Strength in the AUD may be fleeting

The smart money has decided there will be no rate cut today by the RBA and the AUD has firmed ahead of the announcement. But there are reasons for the RBA to put a cut back on the agenda and renewed price falls in its key commodity markets may encourage the RBA to re-instate a preference for a lower AUD. Strength in the AUD on a no cut announcement may be fleeting and it is likely to fall if the RBA inserts even a modest easing bias into the statement.

Reasons for the RBA to revert to an easing bias

The Australian rates market has convinced itself there will not be a rate cut today mainly because there has not been any sage newspaper reporter predicting one, and some of the more prescient economists are suggesting not enough has changed to warrant a cut after a relatively neutral policy statement one-month earlier at which the RBA noted improvement in non-mining sectors of the economy.

There are three key developments since the previous RBA meeting that have raised the prospect that the RBA may cut rates again. Large banks have raised their variable mortgage rates by between 10 to 20bp, the CPI inflation data was significantly lower than expected, and Australian commodity prices have weakened, threatening to make new lows.

In light of these developments, even if the RBA leave rates on hold today, it may insert an easing bias into the report and it may re-engage in talking the exchange rate lower.

RBA may re-engage in currency jawboning

In the 6 October policy statement the RBA said: “The Australian dollar is adjusting to the significant declines in key commodity prices.” In the minutes from this meeting, released on 20 October, it said, “This rebalancing [from resources to non-mining] was being increasingly supported by the depreciation of the Australian dollar, which had led to a noticeable increase in net service exports over the past year.”

These somewhat up-beat assessments helped support the AUD after the last meeting. The chart below shows the AUD TWI, AUD/USD and CBA Australian commodity price index.

Greg Gibbs
Director, Amplifying Global FX Capital
Greg.Gibbs@ampGFXcapital.com
+65 9238 0264

The AUD is little changed since the previous meeting and commodity prices are somewhat lower. Perhaps ominously commodities are retesting the lows for the year, threatening to undermine sentiment more significantly as the market links weaker commodity prices to reports of weaker than expected industrial production and fixed asset investment in China.

The RBA does not need to express alarm over the level of the exchange rate, but given the recent trends in resource sector assets it might want to highlight the need for a sustained period of a lower exchange rate to support non-mining sectors.

Lower inflation outlook

The key underlying trimmed mean (2.1%y/y) and weighted median CPI (2.2%y/y) inflation measures came in 0.3ppt below expected on their annual rates in Q3, dipping a bit to near the lower part of the RBA's 2 to 3% target range for inflation, rather than rising to the middle of the band as was expected. This lower starting point for inflation should bring down the RBA inflation forecasts somewhat that are to be updated on Friday in the quarterly Statement on Monetary Policy (SoMP).

In its August SoMP, the RBA forecast year end inflation at 2.5%, and in a range of 2 to 3% over the three year horizon.

In its most recent 6 October policy statement, the RBA said, "Overall, the economy is likely to be operating with a degree of spare capacity for some time yet, with domestic inflationary pressures contained. Inflation is thus forecast to remain consistent with the target over the next one to two years, even with a lower exchange rate."

Greg Gibbs
Director, Amplifying Global FX Capital
Greg.Gibbs@ampGFXcapital.com
+65 9238 0264

The view on inflation was benign and has received little attention in RBA statements. The most recent CPI data may open the door for the RBA to insert an easing bias into their report. The RBA may be reluctant to make it seem that a policy cut hangs on the last CPI release, but it could note the data do raise the possibility that inflation trends are lower than previously forecast.

Linking policy to progress on financial stability

The RBA acknowledged tentative signs that the housing market and bank lending were beginning to respond to prudential tightening at its previous meeting. Evidence on the housing market over the last month has continued to show cooling in sales and prices in the major cities. Building approvals released yesterday were also showing evidence of peaking. However, overall lending growth to the sector was little changed at a solid although not alarming annual rate of around 7.5%.

In light of the rise in bank variable rates we might expect further moderation in the housing market. However, if the RBA were to cut rates so soon after this tightening in credit conditions that have only just started to dampen housing market activity, it might appear overly sensitive to the sector and send confusing signals to the market in which it would probably prefer further moderation in lending.

