Mizuho Brief: AUD

Economics & Strategy | Asia ex-Japan

15 Jan 2025 | Vishnu Varathan | Head Macro Research, Asia ex-Japan

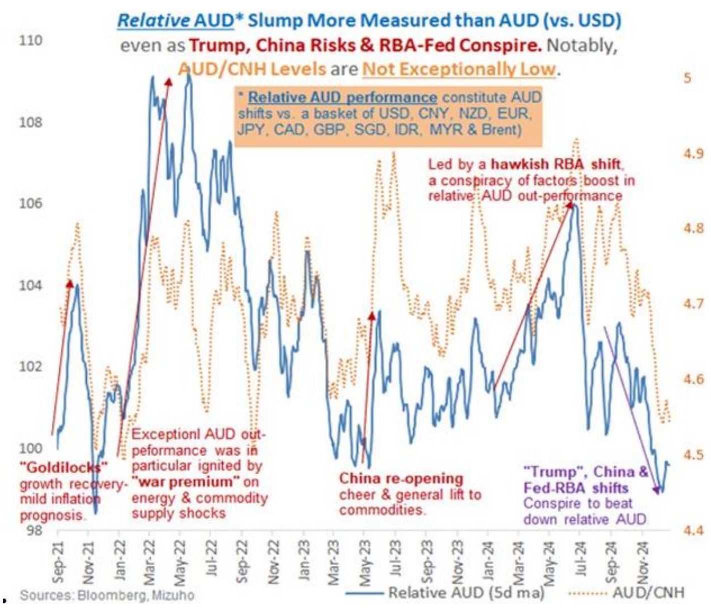
Why AUD Bears Will Not Intimidate the RBA

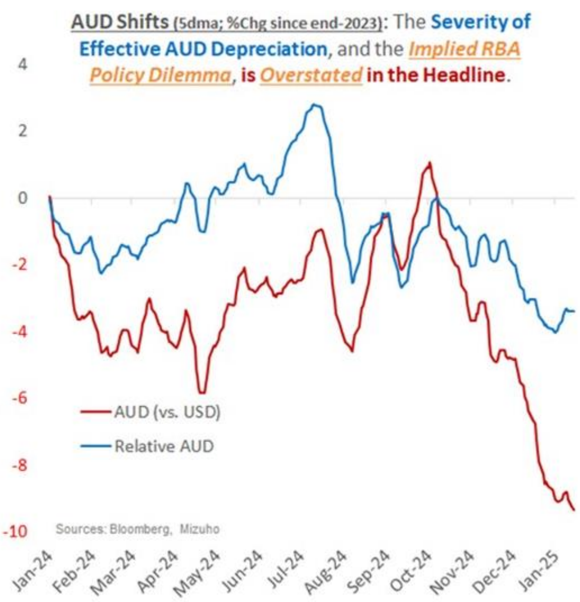
"Your focus determines your reality" - ***Qui-Gon Jinn in Star Wars: Episode I – The Phantom Menace.***

In a Nutshell:

