22 March 2017

Market Update

Aussie Dollar Antics

Market sentiment has chopped and changed around since the US Federal Reserve lifted the cash rate for a third time in this new interest rate cycle. This *Market Update* seeks to provide an analysis of the five factors to watch out for in the Australian dollar.

Global and Domestic Growth

In direct contrast to last year, the 2017 year has commenced on a particularly bright note. Manufacturing PMI's have broadly lifted around the globe. The IMF and the OECD have revised up their growth projections for this year and again next year. Such a backdrop bodes well for both the Australian economy and the Aussie dollar.

The big driver for the Australian economy remains the Chinese economy. The good news is the Chinese economy is growing strongly, if not running a little hot. Hence, officials are pulling the reins in on stimulus and tightening policy via raising repo (inter-bank) rates.

Looking further out, the Chinese economy is forecast to grow at a slower rate from 6.7% in 2016, to 6.5% in 2017, and slower again in 2018 at 6.2%.

Domestic GDP has been grinding lower as the economy transitions away from the high growth mining construction phase. However, the brighter global backdrop coupled with the near completion in the drop in mining investment has seen the RBA raise their GDP forecasts to 3% growth by the end of this year.

Tailwinds include a revival in the commodity markets, strong house price growth and a suite of infrastructure projects commencing this year.

Headwinds include the dual slowdown in mining and housing construction, and the closure of car manufacturing. Doing business remains expensive relative to other parts of the world, and rising energy costs presents an acute problem for domestic manufacturers and producers. Furthermore, the high debt and low wage growth backdrop for householders is likely to weigh on consumption spending over the next couple of years.

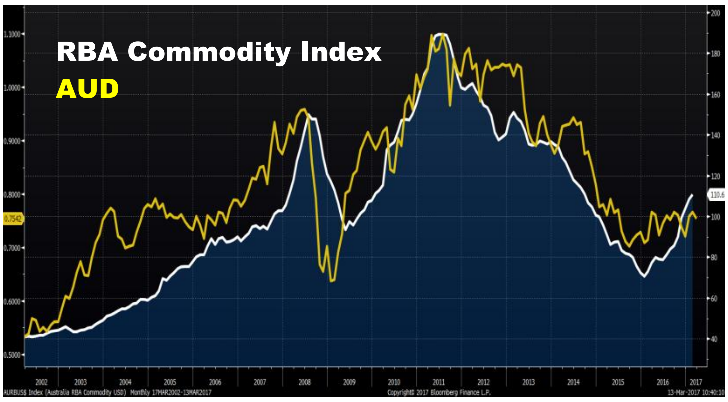
Commodities and the Terms of Trade

The commodity cycle is a longer term driver for the Aussie dollar, but an important one nonetheless. The sheer scale of the re-rating in commodity prices over the last six months has been nothing short of remarkable, notably for the bulk commodities.

As such, this is feeding into positive incomes at the national level via the terms of trade. However, the jump in commodity prices is widely expected to be temporary, as demand from China slows. In addition, China's transition away from investment and construction into internally generated demand via consumption is also likely to weigh on commodity prices.

Having said this, the spike in bulk commodity prices have taken Australia's trade balance to the highest ever trade surplus, back in December. But, trade surpluses are typically short lived here in Australia.

Relatively high commodity prices are likely to instigate a supply response from producers, and in turn drag prices lower. The oil markets are an example of this, whereby rising US shale oil production is weighing upon oil prices globally.



Commodities and the $A remain close friends (Bloomberg)

Interest Rate Differentials

The global economy has witnessed a shift away from monetary policies (zero cash rates and unlimited bond buying programs) toward greater fiscal policies (tax reform and infrastructure spending).

Darryl Conroy
Financial Markets Research

darryl.conroy@suncorp.com.au

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Whilst such a shift could take many months to evolve, it should result in a normalisation of cash and bond rates around the world.

This change in the interest rate cycle is expected to be led by the US Federal Reserve. The Fed has now affected three rate hikes, and their dot plot predicts another three hikes this year, and another three the year after.

The future direction for Australia's cash rate remains much less certain, but international markets are dragging our long term bond yields higher. The RBA seem content to leave cash rates on hold for this year.

The spread between the two-year Australian Government Bond and the US two-year Treasury Note, is at a decade low 54bps against a twenty five year average of 233bps. Such a backdrop may favour the US dollar in the short term, but given Australia's ongoing need to borrow from overseas, suggests a return to averages over the longer term.

The US Dollar

The Australian dollar is priced in terms of US dollars, hence US dollar strength equates to Aussie dollar weakness and vice versa.

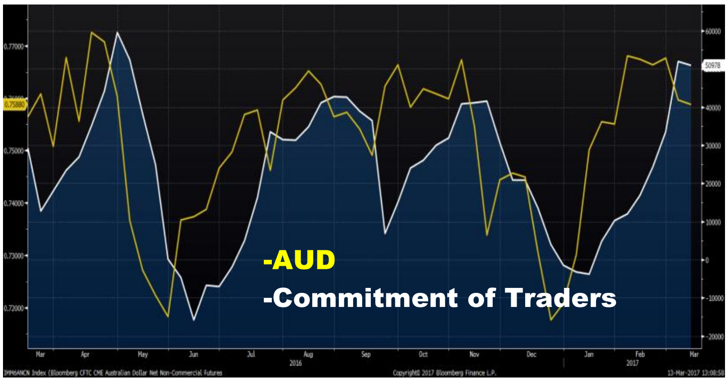
The US dollar index (DXY) reached its highest level in fifteen years since Donald Trump assumed his seat in the Oval Office. However, the success of Trump's policies are dependent upon a weaker US dollar. Hence, policy measures to weaken the greenback are a distinct possibility.

The above chart shows the AUD/USD on a weekly basis. From a technical perspective, the AUD looks like its building up for a kick higher.

Noting, the AUD has tested lower levels, yet keeps coming back to a two-and-a-bit year resistance level around US77.3c.

Market Sentiment

Trader sentiment can be measured via the commitment of traders (COT) report from the US Commodity Futures Trading Commission (CFTC), but how politics will play out in foreign exchange markets remains highly uncertain.



AUD trades in sync with trader sentiments (Bloomberg)

The Trump administration has thus far proved to be both unorthodox and unpredictable, although markets are adjusting to this more abrupt style.

However, the global rise in populism is likely to impact upon trade via protectionist policies, hence we can expect bigger swings in currency markets.

Summary

As it currently stands, the Australian dollar is hovering around its average levels for the last twenty-five years, and the above listed five drivers are equally as inconclusive.

On a fundamental basis, the Aussie dollar should trade lower on the back of a resurgent US dollar. Technical analysis, however, suggests the Aussie dollar may jump higher in the near term.

In summary, persistent strength in commodity prices and a trade surplus may encourage the Aussie dollar higher in the months to come. Just beware of temporary bouts of weakness around Fed rate hikes. Over the longer term, the Aussie dollar should emulate moves in both the Chinese economy and the commodity markets, that is, lower over time.

Darryl Conroy
Financial Markets Research

✉ darryl.conroy@suncorp.com.au