FX STRATEGY *Soundbites*

What does a new Fed cycle mean for the USD and the AUD?

- **Ahead of G20 we assume the US and China will agree an uncomfortable truce with no removal of tariffs**
- **This means the Fed is likely to embark on a new easing cycle at the end of July**
- **The USD has a bias to underperform on the first month post the Fed's first rate cut**
- **10y UST yields have a bias to decline ahead of the Fed's first cut ,followed by a period of consolidation and further decline**
- **The above suggest USD/JPY has downside risk ahead and after a new Fed easing cycle**
- **After an initial boost, AUD/USD performance is mixed, suggesting a range-trading environment around 70c over coming months**

As noted in our latest Global FX Strategist, our base case scenario ahead of this weekend G20 meeting is that Presidents Trump and Xi will agree to a somewhat uncomfortable truce that sees the two super powers re-initiating trade negotiations but without the removal of current tariffs. We also expect the ban on Huawei and other Chinese IT firms to proceed as scheduled by the US Commerce department.

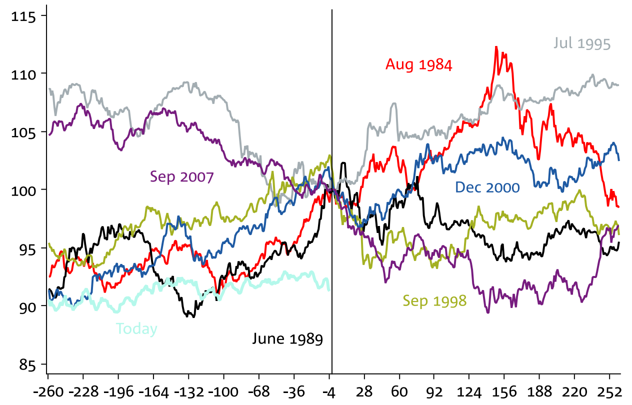
On this basis, we would then expect the Fed will embark on a new easing cycle at the end of July, reducing the Funds rate target by 25bps to 2.00% -2.25%% followed by another 25bps cut in September. In addition to stubbornly low US inflation, the persistence of trade tensions is already suggesting a US growth slowdown lies ahead, evident by a softening in business surveys coupled with anecdotes of delays in investment decisions. We would also note the significant risk of enduring trade tensions leading to the Fed having to do more than just a couple of 'insurance' rate cuts.

What does a new Fed easing cycle mean for the USD?

Chart 1 (right) show the USD performance a year before and after the Fed begins a new easing cycle (last six easing cycles). Although ahead of the Fed's first cut USD performance is mixed, there is a strong bias for the big dollar to underperform at least in the first 20 trading days post the first Fed cut. Notably, however, in 1995 when the Fed only eased 3 times, the USD performance was initially relatively muted ahead of a period of decent appreciation.

A month after the Fed has eased, performance divergence begins to emerge and after 150 days history shows the USD ended higher on three occasions and lower on the other three. Here, we would suggest that what other Central Banks do matters, in other words if other Central Banks join the Fed easing cycle, then the USD's underperformance tends to subside, at least on interest rate considerations alone. Although the lesson of the 1995 (insurance cut) scenario is that under a new Fed easing cycle there is a need to be cautious in assuming a softer USD outlook, in today's environment where other major central banks have (very) limited capacity to follow the Fed (in particular the ECB and BoJ, already operating with negative policy rates) USD weakness at least in the early stages of a new Fed easing cycle seem more likely than not.

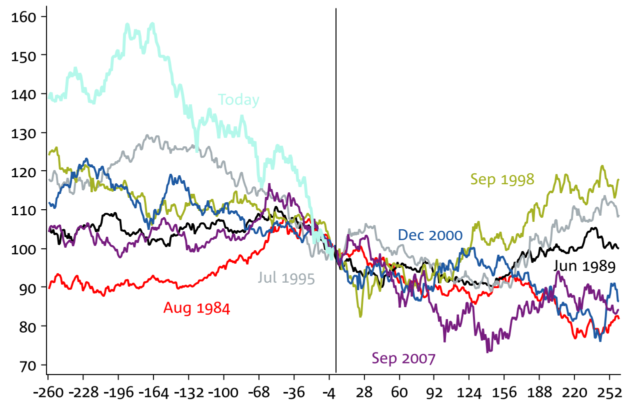
Chart 1: US$ TWI in and out of Fed easing cycles



Source: National Australia Bank, Macrobond

The second chart below shows how 10y UST yields behave in and out of Fed easing cycles. Notably and unlike the USD, yields have a solid tendency to decline ahead of the Fed's first cut. Based on the previous 6 easing cycles, immediately after the Fed has eased, 10y UST yields have a biased to consolidate their pre-easing declines, however 90 days or so later on all occasions 10y UST yields ended lower. Only after 90 days does a divergence emerge, with 10y UST yields ending higher in three instances and lower in the other three.

Chart 2: 10y UST yields in and out of Fed easing cycles



Source: National Australia Bank, Macrobond

From an FX perspective, how 10y UST yield behave at the start of Fed easing cycles is relevant for USD/JPY given that since the introduction of the BoJ's Yield Curve Control policy, the correlation between USD/JPY and 10y USTs has increased. Thus, if history repeats itself the

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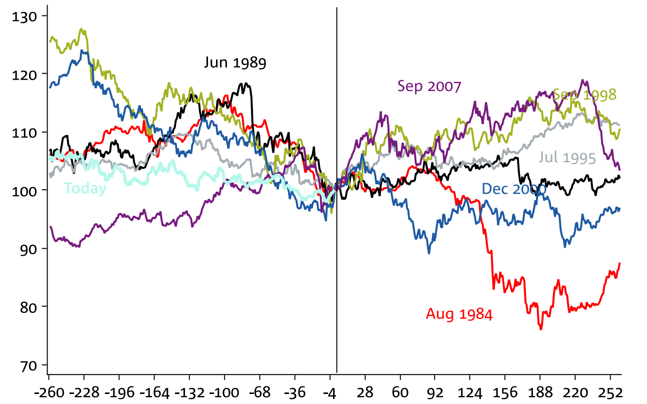
prospect of lower 10y UST yields over the coming months point to downward pressure on USD/JPY.

What about the AUD/USD?

In an almost mirror image to the USD chart, the AUD/USD has a tendency to outperform in the initial stage of Fed easing cycles (first month), but thereafter its performance is mixed (Chart 3).

In today's environment we would expect the market to persist in the view the Fed will be starting to cut rates in July and for the US dollar to continue weakening thereafter, at least initially. This likely means the AUD/USD claws its way back above 0.70, but given the prospects of further RBA easing, we expect the pair to range trade in out of this big figure over the coming months, at least on interest rate considerations alone.

Chart 3: AUD/USD in and out of Fed easing cycles



Source: National Australia Bank, Macrobond

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