

FX COMMENT

WHERE MIGHT THE AUD BASE?

14 MARCH 2012

INSIDE

Fundamentals 2
 Technicals 3

CONTRIBUTORS

Andrew Salter
 FX Strategist
 +61 2 9227 1982
 Andrew.Salter@anz.com

Tim Riddell
 Head of Global Markets
 Research, Asia
 +65 6681 8718
 Tim.Riddell@anz.com

CHINA REBALANCING AND PAUSE IN INDUSTRIAL CYCLE EXPECTED TO DRAG ON GLOBAL RECOVERY

Forward-looking indicators of the global industrial cycle suggest economic momentum should pause or ease in the first half of 2012 (see *ANZ Macro Strategy – Buy Risk on Dip around mid-2012!*). The rebalancing of growth in China, which is reportedly already underway, also suggests some slowing. Indicators such as the JP Morgan global lead index and our own in-house lead index edged lower in February, the first time this has happened since the third quarter of 2011 (Figure 1). Our strategy team’s call is not for a repeat of the disappointingly deep slow down of 2011, but a temporary pause in the manufacturing cycle appears possible.

THE AUSTRALIAN DOLLAR SHOULD BASE ABOVE USD1.03 IN THE EVENT OF A MODEST SLOWDOWN

In this environment the Australian dollar’s appreciation would slow. The question concerning markets is where will it base in the near term? This note suggests that given the correlation with indicators of the industrial cycle, we might expect it to ease as far as US1.0350 on a monthly average basis if the slow down is modest, as we expect. If it is a slowdown of the kind witnessed in 2011, or one centred more specifically in China, and the AUD experiences a somewhat deeper correction, technical indicators suggest that a re-test of long-term support above USD0.98 would ensue.

FIGURE 1. INDICATORS OF THE GLOBAL INDUSTRIAL CYCLE



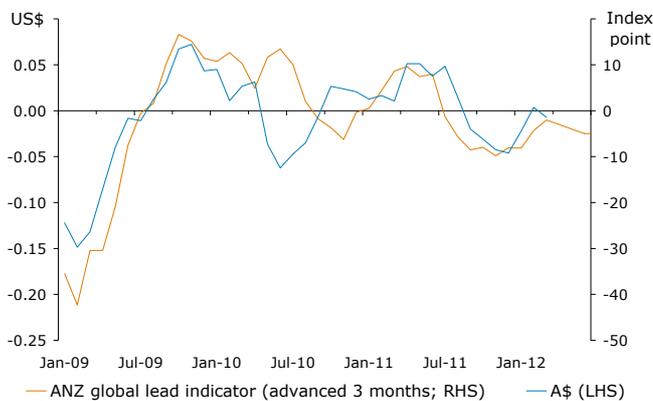
Sources: ANZ, JP Morgan

FUNDAMENTALS, POSITIONING & SENTIMENT

FUNDAMENTAL OUTLOOK

The ANZ global lead index is a GDP-weighted average of the global PMIs with particular emphasis on the forward orders components. Since the Lehman's default in late 2008, asset markets have become particularly vulnerable to downturns in the global industrial cycle. The Australian dollar is a prime example. Since Lehman's the Australian dollar has shown a strong correlation to indicators of the global cycle such as the ANZ global lead index (a correlation of 0.79 in detrended levels). In fact, deviations from trend have generally led moves in the currency, preceding them by 1-3 months on average (see Figure 2).

FIGURE 2. AUD AND ANZ LEAD INDICATOR (DEVIATION FROM TREND*)



Sources: ANZ, Bloomberg * HP filter with lambda = 14400

In terms of month-to-month changes in the index and the currency, the strongest relationship is contemporaneous. We use these observations to estimate where the Australian dollar might land should the global industrial cycle pause. Since the depth and protractedness of the slow-down is not known, two scenarios are considered:

- (1) Scenario one (our base case) sees a modest slowdown that is not particularly deep
- (2) Scenario two mimics the slowdown seen in 2011 and should be considered a lower bound, given the expectations of our strategy team

These two scenarios are depicted graphically in Figure 3. Scenario one places the Australian dollar around USD1.0350 in the later half of the year. Scenario two has it around USD1.01.¹

¹ For the technically minded, we run the following regression on monthly detrended data (HP filter, $\lambda=14400$) from Jan 2009 to Feb 2012:

