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Australian dollar—which way from here?

After reaching a low of USD0.68 in January 2016, the Australian dollar, or the 'Aussie' as it's commonly known, has strengthened in recent months. This is despite a number of factors, which would ordinarily be expected to see the currency weaken.

Not only is the Australian dollar important for the Australian economy, but it also plays a significant role for investors who hold assets in offshore markets. Given the importance of holding a globally diversified portfolio, a view on the outlook for the currency is a key driver for portfolio positioning.

In this article we look at why the Australian dollar has moved counter to expectations in recent months. We also examine the key drivers of the currency, and how we think they will influence it going forward.

An important role on the world stage

The Australian dollar plays a key role in global financial markets, and is one of the most highly traded and referenced currencies in the world. The key reasons for the currency's important role within global financial markets are:

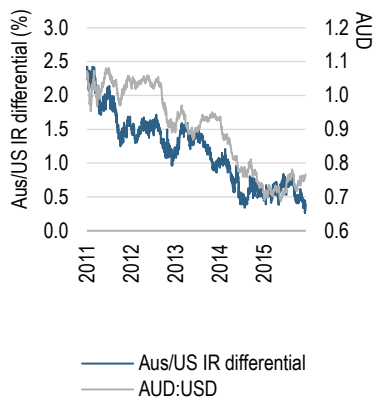
- it's considered an easily accessible and liquid proxy for Chinese economic performance;
- Australia is a major trading nation with a heavy dependence on importing goods and exporting raw materials;
- the currency's correlation with global risk means it's used by traders to take a view on the outlook for global risk;
- it's a liquid proxy for traders wanting to take a view on the directionality of commodity prices (this is due to its 'risk-on' nature and perceived link to China); and
- it's used globally as part of a 'carry trade' to take advantage of Australia's interest rate premium relative to the likes of Japan.

Figure 1: The Australian dollar is in the top five crosses for US dollar

USD CROSS	2004		2007		2010		2013	
	AMOUNT	%	AMOUNT	%	AMOUNT	%	AMOUNT	%
EUR	541	28.0	892	26.8	1,098	27.7	1,289	24.1
JPY	328	17.0	438	13.2	567	14.3	978	18.3
GBP	259	13.4	384	11.6	360	9.1	472	8.8
AUD	107	5.5	185	5.6	248	6.3	364	6.8
CAD	77	4.0	126	3.8	182	4.6	200	3.7

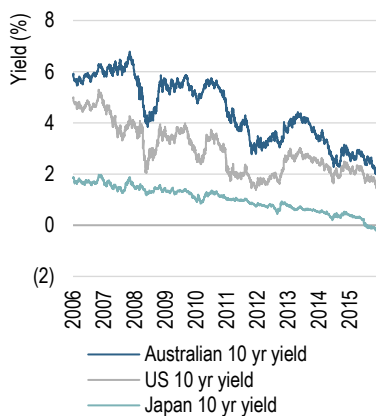
Source: Bank for International Settlements, Triennial Central Bank Survey 2013.

Figure 2: Australian and US interest rate differentials



Source: Bloomberg

Figure 3: Australian, US and Japanese yields



Source: Bloomberg

Major influences on our currency

While the reasons why market participants trade the Australian dollar vary, what is common among most of these investors and traders is the set of inputs they use to forecast the future direction of the currency. The major factors that influence the currency include interest rates; inflation differentials; commodity prices and terms of trade; the perceived strength of China's economy; the global risk environment; and market positioning.

Interest rate differentials may work against the Australian dollar

Interest rates are a key determinant of the yield that investors can earn on Australian fixed income securities. As Australian fixed income securities become more appealing they attract more foreign capital, which in turn, increases the demand for Australian dollars. Based on this rationale, and all else being equal, lower domestic interest rates should lead to a depreciation of the Australian dollar, while higher interest rates should see the currency strengthen.

However, it's important to realise that all else isn't equal, and currencies are a two-way market. For this reason, the monetary stances of other central banks are also important. For instance, the AUDUSD cross is dependent on the interest rate policy of both the Reserve Bank of Australia (**RBA**) and the US Federal Reserve (**Fed**). This means that what becomes important is the interest rate differential. And that is one reason why the Australian dollar hasn't fallen in recent months—despite the RBA's series of interest rate cuts.

