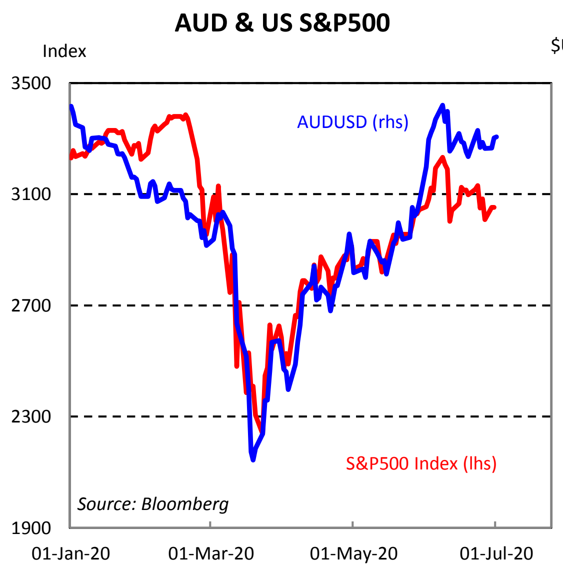
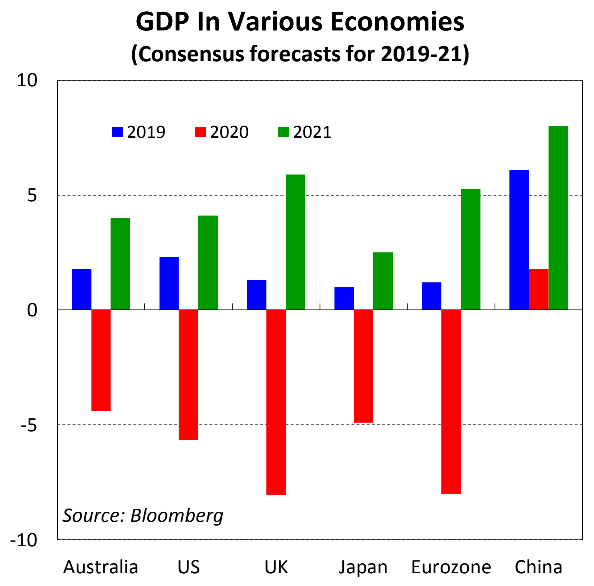
Wednesday, 1 July 2020

Australian Dollar Outlook

Is the Golden Child Back?

- **The impact of COVID-19 has resulted in large swings in the Australian dollar over recent months. The Australian dollar fell from 70.17 US cents at the beginning of the year to a 17-year low of 55.10 US cents on March 19. It did not hold around these low levels for long, recovering to an 11-month high of 70.63 US cents on June 11. It has since corrected and is consolidating in narrow range just below 70 US cents.**
- **Despite the risks to the economic outlook being skewed to the downside, a nascent global recovery is underway. A recovery, albeit an uneven one, would suggest further resilience in the Australian dollar over the medium and longer-term.**
- **The handling of the crisis from COVID-19 in Australia has generally been viewed favourably in comparison to the rest of the world and the economic contraction in Australia this year is also expected to be smaller than in other advanced economies.**
- **The impact of COVID-19 on the economic outlook will continue to provide significant uncertainty and suggests that volatility in the AUD is likely to continue.**
- **The global recovery, Australia's well-perceived handling of the crisis in comparison to other parts of the world and its trade linkages to China (and the rest of Asia) suggests the Australian dollar could approach levels closer to its post-float average (around 76 US cents). We have revised our end of year forecast to 72 US cents. Our forecast for the end of 2021 is 76 US cents.**





The Australian dollar has commonly moved with the fate of the global economy, and the impact from developments regarding COVID-19 has been no exception. There have been massive swings in the currency, tracking the gyrations in market sentiment and concerns over the impact of COVID-19. The Australian dollar has followed the US S&P500 closely this year, highlighting the significance of financial market sentiment in driving its value.

With the spread of COVID-19 throughout the world and the lockdown measures aimed at curbing the spread of the virus, the Australian dollar fell from US$0.7017 at the beginning of the year to a 17-year low of US$0.5510 on March 19. However, the Australian dollar did not hold around these low levels for long.

With the world exiting lockdown and businesses resuming operations, sentiment has improved immensely, with investors encouraged by economic activity restarting. Moreover, markets have a tendency to undershoot in extremely pessimistic environments, which characterised financial markets in mid to late March. This undershooting has exacerbated the rebound in risk appetite as reflected in the rally in share markets and currencies like the Australian dollar.

The recovery in risk appetite led to the Australian dollar reaching an 11-month high of 70.63 US cents on June 11. More recently, the Australian dollar has eased from this peak, but it is currently trading near 69 US cents and close to a level before the pandemic began. For much of the past 3 weeks the Australian dollar has been consolidating in a range within 0.6775-0.6980.

The US share market provides another indication of how far risk appetite has recovered, the US S&P500 is just down 8.1% from its peak on February 19 and the Nasdaq hit a record closing high on June 23.

