Friday, 28 July 2017

Australian Dollar Outlook

Turning Points and Policy Shifts

- **The Australian dollar recently broke out of its narrow trading band where it has been stuck for nearly two years. This month, the Australian dollar rallied to its highest since May 2015, breaching the 80 US cent mark. In trade-weighted terms, it is close to 6% higher since its recent low on June 2. It largely reflects US dollar weakness. However, underpinning these movements is a change in expected settings of monetary policy in key advanced economies, including Australia.**

- **Has the AUD rally gone too far? In the near-term, most likely so. Financial markets have a habit of overreacting. Some retracement is likely given we expect the Federal Reserve (the Fed) to continue to tighten policy, despite the Fed's more cautious stance of late. We also do not expect a rate hike from the RBA any time soon.**

- **Nonetheless, change is in the air. The Fed is no longer the sole central bank in the world considering tighter monetary-policy settings. This changing story suggests the US dollar index might have peaked in January this year. The current downward trend since then is likely to continue.**

- **While we do not expect an RBA rate hike to occur, the risk of another cut in this cycle has clearly reduced. In the space of a few months, markets have moved from pricing in a small chance of a rate cut to a chance of a hike over the next 12 months. It partly reflects an improvement in domestic economic conditions. Given that the rhetoric by global central banks has moved towards tightening, markets will likely continue to price in some chance of an RBA hike despite some downside risks to the domestic outlook remaining.**

- **Over the long-run, a key gauge for the Australian dollar is the outlook for commodity prices. On this front, prospects have become relatively more positive. But our view that commodity prices should broadly move sideways suggests a limit to how far the AUD can appreciate.**

- **We expect some near-term pullback in the AUD. However, the shift in global monetary policy settings amid an improving global and domestic backdrop has resulted in an upgrade to our end 2017 AUD forecast from 75 US cents to 78 US cents. We expect a modestly higher AUD for the end of 2018 at 82 US cents.**

The Australian dollar recently broke out of its narrow trading band where it has been stuck for nearly two years. From mid-2015 until recently, the Australian dollar had traded within a 10 cent range of between 68.3 US cents and 78.4 US cents.

This month, the Australian dollar not only broke through this recent trading band, it rallied to its highest since May 2015, breaching the 80 US cent mark. In trade-weighted terms, it is close to 6% higher since its recent low on June 2.

Other key currencies have also appreciated notably against the US dollar, including EUR and GBP. It largely reflects US dollar weakness; however underpinning these movements is a change in expected settings of monetary policy in key advanced economies, including Australia.

Policy Shifts – A Changing Story

Over the last few years, one of the dominant themes for global financial markets has been the Federal Reserve being alone among major central banks around the world in tightening monetary policy. This divergence has been a major underlying cause for the strength in the US dollar.

This is no longer the case; there has been a shift in the direction of monetary policy. The Federal Reserve is still expected to raise interest rates further and to reduce its balance sheet or holdings of bonds. However, we have continually stated that monetary policy tightening by the Fed had been factored into currency markets to a large extent. Now, the Federal Reserve it is no longer alone in taking the foot off the monetary policy easing pedal. Commentary from the European Central Bank (ECB) that it could begin paring its asset purchases signals a reversal to the very easy monetary policy stances of the past few years. In addition to the ECB, the Bank of England (BoE) is moving closer to the prospect of a rate hike and the Bank of Canada (BoC) has already taken that step in raising official interest rates.

While financial markets take into account a world of less accommodative monetary policy, recent rhetoric from the Federal Reserve has struck a less hawkish tone. US policymakers have expressed concern that inflation has not picked up, despite the economy being close or at full employment. On top of the Fed's more cautious stance, there has yet to be more clarification on stimulus policies from the Trump administration.

The combination of these factors has been behind the broad US dollar weakness of the past few months.

Could the RBA Be Next?

