Australian dollar strategy and tactics report

PwC Treasury Advisory | Rangatōpū Rawa

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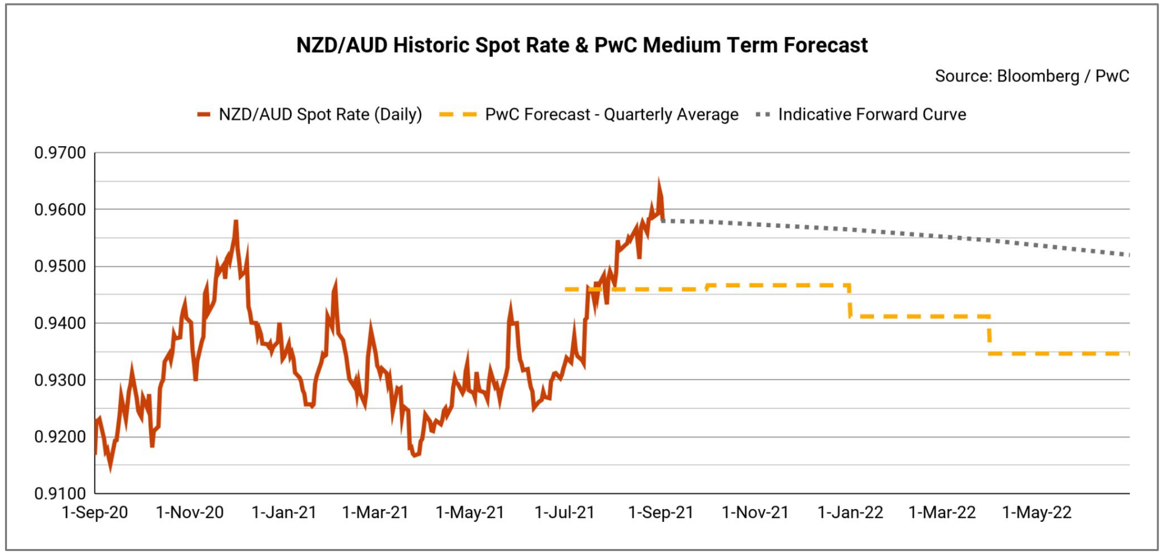
NZD/AUD: Base recommendations & forecasts

Current Spot: 0.9580



Core NZD/AUD exchange rate views

We continue to see the NZD/AUD centred around a 0.9100 - 0.9600 trading range throughout 2021. A near-term test of the topside of that range has since occurred, however we view such a move as unlikely to be sustained.

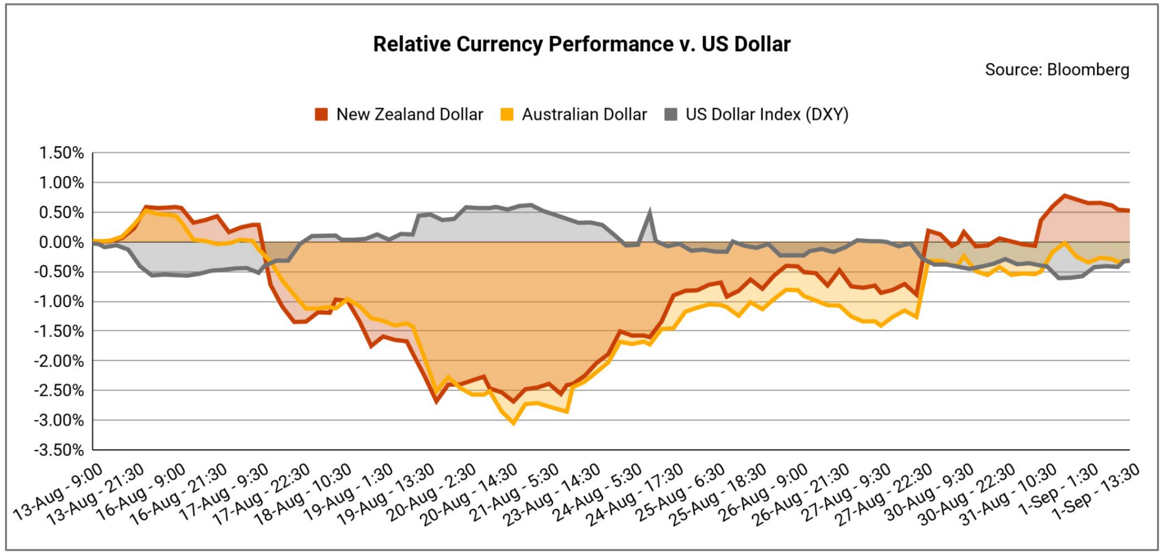
Shifting market dynamics and Covid case counting continue to impact the NZD/AUD landscape. While both the NZD and AUD have outperformed the USD recently, the NZD has maintained a relative edge - a less influential (at this stage) Covid impact and an RBNZ-led widening of interest rate differentials provided that edge. That being said, with much of the domestic interest rate expectation already priced into the NZD, technical analysis arguing for multiple roadblocks beyond 0.9600, and a number of favourable AUD drivers in the mix, the road higher (toward 0.9700) will be challenging.

