Monday, 29 January 2018

Australian Dollar Outlook

Still Backing the Bulls

- **After trading within the range of 0.7160-0.8124 over the course of 2017, the Australian dollar ended 2017 at 0.7801. It was right on our forecast of 78 US cents which we had in place since late July 2017.**

- **The improving global backdrop has translated to stronger prospects for demand in commodities, as reflected in higher commodity prices. This should continue to be a source of support for the Australian dollar over the course of this year.**

- **Another key support for the AUD has been weakness in the US dollar, which has continued to trend downwards since its peak in January 2017, as we had expected. Key to our weak US dollar view was the notion that the Federal Reserve is now no longer the sole major central bank in the world tightening monetary policy. We expect that as major central banks around the world begin or look to tighten policy, the downward trend in US dollar that has occurred since early 2017 could have further to run.**

- **We expect however, that the RBA will be less willing to increase official interest rates any time soon in comparison to other major central banks. The yield advantage of the Australian dollar over the US dollar is disappearing and should reverse in due course. As such, we think the trend appreciation in the Australian dollar will only be gradual.**

- **Nonetheless, the Australian economy has seen improvement, particularly with regards to the labour market. Along with the upswing in the global economy, these factors would suggest that the RBA is still moving closer towards the beginning of a rate hiking cycle, not away from it. Moreover, the US tightening cycle is well-underway and well-anticipated; three rate hikes by the Federal Reserve this year will hardly come as a surprise to currency markets.**

- **After rallying significantly over a short period of time, the Australian dollar may be due for a period of consolidation in the near-term. However, we expect the upward trend in the Australian dollar that began in early 2016 to continue. Predominantly reflecting a weaker US dollar profile, we are upgrading our AUD forecast for the end of 2018 from 82 to 84 cents.**

After trading within the range of 0.7160-0.8124 over the course of 2017, the Australian dollar ended 2017 at 0.7801 (according to Thompson Reuters). It was right on our forecast of 78 US cents which we had in place since 28 July 2017.

Since the turn of the year, the AUD has maintained its strength, and is currently trading at close to 81.1 US cents.

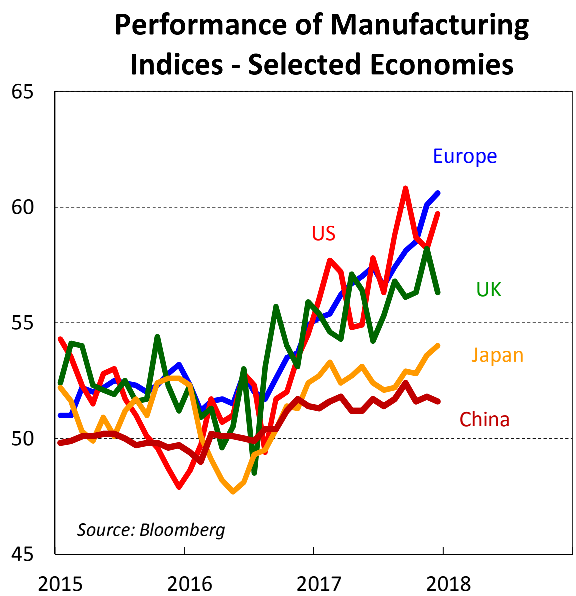
In our AUD Outlook entitled “Turning Points and Policy Shifts” published in July last year, we raised some key themes which remain relevant today and are continuing to provide support to the Australian dollar. These include an improving global and domestic outlook despite some ongoing challenges for the Australian economy. Importantly, we had expected the US dollar to continue its downward trend, which suggested that the AUD was unlikely to revisit the cyclical low below 70 US cents it hit in January 2016 in the near-term.

