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Thursday, 12 July 2018

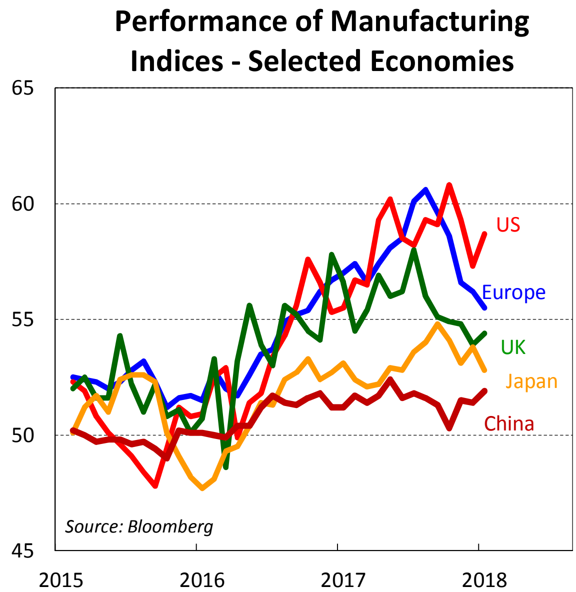
Australian Dollar Outlook

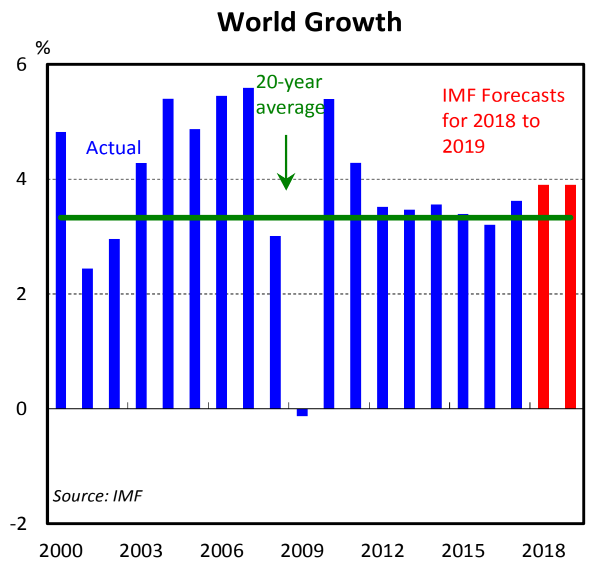
Uncertainty Creeps In

- **A multitude of factors have placed downward pressure on the Australian dollar in recent months. These include a lift in downside risks to global growth, particularly with rising global trade tensions. In addition, there has been an overall escalation of risk aversion in financial markets.**
- **We see a great deal of uncertainty surrounding the outlook for the Australian dollar. Key fundamentals, commodity prices and interest rates, are not providing a clear gauge on the direction of the AUD. Moreover, the inclination for US President Trump to backflip on policies suggests that there is significant uncertainty to the global economy and, therefore, the Australian dollar outlook.**
- **There has been a clear shift in the way financial markets are reacting to information since the turn of the year. Over 2018, the relationship between commodity prices and the Australian dollar has broken down somewhat. A likely explanation for this breakdown is a shakeup in financial market sentiment, increased attention on inflation and concern over rising interest rates. In a risk-averse environment, the Australian dollar tends to come under downward pressure.**
- **Additionally, the widening interest-rate differential between Australia and the US, which has posed a downside risk for some years, might be now having more of an impact in pressuring the Australian dollar lower. The US economy is also once again a standout in the world and performing relatively strongly in comparison to other economies. This comparative strength has assisted in propping up the US dollar against other major currencies.**
- **A key question for the currency outlook is whether some of the recent drivers bringing down the Australian dollar have a longer-lasting impact.**
- **Given that uncertainty surrounding global trade negotiations is likely to persist for some time and given that we do not expect the risk aversion in financial markets to subside substantially over the near term, we have downgraded our Australian dollar forecasts.**
- **We now expect the Australian dollar to end 2018 at 74 US cents and end 2019 at 76 US cents.**

A multitude of factors have placed downward pressure on the Australian dollar in recent months. These include a lift in downside risks to global growth, particularly with rising global trade tensions. In addition, there has been an overall escalation of risk aversion in financial markets and some concerns about inflation, particularly in the US. The US federal funds target rate also moved above the Australian cash rate on June 14 for the first time since late 2000. It begs the question of what interest-rate differentials mean for the AUD outlook.