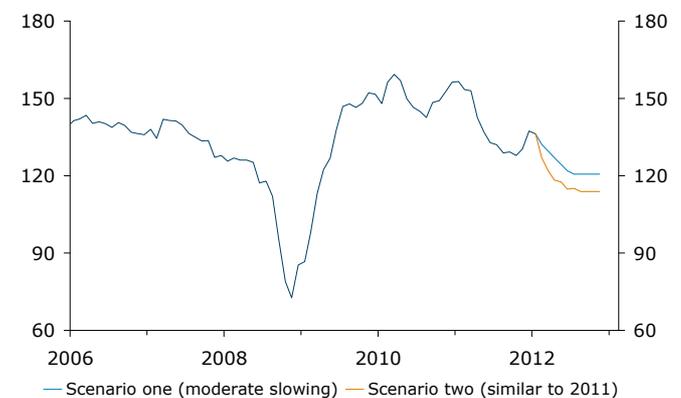
$$\Delta \text{AUD}/\text{USD}_t = b_0 + b_1 * \Delta \text{ANZ}_t + e_t$$

Where ANZ is the ANZ global lead index and AUD/USD is the monthly average exchange rate according to Bloomberg data. $R^2=0.30$, with b_1 significant at the 1 per cent level and the Durbin Watson statistic inconclusive for first-order auto-correlation in the errors.

It is important to keep in mind these estimates are made on the basis of monthly averages data. They do not preclude the exchange rate moving either side of these averages on a daily or intra-daily basis. Indeed the range of the Australian dollar in recent months has been between USD0.05-0.10 and so such movements can be strong.

Indeed in the event where a pause in the global economic cycle leads to a spike in risk aversion, levels available to investors in the currency may be substantially lower than what is implied by these monthly averages data. In this regard, an understanding of positioning, sentiment and the market's technical levels is prudent.

FIGURE 3. SCENARIOS ASSUMED FOR ANZ LEAD INDICATOR TO JULY 2012

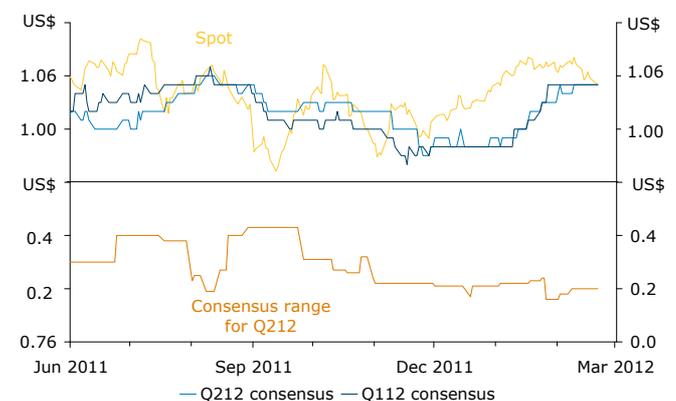


Sources: ANZ

SENTIMENT & POSITIONING

Positioning in the currency of late appears somewhat one-directional. The range of forecasts as surveyed by Bloomberg – around 34 global banks – has narrowed to its lowest levels in around one year. Such uni-directional sentiment suggests that positioning may be stretched.

FIGURE 4. CURRENT ECONOMIST & STRATEGIST FORECASTS FOR THE AUD

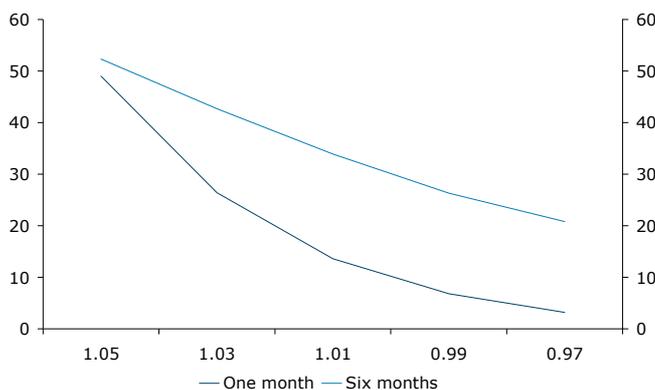


Sources: ANZ, Bloomberg

FUNDAMENTALS, POSITIONING & SENTIMENT

The outlook of the options market is not quite as rosy. According to the probability implied by option prices, market participants have assigned a 40 per cent chance of the currency reaching the scenario one outcome. They have assigned a probability of around 30 per cent of reaching scenario two (Figure 5). To be sure, these are particularly strong expectations for depreciation in the currency, and suggest that this market does appear recognising the possibility of a slowing in the global industrial cycle. On a side note, the options market prescribes little chance of a sharp correction in the near term (see the one month series in Figure 5). This is consistent with lower volatility in the Australian dollar following its adoption in the portfolios of global asset managers (see *Adieu to the Australian dollar's elevator?*).

