



Cyclical versus structural: The currency tussle

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Forecasting is a difficult business and perhaps one the hardest things to get right is the exchange rate. Even getting the direction right is a worthy achievement. Correctly forecasting the direction *and* the magnitude of a move is something worth savouring indeed.

Despite the difficulty of the task, there are cyclical and structural factors that can help shape a view on where the Australian dollar will head.

On the cyclical side, trends in G3 (US, Japan and Europe) industrial production are important. Periods of G3 industrial strength tend to be associated with higher commodity prices, which support our currency because about one-third of Australian exports are raw materials. G3 industrial production was firm over 2004 and rising commodity prices helped boost the Australian dollar over that time.

Expectations over the next 18 months are for G3 industrial output growth to moderate. If this view proves correct, then this factor will swing from supporting the Australian dollar to only being neutral to slightly negative.

Other cyclical indicators, such as short- and long-term interest rate differentials, are also providing less support to the Australian dollar of late. For example, the spread between the Australian and US cash rate has narrowed to 2.25% now from 4.25% in mid-2004.

This gap is likely to narrow further because the US Federal Reserve is expected to add to its nine interest rate increases since mid-2004 while the Reserve Bank of Australia is likely to keep rates on hold for a while.

While these cyclical indicators point to a mildly weaker currency, structural factors are working in the opposite direction. Australia's terms of trade have powered to their highest in 30 years yet gains in Australia's real exchange rate have lagged, suggesting there could be further currency upside.

Bearing in mind these tensions, Perennial has an Australian dollar target of 74 US cents for the end of 2005 and 72 US cents at the end 2006. If there is risk to these exchange rate forecasts, it is on the upside. That's because Perennial has underweighted structural support relative to the recent slippage in cyclical factors.

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