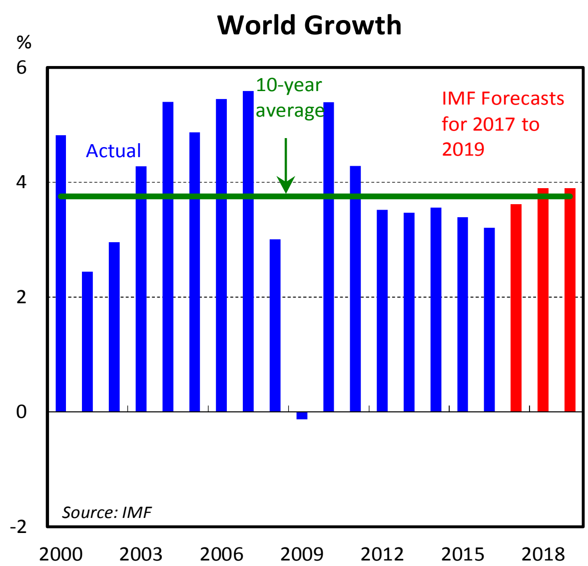
Following the US Federal Reserve

Key to our weak US dollar view is the notion that the Federal Reserve is now no longer the sole major central bank in the world tightening interest rates. The major factor behind the long-run rally in the US dollar between mid-2014 to early 2017 was the fact that the US Federal Reserve was alone in tightening monetary policy. Meanwhile other major central banks around the world were still considering further monetary stimulus. That policy divergence has continued to dissipate and the prospect of other central banks tightening or moving away from providing monetary stimulus has been a key policy shift in global financial markets. This shift has suggested to us that the US dollar index had most likely peaked in January 2017.

Since its most recent peak in January last year, the US dollar index has weakened over 13 percent. The depreciation comes despite the fact that the US Federal Reserve lifted official interest rates three times over the course of last year. However during this period, other central banks including the Bank of England (BoE) and the Bank of Canada (BoC) began raising their official interest rates and the European Central Bank (ECB) announced in December it would begin tapering its asset purchases this month.

The shift away from global monetary stimulus and towards tightening is only just beginning. We expect that as major central banks around the world begin or look to tighten policy, the downward trend in US dollar that has occurred since early 2017 could have further to run.





Global Economy – Maintaining Momentum

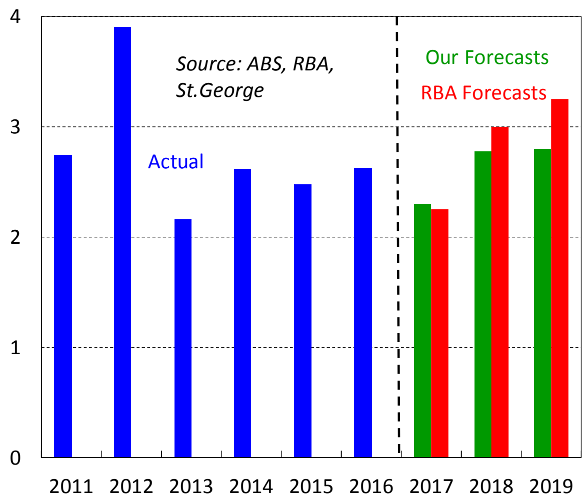
The move away from global monetary stimulus goes hand in hand with an improving global economic backdrop. Optimism in regards to the global economic outlook and rising commodity prices have provided support to the AUD, particularly over the latter part of December 2017.

A broad-based upswing in global economic activity has been underway since 2016, and economic indicators are suggesting that this strength will continue. The IMF has recently upgraded its world growth forecasts 0.2 percentage points higher to 3.9% for both 2018 and 2019. If growth turns out as the IMF forecasts this year, world growth would be at its fastest pace in seven years. A pickup in global activity improves prospects for the Australian economy and also underpins demand for commodities.

