World First briefing note:

Where now for the AUD?

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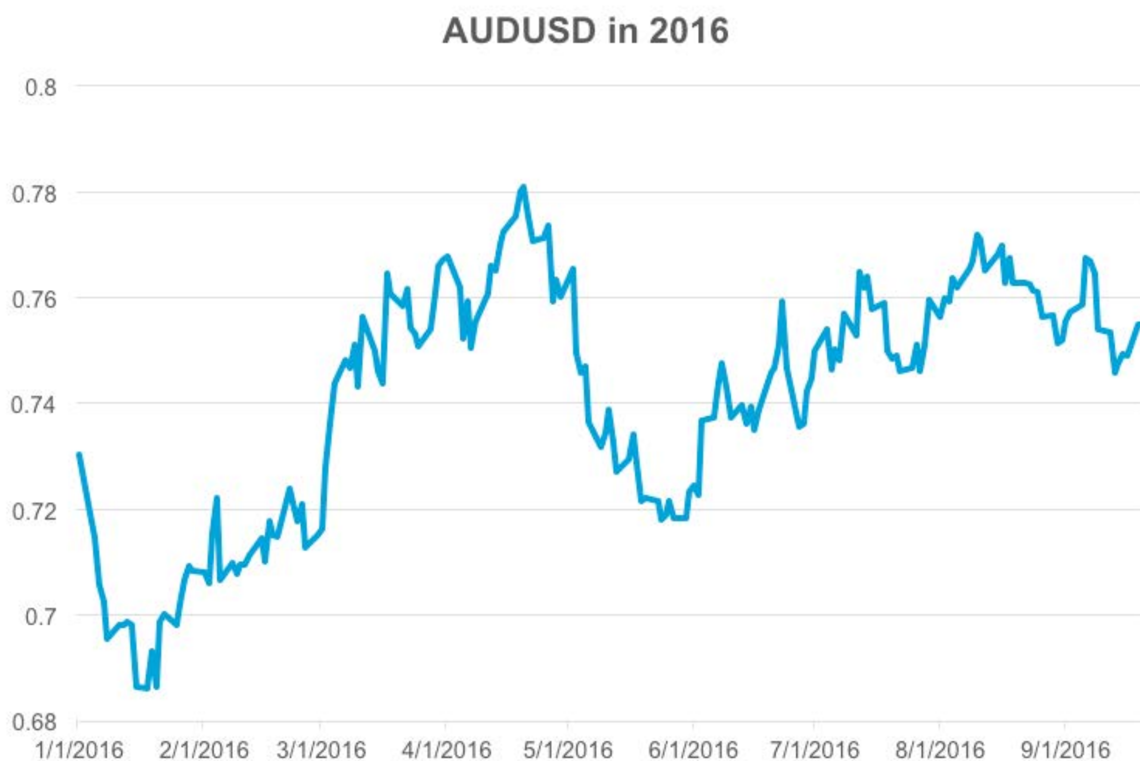
The Past 12 Months

The AUD has had to play second fiddle to a fair few risk events through 2016. This past year has seen a huge amount of risk flow on and off the table and has left markets doubting and scared while central banks, excluding the Federal Reserve, have run to loosen policy in a bid to keep both demand and growth stable.

Indeed, in the past 12 or so months the AUD has been subject to a Chinese yuan devaluation, pressures on bank funding models in Europe, the impact of Brexit and an uneven and uncertain rebound in commodity prices. For the most part this has led AUD higher, away from the multi-year lows it hit in January of this year.



This is more of a USD story than an AUD story in my opinion. Following the Federal Reserve's decision to increase interest rates last December the US central bank started to tell the market that, as a median estimate, it expected to hike interest rates 4 times in 2016; the USD was the only place to be and combined with a heady risk environment, AUD was sold.

But we haven't seen rates rise 4 times in 2016. They haven't risen once yet and, at the time of writing, there is only a 55% chance of a single 25bps increase in interest rates by the end of the year. For all the chatter of a stronger USD, AUDUSD is 3.5% higher since Jan 1 as investors weathered the risk environment and went for yield.

The question we must now answer is whether this AUD strength can continue?

Commodity prices

AUD exports commodities and imports risk; for every tonne of iron ore that is refined and prepared for export, the Australian economic machine becomes increasingly tied to China and therefore, risk. Australian terms of trade have improved since the beginning of the year; it would have been difficult for them to get much worse. Iron ore has gained by about a third since the beginning of the year with tin up around a quarter since then and while many analysts are not expecting a huge rally in base metals there is a definite feeling that the worst is over.

There is still a large over-supply in commodities at the moment. At the beginning of the year that was in raw materials as overinvested miners struggled to run down operations. The pressure has now passed to refiners as they sit on inventories of metals ready for export. Of course it is the demand side that has to be strong enough to pick up the slack and, needless to say, there is significant blockage as to what is happening in the economy of the market's largest consumer.

