Australia: RBA unlikely to lend a hand to AUD

Despite a calmer bond market, the Reserve Bank of Australia is likely to reiterate that significant stimulus remains necessary to reach its inflation and employment goals. AUD rate attractiveness should remain low when compared to other commodity FX, especially NZD, although short-term undervaluation suggests limited further AUD/USD downside

Reserve Bank of Australia Governor Philip Lowe

Source: Shutterstock

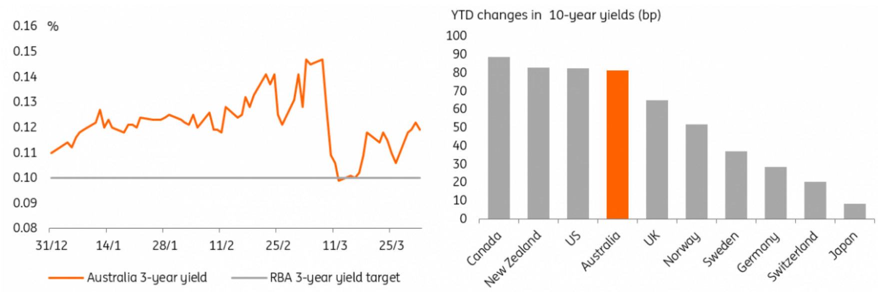
Bond concerns have eased

Next Tuesday, Australia's central bank meeting is likely to be one of those meetings we'll forget about pretty quickly. There will be no discussion about touching the cash rate; currently, at 0.10% and despite the bond purchase programme set to expire this month, the central bank has already announced that a new one worth AUD100bn will start immediately after.

In recent times, arguably, the biggest focus for the Reserve Bank of Australia has been the extremely volatile bond market. The pace of bond purchases spread across the curve initially proved ineffective in curbing the upside pressure to yields stemming from US bonds. The RBA intervened at the beginning of March by doubling its daily purchases and sent a clear signal that it intends to maintain a grip on yields.

As shown in Figure 1, recently, markets have been more reluctant to test the Bank's determination to defend its 0.10% three-year yield target. Despite some tendency to stay above target, three-year yields are closer to the 0.10% level than they used to be in February and early March.

Fig. 1 & 2 - Aussie bond market seems less concerned now



Source: Refinitiv, ING

On the long-end of the curve, the exposure to US yields suggests the headaches for Aussie bonds aren't over yet if – as our rates team expects – US bonds continue to underperform in the coming months. The RBA's purchases are spread across the yield curve, but its ability to control long-end yields is inevitably limited.

Anyways, so far, Aussie bonds don't really stand out as a particular underperformer among other G10 high-yielding countries in 2021 (Figure 2).

End of government's jobs support suggests lower-for-longer

The RBA has retained a dovish stance over the past few months, reiterating that to reach its inflation (2-3%) and employment (close to 4%) targets, a significant amount of monetary stimulus is required. Both measures had however shown some encouraging signs, with inflation rebounding to 0.9% and unemployment dropping to 6.8% in 4Q21.

A big contribution to limiting the impact of the pandemic on jobs in Australia (the peak in unemployment was limited to 7.5%) had come from the Jobseeker scheme, which subsidised businesses to keep paying wages throughout the pandemic. However, in a surprise move, the scheme (worth around 5% of Australian GDP) was not extended by the government and expired on 28 March, which is now expected to have a negative impact on the recovery as the Treasury estimates around 150,000 jobs could be lost.

Ultimately, this could challenge the RBA's forecast that the unemployment rate would drop to 6% by the end of 2021. The next forecast will be released at the May meeting, but for now, worsening expectations around the recovery path in the jobs market are likely to widen the perceived role of the RBA in providing continued support to the economy.

This is one of the reasons why any hawkish shift from the RBA appears highly unlikely in the short-term.

AUD: Central bank to remain unsupportive, but undervaluation may help

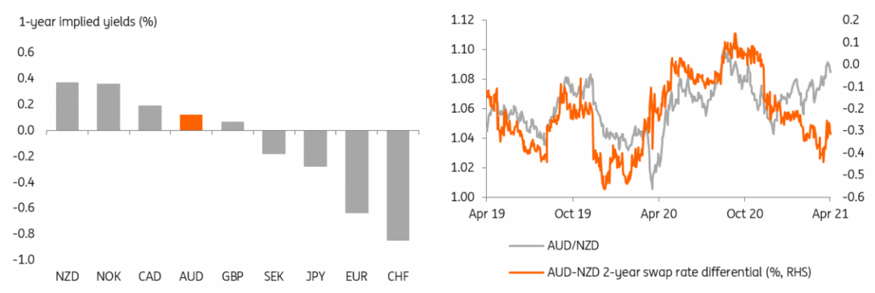
Markets are probably expecting the Bank to stick to its extremely dovish tone at next week's meeting and there are very low expectations about any hawkish signal in the short-run. In turn, we do not expect a reiteration of the lower-for-longer narrative to have a significantly negative impact on AUD next week.

> *AUD now presents the lowest implied yield in the G10 commodity bloc*

What is worth noting is that with rate expectations anchored (due to the RBA dovish stance and less upbeat expectations on the employment recovery) and the RBA having taken back control of three-year yields (currencies are naturally more sensitive to front-end rates), monetary policy looks unlikely to help AUD recover from its grim period.

AUD now presents the lowest implied yield in the G10 commodity bloc, as shown in figure three.

Fig. 3 & 4 - AUD rate attractiveness is rather low



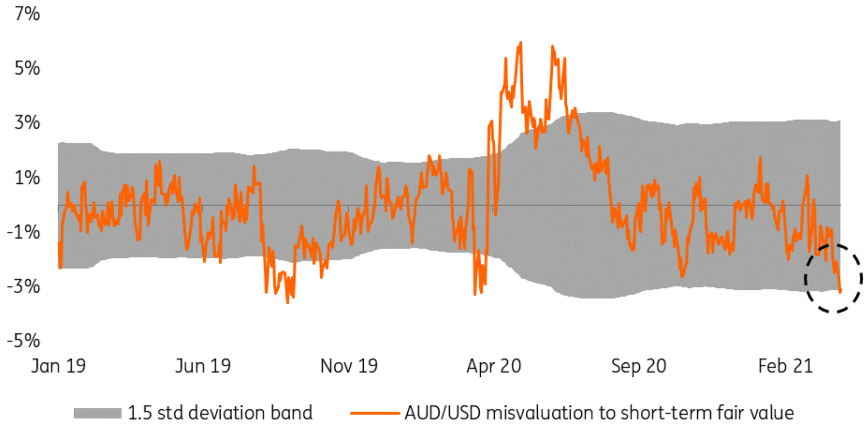
Source: Refinitiv, ING

This lower rate attractiveness of the AUD compared to its peers is still not evident in some FX dynamics, especially when it comes to the AUD/NZD cross rate, that appears to be trading at much higher levels than what the rate-differential would suggest (as shown in Figure 4)

Looking at AUD/USD, we note that the recent drop (3.3% over the past two weeks) was not fully warranted by a similarly-sized deterioration in the pair’s major short-term drivers. According to our short-term fair value model - which takes into account the short-term rate differential, the shape of the yield curve, relative equity performance, commodity prices and global risk appetite - AUD/USD is undervalued by 3.0%.

As shown in Figure 5, the mis-valuation is outside of the 1.5 standard deviation band, suggesting it is now at abnormal levels. This may imply, in turn, a more limited downside room for the pair in the short run.

Fig 5 - AUD/USD looks undervalued in the short-term



Source: ING

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