A further indication of how risk appetite has moved over this period is the volatility index (commonly known as VIX), which is a measure of risk aversion. The index rose to 82.7 on March 16, the highest since the index was first calculated in 1990, before retreating to a reading of 30.4 today. It remains above its long-run average of 19.4.

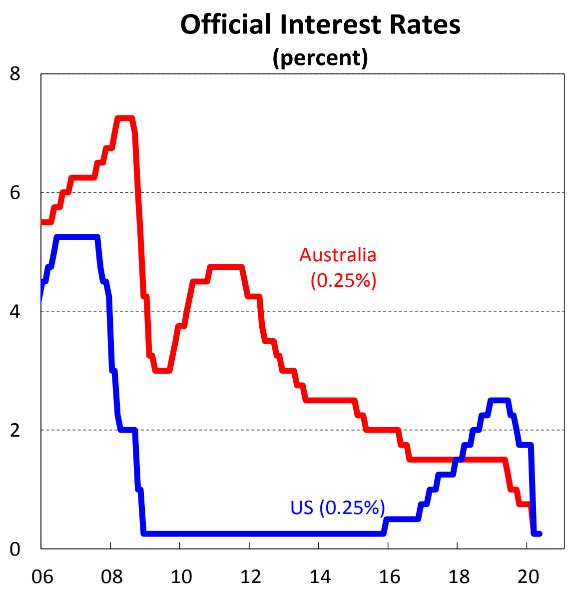
Onwards and Upwards?

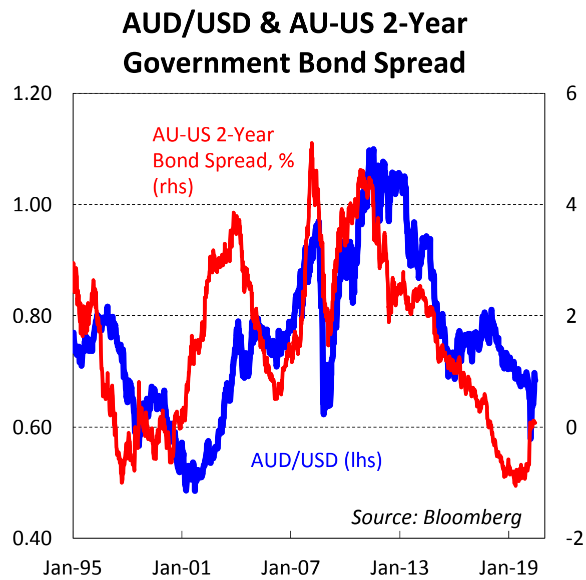
Despite the risks to the economic outlook, which are skewed to the downside, a nascent global recovery is in place. A recovery, albeit an uneven one, would suggest further resilience in the Australian dollar over the medium and longer-term.

The Australian economy is also beginning to stand out from the rest of the pack. The handling of the crisis from COVID-19 has generally been viewed favourably in comparison to the rest of the world. New daily cases in Australia peaked at 468 on March 28, and have declined or stayed low since. Additionally, the economic contraction in Australia has so far been less pronounced than in other advanced economies. Consensus expectations for Australian GDP are for a contraction of 4.4% this year (our forecast is for a 4.0% contraction). By comparison, median expectations are for the US economy to contract 5.7% this year and the euro zone economy to shrink 8.1%.

It was just over 10 years ago, when Australia was credited in its effective handling of the Global Financial Crisis (GFC). Australia was one of the select few countries which avoided a technical recession. While there were a multitude of factors which led to the outperformance of the Australian economy at that time, the Australian dollar rose from a low of US$0.6009 on 27 October 2008 to US$0.9406 on 16 November 2009. That equates to a 34 US cent increase in a period just over a year.

We do not think current conditions will warrant a similar-sized increase in the Australian dollar. After the GFC, significant stimulus in China drove an unprecedented mining investment boom, which is unlikely to be repeated. But we are again facing a global economic recovery after a sharp downturn and Australia is also seen to have handled the crisis relatively well.





Australia’s outperformance suggests the Australian dollar could lift beyond its pre-crisis levels.

The interest-rate differential between Australia and the US provides another indication of fundamentals becoming more supportive for the Australian dollar. The spread between Australian and US 2-year government bond yields turned positive from mid-April, after holding in negative territory from early 2018, and suggests the yield differential will be less of a negative influence on the Australian dollar.