Given the rapid appreciation of the NZD/AUD cross rate, we encourage clients to discuss bespoke hedging strategies with their principal advisor.

Exporter hedging recommendations	
0-12 months	No additional hedging at current levels. Continue to maintain staggered orders, elevating initial target levels to 0.9450 (from 0.9350) with a view to approaching policy midpoints by 0.9350. Consider purchased options if needed to maintain compliance (or collars). Contact us for specific recommendations where needed.
12-24 months (no filters)	Target retracements below 0.9350 to increase hedging by one or two months beyond minimums.

Importer hedging recommendations	
0-12 months	The advance above 0.9600 should have ensured hedging levels are at policy maximums. Add additional hedging at current levels as cover is utilised, noting increased forward point costs. Contact us for specific recommendations where needed.
12+ months	Filter tests not activated. Trigger level is currently 1.0040

NZD/AUD: Isolating the interest rate influence



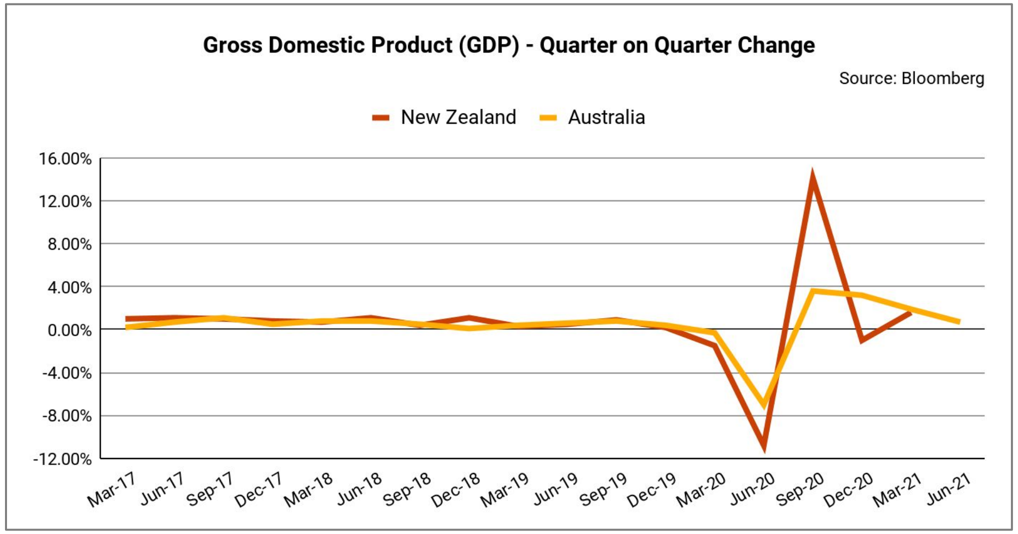
The NZD/AUD cross rate advanced above 0.9600 earlier this week, a 2021 high. Increasing interest rate differentials, inspired by the words of the Reserve Bank of New Zealand (RBNZ), were certainly a contributing factor, but interest rates are not the sole driver. The New Zealand dollar declined sharply following the announcement of lockdowns and an on-hold RBNZ, but so too did the Australian dollar. The subsequent rhetoric from RBNZ officials reinforcing that interest rate increases remain very much in the near-term future for New Zealand bolstered the NZD/USD, with AUD/USD going along for the ride, albeit a few steps behind. There was clearly more to the movement than just interest rates and case counts. Still, interest rate differentials will remain a significant driver of NZD/AUD over the medium term with the currency pair reacting in anticipation of future moves rather than awaiting realisation.