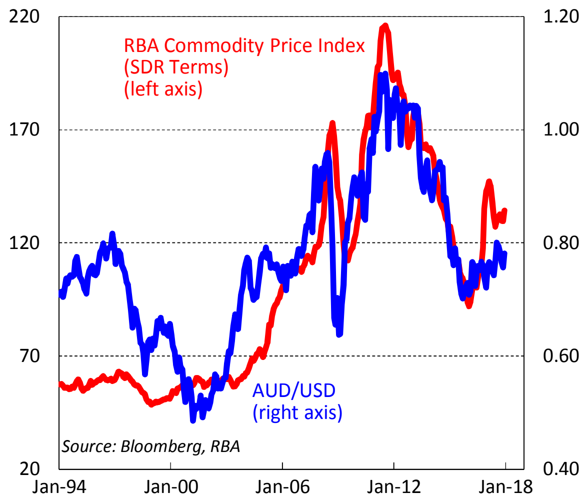
Prices of most commodities have rallied sharply on hopes that the strong momentum in the global economy will continue and boost demand. Oil prices in particular, have increased significantly. While the prospects of stronger demand have been a major factor behind the recent increase in oil prices, production cuts from OPEC and non-OPEC members have also assisted in eliminating the supply surpluses of earlier years.

Expectations of ongoing strong supply in many commodity markets could cap further price gains. Nonetheless, stronger momentum in the global economy would support demand and prices. In this environment with global economic activity picking up, we would expect modest increases in commodity prices and support for the AUD.

AU Eco Growth & Forecasts
(percent)



AUD & RBA Commodity Price Index



Domestic Risks and the RBA

There are however, factors which could keep a lid on the AUD's appreciation, as there continues to be downside risks for the domestic economy.

Softening conditions in the housing market and downside risks for consumer spending continue to weigh on the outlook. Indeed, we expect that economic growth will undershoot the RBA's forecasts this year and next year (see chart above left).

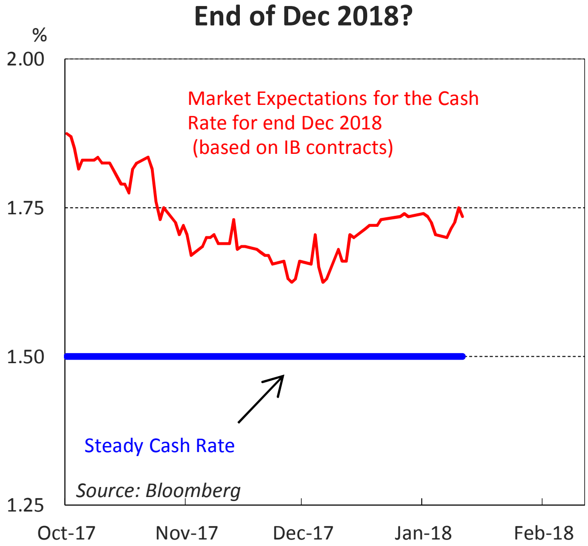
Nonetheless, there are signs of improvement in business investment intentions and the large pipeline of public infrastructure spending provides more positive signs for the outlook. Moreover, the strong conditions in the business sector are spilling over to the labour market, which has seen phenomenal strength over the past year.

While we expect some moderation in job growth (the current pace of over 30k job growth per month is unlikely to be sustainable), we expect that employment growth will be sufficient to bring down the unemployment rate. Job ads, ongoing elevated business conditions and momentum in the global economy point to further solid growth in employment. Indeed, there is a risk that the unemployment rate, which currently sits at 5.5%, could undershoot the RBA's year-end forecast of 5.5%.

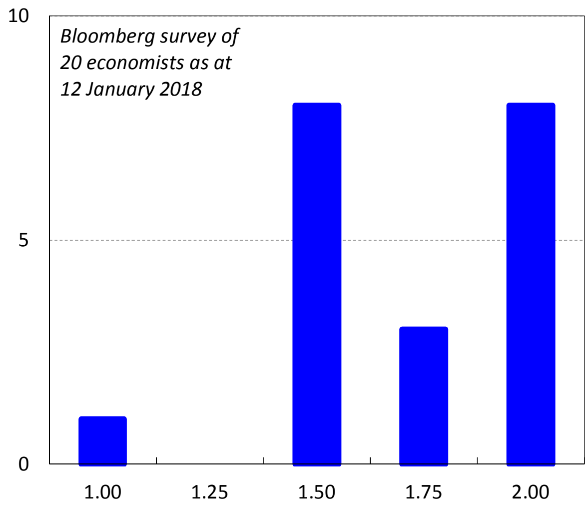
These signs of improvement in the domestic economy along with the global shift in monetary policy stances towards tightening have resulted in financial markets almost fully pricing in an RBA rate hike by the end of the year.

