Deutsche Bank
Research

Australia | Foreign Exchange FX Spot | Date 19 June 2014

FX Daily

AUD: Forecasting Flows; The Fed and the Aussie; Iron Ore Tension

Forecasting flows

In an FX daily last week we showed that credit growth, business investment and the ratio of Australian to US interest rates could explain the bulk of the variation in net FDI and portfolio flows. In this daily we use our published house forecasts for Australian business investment, credit growth and 10-year bond yields, along with our published long-term forecasts for US 10-year bond yields to forecast net FDI and inbound portfolio flows (as shown in Figures 1 to 6 over the page). We then combine this with our forecasts for the Australian current account deficit to estimate the basic balance through to end-2015. As Figure 8 shows, the sum of these suggests deterioration in the Australian basic balance over 2014 and 2015 – despite the significant improvement seen in the current account deficit on account of growth in mining exports. That said, the deterioration in the basic balance is relatively modest – and would be consistent with an ~6% decline in the AUD TWI to ~67.5 come end 2015. (This is, we should note, a more modest decline than our current forecasts.)

The Fed's hold on the AUD

It would be, perhaps, a little remiss to not touch on the Fed in the day following an FOMC meeting. That is particularly the case for the AUD given the very tight levels relationship that continues to exist between AUD/USD and the US 10-year bond yield as shown in Figure 9 over the page. To be sure, the fairly tight relationship between the US 10-year bond yield and AUD/USD has only existed since the second half of 2012. As for what might have been the catalyst that has seen the AUD move quite closely with US yields, we think the most plausible explanation is that since mid 2012 the front end of the Australian rates market has consistently priced an RBA cash rate in the vicinity of 2.50% – see Figure 10. That is, with the front end of the Australian rates market relatively stable, the AUD has tended to track the US long end. Should the market see the RBA coming back into play on a 12-month horizon then we would expect the relationship between AUD/USD and the US 10-year bond yield to weaken. For now the market has the RBA 'out of play' (as do we).

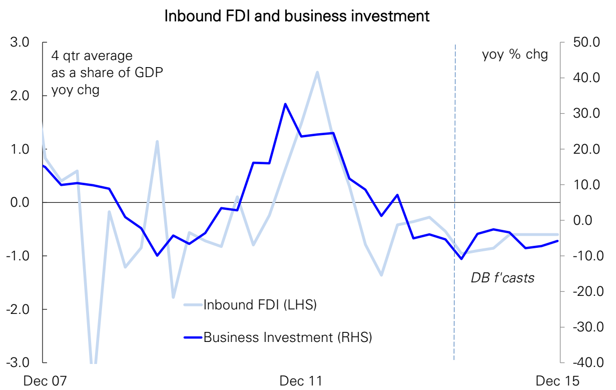
Tension

We noted in an FX blog post this week that the decline in iron ore prices versus the stability in the AUD had pushed an 'AUD / iron ore pressure index' (an index of the normalized AUD TWI minus normalized iron ore prices) to levels consistent with RBA 'commentary' on the currency (Figures 11 & 12). We also noted that an 8% decline in the AUD TWI to 66.5 would see it roughly 'consistent' with the current iron ore spot price. Given, however, the US 10-year bond yield's 'hold' over the AUD we aren't necessarily saying that the AUD will *immediately* decline to that level. Rather, we are saying that there is an element of 'tension' between the AUD and the likely terms of trade (reflected in the iron ore spot price). That disconnect will, *ultimately,* be resolved either: through higher US yields seeing a lower AUD; or the Australian rates market moving to price rate cuts in Australia which should see a lower AUD; or (less likely in our view) a strong recovery in iron ore. (Or, of course, some combination of the above.)

Resolution

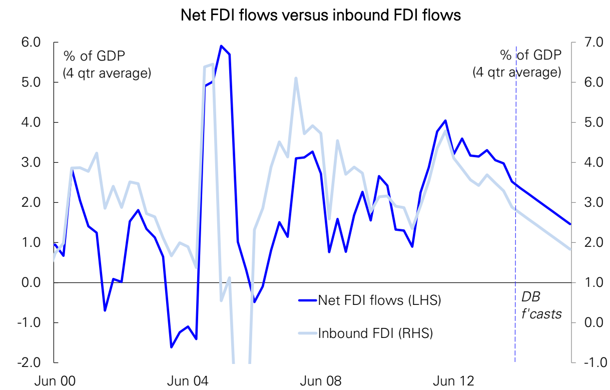
As for how long 'resolution' can take – comparing Figures 9, 11 and 12 would suggest that the catalyst which ultimately resolved the H2-2012 divergence between the iron ore price and AUD was the sell-off in US rates in May 2013 (sparked by the Fed raising the prospect of tapering).

