Investec
Investec Bank plc (UK)

26 April 2021

Economics

Global Economic Overview

Mapping out our views on monetary policy

Global

Globally, Covid-19 cases are continuing to accelerate and currently running at an average of over 800,000 new cases per day. India, a current Covid hotspot, is contributing around a third of cases to this daily tally. In contrast, extensive vaccination programmes in parts of the world have seen some nations, such as the US and UK, manage to keep new infections low and ease restrictions. This has led to a tale of two halves, with positive upgrades to the US and the UK growth outlook being offset by downgrades to India, Japan and China (with the downgrade to China prompted by a weaker-than-expected Q1 reading, rather than a worsening Covid situation), resulting in our 2021 forecast remaining unchanged at 6.2%.

United States

Rapid vaccination rates and President Biden's various fiscal packages are setting the scene for rapid growth over 2021 and 2022, with economic momentum so far this year more rapid than we had expected. We have upgraded our 2021 growth forecast by 1 ppt to 6.9%. Inflation pressures seem to be gathering, but the Fed's view is that such a build-up is temporary and that it is not yet time to talk about tapering QE. But we do consider that this is on the cards towards the end of the year. Using the timeline of 2013-2016 as a guide, we still see the first hike in the Fed funds target in Dec 2023; a pace of tightening of two 25bp increases per annum; and (perhaps) the first move by the Fed to shrink its balance sheet in 2025. Of course, this timetable is highly uncertain and subject to considerable disruption.

Eurozone

The Euro area continues to see varying rates of Covid infections and restrictions, a triggering of Germany's 'emergency brake' being the latest development. However, the pace of vaccinations has picked up significantly, offering a path to looser restrictions. Ultimately this underlines our view of a strong H2 rebound and our GDP forecasts of 4.4% 2021 and 5.0% 2022. Nonetheless ECB policy is set to remain exceptionally accommodative. On QE policy we expect PEPP to run its planned course to March 2022, but with the total €1.85trn envelope not fully used. This should be a precursor to an end of APP purchases in December 2022. However we expect a change in interest rates is a long way off, with no change until Q4 2023.

United Kingdom

First tentative figures support the notion that the receding impact of Covid, allowing an easing in social restrictions, coupled with a large if unevenly distributed balance of household savings, will lead GDP sharply higher from Q2 onwards. We have nudged up our already above-consensus growth forecast for 2021 a little further, by 0.2pp to 7.5%. Against such a backdrop, we expect the Bank of England to increasingly focus on its plans for withdrawing stimulus. In contrast to the Fed and the ECB, an ending of asset purchases will probably be followed by some balance sheet reduction, including some gilt sales, before a first rate hike in May 2023.

Please click here for a summary of our economic and market forecasts

Philip Shaw
+44 (0) 20 7597 4302
philip.shaw@investec.co.uk

Ryan Djajasaputra
+44 (0) 20 7597 4039
ryan.djajasaputra@investec.co.uk

Ellie Henderson
+44 (0) 20 7597 6714
ellie.henderson@investec.co.uk

Sandra Horsfield
+44 (0) 20 7597 5882
sandra.horsfield@investec.co.uk

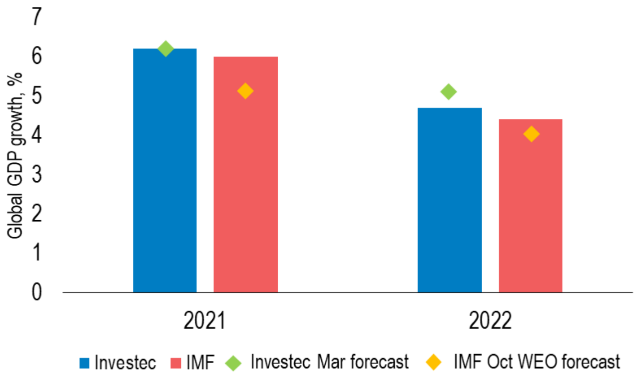
Jesse Lewis
+44 (0) 20 7597 5675
jesse.lewis@investec.co.uk

Laurie Perdikis
+44 (0) 118 922 3531
laurie.perdikis@investec.co.uk

Global

In the latest *World Economic Outlook (WEO)* publication, the IMF upgraded its global 2021 and 2022 growth forecasts, citing continued resilience of economic activity to restrictions and additional fiscal support as reasons for the upgrade. This brings the IMF's estimate for 2021 closer to our own view, which has remained unchanged at 6.2%, with upgrades to the US and UK (see US and UK sections) offset by smaller downgrades to China, India and Japan. Conversely, for 2022, our forecast is a touch lower than reported in the last *Global*, mainly reflecting the evolving Covid-19 situation depressing growth prospects in India and some of the smaller developing economies.

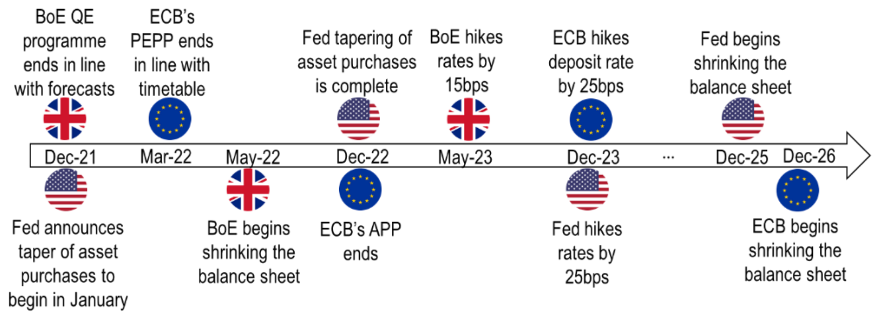
Chart 1: IMF upgrades global growth prospects



Source: IMF, Investec

In this monetary policy-themed *Global* we have set out our detailed rate and asset purchase expectations in each regional section below. Chart 2 summarises these forecasts in a timeline of expected policy moves, which highlights our belief that the BoE's sequencing of events will differ from that of the Fed and the ECB. We anticipate that the BoE will start shrinking its balance sheet a year before its first rate hike of 15bps in May 2023. In contrast, we envision that the Fed and the ECB will begin with a rate hike (slightly later than the BoE, in December 2023, although by a larger increment of 25bps), and delay the reduction of their balance sheets until the latter half of the decade.