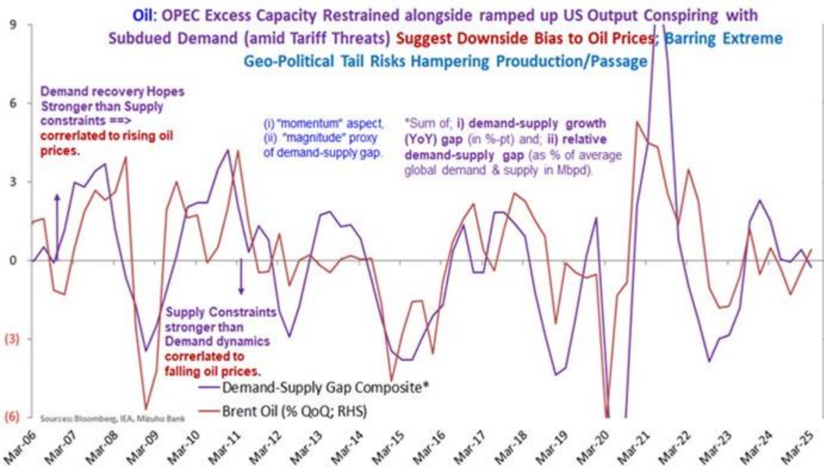
- **Sharp AUD depreciation challenges**, ***but does not incapacitate,*** **the RBA** (in terms of scope to ease). The **RBA's focus is growth-inflation dynamics**, ***not the AUD*** *(even if it is of some concern).*
- For one, **imported inflation risks from AUD drop are exaggerated** by bilateral AUD-USD shifts,
- What's more, **tradable inflation is assuring subdued** further diminishing the risks of inflation flaring up. Especially as **underlying dis-inflation dynamics are intact**. More so, as **subpar growth and fragile underlying consumer dynamics dampen demand-pull risks** further.
- Notably, **real rate spread pick-up** from Fed's front-loaded easing alongside more **advantageous (to AUD)** inflation dynamics **provides RBA doves with sufficient cover**.
- RBA Outlook: **Rate cuts set for no later than April**, with *February a distinct option.* ***Risks tiled to more, not fewer cuts***, vis-à-vis our **call for a cumulative 75bp of cuts in 2025**.
- AGB Yields: Consequently, front-end (3Y) yields could head towards 3.1-3.4%, with 10Y set for 4.0-4.2%, **entailing some bull steepening**; possibly mildly accentuated on fiscal slippage.
- AUD: Partial recovery to 0.68 by late-2025/early-2026 ***subject to near-term accentuation of downside risks****;* assuming initial intensification of Trump-China-Fed risks scale back to reveal some relief.
- Structural Caveat for AUD: Lower commodity demand multipliers from China stimulus though could stymie a fuller recovery consistent with past China stimulus.

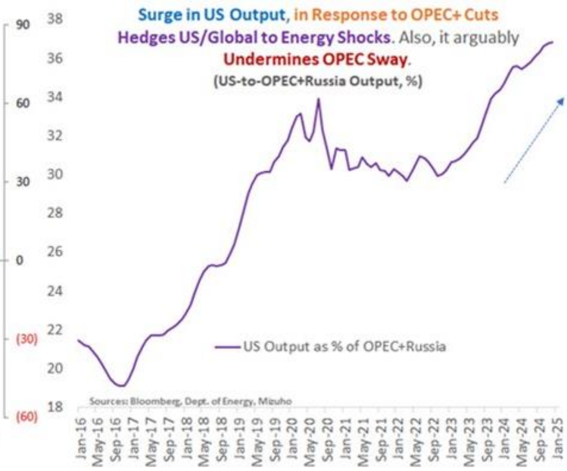
- A **brutally bearish turn in the AUD** (down 10-11% since end-Sep 2024) to sub-0.62 **will inconvenience**, ***but not intimidate***, the emerging **RBA doves *(into inaction)***.
- After all, **the RBA's distinctly dovish shift**, (although still conditional on disinflation not being derailed) is **validated by** a **confluence of less sticky inflation** and a **sobering shortfall in growth**.
- ***But*** the **trouble is**, the **RBA's shift has coincided with** a **sharp and sustained drop in AUD** (to test 61 cents), which typically threatens to **complicate plans for easing**.
- And to be sure, *imported inflation risks re-introduced by AUD plunge of this magnitude* (10-11% since end-Sep 2024 and nearly-5% in just Dec), *simply cannot be dismissed.*
- *Nonetheless,* **concerns of AUD bears hijacking RBA doves are overblown** on five counts.



