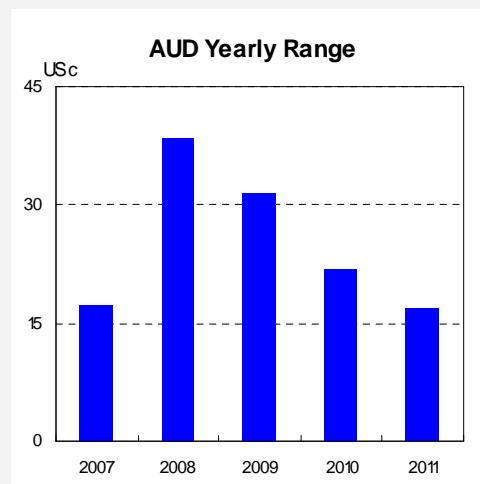
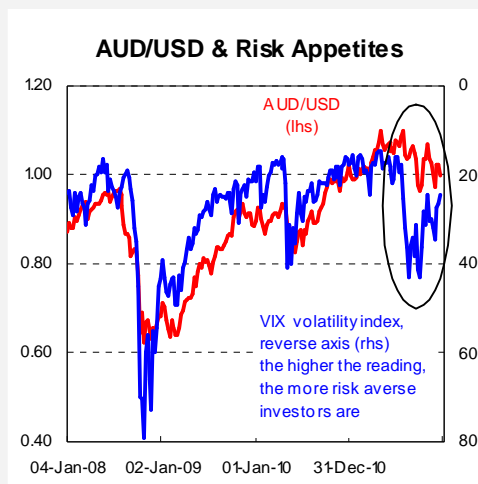


# AUSTRALIAN DOLLAR OUTLOOK

## Riding the Aussie Rollercoaster

Thursday, 22 December 2011

- The Australian dollar is being subject to strong bouts of volatility in recent times, reflecting heightened uncertainty over developments in Europe. Increased downside risks to the world economy and greater than usual uncertainty suggests that volatility will remain a key theme for the AUD over the next few months.
- Heightened risk aversion and growing downside risks to global growth are weighing on the Aussie and are largely behind the Australian dollar's fall since it hit a peak in July. If the worst in Europe transpires, the AUD is likely to face further downward pressure.
- While the Australian dollar has been vulnerable to growing problems in Europe, the AUD has shown greater resilience during bouts of risk aversion this year in comparison to previous episodes of risk aversion. In our opinion, this reflects strong underlying fundamentals.
- Australia's economic outperformance especially during and since the GFC, close trade ties with Asia and high terms of trade are key fundamentals supporting the AUD. Further, Australia's now unique triple-A sovereign credit rating and relatively high interest rates are very attractive for foreign investors.



### Volatility and the Aussie – “Like Peas and Carrots”

The Australian dollar has undergone extreme volatility in recent times. Over the past six months, the AUD has traded as high as 1.1081 on 27 July and as low as 0.9388 on 4 October. Underpinning the large ructions in the currency and financial markets in general has been heightened uncertainty on developments in Europe and whether or not European leaders can tackle the crisis effectively.

The uncertainty in Europe extends to the broader global economic outlook, and depends highly on what politicians will ultimately decide. This provides more than usual uncertainty around the outlook for the economy and also for the Australian dollar. It further suggests that volatility will likely be a key theme for the Australian dollar in coming months.

### Heightened Risk Aversion

It remains possible that EU leaders could announce a “bazooka” and reveal dramatic new

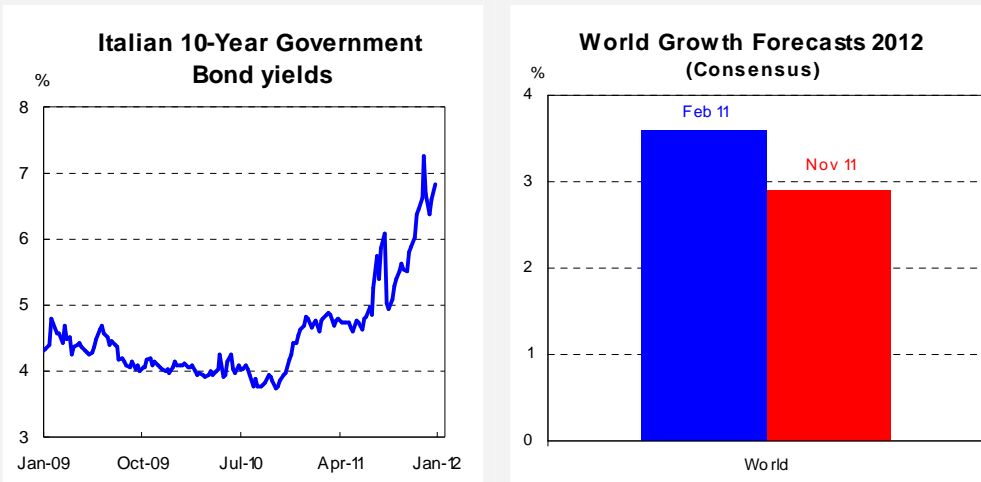
measures that would be enough to appease markets. Some measures that markets are hoping for include jointly issued Euro bonds, “monetizing” of debt (European Central Bank (ECB) ramping up their purchase of bonds) and/or greater IMF involvement. However, an effective solution is looking increasingly unlikely with every passing moment and the political hurdles are very high. In the meantime, downside risks to the financial system and the broader economy are growing the longer concerns about government debt continue. In this environment of increasing downside risk and uncertainty, investors remain risk averse.