FIGURE 5. OPTION-IMPLIED PROBABILITY OF AUD/USD BEING ABOVE LEVEL (PER CENT)



Source: Bloomberg

AUD/USD TECHNICALS

The current technical debate centres upon whether the highs of 2011, between 1.10 and 1.11, formed a near term or cyclical top and current price action is critical.

FIGURE 6. AUD/USD WEEKLY BAR CHART WITH RSI AND SLOW STOCHASTICS



Sources: ANZ, CQG

If a mere short term top formed, AUD/USD should now be forming a further up-leg within a series of measured moves (green arrows in Figure 6) to 1.20. Therefore dips off late February's test of 1.0855 ought to hold above 1.0400. A swift regaining of levels above 1.0775 should bolster the uptrend and underscore the 1.04-1.05 area as a strong support zone.

However, this possibility is becoming suspect and the latter scenario, of a cyclical top having formed last year, seems the more likely. This latter scenario suggests that AUD/USD is still forming a broad trading range and the recent push above 1.08 was actually defining a lower top within this range. Therefore a fall below 1.0400 (confirmed below 1.0350) is likely to trigger retests of recent lows at 0.9660 (also rising channel support) and 0.9385-90 (the low of October 2011).

If the slide becomes a more aggressive flush out, AUD/USD could form a deep retracement to 0.9140-50 area (38.2% of the rally off the 2008 low of 0.6010).

Consequently near term price action is of increasing importance.

TECHNICAL SUMMARY

Any failure to hold above 1.0400 could trigger slippage to redefine the base of a broad consolidation pattern. Although support is likely at 0.9660, bias will be for a sharper flush to retest the October 2011 0.9385-90 low, if not the longer term retracement target of 0.9140-50, before AUD rebounds once again.

CONCLUSION

Indeed if the slowdown were as protracted that of 2011, the AUD might be expected to trade down to below USD1.03 and thus extend to the October 2011 lows. It is important to emphasize that such a slowing is not our central scenario and should be considered a low probability event. It is more likely that the slowing in the global industrial cycle sees the Australian dollar base somewhere above USD1.0350. Looking further ahead we are optimistic that the currency will see levels of USD1.10 in the medium term. The high level of commodity price, the wide interest rate available to offshore investors, and the notable changes occurring in developed economies with regards to expanding money supplies and changing credit ratings will all conspire to see the currency strong over the medium term.

IMPORTANT NOTICE

IMPORTANT NOTICE: The distribution of this document may be restricted by law in certain jurisdictions. Persons who receive this document must inform themselves about and observe all relevant restrictions.

COUNTRY/REGION SPECIFIC INFORMATION:

AUSTRALIA. This document is distributed in Australia by Australia and New Zealand Banking Group Limited (ABN 11 005 357 522) ("ANZ"). ANZ holds an Australian Financial Services licence no. 234527. A copy of ANZ's Financial Services Guide is available at <http://www.anz.com/documents/AU/aboutANZ/FinancialServicesGuide.pdf> and is available upon request from your ANZ point of contact. If trading strategies or recommendations are included in this document, they are solely for the information of 'wholesale clients' (as defined in section 761G of the Corporations Act 2001 *Cth*). Persons who receive this document must inform themselves about and observe all relevant restrictions.

BRAZIL. This document is distributed in Brazil by Australia and New Zealand Banking Group Limited (ABN 11 005 357 522) only for the information of the Central Bank of Brazil. No securities are being offered or sold in Brazil under this document, and no securities have been and will not be registered with the Securities Commission - CVM.

BRUNEI. JAPAN. KUWAIT. MALAYSIA. TAIPEI. This document is distributed in each of Brunei, Japan, Kuwait, Malaysia and Taipei by Australia and New Zealand Banking Group Limited (ABN 11 005 357 522) on a cross-border basis.