It's a difficult balancing act for the RBA; it may prefer housing moderation, but it wants stronger overall economic growth, particularly in the non-mining sector. It has accepted that cutting rates over recent years would boost housing investment and activity and this was intended to be a part of supporting economic rebalancing during the resources sector down-turn. But it stoked excessive growth in investor lending to the sector and rapid price gains in the major cities from already high levels. The RBA has acknowledged that households have limited capacity to further extend borrowing.

The answer has perhaps always been greater use of prudential measures to control lending, and arguably the regulators were too slow to act decisively. But now they have acted, it appears too early to presume enough momentum has been taken out of the housing market to allow some further rate cuts.

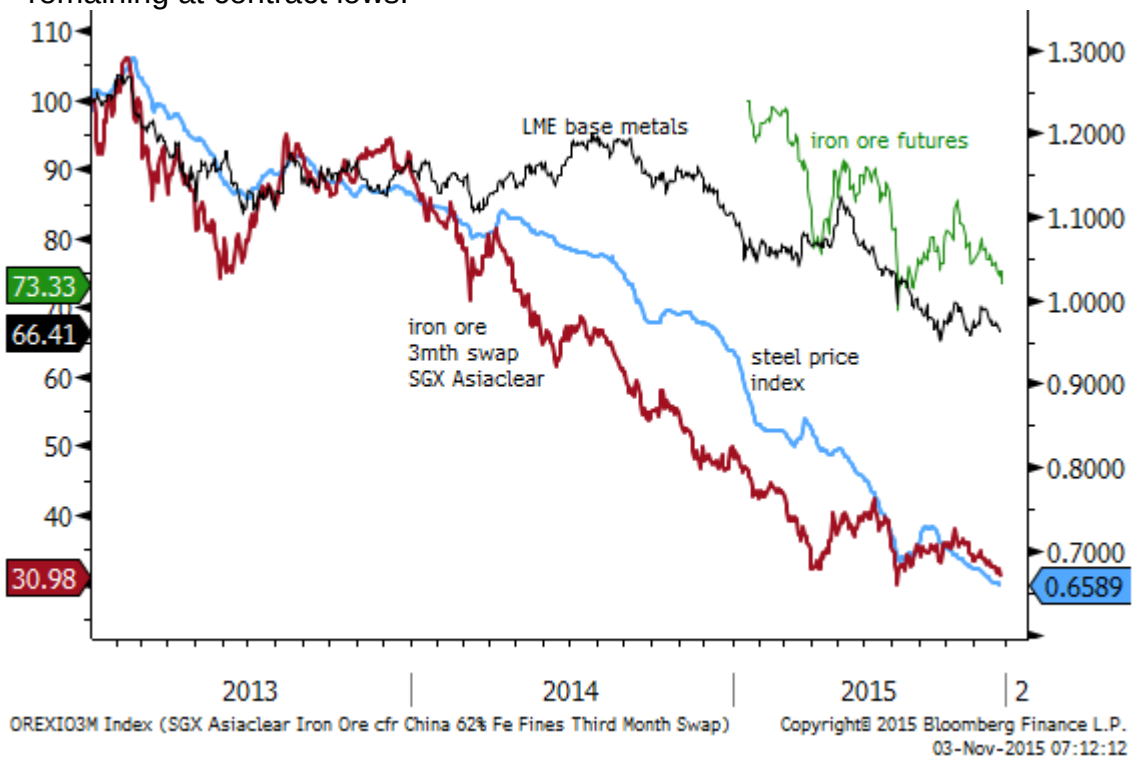
The RBA could make rate cuts appear more conditional on these financial stability concerns. It may note that it is paying closer attention to impact of recent prudential measures.

Markets on the Move

- Iron ore futures prices continued a steady decline on the Dalian Futures Exchange; the most active contract for Jan-16 fell 2.5% on Monday to a new low since July. The one-month SGX Asiaclear swap price fell sharply by $4.7 to $47.4 per metric tonne to around its previous lows for the year seen in April and July. The 12mth swap price fell $1.3 to $39.85 a new low in the contract since data available in 2009.

