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AUD Outlook

Friday, 17 March 2016

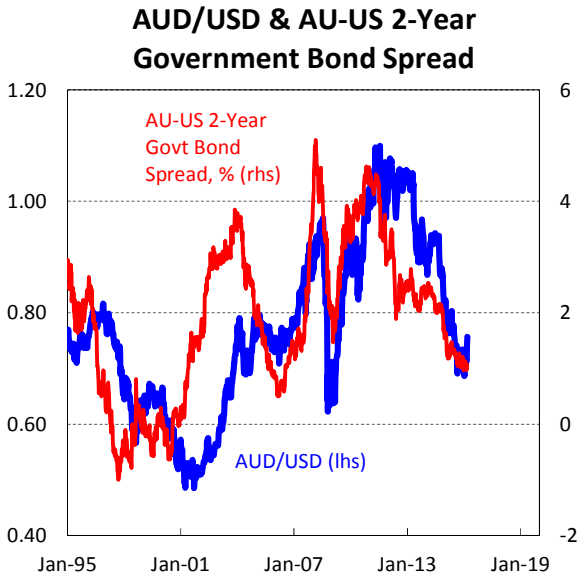
- **After a sharp slide in the first few of weeks of this year, the Australian dollar has rebounded nearly eight cents over a short two-month period.**
- **In our opinion, the AUD is vulnerable to a sell-off over the next few months. While we maintain that some of the concerns regarding the Australian economy and the outlook for China were overdone at the turn of the year, we think that sentiment has now shifted too far and too quickly the other way.**
- **Nonetheless, at the same time, a number of downside risks for the Australian dollar have eased. We are more assured that the bottom in commodity prices has passed, and concerns over China have lessened, at least over the near-term. A slower path of rate hikes by the Federal Reserve also limits the prospects of US dollar appreciation.**
- **Given that challenges remain for the world economy, there is a risk that concerns over China and the global economy could lift, and turmoil in financial markets could once again escalate. This could result in further volatility in currency markets and the Australian dollar.**
- **On balance, we continue to expect the AUD should trade close to the low-to-mid 70 US cent range for the remainder of the year.**
- **Our mid-year AUD forecast has been revised higher to US$0.72, largely reflecting an easing in risk aversion and a higher starting point for commodity prices. However, we are maintaining our forecast of US$0.74 for the end of 2016.**

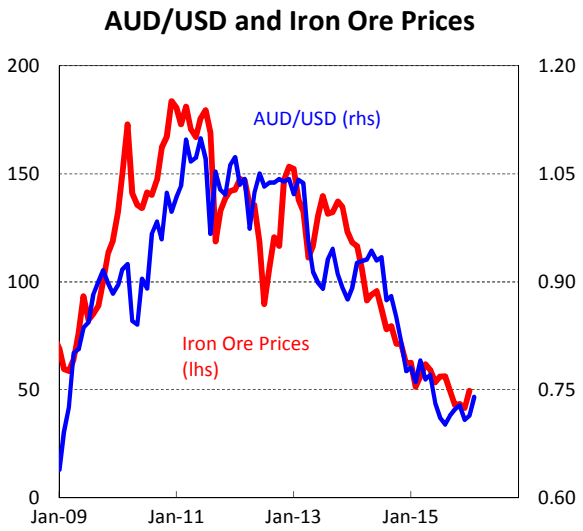
Where We've Been

After plunging to a seven-year low of US$0.6827 on 16 January, the Australian dollar has rallied nearly eight cents in two months and hit an 8½-month high this morning of US$0.7657. The extent and speed of the AUD's appreciation has caught many, including ourselves by surprise - the AUD has already surpassed our end of year target of 74 US cents.

A number of factors have contributed to the Australian dollar's ascent. These include:

- Stronger-than-expected performance in the Australian economy
- A rebound in commodity prices
- An easing in concerns over China
- A recovery in risk appetite
- A slower-than-expected path of rate hikes from the Federal Reserve





Where Are We Going?

In our opinion, the AUD is vulnerable to a further sell-off over the next few months. While we maintain that some of the concerns regarding the Australian economy and the outlook for China were overdone at the turn of the year, we think that sentiment has now shifted too far and too quickly the other way.

