

FX Strategy

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Kasper Kirkegaard, Analyst, +45 45 13 70 18, kaki@danskebank.com

AUD: What goes up...

- In this research note, we take a closer look at the Australian economy, with an emphasis on the outlook for AUD in 2008. The Australian economy is in its 16th year of expansion, and, despite a slow-down in global growth, we do not expect it to slow significantly. Inflationary pressures have been building though, and we therefore expect the Reserve Bank of Australia (RBA) to increase its policy rate by 25bp in 2008.
- AUD is highly overvalued compared to levels implied by long-run equilibrium and will have to see a significant correction. When this correction will take place, however, and how gradual it will be, is uncertain. While relative growth and interest rates remain favourable, three factors will weigh on AUD in 2008, as global growth slows, commodity prices peak, and global risk aversion remains high or rises. We will therefore consider going short AUD when we see one of these triggers.
- AUD could, however, see relief in the very short term, if Q4 inflation numbers released on 23 January turn out to be above the RBA forecast. This would most likely trigger an interest rate hike at the 5 February meeting, which is now only priced with a 40% probability by the market. We do in fact expect the RBA to hike the policy rate by 25bp at the February meeting, although it is a very close call.

Introduction

The Australian economy is generally in good shape and is expected to maintain high growth in the short term. However, 16 years of continuous expansion is beginning to weigh on capacity utilisation and price and wage pressure has therefore been building. As a result, the RBA has taken the policy rate to 6.75% and we expect the RBA to deliver one more rate hike this year. The main restrictions to growth in the short term are thus limited supply capacity, and the risk of inflation and an appreciated currency curbing export growth. In terms of the AUD, we expect relative growth and interest rates to remain favourable throughout the year. This should bring short term relief to the AUD, but does not remove the fact that the AUD is historically overvalued - particularly against the USD. We therefore expect the AUD to begin a correction this

year and see the global slowdown and increased risk aversion as potential triggers.

We are therefore forecasting a gradual depreciation of the AUD and expect AUD/USD to reach 88, 84, and 80 in 3, 6, and 12 month's time respectively, compared to a forward of 87, 86, and 84.5. This implies an expected EUR/AUD of 173, 179, and 175 in 3, 6, and 12 month's time, compared to a forward of 168, 169, and 172.

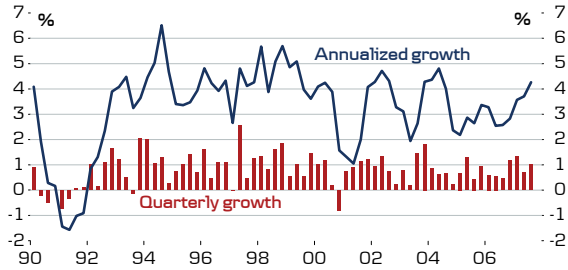
Domestic Business Cycle

First, we take a look at the domestic business cycle, then the domestic monetary cycle, and finally we draw inference for the AUD.

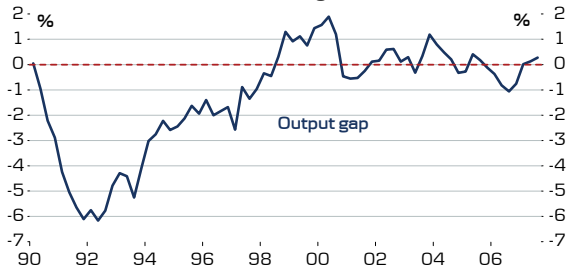
The Australian economy is growing rapidly, and is currently in its 16th year of an ongoing expansion.

This expansion is unprecedented in Australian economic history, and has made the country the 17th richest in the world, as measured by GDP per capita. Growth has even accelerated in recent years and the economy continues to grow at above trend growth rates. Despite the lengthy expansion there are still no signs of any imminent slowdown and the OECD composite leading indicator (CLI) is still signalling strong growth.

