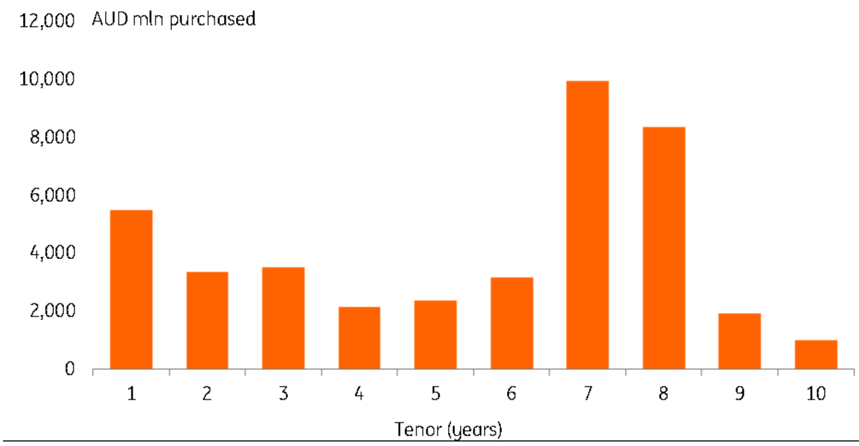
Australian QE: A premature tapering?

After hinting at tapering if conditions improve, Australia's central bank actually trimmed its daily bond-buying today. However, an excessive steepening of the yield curve may act as a deterrent to unwinding QE. Looking at AUD, we're not convinced the recent rally is an initiation of a sustained recovery just yet

Impact on the yield curve so far

Since announcing a yield-curve-control scheme (keeping the 3-year yield at 0.25%) on 19 March, the Reserve Bank of Australia has purchased AUD 41.5 bn of government bonds on the secondary market. The breakdown of the bond purchases in terms of maturities (Figure 1) shows the Bank has intervened in various segments of the curve, especially in the 7- 8-year tenors.

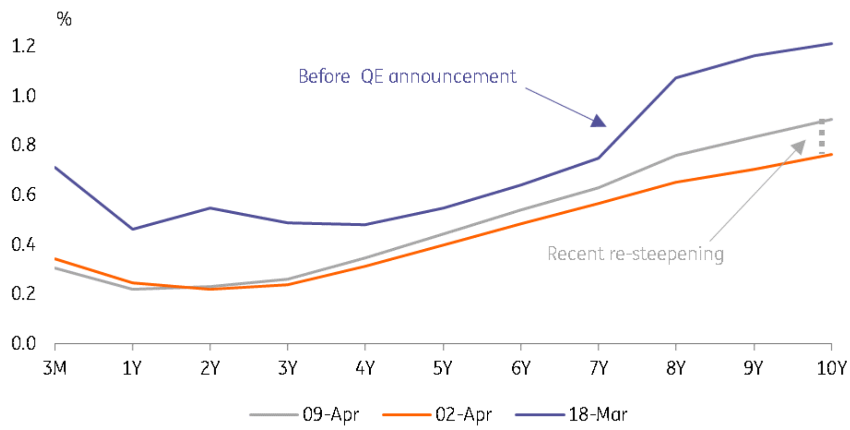
Fig. 1 - Breakdown of RBA bond purchase by tenor



Source: ING, Bloomberg

Whilst largely succeeding in keeping the 3-year yield at the 0.25% target, the whole AU yield curve has understandably shifted lower since the start of the bond purchase scheme (Figure 2). Looking at the slope of the yield curve, an initial fierce steepening around the QE announcement was followed by some stabilisation in the 10Y-2Y differential.

Fig. 2 - Australian sovereign yield curve (before and after QE)



Source: ING, Bloomberg

However, the curve has started to steepen again in the past few days. This has largely been the result of the more upbeat global risk sentiment and consequent UST 10-year underperformance. However, the RBA policy statement on 7 March has likely come into play too lifting Australian 10-year yields as the central bank surprisingly hinted at some tapering “if conditions continue to improve”.

RBA trimming bond purchases

With only three weeks into the QE programme and – above all – with still little material evidence of the actual economic impact of Covid-19 on the global (and Australian) economy, the prospect of tapering may look a bit premature.

It must be noted that tapering likely poses a risk of an extreme steepening of the yield curve

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However, the RBA seemed to put words into action today and made the smallest daily purchase of securities so far: AUD 1.5 bn. Surely, we would need to see a trend in lower purchases to conclude the Bank is actually starting to unwind its QE scheme. Next week is likely to be crucial in this sense.

It must be noted that tapering likely poses a risk of an extreme steepening of the yield curve, especially if global risk sentiment keeps improving and US 10-year yields rise. The central bank may stick to its stated objective to control the short-end of the curve (also given the limited ability to control the UST-driven back-end), but recent buying of longer-dated bonds suggest that the Bank may not be entirely at ease with surging back-end yield.

This is understandable considering that supply is set to pick up soon as the government builds debt to finance its anti-pandemic fiscal stimulus plan.

AUD: Don't get too excited

The recovery in risk sentiment, accompanied by the hawkish wording in the RBA statement set the AUD for a substantial rebound this week. If indeed the RBA is determined to scale back its bond purchase, this would inevitably provide additional steam to the AUD.

However, we are still not convinced that the recent rally is an initiation of a more sustained recovery just yet. And this is largely because, despite the encouraging signals in terms of slowing contagion in Europe, lingering uncertainty around the depth of the upcoming global recession suggests a big deal of caution when betting on procyclical currencies.

Looking more specifically into AUD, a plunge in trade flows and a slowdown in Chinese demand doesn't bode too well for the export-dependent Australian economy, which may see the impact of the Covid-19 extending well beyond the lockdown-related disruptions. Commodity prices may also remain quite depressed, in particular iron ore (Australia's main export), whose price prospects were already gloomy on the back of an increase in supply from Brazil.

Finally, it is important to remember how the AUD has historically been the key shock absorber in turbulent times for the Australian economy, which suggests the RBA (and, even more, the government) may not be content with a large recovery in AUD as the country deals with the big hit. While direct FX interventions don't seem to be on the cards just yet, an appreciating AUD may be another disincentive to scale back QE.

As the USD appears to be bearing most of the brunt for the fall in risk aversion, we still expect defensive currencies JPY and EUR to be a safer bet than the procyclical currencies such as AUD in the near future.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com