FX STRATEGY:

AUD Annotated Chart and Model Update

The AUD in January 2019

The AUD/USD traded in a larger than usual range in January. Early in the month a JPY induced flash crash shoved the currency down to its monthly low of 0.6741, a level not seen since March 2009. While a swift recovery ensued, taking the currency above 71c, later in the month the AUD/USD was further boosted by news of a temporary end to the US government shutdown followed by a dovish Fed announcement. The AUD/USD reached its monthly high of 0.7295 on January 31st, before closing the month at 0.7270.

Ahead of the January 3rd flash crash, the AUD/USD started January at 0.7052 weighted down by concerns over China's slowdown following a contractionary China manufacturing PMI print on the last day of 2018. On the 'flash crash', we think the highly leveraged Japanese retail investors were almost certainly the (initial) catalyst for the move. The Tokyo market was closed; impacting liquidity at the open and the yen had strengthened significantly the night before, putting many short JPY positions significantly offside. This combo was a perfect trigger for a forced liquidation into an illiquid market.

Post the crash the AUD/USD quickly recovered and a few days later it was further boosted by early signs of a change in Fed rhetoric. On January 5th Fed Chair Powell stated "muted inflation" was a good reason for the Fed to be "patient". Powell's speech triggered a period of broad improvement in risk appetite evident by gains in equity and credit markets. But, somewhat unusually, the AUD/USD failed to benefit from it. Concerns over China's economic state (China's GDP growth slowed to historical low in 4Q) as well as uncertainty over US-China trade negotiations weighed on the AUD.

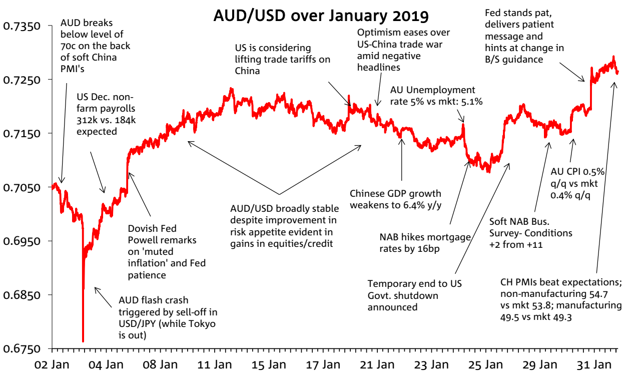
Later in the month news of a temporary end to the US government shutdown along with a new round of China stimulatory measures and encouraging signs on US-China trade talks boosted the AUD/USD. Meanwhile, mixed domestic data releases provided the currency with short lived burst in volatility. Of note the sharp fall in business conditions in the December NAB Survey (January 29th) means the January edition, due for release next month, will be an important focus for the currency and the RBA.

On the last day of the month the AUD/USD traded just below 73c, amid a broad based boost in risk sentiment following an unambiguously dovish FOMC meeting. The Fed confirmed its willingness to be patient and also hinted at an imminent change to its balance sheet normalisation guidance.

The NAB AUD Model

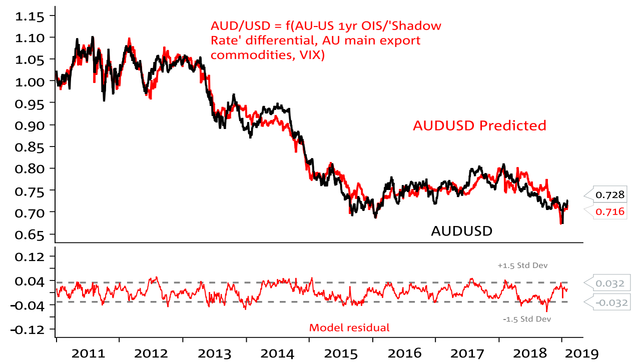
Late in December our model signalled the AUD/USD was expensive and our Short Term Fair Value (STFV) estimate ended the year at 0.6840 vs spot at 0.7050. Over the course of January a Fed led improvement in risk appetite alongside a broad based rise in commodity prices lifted our STFV estimate, ending the month a 0.7160, meaning the AUD/USD closed January comfortably inside its fair value range.

Chart 1: AUD/USD in January



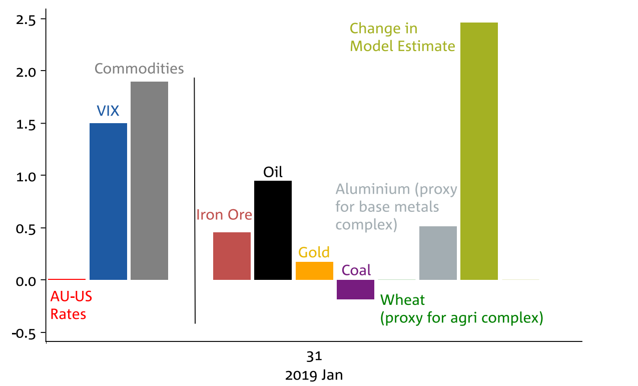
Source: Bloomberg, National Australia Bank

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



Source: National Australia Bank, Macrobond

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



Source: National Australia Bank, Macrobond

Commodities were the biggest contributor to the rise in our STFV estimate during the month with decent gains in oil (+15%) and iron ore (+6.7%) prices the main contributors. The improvement in risk appetite was also a positive influence, as evident by the ~9 point decline in the VIX index. In January, the AU-US rates differential was of little consequence to our STFV estimate (Chart 3).

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