These factors points to an increased downside risk for the Australian dollar. We examine these risks and assess the implications for our currency forecasts.





Is the Global Economy Still on Track?

Indicators on global economic activity are suggesting some easing in momentum, but are still pointing to a relatively firm expansion. The IMF is expecting global growth of 3.9% in 2018 and 2019, although consensus forecasts are expecting slightly slower growth of 3.8% and 3.7%, respectively.

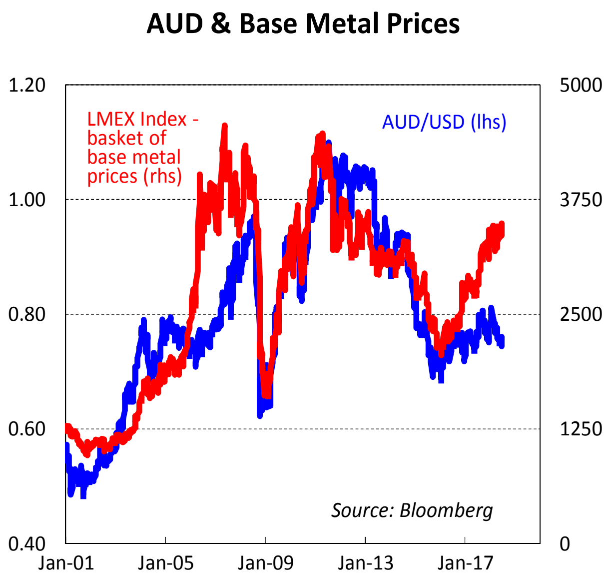
Escalating trade tensions between the US and other parts of the world has posed a downside risk for the global economy.

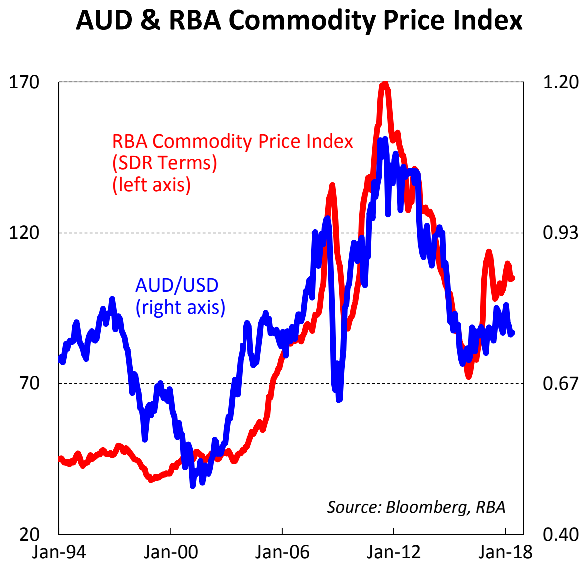
While the tariffs themselves may not have a significant direct impact on economic growth, the tensions have raised uncertainty for businesses around the world. Further, there is a risk that the dispute could become prolonged or take a turn for the worse.

The uncertainty over trade has the potential to dampen confidence and dent the recovery underway in the global economy.

Commodity Prices

Commodity prices have recently come under some downward pressure as a result of recent trade tensions and the downturn in financial market sentiment. Nonetheless, prices of most commodities have held up reasonably well, and prices of some commodities, such as oil, have trended upwards over recent months. Indeed, the outlook for commodity prices provides some upside risk to the Australian dollar. That being said, the relationship between commodity prices and the Australian dollar has broken down somewhat since the beginning of this year. While this relationship could reassert itself overtime, this divergence suggests that other factors are currently keeping the AUD under downward pressure in the near term. Moreover, trade tensions suggest downside risk to global growth and, therefore, demand for commodities.





Is the Yield Differential Back in Play?

