestly over the medium term, but remain elevated in the short-term. Our forecast is for the AUD to be 95 US cents at the end 2013 and 91 cents at the end 2014.





A Backflip in the US

On 18 September, the Federal Reserve surprised markets by refraining from tapering its asset purchase program (QE). The outcome was unexpected given earlier signals by Fed officials, which suggested that the first move for unwinding its asset purchase program could be “later this year”.

The drama unfolding in the US political scene over the past few weeks has further increased the risk that the first move for tapering would be later rather than sooner. Although the immediate risk of US default has been resolved, there is likely to be a detrimental impact on growth. The government shutdown which took place from 1 October and lasted for 16 days is estimated to have detracted 0.25-0.5 percentage points from annualised GDP in the fourth quarter. The impact may have been greater depending on the damage to confidence from the partial shutdown and the difficulty faced by Congress in raising the US debt ceiling.

Additionally, the shutdown is going to undermine the quality of government statistics. Therefore, it will be difficult for the Federal Reserve to gauge how the economy has withstood the uncertain political environment. Tapering depends on the economy meeting the Fed’s forecasts, and the Federal Reserve will probably not gain a clear picture of the health of the economy until the end of the year or early next year.

This would suggest that the first move for tapering by the Federal Reserve will be later than previously thought, and it is looking unlikely to occur this year. Consensus for tapering to start is forming around March next year, but it could be even later, in our opinion. More monetary stimulus for longer would mean further downward pressure on the US dollar (and also downward pressure on long-term interest rates).

The RBA in “wait and see” mode

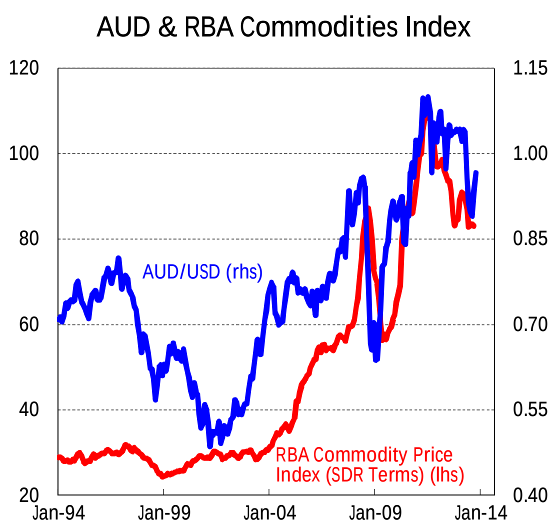
The strong Australian dollar has been a major concern for the RBA, as repeatedly expressed in its commentary. These sentiments were again echoed on Friday by RBA Governor Glenn Stevens who said that he would “prefer it to be lower than this,” and that a “lower currency would be helpful” in rebalancing the economy.

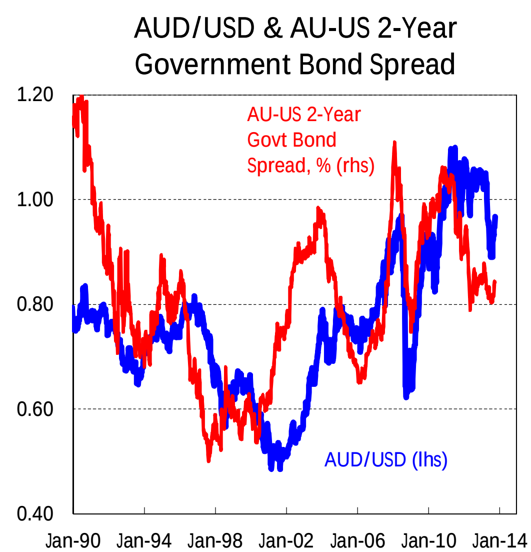
While the RBA clearly would like a lower Australian dollar, recent rhetoric suggests that there has been a slight shift in RBA thinking. There appears to be a bit more complacency about where the Australian dollar is sitting, despite its recent appreciation. The Australian dollar has appreciated over 8 per cent against the US dollar and over 4 per cent in trade weighted terms since early September. Indeed, Glenn Stevens seemed to justify its appreciation saying that the direction of the currency was “not entirely surprising” citing the reduced expectations of Fed tapering and improving economic data from China.