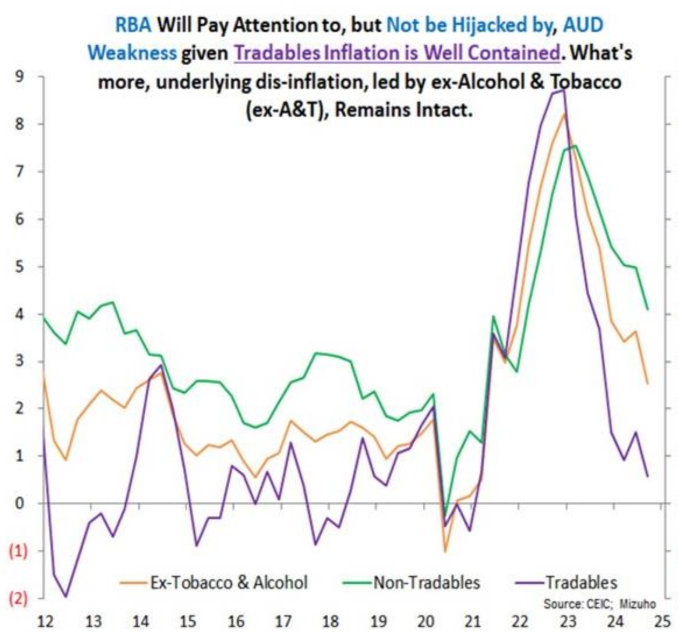


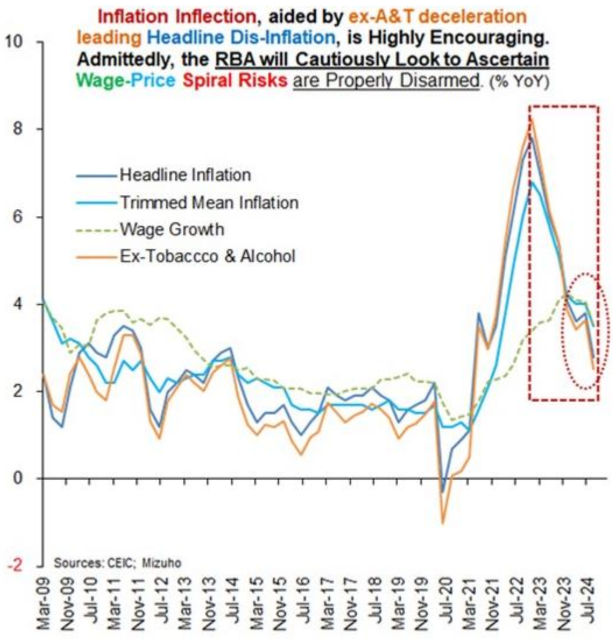
- Wider Russian Sanctions: Brent crude has jumped over $80/bbl in response to **significantly widened net of sanctions on Russia's oil** exports – hitting ***shipping*** , ***trading*** and ***insurance****.*
- Supply Crimp Fears: The **bullish (**crude) **price reflex**, presumably ***driven by fears supply being materially crimped*** (to the order of 500K-800KBpd) for is **wholly justified**. And *may be more upside shocks left.*
- But Not a Game-Changer: *But* the **grander demand-supply dynamics** are still shaping up for **relatively stable**, ***not soaring,*** **oil prices.**
- Five Key Mitigating Factors: To be sure, geo-political shifts continue to pose a serious upside risk to oil. But there are five mitigating factors to quell fears of unremitting bullish trend in oil.



