Credit Research
Macro

2022 Credit Outlook: FX. RBA holds most of the cards

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Andrew Mayes
Director, Credit Research
+61 3 8668 8829
andrew.mayes@fiig.com.au

The Reserve Bank of Australia's relatively dovish stance on interest rates is likely to be one of the main drivers for the Australian dollar in 2022, but an aggressive US Federal Reserve could also influence the local currency's fortunes.

Summary

- Two key determinants of the exchange rate are the terms of trade and interest rate differentials. Despite the surge in commodity prices, the Australian dollar has at times failed to keep pace with both them and our terms of trade. Part of this can be explained by rising prices that emanated from temporary supply disruptions rather than a sustained increase in demand.
- Another reason relates to other main determinant of exchange rates, interest rate differentials, being the difference between interest rates in Australia and those in major advanced economies. The RBA introduced a number of measures that helped to lower interest rates along the curve, narrowing the interest rate differential, and with it, a lower Australian dollar than what would have otherwise been the case (certainly if the relationship between the Australia's terms of trade and the dollar had been allowed to persevere).
- The RBA has remained comparatively dovish at a time when central banks around the globe are looking to tighten monetary policy aggressively. As such, despite unprecedented monetary and fiscal support reinforcing growth and commodity price expectations in 2021, the Australian dollar has remained relatively anchored.
- As we look forward to the current year, the Australian dollar is likely to be largely influenced by interest rate differentials and the US dollar, with the latter sensitive to an aggressive US Federal Reserve that still appears to be assessing its options as it seeks to bring inflation under control. The RBA has judged that a necessary precursor to higher rates will be unemployment close to or below 4 per cent and wage growth returning to above 3 per cent. With progress toward both apparent, markets are pricing in three rate hikes locally in 2022.
- If the RBA does not hike rates as markets are anticipating, or the US Federal Reserve signals an even tighter response, there is a real prospect of currency weakness, at least in the short-term, which could see the AUD/USD dollar retest the lows of late-2021 of 70c in early 2022.
- We would see more arguments in favour of a stronger Australian dollar throughout 2022. Assuming we see a more reactionary central bank locally, a realignment with commodity prices appears a reasonable prospect, although we don't believe the RBA will be in a hurry to raise rates. And while commodity price indices point toward further growth, the pace is slowing. As such, we would lean toward an ascendency in AUD/USD toward mid-70c, but it may not materialise until later in the year.

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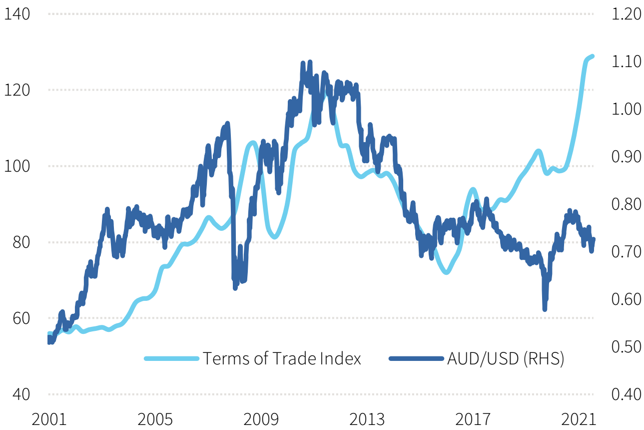
AUD fails to keep pace with soaring commodity prices and the terms of trade…

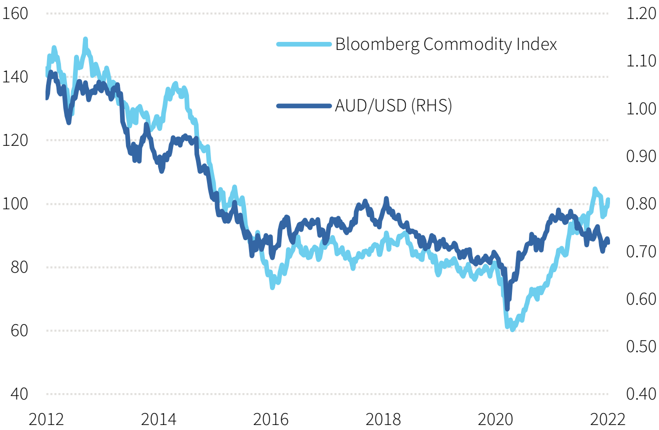
The Australian dollar is influenced by a number of domestic and international factors. Two key fundamental determinants of the exchange rate are the terms of trade (ratio of export prices to import prices) and differences between interest rates in Australia and those in major advanced economies.

Figure 1: AUD/USD and Terms of Trade



Source: Bloomberg, FIIG Securities

Figure 2: AUD/USD and Commodity Prices



Source: Bloomberg, FIIG Securities

Historically, the Australian dollar has shared a close relationship with both the terms of trade (see Figure 1) and more pointedly, commodity prices (see Figure 2). This makes intuitive sense, with the latter accounting for a large share of Australia's exports and so movements in commodity prices result in movements in export prices. Despite the surge in commodity prices in recent years, the Australian dollar has at times failed to keep pace with both them and our terms of trade. Part of this can be explained by rising prices for much of 2019 that emanated from temporary iron ore supply disruptions in Brazil rather than a sustained increase in demand. As such, they did not lead to large increases in capacity or production by Australian producers, which is typically funded through offshore markets, which can consequently lead to a higher Australian dollar.