Figure 1: Based on our forecasts for business investment we can generate inbound FDI estimates …



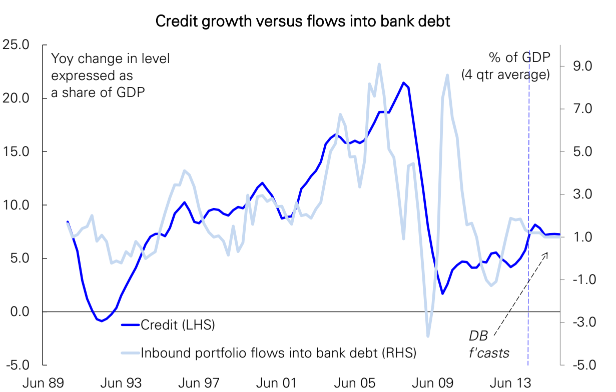
Source: Deutsche Bank, ABS

Figure 2: … which tend to be the driver of net FDI flows.



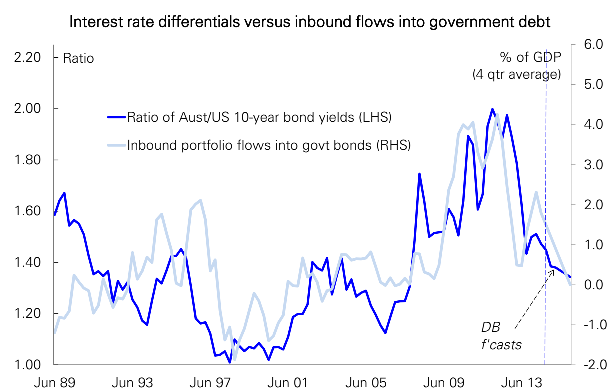
Source: Deutsche Bank, ABS

Figure 3: On the portfolio flows side credit growth around nominal GDP growth …



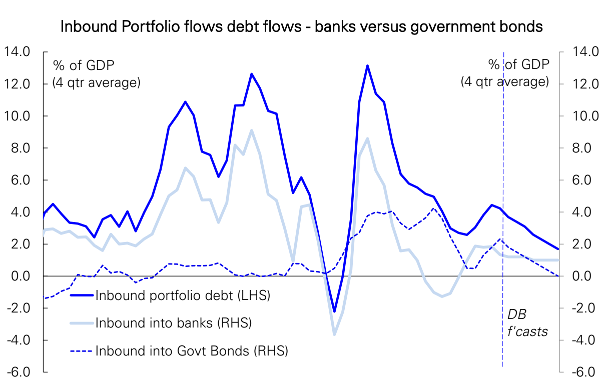
Source: Deutsche Bank, ABS, RBA

Figure 4: … and a narrowing of the Australian / US 10-year interest rate differential …



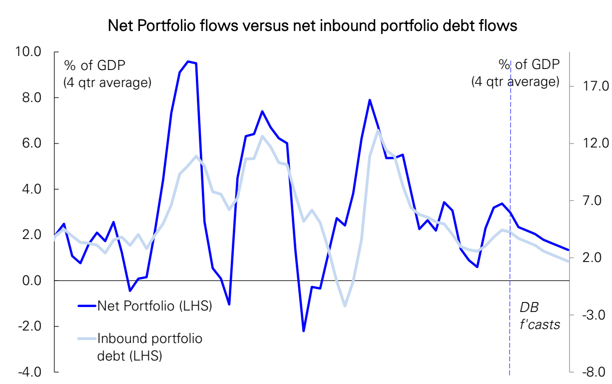
Source: Deutsche Bank, ABS, Bloomberg Financial LP

Figure 5: … sees a reduction in inbound portfolio debt flows …



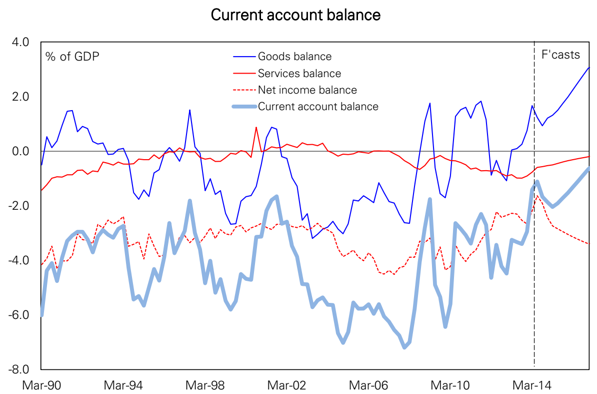
Source: Deutsche Bank, ABS

Figure 6: … which suggests a reduction in net portfolio flows.



