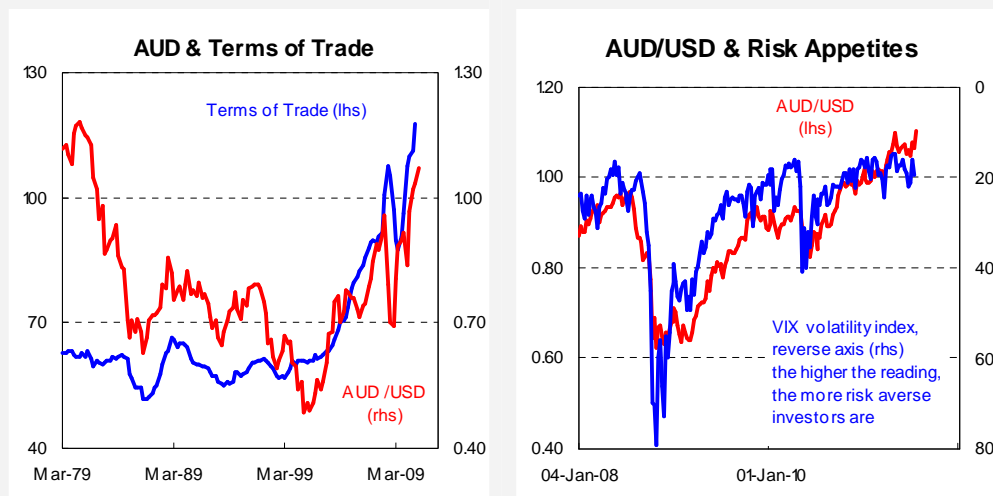


AUSTRALIAN DOLLAR OUTLOOK

The 'New-Safe Haven' Currency

Wednesday, 27 July 2011

- The AUD's close negative correlation with risk aversion appears to have broken down; the AUD has shown greater resilience during bouts of risk aversion this year, suggesting investing in the AUD is considered a safer bet than in the past.
- Australia's attractive interest rates together with the high terms of trade suggest that the AUD will maintain strong support above parity.
- But increased downside risks to the world economy limit the upside for the AUD.
- We expect the AUD/USD to end this year at 1.05 and end 2012 at 1.01.



We examine below the outlook for the currency.

Safe-Haven Flows and Risk Appetites

Since the start of this year, market talk has swirled that the Aussie dollar is the new safe-haven currency. Typically, bouts of risk aversion would cause the AUD to come down the elevator. However, a number of local and international events this year has seen risk aversion rise yet the AUD has held up reasonably well. The current uncertainty dominating financial markets, for example, has not prevented the AUD reaching a new post-float high today above 1.1050.

It is still the case that heightened risk aversion weighs on the AUD, but not as much as it once did. The AUD no longer appears to come down the elevator when risk appetites diminish. Indeed, often falls in the AUD are often viewed as opportunities to buy the AUD.

The correlation between risk aversion (as measured by the VIX index) and the AUD/USD exchange rate sits at around 28% this year thus far compared with 72% in 2010 and 94% in 2009. The weaker correlation this year lends some support to the notion that the AUD is no longer as significantly impacted by risk aversion as it once was.

A colleague recently remarked perhaps the AUD is the new holiday haven; that is, it's a temporary phenomenon until the USD undergoes a sustained recovery. This assumes, however, that the AUD's ascent has been entirely cyclical. But we feel there is also a structural element behind the Australian dollar's rise. Indeed, we see one of the key reasons behind the new attitude towards the AUD having a lot to do with structural changes (see over the page).

