FX Strategy: AUD Forecasts Revised - Lower

National Australia Bank

AUD Forecasts Revised - Lower

- **Price action since Monday's AUD bounce convinces us to revise our AUD forecasts lower; support from downside US data surprises likely to prove ephemeral**
- **Higher FX volatility kills the carry attractions of AUD**
- **Short positioning and likelihood of support holding in the 0.94 area (at least temporarily) leads us to expect recent losses to be consolidated not extended**
- **Rising US (real) yield backdrop to drive 'fair value' lower and is key to our new lower forecast track**

We have been flagging likely downward revisions to our AUD forecast for a couple of weeks now, following first the somewhat unexpected May RBA rate cut then the range-break higher in US Treasury yields as Fed chairman Bernanke did nothing to assuage fears that 'tapering' of the Fed's current $85bn per month bond buying program could soon commence. Monday's vicious AUD/USD rebound in the wake of the soft US manufacturing ISM report appeared to vindicate our decision to hold off through this week's batch of Tier -1 US data. But price action since then convinces us that any support from weakness in one or more of the upcoming key releases (notably Friday's US payrolls report) is likely to prove ephemeral. The Fed's 'bias to taper' looks quite entrenched, with financial stability concerns linked to keeping the 'pedal to the metal' for too long are now a consideration alongside ensuring that a premature throttling back of QE does not derail recovery. In any event there is clearly an idiosyncratic component to negative AUD price action and we are now revising our AUD (and NZD) forecast track down.

Volatility kills the carry trade

While it is totally appropriate to view the 10% fall in the AUD/USD rate since mid-April as largely a product of US bond yield-related USD strength and augmented by the RBA's response to evidence of sub-par Australian growth and persistent exchange rate strength, we can also view recent FX moves through a different prism – sharply rising FX volatility. Volatility has long been the nemesis of the carry trade and the 70% jump in implied volatility (3-month) off the April lows (Chart 2) has produced a slump in volatility-adjusted attractions of the AUD carry trade (Chart 3). In short, a 300bps yield pick-up on AUD over equivalent USD money market products is a lot less attractive when annualised volatility is 12% than when it is 7%.

In the absence of a retracement of at least half of the recent spike in volatility, there is no reason to expect interest in the AUD as a carry trade currency to revive. On the contrary, if volatilities rise further, this will almost certainly go hand in hand with further weakness. That said, rapid moves higher in volatility such as we witnessing at present tend not to be sustained, so we would not be surprised to see stabilisation in

Table 1: FX Forecast Summary

	7/06/2013	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
AUD/USD	0.96	0.95	0.94	0.93	0.92	0.90	0.88	0.87
NZD/USD	0.80	0.81	0.82	0.83	0.82	0.80	0.79	0.79
USD/JPY	97	100	104	105	107	110	111	112
EUR/USD	1.32	1.29	1.27	1.27	1.24	1.22	1.20	1.18
GBP/USD	1.56	1.51	1.49	1.48	1.46	1.44	1.42	1.40
USD/CHF	0.93	0.97	0.98	0.97	1.00	1.02	1.04	1.06
USD/CAD	1.03	1.03	1.03	1.02	1.03	1.02	1.02	1.01
USD/CNY	6.14	6.14	6.12	6.10	6.10	6.10	6.10	6.10
AUD/NZD	1.20	1.17	1.15	1.12	1.12	1.13	1.11	1.10
AUD/JPY	93	95	98	98	98	99	98	97
AUD/EUR	0.72	0.73	0.74	0.73	0.74	0.74	0.73	0.74
AUD/GBP	0.61	0.63	0.63	0.63	0.63	0.63	0.62	0.62
AUD/CHF	0.89	0.92	0.92	0.90	0.92	0.92	0.92	0.92
AUD/CAD	0.98	0.97	0.97	0.95	0.95	0.92	0.90	0.88
AUD/SGD	1.19	1.17	1.18	1.16	1.15	1.13	1.10	1.09
AUD/KRW	1071	1087	1093	1093	1081	1058	1034	1022
AUD/CNY	5.87	5.80	5.75	5.67	5.61	5.49	5.37	5.31
AUD TWI	72.20	72.36	72.60	71.93	71.24	70.67	69.84	68.59