Chart 2: Investec estimated timeline of monetary policy decisions by BoE, Fed and ECB

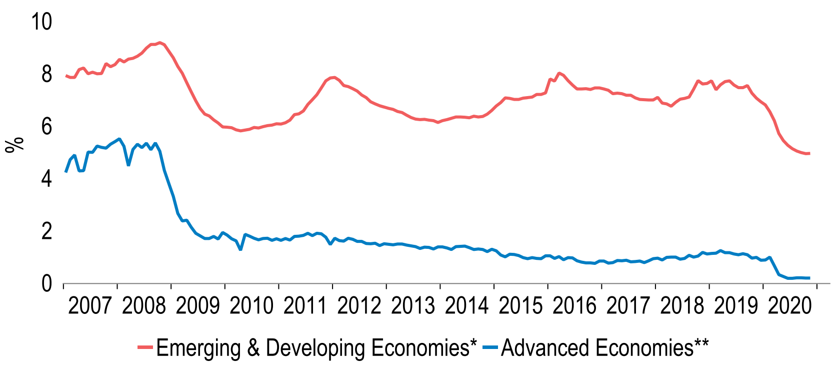


PEPP – Pandemic Emergency Purchase Programme, APP – Asset Purchase Programme

Source: Investec

Central banks in EMDEs also have to consider their timeline for tightening, after cutting key policy rates and adopting APPs*** in response to the pandemic. Reportedly, 27 EMDEs launched APPs during the crisis – many for the first time. The recent IMF *WEO* expressed concerns that the differing timelines across income groups of reversing these moves risk a potential repeat of the 2013 taper tantrum (see US section), where signals of an unexpected tightening in the US had led to sharp capital outflows in EMDEs. Given the contrast in vaccination rates, AEs are expected to be in a position to tighten first, with the fear that diverging rates will leave EMDEs exposed to financial disruptions once again.

Chart 3: Monetary policy responses to the pandemic by income group, average policy rates

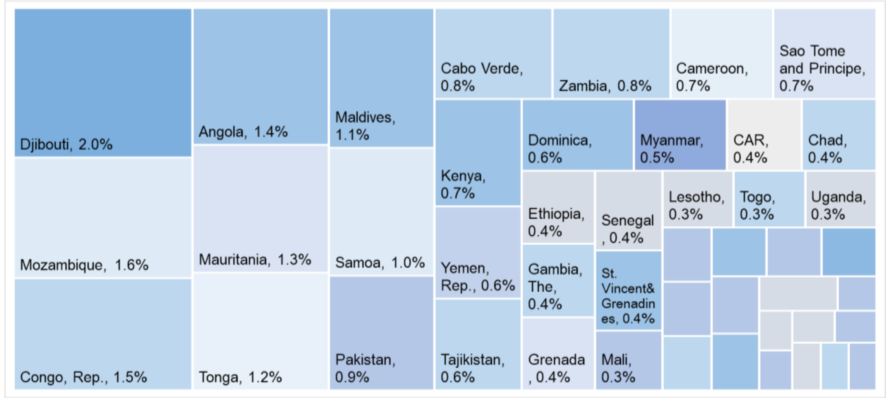


*Average of 67 EMDEs **Average of 16 AEs ***Asset purchase programmes

Source: World Bank, Investec

The World Bank/IMF have spearheaded a G20 initiative to suspend debt service payments for the poorest economies while they focus on fighting the pandemic. This includes G20 members outside of the Paris Club, such as China, one of the largest creditors for DSSI-eligible nations. As shown in Chart 4, Djibouti is set to benefit the most from the scheme. However, concerns about the initiative have arisen as ratings agency Moody's suggested that private sector participation (which is encouraged, but not required under the scheme) could be classed as a default and thus risks a credit rating downgrade, resulting in some eligible countries opting out of the scheme.

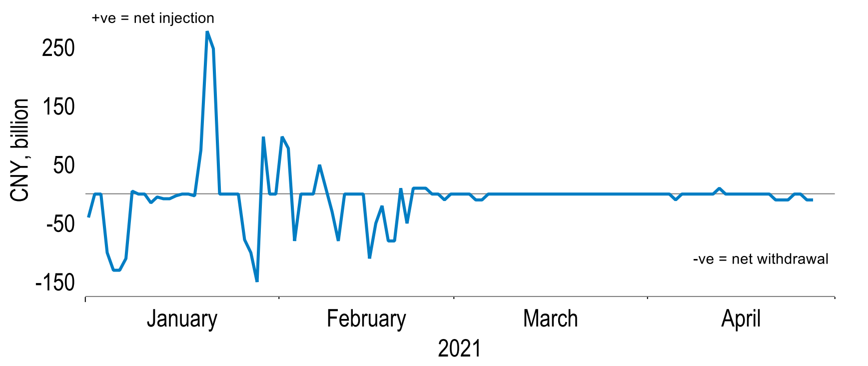
Chart 4: Nations to benefit from the extension of the Debt Service Suspension Initiative (DSSI)*



*Figures represent potential DSSI savings from Jan – Jun 21 (% of GDP) Source: World Bank, Investec

With the economy largely recovered from the pandemic, Chinese policymakers have turned their attention to a deleveraging campaign that aims to reduce financial risks. But the liquidity squeeze at the start of the year rattled markets. Since then, officials have encouraged local governments to reduce debt levels, but the PBoC has committed to a more cautious stance, ensuring stable financial conditions for the remainder of 2021, as illustrated in Chart 5. Once accounting for base effects, an underwhelming Q1 GDP growth rate raises questions on how far officials are willing to take this deleveraging drive, considering the potential hit to short-term growth prospects.

