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OBSERVATIONS

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Can the Aussie remain on the front foot?

Unlike the negotiations between Cricket Australia and its players, the Australian dollar, or ‘Aussie’, has made noticeable progress recently. A key driver of this has been the testimony to Congress by US Federal Reserve (**Fed**) Chair Janet Yellen. An important question for Australian investors and the economy is whether the currency will continue to advance, or whether this is just a short-term violation of a trading range.

Why did the Aussie suddenly break out of its trading range?

For most of the past year, the Australian dollar has hovered around the USD0.76 mark. Stronger relative economic growth, an interest rate premium, and ongoing Chinese economic strength are key reasons for capital being attracted to our shores. In addition, Australia’s improved terms of trade and current account have added further support for the currency. It is only really the fall in commodity prices which has been a detractor for performance.

Last week, however, the currency rallied sharply and broke USD0.78 for the first time in two years. It has continued to rally this week and is currently above USD0.79. There are four primary drivers of this recent spike:

1. **‘Dovish’ comments by Fed Chair Janet Yellen**—During her two-day address to Congress, Janet Yellen said that the Fed’s path was not pre-set and that the Fed will implement "gradual rate hikes" over "the next few years."
2. **Weaker US inflation and retail sales data**—This casts doubt over the strength of the economy and the need for higher interest rates—especially given the partial unwind of the Fed’s balance sheet, which is expected to begin at the end of the year.
3. **Doubt that President Trump can implement policy reform**—Growing disappointment over the ability of President Trump to implement policy reform was made more obvious last week. Congress was unable to vote on healthcare reform, thus potentially delaying any fiscal reform at all.
4. **Stronger Chinese import data**—Stronger data suggests that the Chinese economy is growing at an acceptable pace. This was supported by GDP growth data for Q2 2017, which subsequently showed that the economy grew at an annualised rate of 6.9%.

The Australian dollar has hovered around USD0.76 for most of the past year

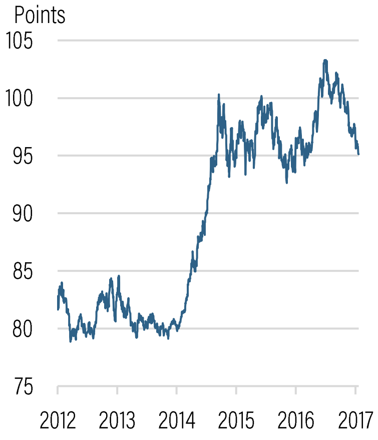
Source: Bloomberg.

The Australian dollar has broken out of its trading range on weaker US data and more dovish Fed rhetoric.

Can the currency continue to advance?

Most of the factors that have caused the Australian dollar to break out of its trading range are US-specific, which means they predominantly impact the US dollar. As such, the recent price activity can more accurately be described as a US dollar sell-off rather than an Australian dollar appreciation.

The US dollar Index over the last five years



Source: Bloomberg.

We expect the Australian dollar to remain around its current level over the near term but with a downward bias over the medium term.

There is no doubt, however, that stronger Chinese data helped the Australian dollar, but only to a minor degree.

Yet when one considers the factors that have supported Australian dollar strength until now (stronger relative economic growth, an interest rate premium, and ongoing Chinese economic strength), it is conceivable that the currency could continue to advance—this is providing the status quo holds and commodity prices rise.

We expect it to remain around current levels over the near term

At Crestone, we believe that we are approaching a near-term top with the Australian dollar. Its recent advance has seen its price move above the forecasts of our key currency research providers. UBS Research (**UBS**) and Commonwealth Bank of Australia (**CBA**) have year-end targets for the Australian dollar of USD0.78 and USD0.76 respectively.

Additionally, the US dollar has likely overshot to the downside with its recent move and has scope to rebound. The US dollar index (**DXY**) is now trading at its average for the past two and half years. This suggests that traders have become overly pessimistic and are not pricing in the true range of possibilities, which include:

- the Fed unwinding its balance sheet and/or continuing to hike rates;
- the Republicans being more successful than expected on policy reform;
- weaker Chinese or Australian economic growth;
- commodity price declines as supply grows and China slows;
- Brexit negotiations creating difficulties for Europe; and
- political uncertainty surrounding Japanese President Abe.

There could be a downward bias over the medium term

Currency markets are inherently difficult to forecast over the medium term due to the vast number of factors which determine their value. Indeed, a Reuters poll of 60 strategists taken in the first week of 2017 forecast the DXY to finish the year at 101.5. However, it has consistently moved away from this level, and is currently trading at 95.25. With respect to the Australian dollar, it is arguably one of the hardest currencies to predict, given its historical correlation to volatile commodity prices.

In saying that, based on the range of factors listed below, we expect to see the Australian dollar remain around current levels over the medium term. However, there could be a downside bias if Chinese growth or commodity prices decline, interest rate differentials move negative, or if the US implements fiscal reform. UBS and CBA are both targeting an exchange rate of US0.80 for the end of 2018.

- **Current account**—continuing to improve and support the currency;
- **Commodity prices**—expected to remain stable following the recent price retracement, which is expected to be neutral for the currency;
- **Chinese growth**—expected to slow gradually as reforms are implemented, which should be neutral for the currency—but it could be a 'black-swan' risk, which could send the Australian dollar sharply lower;
- **Interest rate differentials**—should move to favour the US dollar as the Fed raises rates and the Reserve Bank of Australia (**RBA**) remains on hold; and
- **US policy reform**—should improve from current pessimism and be supportive of the US dollar, but the timing is highly uncertain.

In summary

While we could certainly use Janet Yellen's persuasive nature in our cricket dispute, it's unlikely she will have as much influence over monetary policy and market sentiment. She has done this superbly since becoming Fed Chair—but the bulk of her influence over the US dollar has likely now been felt.

While currency markets are notoriously volatile over the short term, we expect the Australian dollar to remain around its current level over the near term, but with a downward bias over the medium term. The upside appears limited unless the RBA turns surprisingly 'hawkish' and lifts domestic interest rates.