CURRENCIES: AUSTRALIAN DOLLAR

RBA'S UPBEAT STANCE TURNS UPSIDE DOWN

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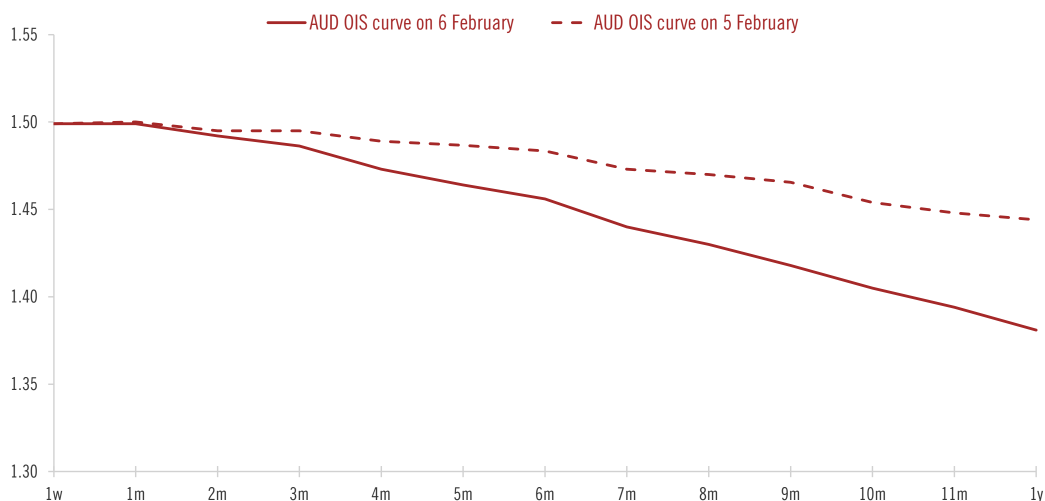
SUMMARY

- On 6 February Philip Lowe, governor of the Reserve Bank of Australia (RBA), sent clear dovish signals, indicating that a rate cut was now as probable as a rate hike. This led to a significant decline in the Australian dollar driven by dovish market expectations for the RBA's rate path.
- This change in monetary policy highlights increasing concerns around the Australian economic outlook that are driven by both internal and external forces.
- While a rate hike is now highly unlikely over the next 12 months, it remains to be seen whether the external and domestic backdrop will necessitate a RBA rate cut, as is currently partly priced in by the market.
- However, it does suggest that the Australian dollar's upside potential is more limited than previously thought. Consequently, we have decided to lower our three-month, six-month and 12-month forecasts to USD 0.73 (vs. USD 0.74, USD 0.75 and USD 0.75, respectively previously) compared to USD 0.71 as it is trading as at 12 February.

CHART 1: AUSTRALIAN OVERNIGHT INDEXED SWAPS CURVE (AS %)



Source: PWM - AA&MR, Bloomberg

Governor Lowe sends the Australian dollar lower

The governor of the Reserve Bank of Australia (RBA), Philip Lowe, sent clear dovish signals regarding monetary policy in his address to the National Press Club of Australia (see transcripts) on 6 February. The previous stance, in which the next policy rate move would likely be up, has been replaced by the view that a rate cut is now as probable as a rate hike. This has emboldened market expectations for a rate cut by the RBA (*see chart 1*), which has in turn weighed on the Australian dollar.

This change in monetary stance mostly reflects increasing concerns over the accumulation of downside risks. On the external front, the slowdown in Chinese economic growth is the main worry, given the strong linkage through trades between the

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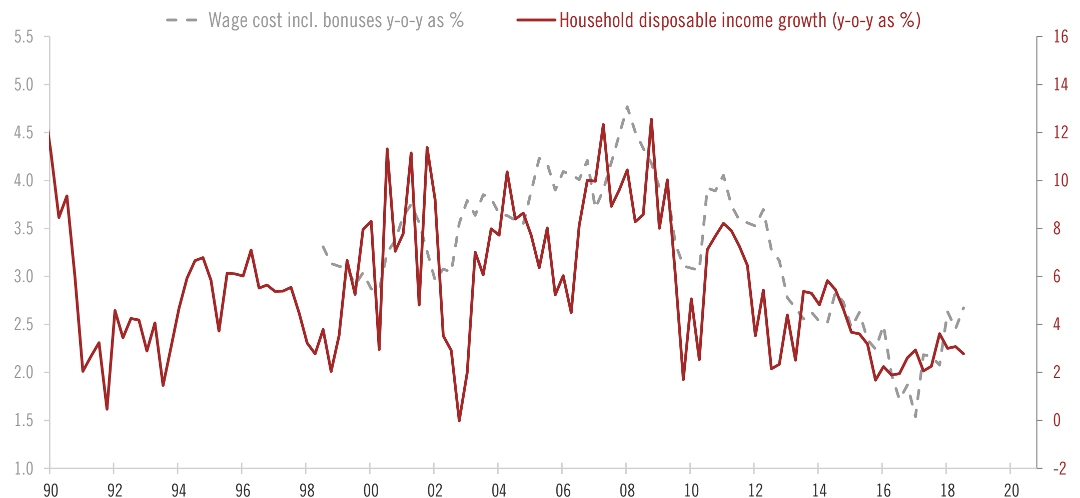
two countries (Australia's exports to China amounted to roughly 35% of total exports in December 2018). On the domestic front, the outlook for consumption growth has become more uncertain.