This relationship re-established itself in the latter part of 2020 (at least directionally) as unprecedented monetary and fiscal support reinforced growth and commodity price expectations. Normally, the resultant rise in terms of trade would translate into higher yields to compensate for increased inflationary expectations, which should lead to an appreciation in the Australian dollar (and which also provides conditions necessary for the so-called 'carry trade'). However, the Australian dollar faded through the second half of 2021 as the US Federal Reserve embarked on a relatively sharp path toward interest rate normalisation in early 2022, while the Reserve Bank of Australia appeared to be in no rush to normalize monetary policy.

At this particular interval then, it stands to reason that the Australian dollar is being largely influenced by interest rate differentials and the US dollar, with commodities seemingly out of the picture--for now.

…as interest rate differentials narrow on the back of a comparatively dovish RBA

As we explored in the second part of our credit outlook on interest rates (click here), the RBA has remained comparatively dovish at a time when central banks around the globe are looking to tighten monetary policy aggressively. Recall the RBA introduced an intermediate- and long-dated bond purchasing program in late-2020 to complement the package of measures that had been introduced earlier in 2020, which focused on the front end of the curve (which made sense at the time, as most borrowers were on floating rate repayment terms). In totality, these measures had helped to lower interest rates along the curve, narrowing the interest rate differential (see Figure 3), and with it, a lower Australian dollar than what would have otherwise been the case (certainly if the relationship between the Australia's terms of trade and the dollar had been allowed to persevere).

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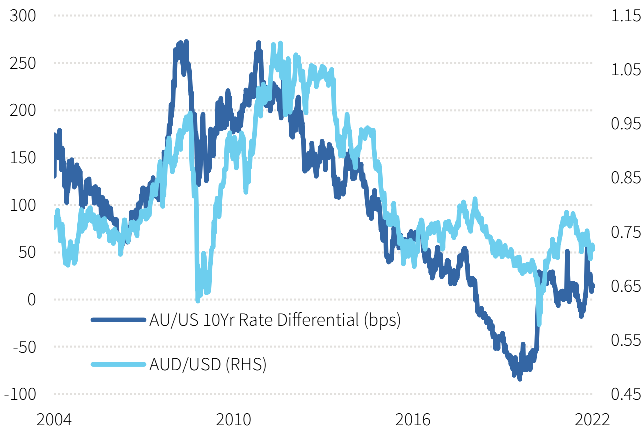
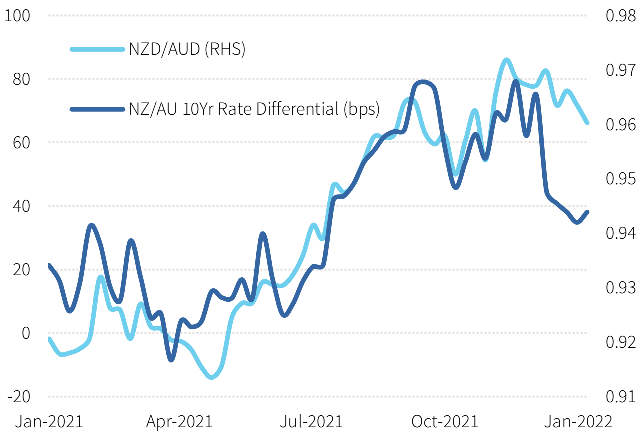
Figure 3: AUD/USD and AU/US 10Yr Interest Rate Differential



Source: Bloomberg, FIIG Securities

Figure 4: AUD/NZD and AU/NZ and10Yr Interest Rate Differential



Source: Bloomberg, FIIG Securities

However, this only tells part of the story. Relative policy stance matters for exchange rates, as the interest rate differential between two countries' bond yields generally move in tandem with the corresponding currency pair. Locally, and more recently, we can view the interest rate differential and its influence on the currency pairing between New Zealand, also considered a commodity currency, and Australia, with the former emerging as one of the more hawkish central banks amongst advanced economies by hiking interest rates in the latter part of 2021. The resultant increase in the interest rate differential and New Zealand dollar can be seen in Figure 4.

Narrowing interest rate differentials and US dollar strength, backed at the time by a particularly strong fiscal policy framework, came at a time when the US Federal Reserve turned more hawkish, signalling an unwind of asset purchases and a commencement of interest rate normalisation.

Trigger for the correction could come from surprises in both the US and Australia

The RBA has judged that a necessary precursor to higher rates will be unemployment close to or below 4 per cent and wage growth returning to above 3 per cent. With progress toward both apparent (see Part 2 of our Credit Outlook Series – Rates, for further insight), markets are pricing in three rate hikes in 2022. While the RBA's reticence is somewhat understandable given the country's inability to generate higher wage growth for a decade, it has created a disconnect, with the central bank not envisaging raising rates until 2023.

