Weak fundamentals and rising geopolitical-trade tensions continue to weigh on AUD

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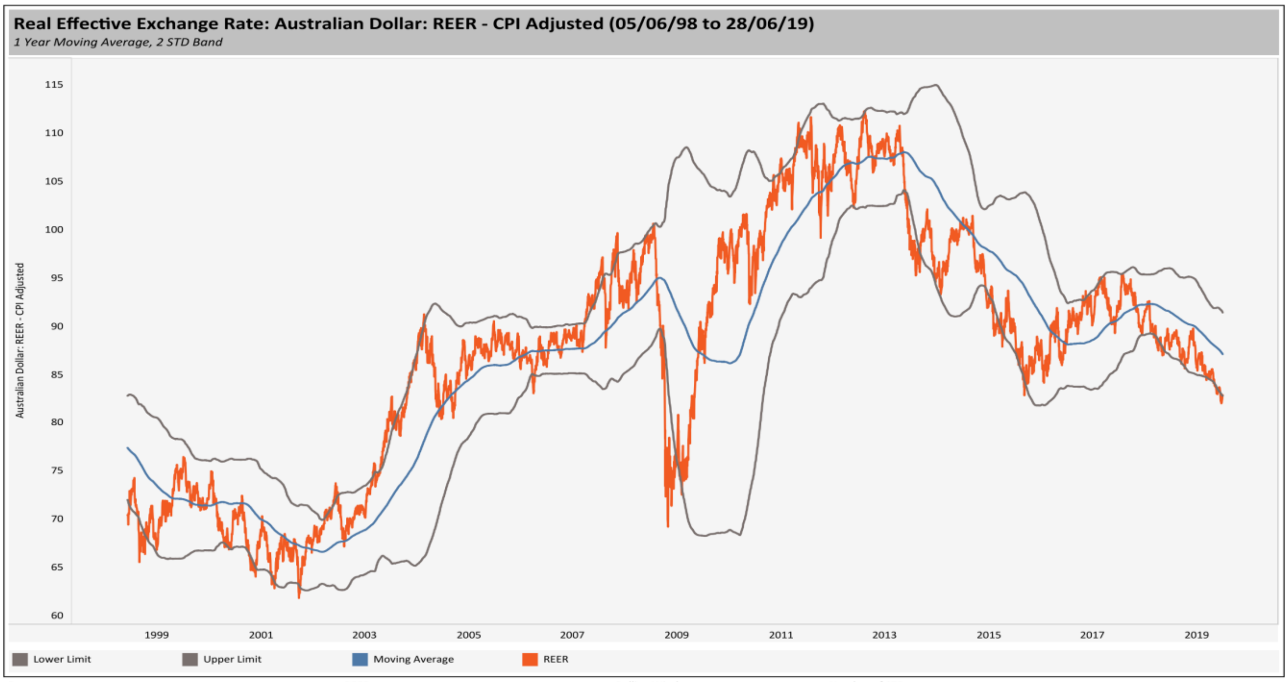
Key Insights

- AUD index against major trading partners shows a clear negative trend for currency since its peak in 2012.
- Over the past 12 months, AUD has weakened against most major currencies, the largest weakness was noted against the Yen and Swiss Franc.
- AUD weakness is also evident over the longer-term period of 3, 5 and 7 years which has benefited investors with unhedged offshore investments – growth and defensive.
- The weakness of the AUD has been fundamentally driven – while the commodity prices have been improving, the rate differential between Australian and 2-year is at 20-year lows. This has been underpinned by weaker GDP growth, lower inflation and dovish central bank.
- The outlook for AUD is positive against Swiss Franc and Euro but negative against the Pound, USD and Yen.

Review of AUD against major trading partners – downside risks still present for AUD Index

The 1-year moving average of the real Australian dollar index highlights the continued weakness of the AUD. The index has been trending down since its peak in late 2012. The negative trend since 2012 reflects the broad weakness against its major trading partners since that period. The most recent downdraft is underpinned by weak domestic economic data, dovish RBA and rising geopolitical concerns and trade wars that could impact global and Chinese economic health. While the weaker AUD is positive for our export competitiveness and domestic financial conditions, it creates challenges for importers and overseas travellers.

