

Aussie Has Overreacted

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Summary Bullets

- The Reserve Bank of Australia (RBA) took a decisively more dovish tone in various communications this week. As a result, the Australian dollar fell roughly 2.1% on the week, which has wiped out all but about 0.7% of its spot gains on the year.
- The OIS curve has shifted lower and now prices in one rate cut during 2019.
- Global fundamentals are much more AUD-supportive than the local monetary policy fundamental. Correlated factors like base metals prices and ADXY argue for AUD strength.
- Our judgment is that AUD will fall below 0.70 if the RBA does cut. Absent that, we would expect AUD to drift higher in order to catch up to global fundamentals and because the rate cut that is priced in would eventually get priced back out. We like being long AUD on crosses and would highlight the EURAUD cross.

What Did the RBA Really Say?

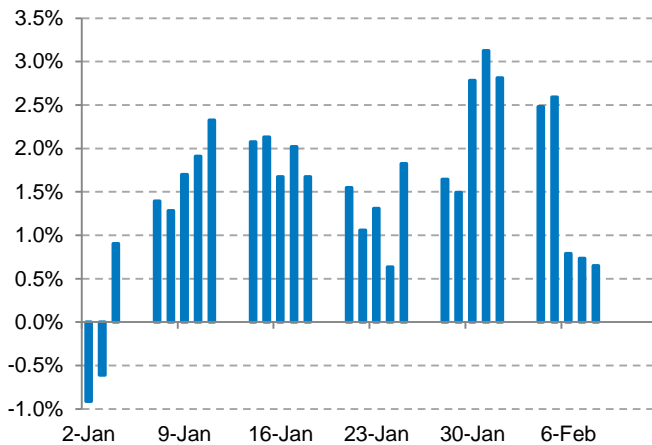
- The RBA took a dovish turn in a series of three communications to the market over this past week. That dovish turn accelerated as the week went on.
- The first communication was the General Media Release (GMR) accompanying the unchanged interest rate decision on Tuesday (local time). That document was fairly neutral in tone. It noted an increase in downside economic risks and the fact that low petrol prices would keep headline inflation in check, but didn't seem to make any type of switch from a soft tightening bias.
- Governor Lowe gave a major speech on Wednesday (local time) and that speech had a more dovish tone than the GMR. Governor Lowe highlighted the softness in the housing market and then went on substantially soften whatever tightening bias the RBA had. He said: "Looking forward, there are scenarios where the next move in the cash rate is up and other scenarios where it is down. Over the past year, the next-move-is-up scenarios were more likely than the next-move-is-down scenarios. Today, the probabilities appear to be more evenly balanced."
- On Friday the RBA released its quarterly Statement on Monetary Policy and accompany forecasts. The closing paragraph of the Statement says: "In light of recent data and inherent uncertainties...the probabilities of these two sets of scenarios (hot economy/cold economy) have shifted to be more evenly balanced than previously. The Board therefore does not see a strong case to adjust the cash rate in the near term."
- The RBA's key forecast changes from the Statement were as follows: The 2019 GDP forecast was cut to 3.0% from 3.3% in November. The 2019 Total CPI inflation forecast was cut to 1.7% from 2.3%. The 2019 Trimmed Mean CPI inflation forecast was cut to 2.0% from 2.2%.

Aussie and AUD Rates have Reacted Sharply

- The market reaction to the RBA communication has been swift and violent—particularly in the FX market. As shown in [Figure 1](#), AUD has given back almost all of the gains it had shown in 2019. For the week, AUD is down 2.2% (as we write on Friday morning in North America).

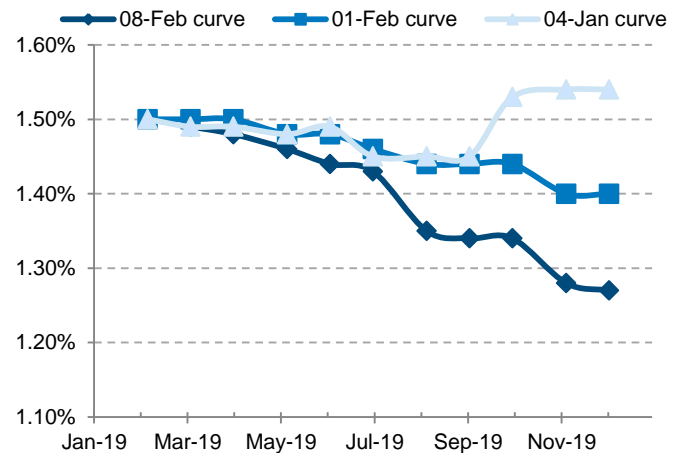
- The reaction in the rates market is to price in one rate cut by the RBA by the end of 2019. A tiny possibility of a late-2019 rate cut has been priced into the curve since December, but the result of this week's communication is a forward OIS rate for the December 3 RBA rate decision that is 13bps lower than it was a week ago (see [Figure 2](#)).

Figure 1: YTD spot return for AUD



Sources: BMO CM, Bloomberg

Figure 2: Australian dollar OIS curves

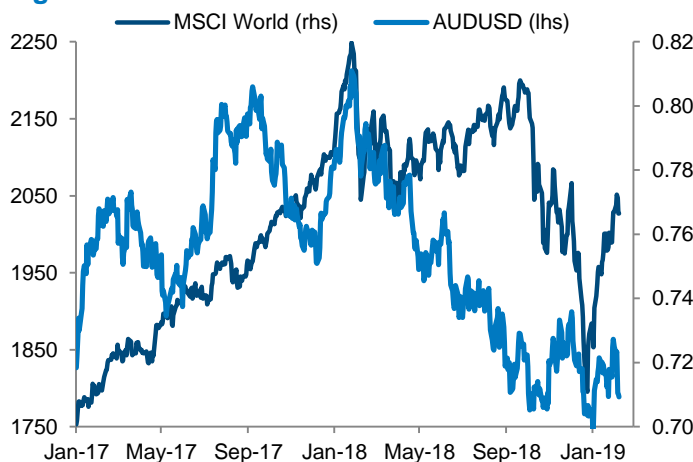


Sources: BMO CM, Bloomberg

Global Fundamentals Paint a Different Picture than AUD's Kneejerk Response...