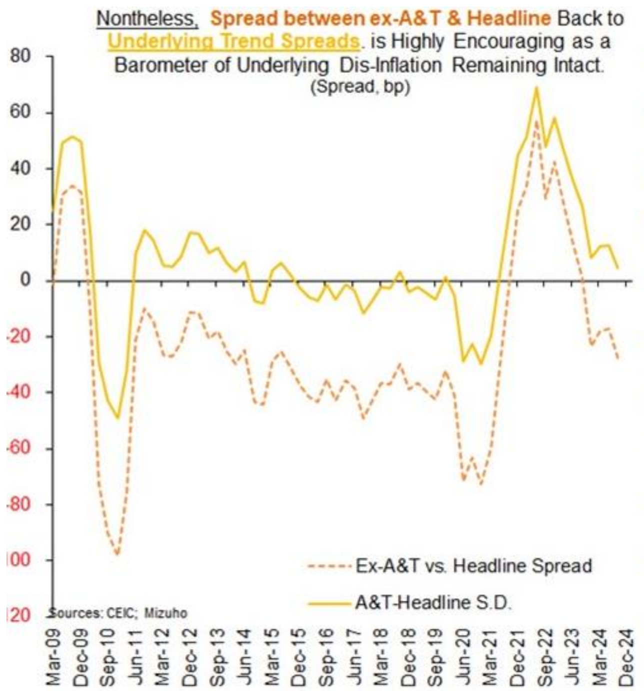


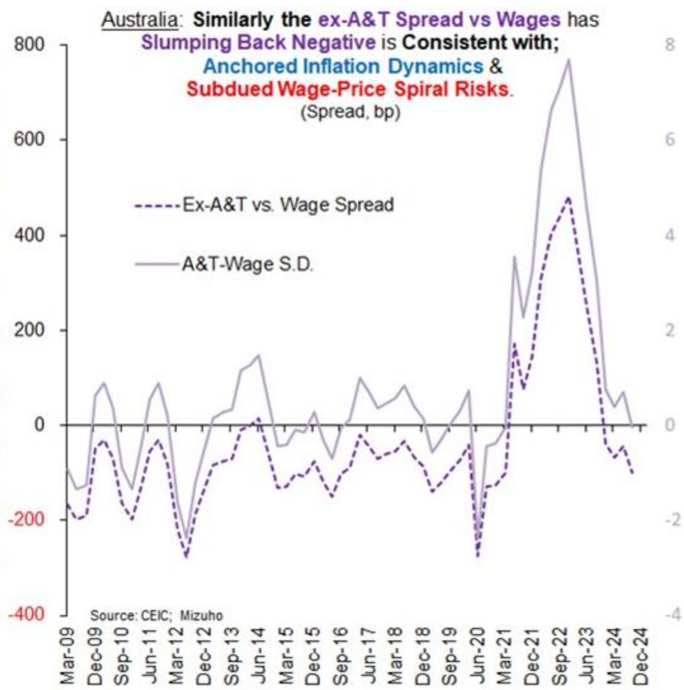
- First, **headline AUD drop** (vis-à-vis the USD) **overstates the effective imported inflation risks** insofar *that relative AUD pullback* (against a wider, more import-relevant basket) is *materially more measured *.*
- Second, and crucially, the **threat of resurgent inflation on account (more diminished) relative AUD stumbles** is **still exaggerated** given that *tradables inflation is much more subdued.*