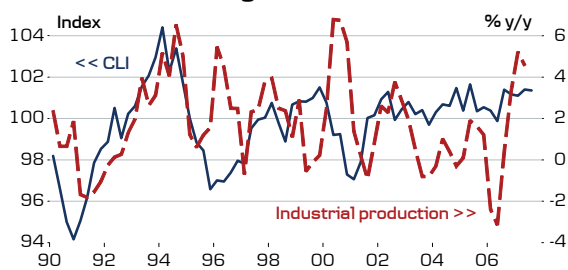
The economy is in its 16th year of expansion...



...With above trend growth rates...



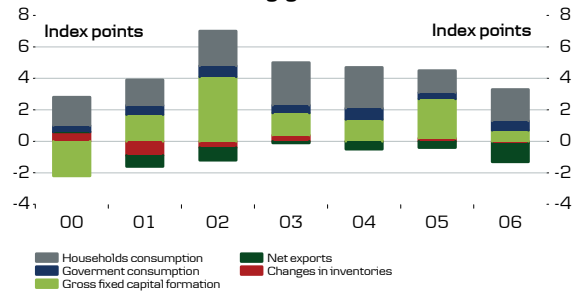
...And no signs of a slowdown



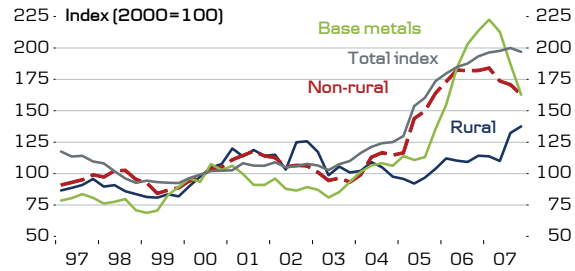
Source: Ecwin

There are, however, some signs of clouds on the horizon and one can question the sustainability of recent year's growth drivers - most notably the high growth in private consumption. The Australian households have experienced high growth in disposable incomes thanks to a positive income shock mainly originating from a rapid rise in the terms of trade. Also gross fixed capital formation has been adding significantly to overall growth - particularly in the mining sector. Growth in gross fixed capital formation has slowed, however, due to a rising cost of capital and a peak in both the terms of trade and house prices.

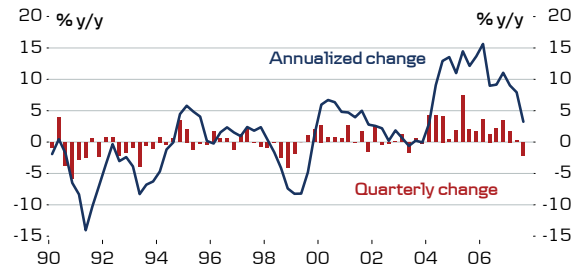
Private consumption and investment has been driving growth...



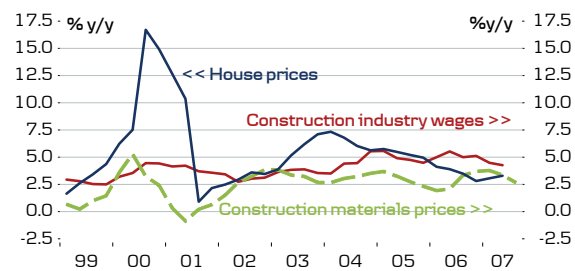
...Not least thanks to a positive income shock from a global commodity price boom...



...But stimulus from the terms of trade is fading...