China and emerging markets

A short sighted and single minded market view on Brexit and the European political arena – of which we'll touch on later - has seen focus lost on the world's 2nd largest economy. As we came into the year we were nervous about Chinese output amid a strengthening yuan and a nervous global economy; Chinese exports still needed to stay cheap so that the transitioning of the economy from manufacturing to services could occur on foundations of solid external demand. That has not happened and news from the Chinese economy has not picked up noticeably since the beginning of the year.

We expect further news from the Chinese corporate sector in the coming months as to the levels of credit and whether further bubble-like conditions are being seen, which will weigh on the likely policy response from the People's Bank of China. That being said, we are almost entirely in the dark as to how well the Chinese economy is growing at the moment. We are of the opinion that it is not just us who doesn't know where Chinese GDP is; we doubt the Chinese authorities really have an idea of what is going on.

Likewise in wider emerging markets we have to bear in mind that if Chinese growth is stagnant at the moment, investors will we be thinking about countries that are not tied to the China – places like Indonesia, Malaysia, Argentina or Mexico as opposed to places like Australia or South Africa.

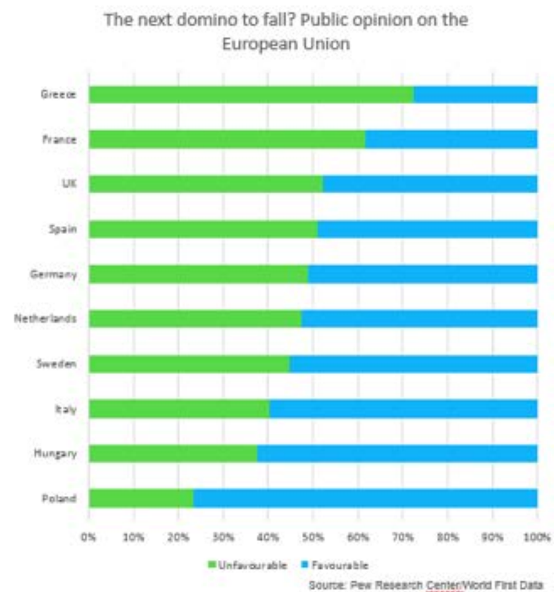
European politics

2016 has been the year of political risk – the Brexit debate, the refugee crisis in Europe and the ascent of Donald Trump closer to the Presidency than anyone thought have made geopolitical predictions very difficult.

We do not expect 2017 to be as aggressive, however substantial risks remain. There are four election cycles in the next 15 months in the Eurozone (Italy, the Netherlands, France and Germany) and EU sentiment is very much in a state of flux. Issues of national identity, weak economic fundamentals, substantial wage compression and security concerns over migratory flows from Syria and Turkey are all points of contention for the European project.

We expect calls for further referenda on EU membership from populist and nationalist parties within these campaigns – France's Front National and the Dutch PVV party the most likely to make such a vote a central part of their campaigns.

The next domino to fall



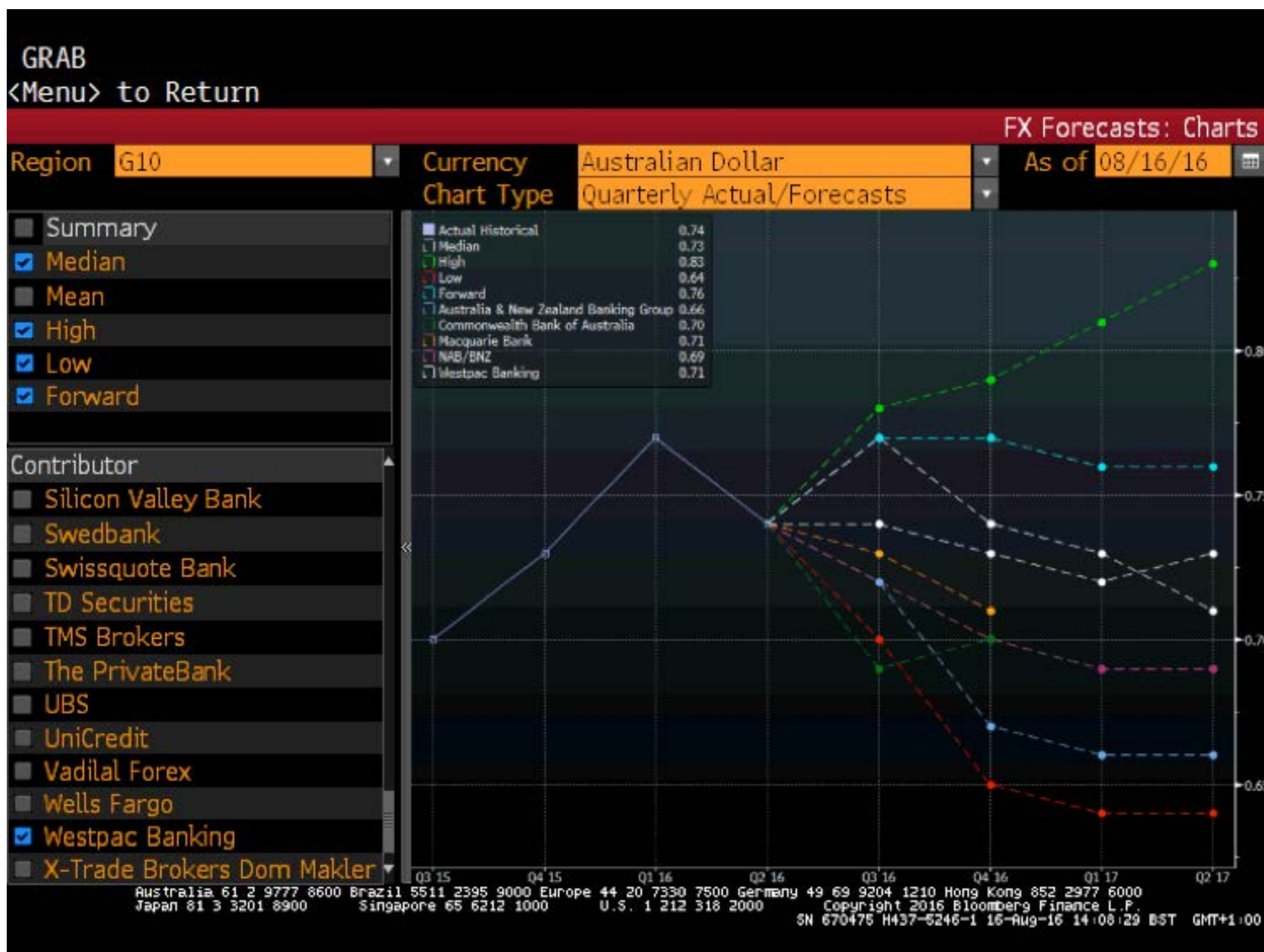
Politicians of every stripe and nationality have acquitted themselves poorly through the Global Financial Crisis, and subsequently, but nowhere more so than in the Eurozone.

