

Thursday, 2 February 2017

Australian Dollar Outlook

Mixed Signals

- The Australian dollar traded within a narrow range over most of the second half of 2016, although it dipped briefly at the end of the year to finish 2016 at US\$0.7208. Strength in commodity prices and stronger than expected growth in the Chinese economy have continued to prop up the AUD. However, USD moves have also been a major factor in determining the AUD's value.
- Resilient commodity prices could continue to provide support for the Australian dollar, but the currency has not had a strong relationship with commodity prices recently, particularly movements in prices of bulk commodities. That said, commodity prices have tended to be better predictor of the AUD over the long-term. A modest decline in prices would still be consistent with an Australian dollar trading close within the 75-80 US cent range.
- In contrast, the narrowing interest-rate differential between Australia and the US points to downside pressure for the Australian dollar. We expect the Federal Reserve to raise official interest rates by 50 basis points this year, although this is largely factored in by financial markets.
- The US dollar and how markets react to Trump's policies and the Federal Reserve will also be a major influence on the Australian dollar. This will be an important driver for currency markets; particularly given other fundamentals are providing mixed signals for the outlook.
- Our view that the US dollar will track sideways suggests that the Australian dollar will also end the year not far from current levels. We expect the AUD to end 2017 at 75 US cents.

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The election of Donald Trump to the US presidency has provided a major boost for the US dollar over the past few months. Expectations of increased infrastructure spending and tax cuts saw the US dollar index scale to its highest in almost 14 years. Nonetheless, the US dollar has since retreated as Trump failed to deliver any further details on these stimulus plans. Moreover, there are concerns that Trump's protectionist policies including high tariffs and restricting borders will weigh on economic growth.

The Australian dollar has moved inversely with the US dollar, falling to an intraday low of

US\$0.7160 on 24 December 2016, but rebounding over the past month to trade around 75-76 US cents on 1 February.

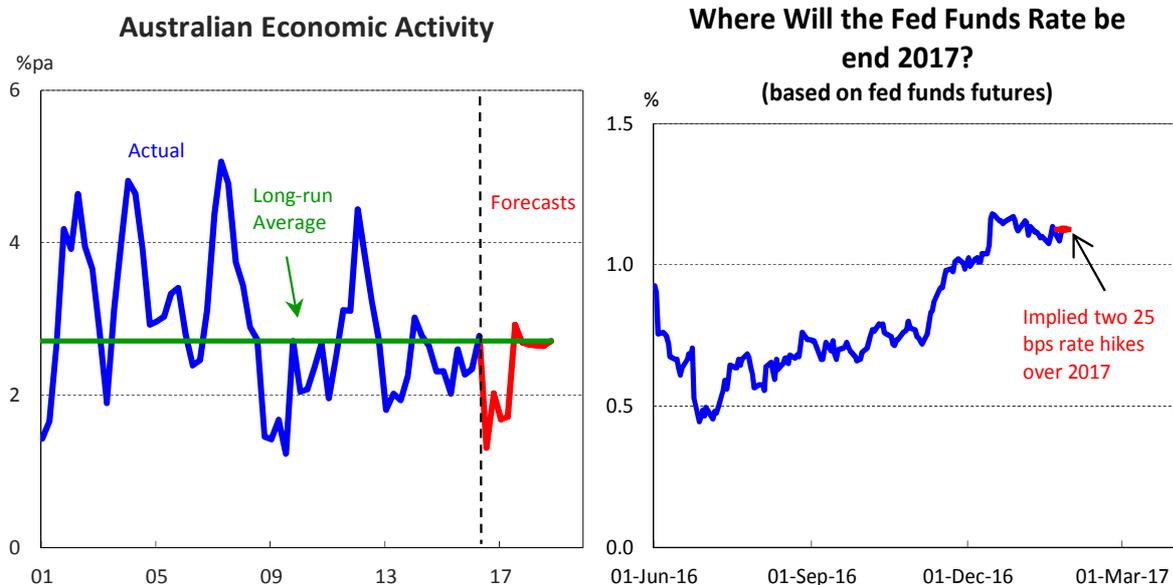
Trump, the Fed and the US Dollar

The election of Donald Trump to the US presidency saw a significant reaction in financial markets. Rhetoric from Trump has hinted at reducing company regulation, cutting taxes and ramping up infrastructure spending. Such policies would act to boost GDP growth, at least over the next couple of years, and have heightened expectations of higher inflation. Bond yields have increased sharply as a result, along with the US dollar.

Expectations that the Fed might need to raise official interest rates more quickly than previously expected have also been a factor in propping up the US dollar, and therefore placed downward pressure on the AUD.