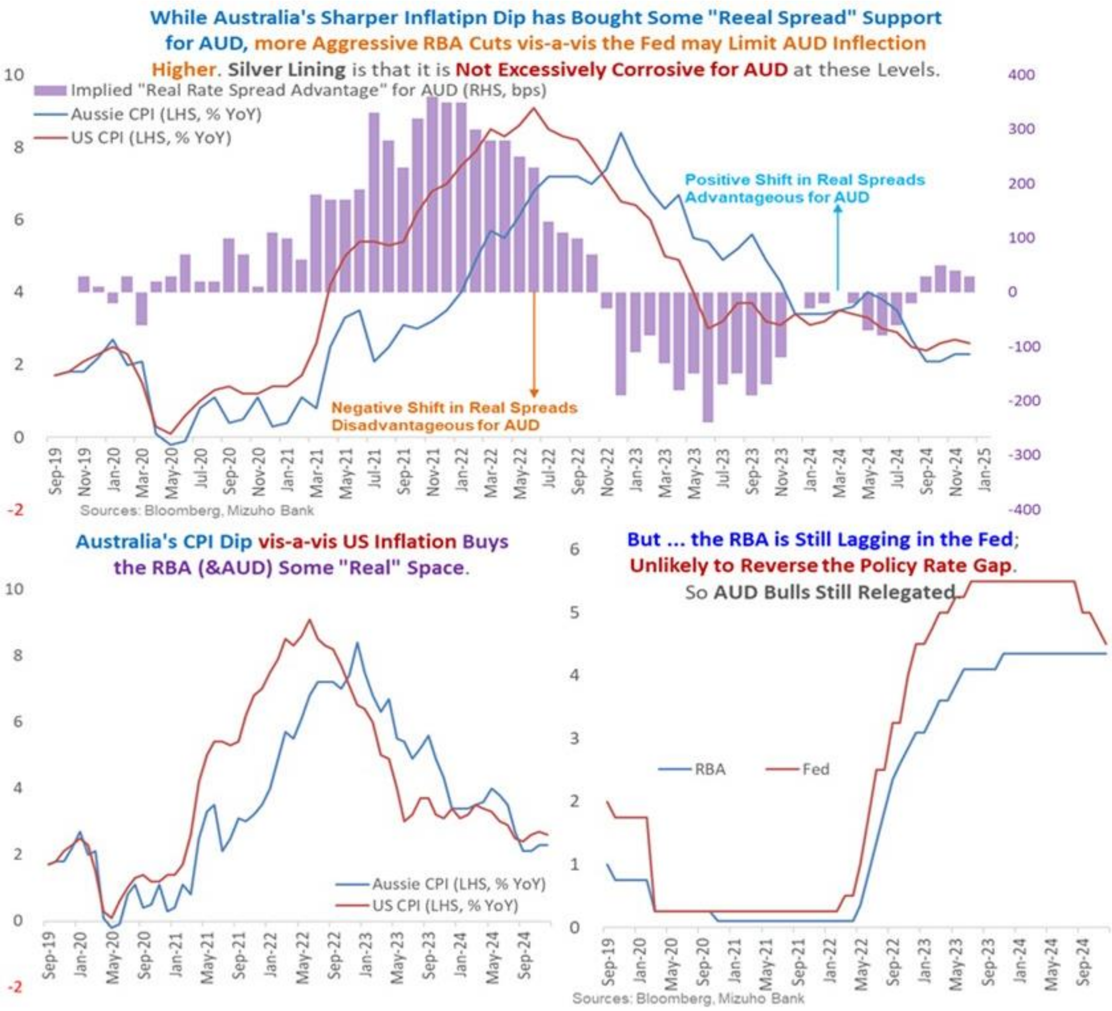


- Third, the broader, **underlying dis-inflation dynamics are encouragingly intact**. Especially so **with dampened demand-pull** factors that are further *stifled* (rather than alleviated) *by a weaker AUD.*





- Fourth, **growth boost from a softer AUD is significantly curtailed**, given the double-whammy of *structural constraints on commodity-driven growth multipliers* and *perversely compromised consumption dynamics.*
- On the former, **commodities-led boost from a softer AUD is stymied** in more demand-constrained world, marked by **diminished marginal commodity demand from China's prolonged property market slump**.
- In fact, a **cheaper AUD** *compromises affordability,* it **perversely accentuates stress on already struggling consumption** – real retail sales have been languishing.
- Simply put, **AUD pressures not only exaggerate inflation risk**, but **may exacerbate** (rather than alleviate) **persistently stressed sub-trend growth**.
- Finally, **Fed cuts**, while short of flipping nominal rate spreads to be a source of AUD boost, nevertheless provides incremental comfort for the RBA to ease (gradually).
- Specifically, by **blunting AUD (pressures) trade-off involved in easing** as **real spreads are marginally supportive of AUD** (albeit tentatively, depending on projected rate path).



