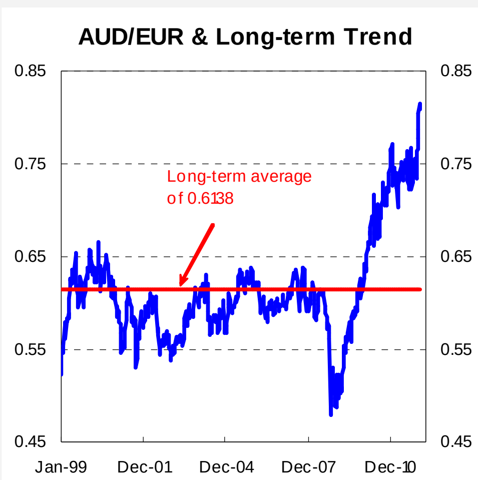
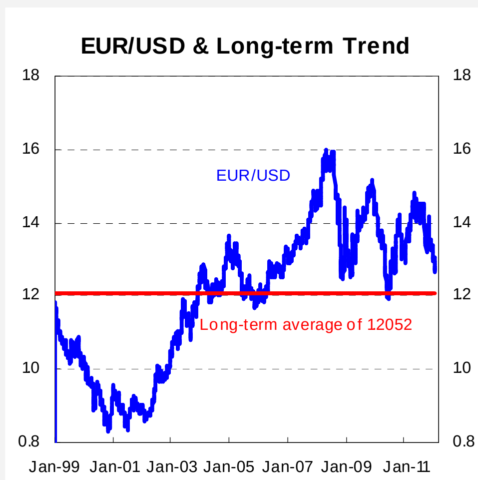
AUD-EUR OUTLOOK

Risk Appetite is the Key

Wednesday, 25 January 2012

- **The Australian dollar has recently soared to record highs against the euro, reflecting heightened concerns about European sovereign risk, political uncertainty and weak economic growth.**
- **We expect the euro to continue its downward trend against the US dollar over most of this year, reflecting relatively weaker prospects for growth in Europe.**
- **The AUD/EUR could potentially reach new highs, but relies on risk appetite staying buoyant. There remain risks to the global economy, which could place downward pressure on the Australian dollar as risk aversion rises.**
- **Having said that, we still expect the AUD/EUR to trade higher than historically is the case.**
- **Currency markets are, however, likely to remain quite volatile as uncertainty over a comprehensive solution in Europe remains. It means forecasts are subject to greater variability than usual.**





The Australian dollar has recently soared to record highs against the euro, touching as high as 0.8177 on 17 January. The Australian dollar's recent relative strength to the euro reflects heightened concerns about European sovereign risk, political uncertainty and weak growth.

It has largely been a story of euro weakness; the euro fell to its lowest in almost 17 months against the US dollar on 13 January of 1.2624 and is currently trading near 1.3000. We think that the euro will continue its downward trend against the greenback, reflecting relatively weaker prospects for growth in Europe.

This suggests that AUD/EUR could move higher over the short-term, but there are risks AUD/EUR won't remain at elevated levels (near 82.00) for long. Indeed, it has pulled back from these heights more recently. Any deepening of European worries could place downward pressure on the Australian dollar as risk aversion rises and the global growth outlook darkens. There is also a risk that US economic data could begin to disappoint once again.

Having said that, we still believe that the AUD/EUR will continue to trade higher than historically is the case (see chart above left). It can likely, on average, hold above 0.7500 in coming months, although volatility will be high.

The Australian dollar's relative strength reflects relatively strong fundamentals, including the relative health of the Australian economy, its high terms of trade, links with Asia, Australia's triple-A sovereign rating and relatively high interest rates.