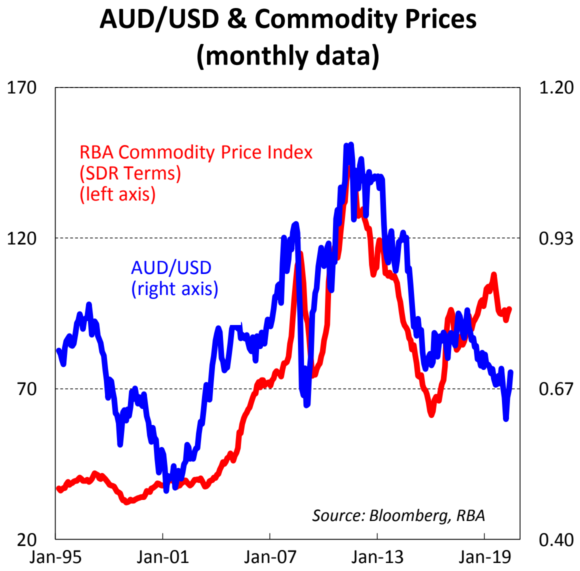
In March this year, the Reserve Bank (RBA) and the US Federal Reserve lowered the official cash rate and the Fed funds rate, respectively to near zero. The RBA’s official cash rate target is at 0.25% and the RBA adopted a 3-year bond yield target of around 0.25%. The target for the Fed funds rate is at 0-0.25%. Both central banks have quantitative easing programs and have adopted additional measures to facilitate lending in the economy. However, with official interest rates near zero in both countries over at least the next year or so, interest rate policies are likely to have a more muted impact on the currency than in the past.

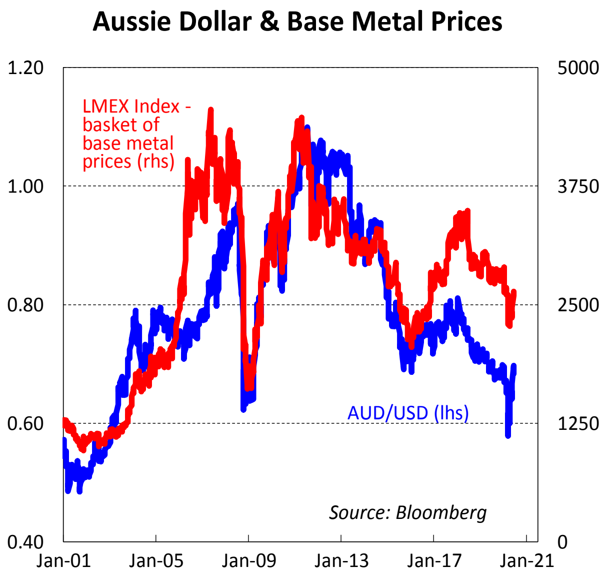
Nonetheless, with Australia’s relative success in containing COVID-19, its economic growth outlook is more favourable. It would suggest that the US Federal Reserve would be more likely than the RBA to deploy further stimulus measures, which would place downward pressure on the US dollar, and upward pressure on the AUD.

Finally, the outlook for commodity prices plays a part in determining the value of the Australian dollar. A global economic recovery points to a stronger rebound in prices of most commodities, including oil, gas and base metals. Iron ore prices are the exception, and are less likely to strengthen further given prices have been supported by constrained supply from Brazil due to COVID-19. Nonetheless, there is the prospect for stimulus in China through infrastructure spending which will be supportive of demand for commodities, although the scale of stimulus is likely to be much less than in the past.

Historically, commodity prices have had a close relationship with the Australian dollar given the sizeable share of commodities among Australia's exports. However, this relationship did not hold particularly well from around mid-2018. Prices of most commodities lifted, while the Australian dollar weakened.

The Australian dollar weakness at the time can be explained by the respective policies of the US Fed and the RBA. The US Federal Reserve was in the middle of a rate hiking cycle, while the RBA was leaving official interest rates on hold. The Australian dollar weakness also coincided with the US Fed funds rate exceeding the RBA cash rate at 1.50% after the FOMC meeting on 20-21 March 2018.





With interest rates in both countries expected to stay at extremely low levels for some time, commodity prices may take on greater importance in determining the Australian dollar outlook. We expect that drivers for the Australian dollar are likely to turn towards the relative outlook for each economy, the global economic outlook and commodity prices.

Conclusion

A recovery from COVID-19 related lockdowns is underway in the global economy, albeit one that is likely to be uneven. This recovery along with Australia's well-perceived handling of the crisis in comparison to other parts of the world and its trade linkages to Asia suggests the Australian dollar could approach levels closer to its post-float average (around 76 US cents). We have revised our end of year forecast to 72 US cents and our forecast for the end of 2021 is 76 US cents.

However, the impact of COVID-19 on the global and domestic economies will continue to provide significant uncertainty for the outlook, and suggest that volatility in the currency is likely to continue.

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Please see detailed forecasts on the following page.

EXCHANGE RATE FORECASTS

	End Quarter Forecasts				
	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
USD Exchange Rates					
AUD-USD	0.7000	0.7200	0.7300	0.7400	0.7500
USD-JPY	106.00	106.00	107.00	107.00	108.00
EUR-USD	1.1300	1.1400	1.1500	1.1600	1.1700
GBP-USD	1.2600	1.2700	1.2700	1.2800	1.2900
NZD-USD	0.6500	0.6500	0.6400	0.6500	0.6600
AUD Exchange Rates					
AUD-USD	0.7000	0.7200	0.7300	0.7400	0.7500
AUD-EUR	0.6190	0.6320	0.6350	0.6380	0.6410
AUD-JPY	74.20	76.30	78.10	79.20	81.00
AUD-GBP	0.5560	0.5670	0.5750	0.5780	0.5810
AUD-NZD	1.08	1.11	1.14	1.14	1.14

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

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