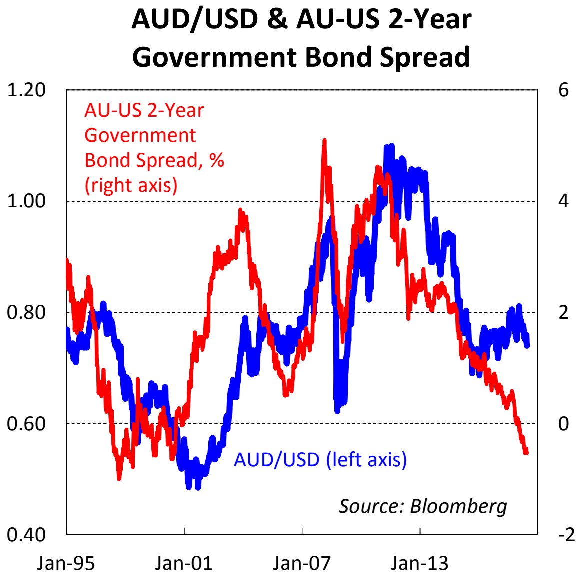
Another likely factor behind the recent Australian dollar depreciation and the resurgence in the US dollar has been concern over rising US government bond yields. The differential between US and Australian two-year government bond yields has been narrowing as a trend since early 2011, and has turned negative (US yields have exceeded Australian yields) since January 26 this year.

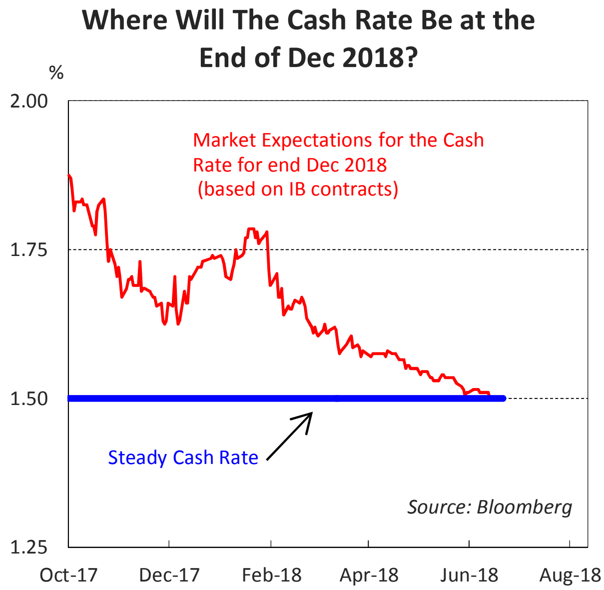
Additionally, the risk of rising inflation has come onto investors' radar. This is particularly the case for the US, where the labour market is becoming increasingly tight. A US unemployment rate of 3.8% suggests that wage inflation is at risk of picking up at a more rapid pace. Inflation has moved towards the Federal Reserve's 2% target. Nonetheless, we believe that there are structural factors keeping wages and inflation low and we do not expect that inflation will become a threat.

The Federal Reserve is still on track, however, to lift the Federal funds rate further this year.

The US economy has become a standout in the world economy. US economic growth has regained strength towards the June quarter of this year, while growth in other major economies, including Europe, China and Japan, has lost some momentum in the first half of this year. It has helped to lift the US dollar index to an eleven-month closing high of 95.31 on June 28.

In contrast, the RBA is not expected to lift official interest rates any time soon. The Australian economy is on course for growth at a little above trend. However, jobs growth has slowed since the turn of the year. The unemployment rate has held within the range of 5.4-5.6% for thirteen consecutive months, suggesting ongoing spare capacity within the labour market. It also suggests that wage growth or inflation is unlikely to pick up anytime soon. Financial markets have pushed out the timing for the first rate hike from the RBA significantly and suggest little chance of a rate hike by the end of this year, after being nearly fully priced in January 2018.





Risk Aversion Lingering

Since earlier in the year, risk aversion has crept back into financial markets. The US S&P500 index has been volatile ever since the index hit a record high on January 26 and has yet to revisit those highs. A key measure of equity market volatility (based on options), the SPX Volatility Index or VIX as it is commonly known, spiked to its highest since August 2015 in February. It has remained elevated relative to its below-average levels throughout 2017.

