Jul 22, 2020

FX Flash

AUD - Still A Buy on Dips

Stay Long

AUDUSD has finally broken out higher and was last seen around 0.7170, resilient in the face of the Covid-19 infections that re-emerged in Victoria and clusters also found in New South Wales. AUD is at 15mth high even as 4.9mn residents of Melbourne (Metropolitan Melbourne and Mitchel Shire) were ordered to stay at home with effect from 8 Jul for the next six weeks, a reversion to stage 3 of lockdown (Stage 4 being most severe). Positive risk sentiment globally buoys the AUDUSD and we would discuss in the report why this AUD has outperformed our view for an eventual move towards the 0.74-figure in the next 12 months.

We hold the view that the AUDUSD is a buy on dips for a few reasons -

1) Since the start of the pandemic that worsened around Mar-Apr, the AUD retains a strong correlation with equities. With risk sentiment likely buffered by sporadic updates on vaccine developments and recovery expectations firmly anchored by central bank and government actions, it is hard to see a substantial correction in the AUD.

2) AUD has reclaimed its carry advantage since the start of the pandemic and RBA's clear unwillingness to consider NIRP underpins the currency.

3) Investors still have confidence in Australia's ability to contain the virus. While the second wave of virus outbreak in Victoria/NSW worsened, there are no signs of the same happening in the other six territories of Australia (based on the Covid case counts reported by Department of Health), suggesting that the authorities have somewhat successfully ring-fenced the outbreaks with interstate border restrictions for now.

4) Assuming Au-Sino relations do not deteriorate to a point of more tariff barriers being erected, China's recovery has benefitted AUD and could continue to boost the currency.

There are tail risks to our view – 1) AU-Sino trade relations souring. 2) An unexpected return in inflation that could result in a forced rate hikes, the return of volatility and an unwinding of AUD.

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Our Still-Bullish AUD View

AUD broke out of the 0.68-0.70-range and was last seen around 0.7170, a 15-month high. The antipode benefits from the current risk-on environment brought about by the combination of the EU stimulus, vaccine development hopes and concomitant broadly softening greenback. Yesterday, RBA Governor Lowe added momentum for AUD bulls. In his online speech, he had ruled out FX intervention, saw negative interest rates as “extraordinarily unlikely” and voiced support for government to maintain fiscal support for the economy.

This came after Treasurer Frydenberg declared more support for smaller businesses hurt by the pandemic and offered guaranteed loans of up to $1mn (prev. limit was $250K) to around 3.5mn firms with the maximum term extended to 5yrs from current 2yrs. The current loan guarantee program only saw 15,600 corporates accepting loans worth a sum of $1.5bn. This would be just one aspect of extending fiscal support. Frydenberg also annouced extension for the JobSeeker and JobKeeper (wage subsidy) program that will cost around $20mn. JobKeeper program will have two tier from Sep so as to better align with the actual hours worked by the beneficiary. The pay-out will fall from current $1500 (per fortnight) to A$1200 for full-time workers and A$750 for those working less than 20hours per week. From Jan—Mar, the program is tapered again to $1000 and $650 respectively. The latest announcements of fiscal support were made ahead of the fiscal update on Thu (23rd Jul).

The environment is certainly constructive for AUD to strengthen further at this point and we continue to look for opportunities to buy dips.

