FX STRATEGY:

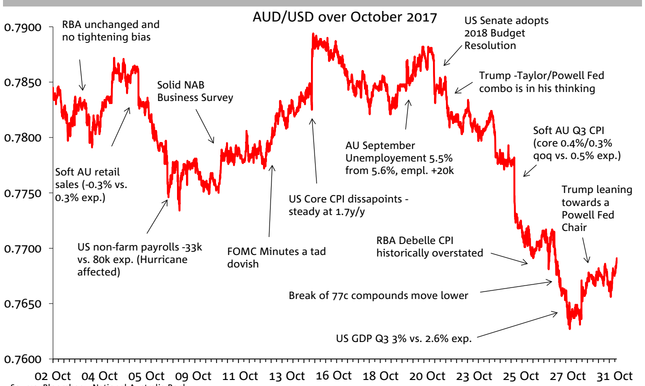
AUD Annotated Chart and Model Update

The AUD in October 2017

AUD/USD traded in a 2.7 cents range during October, the monthly high of 0.7894 seen on the 14th and the low of 0.7627 on the 27th. The currency range traded in the first half of the month amid a mix flow of data and news, but then a changed in USD fortunes and a soft Q3 Australian CPI print weighted on the AUD/USD with the pair ending October close to the lows for the month.

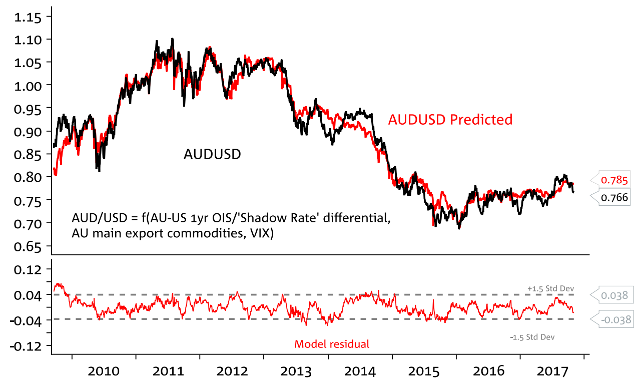
Soft Australian retail sales (-0.3%) and an RBA which did not reveal any tightening bias weighed on the AUD/USD early in the month while a hurricane affected non-farm payrolls report was a downward force on the USD. The big dollar struggled to perform mid-way through the month amid a dovish tinge to the September FOMC Minutes and a US CPI report which revealed core inflation undershooting expectations for the 6th time in the past 7 months. AUD then drew support from a strong Australian Labour force report, which proved short-lived given a turnaround in USD fortunes. This was on the back of an improved US tax reform prospects following the US Senate passage of a 2018 Budget Resolution. Speculation over President Trump's Fed Chair nominee initially boosted the USD with a Taylor-Powell combination seemingly under consideration. The AUD was not helped by a softer than expect Q3 inflation report and then the break of the technically important 77c level. Later in the month the RBA deputy governor Debelle didn't help the AUD by noting that domestic CPI could be overstated by 0.25% due to 'substitution bias', before the USD rally was arrested by reports suggesting Trump was biased towards nominating Governor Powell to be the next Fed chairman.

Chart 1: AUD/USD in October



Source: Bloomberg, National Australia Bank

Chart 2: NAB's AUD/USD short term fair value model



Source: National Australia Bank, Macrobond

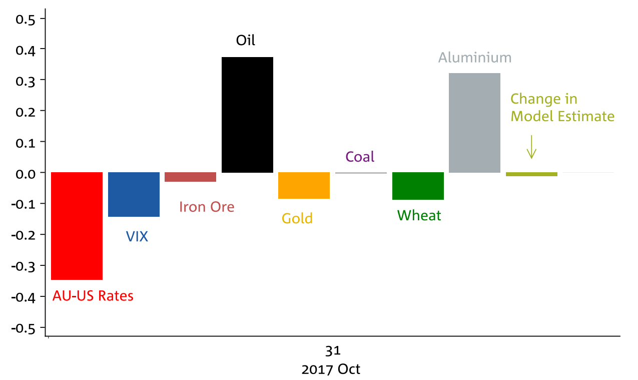
The NAB AUD Model

October witnessed a widening disconnect between the AUD/USD spot rate - down almost two cents - and our short term fair value (STFV) estimate, the latter unchanged on the month. This has nevertheless still left AUD/USD trading inside its 1 standard deviation range of +/-2.5 cents. Indeed, we really only consider the currency to be misaligned versus this STFV estimate if it falls outside of a 1.5 standard deviation range (i.e. just under +/- 4 cents). See Chart 2.

In the early part of the month, AUD weakness – and underperformance relative to the broad US dollar strength story – could be readily explained by the combination of widening interest rate differentials in favour of the big dollar and commodity price weakness (in particular gold, iron ore and coal). In the latter part of the month however, the rally in oil and aluminium prices meant that overall, commodity prices were slightly supportive rather than subtracting from STFV (Chart 3). At the same time, the VIX risk appetite proxy shifted from being slightly supportive to mildly negative (i.e. from sub 10 to back above 10, albeit still significantly below its long term average close to 20).

Our sense is that it the test – and breach - of key technical levels on AUD/USD (i.e. ~0.77) that took over from commodities as the driver of AUD underperformance.

Chart 3: Drivers of change in NAB's STFV model



Source: National Australia Bank, Macrobond

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