Nonetheless, at the same time, a number of downside risks for the Australian dollar have eased. We are more assured that the bottom in commodity prices has likely passed. Further, the high growth target set by Chinese authorities along with their intention to prioritise short-term stimulus over extensive reform, should continue to support global demand and therefore the AUD, at least in the near to medium-term. There is also less pressure for the USD to appreciate as the Federal Reserve has signalled it will be more cautious in raising official interest rates. These factors have offset ongoing concerns regarding the medium-term outlook for the domestic economy which will continue to be weighed down by weak business investment.

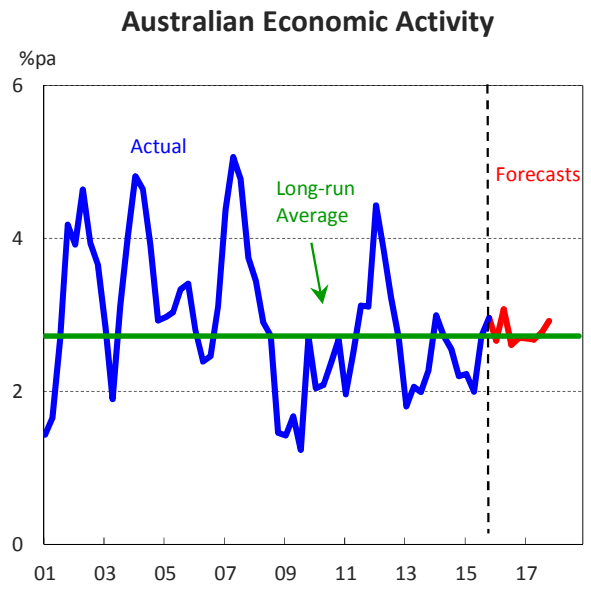
We have upgraded our end June AUD forecast from US$0.70 cents to US$0.72, but are maintaining our forecast of US$0.74 for the end of 2016. We examine some of the drivers behind our forecasts below.

The Australian Economy – Showing Resilience

The Australian economy performed remarkably well over the second half of 2015. There was firmer evidence that non-mining sectors were recovering. Moreover, despite the large drag on economic growth from falling mining investment, the economy grew at a relatively healthy pace and the unemployment rate fell from a peak of 6.3% in July to 5.8% in February.

However, there remain challenges for the Australian economy, which could become more apparent in upcoming data. Declining mining investment will continue to weigh on economic growth, and a recovery in non-mining investment is lacking. Income growth is weak, and could constrain consumer spending growth in months ahead. Further, the strength in the labour market witnessed towards the end of last year is unlikely to be sustained. That said, we continue to expect the Australian economy will grow moderately at a pace close to trend at 2.8% for 2016, and for the unemployment rate to remain steady over most of this year. Evidence that the non-

mining sectors of the economy are recovering is a major positive. However, we may not see growth picking up to an above trend pace until well into 2017 or even in 2018.



Interest Rates – Steady On

Our expectations for growth and employment support our long-held view for the RBA to keep rates on hold for all of this year. However, the RBA may not begin raising rates until well into 2017 given that growth may not pickup to an above-trend pace for some time.

Markets are still pricing in a relatively high chance of an RBA rate cut by the end of the year, although pricing is not as misaligned with our cash rate expectations as in the past. Markets are pricing in a 68% probability of a 25 basis point rate cut by December, but this is down from the above 80% chance recorded in early March.

Despite the Australian economy's relatively healthy performance, lingering challenges may keep the chances of a rate cut alive, and place a cap on any AUD appreciation. Some risk of an easing remains intact given inflation remains low, and the RBA is keeping the door open for further monetary easing.

China & Commodity Prices – Pessimism/Optimism Overdone?

A major factor helping to support the Australian dollar has been some easing of concerns over China and a rebound in commodity prices. We have indicated in our previous commentary that the pessimism regarding the Chinese economy and commodity prices in earlier months was overdone. However, we believe that sentiment may have shifted too far the other way.

This shift in sentiment is reflected in a rebound in commodity prices. The broad CRB index has risen 14.6% from its lows in February. Iron ore prices lifted from a low of US$38.30 a tonne on 11 December 2015 to a high of US$63.74 on 7 March (a 66.4% increase).

While a stronger Chinese growth is a positive for the near-term global growth outlook and supportive for the Australian dollar, the fiscal and monetary stimulus measures in order to achieve its growth target this year will do little to resolve some of the challenges that have faced

China in recent years. Indeed, it could prolong the concerns over high debt levels among the corporate and government sectors. There will also continue to be uncertainty regarding the ability of authorities to liberalise financial markets, particularly its currency market. Loose monetary policy could add pressure for capital outflows and/or further devaluation of the yuan.