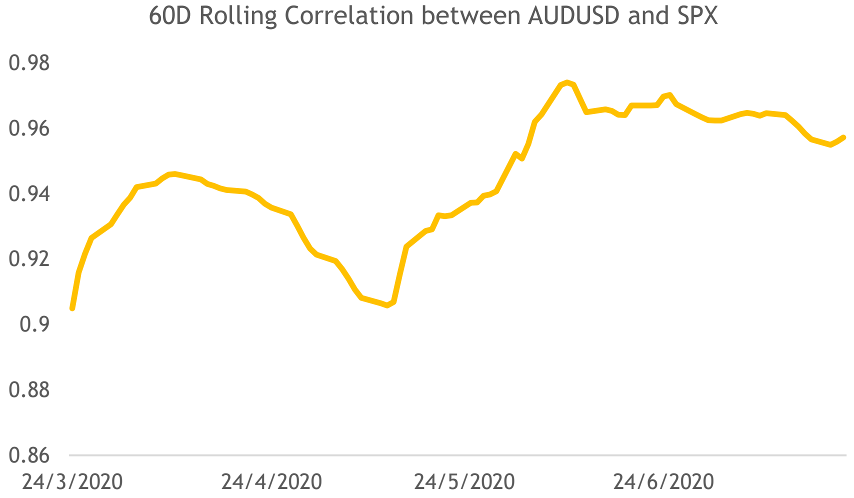
While AUD may seem rather elevated at this level, bullish drivers may continue to buoy the antipode. These may have been mentioned in other pieces but at this point of break-out, we still would like to recognize that these factors are unlikely to fade in the current environment:

1) an expectation that an eventual effective vaccine would be developed with commercial availability expected within the next 1.5years
2) China’s recovery to continue to underpin the demand for Australia’s resources (assuming no breakdown in AU-Sino relations).
3) subdued inflation environment, global interest rates to remain low and constructive for cyclical recovery and carry trades that typically benefit the AUD.

Recovery is priced in the AUD and Vaccine hopes Buffer Downsides

AUD has risen quite substantially on the expectations that much of the world would recover from the pandemic eventually. This is especially so in light of the fact that researchers around the world along with pharmaceutical companies are on a race to develop the vaccines. Before vaccines arrive, the swift response of the government and central banks have spurred plenty of projections for recovery (be it U-shaped, V-shaped or Swooshed) and global equities seem to have recovered substantially with the NASDAQ back at record high. Correspondingly, the recovery forecasted seems to be already in the price action of the AUD which strengthened the most against the USD compared to regional peers.

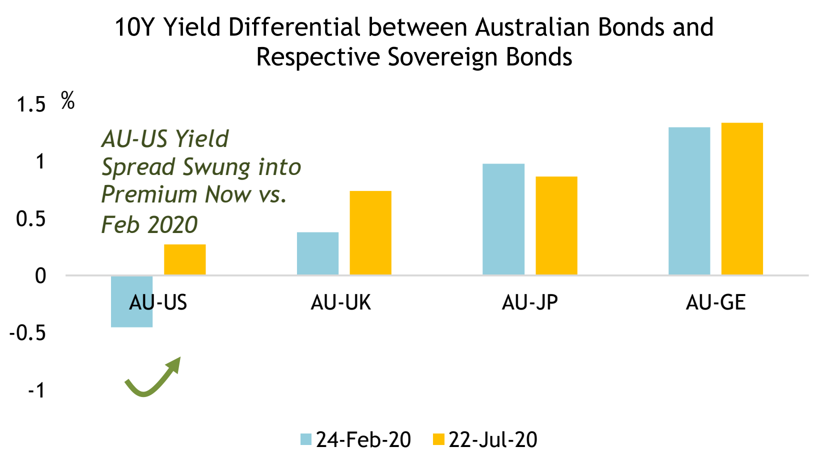
Correlation between AUDUSD and SPX Show Signs of Picking Up Again



Source: Maybank FX Research & Strategy, Bloomberg

Even so, expect sporadic positive updates in vaccine development and massive stimulus abound that fuel expectations of recovery to translate into resilience in risk appetite that could provide buffers for the AUD from shocks (poorer-than expected economic data in the interim, covid-19 second wave).