...And the housing market does not look like a place of rescue



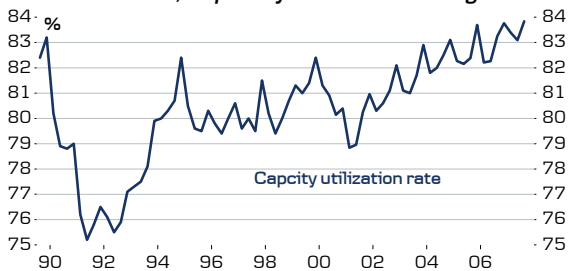
Source: Ecwin

While there are signs of increased tightness on the housing market, which could lead to increased building activity, this is still to materialise fully. Meanwhile, house prices have peaked for now in most major cities and have returned to growth rates more in line with growth in overall construction prices. Contrary to the high contribution to growth from investment and consumption, net exports have been the main restriction to growth in recent years. Contributions to growth from net exports have become increasingly negative and "subtracted" 1.2 percentage points of overall growth in

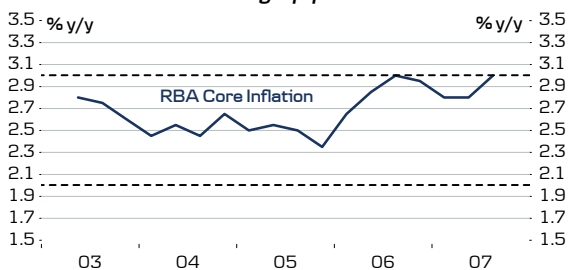
2006. The main factor behind the negative growth in net exports is slow growth in exports, caused mainly by the terms of trade boom, an appreciating currency, and supply constraints in the exporting sector - not least in the agricultural sector, where an extensive drought has constrained supply.

There has been substantial growth in most supply factors though, but the prolonged and rapid expansion is beginning to weigh hard on capacity utilisation, and is thereby increasing price pressures.

Due to rapid economic expansion and slowing investment, capacity utilisation is high...



...Driving up prices...



Source: Ecwin

Although headline CPI is fairly low, core inflation has begun to pick up and the latest inflation numbers showed that core inflation is now at the upper limit of the RBA's official inflation target zone. Rising energy and food prices have been the main reason behind the latest boom in prices, while the underlying price pressures have mainly come from the non-traded sector. The main question at the moment is thus, when and if wages prices will accelerate significantly. The unemployment rate stands at record lows, thanks to rapid growth in employment, and the labour market has become increasingly tight. Nevertheless, the wage pressure has been rather subdued until now - although there are some signs of acceleration.

...Also on the labour market - though wage pressures are still somewhat subdued

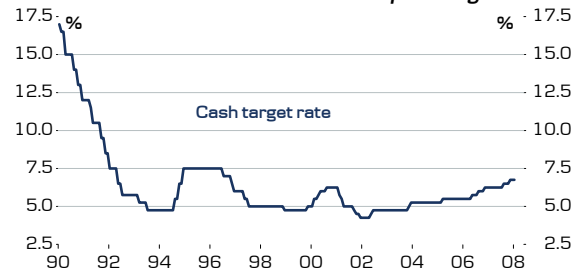


Source: Ecwin

Domestic Monetary Cycle

As a consequence of the increased price pressures and few signs of the economy slowing significantly, the RBA has taken the policy rate to 6.75%. While the RBA perhaps became less hawkish in its rhetoric in 2007, the higher than expected inflation numbers for Q2 and Q3 left little room to manoeuvre. And on both occasions, the RBA chose to hike the policy rate by 25bp at the meeting following the release of inflation numbers.

The RBA has been forced to keep hiking rates...



...And though the policy rate is a stunning 6.75%, monetary policy is not that restrictive

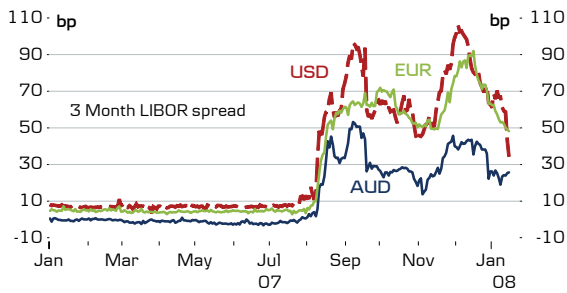


Source: Ecwin

While the current monetary stance is not that restrictive, the latest interest rate hikes from the RBA are still feeding into the economy and monetary and credit conditions have furthermore become tighter following the global credit contraction. The global credit crisis has not had as great an impact on the Australian economy though, as on the major economies. Nonetheless, it is clear that the

RBA have been given a helping hand in its efforts to contaminate price pressures.