Indeed, Australia's household disposable income growth is at historical low levels. In recent years, consumption growth has been resilient and stayed above income growth, thanks to a decline in the savings ratio (which stood at 2.4% in Q3 2018 versus slightly above 8% in 2014). Unless wage growth rises, the high levels of household debt combined with the recent decline in housing prices may take a toll on consumption. Hopefully, wage growth hit its trough in the first quarter of 2017, as it likely has, and should boost disposable income in future (*see chart 2*). Furthermore, a rise in wage growth tends to supersede any negative wealth effects stemming from declining house prices, particularly in this case, given the current housing market correction follows a prolonged period of strength. That being said, despite the current tight labour market, the RBA expects the rise in wage growth to be gradual.

CHART 2: HOUSEHOLD DISPOSABLE INCOME GROWTH LAGS WAGE GROWTH



Source: PWM - AA&MR, Thomson Reuters

With such high uncertainty around domestic consumption, the rationale for a rate hike is very thin. Especially as both headline and underlying inflation remain below the 2-3% target range (*see chart 3*) and the RBA has just revised its inflation projection lower, on the basis that the measures of inflation should remain at or below the lower bounds of the target range in coming quarters.

Our scenario does not favour an imminent rate cut

Although we expect a decline in Chinese economic growth from 6.6% in 2018 to 6.1% in 2019, Chinese monetary and fiscal stimulus should prove supportive of growth and lead to a modest rebound in economic activity in the second half of the year. Furthermore, our base scenario sees a 'mini-deal' between the US and China on trade. This should alleviate some short-term concerns around the Chinese economy. As a result, the external

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backdrop in the coming months is unlikely to worsen, making it unlikely to trigger a RBA rate cut.

While the oil price decline in Q4 2018 will further weigh on headline inflation, the tight labour market, strong leading labour market indicators and measures of underlying inflation that are close to the RBA's target range, reduce the chances of a rate cut driven by domestic factors in the short term.

Reduced upside potential for the Australian dollar

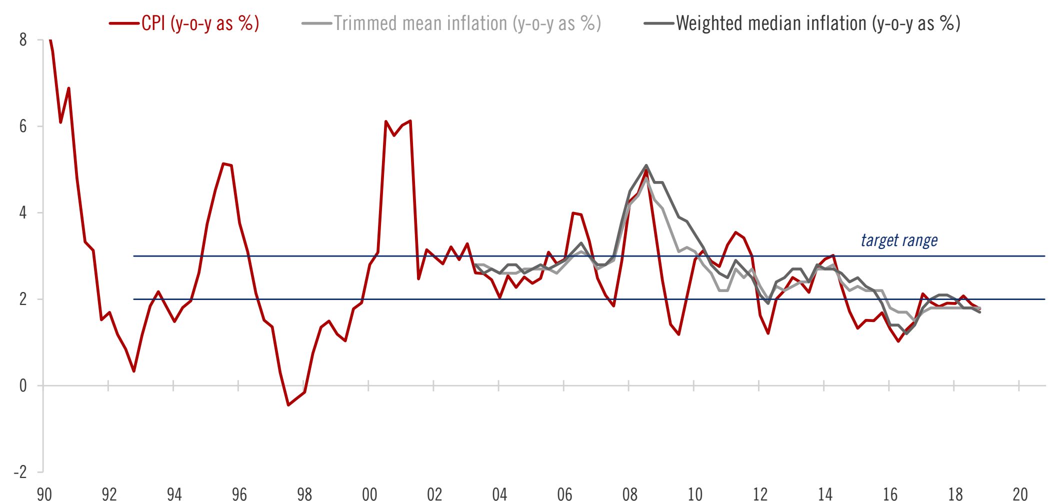
Our previous forecasts were based on the short-term outperformance of the Australian dollar in particular. The rationale for this view was based mainly on three assumptions - first, a rebound in risky assets after the sell-off at the end of 2018 that was caused by fears of a US recession and a too hawkish US Federal Reserve; second, positive developments in US-China trade discussions that favoured a 'mini-deal' by March; third, a RBA that would stay rather optimistic about its ability to raise rates at some point in time, given a tight labour market and positive business leading indicators.

We now see reduced upside for the Australian dollar. Indeed, the US stock market already rose roughly 15% since its 24 December low, prospects of a 'mini-deal' seem now more entrenched among investors and the RBA has turned cautious. As a result, we have adjusted our forecasts lower.

That being said, we see limited potential for a decline in the Australian dollar relative to the greenback, notably because we do not see a RBA rate cut as particularly likely in 2019 (as previously mentioned), but also because we do not expect the recent strength of the US dollar to be sustainable.

In sum, our new forecast for the AUD/USD for the next three months is USD 0.73, given our belief that markets are too pessimistic about the external backdrop. The six and 12-month forecasts have also been revised to USD0.73, as a negative interest rate differential should be offset by supportive terms of trade and a weakening US dollar.

CHART 3: AUSTRALIAN INFLATION



Source: PWM - AA&MR, Thomson Reuters, RBA

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