Australian interest rates remain well above other developed markets, and our fixed income securities are still attractive to large institutional investors given that the alternative is earning near-zero or even negative interest rates in Japan and Europe. The fact that the Fed has kept interest rates on hold for longer than expected, and continues to speak with a 'dovish' tone, has also seen demand for Australian assets and the Australian dollar increase.

Over the medium term we expect the RBA to maintain an easing bias and possibly cut interest rates again. Conversely, the Fed is expected to raise rates later this year or early next year. This should see the interest rate differential work against the Australian dollar, and weaken the currency.

Outside the AUDUSD cross, while quantitative easing (**QE**) is still being used, the effectiveness of unconventional monetary policy and negative interest rates is being widely challenged, especially in Japan. Offshore QE is still buoying the Australian dollar but its impact may subside over coming months if the Bank of Japan alters its policy stance at its 21 September meeting.

The impact from inflation is likely to be minimal

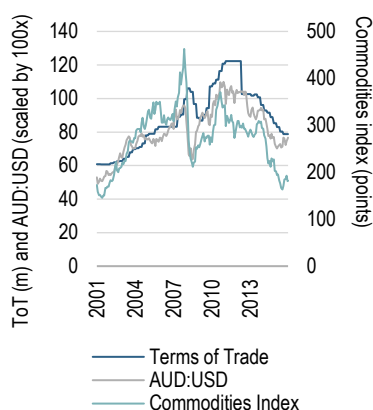
In general, high inflation is detrimental to a currency while low inflation is supportive. The reason for this is that persistently low inflation increases the purchasing power of a currency relative to the currency of a country with a higher inflation rate. In essence, this means that the currency becomes more valuable in terms of its ability to purchase global goods. This, of course, is dependent on all else remaining equal, which we know isn't always the case.

Inflation differentials have become less relevant in recent years due to systemically lower inflation on a global basis, and a shrinking of the magnitude of the differentials across most developed nations. In addition, the ultra-low inflationary environment has led to interest rate cuts and QE, which has greatly altered the supply of currencies, countering the exact dynamic described above. Therefore, while the downward trend in Australian inflation should be positively impacting the Australian dollar, in reality it's contribution is likely to be minimal, especially given the RBA has reduced interest rates as a result.

Commodity prices are expected to have a negative impact

A country's terms of trade is the ratio of its export prices to its import prices. The terms of trade improve when the prices that a country receives for its exports are higher than what it pays for its imports. With improved terms of trade, the country receives higher revenue creating a greater demand for its currency. As with any asset, higher demand puts upward pressure on its price and should see the

Figure 4: Australian terms of trade and commodity prices



Source: Bloomberg

Australian dollar appreciate. The bulk of Australia's exports are commodities (namely iron ore and coal). As such, the price of commodities impacts our terms of trade and the demand for the Australian dollar. This explains the strong link between the Australian dollar and commodity prices as seen in Figure 4.

The Australian dollar is notoriously difficult to forecast and is one of the more volatile developed market currencies. This is due to the breadth of the commodity sector and the fact that many of the key variables that determine commodity prices are highly volatile. In addition to this fundamental reasoning, global traders also understand the link between the two and commonly trade the Australian dollar as a commodity proxy given its liquidity.

Commodity prices currently appear 'fair' given that supply and demand imbalances witnessed over the last couple of years have largely been rectified. However, there are a number of factors that we expect will weigh on commodities over the medium term, including:

- **rising interest rates in the US**—as the Fed raises interest rates, the US dollar is expected to strengthen, and this should weigh on commodity prices given they are priced in US dollars; and
- **Chinese economic rebalance**—although Chinese economic growth has held up well so far in 2016, there remains excess capacity in the economy, and we expect this to weigh on China's demand for commodities as the economy rebalances.

Overall, we expect these factors to negatively impact the Australian dollar. However, the extent of the impact will depend on if, and by how far, commodity prices fall. We expect this to be moderate unless China experiences a 'hard landing', which isn't our base case.

A moderation in Chinese economic growth is expected to weigh on the Australian dollar

Many global traders and hedge funds trade the Australian dollar as a China proxy. This is a very popular option given the difficulty of accessing China's capital markets directly, and the lack of liquidity in the physical commodities markets.