The risk therefore is that issues that take political focus away from the economics of Europe mean a slower and more unpredictable recovery for the wider Eurozone and therefore a greater pressure on the European currency, and risky assets as a result.

Longer term outlook for the AUD

Despite an uncertain world and one of the strangest political atmospheres ever, risk has done relatively well this year; look at equities, commodities and the Brazilian real this year.

Overall markets are expecting a softening of the AUD



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Should Australia's terms of trade deteriorate further as commodity prices weaken in the event of poor news from China and the wider global economy, this would render the AUD even more vulnerable. Combine this with the knowledge that AUD is one of the most sensitive currencies to risk, AUDUSD could slide to around 0.70 by the end of the year.

Despite recent comments from the Reserve Bank of Australia, we are lead to believe that additional rate cuts are likely by the end of the year. While interest rates are at a record lows, we have to think that despite the lack of easing bias the reluctance of the major 4 banks to pass on the rate cut and continuing weak inflation will push the RBA into additional action.

But a cut to record lows still has done little to tarnish AUD strength. Australian 10yr debt still pays 2.12% compared to 1.19% in Canada, 1.69% in the US and 0.85% in the UK and political risk is low compared to most, and therefore we can still see buying support remaining for the currency.

We also like the Fed for another rate rise this year. Rate expectations in a post-Brexit world are a difficult beast. Markets are currently only pricing in 19bps of hikes from the Federal Reserve in the next 12 months; a number that looks very cheap given the recent run of US data.

That ascribes a 55% probability of a hike in interest rates by the end of the year, and while the Federal Reserve has been quick to find the grey cloud amongst the silver linings, we have to think that should the US data picture continue to look as rosy as it does at the moment, then we can look for a cheerful return to higher rates in the US sooner rather than later.

If there is going to be a rate hike this year, we think it will take place in December so as to allow the Federal Reserve some insulation.

So, putting this all together we know that the pain trade for AUDUSD is for it to head higher and, as we can see from the HI-LO there are people out there calling for a run above 0.80. The law of averages however is that we will see some of this overvaluation in AUD slide out of the price as inflation dynamics remain weak and political pressures elsewhere limit investor appetite for risk.

We therefore believe that AUDUSD should trim down to 0.70 in the coming 12 months.

What does this mean for Australian businesses?

Importers should seek to protect their profit margins at the highest possible levels and the best solution available would be through simple and bespoke hedging contracts. World First clients were recently able to lock in protection at higher levels in the AUD on the back of such recommendations. Looking forward, there will be further spikes in the AUD which importers can take advantage of and seek to hedge at higher levels.

This year exporters have endured a rise in the AUD that has stayed at unexpected levels for a surprising amount of time. Many companies are trying to remain patient and wait for some reprieve though there are products available which allow exporters to exchange at levels lower than where the spot market is trading.

Many dips in the AUD have been occurring in European and North American trading hours. For those looking to take advantage of opportunities at these times, short term or spot contracts can be triggered through targeted orders.

World First clients have been taking advantage of these opportunities with 24/7 account management in order to protect their FX exposure against market movements.

Our importing and exporting clients receive a full, free consultation on how to best protect their profit margins at the best possible levels through simple and bespoke hedging contracts. Clearly, having a specialist on your side can help your business navigate the often volatile global currency market.

Wonder what this might mean for you?

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