Amplifying Global FX Capital

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Low AUD crucial for RBA game-plan

The surprise overnight was that the BoE suggested a weaker outlook for its trading partners' growth is likely to delay its rate hikes until 2017, and it may implement macro-prudential measures to help sustain lower rates; clearly negative for the GBP and it has reacted. The news may have also weighed on the USD to some extent, suggesting that the Fed should also move cautiously on its plans to hike. A hike now seem quite likely in December, provided the data and global financial conditions are reasonably stable. Needless to say the payrolls report in the US may set the tone for the USD. German factory orders were weak with the intensifying scandal at VW potentially a contributing factor. This should keep the ECB on track to ease policy in December. The RBA Statement on Monetary Policy significantly lowered its inflation outlook over the next year. Its growth outlook was little changed with weaker trading partner growth offset by a firmer outlook for non-resource sectors. This view relies on the AUD remaining low and suggests that the RBA would be more comfortable if the currency fell than rose; especially in light of recent falls in commodity prices. And might use its easing bias if the AUD were to rise much.

RBA outlook implies it has a preference for a lower AUD

The RBA has lowered its inflation forecast over the coming year by 0.5ppt to be around the lower end of its 2 to 3% target band. This is a significant downgrade and one that they noted now affords them "scope for further easing of policy, should that be appropriate to lend support to demand."

The RBA said the lower than expected inflation outcome in Q3 was "broad-based". It said, "Domestic inflationary pressures are well contained, consistent with low growth in labour costs and spare capacity."

It noted that the pass-through from a lower exchange rate in the last two years to higher inflation appears to have been, "tempered by heightened competitive pressures domestically."

Its forecast for inflation to rise over the three-year horizon, back into the target 2-3% band, in about a year's time, relies on this pass-through from the lower exchange rate taking place as economic growth strengthens.

The outlook for GDP growth is a little lower this year, but unchanged next year, and then about a quarter ppt lower in 2017, which may reflect a notion that potential growth in the economy is not quite as strong. The growth outlook reflects a balance between a weaker outlook for trading partner growth and an improvement in the outlook for non-mining sector domestic growth.

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The RBA, like several other central banks is seeing a weaker trend for emerging market growth. But perhaps more importantly for Australia is the weakest part of the Chinese economy is its construction and heavy industry sectors.

The RBA said its outlook for its terms-of-trade is little changed since August, but this outlook is for further declines, and the Bank's weaker outlook for Chinese and other trading partner growth suggests the price outlook may be weaker still. The most recent trends since the drafting of this report are certainly weaker with iron ore and metals prices globally approaching their previous lows for the year in Q3, threatening to further dint confidence in the resources sector.

The RBA has expressed its pleasure at the fall in the AUD over recent years, noting it is providing significant support to the non-mining sector and helping stabilise the profits of the mining sector. It appears comfortable with its current levels stating that, "The Australian dollar is adjusting to the lower commodity prices."

But a crucial part of the RBA's outlook for a strengthening recovery in the non-mining sector suggests that it will be eager for the AUD to remain at its current lower levels and adjust lower if commodity prices were to continue to fall.

The RBA said, "The support to economic activity from the depreciation of the exchange rate has been particularly apparent in the sizeable contribution to growth from net service exports."

It said, "The improvement in domestic demand and the increased support to demand for domestic production afforded by the lower exchange rate are expected, in time, to lead to a rise in non-mining business investment."

As such, the level of the exchange rate and its connection to commodity prices are crucial to the RBA's outlook. The more benign inflation outlook and the recent weakness in commodity prices suggests that the RBA would be quite comfortable with the currency falling, but certainly uncomfortable if it were to rise much.

In the news

- The BoE Inflation report was significantly more dovish that expected, contrasting with the tone set by the US Federal reserve last week. The Report projects inflation based on market-pricing of rate hikes. Its forecasts project inflation remaining low for the next few years, suggesting market pricing at the time the report was prepared, for no change in rates in 2016 and two hikes in 2017 from 0.50% to 1.0%, is likely to only just achieve the BoE's 2% inflation objective in three years. As such, the Bank has pushed back against rate hike expectations in 2016 that were creeping into the market.
- BoE Governor Carney said he is considering implementing new macro-prudential measures, implying that a longer period of low rates may increase the case for using such measures to contain excessive credit growth in some segments of the

housing market. The FT reported: Encouraging domestic spending had potentially serious consequences, Mr Carney warned, citing “unsecured credit growth at 8 per cent for consumers, house price growth picking up, activity in the housing market picking up and a further fall in the savings rate to historically low levels”. “We are conscious of those developments,” he said, adding that the BoE would need to think about using levers to curb credit” Attention now turns to the BoE Financial Policy Committee meeting statement on 1 December (Carney indicates BoE’s willingness to rein in credit – FT.com)

Markets on the Move

- UK 2yr swap rates fell 3.8bp on Thursday, recovering a bit in the afternoon after being down by around 6.5bp for a time after the BoE Inflation Report.
- Eurozone 2yr swap rates fell by 0.6bp, USA 2yr swap rates were little changed around their high since 17-Sep, just ahead of the contentious FOMC meeting of that month.
- Australian 3yr govt bond yield is up 17.6bp this week, around a third of that rise came on Tuesday before and after the RBA unchanged rates decision, they drifted up through the week in line higher US yields, and appeared to rise a few more bp on the RBA Governor Stevens speech on Thursday, probably on final capitulation over the rate cut expectation this year. A slim 5bp of easing is priced in for Dec, odds of a cut are now around 40% priced for Feb and a cut is fully discounted around mid-next year, about 30bp of cuts are priced over 12 months.
- New Zealand 2yr swap rate unchanged over the week, down around 2bp from the peak ahead of the weaker than expected employment report on Wednesday. Odds of a cut are around 40% at the 16 Dec meeting, a cut in Jan is about 60% priced in and about 90% priced in at the March MPS next year. 30bp of cuts are priced in over 12 months.

- Copper fell 2.8% on Thursday, mostly in US trading, down 3.0% this week, approaching lows for the year in Aug and Sep.
- Iron ore futures in China fell to a new low since July, weaker in the overnight session.
- Oil prices fell for a second day, to a low since Wednesday a week ago, in the middle of its range for the last month, towards the lower half of its range for the last few months, largely trending sideways, yet to convincingly show a bottoming pattern from its bear-market that began in mid-2014.
- Gold has retreated $42 so far this week, falling as the USD has strengthened.
- US equities down 0.1% on Thursday. Metals and mining sector equites fell 3.4%, steel sectorequities fell 1.6%, and Energy sector equites fell 1.0%. Gold miners lead the fall in mining shares

Economic news

- German factory orders fell 1.0%y/y in Sep, weaker than +1.9% expected, down from +1.7%y/y in Aug (revised lower from -1.8%). Auto orders have fallen sharply in recent months, down 9.7% over three months, down more so from foreign orders.

- Eurozone retail sales rose 2.9%y/y in Sep, a bit below 3.0% expected, up from 2.2%y/y in Aug.
- Eurozone Retailing sector PMI was 51.3 in Oct, down from 51.9 in Sep.
- USA jobless claims were 276K last week, up from 260K the previous week, weaker than 262K expected. The 4-week moving average was 262.8K, just up from its long-term low the previous week.
- UK Halifax house price index rose 9.7% 3mth-yoy in October, above 9.5% expected, a high since Aug-2014.

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