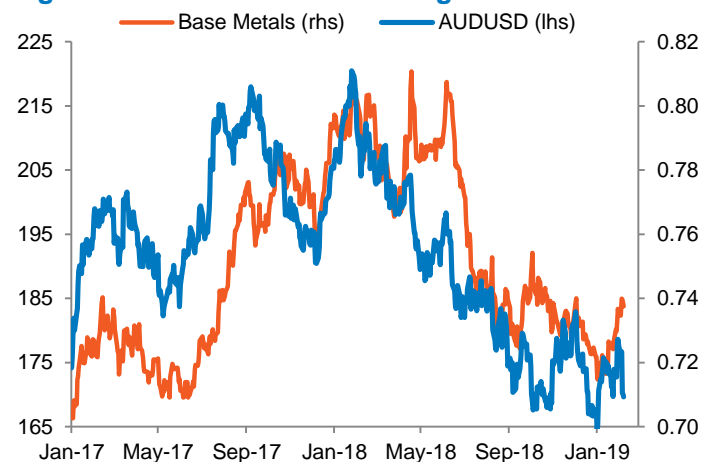
- Like most currencies, the movements in AUD stem from a variety of local and global factors. When there is interesting local news, that news can take over and drive AUD movement for a week or two. But in periods when local news is sparse (which is most of the time for AUD), global factors tend to dominate.
- The global factors that tend to drive the AUDUSD exchange rate are risk appetite, commodity prices, sentiment toward the Asia-Pacific regional economy and the 'big dollar' (USD index).
- One proxy of risk appetite is simply just the level of the MSCI equity index. The AUDUSD exchange rate has somewhat of a mapping with AUDUSD over the past several years. The sharp drop in MSCI World during December of 2018 corresponded with a decline in AUDUSD. However, while MSCI World has almost fully retraced its decline since early-December, AUDUSD is running behind, as shown in [Figure 3](#).

Figure 3: AUDUSD and MSCI World



Sources: BMO CM, Bloomberg

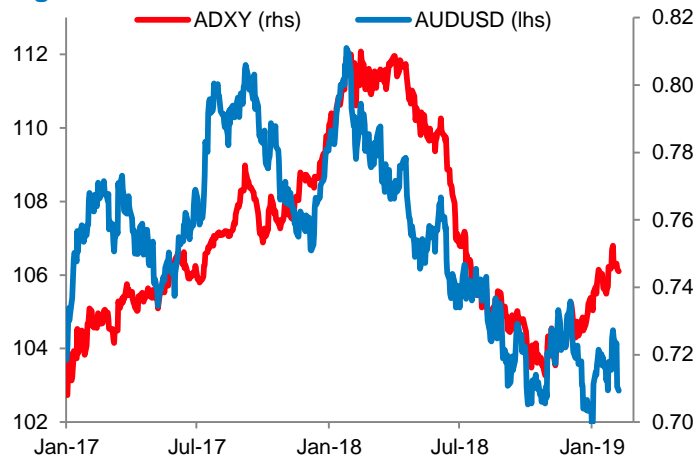
Figure 4: AUDUSD vs Bloomberg Base Metals Index



Sources: BMO CM, Bloomberg

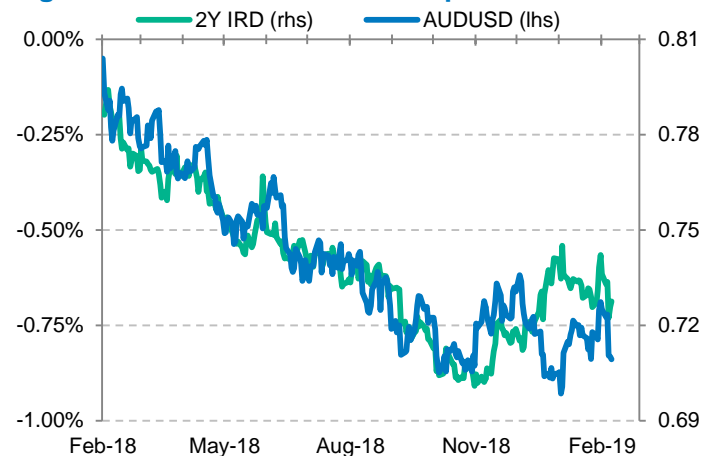
- The correlation between AUDUSD and the Bloomberg Base Metals Index is much tighter than AUDUSD's correlation with MSCI World. As shown in [Figure 4](#), the tiny rally in AUDUSD this year also trails the base metals move.
- AUDUSD also has a reasonable mapping with the ADXY index of local Asian currencies. As shown in [Figure 5](#), AUDUSD has underperformed ADXY over the past few months. We would argue that AUD now appears substantially cheap relative to that index.

Figure 5: AUDUSD and ADXY



Sources: BMO CM, Bloomberg

Figure 6: AUDUSD vs its 2Y Swap Rate Differential



Sources: BMO CM, Bloomberg

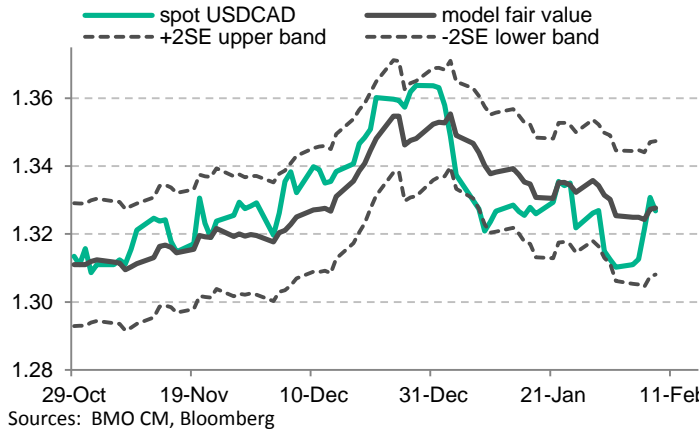
- It's not nearly as definitive of a case, but we'd even say that AUDUSD is a bit rich relative to interest rate differentials. As shown in [Figure 6](#), the discount in AUD-denominated swap rates relative to USD-denominated rates is about the same place that it was after the Fed's December rate hike. Yes, the AUD 2Y swap rate is down 18bps over that interval, but so is the USD 2Y swap rate. And while the AUD OIS curve prices in almost a full hike by the end of 2019, the USD OIS curve also prices in the possibility of a cut.