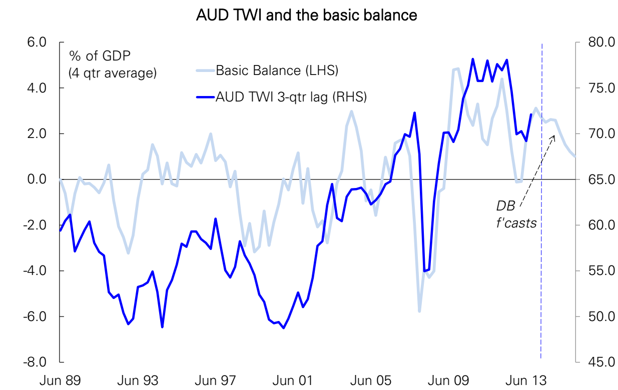
Source: Deutsche Bank, ABS

Figure 7: Our current account deficit forecasts show an improvement in the trade balance, offset in part by a higher net income deficit …



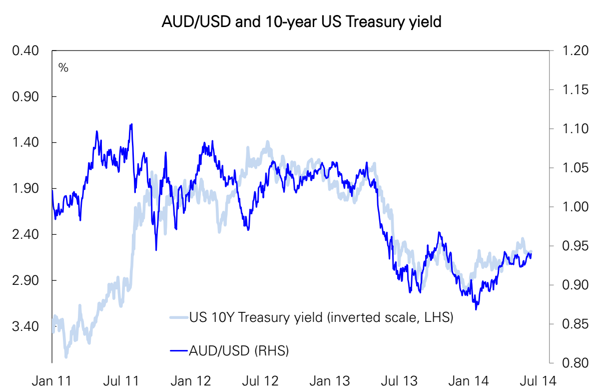
Source: Deutsche Bank, ABS

Figure 8: … which combined with our forecasts for capital flows produces a modest deterioration in the basic balance.



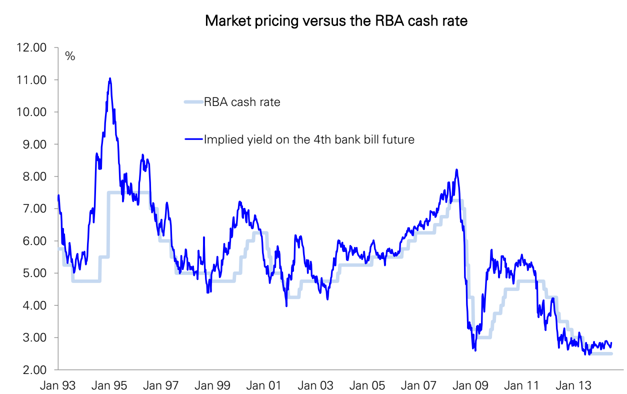
Source: Deutsche Bank, ABS, Bloomberg Financial LP

Figure 9: The Australian dollar has tended to move with the US 10-year bond yield …



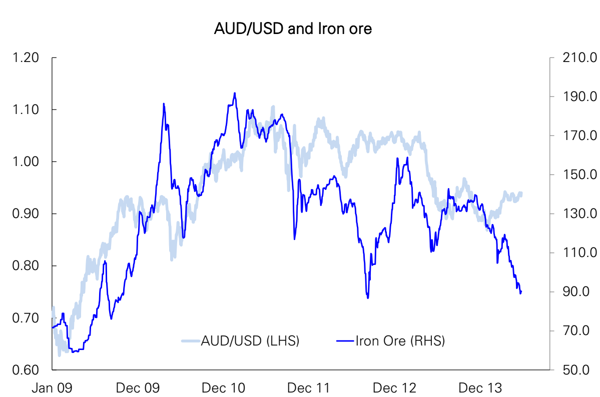
Source: Deutsche Bank, Bloomberg Financial LP

Figure 10: … since the local rates market moved to pricing a circa 2.50% cash rate.



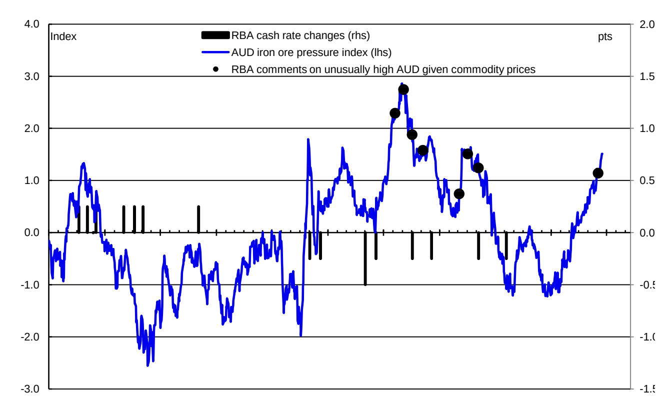
Source: Deutsche Bank, Bloomberg Financial LP

Figure 11: The combination of lower US yields this year (supporting AUD) versus a weaker iron ore price …



Source: Deutsche Bank, Bloomberg Financial LP

Figure 12: … presents some 'issues' for the RBA.



Source: Deutsche Bank, Bloomberg Financial LP, RBA