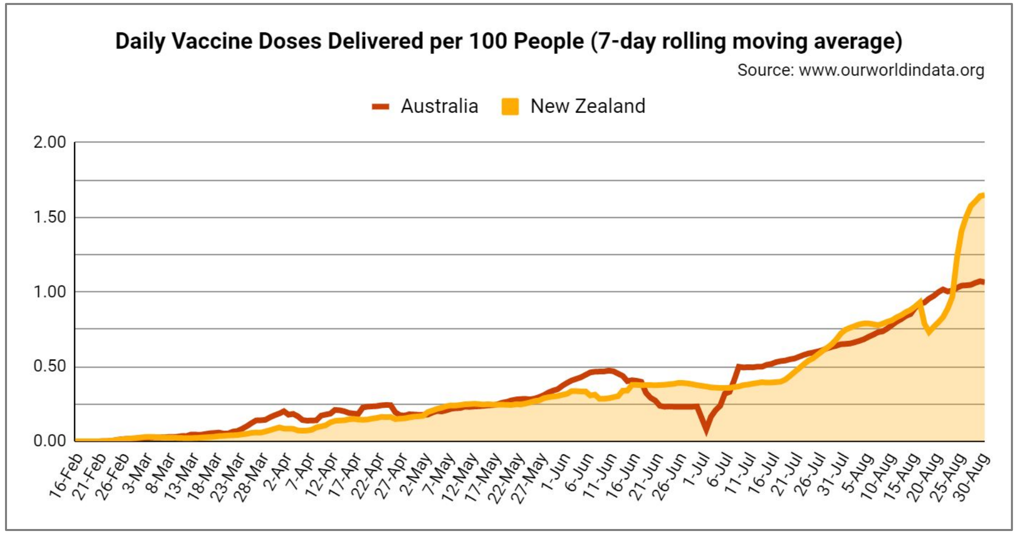
The market's implied expectations for the path of the Official Cash Rate (OCR) broadly mirror that of the RBNZ - to a point. The RBNZ's OCR-track implies a rapid pace of increases, elevating the cash rate to 2% by the third quarter of 2023. Market pricing doesn't quite go that far, but is comfortable with an unwinding of 2020's emergency policy response settings, bringing the OCR back to 1.00% by mid-2022. As discussed/illustrated in this week's New Zealand Interest Rate Report, interest rate expectations of the RBNZ are jam-packed through to the end of 2022, though it is almost always possible to squeeze a little more expectation paste out of the tube and onto the market brush. By contrast, the Reserve Bank of Australia (RBA) have repeatedly made it clear that they will not be tightening policy anytime soon, and should the Covid situation deteriorate, may actually inject additional stimulus. Essentially RBNZ expectations are near capacity and offer potential for disappointment should the RBNZ not be in a position to deliver. The RBA have plenty of headroom available and while it may not increase interest rates in the near term, as the bank moves toward indicating a tighter monetary policy future, the AUD should benefit relative to the NZD.

