

The Australian dollar outlook

In mid December, the Australian dollar was sitting at around 90.5¢. Since that time the AUD has moved in a 93¢ to 86¢ range. We are now sitting at the extreme lowpoint of that area after a run of negative sentiment accumulated in the early part of February. Indeed, the AUD is at its lowest ebb in some time.

Our core thinking had been that the currency would have a final surge to 96¢ early in the year before

“a move out of risk assets could see the AUD lose 5 to 10 ‘big figures’. The rout will be stopped by the realistic assessment that Australia will continue to benefit from its unique position to service the expected ongoing surge in Chinese industrial demand ... We have consistently looked for the AUD to resume its uptrend through the latter part of 2010.” (That is a direct quotation from my analysis in the December-January Market Outlook report).

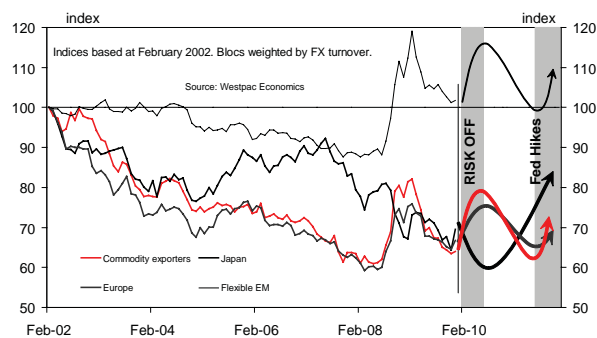
We now suspect that the Q1 upsurge we anticipated exhausted itself around 93¢ rather than our 96¢ target. So the recent peak has been both lower and earlier than we had expected. However, the precise timing of the emergence of the risk aversion trade was always uncertain. It is a sentiment driven phenomenon after all. The nervous trading in global markets in the year to date is a sign that we are now moving into that “risk aversion” period that we anticipated would result in the 5¢ to 10¢ swing.

The new dimension to this trade that we did not anticipate is market reaction to the Chinese authorities beginning to tighten lending guidelines. This has raised global concerns that the authorities will over tighten. From Australia’s perspective we think this news is actually encouraging. With Chinese inflation still “low” at 1.9% compared with the high single digit rates when the authorities eventually over tightened over the 2004/08 period we expect it is highly unlikely that the authorities will make a policy mistake, thus imposing a hard landing. Appropriate management of the current surge is likely to ensure that strong growth can be sustained for longer, supporting Australia’s prosperity.

These developments in China; the Greek tragedy; three consecutive down weeks on the US stockmarket; and conflicting messages in the US data are suggesting to the markets that they turn away from risk. We have lowered our target for June from 90¢ to 85¢. That embodies an 8¢ correction from December and is consistent with our previous assessment in all but timing.

We are maintaining our target of 95¢ for the end of the year. We see the second half of 2010 as a period where markets become much more relaxed about the likely success of China achieving a “soft landing”. That reversal will still be in the context of the US

US dollar performance by bloc



economy demonstrating its inability to achieve self sustaining growth once the stimulatory effects of the fiscal packages have waned. Renewed optimism about China; some evidence that the Chinese authorities are prepared to allow modest appreciation of the CNY; and forward looking markets anticipating some inevitability of the eventual sustained recovery in the US should see a return of risk appetites among investors. Recall the first half of 2008 when markets favoured risk assets despite the obvious difficulties being faced by the US with the credit crisis.

This scenario is neatly summarised in the chart above. It provides a sound basis for our views on other currency blocs. In the figure we divide the future into three phases. The first phase, featuring risk aversion, favours the USD over all blocs except Japan. The second phase is marked by renewed confidence about China and ongoing disappointment in the G3. This heralds rising risk appetite with emerging markets, commodity currencies, and to a lesser extent the euro, strengthening against the USD. With this preference for risk the Japanese yen can make the necessary downward adjustment to restore its competitiveness and, maybe, generate some much needed inflation.

The final stage of the two year cycle will come with the first tightening by the US Federal Reserve sometime in 2011 – probably before the Europeans, and certainly with more determination to normalise relatively quickly given the memory of Greenspan’s over accommodative policy through the early and middle part of the decade. For a time that is likely to see the USD appreciate against all currencies. The scale of this move is up for debate. The Greenspan/Bernanke normalisation phase achieved only currency stability for the USD on a broad basis, not outright appreciation.

Bill Evans, Chief Economist

Australian dollar forecasts

	Latest (Feb 5)	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11
AUD vs						
AUD index*	100	97.6	97.0	102.0	107.0	107.0
USD	0.8642	0.86	0.85	0.90	0.95	0.93
JPY	76.90	76	77	86	95	99
EUR	0.6290	0.62	0.63	0.64	0.66	0.64
NZD	1.2572	1.26	1.25	1.22	1.20	1.19
CAD	0.9269	0.92	0.92	0.92	0.93	0.93
GBP	0.5486	0.53	0.54	0.55	0.56	0.54
CHF	0.9212	0.91	0.90	0.95	1.00	0.99
SGD	1.2276	1.20	1.19	1.25	1.32	1.28

*Nominal trade weighted index, with latest data compiling the base. Weights from Reserve Bank of Australia. A reading above (below) 100 indicates a rise (fall) in the AUD. ^Approximate market forward price for AUD/USD, not a forecast. Sources: Bloomberg, Westpac Economics.

US dollar forecasts

	Latest (Feb 5)	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11
USD vs						
USD index*	100	101.99	102.90	99.94	100.16	98.85
JPY	88.98	88	91	96	100	106
EUR	1.3739	1.38	1.36	1.4	1.43	1.46
AUD	0.8642	0.86	0.85	0.9	0.95	0.93
NZD	0.6874	0.68	0.68	0.74	0.79	0.78
CAD	1.0725	1.07	1.08	1.03	0.98	1.00
GBP	1.5754	1.62	1.58	1.65	1.68	1.74
CHF	1.0660	1.06	1.06	1.06	1.05	1.06
ZAR	7.6800	7.80	7.92	7.35	6.84	7.01
SGD	1.4205	1.40	1.40	1.39	1.39	1.37
HKD	7.7693	7.75	7.75	7.75	7.75	7.75
PHP	46.17	47.3	47.1	46.5	46.1	46.0
THB	33.13	33.4	33.3	33.2	33.1	32.8
MYR	3.42	3.43	3.41	3.40	3.38	3.34
CNY	6.8268	6.82	6.80	6.78	6.76	6.70
IDR	9326	9600	9500	9200	8900	8700
TWD	32.02	32.1	32.0	31.9	31.8	31.6
KRW	1151	1170	1128	1075	1050	1092
INR	46.25	46.5	46.0	45.6	45.2	44.0

*Broad (20 MTP) nominal trade weighted index, with latest data compiling the base. Weights from US Fed. A reading above (below) 100 indicates a rise (fall) in the USD.