Exhibit 1. The real Australian dollar index continues to face downside risks, negative recent trends underpinned by weaker fundamentals



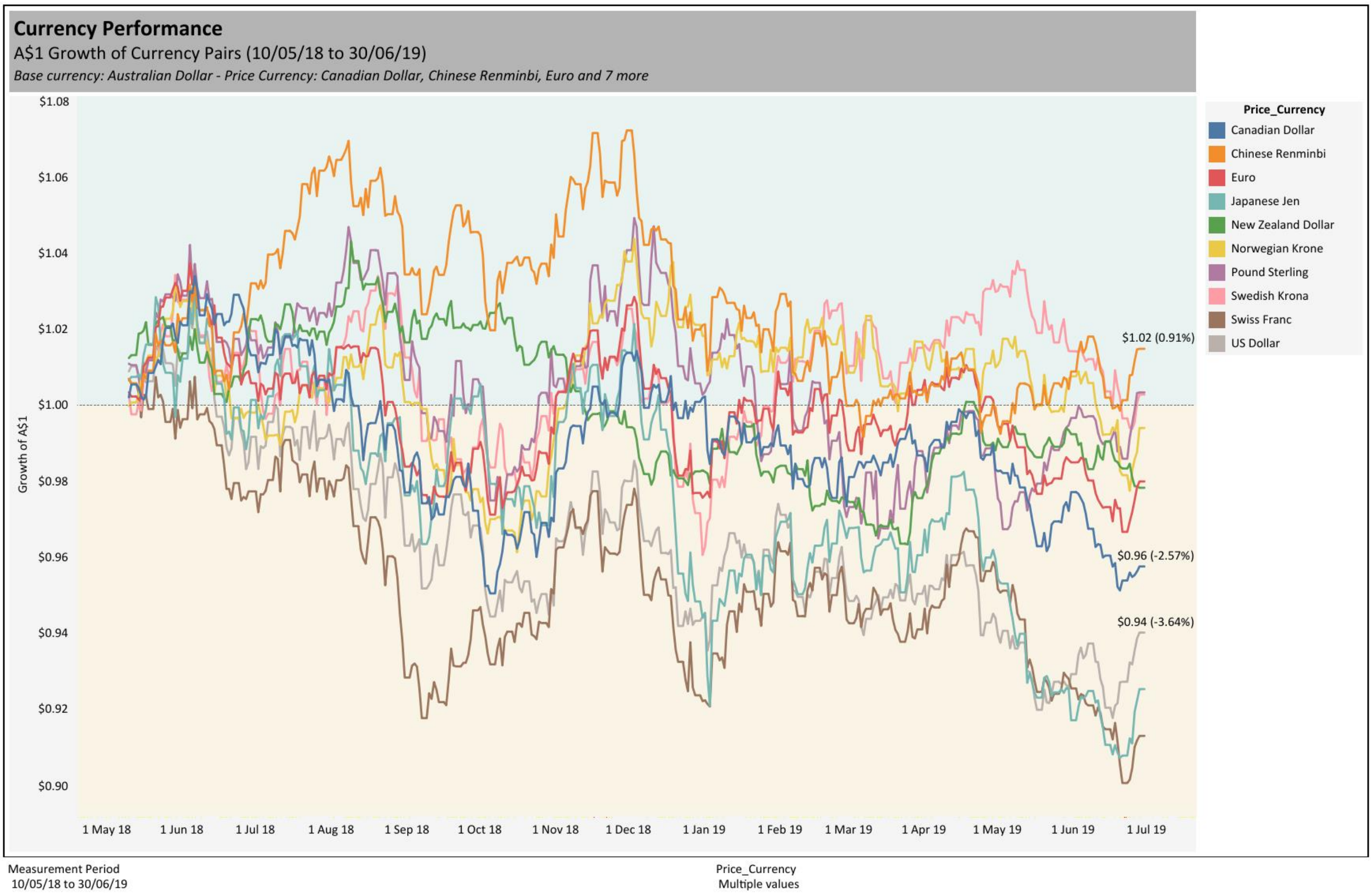
Date	REER	Rolling Window	Number of STD
02/01/97 to 30/06/19	Australian Dollar: REER - CPI Adjusted	1 Year	2