How We Would Trade it From Here

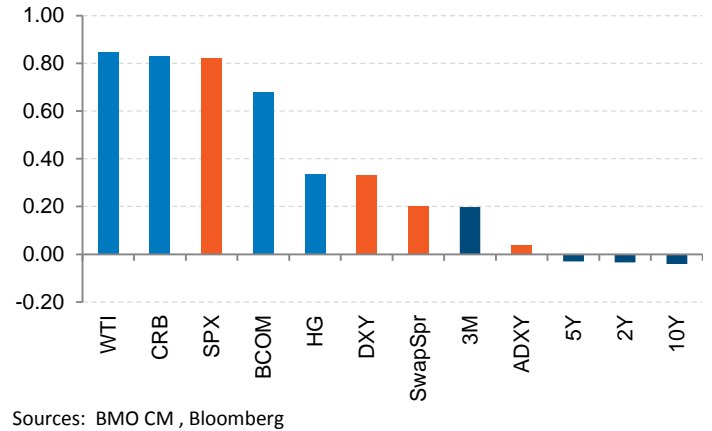
- Our read on the market reaction to the RBA communications is that there has been a moderate overreaction in rates and a slightly bigger overreaction in FX.
- We think that it is highly unlikely that the RBA would cut its base rate in 2019 if the Fed doesn't, which is basically what is priced into rates and FX markets. Although we admit that AUDUSD would probably move to something like 0.66 if that were to happen.
- We also think it is unlikely that the market moves to pricing in 2-3 more rate cuts from the RBA than from the Fed. Such a scenario would probably push AUDUSD to 0.68, but we wouldn't give it more than a 10% probability. In fact, the next big Australian data release (Q4 GDP) is more likely to cause the rates market to price out any 2019 cuts in our view.
- We think that it is more likely that the RBA hikes in conjunction with the Fed at some point late in 2019 than that the RBA cuts. And in fact, if you read their statement on the balance of risks carefully, that's what Lowe and the RBA said. The phrase "**more** evenly balanced" does not mean 'evenly balanced.' It simply means that the tightening bias is softer.
- So with all that said, we'd be a buyer of AUD on crosses. We highlight short EURAUD as an interesting trade at this juncture, with a target of that pair reaching 1.55 in the next 3M.

Additional FX charts

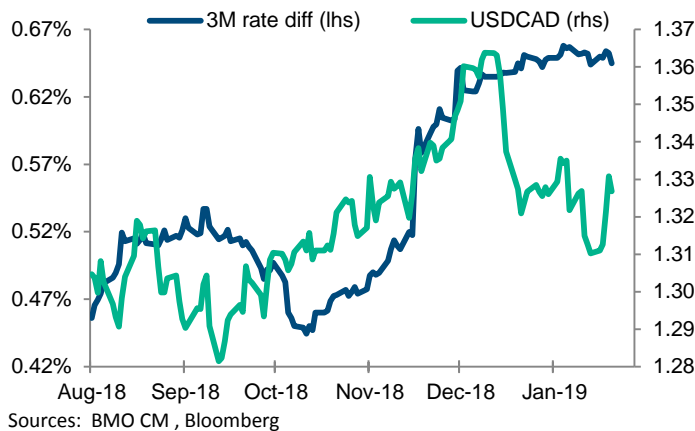
USDCAD spot and BMO model's financial fair value



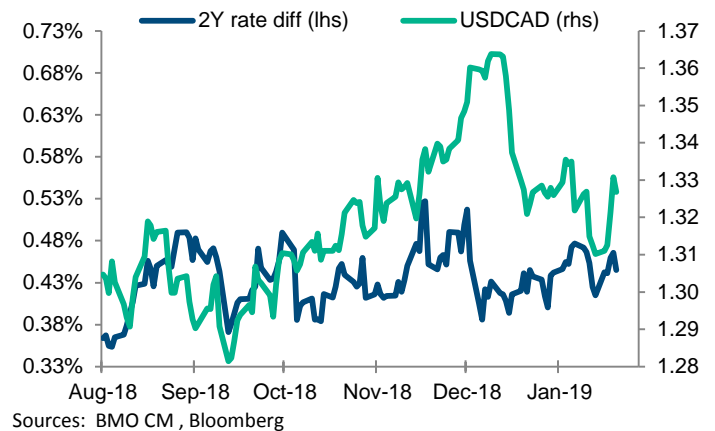
3M out-of-sample R2 of variables against USDCAD



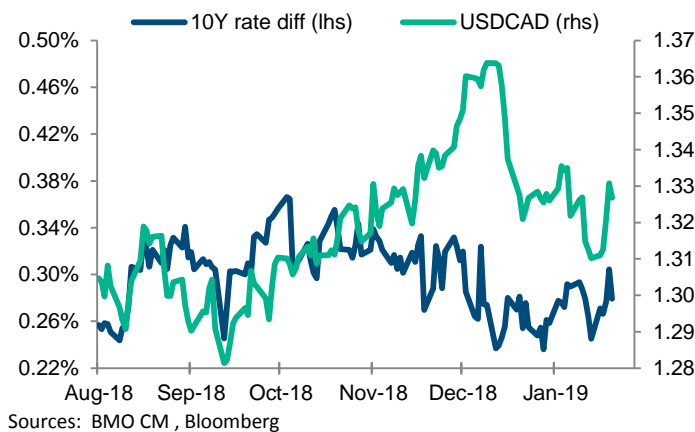
USDCAD and the 3M OIS interest rate differential



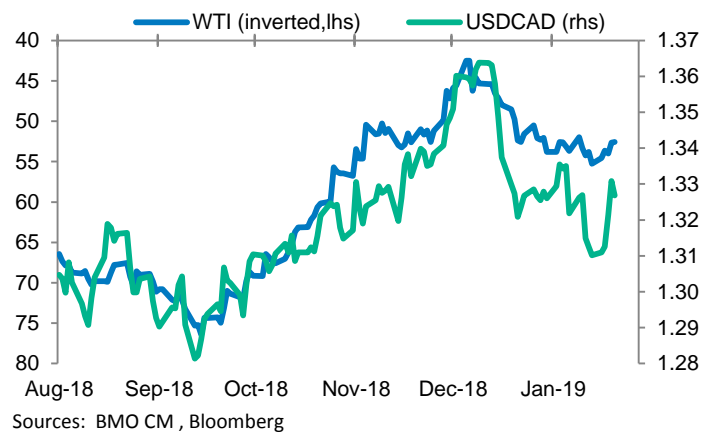
USDCAD and the 2Y swap rate differential