Terms of Trade

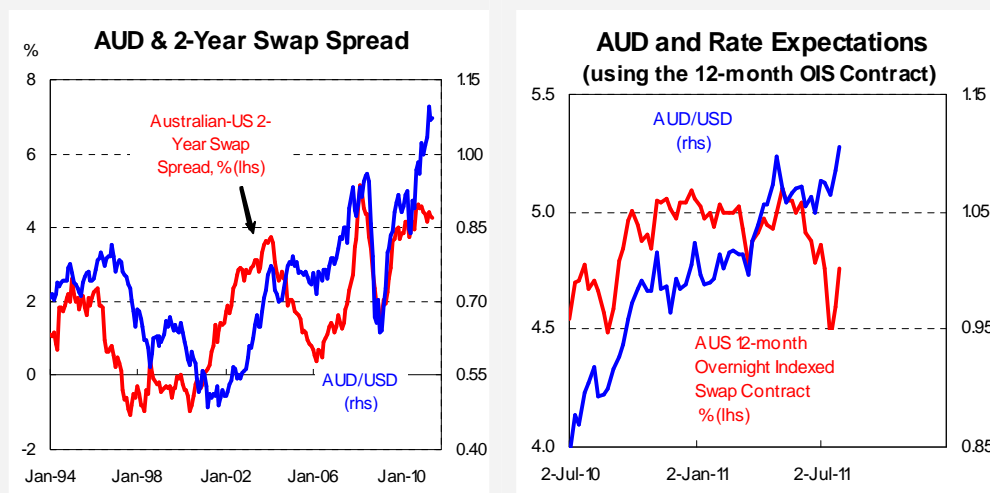
The terms of trade is the ratio of export prices to import prices. This ratio struck a record high

in the June quarter. Its rise over recent years reflects an underlying structural change in the Australian economy and reflects a major structural change in the global economy. That structural change is the industrialisation and urbanisation underway in China. It is feeding a resources boom in Australia. China is hungry for Australian commodities and this hunger is helping to push up commodity prices and Australia's terms of trade. The rising terms of trade is giving a significant injection of income to Australia and underpinning economic activity.

This is Australia's fifth resources boom. Past booms in Australia were different to this current boom in that the exchange rate was fixed. In this boom, the AUD is freely floating and so the lift in the terms of trade is pushing up the AUD as a way of absorbing some of the inflationary pressures.

The close positive correlation between the terms of trade and the AUD suggests to us that the AUD will trade higher than historically was the case. The long-run average (i.e. ten-year average) for the AUD is around USD0.7600.

Over the medium to long term, the strong continued growth in private business investment (largely in the mining sector) should lead to a strong rise in investment flows to Australia and the AUD. The terms of trade level also suggests that the AUD could try to stretch to USD1.1500 on the terms of trade boost alone.



Interest Rates

Underlying inflation has passed its low point and is expected to lift further. The inflation backdrop in Australia is such that a tightening cannot be taken off the table and that will provide continued demand for the AUD.

Financial markets are still under-estimating where the official cash rate is likely to be in twelve months' time. In terms of the economist fraternity, there is a wide divergence of views about the outlook for the cash rate but the overwhelming consensus remains that the cash rate will rise further.

We think rates are on hold in the next few months but further tightening can't be ruled out, especially if uncertainties from the global and domestic economics diminish.

Sovereign Ratings and Fiscal Balances

Amid times of uncertainty foreign investors seek relative safety. Downside risks to the world economy have risen in the past month and uncertainty accordingly has increased. These risks are largely due to the sovereign debt issues in Europe, the US debt negotiations and the slower growth in the US economy. Typically, risks to the world growth outlook do hurt the AUD and the current episode is no exception; we think the upside for the AUD is lower than otherwise would be the case.

But Australia's standing amid foreign investors is elevated; this elevation began when Australia escaped the worst of the global financial crisis by avoiding a recession. Since then the Australian economy still shines brightly compared to many other advanced economies.

Australia has an enviable AAA sovereign rating and a high benchmark cash rate at 4.75%. It makes the AUD attractive to foreign investors.

Fiscally, Australia also looks to be in good shape. Foreign investors generally prefer the currencies of countries with sound and stable balance sheets and economic policies. In this light, again Australia looks attractive, especially when compared with the challenging levels of government debt of the US, UK and Japan.

