January 17, 2017

FX Insight

AUD - Timing The Next Entry

AUD has made a U-turn from its base at mid-0.71

AUDUSD was resisted by the 0.75-figure last week, after a rather dramatic swing from its recently formed base at mid-0.71. The swing higher is mainly due to a couple of factors – the USD retreat and the metal rally that stems from China demand.

Will We Continue To See More AUD Gains?

We do not think this is the end of the AUD uptrend. Strong infrastructure demands could continue to lift metal prices, improve Australia's terms of trade and lift the AUD. In addition, we see less chance of a policy rate cut as inflationary pressure builds externally and rise in export earnings boost income. In addition, AUD is still cheap relative to our FX Tracking model which prices the AUDUSD at 0.82 as fair.

We Like AUD against the USD, JPY, SGD

The USD is dominant this year and so one has to properly time the entry into a long AUDUSD trade. We see a potential inverted head and shoulders formation that could suggest an opportunity to buy at 0.73. We look to buy AUDJPY on dips as well for a target of 95. Against the SGD, we are also still bearish, we look for the AUDSGD towards the 1.10/12-region.

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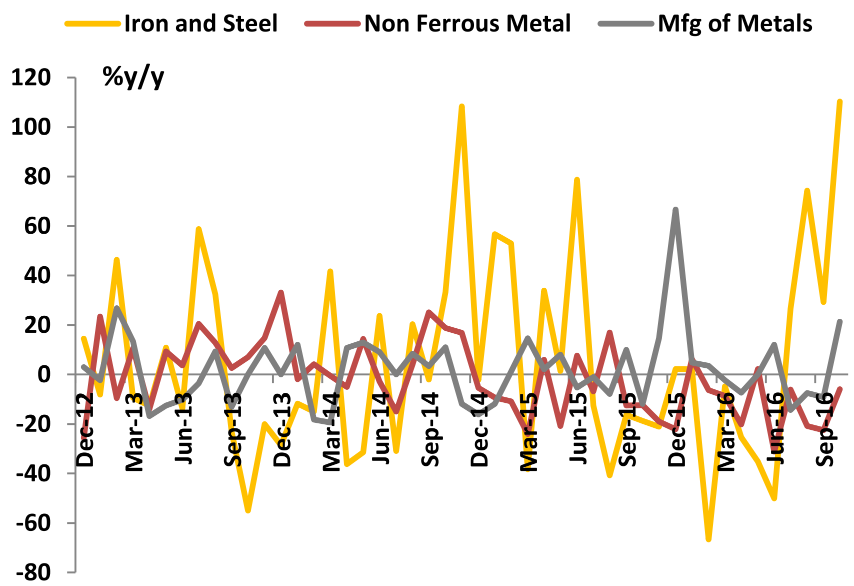
AUD and China

Since the start of the year, AUD bulls have taken advantage of the subdued USD to rally against the greenback. Not only that, the AUD was also lifted by the metal rally. China's efforts to reduce excess capacity as well as her launches of many rail infrastructure projects led to a surge in the metal prices at home. This boosted the prospect of Australia's external balance which had already seen a significant improvement from an expected A$550mn deficit in Nov to an actual surplus A$1243mn. The breakdown showed that iron and steel exports saw a jump of 110%y/y in Nov and the promise of more infrastructure spending from the US, China and other parts of Asia and the World suggest that the rise in metal prices are not nearly done yet.

Chart 1: Metal Prices Have Been Lifted By Fiscal Pledges By The Chinese Government