Source: Foresight Analytics
Data source: Thomson Reuters and Datastream

AUD weakness over the past 12 months was broad-based, downside persists

Exhibit 2 provides more granular details on AUD index and puts the broad currency weakness in conext. The data shows AUD's weakness continued over the past 12 months, mainly against Swiss Franc, Japanese Yen, USD and Euro throughout the past 12 months. Overall, the weakest performance over the past 12 months was against the Swiss Franc while the best performance was against the Chinese Yuan.

Exhibit 2. AUD experienced a broad-based weakness over the past 12 months



Source: Foresight Analytics
Data source: Thomson Reuters and Datastream

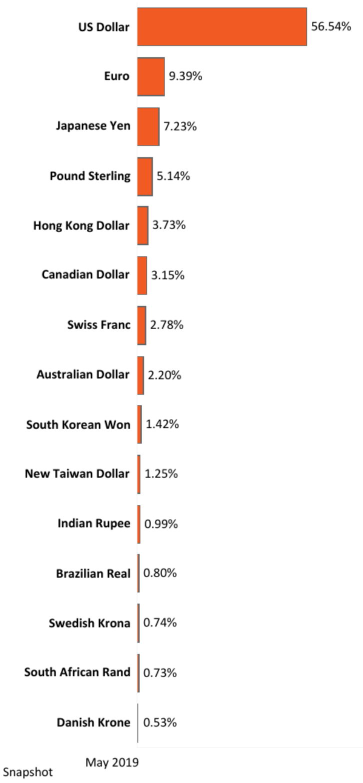
AUD weakness extended over the medium to long term

Exhibit 3 below presents data on the longer-term return and risk patterns of AUD against the 10 major currencies. The data shows broad-based weakness was not just a short term 12-month issue. Over the longer period of 3 to 7 years, AUD has been a general loser against all major currencies except the British Pound. Over a 7-year period, AUD lost most ground against USD, Hongkong Dollar and Korean Won. On the other hand, over the past several years AUD has demonstrated general resilience against the Canadian Dollar, Taiwan Dollar and Indian Rupee.

The data also shows a generalised convergence in currency volatility. Some exception to this trend includes AUD/JPY which continues to be abnormally high, tracking its 5-year annualised average. The volatility of AUD/CHF is also extended and is closely tracking its 15-year average. From the dataset, it appears that the Swiss Francs (CHF) has lost its stripe as a safe haven currency for now.

Exhibit 3: Longer-term pattern on AUD versus major currencies is negative

Top 15 currencies by weight in the MSCI ACWI NR index (May 2019)



Currency Pairs Returns (30.06.2019)

The returns are calcuated using monthly closing mid spot rates at 4 p.m London time expressed as amount of foreign currencies for one unit of Australian dollar.

	1 month	3 month	6 month	1 year	Annualised 2 year	Annualised 3 year	Annualised 5 year	Annualised 7 year	Annualised 10 year	Annualised 15 year
AUDGBP	0.67%	1.56%	0.06%	-1.35%	-3.22%	-0.40%	0.06%	-2.32%	1.22%	2.46%
AUDKRW	-1.61%	0.58%	3.32%	-1.67%	-4.00%	-1.84%	-3.19%	-5.07%	-2.34%	0.05%
AUDEUR	-0.51%	-2.39%	0.44%	-2.56%	-4.22%	-2.72%	-2.17%	-3.78%	0.72%	0.50%
AUDTWD	-0.66%	-0.69%	0.84%	-3.65%	-3.61%	-3.24%	-5.05%	-4.72%	-1.95%	-0.54%
AUDINR	0.24%	-1.41%	-1.33%	-4.51%	-1.31%	-1.26%	-3.10%	-2.27%	2.31%	2.77%
AUDUSD	1.17%	-1.07%	-0.44%	-5.19%	-4.46%	-1.96%	-5.73%	-5.25%	-1.38%	0.03%
AUDCAD	-2.00%	-2.96%	-4.42%	-5.48%	-3.99%	-1.53%	-1.80%	-1.76%	-0.21%	-0.09%
AUDHKD	0.83%	-1.53%	-0.68%	-5.59%	-4.42%	-1.73%	-5.58%	-5.15%	-1.30%	0.04%
AUDCHF	-1.35%	-2.97%	-0.99%	-6.57%	-3.57%	-1.95%	-3.91%	-4.86%	-2.43%	-1.60%
AUDJPY	0.79%	-3.72%	-1.97%	-7.58%	-6.38%	-0.52%	-4.54%	-1.08%	-0.26%	-0.03%