The Australian dollar tracks quite closely with risk appetite (see chart above left) or investor sentiment. This means in times of increased uncertainty and concern about the outlook for global economic growth, the Australian dollar weakens against the US dollar. These concerns have weighed on financial markets throughout the second half of this year and are largely behind the Australian dollar’s fall of more than 8 cents since its peak on 27 July.

#### Global Growth Worries Escalating

Developments in Europe have significantly worsened, particularly over the second half of this year. While alarming, the rescue packages aimed at Greece, Ireland and Portugal were seen as limited to the peripheral economies of Europe. However, a “managed” default or a 50% writedown of Greek debt for private bondholders led investors to question “who would be next?”

More concerning has been the contagion to Italy, the third largest economy in Europe. Italy has the third largest government bond market globally (after the US and Japan) and concern about its ability to repay its debt has seen Italian bond yields rise sharply, further inhibiting its ability



to repay its debt.

The lack of an effective solution in Europe has led credit ratings agencies to threaten downgrades of the stronger Euro zone nations. Belgium has had its credit rating downgraded by Moody’s and Standard and Poor’s and France is viewed as a high risk of downgrade given its high debt burden and the exposures of financial institutions to Italian, Spanish and Greek sovereign debt.

Contagion has also spread to the banking sector, particularly in Europe. Concerns have arisen as a result of the exposures to European sovereign debt and funding pressures have lifted to its highest since the GFC. Furthermore, measures by central banks globally to support liquidity have done little to relieve funding pressures.

The escalation of these concerns is threatening the survival of the Euro as a single currency unit itself, and has the potential to plunge Europe into a deep recession. Even if the worst is avoided

in Europe, recession is still looming as the austerity measures drag on growth and spending is likely to be curtailed on weaker confidence and lower availability of credit given banks are facing funding pressures.

Downside risks to the broader global economy can arise through trade links between Europe, weaker confidence can impact negatively on wealth and spending and tighter funding pressures for banks may restrict credit, weighing on spending further.

The Australian dollar is often viewed as a barometer for global growth, and has come under pressure as these global growth worries have escalated. Investors are also more supportive of the US dollar after recent US economic data has surprised on the upside, and worries about a double-dip recession have subsided.

#### Long-term Fundamentals Still Intact

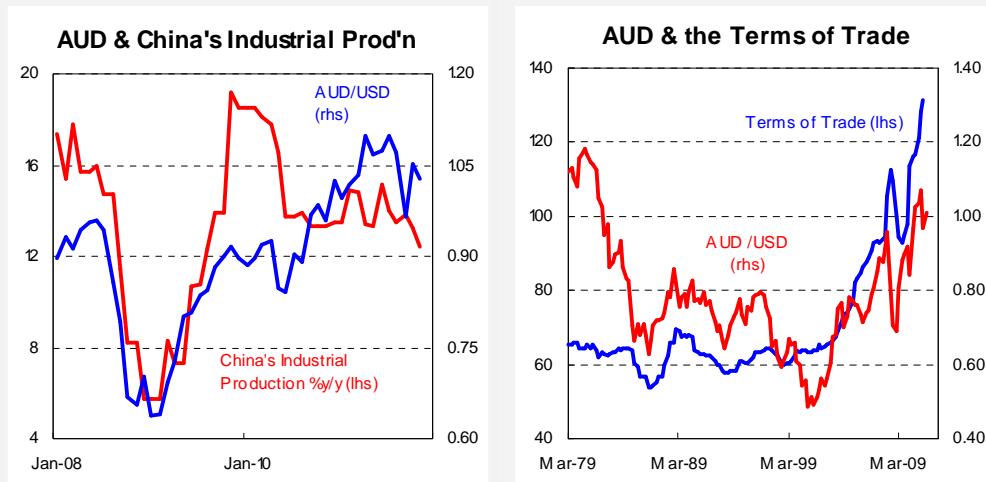
Despite these escalating worries about the global economy and heightened risk aversion, the Aussie still appears to be holding up relatively well (see chart p1 right). The Aussie has no doubt fallen, but typically, historical bouts of risk aversion would cause the AUD to “come down the elevator”. The Aussie’s relative strength reflects some of the long-term fundamentals that have supported the Australian dollar in recent years. Further, the Australian economy has proved that it is well placed to handle negative shocks to the global economy as shown during the GFC, which managed to escape a recession unlike other advanced economies.