Source: Bloomberg

Chart 2: Australia's Exports of Iron and Steel Jumped 110%y/y in Nov



Source: CEIC, Maybank FX Research

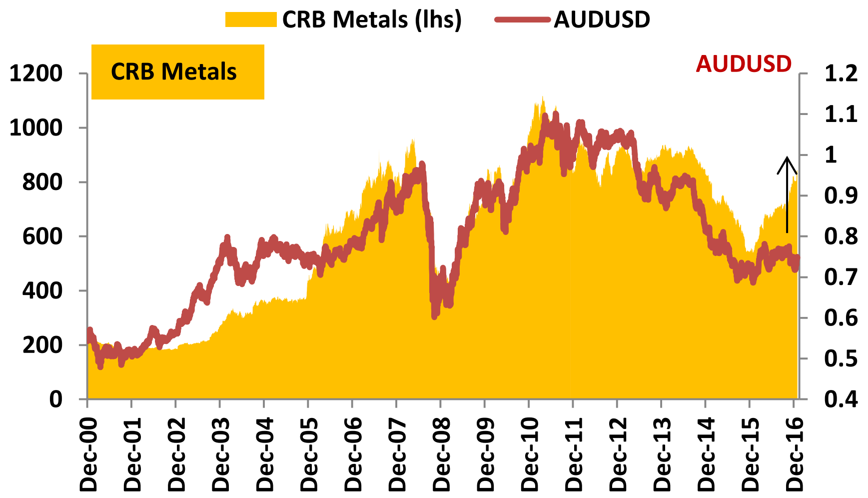
Just to be clear, this is not our first bullish AUD piece. We have been medium-term bullish on AUD since last Dec. We flagged upside risks to the AUD against the USD, against the SGD and against the JPY. While we are wary of some corrections, we see further upside extension in the AUD. Here are the key reasons to be bullish on the Australian dollar.

Infrastructure Demand Lifts Australia's Terms Of Trade

Towards the transition of 2016-2017, the world has shifted from a phase of sluggish growth to one that sees a little more growth, a little more inflation. Even so, the global environment is still conducive for AUD bulls. With the Fed on tightening their monetary policy, more central banks in other parts of the world see less room for monetary action. Many turn to fiscal expansion to support their economies. It is not just China but to a large extent, it is. AUD stands to benefit from the re-focus on infrastructure improvement.

Since 2016, China has started to reduce its excess capacity in earnest, the reduction in inventory and supply has led to a significant rise in the price of steel and coking coal. In addition, on-going infrastructure projects by the Chinese government, the requirements of the One Belt One Road initiative, the infrastructure plans by the incoming US Trump administration should continue to underpin the demand for these commodities. That should in turn, continue to support the prices of key commodity prices and lift Australia's terms of trade, positive for the AUD. In Chart 3, one can see that AUDUSD still has quite a bit of catch up to do with the commodity prices.

Chart 3: AUDUSD Needs to Catch Up To The Commodity Price Recovery

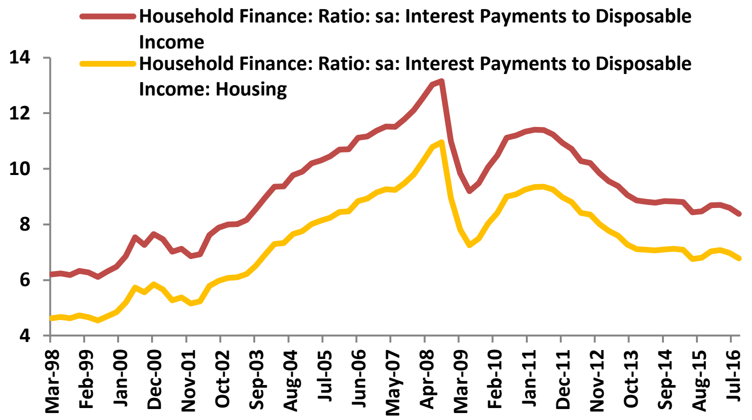


Source: Bloomberg, Maybank FX Research

Risk of Rate Cuts Lessen

We still think that the economy is not ready for a rate hike and risks are still tilted towards a cut but the risk has reduced. Retail sales have been sub-par, rising just 0.2%m/m in Nov. Household consumption was the key pillar of growth for 3Q and the outlook is a little uncertain. While household interest payments to disposable income ratio has fallen (Chart 4), the household debt to disposable income continues to rise. Uncertainty about the economy and higher debt levels could restrain household spending. The past two rates cuts were done in order to raise demand to nudge price pressures nearer towards the 2-3% inflation target. Since then, RBA has recognized that the "risks to global inflation appear to be more balanced than they have been for some time" in its November Statement on Monetary Policy. So while household consumption is still rather subdued, external price pressures from recovery elsewhere could raise the CPI notwithstanding some mitigation from the currency strength. Hence, a cut may not be so pertinent at this point. At the same time, stronger export earnings arising could also raise income and lift domestic consumption. The current metal rally allows breathing space for Australia's economic rebalancing effort, allowing RBA some time to watch and mull over their next action. Hence, while we still see a risk of rate cut in May, that risk has somewhat reduced in May. Should consumer confidence improve, the upside risk to AUD may increase even more.