Periodic Volatility of Currency Pairs (30.06.2019)

The volatility is calcuated using monthly closing mid spot rates at 4 p.m London time expressed as amount of foreign currencies for one unit of Australian dollar.

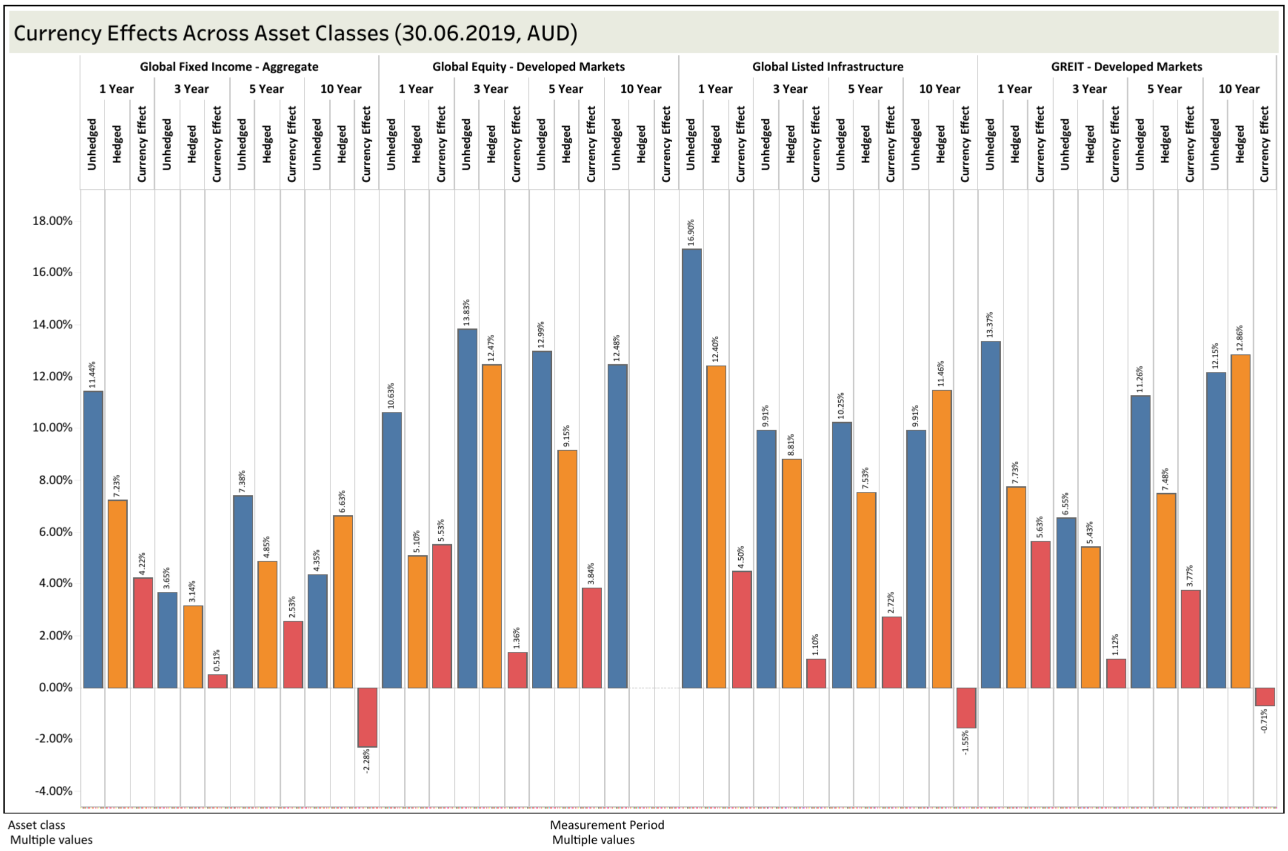
	1 year	Annualised 2 year	Annualised 3 year	Annualised 5 year	Annualised 7 year	Annualised 10 year	Annualised 15 year
AUDJPY	11.36%	9.60%	9.48%	10.69%	10.89%	12.93%	14.63%
AUDCHF	10.61%	9.06%	8.36%	9.68%	9.69%	9.58%	10.41%
AUDINR	8.69%	7.74%	7.83%	8.79%	8.60%	9.17%	10.36%
AUDEUR	8.15%	7.38%	7.55%	7.97%	8.70%	8.67%	8.72%
AUDUSD	7.99%	8.11%	8.18%	9.52%	9.40%	11.43%	12.74%
AUDTWD	7.84%	7.27%	6.90%	7.15%	7.52%	8.90%	10.27%
AUDHKD	7.81%	8.08%	8.20%	9.42%	9.32%	11.29%	12.65%
AUDGBP	7.40%	8.30%	9.31%	10.58%	10.25%	10.56%	10.83%
AUDKRW	7.09%	7.77%	7.74%	7.51%	7.77%	7.52%	9.87%
AUDCAD	6.66%	5.37%	5.95%	6.75%	7.03%	7.58%	8.94%