- The upshot is that the *sharp AUD stumble may augment* (timing/pacing), *but not outright arrest, RBA rate cuts*. Afterall, the **RBA's focus is growth-inflation dynamics**, ***not the AUD*** (as much of a concern it may be).
- We expect that the **RBA will initiate its first rate cut no later than April**, ***although February is "live' and arguably compelling*** for a cut if inflation remains reasonably tame.
- RBA Outlook: For the year, we **expect 75bp of cumulative cuts**, with the ***balance of risks tilted to more, not fewer, cuts***. *And preferably front-loaded, subject to inherited constraints form the Fed.*
- Especially *given that the threat of adverse demand shocks, intensifying economic pain amid already woefully sub-par growth, edge out* the risk of sustained demand-pull price dynamics taking hold.
- AGBs Yields: The resultant impact on the **AGB yield curve** will probably be **tilted to some bull steepening**, with *fiscal slippage an incremental dampener on long-end pullback.*

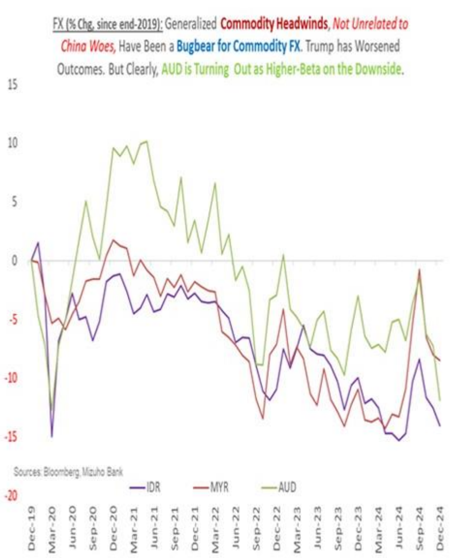
  - 3Y AGBs are set to head lower to 3.1-3.4% (from ~4.0% now)
  - 10Y AGBs with potential to head to 4.0-4.2% (from ~4.6% currently)

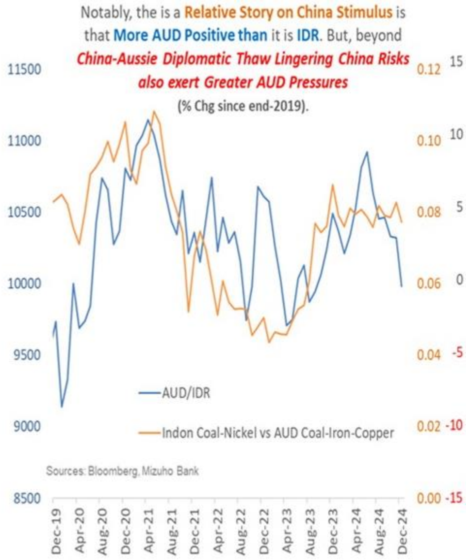
- AUD: Notwithstanding the RBA's rate cuts, **AUD** looks **set for a bumpy, partial recovery** (to ~0.68) by year-end, although *subject to persistent, if not dominant, downside risks initially.* This is on account of/conditional on;

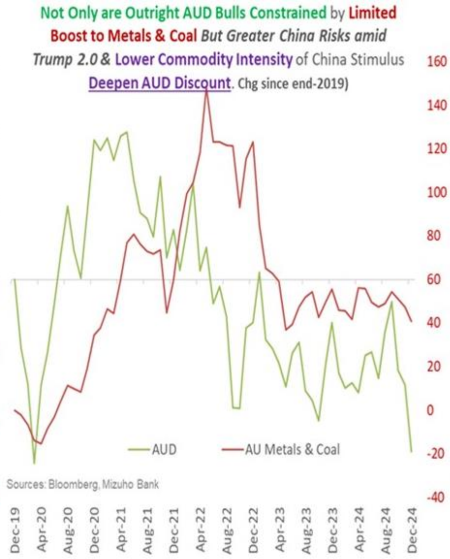
  i. **Stretched US exceptionalism**, and *corresponding USD outperformance,* **fading alongside Trump-China risks**; with *resultant, slightly higher-beta lift to AUD* (reversing recent higher-beta downturn)

  ii. **Weakness in excess of commodity fundamentals already baked in**, therefore setting **AUD up for slightly more emphatic "relief" gains**.

