

AUSTRALIA MARKET OUTLOOK

By Daryl Guppy

This newsletter has a focus on technical analysis but Guppytraders also provides wider economic and market analysis for Government and financial organisations. This helps set the framework for technical and chart analysis. This week we include some of these analysis notes as the Australian economy has very quickly reached a major turning point. This impacts dramatically on traders because it changes the types of trades that are available.

Four factors have impacted on the Australian dollar. They are:

- 1) Confirmation of the end of quantitative easing in the US and the consequent inevitable rise in US interest rates
- 2) The unwillingness of the Australian Reserve bank to increase interest rate and the consequent potential use of blunt sectorial tools to cool the housing market
- 3) The dramatic strengthening of the US dollar
- 4) The stabilisation of the Chinese economy at lower growth rates with a long term reduction in commodity demand. This creates a shakeout in the supply side of the market.

Confirmation of the end of quantitative easing in the US and the consequent inevitable rise in interest rates.

The primary impact here is the end of the Australian dollar carry trade. Low interest rates in the US and high interest rates in Australia created a no-brainer carry trade. Borrow in USD, buy AUD, and let the interest differential carry the trade. Even with AUD parity the interest rate differential made this an attractive trade. Foreign funds flow into Australian investment instruments was substantial.

Now the carry trade no longer makes sense. The smart money is going back to the US in anticipation of rising interest rates. The removal of foreign capital is impacting the Australian, and ASEAN, economies.

The unwillingness of the Australian Reserve bank to increase interest rates and the consequent potential use of blunt sectorial tools to cool the housing market

The flight of capital from Australia has been accelerated by the low probability of any increase in interest rates. High unemployment figures, deep suspicion about the validity of several key economic indicators as a result of changes to the statistical collection methods and the collapse of key commodity prices all point to a deteriorating economy where the prospect of maintaining interest rates at current levels remain high. Current interest rates led to the unwinding of the carry trade. Lower interest rates will accelerate this process as capital looks for better yields and capital returns elsewhere.

The talk of using blunt tools to cool the housing bubble adds to the downwards pressure on the economy. The housing boom is reputedly driven by high levels of non-US dollar international investment. Targeting this sector of the economy will be perceived by some as a race based attack and will lead to the further withdrawal of capital.

In any event, this situation is analogous to the China housing bubble and responses in China where specific conditions have been imposed on buyers of second homes, such as increasing the level of deposit required. The impact in China has been to pull the rug out from under economic expansion. The same impact can be expected in Australia, and this adds to pressure on the AUD.

The dramatic strengthening of the US dollar.

The weakness of the AUD is a direct corollary of the strength of the US dollar. This dollar strength is tracked with the Dollar Index – DXY.



The monthly chart of the dollar index puts the recent US dollar rally into a broader context. Starting 2011 November until 2014 August the US Dollar traded in a sideways consolidation band between \$0.79 and \$0.84. The width of this band is projected above the long term resistance level near \$0.84 to give an upside target near \$0.89. There is a strong probability that the current rally will reach the \$0.89 level.

The \$0.89 level is a long term resistance level. This acted as a strong resistance from 2008 October to 2009 March. It again acted as a resistance level in 2010 June. This suggests that it will again act as a strong resistance level for the current rally above \$0.84.

The behaviour of the US dollar near this resistance level has been consistent. In 2008 and 2009 the dollar retreated rapidly from the resistance level. In 2008 December the market retreated from \$0.89 to support near \$0.79. When the market reached resistance near \$0.89 in 2009 March it was again followed by a rapid retreat to support near \$0.79. The third test of resistance near \$0.89 in 2010 June was also followed by a rapid fall and a test of support near \$0.79. This behaviour suggests there is a high probability the US dollar will retreat rapidly from the current rally target of \$0.89.

There is an important difference between the situation now and the situation in 2008, 2009 and 2010. Now there is good support near \$0.84. The \$0.84 level was tested as a resistance level in 2012 July and again between 2013 May and July. This suggests that any retreat from \$0.89 will find support near \$0.84. There is a lower probability that the US dollar will retreat and retest support near 0.815.

Rather resistance level near \$0.89 is well established. In 2004 March to August and in 2005 July to 2006 March this level acted as a support level. This suggests that if the dollar index can move above resistance near \$0.89 that there is a strong probability that any further rise will be limited. The next technical target is \$0.94. This was a support level in 1997, 1998 and again in 2003.

The short term outlook for the US dollar is a rally continuation towards \$0.89 followed by a retreat and retest of support near \$0.84. Then traders will look for a consolidation in the trading band between \$0.84 and \$0.89.



The strength of the US dollar is negative for the Australian dollar. There are two technical scenarios for the Australian dollars.

The first is the development of a sideways trading band between support near \$0.87 and resistance near \$0.94. This continues the consolidation and rebound rally trading pattern seen since 2013 June. This pattern has one weak point. The appearance of support near \$0.87 is not an historical support level. This matches some minor clustering in 2010 and 2008 but it is not an established support level.