Source: Foresight Analytics
Data source: Morningstar and Thomson Reuters

Weaker AUD has been positive for investors in global assets.

A weaker AUD has not been all that bad. Investors with unhedged portfolio investment overseas have benefited quite significantly from the weaker AUD trend. When AUD is weak, the currency effect is positive from a translation perspective. Exhibit 4 shows that the AUD moves over the past 1 year, 3 years and 5 years have translated into positive currency effects for unhedged defensive and growth assets. For instance, unhedged developed market Global equity investors realized a positive currency effect of 5.53% over the past year, 1.36% over the past 3 years and 3.84% over the past 5 years. Similar quantum of positive currency effects was noted across Global Listed Infrastructure (unhedged) and Global DM REITs, although the 12-month pick-up in FX effect for Global Listed Infrastructure was lower at 4.5%. Overall, a weaker AUD has accounted for a substantial proportion of 12-month total returns delivered from offshore investments.

Exhibit 4: Unhedged Defensive and Growth assets benefited substantially from weaker AUD over the past 12, 36 and 60 months



Source: Foresight Analytics
Data source: Morningstar

AUD Fundamental Factor – Interest Rate differential and Commodity Prices

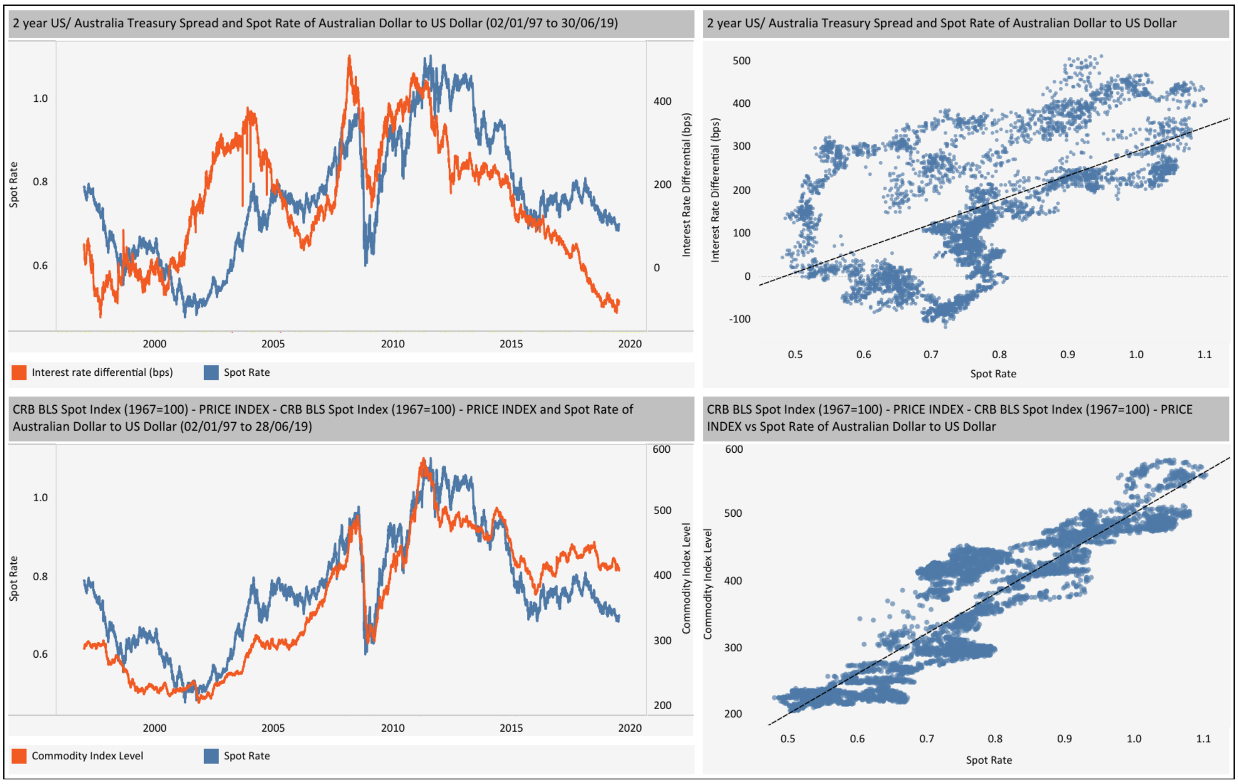
Based on Foresight's predictive modelling work, the 2-year interest rate differentials between Australia and the US has significant predictive power for the AUD/USD. Exhibit 5 shows the relationship between the rate spread and AUD/USD. Interestingly, the rate spread is at 20 year low. While there is a strong positive relationship between the rate spread and AUD/USD, there are periods when the relationship diverges. The current dataset is certainly pointing to this breakdown and it remains uncertain as to how long this divergence will last. That said, the negative trend for AUD/USD is highly pronounced. The lower Australian 2-year bond yield reflects a weaker economic and inflation outlook for Australia.

