AUD Outlook

Monday, 17 June 2013

BankSA

A Slippery Slope

- Having sat in the range USD 1.02-1.06 since July 2012 the AUD has broken out on the downside, falling around 7% since early May.
- Is this to be a repeat of the trading patterns seen in September-October 2011, November-December 2011 and May-June 2012 where the AUD fell from the 1.04 level down to 0.97 before moving back above parity? We suspect not.
- The factors that had pushed the AUD higher and helped it sustain those levels had been Australia's strong terms of trade (mostly from firm commodity prices), a positive interest rate differential with the US, our AAA credit rating, the effective debasement of the US currency via quantitative easing and finally a stronger pace of GDP growth.
- The RBA has noted for some time that the AUD has been relatively strong against the USD given the decline in our terms of trade (mostly commodity prices). Other things had been holding it up. With commodity prices now well off their peaks, the market has focused on potential changes in US quantitative easing.
- Quantitative easing was introduced by the US Federal Reserve as a mechanism to stimulate the US economy. The impact of effectively 'printing money' was to keep bond yields low and force capital to seek more productive uses. This policy would remain in place until the US economy showed signs of sustainable recovery.
- Of late, the US economy has been displaying signs of economic growth. Jobs are being created as cheap energy and relatively cheap labour are boosting manufacturing activity. With this growth, speculation has arisen that the US authorities will soon reduce the pace of quantitative easing. The phrase 'tapering QE' has become common. It is this speculation that appears to have triggered the selloff in the AUD.
- Other factors causing the AUD to move lower against the USD are concerns about the outlook for GDP growth in Australia, and expectations for further reductions in Australia's official cash rate. In addition, the spurt of central bank purchases seen in late 2012 and early 2013 appears to have lost momentum. Having already diversified their currency holdings they do not appear to be adding to them. Hedge funds, which were buyers of AUD in 2012 and early 2013 are also reported to have reduced their buying activity.
- With the AUD currently around US 95 cents what, if anything, will move it back to parity? Our AAA credit rating cannot improve. The official cash rate seems likely to edge lower in the months ahead. Our rate of GDP growth is now below trend and likely to soften while US GDP is expected to at least maintain its current pace. Our terms of trade are not expected to collapse but softer commodity prices are possible given increases in global supply in recent years.
- There remains significant uncertainty to the outlook, particularly surrounding the prospects for quantitative easing in the US. Therefore, we expect currency markets to continue to go through

a period of high volatility.

- However, given the above, the risks for the AUD appear to be on the down side. Our new target for the AUD against the USD for the end of 2013 is US 92 cents.

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