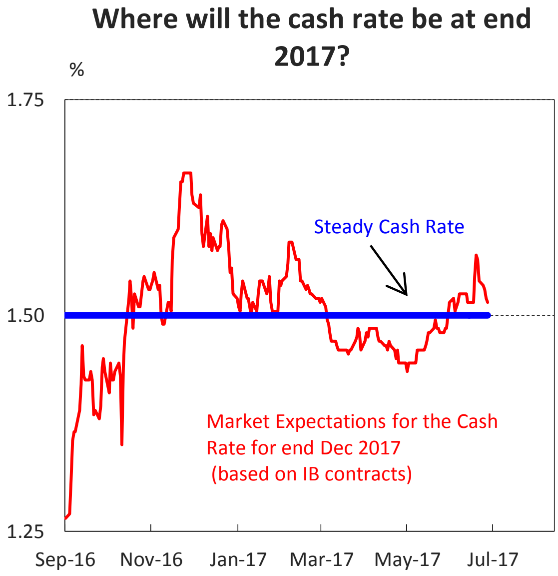
The question of higher global interest rates has naturally been raised in Australia. Talk that the RBA could join the chorus of less accommodative monetary policy stances surfaced in early July, and was reinforced by discussion by the RBA board of the neutral cash rate. Financial markets have since priced in small chance of a tightening by the end of the year (10% as of July 27) and a 72% chance by the end of 2018. This is a major turnaround from the 26% chance of easing by the end of the year, priced in as of May 31.

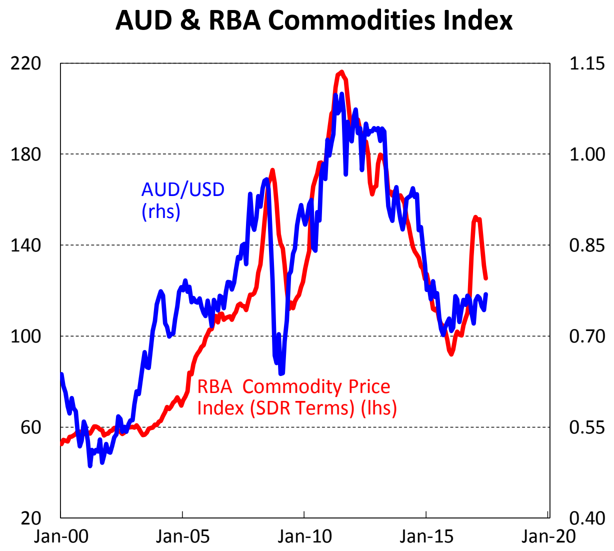
We do not think the RBA is not close to raising official interest rates. Recently, there has been an improvement in the labour market. However, there remains spare capacity in the domestic economy as indicated by the unemployment rate, a high level of underemployment and slow wage growth. The outlook for growth is also clouded by weak prospects for consumer spending and a downturn in residential construction.

Our view that the RBA is unlikely to lift rates any time soon would suggest there is a limit to how far the Australian dollar would appreciate in the near term. Indeed, we expect some pullback in the AUD as there is a strong likelihood investors will pare back their expectations of rate hikes. Recent comments by RBA Assistant Governor Debelle and RBA Governor Lowe have downplayed the chance of a near-term rate hike.

Nonetheless, we expect that the long-run upward trend in the AUD ever since early January is likely to continue. Rate hikes may remain a way off, but the chances of a rate cut from the RBA in this cycle have greatly reduced.

At some point, the RBA will be ready to lift official interest rates. While global central banks continue to step up their rhetoric in unwinding their easy monetary policy stances, financial markets will unlikely pare back their expectations substantially for rate hikes in Australia. The risk is that markets will continue to price in a fair chance of a rate hike and continue to provide upward pressure on the AUD over the medium term.





Don't Forget About Commodity Prices

Over the long-run, a key gauge for the Australian dollar is the outlook for commodity prices. On this front, prospects have become relatively more positive. A synchronised global upswing has continued, and stimulus from Chinese authorities has been supportive of economic growth in China.