USDCAD and the 10Y swap rate differential

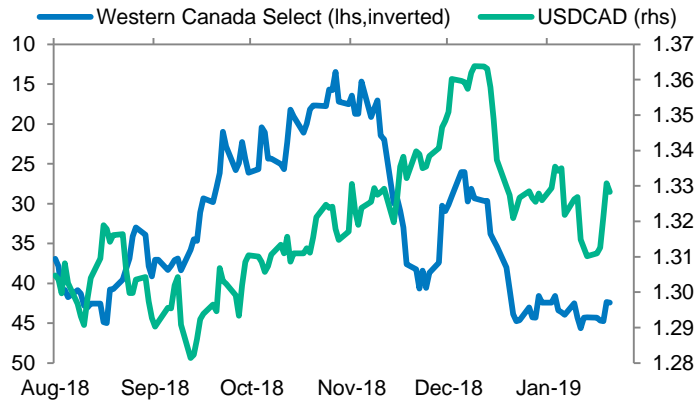


USDCAD and front-future WTI crude

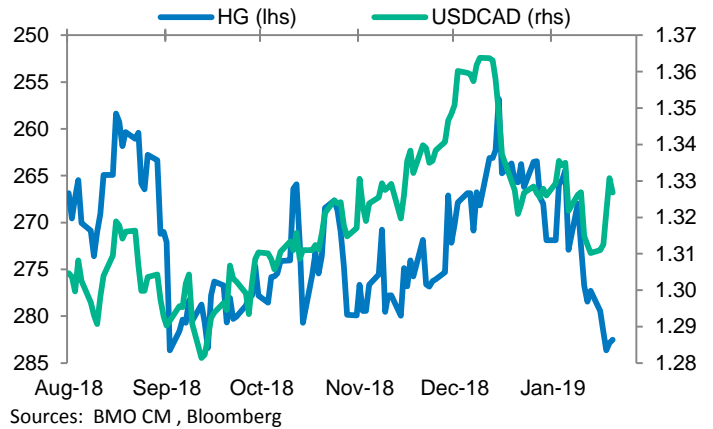


Additional FX charts

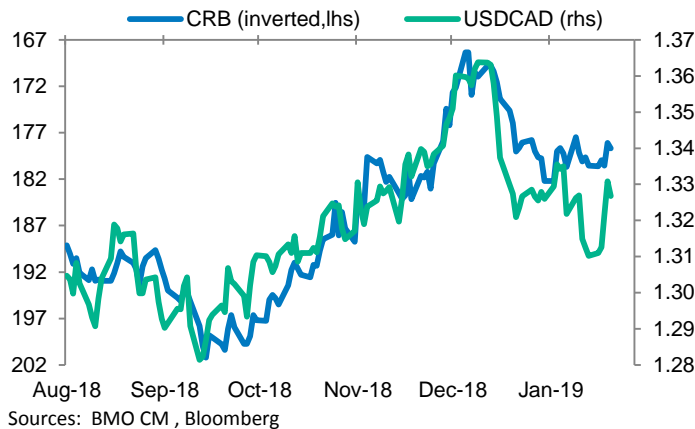
USDCAD and spot WCS-grade crude



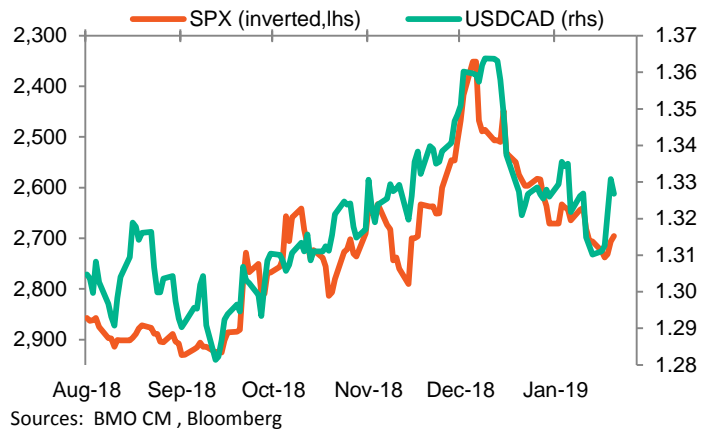
USDCAD and front-future copper



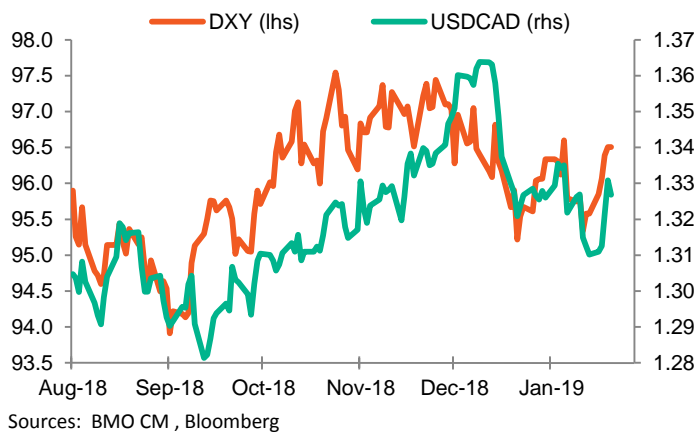
USDCAD and the CRB commodity price index