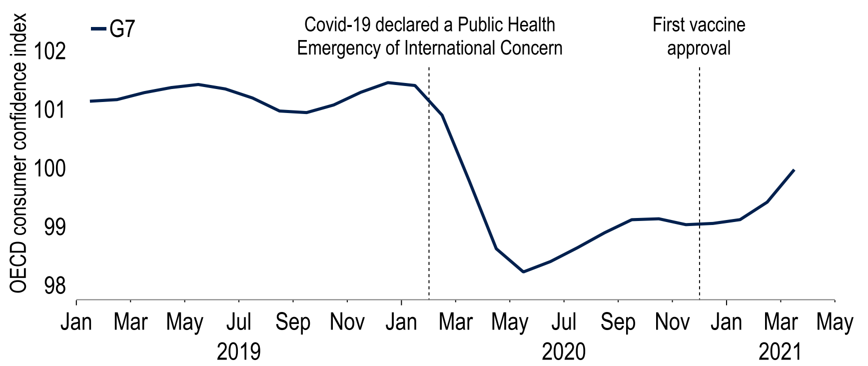
Chart 5: PBoC keeps liquidity stable via OMO by offsetting the amount maturing



OMO – Open Market Operations Source: Investec, Macrobond

Restrictions to economic activity for more than a year because of the pandemic have led to an estimated build-up of over $5.4trn in global excess savings (when compared with 2019 spending levels) according to credit rating agency Moody's – this is equivalent to over 6% of global GDP. A recent resurgence in consumer confidence in G7 countries (Chart 6) shows the growing willingness to spend as some restrictions ease and vaccines are rolled out. We may therefore see a portion of excess savings released into the economy. Moody's estimates that by spending a third of their excess savings, consumers could increase global output by over 2ppts this year and next.

Chart 6: Consumer confidence grows in the G7 countries whilst excess savings build

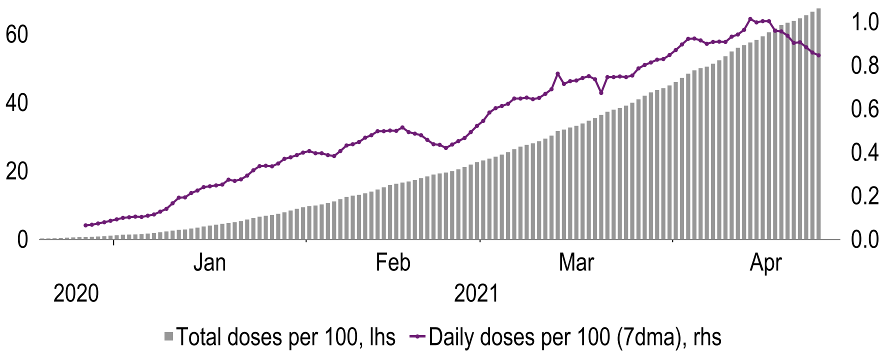


Source: Macrobond

United States

The US recovery continues unabated. Helped by two rounds of stimulus cheques, retail sales soared by 7.7% (q/q) over Q1 as a whole, while the rapid pace of vaccinations and further lifting of Covid restrictions are set to support growth in Q1 & Q2. Fiscal wrangling with the Republicans looks set to intensify. This is over President Biden's intended $2.3trn infrastructure package, his $1.8trn '*American Family Plan*', plus income, CGT & corporation tax hikes. In response the GOP is mulling the use of the debt ceiling as a blocking weapon. Congressional complexities aside, faster H1 economic momentum results in an upgraded 2021 GDP forecast of 6.9% from 5.9%. 2022 is nudged up to 4.9%.

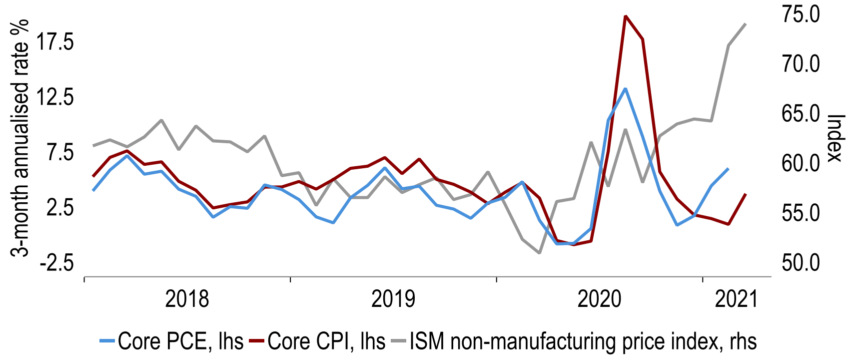
Chart 7: US vaccination rates – slowed recently but still rapid



Source: Macrobond

Inflation indicators have firmed recently and beaten expectations. Chart 8 shows core CPI and PCE moves (expressed as 3m saar, to avoid base effects from last spring). Also, cost pressure indicators from manufacturing and services surveys are rising. Critically, the FOMC views any price pressures as temporary. The Fed's 'make up' strategy does explicitly state that it will compensate for periods of low price pressures by allowing inflation to run above its objective. However Chair Powell warned last week that the central bank is not seeking to achieve above 2% inflation for a prolonged period. 10y Treasury yields are off highs (currently 1.58%) as investors mull the likely shape of the Fed's monetary exit strategy.

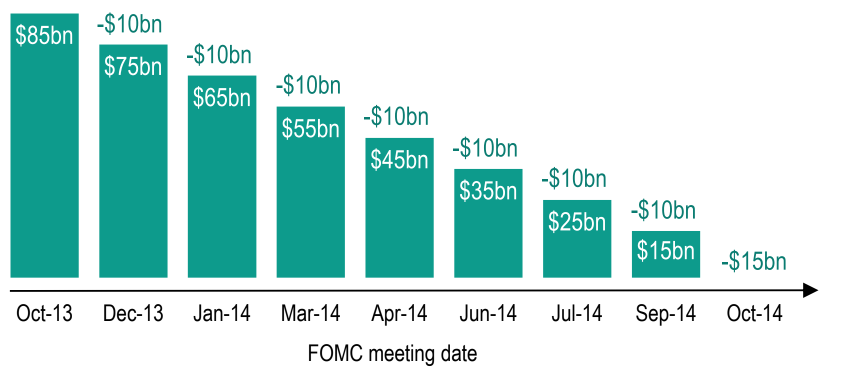
Chart 8: Inflation gauges have risen recently, while surveys show price pressures building



Source: Macrobond

The first stage may be a gentle hint from the FOMC on tapering its QE purchases. The Fed's purchases are open-ended and tapering is specifically seen as the intention to reduce bond buying ($120bn-plus of assets per month) to zero. This contrasts with the ECB, which, similar to the BoE's approach, varies its purchases subject to its total 'envelope'. Senior Fed officials have to a person insisted that it is not yet time even to talk about tapering. The Fed will want to avoid a major market sell-off such as in 2013 (taper tantrum) sparked by the then Fed Chair Ben Bernanke's remarks to Congress, when he suddenly announced the Fed's intention to end QE.