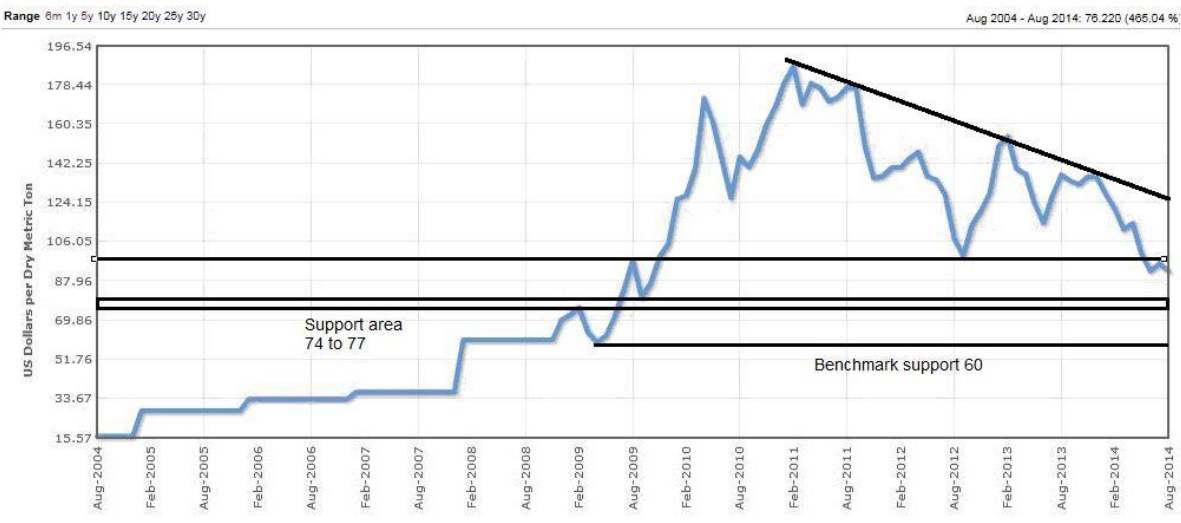
The strongest technical support level is near \$0.79. This is the second technical scenario. This was a key resistance level in 2004 and again in 2005 and in 2007. Although it acted as a resistance level, it did not provide support in 2008 when the dollar collapsed from \$0.94. There is minor support near \$0.80 in 2010. This suggests that any fall below \$0.87 has a downside target between \$0.79 and \$0.80.

The key indicator of a bullish change in direction of trend is a close above \$0.94 on a weekly chart. This is most likely to coincide with a retreat of the US dollar from resistance targets near \$0.89.

The stabilisation of the Chinese economy at lower growth rates with a long term reduction in commodity demand. This creates a shakeout in the supply side of the market.

The slow down in the Chinese economy reflects the emphasis on the quality of growth and the sustainability of growth. Whilst nominal targets for 2014 remain near 7.5%, Vice Premier Zhang Gaoli has described the current performance as on track and acceptable. There is a reasonable probability that 2015 and 2016 growth rate targets will be lowered. Government appears to be well attuned to managing expectations on a domestic and global basis.

Iron Ore Monthly Price - US Dollars per Dry Metric Ton



Description: China import Iron Ore Fines 62% FE spot (CFR Tianjin port), US Dollars per Dry Metric Ton

Iron ore is not a freely traded continuous auction market so technical analysis methods are applied with a little more caution. The CFR Tianjin port price chart shows a sustained downtrend. On current values, priced must move above \$124 before the downtrend is broken. This seems unlikely. The support area is between \$74 to \$77. This captures the peak and rebound price areas during 2009 after the abandonment of the fixed price structure.

A longer term support level developed near \$100. This uses the 2009 peak price and the 2012 support rebound level. This provides a resistance level for any rally away from the \$74 to \$77 support area.

The 2009 retreat to \$60 benchmark support sets a further downside target should support fail to hold in the support band area. However, the structure of the market pre-2009 makes it very difficult to apply standard technical and chart analysis to this chart to set reliable downside support targets.

The key conclusion is that the downtrend pressure in iron ore will continue. Resistance features near \$100 and the value of the downtrend line provide significant resistance to a reversal of the downtrend. The key level is the \$74 to \$77 support area and traders will watch for consolidation inside this band.

Conclusion

With the collapse of the AUD carry trade the AUD will again become more fully responsive to commodity pricing. The AUD will return to a commodity currency status. The downside is the continued fall or stabilisation in demand for commodities key to Australian economic prosperity. The iron ore industry will shrink and consolidate as prices continue to fall on the back of depressed demand. The lack of a freely traded market makes it difficult to estimate where the price will stabilise on support.

The Australian coal industry faces the same trajectory as the iron ore industry as China demand for coking coal is wound back. The demand curve falls further as China moves to implement clean energy targets. The idea that Australian coal production will not be impacted by these policies is naive.

This decline in the commodity space puts continued pressure on the AUD and will weaken the relationship between AUD and USD.