Similarly, the consensus view in a survey of economists suggests that the RBA will raise official interest rates once this year. In contrast, the downside risks to the domestic economy suggest to us that the RBA is unlikely to lift the official cash rate this year.

Where Will The Cash Rate Be at the End of Dec 2018?



Where Will the Cash Rate Be at the End of Dec 2018?



Our less optimistic view of the outlook further suggests some limits to how far we expect the AUD can appreciate. Nonetheless, the improvement in the domestic economy, and in particular the labour market, suggests that financial markets would likely continue to price in some chance of tightening sometime in the near future. The next move in the cash rate is increasingly likely to be higher, rather than lower.

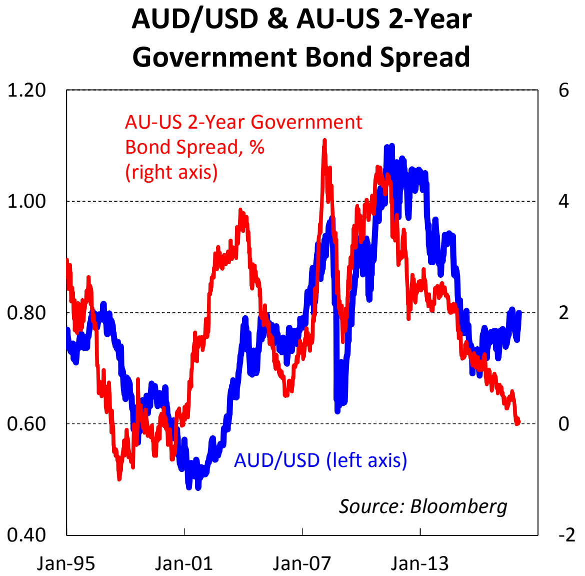
What About That Narrowing Interest Rate Differential?

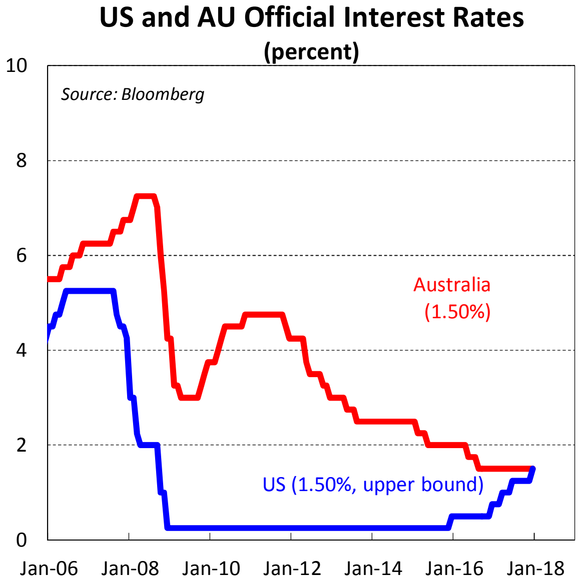
A point to highlight is that the interest rate differential between the US and Australia has narrowed significantly. Indeed, the spread between Australian and US 2-year government bond yields turned negative late last year for the first time since 2000, when the Australian dollar was trading at below 60 US cents. US official interest rates are expected to hit 2-2.25% by the end of this year, in contrast with the Australia's RBA official cash rate which we expect to remain steady at 1.50%.

We however, do not expect the Australian dollar to come under significant downward pressure, given the more positive global growth outlook and expected weakness for the greenback.