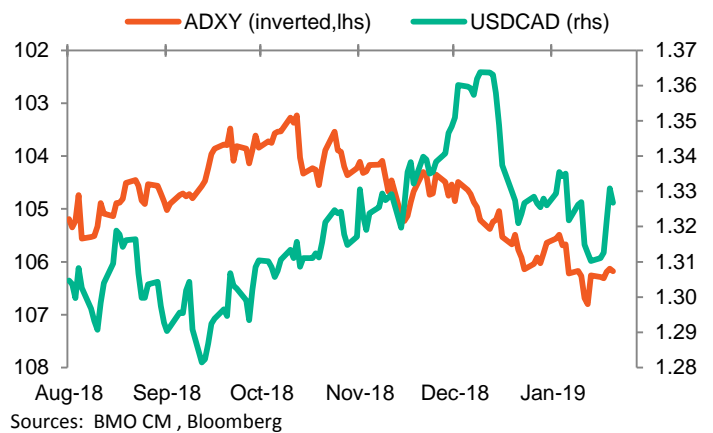
USDCAD and the S&P 500



USDCAD and the DXY dollar index

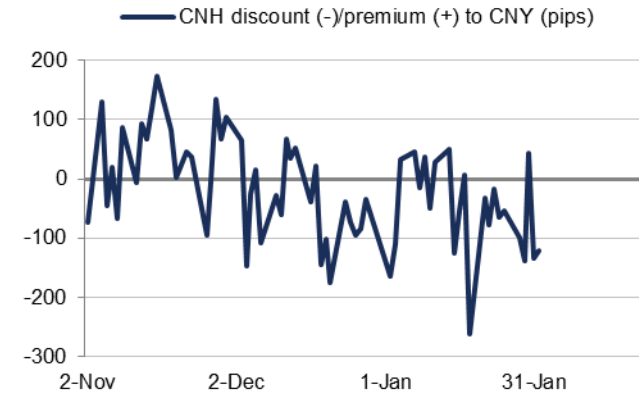


USDCAD and the ADXY Asian currency index

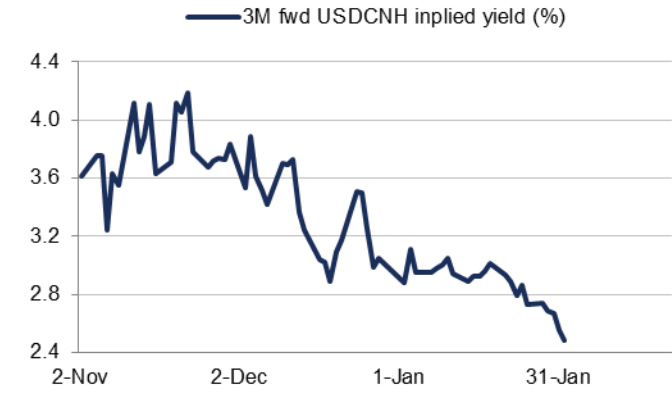


Additional FX charts

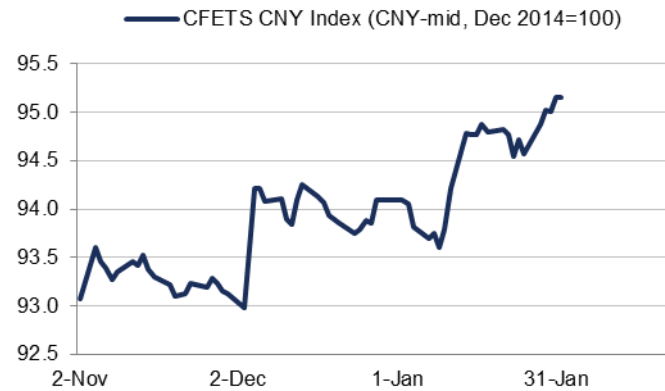
Spot USDCNH/USDCNY differential



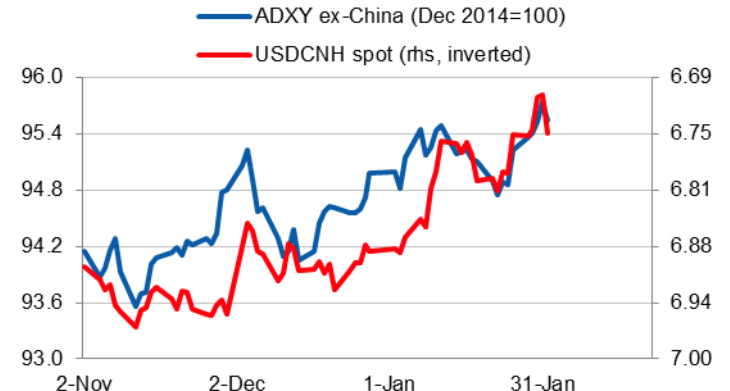
3M forward USDCNH implied yield



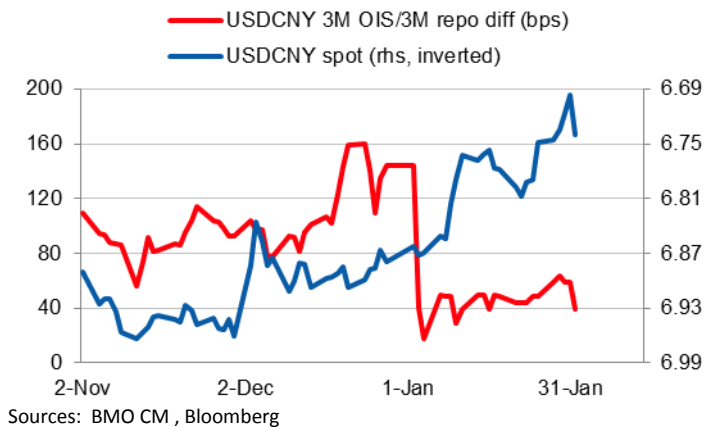
CFETS CNY Index (-90 calendar days)