  iii. More **encouraging signs of China stimulus** (with resultant economic backstop for China), with **commodity channel lift for AUD**. Although, *diminished commodity demand multipliers from China stimulus* will likely *dampen the extent of attendant AUD rebound.*







Guatemala: This document does not constitute an offering under the rules of the Ley del Mercado de Valores y Mercancías (Stock Exchange Act, Decree 34-96 of the Congress of the Republic of Guatemala), and any of its amendments, including without limitation, Decree 49-2008 of the Congress of the Republic of Guatemala, and its applicable regulation (Governmental Accord 557-97). The document will not be registered for public offering with the Securities Market Registry of Guatemala (Registro del Mercado de Valores y Mercancías), because the products will not be offered or sold: (1) to any person in an open market, directly or indirectly, by means of mass communication; (2) through a third party or intermediary to any individual person or entity that is considered an institutional investor, including entities that are under the supervision of the Guatemalan Superintendency of Banks (Superintendencia de Bancos), the Guatemalan banking regulator, the Guatemalan Social Security Institute (Instituto Guatemalteco de Seguridad Social) and its affiliates; (3) through a third party or intermediary to any entity or vehicle used for purposes of collective investment; or (4) to more than 35 individual persons or entities.

Hong Kong: This document, when distributed in Hong Kong ("**HK**"), is distributed by MHSA or MBHK, depending of the Mizuho entity which you are a client of.

Japan: This document is intended only for certain categories of persons to whom a foreign securities broker is allowed to carry out regulated activities under the relevant articles of the Financial Instruments and Exchange Act (the "**Act**") and the subordinate legislative instruments (as amended), including but not limited to Financial Services Providers who are engaged in an Investment Management and certain Financial Institutions subject to conditions and limitations in Article 17-3(i) of the Order for Enforcement of the Act. It is solely for the use of such investors and shall not be distributed, forwarded, passed on or disseminated to any other person. This document is solely for the purpose of supplying general information and shall not constitute any investment or financial advice in relation to any products or services.

Malaysia: These documents shall be distributed solely to existing subscribers or clients of Mizuho Securities, and do not constitute an invitation, offer, or recommendation to subscribe for or purchase any securities mentioned therein. These materials also do not, whether directly or indirectly, refer to a prospectus in respect of securities of a corporation; in the case of a unit trust scheme or prescribed investment scheme, a prospectus in respect of any unit of the unit trust scheme or prescribed investment scheme, as the case may be; an issue, intended issue, offer, intended offer, invitation or intended invitation in respect of securities; or another notice that refers to a prospectus in relation to an issue, intended issue, offer, intended offer, invitation or intended invitation in respect of securities. Whilst there may be statements concerning securities and/or derivatives of a certain corporation or entity in these materials, we wish to highlight that these do not constitute, whether directly or indirectly, any form of advice, recommendation, encouragement, promotion, analysis, report or inducement to take any action , i.e., to buy, sell, or hold any securities and/or derivatives, nor is it a form of inducement for the reader to take any position regarding a particular class, sector, or instrument in relation to the securities and/or derivatives so mentioned.

New Zealand: This document is intended only for persons who are "wholesale investors" and "wholesale clients" under the Financial Markets Conduct Act 2013 ("**FMCA**"), as persons who are an "investment business", meet relevant investment activity criteria, are "large" or are a "government agency", in each case within the meaning of clauses 37 to 40 of Schedule 1 of the FMCA. It is not intended for, and should not be reproduced or distributed in any form to any other person in New Zealand. This document is distributed in New Zealand by MHSA or MHSS, which are licensed in their respective jurisdictions but are not registered as overseas companies or financial service providers in New Zealand or licensed under the FMCA. Nothing in this document constitutes or is supplied in connection with a regulated offer nor an offer to the public within the meaning of the FMCA.

Singapore: This document is distributed in Singapore by MBSG or MHSS, a holder of a capital markets services licence and an exempt financial adviser regulated by the MAS. Nothing in this document shall be construed as a recommendation, advertisement or advice to transact in any investment product mentioned herein.

