

Tuesday, 31 March 2015

Australian Dollar Outlook

Still Under Pressure

- We have revised our AUD forecasts for this year down slightly to reflect developments over recent months. We now expect the AUD to end 2015 slightly lower at US\$0.73.
- The balance of risks continues to suggest that the AUD could weaken further against the US dollar. This largely reflects diverging monetary policy stances between the US Federal Reserve and the RBA.
- We expect the upward trend in the US dollar against most other major currencies to continue. While US Federal Reserve rate hikes are factored into financial markets to an extent, the expected pace of rate tightening implied by financial markets in coming years continues to be very conservative. This highlights the risk of upward surprises, and point to a risk that the US dollar could lift further.
- A softer outlook for the Australian economy, the likelihood of another domestic rate cut in the near-term and downside risk to commodity prices also point to a weaker profile for the Australian dollar. Nonetheless, the Australian dollar's recent decline places it much closer to levels as suggested by commodity prices in comparison to recent years.
- As monetary policy decisions by the Federal Reserve have become increasingly data dependent, currency markets are likely to be volatile over the next few months, particularly around Federal Reserve monetary policy meetings when changes to policy could occur and also on economic data releases.

The Australian dollar has come under pressure in recent months, weighed down by falling commodity prices, an uncertain domestic growth outlook and a rate cut from the RBA. The Australian dollar has fallen over 17% against the US dollar, after reaching a 2014 peak of US\$0.9497 on 1 July. A stronger US dollar has also been a major factor, reflecting growing expectations the Federal Reserve will hike rates this year.

We continue to see further downside risks to the AUD this year. Moreover, some of these risks have intensified over the past few months, which include a weaker growth outlook for the Australian economy and downward pressure on the prices of key commodities. Further, while there is market uncertainty surrounding the exact timing the US Federal Reserve will start to raise interest rates, it is likely that monetary tightening in the US will begin this year. We expect it could begin as early as June.

Large scale quantitative easing from the European Central Bank (ECB) and Bank of Japan (BoJ) is supporting capital flows away from Europe and Japan. That could suggest less downward pressure on the AUD in trade-weighted terms and against other currencies such as the EUR and JPY.

On balance, we expect the AUD to end 2015 at US\$0.73. (Please see page 6 for more detailed forecasts.)

Growth Outlook

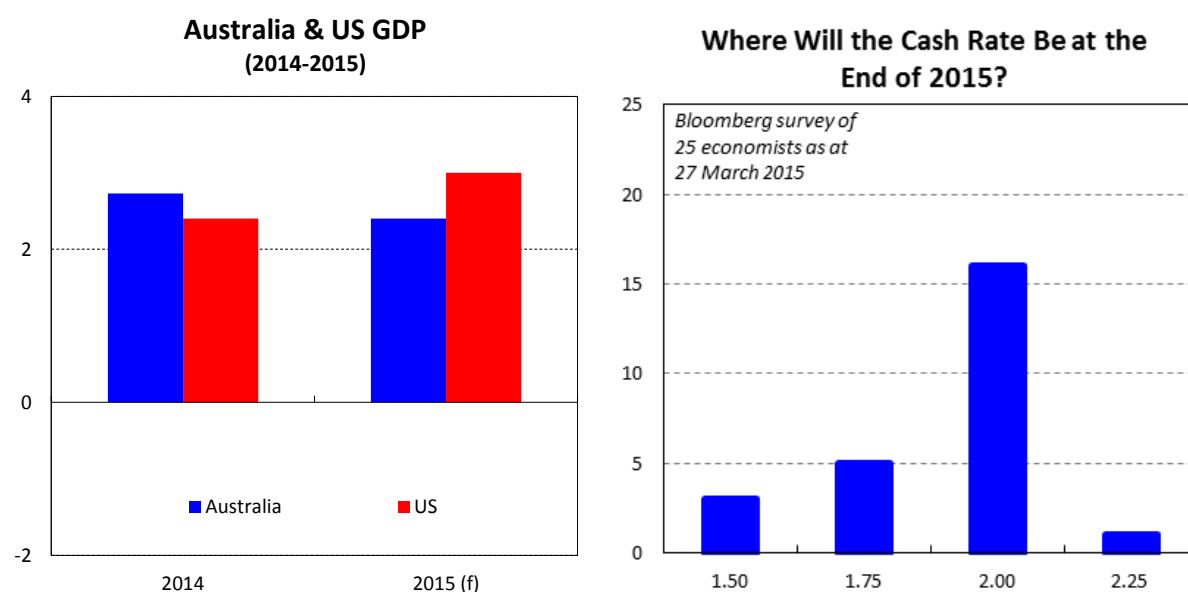
The outlook for the Australian economy has become less promising in recent months. Economic growth has slowed since the middle of 2014, and it now appears that the economy will continue to grow below trend for much of 2015. We expect growth of just 2.3% in 2015 after growth of 2.7% in 2014.