EUROPEAN ECONOMIC AREA ("EEA"): UNITED KINGDOM. Australia and New Zealand Banking Group Limited (ABN 11 005 357 522) ("ANZ") is authorised and regulated in the United Kingdom by the Financial Services Authority ("FSA"). This document is distributed in the United Kingdom by ANZ solely for the information of persons who would come within the FSA definition of "eligible counterparty" or "professional client". It is not intended for and must not be distributed to any person who would come within the FSA definition of "retail client". Nothing here excludes or restricts any duty or liability to a customer which ANZ may have under the UK Financial Services and Markets Act 2000 or under the regulatory system as defined in the Rules of the FSA. **GERMANY.** This document is distributed in Germany by the Frankfurt Branch of ANZ solely for the information of its clients. **OTHER EEA COUNTRIES.** This document is distributed in the EEA by ANZ Bank (Europe) Limited ("ANZBEL") which is authorised and regulated by the FSA in the United Kingdom, to persons who would come within the FSA definition of "eligible counterparty" or "professional client" in other countries in the EEA. This document is distributed in those countries solely for the information of such persons upon their request. It is not intended for, and must not be distributed to, any person in those countries who would come within the FSA definition of "retail client".

HONG KONG. This document is distributed in Hong Kong by the Hong Kong branch of Australia and New Zealand Banking Group Limited (ABN 11 005 357 522), which is registered by the Hong Kong Securities and Futures Commission to conduct Type 1 (dealing in securities), Type 4 (advising on securities) and Type 6 (advising on corporate finance) regulated activities. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. If in doubt about the contents of this document, you should obtain independent professional advice.

PEOPLE'S REPUBLIC OF CHINA. If and when the material accompanying this document is distributed by Australia and New Zealand Banking Group Limited (ABN 11 005 357 522) ("ANZ") or an affiliate (other than Australia and New Zealand Bank (China) Company Limited ("ANZ C")), the following statement and the text below is applicable: No action has been taken by ANZ or any affiliate which would permit a public offering of any products or services of such an entity or distribution or re-distribution of this document in the People's Republic of China ("PRC"). Accordingly, the products and services of such entities are not being offered or sold within the PRC by means of this document or any other document. This document may not be distributed, re-distributed or published in the PRC, except under circumstances that will result in compliance with any applicable laws and regulations. If and when the material accompanying this document relates to the products and/or services of ANZ C, the following statement and the text below is applicable: This document is distributed by ANZ C in the Mainland of the PRC.

SINGAPORE. This document is distributed in Singapore by the Singapore branch of Australia and New Zealand Banking Group Limited (ABN 11 005 357 522) ("ANZ") solely for the information of "accredited investors", "expert investors" or (as the case may be) "institutional investors" (each term as defined in the Securities and Futures Act Cap. 289 of Singapore). ANZ is licensed in Singapore under the Banking Act Cap. 19 of Singapore and is exempted from holding a financial adviser's licence under Section 23(1)(a) of the Financial Advisers Act Cap. 100 of Singapore. In respect of any matters arising from, or in connection with the distribution of this document in Singapore, contact your ANZ point of contact.

UNITED ARAB EMIRATES. This document is distributed in the United Arab Emirates ("UAE") or the Dubai International Financial Centre (as applicable) by Australia and New Zealand Banking Group Limited (ABN 11 005 357 522) ("ANZ"). This document: does not, and is not intended to constitute an offer of securities anywhere in the UAE; does not constitute, and is not intended to constitute the carrying on or engagement in banking, financial and/or investment consultation business in the UAE under the rules and regulations made by the Central Bank of the United Arab Emirates, the Emirates Securities and Commodities Authority or the United Arab Emirates Ministry of Economy; does not, and is not intended to constitute an offer of securities within the meaning of the Dubai International Financial Centre Markets Law No. 12 of 2004; and, does not constitute, and is not intended to constitute, a financial promotion, as defined under the Dubai International Financial Centre Regulatory Law No. 1 of 200. ANZ DIFC Branch is regulated by the Dubai Financial Services Authority ("DFSA"). The financial products or services described in this document are only available to persons who qualify as "Professional Clients" or "Market Counterparty" in accordance with the provisions of the DFSA rules. In addition, ANZ has a representative office ("ANZ Representative Office") in Abu Dhabi regulated by the Central Bank of the United Arab Emirates. ANZ Representative Office is not permitted by the Central Bank of the United Arab Emirates to provide any banking services to clients in the UAE.