Where the materials may contain a recommendation or opinion concerning an investment product, MHSS is exempted from complying with sections 34, 36 and 45 of the Financial Advisers Act 2001 of Singapore. This document is only intended for distribution to "institutional investors", "accredited investors" or "expert investors", as defined under the Financial Advisers Regulations, and is solely for the use of such investors. It shall not be distributed, forwarded, passed or disseminated to any other person.

South Korea: This document is distributed in South Korea by Mizuho Securities Asia Limited, Seoul branch solely acting as a broker of debt securities under the Korea Financial Investment Services and Capital Markets Act.

Switzerland: This document is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any financial instrument or to adopt any investment strategy mentioned in this document. The information contained on this document shall not be construed to be an advertisement for any of the financial instruments or services mentioned herein.

Taiwan: This document distributed via MHSA or MHSS from outside Taiwan shall not be re-distributed within Taiwan and does not constitute recommendation of, and may not be used as a basis for recommendation of, securities within Taiwan. This document may not be distributed to the public media or used by the public media without prior written consent of MHSA or MHSS (as the case may be).

Thailand: This document does not constitute any investment or financial advice or any general advice in relation to any products or services and, when distributed in Thailand, is intended only for "institutional investors", as defined in the Notification of the Office of the Securities and Exchange Commission No. Gor Thor. 1/2560 Re: Provision of Advice to the Public which is not classified as the undertaking of Investment Advisory Business dated 12 January 2017 (as amended). It is solely for the use of such investors and shall not be distributed, forwarded, passed on or disseminated to any other person. The distribution of this document to such institutional investors in Thailand, is solely for the purpose of supplying general information, without charge. It neither constitutes any intention to conduct, or any engagement in any securities business, service business, investment or financial advisory business, or any other business in Thailand, for which Thai licensing is required, nor marketing, offering, solicitation or sale of any products, securities, or services to customers, potential customers or any person in Thailand.

United Arab Emirates (excluding the Dubai International Financial Centre and the Abu Dhabi Global Market): This document is intended only for persons who qualify as professional investors as defined in the Securities and Commodities Authority ("**SCA**") Rulebook. It is not intended for or should not be passed on, directly or indirectly, to other classes of persons/investors in the United Arab Emirates. The contents of this document have not been reviewed or approved by, or deposited with, the Central Bank of the United Arab Emirates, SCA or any other regulatory authority in the United Arab Emirates. If you do not understand the contents of this document you should consult an authorised financial adviser.

United Kingdom / Germany / European Economic Area: This document is being distributed in the United Kingdom by Mizuho International plc ("**MHI**"), 30 Old Bailey, London EC4M 7AU. MHI is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority and is a member of the London Stock Exchange. This document may be distributed in the European Economic Area by MHI or Mizuho Securities Europe GmbH ("**MHEU**"), Taunustor 1, 60310 Frankfurt, Germany. MHEU is authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("**BaFin**"). For the avoidance of doubt this report is not intended for persons who are Retail Clients within the meaning of the FCA's or the BaFin's rules. Details of organizational and administrative controls for the prevention and avoidance of conflicts of interest can be found at https://www.mizuhoemea.com.

United States: This document is being distributed in the United States by Mizuho Securities USA LLC ("**MSUSA**") and is the responsibility of MSUSA. The content of publications distributed directly to US customers by non-US members of Mizuho Securities is the responsibility of such member of Mizuho Securities which distributed it. US investors must affect any order for a security that is the subject of this document through MSUSA. For more information, or to place an order for a security, please contact your MSUSA representative by telephone at 1-212-209-9300 or by mail at 1271 Avenue of the Americas, New York, NY 10020, USA. MSUSA acts as agent for non-US members of Mizuho Securities for transactions by US investors in foreign sovereign and corporate debt securities and related instruments. MSUSA does not guarantee such transactions or participate in the settlement process.