In contrast, growth in the US is picking up. The US economy grew by 2.4% in 2014 and is expected to grow at 3.0% in 2015 according to consensus forecasts.

Commodity prices have declined sharply, and this is having a negative impact on income growth in Australia. The sharp decline in mining investment is continuing. While this downturn in mining investment has been largely anticipated, business surveys have recently indicated that the slow recovery in non-mining business investment could stall this year. A further recovery in non-mining investment is required for economic growth to pick up to a pace strong enough for the unemployment rate to start trending downwards.

A more subdued domestic outlook helps to justify a weaker exchange rate. The lower currency would boost demand from overseas as exports become more competitive at a time when demand domestically is lacking.

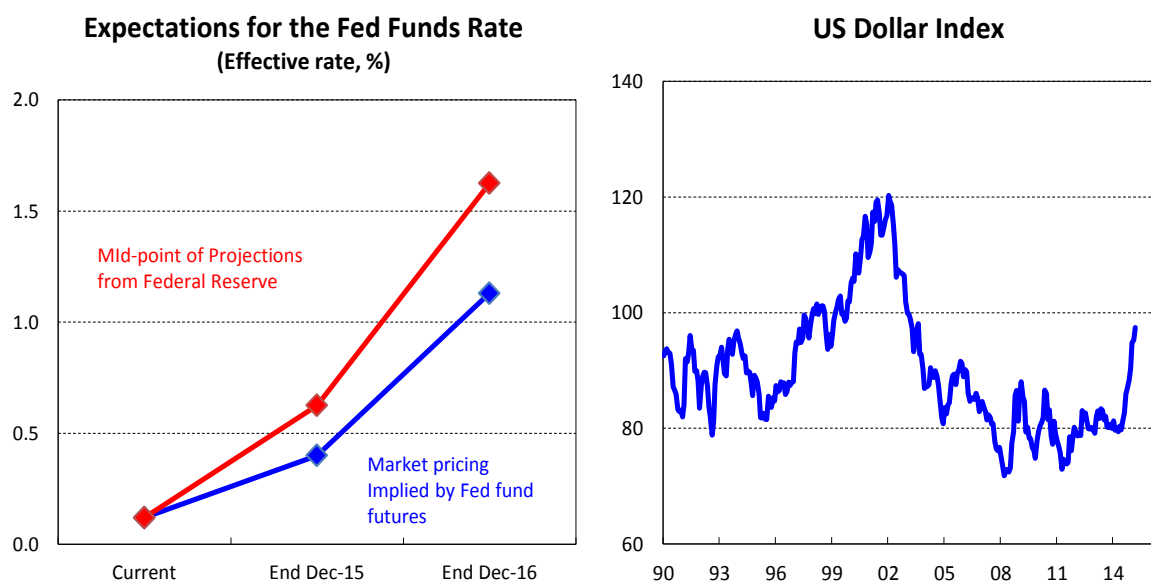
The prospect of below trend growth and the downside risks that remain also has implications for the interest rate outlook.



RBA and Interest Rates

On 4 February, the RBA announced a 25 basis point cut to the cash rate to 2.25% after leaving it on hold for 1½ years. We expect the RBA to cut the cash rate once more in April or May by another 25 basis points, but the odds have recently shortened for an April rate cut. There is a risk of a further rate cut to take the cash rate below 2.0%, but on balance we expect rates to stay on hold for the remainder of the year.

Interest-rate futures markets have priced in a 65% chance of a rate cut at the RBA's meeting in April, and fully priced in a 25 basis point cut in May. Markets are also close to fully pricing in another 25 basis point rate cuts by the end of 2015, more than expectations of most economists. This could imply that further downward pressure to the AUD could be limited if the RBA cuts rates only once more as we expect.



US Dollar and the Federal Reserve Outlook

A major reason for recent weakness in the AUD has been the US dollar story. Against a basket of currencies, the US dollar hit its highest in 12 years on 13 March 2015, although it has fallen from these highs in recent days. It remains over 22% higher since mid-2014.

Expectations that the Federal Reserve will begin raising official interest rates this year have provided support to the US dollar. Further, the Federal Reserve will be unlikely to raise interest rates just once from its 0-0.25% range – a series of rate hikes is a more likely scenario.

The timing of the first rate hike or “lift off” is a big question for financial markets. The Federal Reserve has indicated that April lift off is unlikely, but there is a possibility of a rate rise in subsequent meetings in June, July or September. Federal Reserve Chair Janet Yellen has previously signalled that she expected tightening to start around middle of this year, although more recent commentary has been more open surrounding the exact timing.