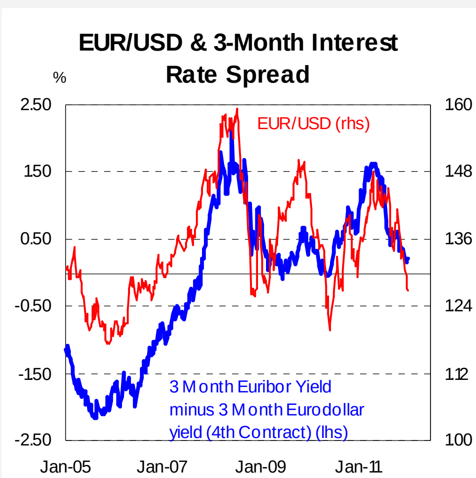
Euro Weakness to Continue

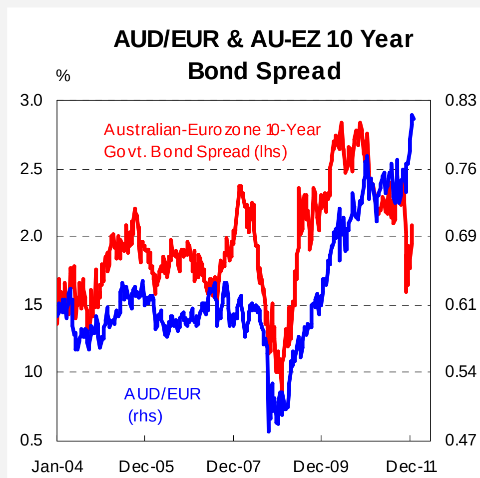
Since hitting a peak of 1.4902 on 2 May 2011, the euro has fallen around 19 cents against the US dollar. The challenges for the Euro zone that remain suggest there is potential further downside for the EUR/USD.

The US economy is expected to show continued signs of improvement in the first half of 2011, although it will not be immune to further woes from Europe. Fiscal policy in the US is also a key risk to the US economic outlook. We expect a slight improvement in US growth this year, but growth is likely to stay below trend. This suggests interest rates are likely to remain at low levels (close to zero) at least for the remainder of 2012.

Nonetheless, prospects for the US remain comparatively better than for Europe. We expect a recession in Europe, as tighter credit, austerity measures and subdued confidence weigh on economic growth.

The significant downside risks to growth have heightened expectations of lower interest rates in Europe this year. The European Central Bank (ECB) might also eventually need to embark on some form of quantitative easing (unsterilised bond purchases). Further interest rate cuts by the European Central Bank (ECB) this year will lead to a narrowing of European-US interest rate differentials. EUR/USD follows closely with this differential (refer to left hand chart below).

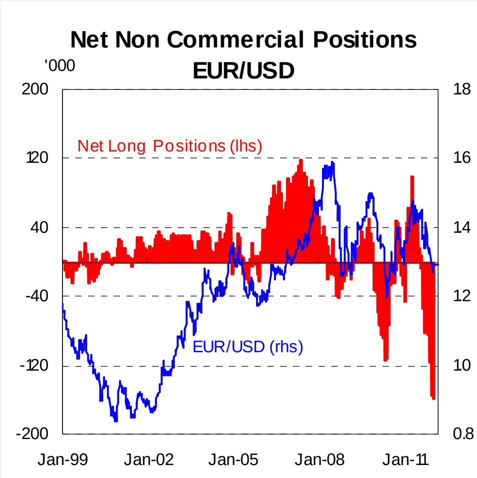


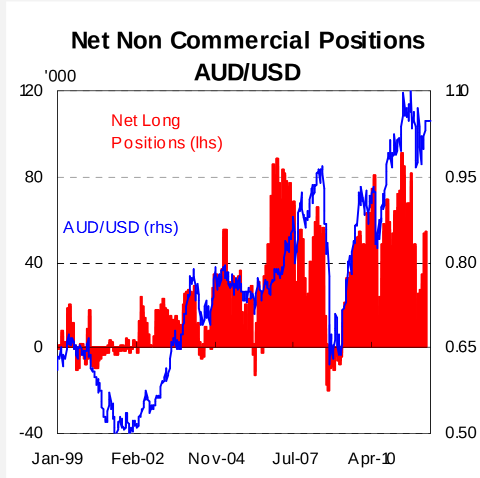


Uncertainty to Remain

A comprehensive solution from Europe remains elusive and is heightening concerns about the region and the euro itself. We remain pessimistic about the overall outcome from Europe, but we believe that a break-up of the Euro zone or a collapse of the euro currency is not the most likely scenario. Current pricing of the euro however, likely reflects these risks.

Any steps in arriving at a comprehensive solution should provide support to the euro. However, weak growth and loose monetary policy in Europe will likely be overwhelming factors keeping the euro under downward pressure over the course of this year.





Net speculative positions on the euro against the US dollar had their largest net short positions on record. Further, a large amount of net long positions for the Australian dollar against the US dollar implies a high level of long AUD/EUR speculative positions. These large positions could continue, although it is more likely that we will see a pullback as is usual when these extreme positions are reached.

There are relatively strong fundamentals supporting the Australian dollar compared with the euro. These include the relative health of the Australian economy, Australia's high terms of trade, its close links with Asia, its triple-A sovereign rating and relatively high interest rates.