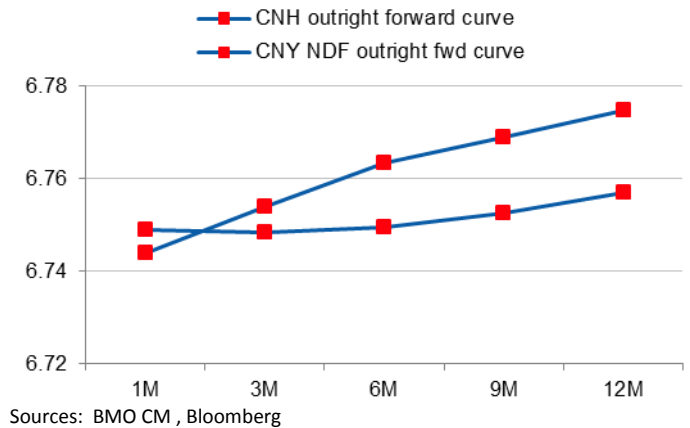
ADXY Index (ex-China) vs USDCNH spot



USDCNY spot vs USD-CNY 3M rate diff

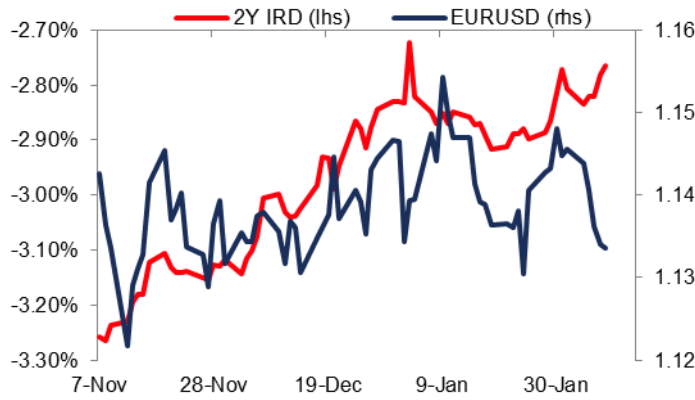


USDCNH and USDCNY NDF outright fwd curves

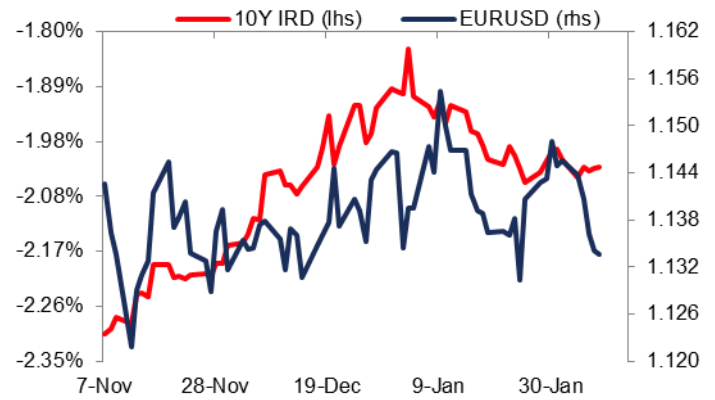


Additional FX charts

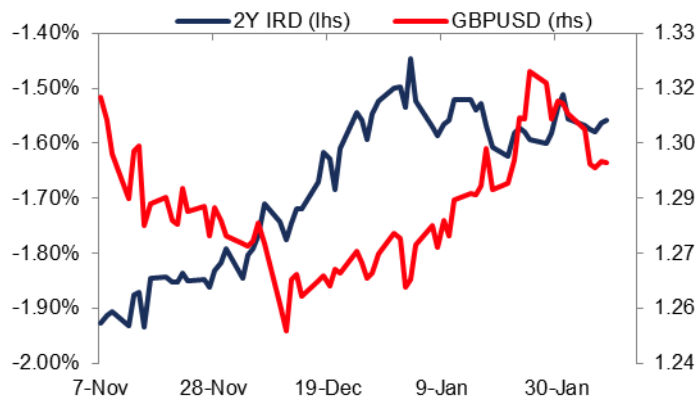
EURUSD and its 2Y swap rate differential



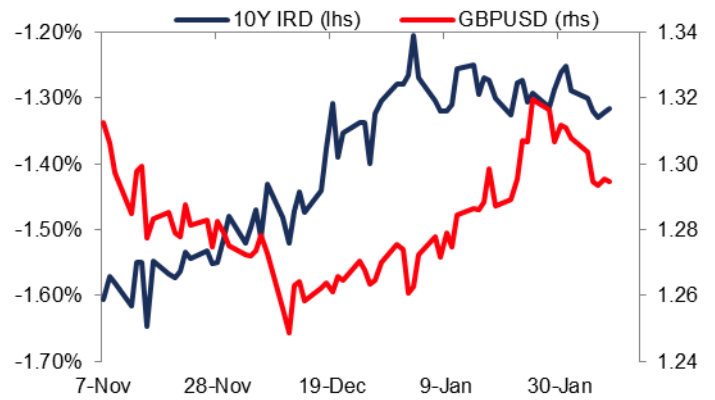
EURUSD and its 10Y swap rate differential



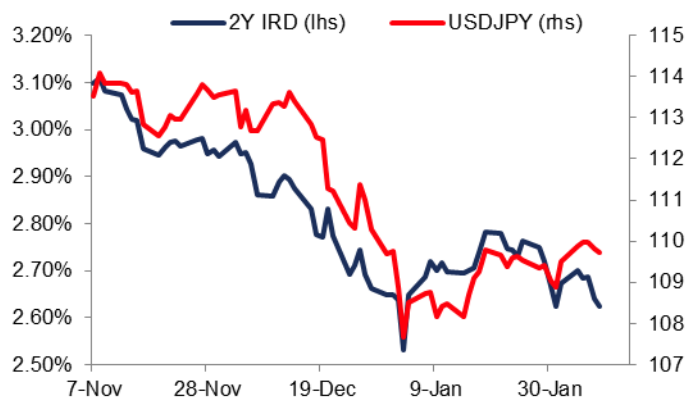
GBPUSD and its 2Y swap rate differential



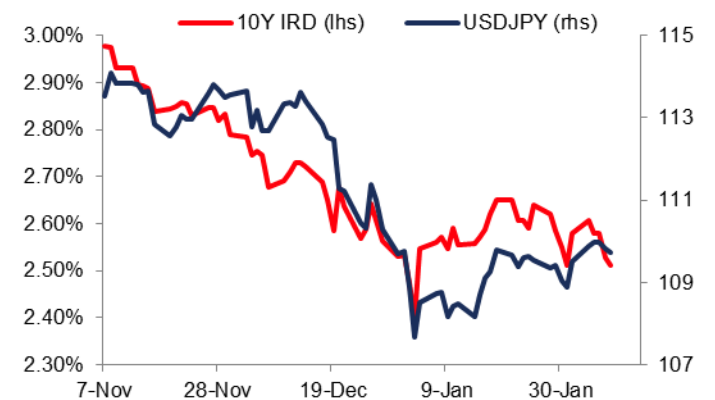
GBPUSD and its 10Y swap rate differential