AUD Reclaims Carry Advantage



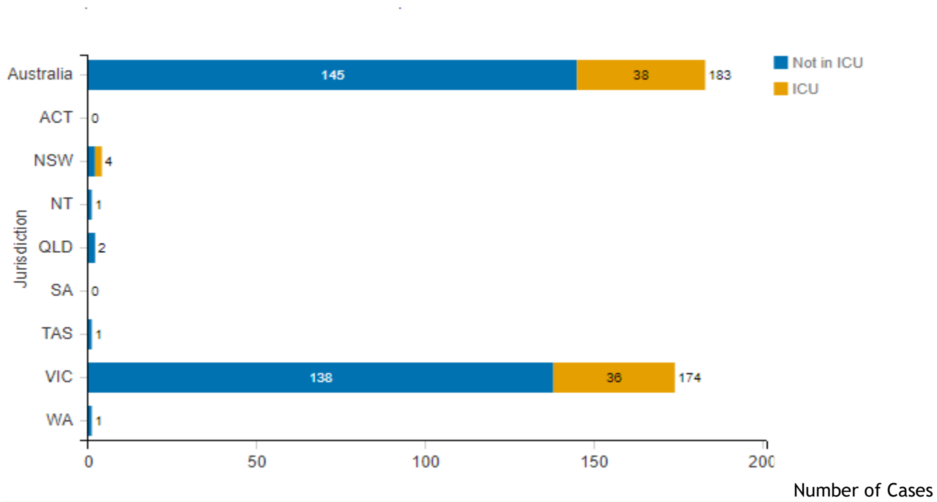
Note: AU-GE refers to the yield differential between that of 10Y Australian bonds and German bunds.

Source: Bloomberg, Maybank FX Research & Strategy

The great lockdown saw aggressive central bank actions and resulted in AUD reclaiming its carry advantage over the USD and other DM rates. RBA's clear and firm "No" to negative interest rates (in Lowe's words "extraordinarily unlikely") continues to support the AUD as the preferred currency over other lower yielding (or even negative yielding) DM FX amid an eager anticipation for a global cyclical recovery. From the chart (in the previous page), the 10y AU-US spread has swung into premium due to the rate erosion of the UST. With the help of RBA's clear signalling, AUD's carry advantage seems to have gained vs. the GBP and EUR. In addition, Australia still has a AAA sovereign debt rating (even though it is on a negative Watch by Fitch) while Fitch had already dished out a downgrade to Canada. Its AAA rating could certainly increase the allure of Australian bonds in a time of uncertainty.

AUD's Resilience to its Second Wave of Covid-19

Australia's Current Covid Cases in Hospitals and ICUs as of 21 Jul 2020



Source: Department of Health, Australian Government

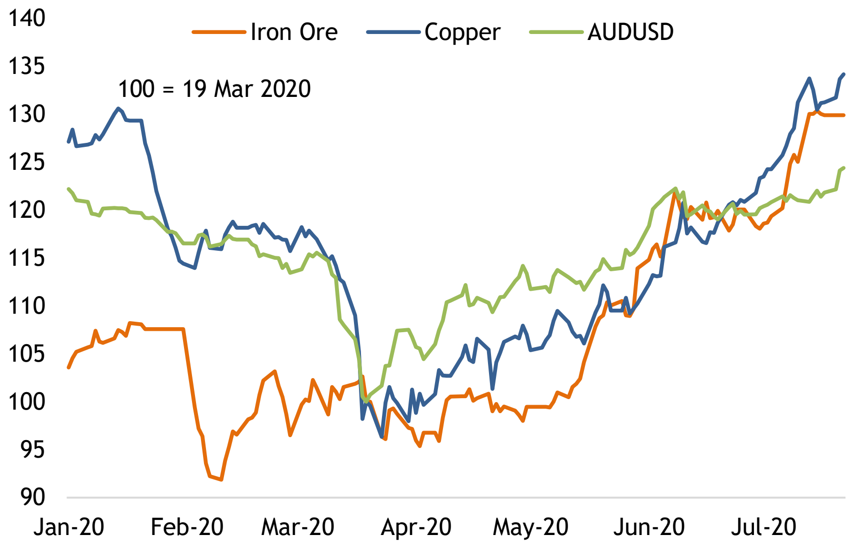
While it may not be very obvious, AUD's outperformance was also because Australia did fairly well in the pandemic crisis at the start. Australia's success in getting the initial outbreak under control had earned international recognition and contributed to the expectations that the economy can emerge from the health crises faster than some developed nations. Hence, even with the current second wave in Victoria and to a smaller extent, New South Wales, the AUDUSD was little affected as there has not been signs of spreads in other states (see chart above), keeping investors' confidence in the AUDUSD and perhaps its AAA credit rating as well. Hence, while economic recovery could still be delayed (consumer confidence already showed signs of being dampened), recovery is not expected to be derailed. Australia's fiscal strength (relative to other countries such as Canada, US, UK) was emphasized by RBA Lowe in his recent online speech and the recent declaration by Treasurer Frydenberg of an extension for JobSeeker and JobKeeper programs, albeit with tapers, also likely brought relief to investors and helped to propel the AUDUSD to its current elevated levels. More details of other fiscal supports and tweaks could be revealed tomorrow.