Perhaps more important for the medium-term outlook for currencies is how far the Federal Reserve decides to hike rates. The midpoints of the Federal Reserve’s latest projections of the Fed funds rate were at 0.625% for the end of 2015 and 1.625% for the end of 2016. These forecasts imply less than three 25 basis point rate hikes this year and an additional 100 basis points of hikes next year. This would suggest a relatively gradual pace of tightening in comparison to previous tightening cycles. A substantial improvement in the labour market supports the case for policy normalisation soon, although subdued inflationary pressures suggests that the Fed does not have to raise interest rates in a hurry.

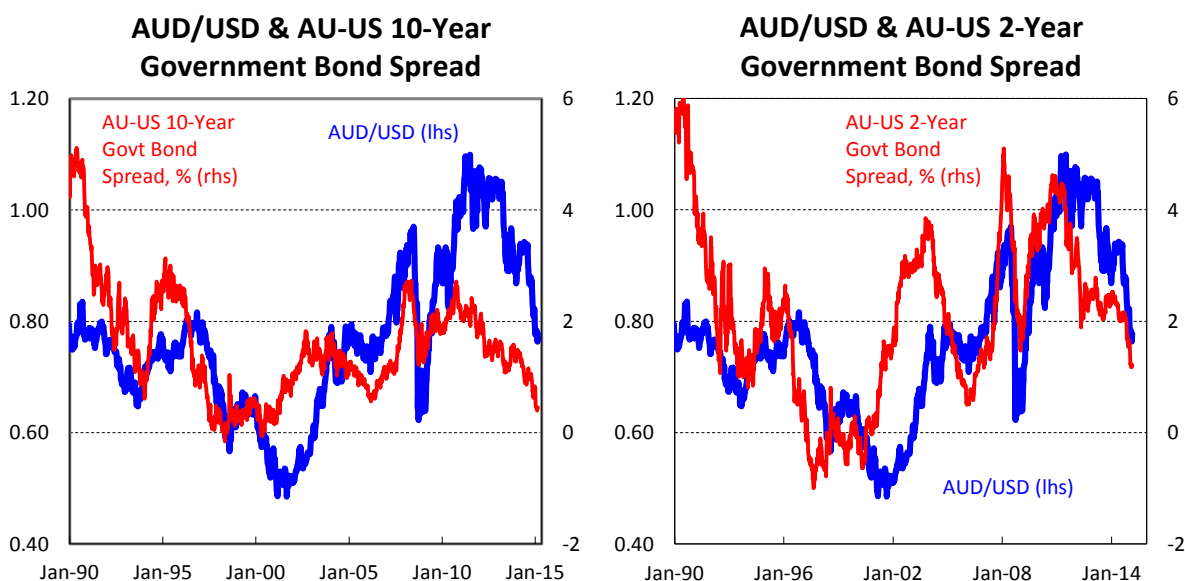
Financial markets continue to expect a more conservative pace of normalisation than committee members of the Federal Reserve. Futures markets are implying a Fed funds rate of 0.40% for the end of 2015 and 1.13% at the end of 2016. The slow pace of Fed tightening implied by financial markets highlight the risk of upward surprises, and point to a risk that the US dollar could lift further.

As monetary policy decisions by the Federal Reserve have become increasingly data dependent, this is likely to result in more significant financial market reactions to upcoming data. It suggests that currency markets are likely to be volatile over the next few months and particularly around upcoming Federal Reserve monetary policy meetings when changes to policy could occur, as well as for significant economic data releases.

Diverging Paths

The likelihood of further rate cuts by the RBA and rate hikes by the Federal Reserve suggests that interest-rate differentials between Australia and the US should narrow and continue to point to further weakening in the AUD against the greenback.

The predicted rate cuts from the RBA and rate hikes by the Federal Reserve have been factored into pricing of currency markets to an extent. However, the diverging monetary policy stances by the RBA and Federal Reserve indicate that yields on Australian government bonds will become relatively less attractive. The spread between Australian and US bond yields have narrowed and will likely narrow further this year, and point to further downward pressure on the Australian dollar (see below charts left and right).



China and Commodity Prices

Over the longer-term, the Australian dollar is guided by the terms of trade (ratio of export to import prices). Movements in Australia's terms of trade largely reflect changes in commodity prices because commodities comprise a majority of Australia's exports.