Moreover, we expect that currency markets will likely to be more sensitive to the potential beginning of a rate tightening cycle by the RBA than the current tightening cycle by the Federal Reserve which has been well-telegraphed and well-anticipated by financial markets, and is already well-underway. Currency markets are forward-looking and move largely on expectations. The AUD will likely appreciate well ahead of an actual RBA rate hike, particularly if the Australian labour market continues on its path of improvement. Further, if the US Federal Reserve lifts official interest rates three times this year as expected by median estimates it will hardly provide a major surprise for the market.

Nonetheless, the disappearing yield advantage Australia had over the US also suggests a limit to how far the Australian dollar can appreciate, particularly given our expectation that the RBA will leave official interest rates on hold all of this year.





Conclusion

The global economic backdrop has improved in recent years. It has translated to stronger prospects for demand for commodities, as reflected in higher commodity prices. This should continue to provide a key support for the Australian dollar over the course of this year.

We expect however, that the RBA will be less willing to increase official interest rates in the near-term. The yield advantage of the AUD over the US dollar should therefore disappear and reverse in due course. As such, we think a trend appreciation in the Australian dollar will be gradual.

Nonetheless, the Australian economy has seen improvement, particularly with regards to the labour market. Along with the upswing in the global economy, these factors would suggest that the RBA is still moving closer towards the beginning of a rate hiking cycle, rather than further away from it. Moreover, the US tightening cycle is well-underway and well-anticipated; three rate hikes by the Federal Reserve this year will hardly come as a surprise to currency markets.

Additionally, further US dollar weakness will also add upward pressure, which we expect will persist as other major central banks around the world pull back on monetary stimulus.

After rallying significantly over a short period of time, the Australian dollar may be due for a period of consolidation in the near-term. However, we expect that the upward trend in the Australian dollar that began in early 2016 should continue. Predominantly reflecting a weaker US dollar profile, we are upgrading our AUD forecast for the end of 2018 from 82 to 84 cents.

Janu Chan, Senior Economist
Ph: (02) 8253-0898

Please see detailed forecasts on following page

EXCHANGE RATE FORECASTS

	End Quarter Forecasts					
	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
USD Exchange Rates						
AUD-USD	0.8000	0.8100	0.8300	0.8400	0.8500	0.8600
USD-JPY	110.00	108.00	106.00	104.00	102.00	102.00
EUR-USD	1.2200	1.2400	1.2800	1.3200	1.3200	1.3400
GBP-USD	1.4000	1.4100	1.4200	1.4400	1.4600	1.4800
USD-CHF	0.9400	0.9300	0.9200	0.9100	0.9000	0.9000
USD-CAD	1.2400	1.2200	1.2000	1.2000	1.1800	1.1800
NZD-USD	0.7200	0.7300	0.7400	0.7500	0.7600	0.7600
USD-CNY	6.4000	6.3000	6.2000	6.1000	6.0000	6.0000
USD-SGD	1.3200	1.3000	1.2900	1.2800	1.2700	1.2600
AUD Exchange Rates						
AUD-USD	0.8000	0.8100	0.8300	0.8400	0.8500	0.8600
AUD-EUR	0.6560	0.6530	0.6480	0.6360	0.6440	0.6420
AUD-JPY	88.00	87.50	88.00	87.40	86.70	87.70
AUD-GBP	0.5714	0.5745	0.5845	0.5833	0.5822	0.5811
AUD-CHF	0.7520	0.7530	0.7640	0.7640	0.7650	0.7740
AUD-CAD	0.9920	0.9880	0.9960	1.0080	1.0030	1.0150
AUD-NZD	1.1110	1.1100	1.1220	1.1200	1.1180	1.1320
AUD-CNY	5.1200	5.1030	5.1460	5.1240	5.1000	5.1600
AUD-SGD	1.0560	1.0530	1.0710	1.0750	1.0800	1.0840

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

Contact Listing

Chief Economist	Senior Economist	Senior Economist
Besa Deda	Josephine Horton	Janu Chan
dedab@stgeorge.com.au	hortonj@stgeorge.com.au	chanj@stgeorge.com.au
(02) 8254 3251	(02) 8253 6696	(02) 8253 0898