AUD: In balance between doves and iron ore

The recent extra dose of dovishness by the Reserve Bank of Australia is not likely to be matched by central banks in New Zealand and Canada, which would warrant some AUD underperformance compared to the rest of the dollar bloc. While a strong iron ore performance has been an offsetting factor, we think current prices are unsustainable, and AUD looks more vulnerable than its peers in the short term

AUD is facing a duality between domestic and external drivers. The recent dovish turn by the RBA has further reduced the appeal of the Aussie dollar's positive carry, but the generalised upbeat market mood about the global recovery and the strong iron ore performance has continued to offer support to the currency.

We think iron ore may show fresh signs of weakness, which suggests AUD's balance of risks may be tilted to the downside in the short-term. In the longer-run, we expect the global reflation narrative and AUD's undervaluation to be the prevailing factors and we see AUD/USD move above 0.80 even if iron ore prices decline.

A dovish turn by the RBA depresses AUD'S rate profile further

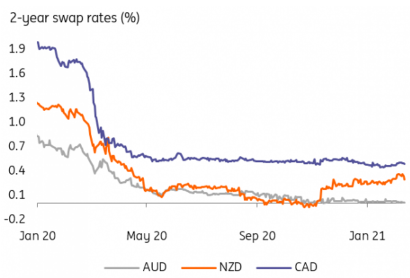
The RBA policy announcement on 02 February surprised the market on the dovish side. Many investors had seen the better-than-expected inflation and employment readings for 4Q as a reason for the Bank to start unwinding some stimulus. Instead, Governor Philip Lowe announced an extension (worth AUD 100bn) of the bond purchasing programme, which will be kept at the current rate of AUD 5bn per week after it expires in April.

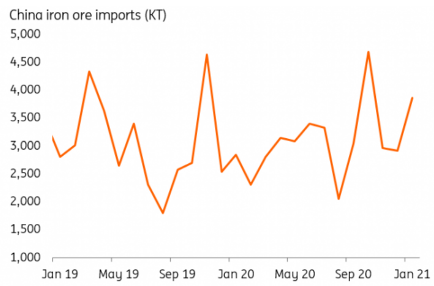
Incidentally, the RBA provided rather strong forward guidance as it forecast no hikes to the cash rate until at least 2024, as policymakers do not expect inflation to move back into the 2-3% target band before then.

While this and the yield-curve-control policy on the 3Y tenor are keeping the short-term anchored, the Australian sovereign curve might – if the RBA's intention plays out - show a more limited steepening, as the RBA's bond purchases have been more and more directed at the 5-10Y maturities. This should remain the case with the additional aim of supporting government finances, as more debt is issued to fund the pandemic response stimulus.

In the G10 $-bloc, AUD was already the currency with the lowest policy rate before the meeting. The QE extension is set to trigger a further build-up in the Bank's balance sheet and is intended to keep rates low across the curve, which should further dampen the AUD's attractiveness from a rate perspective (Fig. 1). That is especially true considering that neither CAD or NZD are likely to see further easing from their respective central banks. The Bank of Canada's latest policy announcement set a rather optimistic tone, while the Reserve Bank of New Zealand has tapered its bond purchases twice already this month and may face some pressure to normalise rates sooner than other central banks to temper surging house prices.

Fig. 1 & 2: AUD low carry attractiveness and Chinese solid iron ore demand





Source: Eikon, ING

Iron ore tightness persists, but price weakness still expected

A key contributor to AUD's recent rallies has been the surge in iron ore prices, which rose sharply in 2020 thanks to resilient Chinese demand (figure 2) and tight supply.

More recently, iron ore prices have come under some pressure as we move into the Chinese New Year, while weaker Chinese steel margins have certainly not helped. However, this downward pressure has been short-lived, with lower shipments from both Australia and Brazil more recently providing some renewed support. Australian flows from Port Hedland were disrupted after bad weather forced the port to shut for several days. For Brazil, expectations of wetter weather could also slow exports somewhat.

While the iron ore market is set to remain in deficit this year, with Brazilian supply struggling to get back to pre-dam disaster levels, we do think that current price levels are unsustainable. We believe the market is pricing in a risk premium as a result of Australian/China tensions, with the potential that this could spill over into the iron ore market. However, we think this is unlikely, given China's strong dependency on Australian iron ore, and the lack of alternative sources. We expect that, as we move through the year, the supply situation will improve, and so expect prices to trend lower. We are currently forecasting that prices will average a little over US$130/t this year.

After the policy shift by the RBA and given the risk of a further iron ore correction from current unsustainable levels, AUD appears more vulnerable than the other $-bloc currencies amid any possible setbacks in the global reflation story.

In the longer run, we still expect AUD to benefit from a risk-positive environment globally and from generalised USD weakness as the global recovery gathers pace. We remain confident about AUD/USD moving above 0.80 in the second half of 2021.

In relative terms, the AUD may struggle to recover more ground to its closest peer NZD as the monetary policy differential looks likely to remain a factor, barring a surprising dovish shift and/or talk of FX intervention by the RBNZ. We think the balance of risks for AUD/NZD is tilted to the downside in the first half of this year, and we could see a move into the 1.05 region.

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