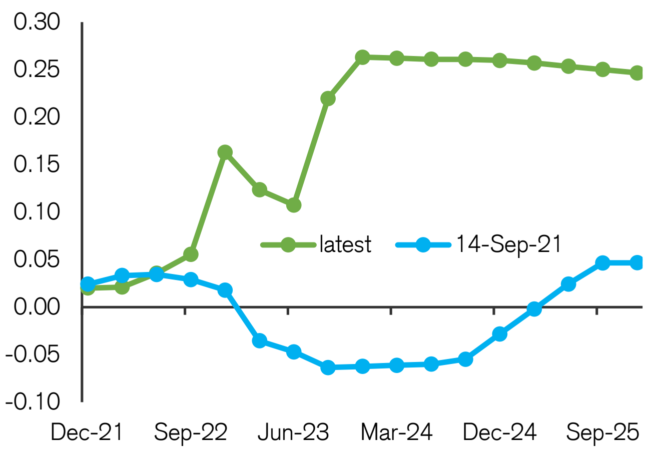
AUD: Still not on the cusp

We revise our AUDUSD target range for Q4 higher from 0.7050-0.7480 to 0.7320-0.7660. Ahead of the RBA rate decision on 2 Nov, we continue to see priced-in rate hiking expectations as high relative to likely RBA intentions: in the immediate near-term, we no longer see this as a sufficiently strong catalyst to trigger a reversal in AUDUSD.

Compared to the more openly bullish tone of our views on fellow G10 energy exporters CAD and NOK, we took a more cautious view on AUD, targeting a broad 0.7050-0.7480 AUDUSD range and looking for AUDNZD to trade between 1.045 and 1.060. The view was based on the idea that the RBA would continue to push back against the market's hawkish monetary policy expectations, at a time when other central banks have been more willing to validate the market's views with actual rate hikes (e.g. Norges Bank and RBNZ). RBA Governor Lowe last discussed this idea in a speech most recently on 14 Sep (link): at the time he suggested that Australia's specific labour market dynamics represented an important distinguishing hurdle against the RBA moving away from its forward guidance that conditions for rate hikes would not realize until 2024.

Figure 9: Markets have unwound expectations that the RBA would lag the Fed in raising rates

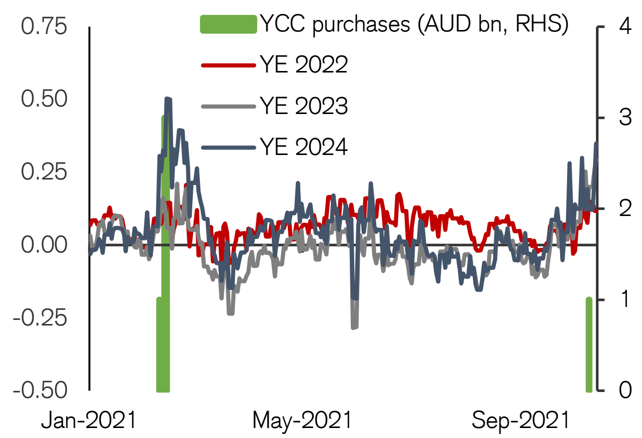
OIS-implied differentials between RBA and Fed policy rates (%)



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Figure 10: Rate differentials nearing Feb highs prompted the RBA to make use of YCC purchases

OIS-implied differentials between RBA and Fed policy rates (%)



Source: The BLOOMBERG PROFESSIONAL™ service, RBA

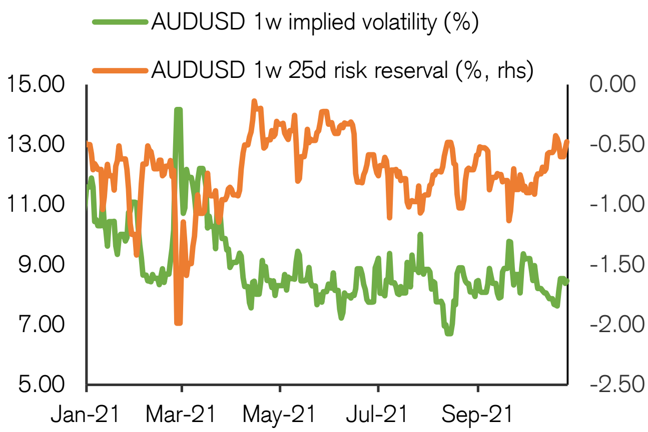
This view has been a challenging one to hold in recent weeks, as the rapid surge in energy prices and the easing of China-related concerns translated in a sharper hawkish shift monetary policy expectations in Australia than elsewhere. The RBA makes no mystery about its willingness to remain aligned in its policy stance with other G10 central banks. Nonetheless, since Lowe's 14 Sep speech, in which he said he found it difficult "to understand why rate rises are being priced in next year or early 2023", markets have effectively unwound expectations that the RBA would lag the Fed in raising rates. They are now pricing in slightly more than two 25bp rate hikes by the RBA by end-2022 (see Figure 9). The gap between market-implied RBA and Fed policy target rates moved back to the levels that back in Feb caused the RBA to accelerate bond purchases under its YCC program (see Figure 10). This shift has contributed to pushing AUDUSD above the top end of our target range.