The rationale behind this proxy is that if the Chinese economy outperforms, China will buy more bulk and base metals, pushing up the price of these materials. This improves Australia's terms of trade and strengthens the currency. A weaker Chinese economy works in reverse.

Trading the Australian dollar as a China proxy is more short term in nature, and is commonly used to trade around Chinese economic data announcements. On a longer-term basis, much of this effect is captured through commodity prices, which remain the key medium to longer-term driver.

While Chinese growth is anticipated to remain healthy, we expect it to moderate from its current official level of 6.7% per annum and to weigh on the Australian dollar.

Global risk could see a depreciation in the Australian dollar

Similar to the China proxy, commodity demand fluctuates with global growth. And as Australia is a commodity exporting nation, the Australian dollar is often used as a global risk proxy. It is considered a 'risk-on' currency by global traders which means it is bought during periods of low risk, and sold when investors seek safety. Conversely, the Japanese yen and Swiss franc are considered 'risk-off' currencies, and perform strongly when there's a flight to safety. Currently, the global risk environment is positive with risk assets across the globe performing strongly. As a result, the Australian dollar has strengthened accordingly.

The issue at the moment though is that recent performance has little to do with fundamentals and everything to do with a renewed environment of monetary easing. This change in environment has been primarily driven by the expectation of further monetary easing following the result of the United Kingdom's referendum where voters decided to exit the European Union. The lack of fundamental rationale in the current rally means that it could easily reverse, likely leading to a depreciation of the Australian dollar.

Market pressures appear relatively balanced

Given that the Australian dollar is often used as a trading currency, it can become 'overbought' or 'oversold'. This is usually measured via indicators called oscillators—two popular examples are Stochastics and RSI. In fundamental terms, this effectively means that traders, as opposite to corporate hedgers and investors, have bought or heavily sold the currency, and the market has moved too far in one direction too quickly.

At some stage, the market has to come back into balance as traders 'square' their positions. As a result, an overbought market typically reverts and weighs on a currency over the very short term, while an oversold market reverts and leads to a currency appreciation.

While the Australian dollar has experienced strong buying in recent weeks it is neither overbought nor oversold at the moment with market pressures appearing relatively balanced.

Expect a weaker Australian dollar over the medium term

The dollar has risen strongly since the start of the year, and is currently trading around USD0.76. Given the higher commodity prices and the Fed remaining on hold, we think the current rally is rational and fundamentally based. We do however expect it to reverse direction as the key variables point to a weaker currency over the medium to longer term.

Our forecasts for Australian dollar cross rates are outlined in Figure 5. These forecasts represent our base case scenario given the current set of data—however, we're conscience that numerous global variables can play out differently to our expectations. The greatest threats to our outlook are the Fed's interest rate hiking profile and commodity prices which we are watching closely.

Figure 5: Australian dollar forecasts

AUD CROSS	CURRENT	2016E		2017E	
		FORECAST	% CHANGE	FORECAST	% CHANGE
USD	0.7688	0.7000	(7.05)	0.7000	(7.05)
EUR	0.6900	0.6030	(10.48)	0.5830	(13.46)
GBP	0.5924	0.5430	(4.81)	0.5830	2.24
JPY	78.40	73.50	(4.63)	77.00	(0.08)
CAD	0.9977	0.8750	(11.45)	0.8610	(12.87)
NZD	1.0675	1.0290	(1.86)	1.0290	(1.86)

Source: Crestone, UBS Global Research

We forecast a level of USD0.70 at the end of both 2016 and 2017, but acknowledge there's a risk that the currency may remain buoyant in the near term. The key basis for continuing to think the Australian dollar will depreciate is:

- the RBA is expected to retain an easing bias while the Fed hikes rates and other global central banks reach their lower bounds in terms of monetary policy;
- higher interest rates in the US should lead to an appreciation of the US dollar versus other major currencies including the Australian dollar;
- Chinese economic growth is expected to moderate and this, in addition to a stronger US dollar, should weigh on commodity prices; and
- Australian economic growth is expected to moderate slightly but this should have little impact on the currency or policy decisions.

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