The credit crisis has not hit Australia as hard as other economies



Source: Ecwin

This was also pointed out by RBA governor Glenn Stevens in the December statement.

“In Australia, the pressures arising from the global financial turmoil have been less pronounced than elsewhere, and the flow of credit to sound borrowers does not appear to have been impaired. Nonetheless borrowing costs have risen appreciably since mid year... as a result both of changes in monetary policy and market-driven increases in funding costs for intermediaries”.

These increases in borrowing costs (driven by higher funding costs) are beginning to fully materialise, and the major domestic banks are now raising mortgage rates, even when there has been no action from the RBA. These developments should, *ceteris paribus*, remove some of the expected monetary tightening from the RBA.

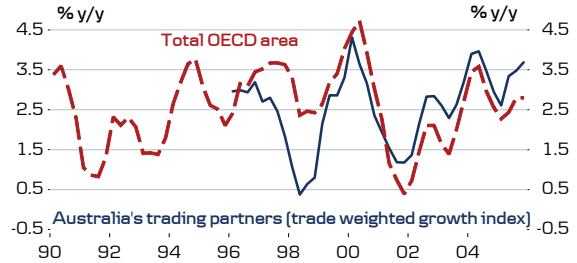
Global developments

While it is yet to be confirmed by hard data just how much the global economy has slowed in recent months, it is clear that growth is slowing. This will weigh on the Australian economy in general, and on the commodity market in particular.

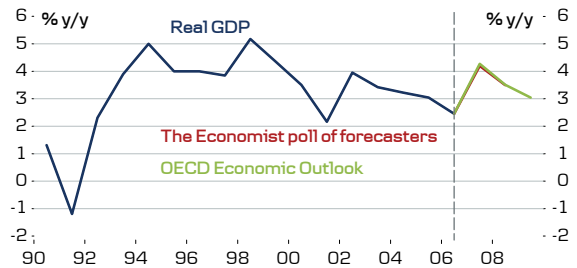
The question is then whether a global slowdown will put an end to the ongoing expansion. One well published argument against this, is the possibility of a decoupling in Asia, which could potentially leave Asian growth less affected by a slowdown in the US and Euro zone. With Asia as the main trading partner sustained growth in that region should help sustain growth also in Australia. The possibility of a decoupling in Asia is, however, still debated and appears somewhat unlikely - especially considering the low share of consumption in Asia's final demand. Data does show though, that Australia's trading partners

are growing faster than the total OECD area. Despite the outlook of a slowdown in global growth, expectations therefore remain for at (or above) trend growth in Australia in 2008.

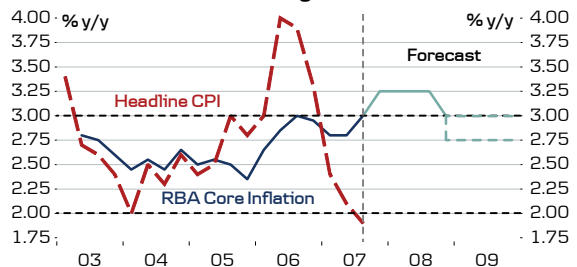
Australia's trading partners have strong growth in real GDP...



...And the Australian economy is thus not expected to slow dramatically...