When financial markets become risk averse, the Australian dollar tends to come under downward pressure. A major factor behind the lift in risk aversion is the increased downside risks to the global outlook due to fears of a global trade war. However, there have been other factors which have kept markets on edge. These include geopolitical tensions, concern about rising bond yields, inflation and emerging markets. Ultimately, the withdrawal of monetary stimulus around the world may be preventing equity markets from scaling to new highs. Further, financial markets were probably due for a reappraisal of risk. In recent years, volatility has become unusually low in recent times and valuations in US equity markets had become stretched.

Conclusion

We see a great deal of uncertainty surrounding the outlook for the Australian dollar. Key fundamentals, commodity prices and interest rates, are not providing a clear gauge on the direction of the AUD. Moreover, the inclination for US President Trump to backflip on policies suggests that there is significant uncertainty to the global economy and, therefore, the Australian dollar outlook.

There has been a clear shift in the way financial markets are reacting to information since the turn of the year. Over 2018, the relationship between commodity prices and the Australian dollar has broken down somewhat. A likely explanation for this breakdown is a shakeup in financial market sentiment, increased attention on inflation and concern over rising interest rates. In a risk-averse environment, the Australian dollar tends to come under downward pressure.

Additionally, the widening interest-rate differential between Australia and the US, which has posed a downside risk for some years, might be now having more of an impact in pressuring the Australian dollar lower. The US economy is also once again a standout in the world and performing relatively strongly in comparison to other economies. This comparative strength has assisted in propping up the US dollar against other major currencies.

A key question for the currency outlook is whether some of the recent drivers bringing down the Australian dollar have a longer-lasting impact.

Given that uncertainty surrounding global trade negotiations is likely to persist for some time and given that we do not expect the risk aversion in financial markets to subside substantially over the near term, we have downgraded our Australian dollar forecasts.

We now expect the Australian dollar to end 2018 at 74 US cents and end 2019 at 76 US cents.

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Please see detailed forecasts on following page

EXCHANGE RATE FORECASTS

	End Quarter Forecasts						
	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
USD Exchange Rates							
AUD-USD	0.7405	0.7400	0.7400	0.7500	0.7500	0.7600	0.7600
USD-JPY	110.76	110.00	110.00	108.00	108.00	106.00	106.00
EUR-USD	1.1684	1.1800	1.1800	1.2000	1.2200	1.2400	1.2400
GBP-USD	1.3207	1.3200	1.3400	1.3400	1.3800	1.4000	1.4200
USD-CHF	0.9906	0.9900	0.9900	0.9800	0.9800	0.9700	0.9700
USD-CAD	1.3133	1.3100	1.3100	1.3000	1.2800	1.2600	1.2600
NZD-USD	0.6768	0.6800	0.6800	0.7500	0.7500	0.7500	0.7500
USD-CNY	6.6210	6.6000	6.6000	6.5000	6.5000	6.4000	6.4000
USD-SGD	1.3624	1.3600	1.3600	1.3500	1.3500	1.3400	1.3400
AUD Exchange Rates							
AUD-USD	0.7405	0.7400	0.7400	0.7500	0.7500	0.7600	0.7600
AUD-EUR	0.6340	0.6270	0.6270	0.6250	0.6150	0.6130	0.6130
AUD-JPY	82.00	81.40	81.40	81.00	81.00	80.60	80.60
AUD-GBP	0.5607	0.5606	0.5522	0.5597	0.5435	0.5430	0.5350
AUD-CHF	0.7340	0.7330	0.7330	0.7350	0.7350	0.7370	0.7370
AUD-CAD	0.9720	0.9690	0.9690	0.9750	0.9600	0.9580	0.9580
AUD-NZD	1.0940	1.0880	1.0880	1.0000	1.0000	1.0130	1.0130
AUD-CNY	4.9030	4.8840	4.8840	4.8750	4.8750	4.8640	4.8640
AUD-SGD	1.0090	1.0060	1.0060	1.0130	1.0130	1.0180	1.0180

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

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