USDJPY and its 2Y swap rate differential

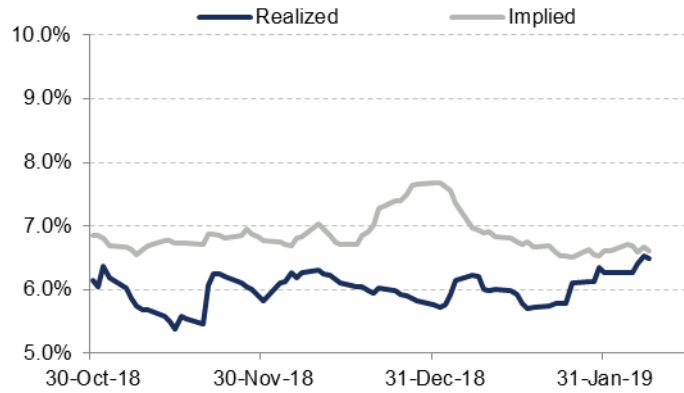


USDJPY and its 10Y swap rate differential



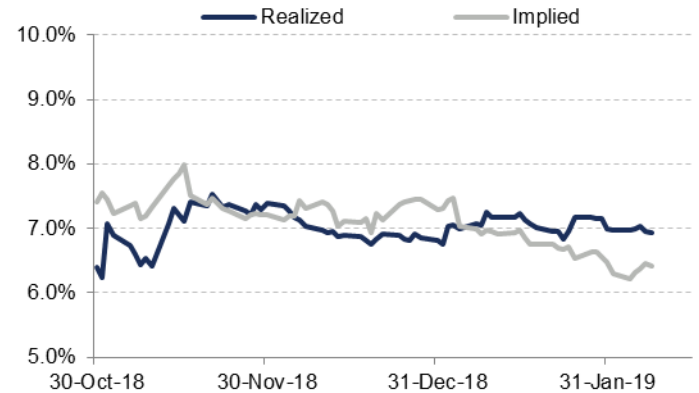
Additional FX charts

USDCAD 3M realized and implied volatility



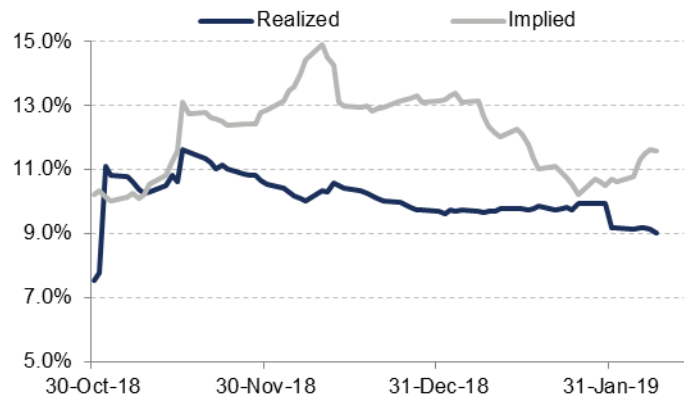
Sources: BMO CM , Bloomberg

EURUSD 3M realized and implied volatility



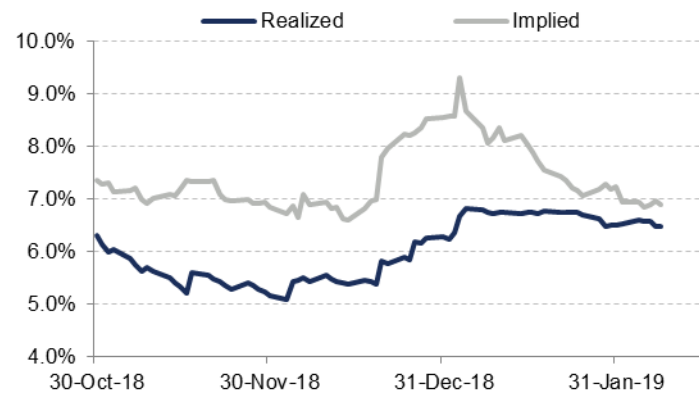
Sources: BMO CM , Bloomberg

GBPUSD 3M realized and implied volatility



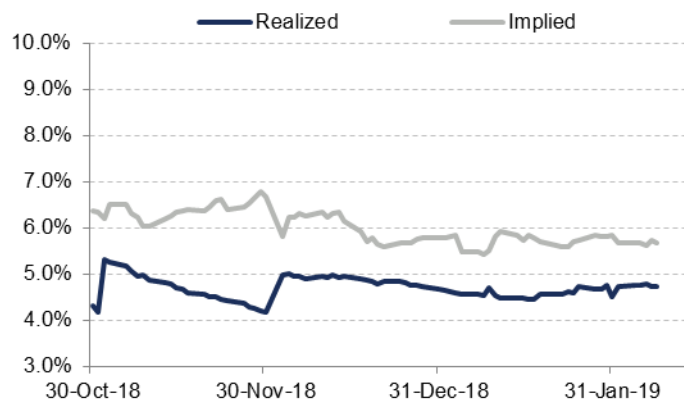
Sources: BMO CM , Bloomberg

USDJPY 3M realized and implied volatility



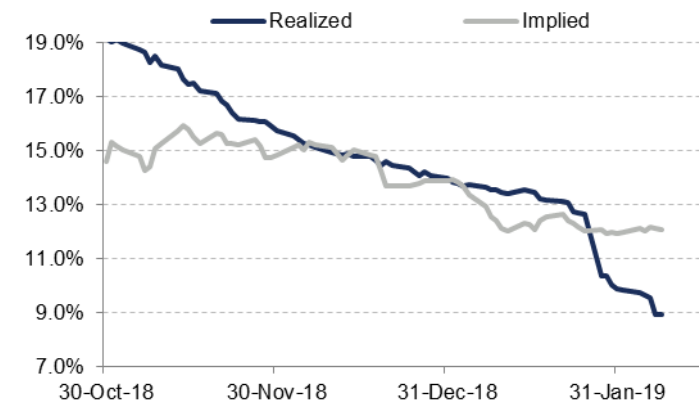
Sources: BMO CM , Bloomberg

USDCNH 3M realized and implied volatility



Sources: BMO CM , Bloomberg