...Leading the RBA to forecast core inflation out of the official target zone



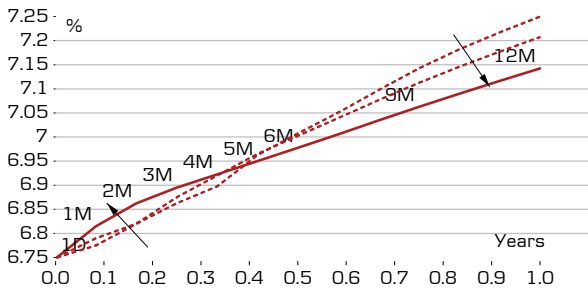
Source: Ecwin and Danske Bank calculations

Where does this leave the RBA then? With no signs of any significant slowdown in growth and record high capacity utilisation, increased price pressure seems inevitable. The RBA does also expect core inflation to have increased in Q4 07 and to remain above the official target zone in the first half of 2008.

This combination of already high underlying inflation and an economy running at very high levels of capacity utilisation has made the market expect further monetary tightening from the RBA. Based on the pricing of overnight interest rate swaps, the market is currently favouring the RBA to deliver one more interest rate hike in this cycle. The timing of this poten-

tial hike is, however, very uncertain and there is currently priced a 39% probability of a 25bp interest rate increase at the 5 February meeting.

The OIS curve has flattened in the past three months



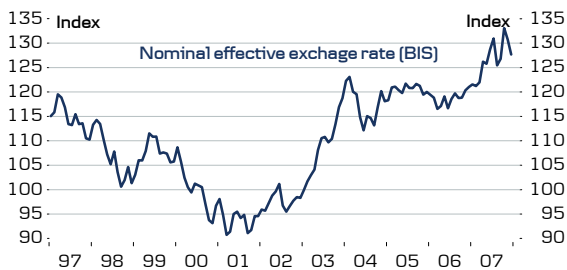
We are also forecasting one more interest rate hike from the RBA in this cycle, and we expect this to be announced at the February policy meeting. The RBA was highly data reactive in 2007 and we expect this to continue in 2008. The Q4 inflation figures released on 23 January will thus likely determine the short term policy actions from the RBA, and a reading of core inflation above 0.8% q/q could trigger a hike. While the RBA has expressed concern for the global economic outlook in its latest statements, we believe that inflationary pressures originating both domestically and internationally will be too high for the RBA to leave interest rates unchanged for now.

Outlook for the AUD

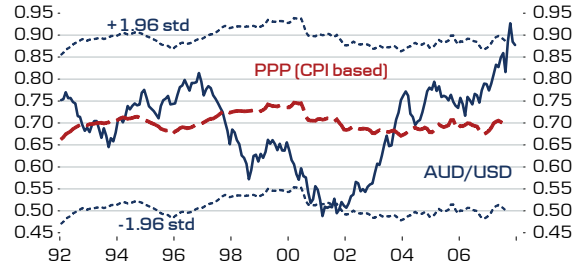
The question is then, how the combination of continued domestic expansion, a global slowdown, and a RBA with a tightening bias should affect the AUD.

The AUD has rallied since 2001 and was the third best performing G10 currency against the USD last year. Recent years' gains have, however, taken the AUD far away from equilibrium, and the AUD now looks fairly expensive, not least against the USD.

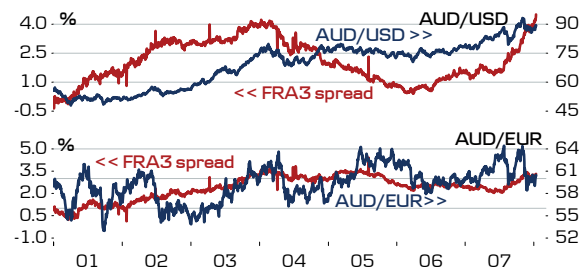
AUD has rallied since 2001...



... And now looks very expensive against the USD...



... But not when looking at relative interest rates...



