Long USDAUD

Thesis: Weak commodity prices due to cooling global (esp. Chinese) demand, a slowing Chinese economy and weakening yuan, and a risk-off environment should weigh down on the Aussie. In regards to monetary policy, aggressive hiking expectations and a June lift-off accurately (if somewhat hawkishly) represent the RBA's path forward. Given the size and number of expected hikes, there isn't much reason to believe that further hawkiness will be priced in the near-term.

Commodity weakness

The Aussie has been supported this year by strong commodities prices (since it is a large exporter of metals, energy, and some grains), but I expect this support to reverse in the near-term. The rally in commodities has recently taken a break due to concerns over continued global demand and pricing of an aggressive Fed hiking cycle. Fertiliser, ags, base and precious metals have slid over the past several days. In the near-term, both of the catalysts for this pause will continue, though I think the concerns over global demand are a stronger driver here. Some earnings reports in the US have indicated cooling demand, as have retail sales in the UK and purchasing manager surveys in Germany, UK, US. In the near-term the big contributor to dropping commodities demand should be China, the largest purchaser in most categories. Chinese lockdowns should have a lagging effect on the demand for key commodities. I foresee the lockdowns continuing and expanding to additional regions of China due to the government's staunch commitment to Zero Covid. We can see that this hasn't been priced in yet if we look at the YoY changes in commodity prices and Chinese imports side-by-side (Appendix B).

China beta

The Australian dollar also has strong exposure to Chinese sentiment in particular, not only due to its aforementioned impact on global and regional commodity demand, but also strong trade partnerships. The PBoC has taken additional measures to support the Chinese economy, including infusing additional MM liquidity, providing stimulus to domestic businesses, and devaluing the yuan. Despite that, the PBoC's easing path has routinely been beaten by corresponding estimates - they are taking their time easing, but the economy still faces headwinds from the real estate sector, financial conditions, omnicron, etc. The slow pace also introduces capital flow risks as aggressive Fed hike expectations grow, which will pile on pressure for the PBoC to use the yuan to absorb such blows. (The Australian dollar has a high correlation with the yuan, especially during past devaluations; see Appendix C.) While some of this can be mitigated, I see additional economic downsides (beyond the omnicron outbreak) piling onto weaker consumer sentiment, retail, manufacturing, and other economic figures coming out. Trade flows between China and Australia should also slow considerably during the course of these lockdowns. Generally, exposure to the Chinese economy and currency should weigh down on the Aussie near-term.

Risk-off

The Australian dollar typically performs poorly in risk-off environments. Strong headwinds to global growth, an aggressive expected Fed hiking cycle, possible further negative geopolitical news (though markets have mostly moved past that, I think it's worth just noting), and the uncertainty involving these factors moving forward should also lend fundamental support to intensifying risk-off market sentiment.

Monetary policy outlook

The RBA has not yet begun its hiking cycle. This is chiefly due to the more moderate inflation facing the country, reflective of the Asia region and its position as a commodities producer, with 4Q21 YoY inflation at 3.7%. Core inflation has not yet jumped out of the CB's 2-3% target band, but analyst estimates and guidance indicate they expect it to when new figures come out on April 26th. Employment numbers are robust, with the unemployment rate around 4% (a 13Y low) and expected to tighten further to below 4%. The RBA has previously indicated that they are looking at wages as an indicator of the permanence of this inflation, but wage growth has been moderate so far (Appendix D). Business conditions indices in March showed rapidly accelerating confidence.

Market expectations are for a 25 bps liftoff in June and six to seven more hikes before year end (Appendix E). I don't think that the RBA will hike in its May 3rd meeting, (unless core inflation is significantly above estimates) because wage data only comes out May 18th. This data (and the Fed's hikes) should reflect the need to begin the hiking cycle, which I think will include a 25 or 50 bps hike in the RBA's June 7th meeting. The market is pricing rapid subsequent hikes because the RBA has hiked aggressively in the past subsequent to the start of the cycle. I think that, given the data and guidance, these hikes are adequately priced. Moving forward, I don't see much upside risk to the currency from shifting expectations of future hikes (especially since they will be, in part, driven by previous Fed hikes).

The one key risk is a 50 bps first hike rather than a 25 bps, or front-loading the hikes. I think that this is possible. However, if the terminal rate stays the same, then this effect on the FX will be somewhat muted, as we saw with the RBNZ's surprise hike recently.

Appendix

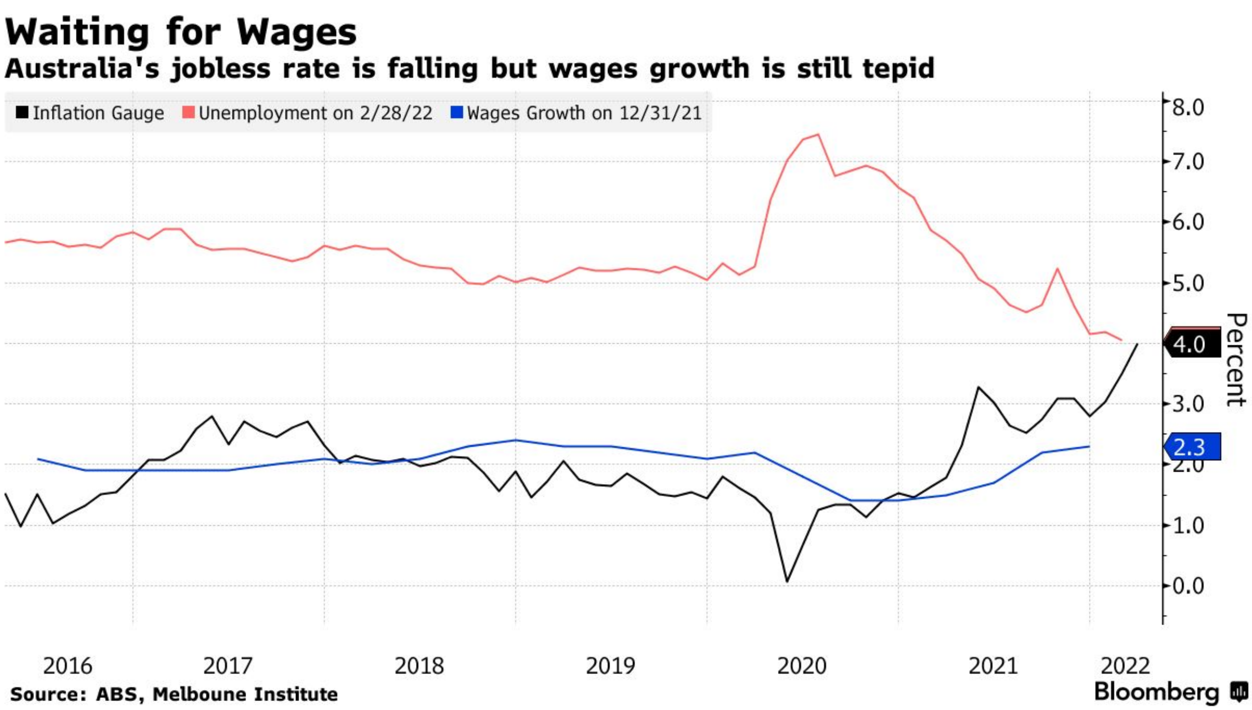
A. USDAUD price chart

B. Commodity prices and Chinese import have recently diverged

Source: Andreas Steno and Macrobond

C. Australian dollar, Chinese offshore yuan comp

D. Australia wages, unemployment, inflation



E. Australia MIPR