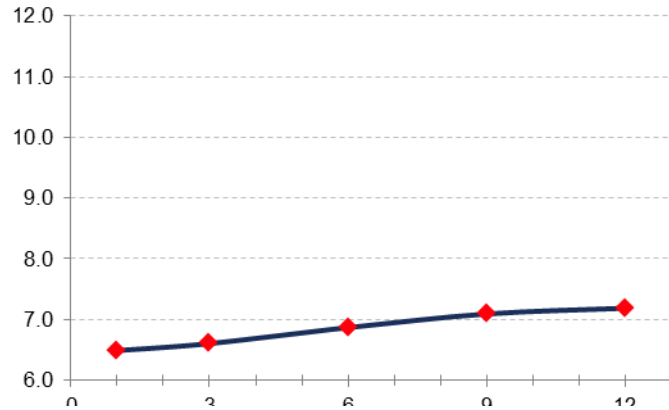
USDMXN 3M realized and implied volatility



Sources: BMO CM , Bloomberg

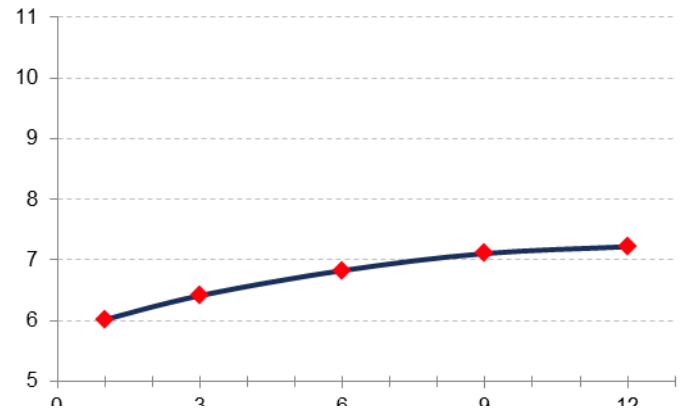
Additional FX charts

USDCAD implied vol curve



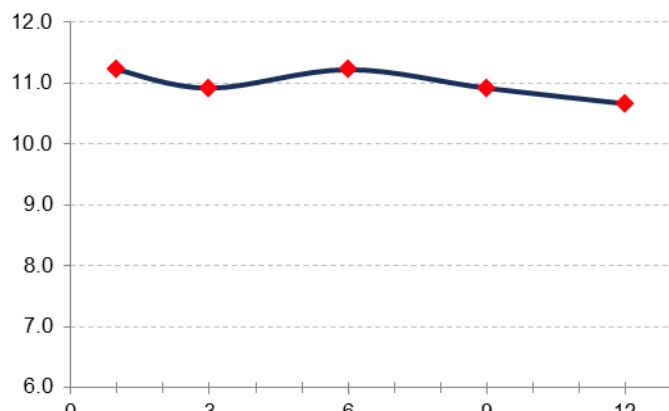
Sources: BMO CM , Bloomberg

EURUSD implied vol curve



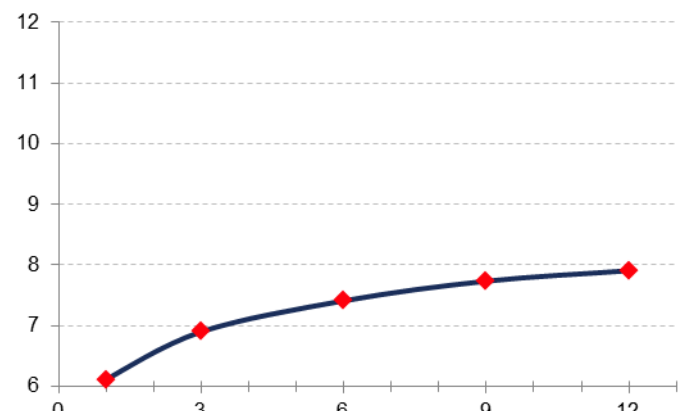
Sources: BMO CM , Bloomberg

GBPUSD implied vol curve



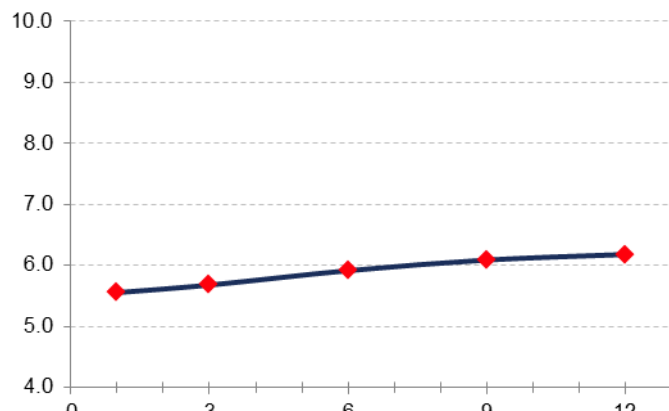
Sources: BMO CM , Bloomberg

USDJPY implied vol curve



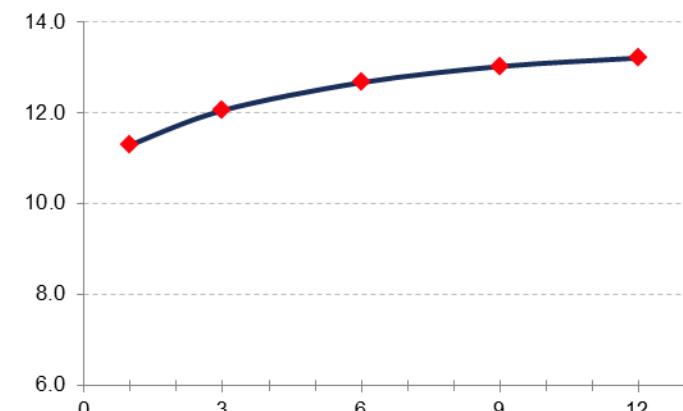
Sources: BMO CM , Bloomberg

USDCNH implied vol curve



Sources: BMO CM , Bloomberg

USDMXN implied vol curve



Sources: BMO CM , Bloomberg

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