...While also relative money growth justifies an expensive AUD/USD



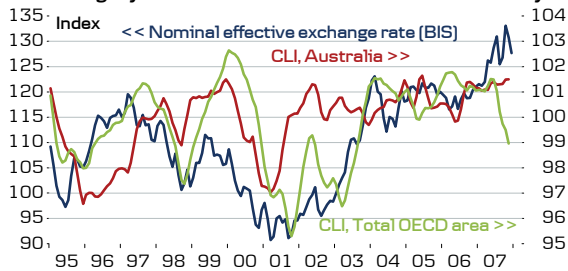
Source: Ecwin

From a relative interest rate perspective, the AUD does not look as overpriced though as it did before November. This is a natural consequence of the repricing that took place of especially the Fed during the autumn. From a UIP consideration the AUD still appears expensive against the USD, however, as relative interest rates on the bond market does not support the high AUD/USD. Higher relative money growth can explain some of this deviation from UIP.

When looking at the AUD it is important also to look at other factors. As we argued in our research paper [FX Strategy: G10: Business cycles and FX performance](#) of 10 December, the AUD is the G10 currency most correlated with the global business cycle. That is, during periods of accelerated (decelerated) global growth the AUD tends to appreciate (depreciate). As indicated by the graph below, the AUD even appears slightly more correlated with the global business cycle than the domestic business cycle. In recent months there has, however, been some divergence from this pattern, as the global leading indicator has fallen significantly without the AUD losing value. This

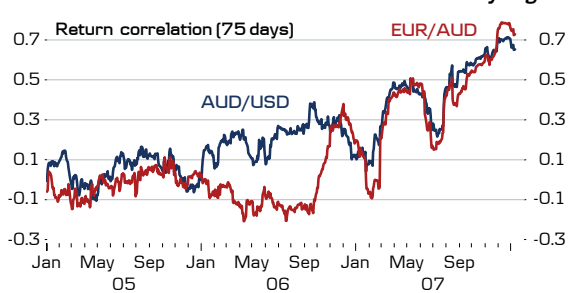
can partly be explained by the current decoupling between production and demand. The credit crisis and US housing slump has made producers increasingly concerned about the global outlook, and as a consequence the CLI is falling. Meanwhile, final demand has proven resilient and could explain some of the current decoupling between the world CLI and the AUD. Final demand is slowing though, and the AUD should come under pressure.

AUD is highly correlated with the world business cycle

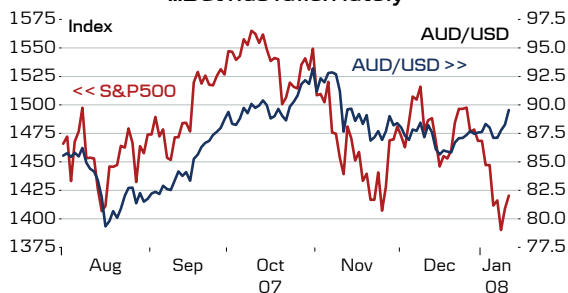


Despite this, it is perhaps surprising that the AUD has not depreciated recently, as global growth is slowing and risk aversion has risen. This is especially surprising as there has been no significant market repricing of the RBA or any significant changes to the domestic growth outlook. This must imply that there are other drivers of the AUD at the moment. One of these is the equity market, where the correlation with the AUD is historically high. Correlations usually rise during periods of financial turmoil, and due to the sensitivity of the AUD to global risk-aversion, correlations are therefore high at the moment.

The correlation with S&P500 is historically high...



...But has fallen lately



Source: Ecwin

Correlations have, however, fallen lately and the AUD have not lost on the latest fall in stock markets. This

could imply that risk aversion has detracted somewhat on the financial markets and is also confirmed by the fact that overall speculative carry positions have not fallen as much as we anticipated - despite rising fears of a US recession. Another driver of the AUD is global commodity prices, which has been one of the main explanations of the strong appreciation in recent years. Commodity prices have been rising lately, which could explain the resilience of the AUD.