Despite a weakening economy, Australia's terms of trade have faced significant improvement since the start of last year. In its July meeting minutes, the RBA noted that since the March quarter iron ore and LNG exports have increased while coal experts have appeared to have fallen as indicated by trade and shipment data. Furthermore, higher iron ore prices had supported overall export values and the trade surplus has increased to almost 3 per cent of GDP in the March quarter[1]. Overall, the trade surplus was at its highest level, and the current account deficit at its lowest level, measured as a share of GDP, since the 1970s.

[1] Reserve Bank of Australia, "*Australia and the Global Economy – The Terms of Trade Boom*", https://www.rba.gov.au/education/resources/explainers/pdf/australia-and-the-global-economy-the-terms-of-trade-boom.pdf?v=2019-08-05-14-45-37

Exhibit 5 shows a positive correlation between AUD/USD and commodity prices. While the relationship between the factor and AUD/USD is much tighter than the 2-year rate spread, the recent breakdown in the relationship is amongst the most pronounced. It seems that investors do not believe the commodity prices will stay high over the longer term.

Exhibit 5. The 2-year interest rate differential between Australia and the USA is at 20 year low; Commodity prices are higher than 2008-9 low.



Period
02/01/97 to 30/06/19

Interest Rate Differential
2 year US/ Australia Treasury Spread

Commodity Index
CRB BLS Spot Index (1967=100) - PRICE INDEX - CRB BLS Spot Index (1967=100) - PRICE INDEX

Price_Currency
US Dollar

Source: Foresight Analytics
Data source: Thomson Reuters and Datastream

Australia dollar fotunes not much brighter over the next 12 months

Based on Foresight multi-factor forecasting model, the outlook for AUD against G5 currencies is weak to stable over the next 12 months.