The response from the RBA so far has been timid. On 22 Oct, the RBA purchased $A1bn of April 2024 government bonds, the first purchase under the YCC program since 26 Feb. As a result, the Apr 2024 bond yield, which the RBA targets at 0.10%, fell from 0.18% to 0.12%. Since then however, no further purchases have taken place, and the

Nov 2024 bond yield, which the RBA does not target under YCC, remains much higher at 0.77%.

Figure 11: Rangebound AUD vols ahead of RBA decision suggests markets do not expect fireworks

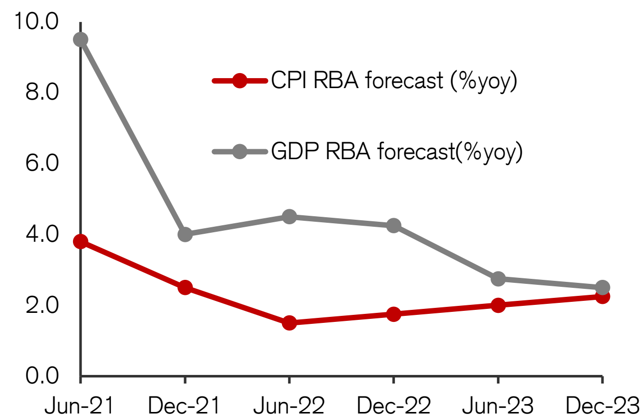
%



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Figure 12: The RBA's long-dated CPI forecasts will be in focus in the SOMP

%



Source: Credit Suisse, RBA Statement of Monetary Policy

With the RBA set to update its policy views and economic forecast in the upcoming rate decision and SOMP projections on 2 Nov and 5 Nov respectively, this resumption in YCC purchases failed to trigger much of a change in policy expectations or in uncertainty around the upcoming policy decision, with front end AUDUSD vols largely range bound. The lack of market excitement around the 2 Nov RBA meeting is likely influenced by timing issues: while Q3 CPI data will be available by the time the board meets next week, the wage growth metric that the RBA has often highlighted as key for the policy outlook will not be formally updated for Q3 until 16 Nov. Furthermore, the Fed's 3 Nov rate decision, from which markets now expect a formal asset tapering announcement, comes just a day after the RBA decision. Governor Lowe's aversion to being out of line with the broader monetary policy zeitgeist is likely viewed as a strong incentive against introducing a major policy innovation ahead of peers.

What to expect from the RBA

In the main, we do not anticipate the RBA to deliver a big policy shake up next week. The decision to intervene in bond markets after months of inaction is in our view a pretty strong signal in the direction of continuity. Still, while on the margin we think forward guidance is unlikely to sway from the latest formulation, we see a number of factors which could keep market hopes for a faster removal of policy stimulus alive. Specifically:

- **Still not enough progress on employment, but getting there:** RBA Governor Lowe has frequently stated he sees wage growth of 3.0%yoy or higher as a prerequisite for inflation to pick up on a sustainable basis. The Q2 wage price index measure (published 17 Aug) showed wage growth at 1.7%yoy, still ways away from the RBA's desired pace. In the meanwhile, however, weekly wage data show a faster growth of 3.5%yoy, with base effects still likely accounting for the deceleration since peak of 11.2%yoy on 17 May (see Figure 13), and 1-year wage growth expectations from the Melbourne Institute have edged higher to 3.3%yoy on 3 Oct (see Exhibit Figure 14). Any acknowledgment of the upward trend by the RBA would be something that markets welcome.