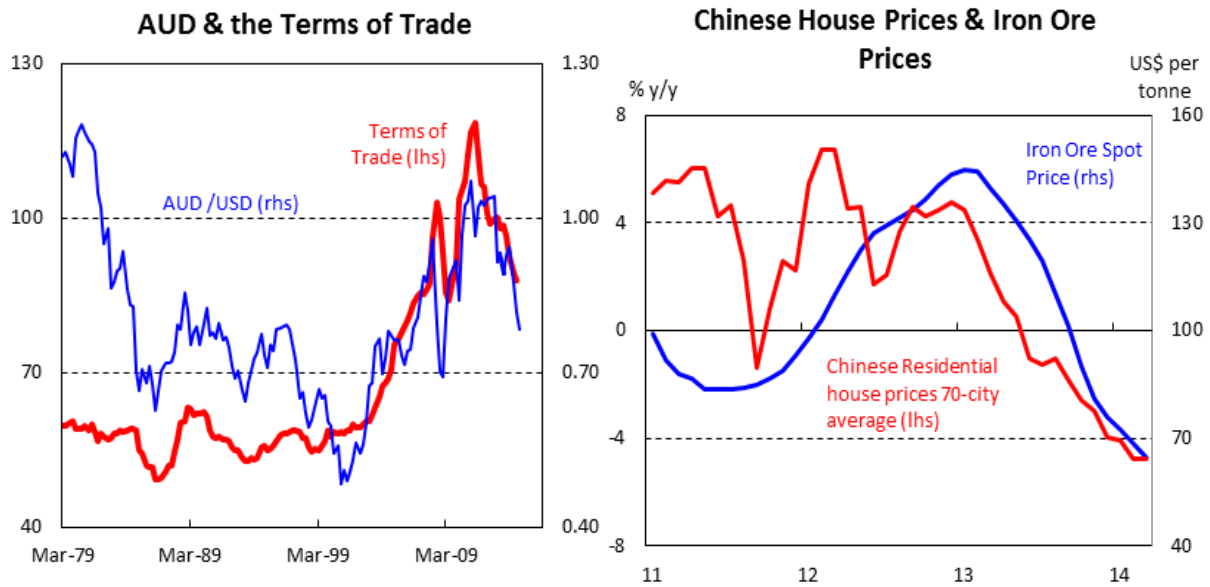
Commodity prices have fallen significantly over the past few years and have continued to point to a weaker Australian dollar. The fall in the prices of most commodities has largely been supply driven, (eg. iron ore, coal and oil). High prices in the earlier part of this decade encouraged a significant amount of new investment to support higher production. Prices have been adjusting lower due to this lift in global production.

However, demand is also likely playing a part behind the weakness in commodity prices. Chinese authorities have announced a target growth rate of 7%. While this remains a healthy pace of growth, there are downside risks emanating from a downturn in China's property sector. A slowdown in residential construction activity in China could also weigh on the demand for raw materials, including Australia's key exports.

The increases to supply, which is expected to continue, and risks to global demand suggests that the prices of Australia's key commodities could remain under pressure. Further declines in the prices of commodities would continue to weigh on the Australian dollar.

However, the Australian dollar has already fallen significantly in step with the decline in commodity prices in recent months. Indeed, even after taking into account a further modest decline in commodity prices, the Australian dollar appears close to its value implied by our commodity-price model. That said, there remains

significant uncertainty around the outlook for commodity prices, and there is a risk that they could fall further.



It's All Relative

The level of currencies such as the US and the Australian dollar are also dependent on developments in other parts of the world. In contrast to the Federal Reserve, the BoJ and ECB are currently providing a significant amount of stimulus to the global economy through their quantitative easing programs. The US dollar is therefore likely stronger than it otherwise would be due to the easy monetary policy stances of other central banks.

The stimulus from Europe and Japan similarly could keep the Australian dollar higher than otherwise against the yen and the euro, and suggests that the Australian dollar could depreciate to a lesser extent in trade-weighted terms, compared to its decline against the US dollar.

Please see detailed forecasts on following page.

EXCHANGE RATE FORECASTS

End Quarter Forecasts

	Jun-15	Sep-15	Dec-15
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USD Exchange Rates

AUD-USD	0.7500	0.7400	0.7300
USD-JPY	123.00	124.00	125.00
EUR-USD	1.0700	1.0500	1.0300
GBP-USD	1.4900	1.5200	1.5200
USD-CHF	0.9600	0.9700	0.9700
USD-CAD	1.2700	1.2800	1.2900
NZD-USD	0.7300	0.7200	0.7100
USD-CNY	6.2000	6.2000	6.1800
USD-SGD	1.3800	1.3900	1.4000

AUD Exchange Rates

AUD-USD	0.7500	0.7400	0.7300
AUD-EUR	0.7010	0.7050	0.7090
AUD-JPY	92.30	91.80	91.30
AUD-GBP	0.5030	0.4870	0.4800
AUD-CHF	0.7200	0.7180	0.7080
AUD-CAD	0.9530	0.9470	0.9420
AUD-NZD	1.0270	1.0280	1.0280
AUD-CNY	4.6500	4.5880	4.5110
AUD-SGD	1.0350	1.0290	1.0220

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

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