Chart 2: AUD Implied option volatility – surging

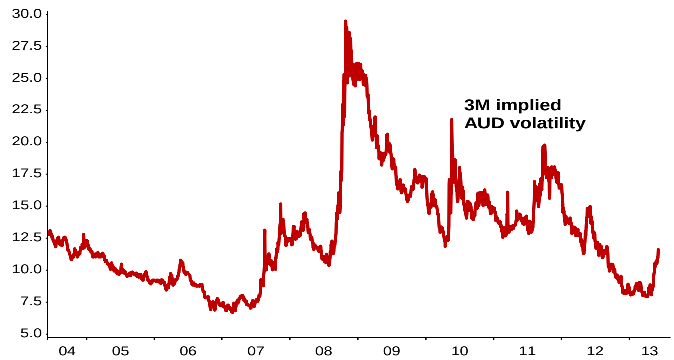
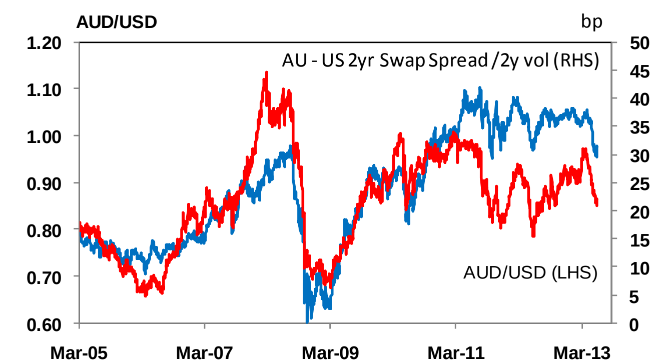


Chart 3: Volatility-adjusted AUD carry – slumping



Source: **NAB**, Bloomberg

Sources: Bloomberg, Reuters EcoWin Pro, National Australia Bank

coming weeks than in turn means that latest AUD/USD losses are consolidated rather than extended. Bear in mind here that speculative long USD positioning has been extreme judging from CFTC/IMM data (Chart 4) and short AUD positioning as of a week ago was close to a record and may well have extended beyond previous extremes in the past week.

Meanwhile, technically there is good reason to look for support in the 0.94 area (Chart 6) to at least temporarily arrest the current downtrend.

'Fair value' falling – and should fall further

We noted last week that the move lower in AUD/USD during May had quite precisely tracked our new short term fair value model estimate and which incorporates a 'Shadow Short Rate' (SSR) series for US interest rates designed to capture the impact of unconventional Fed policy settings and which create the effect of negative nominal rates (see '*Refining our AUD Fair Value Model... 02/05/2013*). A sharp rise (less negative) SSR during May (via the impact on the zero coupon yield curve of Fed 'tapering' expectations) together with reduced risk appetite (higher VIX) saw our fair value estimate fall from above parity to around 0.96 (Chart 7).

Unless the Fed's 'bias to taper' is extinguished by a string of sub-par incoming US releases, our assumption that US yields will be under additional upward pressure in H2 2013 should be driving our model estimate of AUD fair value still lower – we suspect to the low 90's come year end (by which time 10-year Treasury yields are forecast to be around 2.5%, rising to 3.25% by end 2014). With inflation expectations seen remaining quiescent, a rising real yield environment remains the key variable driving our expectation for sustained USD appreciation during 2014 (end 2014 forecast now 0.87). From the local side, while we acknowledge risks of earlier RBA action (and where the unemployment rate trend is likely to be key) we currently hold to our forecast for only one more rate cut in this cycle and the final cut coming only later in 2013.

Asymmetric risks

In revising out forecasts lower, we acknowledge that risks around our new forecast track are asymmetric, i.e. skewed in favour of actual out-turns being lower not higher than our new forecasts an RBA cut as early as July/August would almost certainly mean our end-2013 forecast of 0.93 being met much sooner/exceeded to the downside, while a literal read across from our bond yield forecasts to the currency would suggest we could be as low as 0.90. On the flip side, if the US economy does underperform expectations and 'tapering' talk gets pushed into 2014, then amid ongoing (and in our view justified) concerns that China growth is not going to accelerate back to above 8%, broader global growth worries and the likely persistence of turbulent market conditions is hardly conducive to significant upside risk on AUD/USD. The latter may not fall as far/fast, but cross rate underperformance should persist.