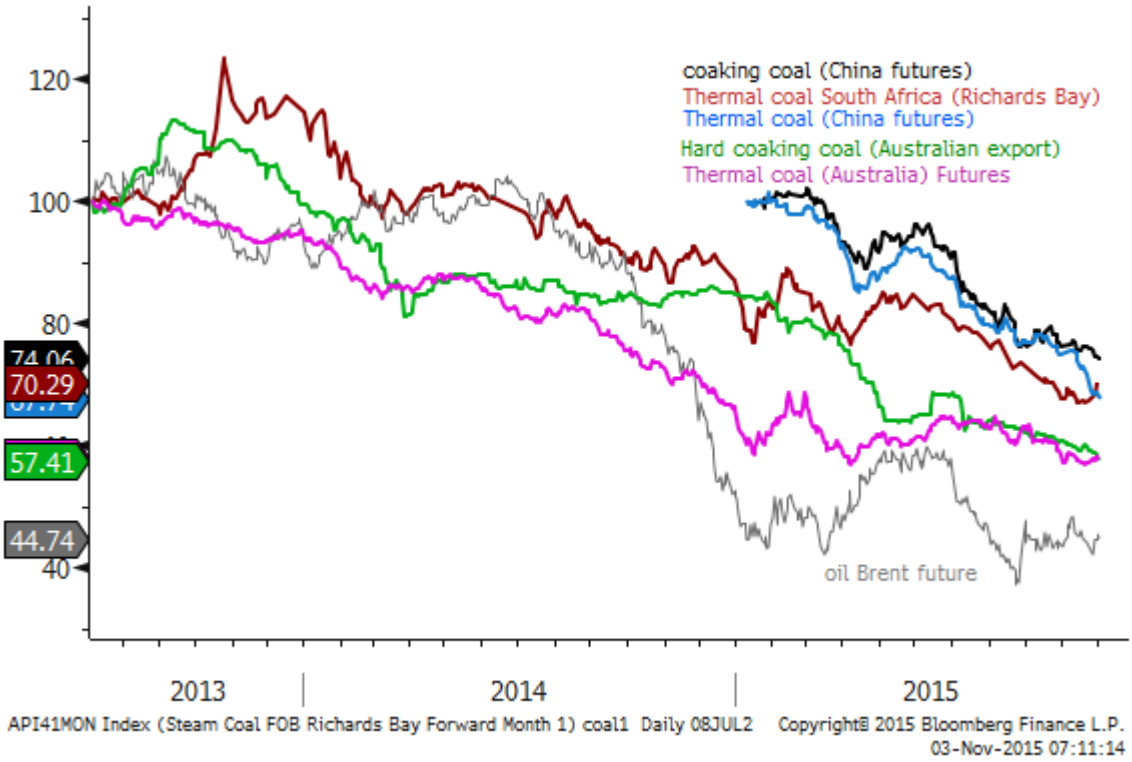
Greg Gibbs
Director, Amplifying Global FX Capital
Greg.Gibbs@ampGFXcapital.com
+65 9238 0264

- Steel prices in China have continued their steady drift lower to around their lows since since data is available since 2003.
- The LME base metals index has fallen a bit further on Monday to a low since September, appearing to be bumping along the lows for the year in Aug/Sep.
- Coking and Thermal coal futures contracts in China were flat of down a bit, remaining at contract lows.



Greg Gibbs
Director, Amplifying Global FX Capital

Greg.Gibbs@ampGFXcapital.com
+65 9238 0264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Amplifying Global FX Capital Pty Ltd	**Amplifying Global FX Capital LLC**
Mailing address:	Mailing address:
P.O. Box 873 Queanbeyan, NSW 2620 Australia	P.O. Box 1071 Breckenridge, Co 80424 U.S.A.
Physical address:	Physical address:
699 Captains Flat Road Carwoola, NSW 2620 Australia	372 Revett Drive Breckenridge, Co 80424 U.S.A.

Greg Gibbs
Director, Amplifying Global FX Capital

Greg.Gibbs@ampGFXcapital.com
+65 9238 0264