Structural Decline of the USD

The large fiscal deficit and alarming debt-to-GDP level that the US has reached is likely to ensure the USD will remain in its long-term structural decline. We can trace this decline back to 1985 on the technical charts.

We project the USD to stay in this structural decline. Indeed, the USD could even recover more than 30% of its value in the short term and still remain in this structural decline.

Not surprisingly then, a growing number of central banks are looking to diversify out of US dollars and some are looking at the AUD as one of the alternatives. For example, last month the Russian central bank said it would hold Australian dollars for up to one per cent of its US\$528 billion in reserves.

US Debt Negotiations

In the US, the USD has undergone a fresh wave of selling in recent days, as a deal between the Democrats and Republicans to raise the debt level proves elusive. Without an increase in the debt limit by August 2, the US Government will run out of cash to pay its bills, including the interest it needs to pay on its debt obligations. The debt ceiling is a cap set by US Congress on the amount of debt the Government can legally borrow. If the interest payments on the national debt are not paid, this would be considered a "default" and would likely have negative consequences for the US and the rest of the world.

The Democrats and Republicans remain in deadlock. This has placed downward pressure on the USD. Markets are attaching a low probability of default, suggesting that a compromise will be reached, even if at the eleventh hour. The low probability markets are attaching to the possibility of default means that an actual default would have significant reverberations in markets; it would include a further sell off in the USD.

Our core view is that a deal will be struck and it will lend some short-term support to the USD.

US Growth Concerns

But any near term support the USD receives from averting a default is unlikely to be significant and long lasting given the wider economic and debt issues at hand in the US.

The US economy has lost some momentum and this is raising concerns about a renewed slowdown. Our analysis of the data is that the US recovery remains intact but that the recovery will be a weak and drawn-out one. This recovery involves a de-leveraging process, which has a lot further to run. This process is weighing on the US economy.

The large twin deficits problem in the US also means that the potential growth rate of the US is lower than in the past.

Further, the USD is unlikely to recover markedly until the Federal Reserve starts tightening interest rates again; the timing of the first tightening appears to be at least another year away.

European Sovereign Debt Issues

The slower rate of momentum in the US economy combined with the sovereign debt issues in the peripheral economies of Europe raise the downside risks to the global growth outlook.

The issues plaguing Europe are not merely sovereign related. There is also a European banking risk because the sovereign debt held by European banks is largely held on the banking books.

At an emergency summit in Brussels on July 21, European policymakers showed that they were prepared to do more than the bare minimum to limit the impact of the euro zone sovereign debt crisis. We cannot say for certain if this marks the definitive end of the European crisis. It's unlikely it is the end, but it seems like a step in the right direction and it has at least helped provide some cautious optimism.

The pull back in the credit default swap (CDS) spreads of the peripheral economies in the wake of the Summit suggests the market has received the new policies well, although it is early days.

China

Global growth continues to be led by non-OECD countries, namely emerging Asia, which includes China. China's inflation rate is currently running above 6% per annum and controlling inflation is the number one task at hand for the Chinese government and central bank. There's some risk of a hard landing when any economy is tightening policy but we think China will achieve a managed slowdown. This slowdown, however, is likely to shave the upside potential for the AUD over the next 12-18 months.

Further, it needs to be remembered that among China's largest export markets are the US and Europe (accounting for more than one third of its exports), so a slowdown in these economies will affect the export potential of China.