Chart 9: QE tapering announced at FOMC meetings in 2013 and 2014



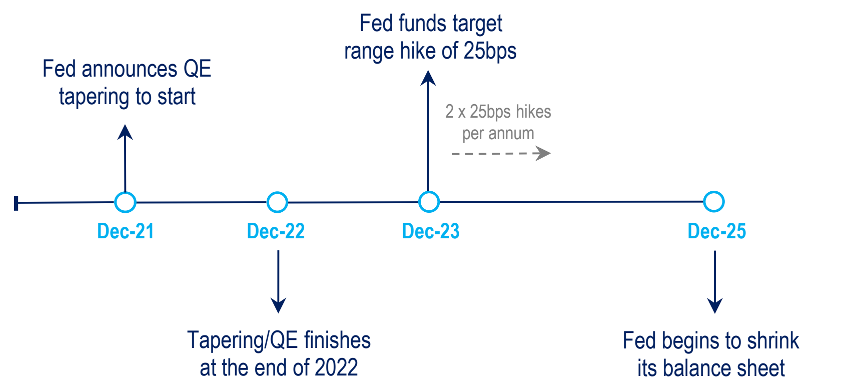
Source: Federal Reserve

Chair Powell recently hinted that while this was not yet set in stone, the Fed would begin by raising rates after QE had ceased and only after then reduce the balance sheet. On this sequencing, and on our view of the economic outlook (far from certain, we admit), we expect tapering to be introduced at the end of this year and to be conducted in incremental steps over 12 months, much like 2013/14. QE would then cease in Dec 2022. We judge that there will be a period of a year before the FOMC senses it is comfortable with lifting the Fed funds target range (in Dec 2023), perhaps at a pace of two 25bp hikes per annum. In the last cycle the Fed waited for close to two years to start shrinking its balance sheet (i.e. QE…

… reversal). Applied here this implies that the FOMC could allow a run-off in its balance sheet from late-2025. This of course is only a rough template – it is hard to overstate the uncertainties. Markets are pricing in tightening similar to ourselves (2*25bp hikes per annum), but starting earlier in Q1 2023. Along the curve, Treasury yields have eased back since late March – 10y & 30y yields are some 20bps below their peaks (currently 1.58% and 2.25%, respectively). One factor may be that housing market conditions seem to have cooled, partly on the back of higher mortgage rates. We still judge that, on average, 10y yields will rise slowly, up to 1.75% at year-end and to 2.0% by end-2022.

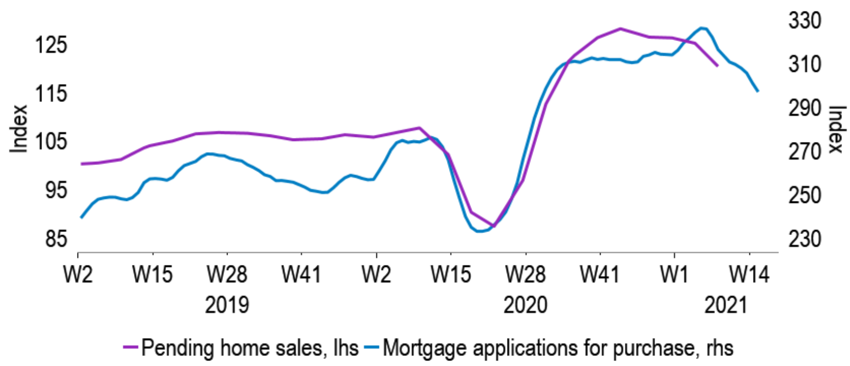
Downward pressure on shortdated rates from copious liquidity remains. This is not so much the case across the Fed funds market itself, where the effective rate has been steady at 6-7bps, well within the 0%-0.25% target range. It is a factor though in repo markets and with the new overnight lending benchmark, SOFR. These have averaged 1bp recently, with some funds trading at negative rates. In March, the FOMC stated that it was open to adjusting both its IOER (0.10%) and RRP (0.00%) rates upwards to push short market rates closer to the middle of the range. This is a technical issue, but will take a careful steer to prevent the misconception that it is a shift in the stance of monetary policy.

Chart 10: Projected Fed tightening timeline



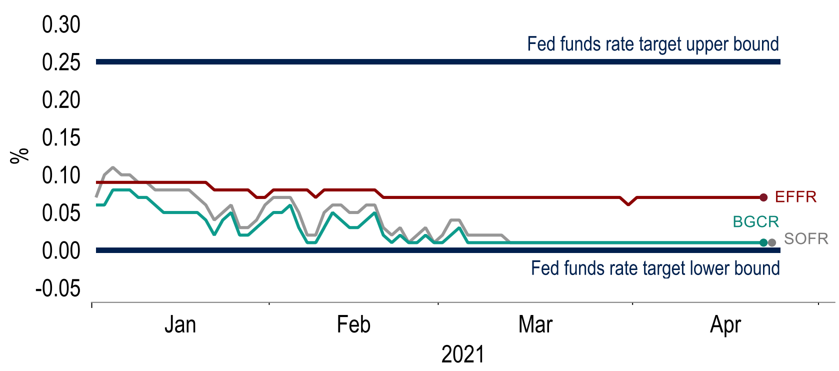
Source: Investec

Chart 11: Housing conditions slowing in response to higher mortgage rates?