Chart 4: Household interest Payment to Disposable Income



Source: CEIC, RBA

AUD is cheap relative to our Fair Value of 0.82

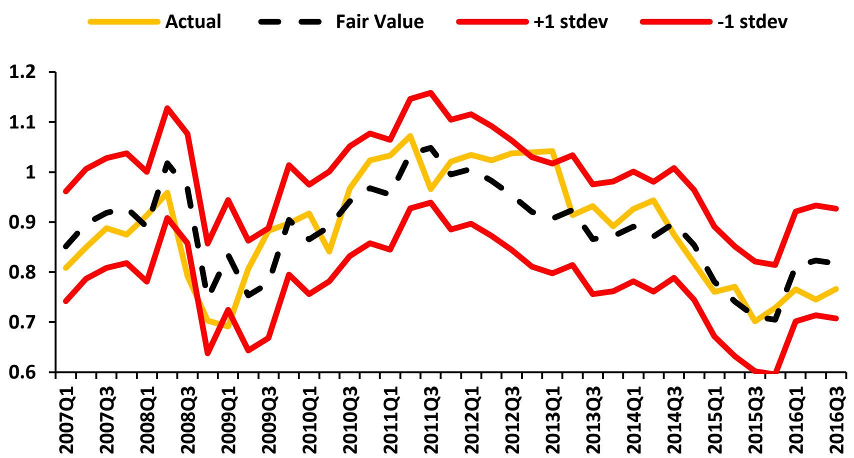
We are estimated a short-medium term fair value of the AUDUSD using pure cyclical variables:

1) The differential between Australia's and US current account to GDP ratios;

2) 10y bond yield differentials between Australia and US adjusted for inflation;

3) Reflation proxy defined as the ratio of World Equities (proxied by MSCI World Index) to World Government bonds (proxied by JP Morgan Global Aggregate Bond Index).

Chart 5: AUD is cheap relative to Fair Value of 0.82



Source: Maybank FX Research Estimates

We run multiple regressions for AUDUSD bilateral currency pair on quarterly frequency data starting from 1Q 2007. The FX Tracking model estimates the AUDUSD value to be around 0.82 with a range of 0.71-0.93 as of 3Q 2016. This suggests that AUD still has quite a bit to catch up to its fair value.

An Opportunity To Buy AUDUSD?

In a week that leads up to Trump's Inauguration on 20 Jan, we see another opportunity to buy AUDUSD. A resurgence of the USD bulls could see the AUDUSD head into an inverted head and shoulders formation with the neckline at 0.7525. Buy towards 0.73, stoploss 0.7150. Target 0.78.