While hope of fiscal stimulus and a faster pace of rate hikes by the Federal Reserve are providing significant support for the US dollar, a lot of optimism has been priced into markets. If the Federal Reserve raises official interest rates by 50 basis points in total in 2017 as expected, then there is unlikely to be a significant reaction to the currency. Fed funds futures are suggesting that markets are mostly pricing in a total of 50 basis points of hikes by the Fed. While we expect the USD to remain elevated, we do not expect the US dollar to rally much further from current levels. Indeed, the US dollar and bond yields have since retreated from their peaks suggesting that their earlier moves were overdone.

There is also a large amount of uncertainty to the extent that Trump's proposals will be enacted. Little detail on his policies has been provided and measures will need to be passed through Congress. This would suggest significant uncertainty around the impact on the US economy and the US dollar. Nonetheless, we expect the US dollar is likely to remain elevated against major currencies while the Federal Reserve continues to raise interest rates.



The Australian Economy and RBA Outlook

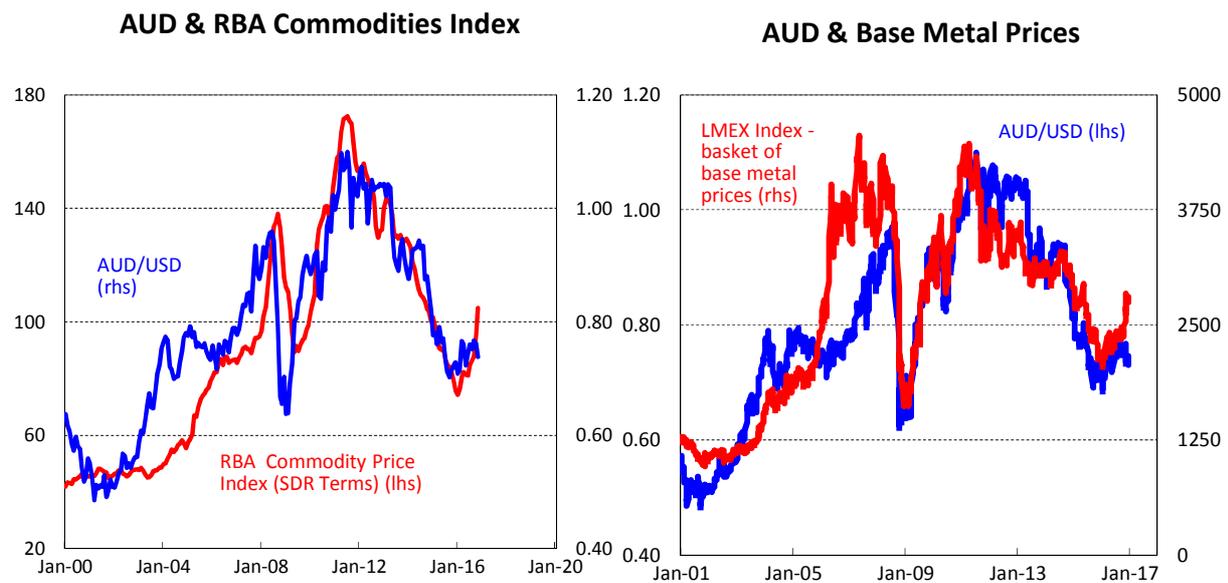
The other factor which will have a major influence on the currency is the outlook for the Australian economy and interest rates.

The Australian economy has been growing at just a modest pace while the unemployment rate

has tracked sideways over the past year. Inflation and wage growth has been subdued, and suggest that there exists spare capacity within the economy.

Without strong prospects of a pickup in the Australian economy to an above trend pace, official interest rates are likely to remain low. This suggests that if the RBA were to move rates this year, there is a greater risk that they will be lower than higher. Market pricing is suggesting just a small chance of a rate cut this year and even a slight chance of a hike by December. Therefore any shift towards an easing bias or a rate cut by the RBA would pose a downside risk for the AUD.

Ongoing low interest rates in Australia and rising interest rates in the US would suggest that the interest-rate differential between Australia and the US will likely continue to widen. This widening points to downside risk for the Australian dollar.



Commodity Prices and China

A rebound in commodity prices has been a key support for the Australian dollar over the past few months. Commodity prices have risen significantly over recent months, particularly prices of coal, iron ore and metals. Monetary and fiscal stimulus in China has boosted growth and demand for commodities. At the same time, there have been some measures to cut excess capacity, particularly in the production of steel and coal. There has also been a more speculative activity in China, as investors seek alternative assets outside of the stock market and real estate. This speculative activity could help explain a lift in volatility over recent months.