Source: Macrobond

Chart 12: Repo rates have softened to the bottom of the Fed funds target range in recent weeks



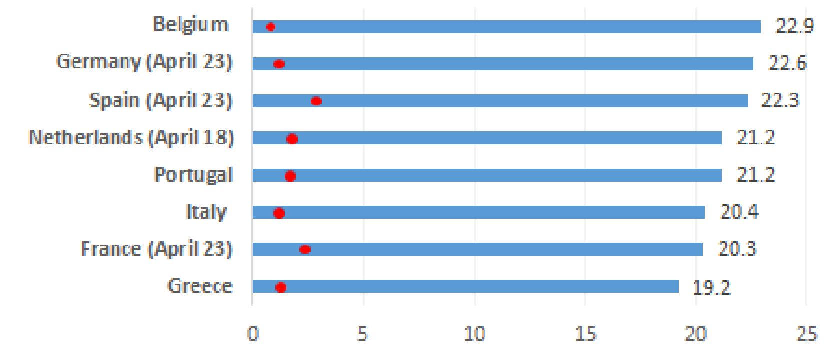
Effective Federal Funds Rate (EFFR), Broad General Collateral Rate (BGCR), Secured Overnight Financing Rate (SOFR).

Source: Macrobond, NY Fed

Eurozone

As European vaccine supply issues begin to smooth out, the vaccine rollout amongst Eurozone economies has ramped up. After a slow start in Germany and France in particular, vaccination rates are now accelerating. Restrictions to tackle the 'third wave' vary across the eurozone, with four-week lockdowns introduced in France and Belgium at the start of April and Germany seeing its 'emergency brake' triggered over the weekend, activating restrictions on a regional basis. But in other cases, such as in Italy, measures are beginning to ease, albeit tentatively. As vaccination rates rise sufficiently, economies will start to unlock, supporting the outlook. Nonetheless ECB policy is set…

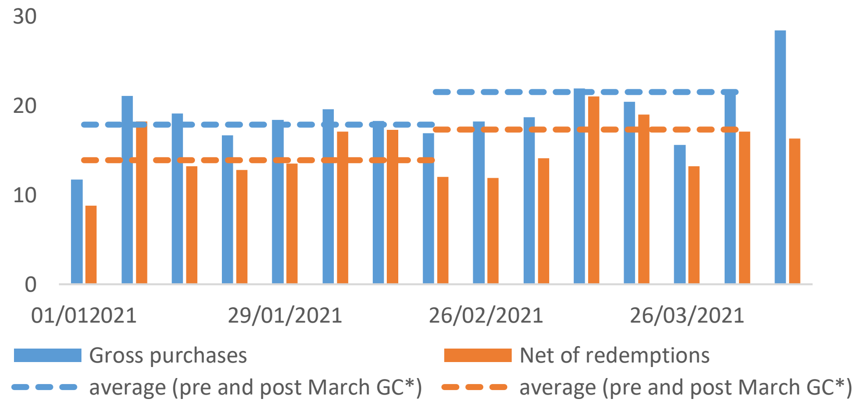
Chart 13: Eurozone vaccinations are on the rise (% of population with one dose)



Source: Our World in Data (26 April); Investec. *Red dot indicates vaccine rates as at 22 Jan-21.*

…to remain accommodative with a particular near-term focus on preventing an unwarranted tightening in financial conditions. March's decision to step up purchases under the PEPP, has been evident in the weekly data, with purchases averaging €22bn, a 20% rise on Jan-Feb. This has, for the most part, limited the rise in yields rather than pushed them lower: yields across the four most liquid markets have seen 10yr rates edge up 10bps. Nevertheless April's ECB meeting judged that conditions had stabilised. Will this increased purchase pace be extended beyond the current quarter? We believe not, with purchases likely to return to previous levels, although the ECB can still act flexibly as needed.

Chart 14: Weekly PEPP purchases - gross and net (€bn, week ending)

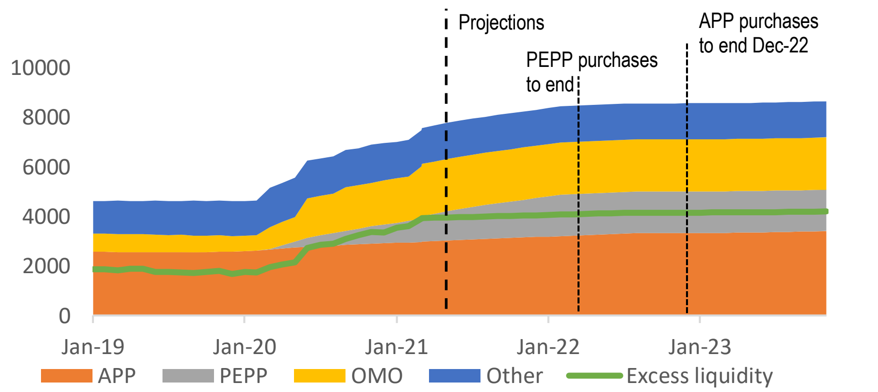


*Governing Council meeting

Source: ECB

This flexible approach should see the ECB conduct PEPP purchases until its planned March 2022 end date. But we suspect that ultimately it may not use the full €1.85trn envelope. On the basis of purchases returning to circa €50bn/ month, the ECB will have bought €1.7trn by March. Should the economy rebound strongly there is also the possibility that purchases are gradually phased out, something which has been touted by more hawkish members of the ECB. QE is not however limited to the PEPP, with €20bn/month also purchased under the APP. This is currently open ended, dependent on a 'robust convergence of inflation to target'. This we suspect will not be evident until the end of 2022, when we expect the ECB to halt asset purchases.

