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Australian dollar mixed in 2018

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- **Australian dollar profited from US dollar weakness in 2017...**
- **...but the outlook for 2018 will be rather mixed**
- **We expect modest weakness versus US dollar...**
- **...but modest strength versus the euro**
- **In 2019 the Australian dollar will rally on higher monetary policy**

Australian dollar profited from US dollar weakness in 2017

The Australian dollar has rallied by 6% versus the US dollar but dropped by 6% versus the euro in 2017. This performance reflects partly US dollar weakness and euro strength. Moreover, the positive economic growth momentum in China and Australia has also supported the Australian dollar whereas weakness in iron ore prices has weighed on Australian dollar. In Australia, the structural change towards a higher contribution of the non-mining sector to economic growth is still ongoing and the labour market is strong. However, wage pressures are low. Recently, the Reserve Bank of Australia has calmed market expectations that the start of the hiking cycle would be soon, by referring to low wage pressures and inflation (currently at 1.9%) being below its 2-3% inflation target. It also focussed more on downside risks. In this report we focus on the outlook for 2018 and 2019.

A mixed outlook for 2018...

We expect a mixed picture for the Australian dollar for 2018 as there will be a number of off-setting factors. On the one hand, the anticipation that the Reserve Bank of Australia will start its tightening cycle should support the Aussie. However, the RBA is in no hurry to hike interest rates because of low wages and inflation and because the private sector is heavily indebted. We expect the RBA to hike rate by 25bp in 2018 (in line with market consensus), while we expect two rate hikes by the Fed (more than consensus) and no rate increases by the ECB. It is likely that central bank dynamics will support the Australian dollar versus the euro but not versus the US dollar.

On the other hand, our China economist expects a modest slowdown in the Chinese economy (in line with market consensus), our base metal analyst forecasts at the end of 2018 a lower iron ore price and speculator could cut some of their net long Aussie positions. These developments will probably weigh on the Australian dollar. All in all, we expect the Aussie to appreciate slightly versus the euro but to depreciate slightly versus the US dollar.

...but 2019 to be positive for the Australian dollar

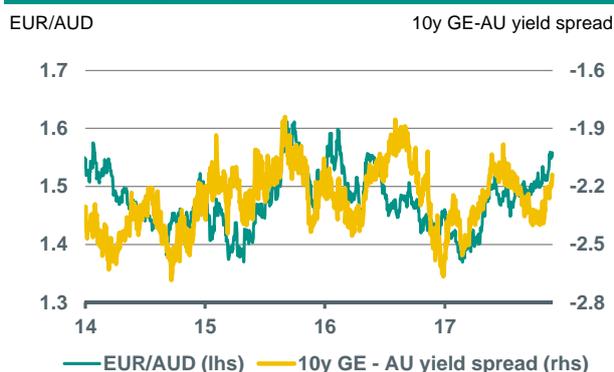
For 2019 we are positive for the Australian dollar. First, the RBA will likely increase official rates three times by 25bp because of strong economic momentum (in 2018 and 2019) and higher inflation. These are more rate hikes than priced in by financial markets and also more than what we currently forecast for the Fed and the ECB. This is positive for the Australian dollar. Second, we expect the 10y yield spread (Australia-US, Australia-eurozone) to widen. AUD/USD and EUR/AUD have a tendency to move in tandem with these respective spreads. So this should be supportive for the Australian dollar. However, a slight weakness in iron ore prices could limit the upside in the Aussie. All in all we expect a rally in the Aussie in 2019 versus US dollar and euro.

Iron ore prices an important driver for AUD...



Source: Thomson Reuters Datastream, Bloomberg, ABN AMRO Group Economics

...as well as yield spreads



Source: Bloomberg, ABN AMRO Group Economics

Our AUD forecasts

New forecasts in red/bold

	30-Nov	Q1 18	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19	Q4 19
EUR/USD new	1.1835	1.1800	1.1700	1.1600	1.1500	1.1800	1.2000	1.2300	1.2500
EUR/USD old		1.1500	1.1700	1.2000	1.3000				
AUD/USD new	0.7562	0.7600	0.7550	0.7500	0.7500	0.7700	0.7900	0.8100	0.8300
AUD/USD old		0.8300	0.8600	0.8800	0.9000				
EUR/AUD new	1.5652	1.5526	1.5497	1.5467	1.5333	1.5325	1.5190	1.5185	1.5060
EUR/AUD old		1.4700	1.4500	1.4400	1.4400				

Source: ABN AMRO Group Economics

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