It appears that while the RBA would prefer a lower Australian dollar to boost growth, its concerns have been partially allayed by some tentative signs of improvement in the domestic economy. Consumer and business confidence have lifted and there were also other signs of improving domestic demand according to RBA liaison surveys. These included a pickup in retail sales in September and improving prospects for investment within the tourism sector. Additionally, the housing market is strengthening.

There still remain some downside risks for the domestic economy. These include the strength of the Australian dollar and whether higher levels of business and consumer confidence can be sustained and then translated into stronger spending. Additionally, the labour market remains soft and the economy is still adjusting away from mining investment-led growth.

However, we think that it would take a significant deterioration to the outlook to persuade the RBA to cut rates again. With the cash rate sitting at 2.50%, interest rates are already very low and will continue to support growth at these levels. In time, this should result in a further pickup in growth. We expect that this recovery will be shallower than previous upturns, and expect that the RBA will keep rates on hold for an extended period of time to support growth and reduce downside risks. We do not anticipate the RBA will hike rates until late 2014. Financial markets have lowered the odds of another rate cut and are starting to "price in" the likelihood of a rate hike by the end of 2014.





Australian Dollar Resilience

Our revised cash rate forecast and the recent turn of events in the US have had implications for the outlook for the Australian dollar and other major currencies, and will mean that the Australian dollar is likely to be higher than what we had previously forecast.

Recent Chinese data has also improved, and gives us greater confidence that the Chinese economy will grow at around 7-7.5% this year and over the next few years. While this pace of growth is still robust, growth is slowing from recent years and point to a softer outlook for commodity prices.

Yesterday, Treasurer Joe Hockey announced an increase in Australia's debt ceiling from $300 bn to $500 bn, which could potentially lift Australian government debt issuance. Strong foreign demand for Australian debt is underpinning the Australian dollar.

Fundamental factors, such as the outlook for commodity prices, the outlook for domestic growth to remain below trend and interest rate differentials, however, continue to point to a weaker Australian dollar the medium term.

Our forecast for the AUD is 95 US cents at the end of 2013 and 91 US cents for the end 2014. Please refer to the following page for detailed forecasts.

Janu Chan, Economist
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EXCHANGE RATE FORECASTS

	End Quarter Forecasts				
	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
USD Exchange Rates					
AUD-USD	0.9500	0.9500	0.9300	0.9200	0.9100
USD-JPY	98.00	98.00	100.00	101.00	104.00
EUR-USD	1.3500	1.3400	1.3200	1.3100	1.3100
GBP-USD	1.6000	1.6000	1.6000	1.6100	1.6200
USD-CHF	0.9100	0.9200	0.9500	0.9700	0.9900
USD-CAD	1.0300	1.0400	1.0500	1.0600	1.0700
NZD-USD	0.8300	0.8400	0.8300	0.8100	0.8000
USD-CNY	6.1000	6.0800	6.0700	6.0600	6.0500
USD-SGD	1.2500	1.2600	1.2700	1.2800	1.3000
AUD Exchange Rates					
AUD-USD	0.9500	0.9500	0.9300	0.9200	0.9100
AUD-EUR	0.7040	0.7090	0.7050	0.7020	0.6950
AUD-JPY	91.56	93.10	93.10	93.00	92.92
AUD-GBP	0.5760	0.5940	0.5940	0.5810	0.5710
AUD-CHF	0.8430	0.8650	0.8740	0.8840	0.8920
AUD-CAD	0.9600	0.9790	0.9880	0.9770	0.9750
AUD-NZD	1.1230	1.1450	1.1310	1.1200	1.1360
AUD-CNY	5.7020	5.7950	5.7760	5.6450	5.5750
AUD-SGD	1.1700	1.1880	1.1970	1.1810	1.1780

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

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