The improvement in global growth should help to prop up commodity prices. The International Monetary Fund (IMF) is expecting world economic growth at 3.5% and 3.6% in 2017 and 2018, respectively, up from 3.2% in 2016. However, any expected pickup should be put into context – global growth forecasts still sit below the average over the last ten years.

In the case of some commodities, there continues to be strong supply due to come online. Oil prices, for example, are gaining support from pledges to cut supply from OPEC. However, at the same time, an increase in US shale production has helped to keep inventories elevated. Strong supply is still expected for iron ore, which would also limit price increases.

Many commodities are, however, close to equilibrium in supply and demand. This would suggest that commodity prices should broadly move sideways and that there is a limit to how far the AUD can appreciate.

Conclusion

We have upgraded our long-held end of 2017 AUD forecast from 75 US cents to 78 US cents. We expect a modestly higher AUD for the end of 2018 of 82 US cents.

Some near-term pullback from current levels is expected, as we continue to expect the RBA to keep rates on hold for some time. Financial markets are overstating the chances of rate hikes in Australia.

Additionally, the Federal Reserve is still expected to continue to tighten monetary policy. While this has been factored into currency markets to a large extent, the US dollar should gain some support as the Fed continues to hike rates and reduce its balance sheet.

However, the more positive global and Australian outlook over the past few months suggests downside risks for the Australian dollar have dissipated.

The Australian dollar is also only one side of the story. More importantly, the theme of the US Federal Reserve being the sole central bank in tightening monetary policy is over. This notion has been fundamental in underpinning US dollar strength over the past few years. We are only just beginning to see rhetoric shift among other central banks in reversing the extraordinarily easy monetary policy stances across the world. It appears increasingly likely that the long-term upward trend in the US dollar that began in mid-2014 ran its course and ended in January this year.

For the AUD, this translates to the view that the cyclical bottom in the AUD hit in January 2016 is very unlikely to be revisited over the medium term. While the AUD rally has probably gotten ahead of itself, the AUD should continue to gain support while the US dollar remains out of favour.

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

Please see detailed forecasts on following page

EXCHANGE RATE FORECASTS

	End Quarter Forecasts			
	Sep-17	Dec-17	Mar-18	Jun-18
USD Exchange Rates				
AUD-USD	0.7800	0.7800	0.7800	0.8000
USD-JPY	110.00	110.00	110.00	108.00
EUR-USD	1.1600	1.1600	1.1400	1.1600
GBP-USD	1.3000	1.3000	1.3000	1.3200
USD-CHF	0.9700	0.9700	0.9600	0.9600
USD-CAD	1.2800	1.2800	1.2600	1.2600
NZD-USD	0.7400	0.7400	0.7400	0.7600
USD-CNY	6.8000	6.8000	6.7000	6.7000
USD-SGD	1.3800	1.3800	1.3800	1.3700
AUD Exchange Rates				
AUD-USD	0.7800	0.7800	0.7800	0.8000
AUD-EUR	0.6720	0.6720	0.6840	0.6900
AUD-JPY	85.80	85.80	85.80	86.40
AUD-GBP	0.6000	0.6000	0.6000	0.6061
AUD-CHF	0.7570	0.7570	0.7490	0.7680
AUD-CAD	0.9980	0.9980	0.9830	1.0080
AUD-NZD	1.0540	1.0540	1.0540	1.0530
AUD-CNY	5.3040	5.3040	5.2260	5.3600
AUD-SGD	1.0760	1.0760	1.0760	1.0960

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

Contact Listing

Chief Economist

Besa Deda
dedab@bankofmelbourne.com.au
(02) 8254 3251

Senior Economist

Josephine Horton
hortonj@bankofmelbourne.com.au
(02) 8253 6696

Senior Economist

Janu Chan
chanj@bankofmelbourne.com.au
(02) 8253 0898