The A$ ascent: pausing for breath after a steep climb

Our weekly view on Asset Allocation

28 June 2021

Issued by Wilsons Advisory and Stockbroking Limited (Wilsons) ABN 68 010 529 665 - Australian Financial Services Licence No 238375, a participant of ASX Group and should be read in conjunction with the disclosures and disclaimer in this report.

Australian dollar pausing

The A$ has had a good 12 months against the US$ (appreciating c. 10%). However, the Aussie has retreated from its cycle high over the last few months.

This past week saw the A$ rapidly lose a couple of cents, although it has since regained some ground to sit just under 76c at the time of writing.

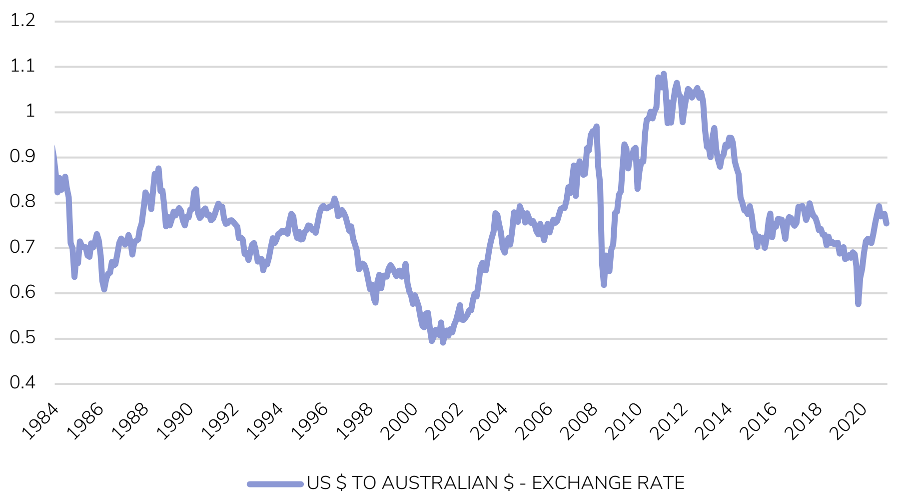
The most recent catalyst for a softening in the A$ was the US Fed, who surprised markets with more hawkish, or perhaps more accurately less dovish, comments around its outlook for inflation and the likely timing of rate hikes.

Specifically, the Fed's guidance for the timing of rate hikes shifted from lift-off in 2024 to two rate hikes in 2023. In response, the US$ rose against most currencies, as did the short-end of the yield curve. Cyclical sectors and other cyclical assets such as commodities and the A$ generally fell in response.

Markets have stabilised in recent days on the realisation that the Fed is still in a very accommodative mindset; however, this incremental shift in Fed thinking probably means the US$ will remain well supported in coming months.

The A$ had already begun to ease over the last couple of months on the back of relatively hawkish comments from other central banks such as the Bank of New Zealand and the Bank of Canada. In contrast, the RBA has remained on a relatively dovish track, though the RBA's early July meeting will provide more guidance around how it is viewing the policy cycle. The RBA is expected to provide more guidance around its QE program. We don't think this will have major implications for the A$. Still, a moderately hawkish surprise can't be ruled out given the shifts we are seeing from other central banks lately, and the stronger than expected domestic economic data, such as the lower than anticipated 5.1% unemployment rate for May.

Exhibit 1: The Australian Dollar rise looks to be pausing for now



Source: Refinitiv, Wilsons

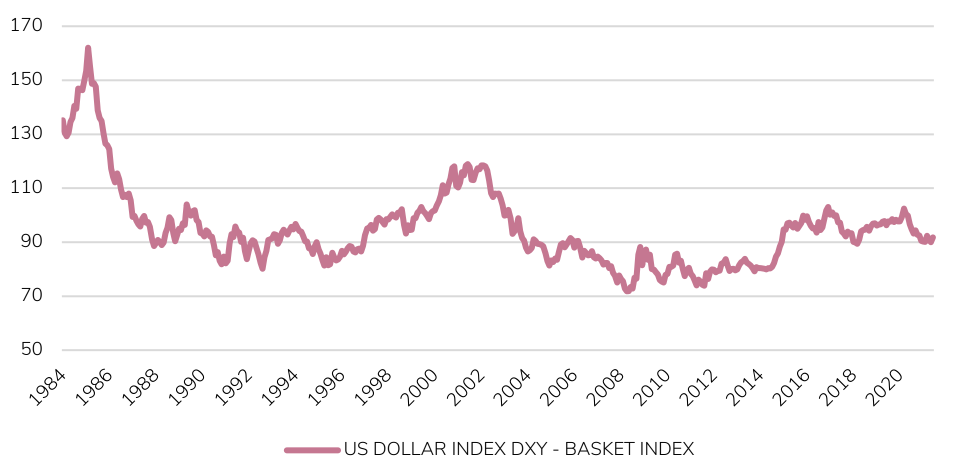
The bigger picture on the US$

The US$ is likely to receive some near-term support driven by relative optimism on the US economy as well as the recent incrementally hawkish shift from the Fed on the rate outlook.