The issues listed above raise the question of whether the reform agenda adopted by the Chinese authorities has been put aside for the sake of meeting its short-term goal of a growth target.

There are also questions about whether the recent jump in commodity prices is sustainable. Indeed, the lift in iron ore prices was despite still weak steel demand and buoyant global supply.

That said, we believe the recent lows in prices of commodities were at unsustainable levels. While strong growth in supply, particularly for iron ore, suggests a pullback in prices is likely, we believe the low point in this cycle for the prices of most commodities is now behind us.

Don't Forget the Other Central Banks

Another factor that is influencing the currency is the outlook for the Federal Reserve. The Fed has recently signalled that it will embark on a very gradual path of monetary policy tightening and more gradual than previously indicated. While we still expect the Fed will raise interest rates this year, we have scaled back our expectation regarding the pace of hikes and expect at a maximum two 25 basis point hikes this year. This should still give the US dollar support, particularly later this year when expectations of tightening will likely mount. However, we think that the US dollar index (US dollar in trade weighted terms) is very unlikely to scale the heights witnessed earlier in the year. In other words, further USD appreciation will be limited. That could further confirm that we will not revisit recent lows in commodity prices and the Australian dollar.

Other central banks around the world continue to be more inclined to monetary policy easing including the European Central Bank and the Bank of Japan. Further easing offshore would encourage flows to Australia where interest rates are relatively high.

Volatility – Still Hanging Around Like a Bad Smell

Given that challenges remain for the world economy, there is a risk that concerns over China and the global economy could lift, and turmoil in financial markets could once again escalate. Turmoil in financial markets could be triggered by the Fed if it becomes apparent it will raise interest rates later in the year. This could result in further volatility in currency markets and the Australian dollar. A possible re-emergence of these concerns continues to pose downside risk to our forecast.

Summary

The key themes as presented in our previous Australian dollar outlook still stand. We expect the AUD should trade close to the low-to-mid 70 US cent range for the remainder of the year, although a re-escalation of risk aversion and heightened financial market turmoil could keep the Australian dollar volatile. That said, we do not believe the AUD will sustain below 70 US cents. But likewise, we do not expect the AUD to sustain a rally to the high 70s over the medium term.

The Australian economy is performing reasonably well given current circumstances, but a sustained pickup in growth is not anticipated for some time. Additionally, there remain some challenges for the Chinese economy even though economic growth this year will likely be another strong outcome. However, we are more confident that the low in the prices of most commodities

are also behind us.

Finally, the Federal Reserve is expected to raise interest rates this year, which would provide the US dollar with support and weigh on the AUD. However, monetary policy stimulus elsewhere around the world will keep the AUD well-bid.

We have slightly revised our mid-year AUD forecast higher to US$0.72 largely reflecting an easing in risk aversion and a higher starting point for commodity prices. However, we have maintained our end of year forecast of US$0.74 US cents.

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Please see detailed forecasts on following page

EXCHANGE RATE FORECASTS

	End Quarter Forecasts			
	Mar-16	Jun-16	Sep-16	Dec-16
USD Exchange Rates				
AUD-USD	0.7400	0.7200	0.7200	0.7400
USD-JPY	113.00	116.00	118.00	118.00
EUR-USD	1.1200	1.1000	1.0800	1.0800
GBP-USD	1.4200	1.4700	1.4800	1.5000
USD-CHF	0.9800	0.9900	1.0000	1.0000
USD-CAD	1.3100	1.3500	1.3500	1.3300
NZD-USD	0.6700	0.6500	0.6600	0.6800
USD-CNY	6.5000	6.5500	6.6000	6.6000
USD-SGD	1.3700	1.4000	1.4200	1.4200
AUD Exchange Rates				
AUD-USD	0.7400	0.7200	0.7200	0.7400
AUD-EUR	0.6610	0.6550	0.6670	0.6850
AUD-JPY	83.60	83.50	85.00	87.30
AUD-GBP	0.5211	0.4898	0.4865	0.4933
AUD-CHF	0.7250	0.7130	0.7200	0.7400
AUD-CAD	0.9690	0.9720	0.9720	0.9840
AUD-NZD	1.1040	1.1080	1.0910	1.0880
AUD-CNY	4.8100	4.7160	4.7520	4.8840
AUD-SGD	1.0140	1.0080	1.0220	1.0510

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

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