In addition, the pandemic also spurred the introduction of the Super Early Release Scheme – that allows eligible citizens and PRs to apply to access up to $10K of their superannuation until 30 Jun 2020 and a further $10K from 1st Jul – 24 Sep 2020. The redemptions on superannuation-related funds that drove up the demand for the AUD in the past few months may continue to boost the AUD given the upcoming tranche of withdrawals expected. That said, the boost to the AUD may not be as significant as the first tranche as hiring conditions may improve alongside easing of movement restrictions and people are likely less eager to dip into the next 10K relative to the first 10k of their superannuation.

AUD is Risk Sensitive and Pro-Cyclical

AUD has been a pro-cyclical currency and an improvement in its terms of trade typically strengthens the currency. The rise in AUDUSD in the past few months was in tandem with the surge in iron ore and copper prices that were due to demand from China.

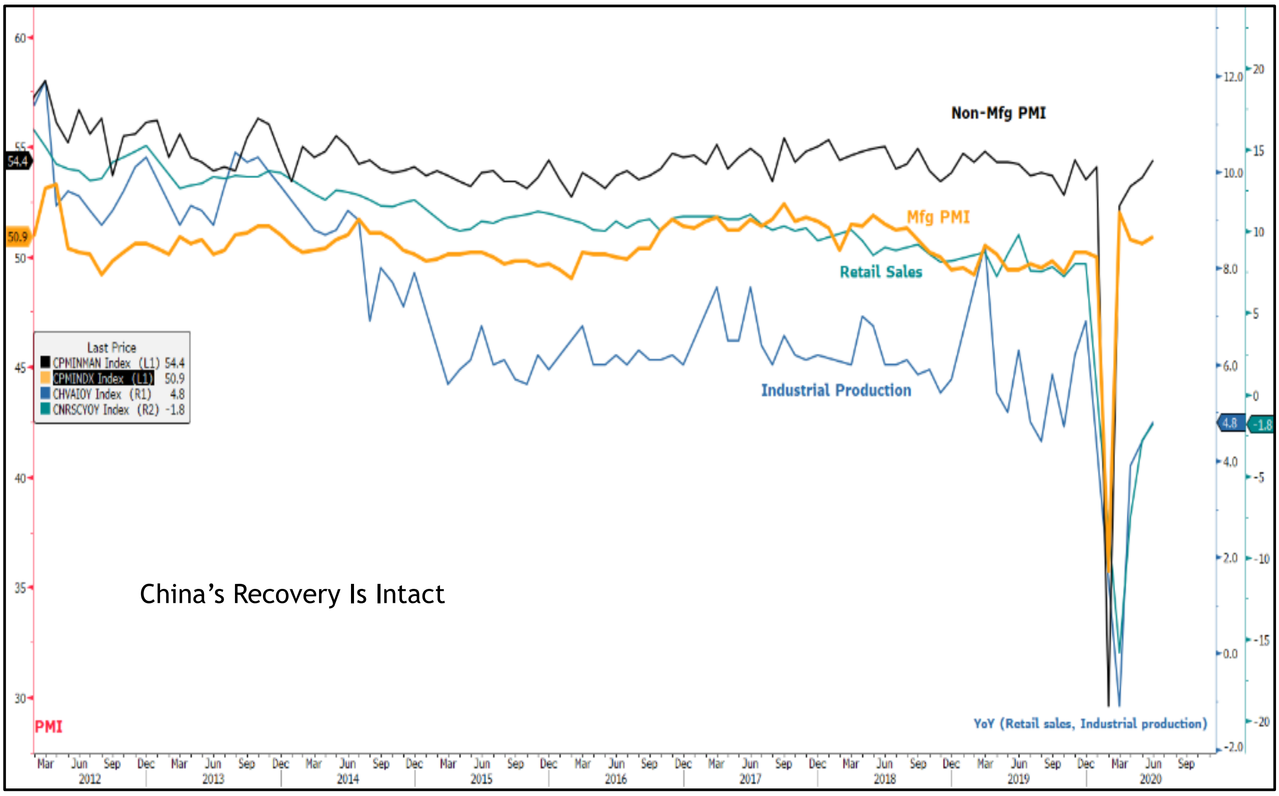
AUD Recovered In Tandem with Copper, Iron Ore