Longer term, our view remains that the US$ likely entered a multi-year downtrend beginning in 2020.

The US$ has a history of going through multi-year bull and bear phases. While the US$ could quite possibly be firm over the next few months, we doubt we are on the verge of a major break to the upside.

Exhibit 2: The US$ Index has tended to move in multi-year waves



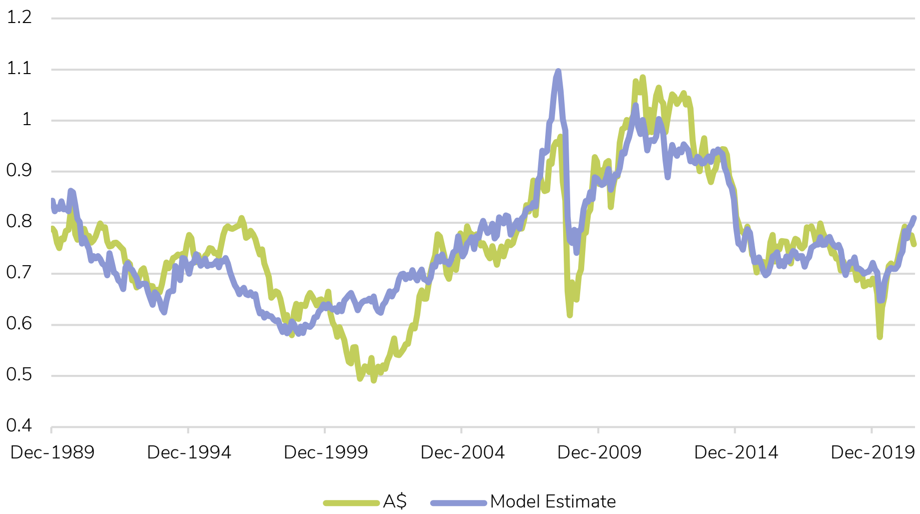
Source: Refinitiv, Wilsons

We continue to see incremental drivers of medium-term dollar weakness in the form of an extended period of above-trend global growth (typically dollar bearish), very heavy US bond issuance (to fund the huge fiscal deficit), and a persistently sizeable current account deficit.

The A$ will likely participate in this broad appreciation trend versus the US$ over the medium-term, albeit the recent pause in the uptrend could extend for a while.

A noteworthy consideration is that the A$ is no longer clearly cheap. The Aussie is now right in line with its simple post-float average of 76c. Longer term fair value measures, such as purchasing power parity (PPP) models, have the A$ on the moderately expensive side of fair value. However, history has shown that the A$ can depart from PPP fair value for years at a time. The 20-year range for the A$ the has been 50c to $1.08, so the A$ has shown a tendency to depart from its long-term centre of gravity for multiple years at a time. We note that our dynamic fair value model based on current interest rate differentials and commodity prices suggests a fair value currently of just over 80c. So, on balance, we still see some upside in the A$.

Exhibit 3: Australian Dollar fair value model - looking moderately undervalued



Source: Refinitiv, Wilsons

The risks to our positive A$ view

We see 3 potential risks to our constructive medium-term A$ view.

1. A rise in global risk aversion

The US$ tends to act as a safe haven currency, while the A$ tends to do well in "risk-on" or reflationary periods. This has largely been the backdrop of the past year. However, we can't rule out a significant rise in risk aversion. We do seem overdue for some correction in risk assets, albeit we still believe the 12-month outlook should favour a degree of "risk-on" positioning given the prospect of a substantial recovery in the global economy at a time of still very low interest rates.

2. Delayed global re-opening could deflate the reflation trade

A key tenant of our still constructive view on risk assets and the A$ is the prospect of progressive global re-opening driving an increasingly strong global growth cycle that will also support commodity prices. If the global vaccine rollout falters and/or COVID variants render vaccines less effective, re-opening may be hampered, and growth estimates may need to be revised down. While this is not our central case, such a scenario could encourage a move out of the A$.

3. The Fed turns genuinely hawkish

We don't see the shift in Fed guidance around interest rates as a dramatic shift in mindset. However, the Fed has, in effect, flagged that its policy intentions are not set in stone. The Fed may become incrementally more hawkish in response to more evidence of strong growth and higher than expected inflation. The Fed and the market could bring forward its view of rates rises into 2022 (the first rise is now priced for January 2023). Once again, this is not our central case.

We think the Fed will do its best to hold the line on no rise until 2023, but an incrementally more hawkish shift can't be ruled out, which would likely buoy the US$.

A$ rise: pausing not punctured

We remain constructive on the A$'s 6 to 12-month prospects, with the prospect of further global re-opening and an above-trend growth environment, typically bearish for the U$ and bullish for commodity-driven/risk on currencies such as the A$. We keep our year-end target of 80c, which suggests retaining at least some partial currency hedging for global portfolios.

We have likely entered a range-trading environment in the near-term, as the US$ finds some support from a somewhat more hawkish Fed. However, the prospect of a strong and sustained global recovery alongside burgeoning US twin deficits should pressure the US$ lower over the next couple of years.

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