It is unlikely that the RBNZ will disappoint on their near term forecasts, but the medium term is rife with uncertainty. Reviewing the evolving stance of the RBNZ across the course of 2021 (negative rates remain an option; increases are likely in 2022; increases would may have occurred in August 2021 if not for lockdowns) paints a picture of a central bank that is nimble and willing to adapt to the rapidly evolving stream of economic data. Should the data stream turn to the south, an expectation unwind would be likely.

Interest rate expectations, or at a more granular level, the data drivers of monetary policy decision making, will serve as the principal driver of NZD/AUD movement over the medium term.

Key drivers of the NZD/AUD exchange rate outlook





Central bank sentiment and related data

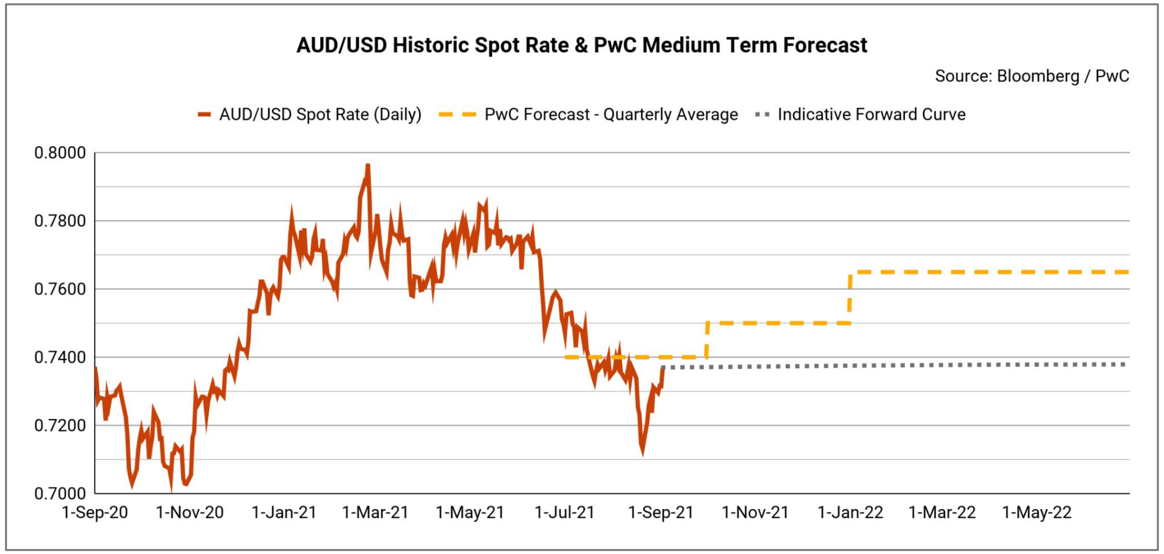
The RBA returns to the diary next week, likely to hit the repeat button on its Spotify app - the modern equivalent of the broken record. As highlighted in our previous report, RBA Governor, Philip Lowe, expressed in the August meeting that lockdowns tend to be followed by sharp rebounds in economic activity, though the bank stood ready to inject additional monetary stimulus if necessary. While our core expectation is for a repeat of that rhetoric, the prolonged nature of the current Australian lockdown may prompt a tweaking of the language. Regardless, the RBA's core stance of maintaining supportive policy settings throughout 2022 should not waver. The Governor may also call attention to this week's expectation-exceeding GDP data for Q2 as well as a slightly faster than anticipated pace of expansion for Australia's manufacturing sector and a slightly slower than anticipated pace of house price appreciation. The lockdown environment does slightly tarnish those results, but the RBA may still view it as a signal that its long-game policies are showing tentative signs of working. From a domestic perspective, New Zealand Q2 GDP data (scheduled for release in a fortnight's time) is the principal near-term NZD data driver of the NZD/AUD equation. While GDP is not a race, performance relative to the Australian outcome will be reflected in the NZD/AUD.