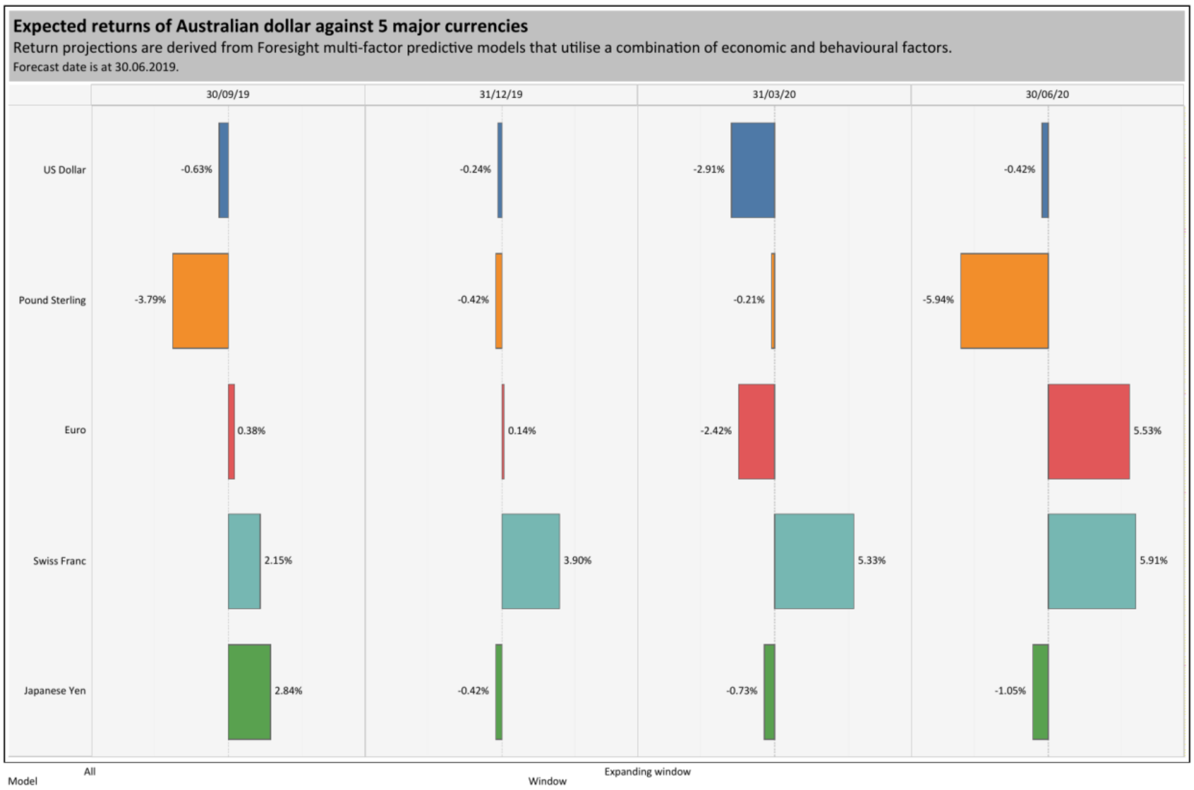
The AUD is expected to depreciate slightly against USD, Pound and Yen. Notwithstanding the Brexit issues, the model is expecting AUD to decline against Pound by 6% over the next 12 months.

On the other hand, the model is predicting 5.5-6% appreciation of AUD against the Swish Franc and the Euro over the next 12 months.

A weaker outlook for the economy and inflation is likely to keep downward pressure on our interest rates and therefore on AUD. Dovish comments from the RBA and its recent interest rate cuts have resulted in the AUD falling to its lowest level in around a decade as investors continue to anticipate further rate cuts from the Reserve Bank. The impact of these rate cuts will improve domestic financial conditions, reduce borrowing rates for businesses, and lower interest payments for households which would create more room for spending.

Given the geopolitical risks and no signs of trade-wars abating, currency volatility is expected to rise. Event risks around a no-deal Brexit and rising uncertainty around the global economic outlook could bring further instability into currency markets in the coming months.