- **Inflation likely has picked up:** at the time of writing, Q3 CPI data have yet to be released. The numbers will be available by the time this report is published and are expected to show a pickup in core trimmed CPI to 1.8%yoy, the highest since Q4 2018. In the meanwhile, inflation expectations as measured by the Melbourne Institute picked up from 2.5%yoy in Aug to 2.7% in Sep. We suspect that the RBA rhetoric will continue to dismiss the numbers as temporary: in absence of an unexpected downturn in actual CPI data, however, we think that market expectations are likely to remain resilient.

- **No major change expected in asset purchases:** In its 7 Sep rate decision the RBA stated that it plans to purchase government securities at the rate of $4 billion a week until at least mid-Feb 2022. This puts QE effectively on autopilot until Q1 of next year: no new guidance for QE should be expected in the Nov meeting. YCC purchases should also remain a sideshow barring another large spike in April 2024 bond yields. With QE and YCC still active, markets will be looking for guidance on whether the bank plans to complete its purchasing programs before it considers rate hikes, or whether it is comfortable with tapering and hiking at the same time.

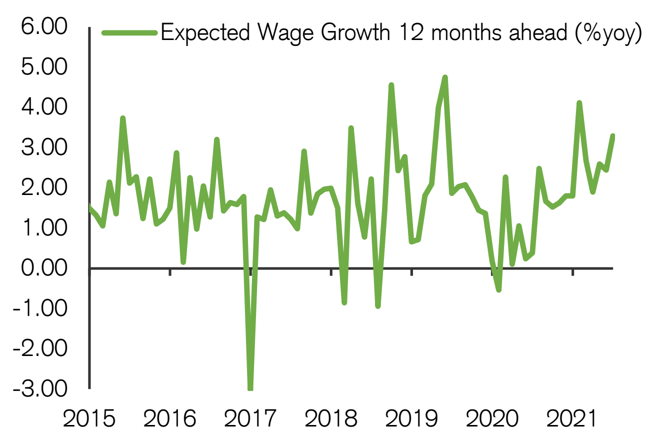
Figure 13: Weekly wage growth data has decelerated, but remains north of 3.0%yoy

%

Source: Credit Suisse, Australian Bureau of Statistics

Figure 14: Markets also expect wage growth to be above 3.0%yoy in one year's time

%yoy



Source: Credit Suisse, The Melbourne Institute

- **Economic forecasts are likely to be revised higher:** Markets likely expect the RBA to upgrade its growth and CPI forecast in the 5 Nov SOMP. The bank's current estimates that CPI inflation will stay below 2.5%yoy through 2023: recent strength in energy prices suggests upside risk to this forecasts.

We turn neutral on AUD and revise our broad target range higher

Two weeks ago we raised the top end of our AUD range from 0.7400 to 0.7480, and signalled the latter as an attractive entry point for shorts. With spot now above that level, we find that the pro-AUD asymmetry that we expected to see at current levels is simply not extreme enough to make the risk-reward of entering fresh AUD shorts compelling, especially with another short AUD expression already amongst our trade recommendations (AUDCAD 0.91 digital put, from 22 Sep - link). Vol markets seems to be pricing limited potential for change from next week's RBA decision, which fits in line with our view. This likely means that AUD might be unfazed by a statement that reiterates the RBA's well-understood willingness to lag markets, without new firepower being deployed. Also, on the positioning front, the unwind of the short AUDUSD position in IMM futures that we highlighted two weeks ago has simply been slower than we anticipated.

We still think that in the medium-term, i.e. over the course of the rest of Q4, the amount of rate hikes priced-in will be a hurdle for meaningful AUD strength. From a more tactical standpoint, however, we also note that the repricing in RBA policy expectations appears much less extreme vs the rest of G10 than it did in Q1 2021. At the time, market expectations moved to price in a meaningful pro-AUD gap in policy rate differentials vs the Fed, especially out to 2024. This time, the gap is more contained, and the macro backdrop is considerably more constructive. We think this, for now, reduces the urge for the RBA to fight back. We suspect this theme be revisited later in Q4, but at current levels the asymmetry is just not extreme enough to make us want to fade it.

With the key points that drove our “fade AUD” view undermined, we turn neutral on AUD and revise our target range for Q4 higher from 0.7050-0.7480 to 0.7320-0.7660. The extremes of the range are around the 23.6% and 61.8% of the 2021 top-to-bottom retracement. We continue to think that the steel-heavy composition of Australia’s export basket makes it a less than ideal expression of rising energy prices, compared to other G10 currencies like CAD and NOK, and we continue to see priced-in RBA tightening expectations as high relative to actual RBA intentions. But in the near-term, we don’t see either as a sufficiently strong catalyst to trigger a near-term reversal in AUDUSD.