Some of these fundamentals we discuss in turn below.

- Close Trade Links with Asia

Emerging economies have been the larger drivers of global growth over the past decade or so. Meanwhile, Australia’s trade links are heavily weighted towards the Asian region. China is Australia’s largest trading partner and the world’s largest consumer of steel and base metals.

Given China is the biggest driver of commodity prices and Australia’s largest trading partner; the Australian dollar is often thought of as a good proxy for the Asian region. Further, given Australia is a small, open economy with a floating currency, it is also seen as an indirect way to benefit from Asia’s recent strong growth.



The Australian dollar has a close relationship with commodity prices. Commodity prices also commonly reflect global demand, but this demand is being increasingly driven by demand in emerging economies such as China.

China’s growth has moderated under the weight of tighter monetary policy earlier in the year. Further, there are signs of slowing growth in exports particularly from Europe where growth is stalling. There is however prospect of further monetary policy stimulus in China as inflation has eased. China has cut its reserve requirement ratio by 0.5 percentage points on 5 December.

Additionally, interest rates and the reserve requirement ratio can come down a long way to boost growth in China.

Softer growth in China will weigh on the AUD, but we expect that China can engineer a soft landing. However, the deeper the crisis in Europe, the more heavily it will weigh on China's exports and the greater the downside for the Australian dollar.

#### - High Terms of Trade

The terms of trade (ratio of export prices to import prices) hit a record high in the September quarter, thanks to strong demand for Australia's commodity exports. The Australian dollar has a close positive relationship with the terms of trade, and helps absorb the price shock associated with rising export prices.

Downside risks to the global outlook and slowing growth in China have led to declines in commodity prices in recent months. RBA commodity prices have fallen 4.5% from their peak in July, but they still remain at high levels.

Despite growth slowing in China, longer-term demand for Australia's commodities remains intact. The industrialisation and urbanisation process currently underway in China still has further to run, and in our view represents an underlying structural change in the economy.

Strong demand for Australia's commodity exports reflect this underlying structural change and suggests that commodity prices, and therefore Australia's terms of trade will also remain high.

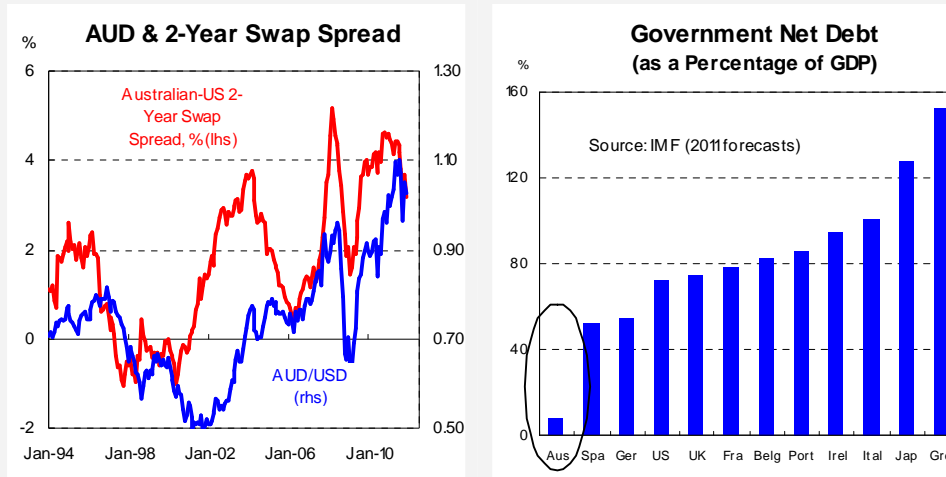
The close positive correlation between the terms of trade and the AUD suggests that the AUD will likely remain higher than historically and very likely to trade higher than its long-term average of around 0.7800.

#### - Relatively High Interest Rates

Australia's relatively high interest rates in comparison to other advanced economies is providing further support for the Australian dollar. Interest rate differentials are a well-known determinant of foreign exchange.

