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HD **Corporate: Capital inflows benefiting Aussie dollar as QE winds down, says Westpac's Cavenagh**

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Capital is flowing to countries with attractive investment opportunities and lifting their currencies as the US Federal Reserve winds down its quantitative easing (QE) programme. The Australian dollar is benefiting from direct investment and portfolio flows, says Jonathan Cavenagh, a currency strategist at Westpac Banking Corp.

The effect of the Fed's QE policy, especially on **equity** and bond markets in the US, has been well documented. The impact on the US dollar and other currencies is less tangible, but it is still a factor for currency traders in making bets on the market. Now that QE is about to end, the currency markets are relooking the relative merits of countries as key drivers for currency levels, according to Cavenagh.

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Australia is a good example of the trends unfolding in currency markets. "Inflows from many parts of Asia have definitely picked up," says Singapore-based Cavenagh, referring to the potential for higher investment returns Down Under. "To quantify that is difficult and we only get a sense of things after the fact, but we can look at the Australian dollar and see how it is trading relative to its traditional fundamental drivers."

To illustrate what he means, he points to the fact that recent capital inflows have buoyed the Australian dollar beyond its fair-value estimate of 87 to 88 US cents to the Aussie unit. A key reason for the inflows has been the fact that Australia is one of the few countries in the world with a triple-A credit rating from Standard & Poor's and government bond yields that are higher than the lower-rated US sovereign debt.

"It's not just for the 10-year tenor, but it's across most parts of the yield curve," says Cavenagh. "Australia's 10-year yield is above 3%; Germany's 10-year yield just dropped below 1% through the second half of [the trading week of Aug 11], so that's a big differential in terms of yield pick-up, when you think of where Germany [is] on the geopolitical risk [spectrum]." While the prevailing yield of about 2.40% on US 10-year Treasury**bonds** is much higher than German bunds, yields on Australian government debt are the highest of the three countries, at almost 100 basis points above those of the US.

Flows to property and real assets

Apart from the yield advantage of Australian debt, a slew of corporate mergers and acquisitions (**M**&A) and the hot property sector in the country have also played a part in drawing foreign capital there. Corporate acquisitions by overseas players for property **firm** Australand and food business Goodman Fielder have stoked interest in assets Down Under and added to investment flows into the country.

"The property flows have been quite interesting to observe," notes Cavenagh. "Some of the movements in property prices in Australia have been quite dramatic over the past 12 months or so, and they have definitely been driven by [historically] low interest rates there." Investors from Asia, especially **China**, **Hong Kong** and Singapore, whose property markets are feeling the effects of curbs on speculation, have been drawn to Australia, where value is still perceived to exist in certain cities. Recently, Singapore-listed companies Heeton, KSH and Lian Beng were reported to have taken minority stakes in a hotel and residential development in Brisbane, which has also attracted investments from other players from the city-state.

Such developments have helped to inject a bid tone into the Australian dollar, keeping it well supported. "Today, it's trading a little above 93 US cents," says Cavenagh when he spoke to The Edge Singapore on Aug 18. "It's a good five or six US cents overvalued and the RBA [Reserve Bank of Australia] is on record as saying it believes it is overvalued relative to its longer-term fundamentals. So, these types of flows are definitely part of the picture as to why the currency has not corrected to where its fair-value estimate suggests it should be."

Over the longer term, the capital inflows and higher yields from holding Australian debt are expected to buoy the currency from falling too much. Despite a fair-value estimate of 87 to 88 US cents, Cavenagh expects the Aussie dollar to decline modestly to around 90 US cents by year-end. That will be largely owing to the fall in Australia's terms of trade with the rest of the world, as one of its largest export commodities, **iron ore**, suffered a 30% fall in price in 1H2014.

Although the price of **iron ore** has stabilised since June, another factor will soon figure significantly as well. "When the Federal Reserve gets to the end of its bond-buying programme, which will be in October or November, the focus will be on when it will raise interest rates," says Cavenagh. "Our forecast is 3Q2014, but the market is probably thinking it will be a little sooner than that, and we think it will generally be an environment in which the US dollar does quite well." That will form the backdrop for a decline in the Aussie dollar to 90 US cents, with a bottoming-out in 1Q2015. As markets start to factor in the possibility of rate hikes by the RBA next year, that should support a recovery of the Aussie unit back to 93 US cents later in the year.

Other currencies

The favourable environment for the greenback provides the backdrop for other currency forecasts by Cavenagh and his Westpac colleagues. They see the euro declining to A$1.31 by year-end from around A$1.33 as at late August. The yen has been stuck in a tight trading range of ¥101 to ¥104 against the greenback after the end of Japan's fiscal year in March. That range should generally hold, but with the Bank of Japan likely to do more QE to revive economic growth and stave off deflation, "dips back towards the 100-to-101 level against the dollar are going to be very well supported, and by this time next year, [the market] will probably be pushing up against the 105 level", Cavenagh predicts.

As for the currencies of Asia, he is selectively bullish on their outlook after a short-lived rally for the US dollar as the Fed ends its QE. "In the next 12 months, I'**m** still optimistic they can actually rise against the US dollar and certainly outperform the euro and yen. The euro and the yen will be bearing the brunt of the stronger US dollar story in that period."

Cavenagh favours North Asian currencies such as the renminbi, Korean won and Taiwan dollar in his ranking of currencies to hold. "The trade data for July showed **China** was running a 6% trade surplus as a share of GDP on an annualised basis, which is a very strong trade position," he observes. "For any economy that runs reasonably large trade surpluses, we think the trend over the next 12 months will be for their currency to appreciate against the US dollar. That is why we think the **Chinese**, Korean and Taiwanese currencies are probably the safest places to be if you are looking to bet on appreciation against the US dollar." The forecasts for these currencies are that they will trade at RMB6.08, KRW1,029 and TWD26.61 versus the US dollar in December and continue to strengthen into next year.

On the other hand, the market outlook for currencies in Southeast Asia is less favourable, with dark clouds over some economies that have structural issues and external challenges. "I think we could see a few more speed humps in Singapore in terms of a weaker housing market as higher interest rates come through [after the Fed's QE ends], and that may see a period in which its exchange rate underperforms the likes of the renminbi and Korean won [against the US dollar]," says Cavenagh. "I'd be more comfortable about owning the Malaysian ringgit, as opposed to the Indonesian rupiah, as the current account deficit could present a headwind to currency performance." Cavenagh's forecast is for the ringgit to appreciate to RM3.16 against the US dollar in December and continue to strengthen to RM3.11 in a year's time.

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