UNITED STATES. If and when this document is received by any person in the United States or a "U.S. person" (as defined in Regulation S under the US Securities Act of 1933, as amended) ("US Person") or any person acting for the account or benefit of a US Person, it is noted that ANZ Securities, Inc. ("ANZ S") is a member of FINRA (www.finra.org) and registered with the SEC. Also, ANZ S's address is 277 Park Avenue, 31st Floor, New York, NY 10172, United States of America (Tel: +1 212 801 9160 Fax: +1 212 801 9163). This document is distributed in the United States by ANZ S (a wholly owned subsidiary of Australia and New Zealand Banking Group Limited (ABN 11 005 357 522)), which accepts responsibility for its content. Information on any securities referred to in this document may be obtained from ANZ S upon request. Any US Person receiving this document and wishing to effect transactions in any securities referred to in this document must contact ANZ S, not its affiliates.

IMPORTANT NOTICE

2. DISCLAIMER

Except if otherwise specified above, this document is issued and distributed in your country/region by Australia and New Zealand Banking Group Limited (ABN 11 005 357 522) ("ANZ"), on the basis that it is only for the information of the specified recipient or permitted user of the relevant website (collectively, "recipient"). This document may not be reproduced, distributed or published by any recipient for any purpose. It has been prepared without taking into account the objectives, financial situation or needs of any person. Nothing in this document is intended to be an offer to sell, or a solicitation of an offer to buy, any product, instrument or investment, to effect any transaction or to conclude any legal act of any kind. If, despite the foregoing, any services or products referred to in this document are deemed to be offered in the jurisdiction in which this document is received or accessed, no such service or product is intended for nor available to persons resident in that jurisdiction if it would be contradictory to local law or regulation. Such local laws, regulations and other limitations always apply with non-exclusive jurisdiction of local courts. Before making an investment decision, recipients should seek independent financial, legal, tax and other relevant advice having regard to their particular circumstances.

The views and recommendations expressed in this document are the author's. They are based on information known by the author and on sources which the author believes to be reliable, but may involve material elements of subjective judgement and analysis. Unless specifically stated otherwise: they are current on the date of this document and are subject to change without notice; and, all price information is indicative only. Any of the views and recommendations which comprise estimates, forecasts or other projections, are subject to significant uncertainties and contingencies that cannot reasonably be anticipated. On this basis, such views and recommendations may not always be achieved or prove to be correct. Indications of past performance in this document will not necessarily be repeated in the future. No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided. Additionally, this document may contain 'forward looking statements'. Actual events or results or actual performance may differ materially from those reflected or contemplated in such forward looking statements. All investments entail a risk and may result in both profits and losses. Foreign currency rates of exchange may adversely affect the value, price or income of any products or services described in this document. The products and services described in this document are not suitable for all investors, and transacting in these products or services is considered risky. ANZ and its related bodies corporate and affiliates, and the officers, employees, contractors and agents of each of them (including the author) ("Affiliates"), do not make any representation as to the accuracy, completeness or currency of the views or recommendations expressed in this document. Neither ANZ nor its Affiliates accept any responsibility to inform you of any matter that subsequently comes to their notice, which may affect the accuracy, completeness or currency of the information in this document.

Except as required by law, and only to the extent so required: neither ANZ nor its Affiliates warrant or guarantee the performance of any of the products or services described in this document or any return on any associated investment; and, ANZ and its Affiliates expressly disclaim any responsibility and shall not be liable for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly and whether in tort (including negligence), contract, equity or otherwise out of or in connection with this document.

If this document has been distributed by electronic transmission, such as e-mail, then such transmission cannot be guaranteed to be secure or error-free as information could be intercepted, corrupted, lost, destroyed, arrive late or incomplete, or contain viruses. ANZ and its Affiliates do not accept any Liability as a result of electronic transmission of this document.

Disclosure of Interests

ANZ and its Affiliates may have an interest in the products and services described in this document as follows:

- They may receive fees from customers for dealing in the products and/or services described in this document, and their staff and introducers of business may share in such fees or receive a bonus that may be influenced by total sales.
- They or their clients may have or have had interests or long or short positions in the products and/or services described in this document, and may at any time make purchases and/or sales in them as principal or agent.
- They may act or have acted as market-maker in products described in this document.

ANZ may rely on information barriers and other arrangements to control the flow of information contained in one or more areas within ANZ into other areas of ANZ. Further details on the above disclosures are available upon request from your ANZ point of contact.