ANZ RESEARCH

FX COMMENT

WHERE MIGHT THE AUD BASE?

14 MARCH 2012

INSIDE

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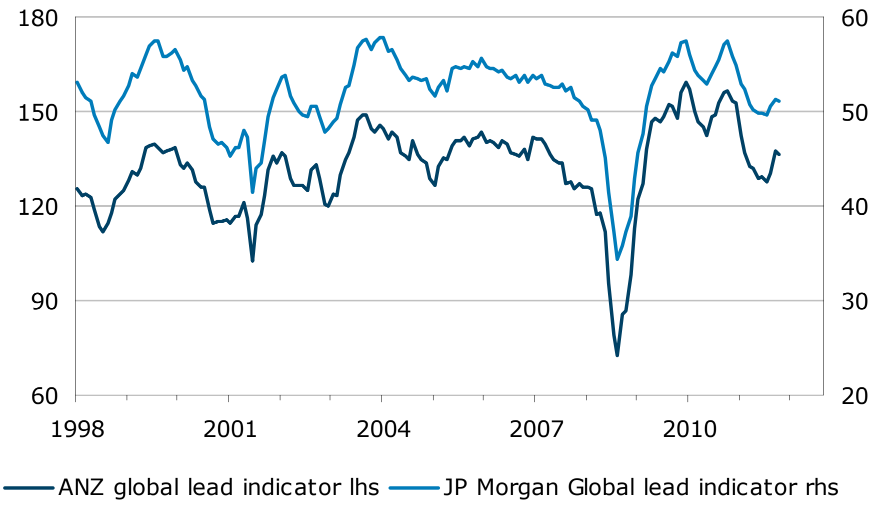
CHINA REBALANCING AND PAUSE IN INDUSTRIAL CYCLE EXPECTED TO DRAG ON GLOBAL RECOVERY

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



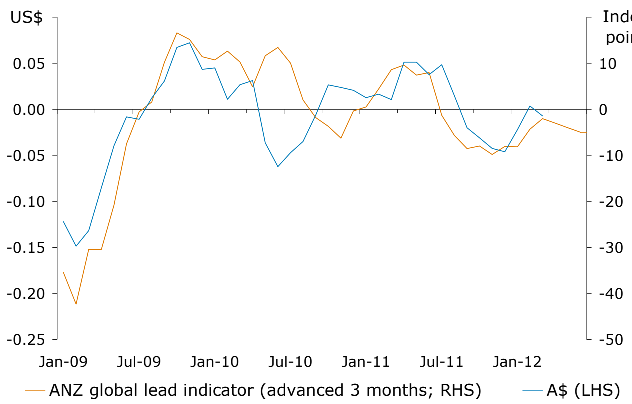
Sources: ANZ, JP Morgan

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 Lehmans 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

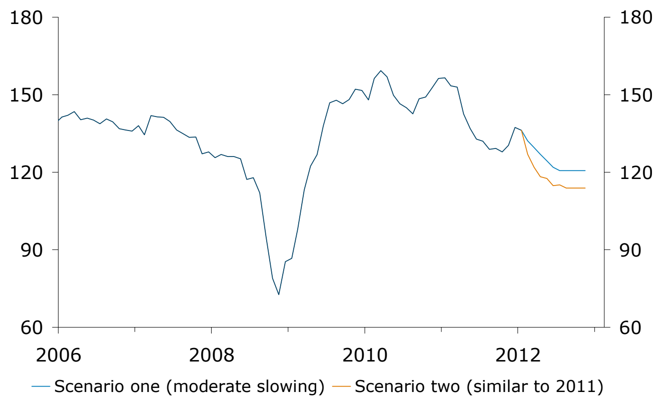
(2) Scenario two mimics the slowdown seen in 2011 and should be considered a lower bound, given the expectations of our strategy team

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]

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 that 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

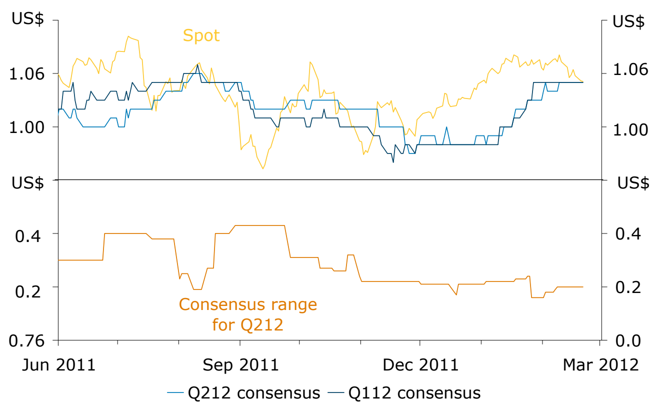


Sources: ANZ

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

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

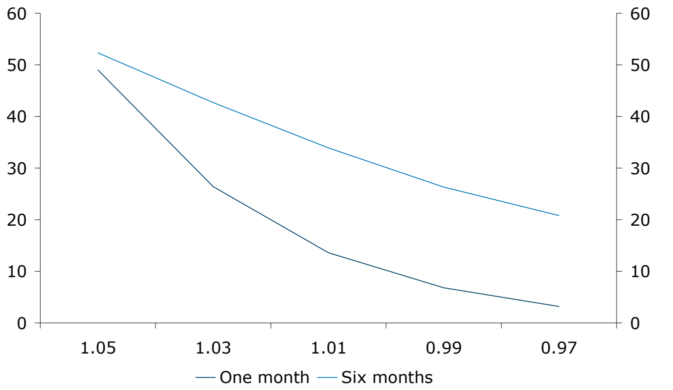
$\Delta AUD/USD_t = b_0 + b_1 * \Delta ANZ_t + e_t$

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.

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 emphasis 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.

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