Note: All prices index to 100 which is their respective price on 19 Mar 2020, the recent trough of AUDUSD.
Source: Maybank FX Research & Strategy, Bloomberg

China's recovery remained underway although recent prints have undershot expectations. The trend of recovery is still intact but talks of some property curbs and an apparent slowdown in easing could mean that growth pick-up may moderate. That could also translate to slower demand for Australia's exports and smaller boosts to the AUD.

Recent Numbers Suggest Recovery Still Intact for China, Positive for AUD



Source: China Federation of Logistics, National Bureau of Statistics

Being risk sensitive, AUD will still react to episodes of risk aversion. So when the PRC Consulate General Houston was ordered to close "in order to protect American intellectual property and American's private information" today, AUD had softened a tad in line with most regional peers with the USD. We still prefer to buy the antipode on dips as the US and China had shown clear preference to keep phase 1 of the trade deal intact and could avoid measures that threaten economic recovery.

Tail Risks to Our View

Given the array of factors underpinning the currency, it is thus hard for AUD to make a substantial correction. However, we do see some risks to our view. Uptrend could be threatened if the Australian-Sino trade relations deteriorate sharply with China imposing tariff barriers against Australia. However, given that most nations still want to focus on economic recovery, country leaders may prefer to engage in non-economic tactics that that would not affect people's livelihood in the here and now.

In addition, most countries are still at risk of the pandemic and weak demand is still a concern. In contrast, inflation seems to be relegated to a lower priority. New BoC Govenor Macklem said he is more concerned about deflation than inflation and Fed Kaplan and Evans have recently hinted preference for inflation to ***overshoot target***. As such, it is also clear that global rates are likely to be kept low and may only be adjusted if price pressure rise in a sustained manner. In the past decades, we had seen accommodative monetary policy repressing volatility and allow carry trades to flourish, benefitting the currencies such as the AUD. On the converse, there is also (a less likely) scenario where a rise in inflation due to unexpected food inflation or the result of a simultaneous use of fiscal and monetary policy for a prolonged period could require a knee-jerk adjustment in policy rates and trigger a downswing in the AUD. We see these as tail risks.

We see these factors as tail risk and our base case look for AUDUSD to move towards 0.74-figure in the next 12months.

For AUDJPY, momentum indicators are bullish as well, especially on the weekly chart. A clean break of the 76.60 resistance could open the way towards 78.70 (61.8% fibo retracement of the 2017-2020 fall) and then the 80-figure (200-wma).

Forecast

Forecast	3Q 2020	4Q 2020	1Q 2021	2Q 2021
AUDUSD	0.70	0.72	0.73	0.74

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