Chart 15: Projected ECB balance sheet (€bn)

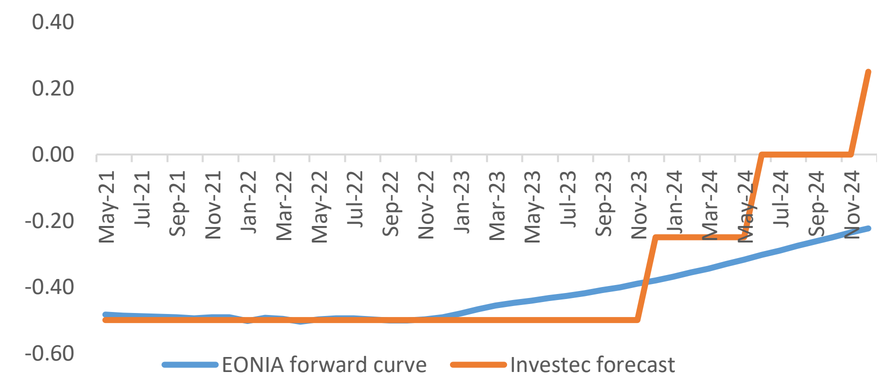


APP- Asset Purchase Programme, PEPP- Pandemic Emergency Purchase Programme, OMO- Open market operations

Source: ECB, Investec

On interest rates we expect that a subdued inflation outlook will keep policy on hold until Q4 2023, where we see a 25bps hike in the Deposit rate to -0.25%. Beyond the first hike, we anticipate two 25bps hikes per annum, on the view that the ECB is keen to move out of negative rates given some concerns about the side effects from prolonged sub-zero rates: the first move below 0% was in 2014. However we are mindful that the ECB strategy review, due later this year, could have implications for this view. Whilst a rise in rates is certainly a long way off we continue to call for an adjustment to the tiering system, given that the current level of excess reserves subject to the Deposit rate is €3.1trn (and set to grow further), 239% more than when tiering was introduced, representing a €16bn annual charge to the banking system.

Chart 16: Investec Eurozone Deposit rate forecast and market implied rate (%)



Source: Macrobond, Investec

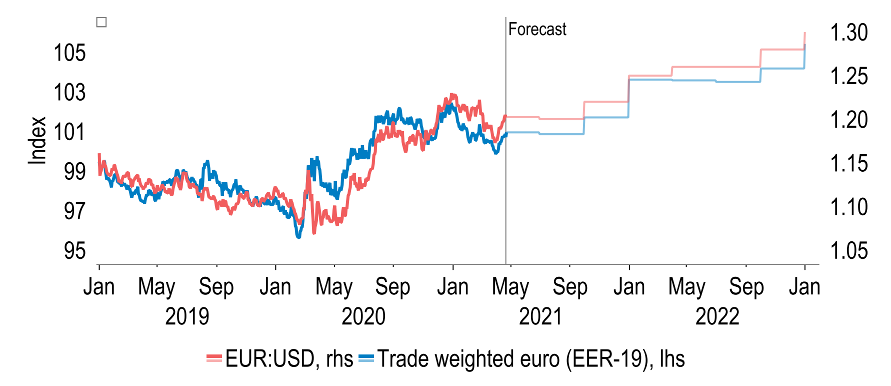
Fiscal policy, via the EU's €750bn NextGenerationEU (NGEU) package also remains a focus, amidst calls for the distribution of funds to be sped up. Here there are two points of note. Firstly, national ratification is still ongoing, with only 17 states completing their approval process so far. On a positive note Germany's Constitutional Court dismissed a challenge, which had risked delaying the process. Secondly, states are finalising their Recovery and Resilience Plans ahead of a 30 April deadline. Once these have been submitted, the European Council is scheduled to approve the plans by the end of May and allow 13% of a country's allocated grants to be distributed within two months.

Chart 17: NextGenerationEU - Recovery and Resilience Facility grant allocations (€bn)

Source: European Commission

By this point we expect the economy to be firmly in recovery mode, given inoculations and a relaxation of social distancing rules, the added fiscal stimulus therefore adding a further shot in the arm to growth across H2. For 2021 as a whole we see GDP growth standing at 4.4% and at 5.0% in 2022. We see this fundamental improvement supporting the euro, particularly across the later part of this year. Our year-end €:$ forecast stands at $1.25, rising further through 2022 to $1.30. However in the near term, headwinds related to Covid remain given infection rates, and hence we see €:$ trending around $1.20 through Q2 until the picture becomes clearer in Q3.

Chart 18: Euro performance and Investec forecasts

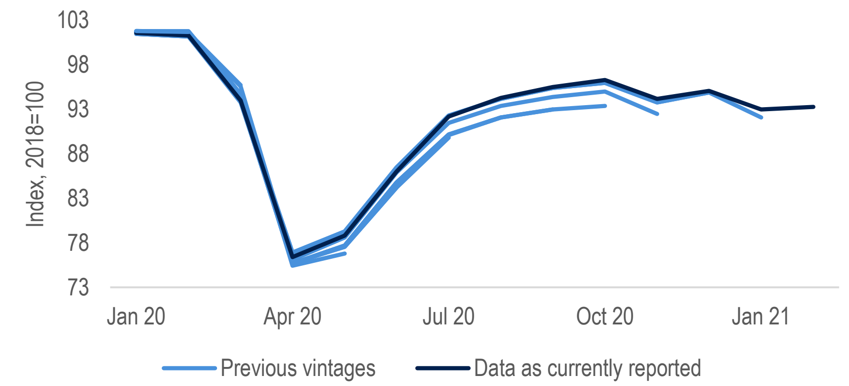


Source: Macrobond, Investec

United Kingdom

The past month's data has strengthened our conviction in our above-consensus growth forecasts. GDP figures have again been revised up (Chart 19), hinting at greater resilience to lockdowns. Falls in Covid case numbers, hospitalisation and death rates have been sustained too, amid solidly rising vaccinations, suggesting no reason to proceed more slowly with easing social restrictions than set out in the government's February roadmap. As outgoing BoE Chief Economist Andy Haldane noted, a 'pretty rip-roaring recovery' is possible if even a small part of the excess savings built up over the pandemic gets spent – of which soaring April restaurant bookings and retail footfall may be giving first glimpses.