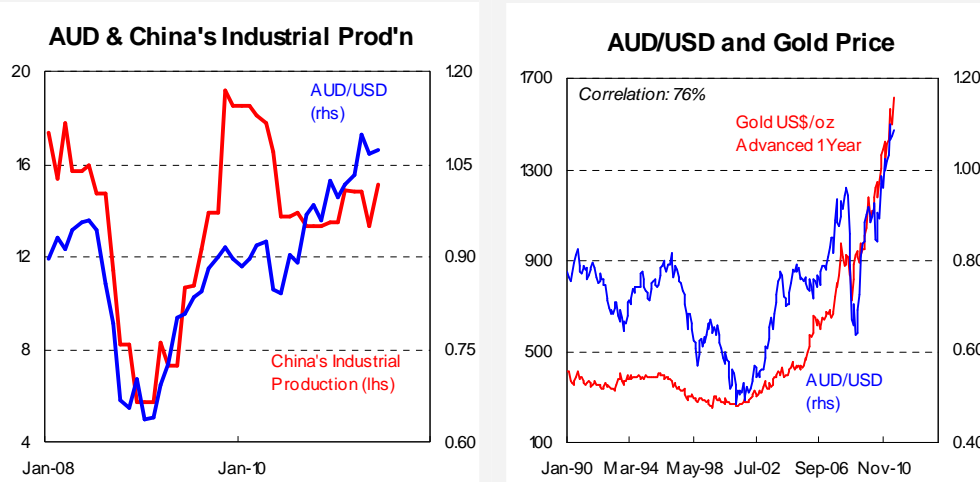
Commodities

The managed slowdown for China is likely to slow demand for commodities, albeit commodity prices should remain relatively high. Traditionally, the AUD has a close positive relationship with commodities.

The AUD also has a close positive correlation with gold. Gold is at historic highs, spurred by safe-haven flows, concerns about inflation and a weakening USD. The gold price advanced one year has a close positive relationship with the Aussie dollar and suggests further modest upside for the AUD in the near term.

Summary

In summary, we expect the AUD/USD to end this year at 1.05 and next year at 1.01. The AUD will remain well supported by Australia's attractive interest rates, high terms of trade and Australia's strong fiscal position. Further, bouts of risk aversion are no longer having the effect it once did on the AUD. However, the increased downside risks to the world economy suggest that the topside potential for the AUD is shaved.



EXCHANGE RATE FORECASTS
Effective 26 July, 2011

	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
USD Exchange Rates						
AUD-USD	1.0700	1.0500	1.0400	1.0300	1.0200	1.0100
USD-JPY	85.000	87.000	89.000	90.000	91.000	92.000
EUR-USD	1.4400	1.4300	1.4200	1.4000	1.3900	1.3800
GBP-USD	1.6400	1.6400	1.6500	1.6600	1.6800	1.6900
USD-CHF	0.8900	0.9000	0.9100	0.9500	0.9900	1.0300
USD-CAD	0.9700	0.9900	1.0000	1.0000	1.0000	1.0000
NZD-USD	0.8200	0.8100	0.8000	0.7900	0.7800	0.7700
USD-CNY	6.3800	6.3000	6.2300	6.1800	6.1300	6.0800
USD-SGD	1.2200	1.2100	1.2000	1.2000	1.2000	1.2000
AUD Exchange Rates						
AUD-USD	1.0700	1.0500	1.0400	1.0300	1.0200	1.0100
AUD-EUR	0.7480	0.7390	0.7430	0.7410	0.7390	0.7370
AUD-JPY	91.00	91.40	92.60	92.70	92.80	92.90
AUD-GBP	0.6520	0.6400	0.6300	0.6200	0.6070	0.5980
AUD-CHF	0.9520	0.9450	0.9460	0.9790	1.0100	1.0400
AUD-CAD	1.0380	1.0400	1.0400	1.0300	1.0200	1.0100
AUD-NZD	1.3050	1.2960	1.3000	1.3040	1.3080	1.3120
AUD-CNY	6.8270	6.6150	6.4790	6.3650	6.2530	6.1410
AUD-SGD	1.3050	1.2710	1.2480	1.2360	1.2240	1.2120

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

Besa Deda, Chief Economist
Ph: (02) 9320-5854

Contact Listing

Chief Economist	Besa Deda	dedab@stgeorge.com.au	(02) 9320 5854
Senior Economist	Josephine Heffernan	heffernanj@stgeorge.com.au	(02) 9320 5751
Economist	Janu Chan	chanj@stgeorge.com.au	(02) 9320 5892

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