The differential between Australia and US interest rates are expected to narrow, but interest rates will remain in Australia's favour. Australia's official cash rate has declined from a cyclical peak of 4.75% to 4.25% and we are expecting the Reserve Bank of Australia (RBA) to lower the cash rate further at least by another 50 bps to 3.75% (consensus among economists is 4.00%). During the GFC, the cash rate fell as low as 3.00% in April 2009.

Compare Australia's cash rate with the equivalent in the US, the Fed Funds rate which stands at 0-0.25%. Comments from Federal Reserve Chairman Ben Bernanke further suggest that interest rates are likely stay at these very low levels at least till mid-2013. We expect the US to avoid a recession, but there are still a number of issues facing its economy such as a sluggish housing market and its own fiscal problems. We expect the US will likely experience sub-par growth over the medium-term, provided Europe doesn't deteriorate significantly.



#### - Healthy Economy and Fiscal Position

Australia's elevated standing stems from its ability to escape 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's AAA sovereign debt rating is also attracting worldwide attention, and is one of only 14 nations to be assigned AAA ratings from all three major credit ratings agencies. Further, only three of these nations sit outside of Europe.

In an environment where levels of government debt are in the spotlight, Australia's fiscal position is looking very healthy in comparison. The debt levels of Australia's federal government are very small and manageable, especially when compared to the US, UK or France.

Foreign investors are likely to prefer the currencies of countries with sound and stable country balance sheets and economic policies. For these reasons, some of the largest global bond and money market investors are extremely positive on Australian government debt.

As worries have escalated in Europe, Australian debt from Australian banks has become more attractive relative to European bank debt. Australian banks have been able to easily access short-term funding in the US given money market funds have shifted investments from European to Australian banks.

#### Summary and Forecasts

Volatility is likely to remain a key theme for the AUD in coming months as investors prepare for what might come from Europe. If the worst transpires in Europe, global growth will weaken significantly, and investor sentiment is likely to fall further. The Australian dollar would then face the prospect of a heavy sell-off.

We, however, expect the AUD remain well supported over the longer term, reflecting strong underlying fundamentals. These include high interest rates relative to other advanced economies, relative strength of the domestic economy given its strong ties to Asia and Australia's strong fiscal position.

We expect the still strong underlying fundamentals for the Australian dollar will reassert themselves towards the end of next year, but will likely be very volatile between now and then. We see the AUD/USD weakening in the first half of 2012 before recovering in the second half. Our forecast for the AUD is \$1.01 at the end of 2012.

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# FOREIGN EXCHANGE FORECASTS

Thursday, 22 December 2011

## BANK SA EXCHANGE RATE FORECASTS

	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
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### USD Exchange Rates

AUD-USD	1.0300	1.0000	0.9900	1.0000	1.0100	1.0200	1.0300
USD-JPY	77.000	78.000	79.000	80.000	82.000	82.000	83.000
EUR-USD	1.3500	1.3200	1.3000	1.3300	1.3500	1.3800	1.4000
GBP-USD	1.5700	1.5500	1.5700	1.5900	1.6000	1.6000	1.6000
USD-CHF	0.9100	0.9400	0.9600	0.9700	0.9800	1.0000	1.0100
USD-CAD	1.0200	1.0200	1.0200	1.0100	1.0000	1.0000	1.0000
NZD-USD	0.7800	0.7800	0.7700	0.7900	0.8000	0.8100	0.8200
USD-CNY	6.3100	6.2400	6.1800	6.1200	6.0600	6.0200	5.9900
USD-SGD	1.2700	1.2800	1.2900	1.2800	1.2500	1.2500	1.2500

### AUD Exchange Rates

AUD-USD	1.0300	1.0000	0.9900	1.0000	1.0100	1.0200	1.0300
AUD-EUR	0.7630	0.7580	0.7620	0.7520	0.7480	0.7390	0.7360
AUD-JPY	79.30	78.00	78.20	80.00	82.80	83.60	85.50
AUD-GBP	0.6560	0.6450	0.6310	0.6290	0.6310	0.6380	0.6440
AUD-CHF	0.9370	0.9400	0.9500	0.9700	0.9900	1.0200	1.0400
AUD-CAD	1.0510	1.0200	1.0100	1.0100	1.0100	1.0200	1.0300
AUD-NZD	1.3210	1.2820	1.2860	1.2660	1.2630	1.2590	1.2560
AUD-CNY	6.4990	6.2400	6.1180	6.1200	6.1210	6.1400	6.1700
AUD-SGD	1.3080	1.2800	1.2770	1.2800	1.2630	1.2750	1.2880

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

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