However, we are unlikely to witness a surge in global commodity demand. The IMF is expecting growth to pick up in 2017 and 2018 to 3.4% and 3.6%, respectively, after estimated growth of 3.1% in 2016. A key factor behind this improvement reflects expectations there will continue to be stimulus supporting growth in China. Nonetheless, rapid credit growth remains a key downside risk, as high debt levels can weigh on the economy. There have recently been measures to curb housing market activity, which could weigh on construction and demand for raw materials.

On the supply-side, bulk commodity producers, especially in Australia, have the ability to increase production if prices continue to lift. Moreover, high prices may encourage Chinese authorities to restart idle capacity. Authorities have already temporarily relaxed their policy to limit Chinese coal output.

Other commodities, such as oil, also face uncertainty. The outlook for oil prices will depend on whether OPEC will successfully curb output. However, US shale producers have the ability to ramp up output particularly if prices lift from current levels.

Higher commodity prices are likely providing the AUD with support, but the AUD appears to be trading much lower than what commodity prices are currently suggesting (see charts above page 3). It appears that the Australian dollar has “decoupled” from commodity prices. This divergence between commodity prices and the AUD might reflect that financial markets are already anticipating that commodity prices will reverse their gains. Consensus forecasts are suggesting iron ore prices will fall to US\$40-60 a tonne by the end of 2017, far below the current price of US\$83 a tonne. Moreover, nearly all contributors to the survey are expecting a decline in prices. There is a similar story for coal prices. Consensus forecasts for coking coal prices are at US\$130 a tonne for the end 2017 in comparison to the current price of US\$170. This could imply that the AUD may not necessarily come under much downward pressure should commodity prices retreat. That said, there is significant uncertainty around the outlook for commodity prices. However, we do not expect that commodity prices will revisit the unsustainable lows that they hit in January.

Australian Dollar Outlook

Key fundamentals for the AUD are providing mixed signals for the outlook. The narrowing interest-rate differential between Australia and the US point to downside risks for the Australian dollar. However, resilient commodity prices could provide support and, in our view, a modest fall in commodity prices may not necessarily bring down the Australian dollar. Indeed, a pullback in coal prices since December appears to have had limited impact on the Australian dollar’s value in recent months.

Commodity prices have tended to be better predictor of the AUD over the long-term. While we expect commodity prices will undergo some further declines over the medium term, a modest decline in prices could still be consistent with an Australian dollar trading close within the 75-80 US cent range.

The US dollar and how markets react to Trump’s policies and the Federal Reserve will also be a major influence on the Australian dollar. In our view, this will be an important driver for currency markets, particularly given other fundamentals are providing mixed signals for the outlook.

As discussed, we expect the US dollar to remain elevated given our expectation that the Federal Reserve will continue to raise official interest rates. However, given at least two rate hikes appear to be priced into financial markets, we think that further significant appreciation in the US dollar is limited. Fiscal stimulus from Trump could provide the US dollar with support, but this is likely to be outweighed by Trump’s protectionist agenda and the unpredictability of Trump’s policies are likely to weigh on risk appetites and therefore the AUD.

On balance, we think that the US dollar index will mostly track sideways over the course of the year, notwithstanding some volatility in between. This would suggest that the Australian dollar will also end the year not far from current levels. We expect the AUD to end 2017 at 75 US cents.

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Please see detailed forecasts on following page

EXCHANGE RATE FORECASTS

End Quarter Forecasts

	Mar-17	Jun-17	Sep-17	Dec-17
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USD Exchange Rates

AUD-USD	0.7400	0.7500	0.7500	0.7500
USD-JPY	113.00	113.00	112.00	112.00
EUR-USD	1.0600	1.0600	1.0700	1.0700
GBP-USD	1.2500	1.2800	1.2800	1.3000
USD-CHF	1.0100	1.0100	1.0000	1.0000
USD-CAD	1.3400	1.3400	1.3300	1.3300
NZD-USD	0.7000	0.7100	0.7100	0.7200
USD-CNY	6.9000	6.9000	6.8000	6.8000
USD-SGD	1.4200	1.4200	1.4100	1.4100

AUD Exchange Rates

AUD-USD	0.7400	0.7500	0.7500	0.7500
AUD-EUR	0.6980	0.7080	0.7010	0.7010
AUD-JPY	83.60	84.80	84.00	84.00
AUD-GBP	0.5920	0.5859	0.5859	0.5769
AUD-CHF	0.7470	0.7580	0.7500	0.7500
AUD-CAD	0.9920	1.0050	0.9980	0.9980
AUD-NZD	1.0570	1.0560	1.0560	1.0420
AUD-CNY	5.1060	5.1750	5.1000	5.1000
AUD-SGD	1.0510	1.0650	1.0580	1.0580

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

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