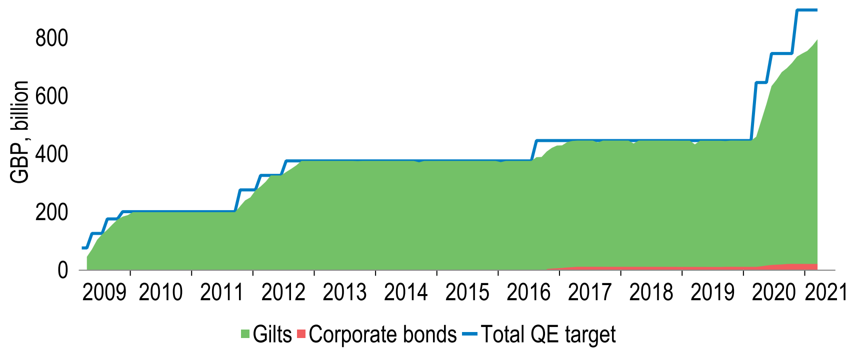
Chart 19: Monthly GDP levels have tended to be revised up in recent months



Source: ONS, Investec

We have thus nudged up our GDP growth forecast for 2021 by 0.2pp to 7.5%; our 2021 forecast slips by 0.1pp to 5.5%. Growth is also underpinned by the vast fiscal and monetary support provided by policymakers. In terms of quantitative easing, in November 2020, the Bank had agreed a further £150bn of gilt purchases to a target level of £875bn, on top of the existing £20bn of corporate bonds. The APF's current gilt holdings are £787.5bn (Chart 20). Were the current purchase of £4.4bn a week to be maintained, target holdings would be achieved by the end of Q3. So to meet the schedule of completion by the end of this year as planned, the rate of purchases will have to slow at some point.

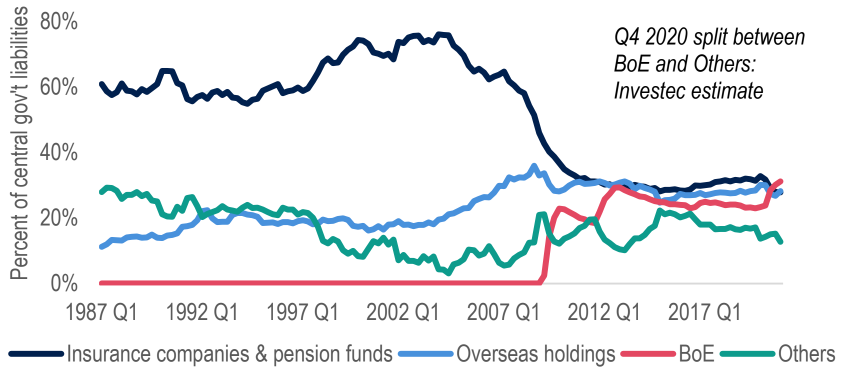
Chart 20: The Asset Purchase Facility (APF)'s holdings are rising towards the BoE's target



Source: Bank of England, Investec, Macrobond

Even the purchases made so far have left the Bank of England as the largest holder of UK gilts (Chart 21). This has aided the public purse: interest payments on gilts held by the BoE's Asset Purchase Facility (APF) are remitted to the Treasury, net of the cost of funding them via commercial bank reserves remunerated at Bank rate. With the interest earned on gilts exceeding Bank rate, this has lowered the government's net interest burden; but as policy rates are raised, the opposite will eventually apply. Operationally to purchase gilts in the open market, the BoE conducts reverse auctions, in which private-sector sellers offer their bond holdings to the APF.

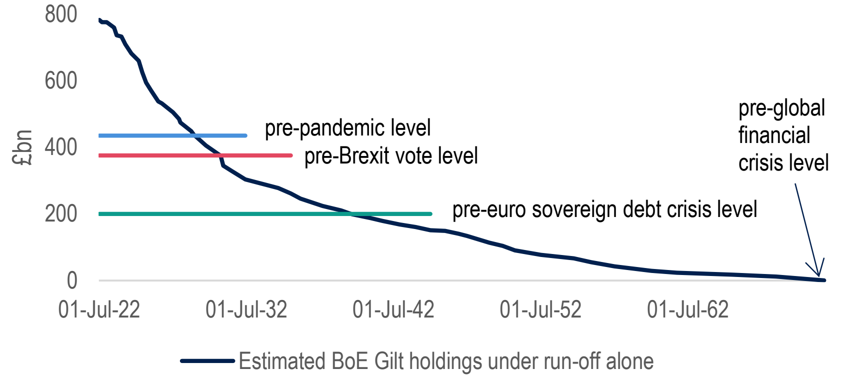
Chart 21: QE has been large enough to make the BoE's APF the largest holder of UK gilts



Source: ONS, Investec

With an eye to the future, the BoE is currently conducting a review on its preferred sequencing for monetary tightening. Prior to the pandemic, under Mark Carney, the Bank had suggested it would not start shrinking its balance sheet before its policy rate had reached 1.50%. But current BoE Governor Andrew Bailey has indicated he would prefer to start shrinking the Bank's balance sheet before beginning to raise rates, perhaps partly to mitigate the negative effect on fiscal sustainability once Bank rate exceeds the rate on the APF's gilt holdings. There are two ways of achieving this: by not reinvesting proceeds from gilts as they mature, letting them 'run off'; or by actively selling them into the market prior to this.

Chart 22: APF gilt holdings would take many years to shrink meaningfully under run-off alone



Source: Investec estimates

We expect the sequencing review to recommend that the balance sheet should start to be shrunk prior to rate hikes. Given our outlook for the economy, we predict this to begin in May 2022. Taking into account the maturity profile of the BoE's gilt holdings, a pure 'run-off' would in the first couple of years shrink the balance sheet by less than £80bn, i.e. under 10% (Chart 22). This is likely to be deemed too slow a start, so some outright sales by the BoE will be probably be needed too. This could be easily achieved by switching the current weekly reverse auctions to standard auctions. A first rate rise could follow in May 2023 – in an initial step of 15bps, before a subsequent pace of two 25bp hikes a year (Chart 23).