Exhibit 6: the 12 month AUD outlook is mixed against major currencies



Source: Foresight Analytics
Data source: Thomson Reuters and Datastream

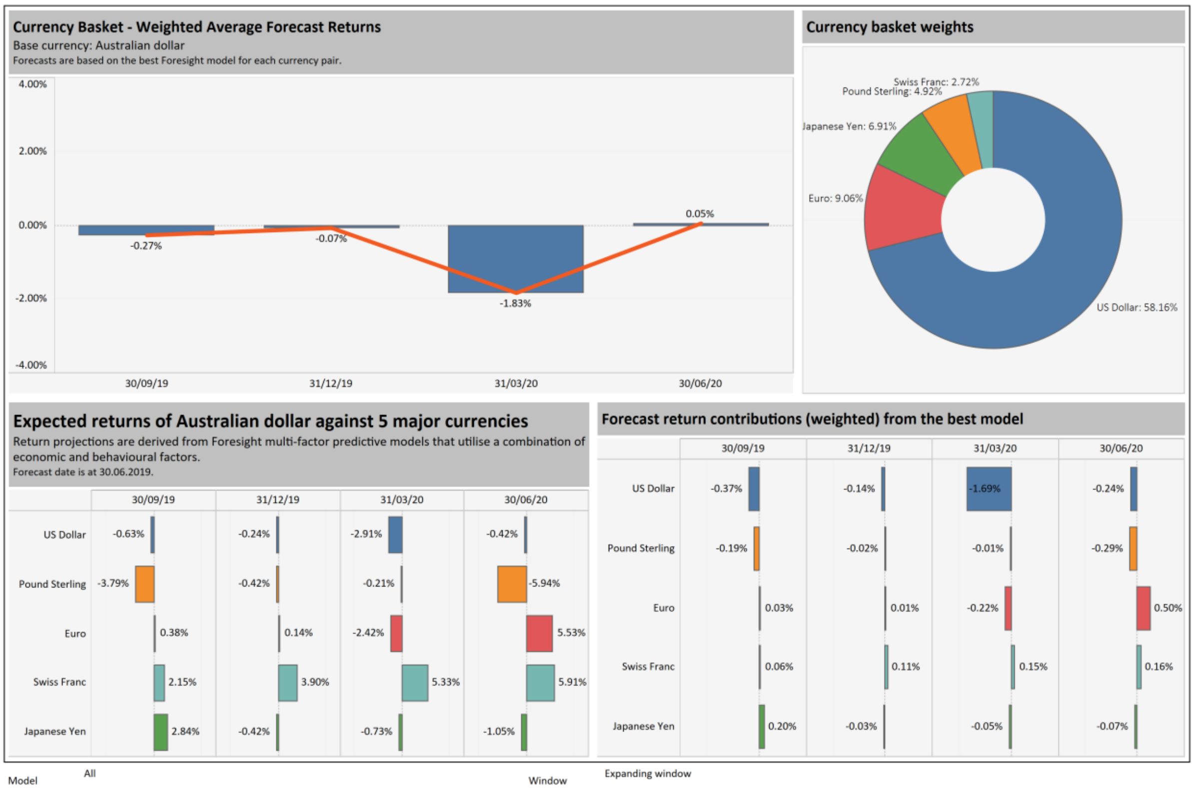
Evidence for hedging currency exposures is strong for Australian investors

Given the current trend of the AUD Index and fundamental outlook for the Australian economy, inflation, interest rates, terms of trade factors relative to its trading partners, the downside risk for AUD remains.

Based on the expected returns for AUD against major currencies and using the current currency weight of the equity market (proxied by the MSCI World), the expected currency effect is modest over the next 9 months (-1.83%) and flat over the next 12 months.

Exhibit 7 also presents the contribution to this return from each of the major pairs. As expected, USD (being 58% of the Global equity index) has the largest impact on the outlook for equity investments followed by the Euro.

Exhibit 7: The case for hedging AUD over the next 12 months is modest



Source: Foresight Analytics
Data source: Thomson Reuters and Datastream

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