Commodity prices have supported the AUD



To summarise: the recent year's large appreciation of the AUD has been created by high global growth, which has driven up commodity prices and provided a significant positive income shock to the already fast expanding Australian economy. This has led to very high domestic interest rates, which has spurred demand for the AUD through carry trades - which has been thriving in a low volatility and cheap money environment. As a result the AUD is entering 2008 as one of the most overvalued G10 currencies.

Where does this leave the AUD in 2008?

In order to answer this question it is necessary to look at the outlook of the individual drivers:

(i) Relative growth in production:

We expect global growth to slow in 2008 and forecast growth back at trend rates. Meanwhile, the Australian economy is not expected to slow significantly, and the outlook is thus for favourable relative growth - especially against the US. Relative growth in itself has, however, historically not been very important for the AUD. The AUD is, nevertheless, very sensitive to global growth.

Implication for the AUD: Neutral →

(ii) Relative interest rates:

Markets are currently seeing the RBA more likely to increase interest rates by 25bp in 2008 than not, and this is also our forecast. Meanwhile, we expect the Fed to cut rates by 125bp, and the ECB by 50bp in 2008. While this is more or less in line with current market pricing, it is clear that relative interest

rates will remain favourable for the AUD throughout the year, and risks are definitely on the upside.

Implication for the AUD: Neutral to positive → (↑)

(iii) Commodities

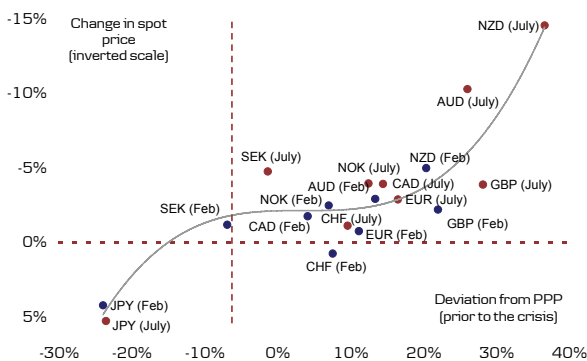
Commodities are very sensitive to global growth and are already at very high levels. With global growth slowing, we therefore expect global commodity prices to fall in H1 and then rebound in H2, as the US economy stabilizes. This should leave prices more or less unchanged in 2008. While there are still some price increases in the pipeline for Australian producers (due to staggered price setting) the overall effect appears neutral to negative for the AUD.

Implication for the AUD: Neutral to negative → (↓)

(iv) Risk sentiment

The AUD has been very sensitive to global risk aversion in recent years, mainly due to its status of carry target currency. Risk aversion has risen significantly since the summer, and we expect it to remain high in 2008 - and is likely even to rise. While there was a significant unwinding of carry trades in H2 last year, we still expect more to come in 2008 - the timing remains an open question though. Nevertheless, as shown in the graph below, currencies far away from levels implied by fundamentals, tends to see the largest corrections in a financial crisis. This could turn out as bad news for the AUD.

Currencies furthest away from fundamentals see largest corrections in financial crisis



Source: Bloomberg and Danske Bank computations

Implication for the AUD: Negative ↓

Conclusion

Overall, we expect the AUD to depreciate during 2008. It might, however, be a while before we see a correction and the AUD could see relief in the very short term.

There is no doubt that the AUD is overvalued (especially against the USD) and will have to see a correction back to equilibrium. When this correction will take place and how gradual it will be, is open to debate. As long as the domestic economy is strong and relative interest rates favourable, it could be costly to go short in the AUD at the moment, and the AUD could see temporary strength in the very short term - not least against the CAD. Three main factors will weigh on the AUD in 2008, however, as global growth slows, commodity prices peak, and global volatility and risk aversion rise. We will therefore consider going short AUD when we see one of these triggers, as there could be a significant correction of the AUD over the year. This could especially be the case against the EUR in H1.

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First date of publication

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