- Economic Growth

Economic growth in Australia is expected to continue to accelerate as we progress through this year as the business investment upswing deepens. Meanwhile, a recession is on the cards for Europe. Australia is not immune to developments in Europe and the global economy, but it is relatively well placed to withstand the adverse events given its healthy banking sector and strong fiscal position. Further, Australia has relatively limited direct trade with Europe and the direct exposures to troubled European debt are small.

- Interest Rates

Relatively higher interest rates in Australia are also supportive of the AUD/EUR. The Reserve Bank of Australia (RBA) is widely expected to cut the cash rate further. We expect 50 basis points worth of cuts this year, slightly more than consensus, but it still leaves rates attractive in comparison to other advanced economies including Europe.

The RBA cut rates as low as 3.00% during the Global Financial Crisis (GFC). While a GFC-like event cannot be ruled out, it is not our core view. Further, these lows reached during the GFC remain much lower than the current interest rate settings in Europe with the main refinancing rate (Europe's equivalent cash rate) at 1.00%. Consensus is expecting at least one more 25bps rate cut from the ECB this year.

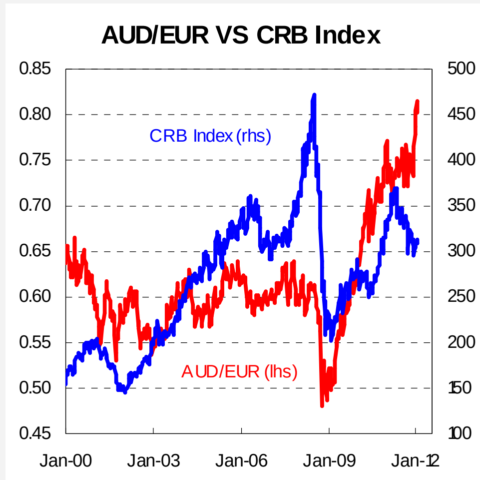
These rate expectations are reflected in the 2-year bond yields for Australian and European government bonds. The spread between Australian and European 2-year government bonds has narrowed since around April last year (see above page 2 chart right), but AUD/EUR has trended higher over this time. Prior to April, the AUD/EUR has tended to follow the 2-year spread closely. This might suggest that AUD/EUR is overbought, but the divergence in part likely reflects strong demand for safe-haven assets including Australian government bonds.

As a result of the problems in Europe and these relatively stronger fundamentals in Australia, money market funds in the US are shifting their investments away from European banks to Australian, Canadian and Japanese banks.

- Sovereign Ratings

Australia maintains the top-notch sovereign credit rating from all three major credit ratings agencies (Standard & Poor's, Moody's and Fitch), one of only twelve countries in the world.

In an environment where the fiscal positions of governments around the world are being scrutinised (predominantly Europe), Australian securities are looking very attractive for international investors, and are another supportive factor for the Australian dollar.



- Commodity Prices

AUD/EUR has tended to track commodity prices, namely the CRB index (see chart left). The CRB index has weakened since April last year, reflecting heightened concerns about the prospects for global growth. Softening commodity prices suggests there is limited upside for the AUD/EUR. But given they remain at high levels compared with history, AUD/EUR is likely to stay at high levels.