Covid case counting - racing to 80%

Fundamental to a sustained economic recovery, and by extension, comparative support for the relevant currency, is the delivery of the Covid vaccine. Singapore has determined that once vaccination rates exceed 80% of the population, freedoms, both for residents and visitors, will return. Applying this as a benchmark, New Zealand and Australia have a fair bit of wood to chop (arms to jab) before either is in a position to benefit from the return of international tourism - a proportionally larger component for New Zealand. A local surge in injections is underway, but brings a fresh set of issues, such as supply. Sprinting midway through a marathon seldom produces long-run rewards. Still, from an NZD/AUD performance perspective, vaccine delivery will become of increasing relevance.

AUD/USD: Base recommendations and forecasts

Current Spot: 0.7370



Importer hedging recommendations

0 - 6 months:

The retracement back toward 0.7400 should have triggered orders, replenishing hedging percentages. Optionality, specifically collars, may be appropriate to maintain policy minimums. Stagger fresh orders from 0.7400 with a view to approaching policy mid-points by 0.7500.

0 - 12 months:

No new cover at current levels, though should still be relatively well hedged. Maintain existing staggered orders from 0.7550. Consider optionality and/or lower order levels where needed to replenish hedging or ensure minimums.

Evolving economic fundamentals across Australia and the United States pose a significant challenge to our AUD/USD quarterly forecasts. The sharp decline in the spot rate witnessed in late August has almost fully retraced, highlighting volatility in the currency pair.