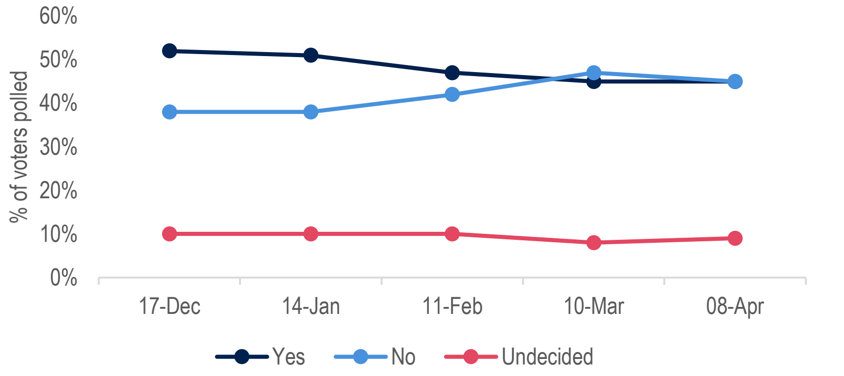
Chart 23: We expect monetary policy steps to broadly follow the schedule below

When	What	Note
Aug 2021	QE purchases slow	First Monetary Policy Report BoE meeting after social restrictions are currently planned to cease
Dec 2021	QE ends	Target of £895bn for APF holdings is achieved
May 2022	Balance sheet reduction begins	Achieved via a mixture of run-off and outright gilt sales in auctions
May 2023	First Bank rate hike	Initial step of +15bps, to bring interest rate back to 'standard' level of +0.25%
Nov 2023 and beyond	Further Bank rate hikes	Pace of tightening two steps of +25bps per annum

Source: Investec

As far as sterling is concerned, we have not changed our forecasts. In light of the improving growth outlook, and the likelihood of strong near-term macro data as the UK economy's unlocking precedes that in the Euro area, there are risks that the pound strengthens sooner than in our baseline forecasts. Set against that, however, is the possibility that the SNP could, despite the latest polls indicating a tilt away from a Yes vote for Scottish independence (Chart 24), gain an outright majority at the Holyrood elections on 6 May. If so, FX markets may be rattled and factor in a greater risk of an eventual second referendum and vote for Scottish independence into GBP's valuation.

Chart 24: Voting intentions for Scottish independence in a hypothetical referendum have slipped



Source: Savanta ComRes Scottish Political Tracker

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Registered Office Address:
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Registered Office Address:
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Global Forecasts

GDP Growth (%)

	Global	US	Japan	China	UK	EU19	Germany	France	Italy
2016	3.3	1.7	0.8	6.9	1.7	1.9	2.2	1.1	1.3
2017	3.8	2.3	1.7	6.9	1.7	2.6	2.6	2.3	1.7
2018	3.6	3.0	0.6	6.7	1.3	1.9	1.3	1.9	0.9
2019	2.8	2.2	0.3	5.8	1.4	1.3	0.6	1.5	0.3
2020	-3.3	-3.5	-4.8	2.3	-9.9	-6.6	-4.9	-8.2	-8.9
2021	6.2	6.9	3.3	8.8	7.5	4.4	3.1	6.8	3.4
2022	4.7	4.9	1.8	5.7	5.5	5.0	5.3	5.2	4.0

Source: IMF WEO, Macrobond, Investec forecasts

Key Official Interest rates (%, end quarter):

	US Fed funds	Eurozone refi rate	Eurozone deposit rate	UK Bank rate	Australia cash rate
Current	0.00-0.25	0.00	-0.50	0.10	0.10
2021					
Q1	0.00-0.25	0.00	-0.50	0.10	0.10
Q2	0.00-0.25	0.00	-0.50	0.10	0.10
Q3	0.00-0.25	0.00	-0.50	0.10	0.10
Q4	0.00-0.25	0.00	-0.50	0.10	0.10
2022					
Q1	0.00-0.25	0.00	-0.50	0.10	0.10
Q2	0.00-0.25	0.00	-0.50	0.10	0.10
Q3	0.00-0.25	0.00	-0.50	0.10	0.10
Q4	0.00-0.25	0.00	-0.50	0.10	0.10

Source: Macrobond, Investec

10-year government bond yields (%, end quarter):

	US	Germany	UK
Current	1.58	-0.25	0.76
2021			
Q2	1.75	-0.25	0.75
Q4	1.75	-0.25	0.75
2022			
Q2	2.00	-0.25	1.00
Q4	2.00	0.00	1.25

Source: Refinitiv, Investec

FX rates (end quarter/ annual averages)

		Current	2021				2022				2020	2021	2022
		26-Apr	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	average	average	average
Euro	€:$	1.210	1.18	1.20	1.22	1.25	1.26	1.26	1.28	1.30	1.14	1.21	1.27
Sterling	€:£	0.870	0.85	0.87	0.87	0.89	0.88	0.86	0.85	0.85	0.89	0.87	0.87
	(£:€)	1.150	1.17	1.15	1.15	1.12	1.14	1.16	1.17	1.18	1.13	1.15	1.16
	£:$	1.391	1.38	1.38	1.40	1.40	1.44	1.46	1.50	1.53	1.28	1.39	1.47
Yen	$	107.7	111	107	105	104	104	104	104	104	107	106	104
	€	130.3	130	128	128	130	131	131	133	135	122	129	132
	£	149.8	152	148	147	146	150	152	156	159	137	147	152
Aussie Dollar	$	0.779	0.76	0.77	0.78	0.80	0.80	0.80	0.80	0.80	0.69	0.78	0.80
	€:AUD	1.552	1.54	1.56	1.56	1.56	1.58	1.58	1.60	1.63	1.66	1.56	1.59
	¥	83.96	84.2	82.4	81.9	83.2	83.2	83.2	83.2	83.2	73.6	82.5	83.2
	£:AUD	1.785	1.81	1.79	1.79	1.75	1.80	1.83	1.88	1.91	1.86	1.79	1.83
Swiss Franc	€	1.105	1.11	1.10	1.11	1.12	1.12	1.14	1.14	1.16	1.07	1.10	1.14
	$	0.913	0.94	0.92	0.91	0.90	0.89	0.90	0.89	0.89	0.94	0.91	0.89
	£	1.270	1.30	1.27	1.27	1.25	1.28	1.32	1.34	1.37	1.20	1.27	1.31

Source: Refinitiv, Investec