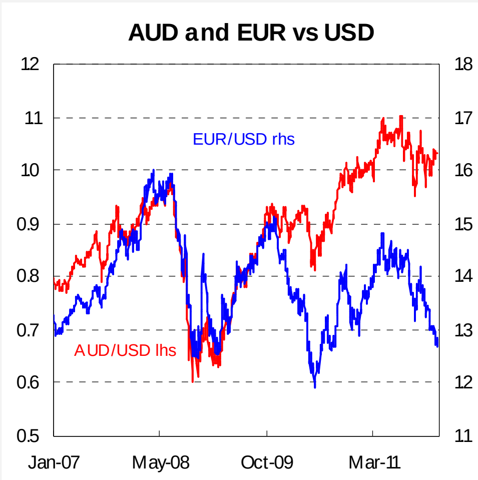
- Risk Appetite

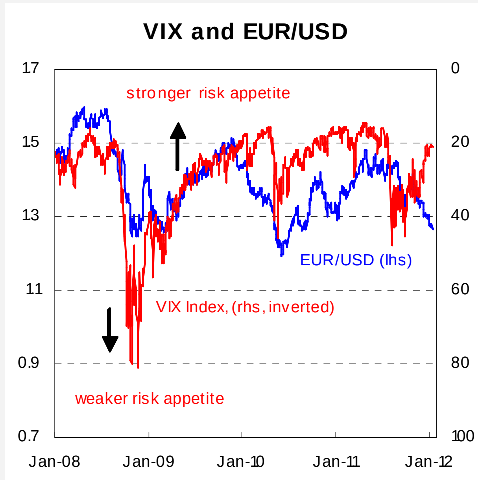
The Australian dollar has tended to follow in tandem with the euro against the greenback, but AUD and EUR has recently diverged (see chart below left). The Australian dollar has held up well, while the euro has continued its decline, driving the AUD/EUR to record highs. A key reason for this has been that risk appetite has lifted despite Euro zone worries persisting.

The Australian dollar generally moves closely with risk appetite or investor sentiment. Sentiment has recently held up in part because the run of US economic data that has surprised on the upside. The more positive news from the US has supported risk appetite offsetting the ongoing troubles in the Euro zone.

Despite some progress in addressing some issues in Europe, significant downside risks remain. We see a risk that investor sentiment could respond once again to these downside risks for the global economy and drag the AUD lower.

The greater the troubles deepen for the Euro zone and the global economy, the greater the downside for the Aussie dollar. A much deeper recession in Europe will have implications for the broader global economy, and more than likely put downward pressure on the Australian dollar as well given it is seen as a barometer of global growth.





Forecasts

We expect that the euro is likely to continue its downward trend against the US dollar over most of this year as problems in Europe continue, and the ECB eases monetary policy. Further, given growth prospects are relatively firmer in the US, the Fed will likely start looking to tighten monetary policy before the ECB, although this will be some time away.

The AUD/EUR could reach new highs, but any further rally for the Aussie against the euro will also depend on risk appetite staying buoyant. In our opinion, there remain vulnerabilities in the US economy and there is a strong likelihood concerns in Europe will flare up again and weigh on sentiment.

We still expect the AUD/EUR to remain higher than historically is the case, reflecting relatively strong fundamentals. Our end June and end of year forecasts for AUD/EUR are 0.8000 and 0.7970, respectively. (Our other forecasts are located on the following page). Currency markets are, however, likely to remain quite volatile as uncertainty over a comprehensive solution in Europe remains. It means forecasts are subject to greater variability than usual.

Janu Chan, Economist
Ph: (02) 9320-5892
Email: chanj@stgeorge.com.au

EXCHANGE RATE FORECASTS

	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
USD Exchange Rates							
AUD-USD	1.0209	1.0100	1.0000	1.0100	1.0200	1.0300	1.0300
USD-JPY	76.910	78.000	79.000	80.000	82.000	82.000	83.000
EUR-USD	1.2961	1.2600	1.2500	1.2600	1.2800	1.2900	1.3000
GBP-USD	1.5543	1.5200	1.5100	1.5200	1.5400	1.5600	1.5800
USD-CHF	0.9381	0.9400	0.9600	0.9700	0.9800	1.0000	1.0100
USD-CAD	1.0213	1.0200	1.0200	1.0100	1.0000	1.0000	1.0000
NZD-USD	0.7772	0.7700	0.7600	0.7800	0.8000	0.8100	0.8200
USD-CNY	6.2949	6.2400	6.1800	6.1200	6.0600	6.0200	5.9900
USD-SGD	1.2966	1.2900	1.3000	1.2900	1.2600	1.2500	1.2500
AUD Exchange Rates							
AUD-USD	1.0209	1.0100	1.0000	1.0100	1.0200	1.0300	1.0300
AUD-EUR	0.7880	0.8020	0.8000	0.8020	0.7970	0.7980	0.7920
AUD-JPY	78.50	78.80	79.00	80.80	83.60	84.50	85.50
AUD-GBP	0.6570	0.6640	0.6620	0.6640	0.6620	0.6600	0.6520
AUD-CHF	0.9580	0.9490	0.9600	0.9800	1.0000	1.0300	1.0400
AUD-CAD	1.0430	1.0300	1.0200	1.0200	1.0200	1.0300	1.0300
AUD-NZD	1.3140	1.3120	1.3160	1.2950	1.2750	1.2720	1.2560
AUD-CNY	6.4260	6.3020	6.1800	6.1810	6.1810	6.2010	6.1700
AUD-SGD	1.3240	1.3030	1.3000	1.3030	1.2850	1.2880	1.2880

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

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**
State Manager SA	**Mark Goldsmith**	**goldsmithm@banksa.com.au**	**(08) 8424 5597**