Implications for key cross rates

Though we have also revised out NZD/USD forecast track lower, the revisions are much less extreme than for AUD such that the AUD/NZD cross is now seen capable of falling as low as 1.10 next year. The current softer/uncertain Australian growth backdrop is at odds with New Zealand where overheating concerns are likely to come increasingly to the fore next year. Our BNZ colleagues see significant risk that the current consensus for rates rising only modestly once a RBNZ tightening cycle commences (2014) could be seriously challenged. Short AUD/NZD on a multi-month basis remains one our highest conviction G10 FX views. Elsewhere we do expect Yen weakness to reassert before long in tandem with a renewed USD upturn to push AUD/JPY back higher. We are much less convinced EUR/USD will hold above 1.30 so see AUD/EUR back lower, while in the absence of incoming BoE Governor Carney being minded to initiate fresh easing measures, risk to our AUD/GBP forecasts lie to the downside.

Chart 4: USD IMM speculative long positioning - extreme

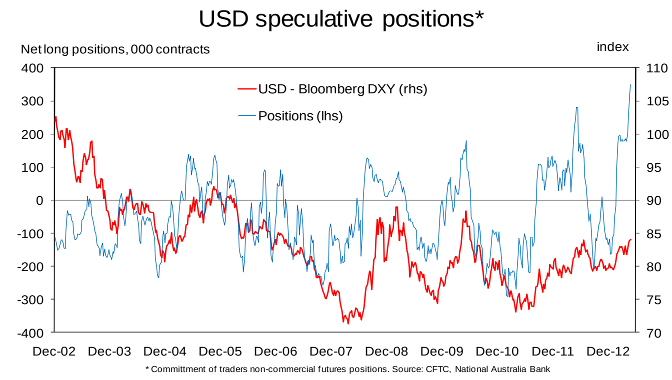


Chart 5: AUD IMM speculative short positioning - extreme

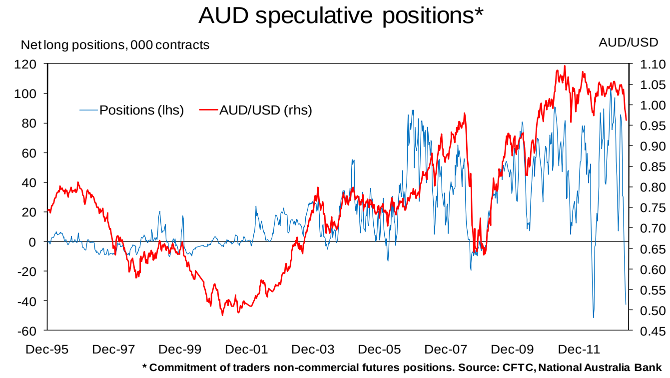


Chart 6: AUD/USD versus VIX

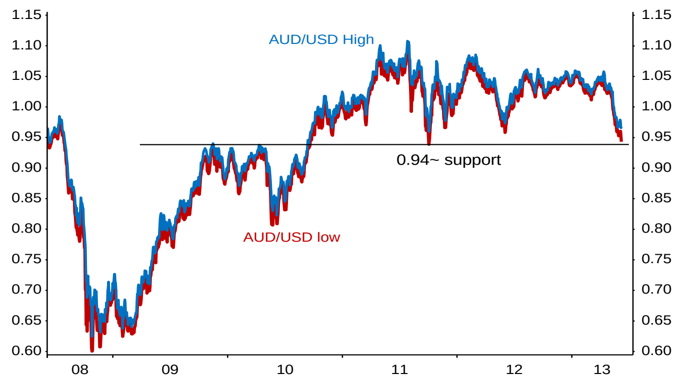
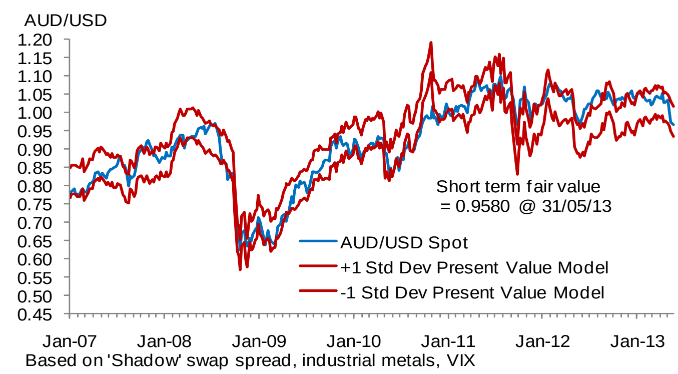


Chart 7: AUD/USD – spot fall in line with model estimate



Sources: Bloomberg, Reuters EcoWin Pro, National Australia Bank

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