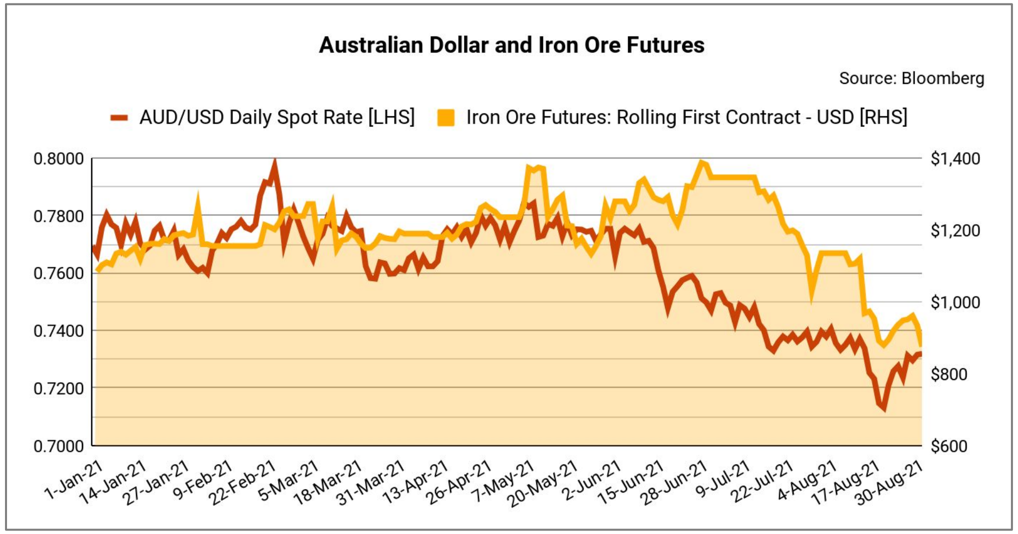
Core AUD/USD exchange rate views

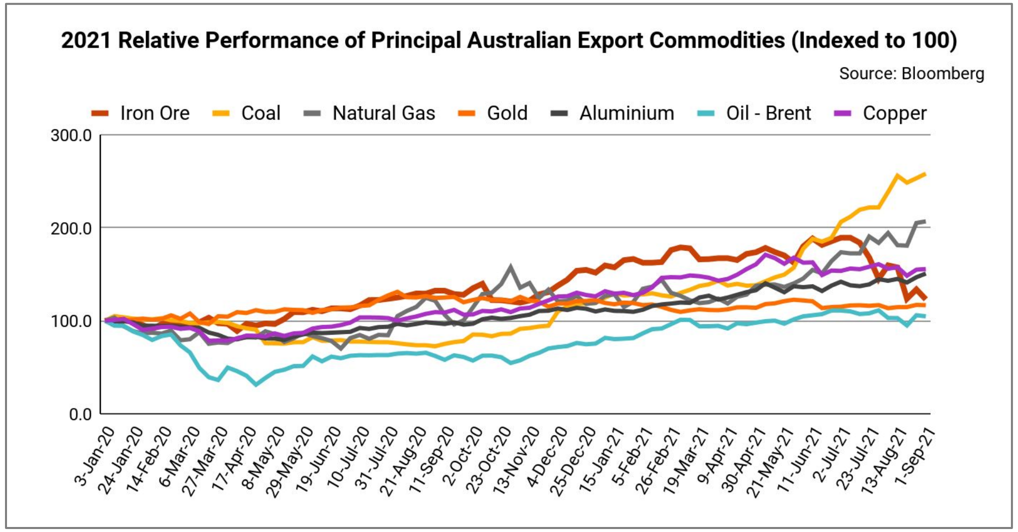
Our long-standing expectation for the AUD/USD to trade a 0.7500/0.8000 trading range across 2021 has been broken. We continue to anticipate an eventual retracement back above 0.7500, though accept that long-term technical support at 0.7000 may be tested first.

The Australian dollar staged a modest recover across the past fortnight, climbing from a 2021 low to the middle of the late July / early August trading range. For the most part, the retracement was attributable to a broad-based weakening of the US dollar - appropriate given the decline was primarily the result of US dollar strength.

The continuation of the current Covid outbreak is weighing upon the AUD/USD, alongside ongoing China concerns and volatility in industrial commodities. While the focus of the commodities aspect has fallen upon the declining price action in iron ore, other commodities within the top-ten export items have held up comparatively well - some even outperforming. Recent data has also served to highlight that the Australian economy, and the Australian dollar, retains a good number of fundamental support factors that should assist in weathering the current AUD negativity storm. Still, despite the bounce, the AUD/USD downward trend is yet to be broken. In the near-term, the most likely catalyst for a further advance is additional US dollar softness. Over the medium term, a successful execution of a Covid vaccination strategy argues for a AUD/USD return to the mid-0.7000's.

Key drivers of the AUD/USD exchange rate outlook





Big picture commodity perspective

In our previous report we highlighted the long-standing links between the AUD/USD and industrial metals. The correlation with iron ore has been, and continues to be, fairly strong, though it is not the be all and end all. Declining iron ore prices were not the catalyst for the AUD/USD mid-year decline, but they certainly helped. From a commodity export perspective, Australia is far from a one trick pony - beyond iron there is plenty of material buried beneath the land down under that the globe's heavy manufacturers desire. Viewing a selection of these can make for a messy chart, but iron ore's decline stands out as the bucking the trend, rather then setting it. Export volumes and values are only one piece of the AUD/USD puzzle, but they do highlight a base level of demand (floor) for the Australian dollar. Recent experience suggests that floor to be in the 0.7000 / 0.7100 region. Tests are possible, but attempts at a break lower should be swiftly rejected - all else being equal.

Dollar domination diminishing (over time)

Uncertainty remains rife in financial markets, though it stems principally from concerns over the economic impact of Covid. As vaccination rates increase and the world adjusts to life with the virus, confidence should return, reducing the desire for safe-haven currencies, such as the US dollar, at a macro level. The potential for new virus variants does argue for further bouts of dollar domination, though the shock factor will likely be comparatively muted (the market having traversed that road before), limiting the flight to safety response. Much like iron ore, the US dollar index (DXY) serves as an (inverse) sentiment indicator for the Australian dollar - the AUD is not a component of the index. Still it remains another big-ish piece of the AUD/USD puzzle.

The expected future actions of the US Federal Reserve are the current focal point for DXY movement. In the very near term, US employment data (this weekend) will set the DXY tone.

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