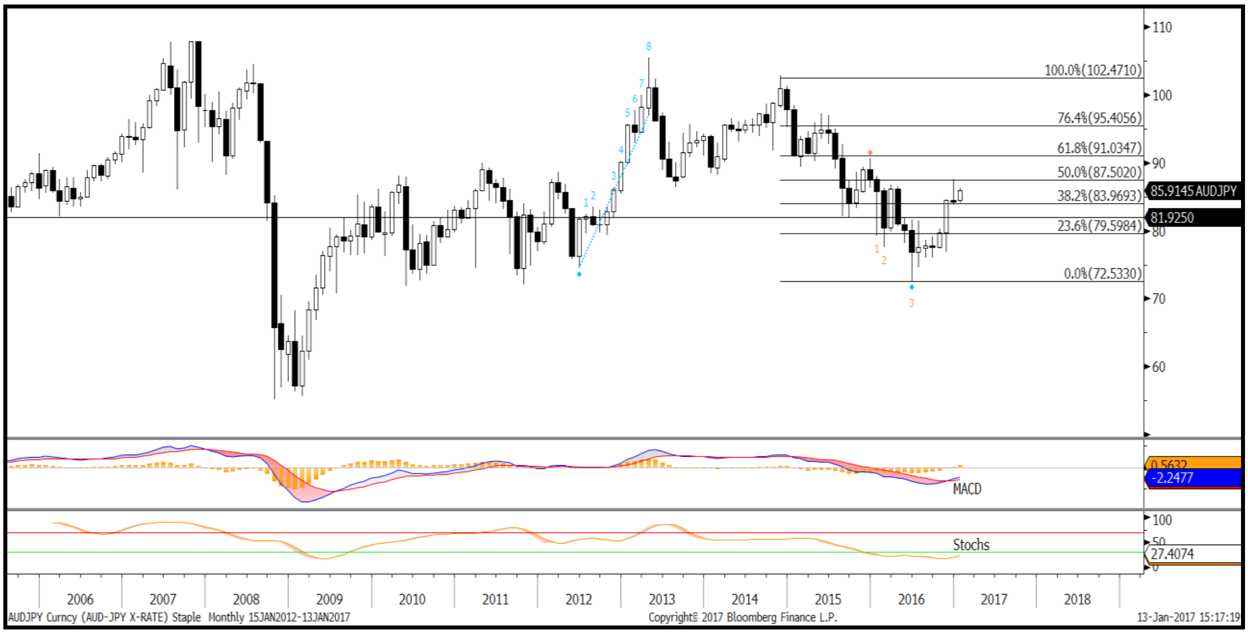
Chart 5: Daily AUDUSD

Source: Bloomberg, Maybank FX Research

AUDJPY – Target 95

Chart 5: Monthly AUDJPY Chart

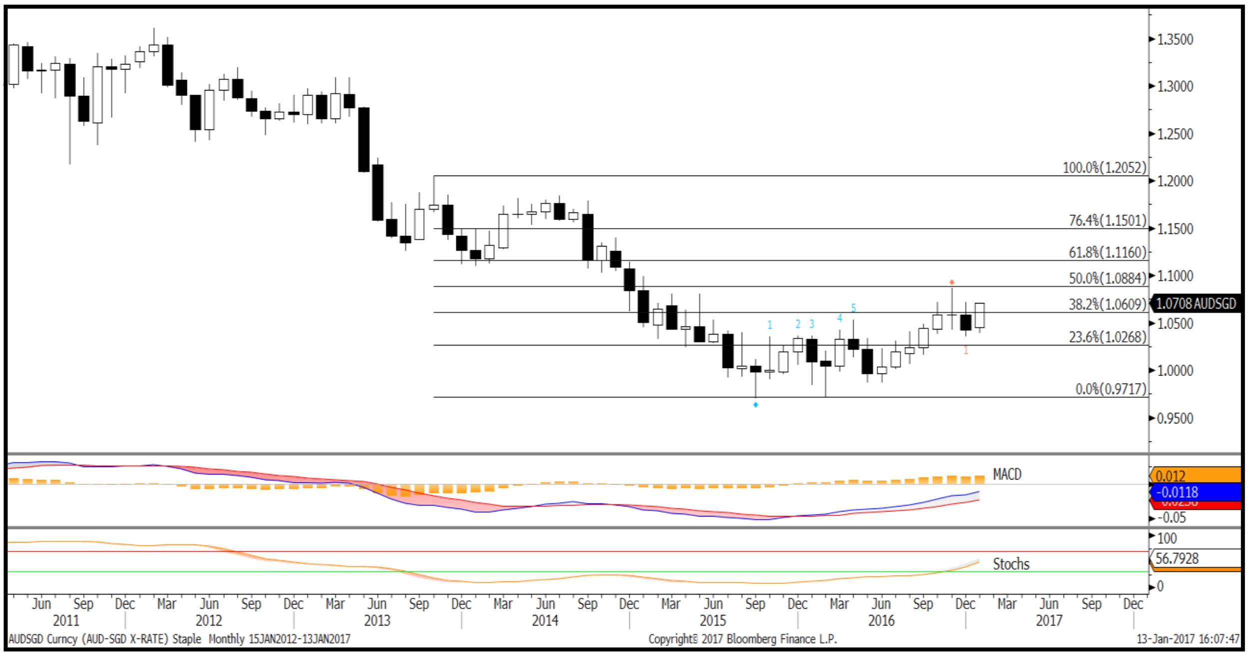
AUDJPY is seeing some upside bias in the medium term as flagged by the monthly chart. Support at the 84.80 (23.6% Fibonacci retracement of the Sep-Dec rally) before the next at 83.1 (38.2%) on the daily chart. Expect commodity rally and the potential for BOJ easing to keep this cross on the upmove. Momentum indicators on the monthly chart are bullish. We look for this cross to head towards 91 first before the 95-figure. Stoploss around 81.



Source: Bloomberg, Maybank FX Research

AUDSGD – Target 1.10/12

Chart 6: Monthly AUDSGD Chart



Source: Bloomberg, Maybank FX Research

AUDSGD should see further gains. Break of the 1.07-level (which I think has broken on last week close), next resistance is at 1.079. The run-up has been decent and could stall for now. Momentum is bullish. We see increasing risk for this cross to move towards 1.10, 1.12 in the medium term. Support is seen around 1.03. Can choose to buy towards that level.

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