Inflationary pressures are indeed elevated in Australia, yet they remain comparatively measured. Although Australia officially reports inflation data on a quarterly basis, the more frequently (monthly) published Melbourne Institute (MI) Inflation Gauge, which has for some time shared a close relationship with official headline inflation, is not indicating a sudden breakout (see Figure 5 overleaf). Stronger than forecasted inflation or indicators to that effect--such as tighter employment conditions and/or stronger wage growth--could force the RBA into raising rates earlier, which might see the Australian dollar appreciate. Although the longer-term inflationary impact from COVID-19 remains uncertain, the latest COVID-19 variant has triggered a near-term increase in worker shortages and in all likelihood further delayed a broader reopening of Australia's borders to an increase in labour supply. The counter to this argument appears to be consumer spending, which has collapsed in some sectors as an in-effect shadow lockdown emerges. For now, forward rates assume no change (see Figure 6 overleaf), although a change in attitude from the central bank may be sufficient to change sentiment toward the Australian dollar, particularly if accompanied by US dollar weakness.

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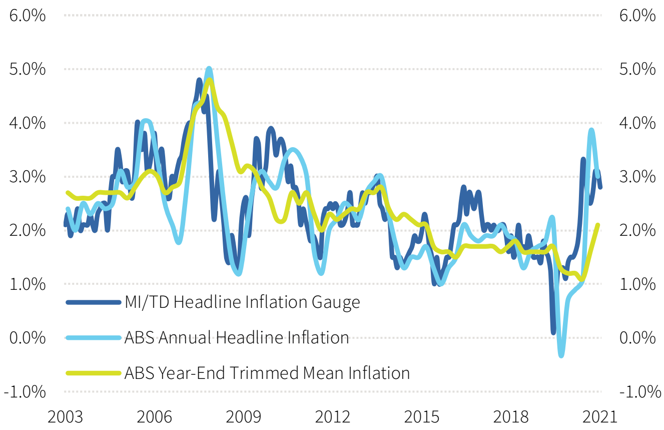
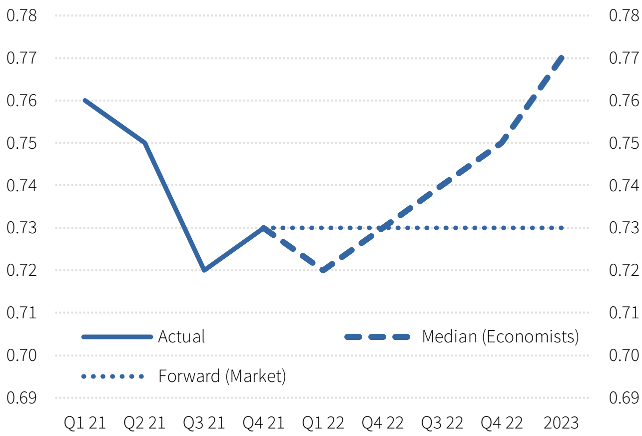
Figure 5: Australian Inflation Measures



Source: RBA, Bloomberg, FIIG Securities

Figure 6: AUD/USD forecasts



Source: Bloomberg

If the RBA does not hike rates as markets are anticipating, or the US Federal Reserve signals an even tighter response, there is a real prospect of currency weakness, at least in the short-term, which could see the AUD/USD dollar retest the lows of late-2021 of 70c in early 2022.

It is instructive that the US dollar has been unable to make further gains over a period when the Federal Reserve has confirmed an earlier ending of monetary stimulus as inflation pushes higher that many had anticipated; recent news of headline inflation reaching 7 per cent saw the US dollar continue a sell-off against a broad range of currencies, including the Australian dollar. While this may relate to the Federal Reserve aligning with a market that had already priced in tighter monetary policy, upward pressure on interest rates is now displaying real evidence of being largely priced into the US dollar. Nevertheless, with an increasing number of officials signalling the need to control inflation as the highest priority, upward pressure to the US dollar may yet persist, particularly as an aggressive Federal Reserve still appears to be assessing its options.

At the risk of aligning ourselves with the consensus (see Figure 6), we would see more arguments in favour of a stronger Australian dollar throughout 2022, but it is unlikely to be a dramatic move. At the outset, a realignment with the terms of trade is unlikely, in our view. For one, mining investment hasn't responded to rising prices with any particular strength. A realignment with commodity prices appears a more reasonable prospect (see Figure 2), assuming we see a more reactionary central bank, which could translate into AUD/USD approaching 80c in the medium term (all else equal). While commodity price indices point toward further growth, the pace is slowing. Some will look to a resumption in stronger growth from China, a country which faces its own set of headwinds, including a property bust and a strict pursuit of region-wide lockdowns to deal with rising COVID cases. We would therefore discount rising commodity prices. We also don't believe the RBA will be in a hurry to raise rates. As such, we would lean toward an ascendency in AUD/USD toward mid-70c, but it may not materialise until later in the year.

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