Wednesday, 18 December 2013

Tapering, Market Rates and the AUD

Winds of Change

- The US Federal Reserve appears set to start scaling back its bond-buying program; the question boils down to timing only.
- Moral hazard considerations support a tapering move occurring sooner rather than later.
- The tapering decision remains highly data dependent. Recent US economic data has been encouraging. So we would not rule out the Fed tapering as soon as tomorrow morning AEST. But our central view is for tapering to start in March 2014.
- We can expect rates to trend higher across the Australian government bond and swap yield curves. The middle to long-end of the curve will continue to be dragged higher by US rates, notwithstanding the recent pullback. Yields at the shorter end of the curve we believe will also be biased higher, but with the RBA retaining an easing bias, the yield curve will stay steep.
- The RBA is unlikely to cut the cash rate again and is set to be on hold for an extended time.
- The AUD/USD should be pressured lower by tapering and further falls in Australia's terms of trade. However, the character of the AUD has changed in recent years, so the downside is limited in our view.
- In the short term, we would expect the AUD/USD to fall further if the Fed tapers tomorrow. However, the risk of being short the AUD is growing and this risk could play out if the Fed does not taper tomorrow morning.

Outlook for US Quantitative Easing

The US Federal Reserve has held the Fed funds rate at a record low for more than four years and embarked on three rounds of quantitative easing. Quantitative easing involves the Federal Reserve purchasing longer-term Treasury securities (US$40bn per month) and agency mortgage-backed securities (US$45bn per month) to put downward pressure on longer-term interest rates, support mortgage markets and help make broader financial conditions more accommodative. Quantitative easing is set to be scaled back or tapered, possibly as soon as tomorrow AEST. It is a question of when not if.

Sydney was fortunate enough last month to have the US Federal Reserve President of Dallas, Richard Fisher, grace our shores. Fisher will be a voting member of the FOMC next year. In his speech to the Australian Business Economists on 4 November he stressed that quantitative easing would not continue "infinitely".

Fisher's speech also raised the notion of moral hazards in continuing quantitative easing for too long.

Firstly, Fisher suggested that the US government had little incentive to make decisions needed to help the US corporate sector move forward. Fisher described the US corporate sector as having possibly the strongest balance sheets ever and being the 'most attractive thoroughbred'. However, corporate America was being held back behind the gates by the US government.

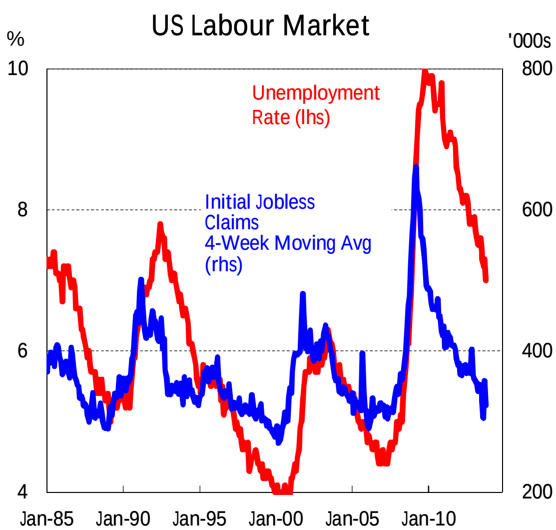
The US government is playing a counter-cyclical role in the economy. But the US economy is also restrained further by a government that struggles to make budget decisions. He colourfully described the US government as moving at the speed of a 'koala' while the US Federal Reserve was moving at the speed of a 'boomer'. It was difficult for US companies to grow spending when US companies have little idea what taxes they will face next year because the US government cannot make a decision.

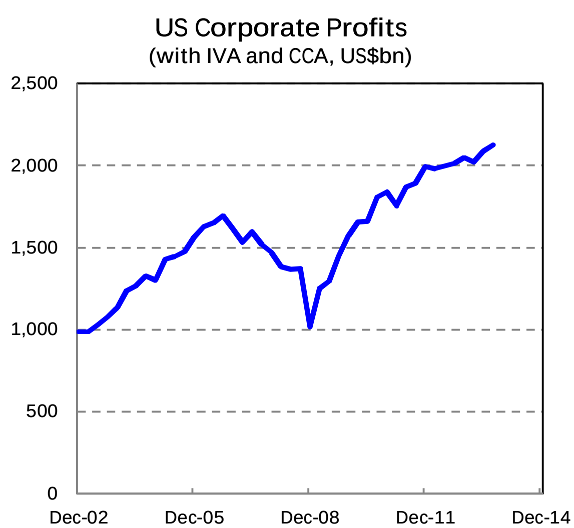
However, the US economy continues to improve and recover, despite the constraints provided by the US government sector. One can easily surmise then that if the US government was to become more effective in its decision-making, the US economy would recover more strongly.

Reading between the lines of Fisher's speech, one was left with the impression that perhaps the Fed needs to begin the tapering process to give the US government an incentive to make the hard decisions because the Fed in many respects is carrying the government.

That was the first moral hazard raised in his speech. The other related to the potential for low interest rates and quantitative easing to encourage recklessness in financial markets. Fisher noted we are not there yet but there is a tipping point. The memories of when former Fed Chairman kept interest rates too low for too long in the early part of the last decade are still fresh, as it is one of the key root causes of the GFC.

It has become increasingly clear from Fisher's speech and other Fed speakers that have subsequently taken to the podium that there is no infinity to quantitative easing and at some point quantitative easing will have to slow down.





The tapering decision is a challenging one and one that remains dependant on the data. The Fed has previously communicated that for tapering to begin it is essential that incoming economic data is broadly consistent with its forecasts on a number of key variables, particularly those for the labour market. The Fed has indicated when asset purchases come to a complete end, the unemployment rate would likely be in the “vicinity of 7%”. The Fed’s unemployment rate forecasts for this year are 7.2-7.3%. On a change to monetary-policy settings, the Fed has indicated an unemployment rate of 6.5% or lower is required.

The current US unemployment rate is 7.0% and non-farm payrolls have averaged 193,000 over the past three months to October. Further, job opening in the US stand at their highest in five years, according to data published last week.

In terms of the jobs data and other economic data, it has been encouraging and suggesting that a tapering decision will occur. Together with Fisher’s remarks and the rhetoric provided by other Fed officials we believe it will occur in March next year.

But a tapering move as soon as tomorrow morning AEST cannot be ruled out; we would attach a 35% probability to such a move.

We know that September didn’t happen but it was a close call. Importantly, September gave financial markets a dress rehearsal.

The current Fed Chairman Bernanke presides over his final FOMC meeting in January 2014 and the incoming Fed Chairman Janet Yellen presides over her first FOMC meeting in March 2014. Consensus had sat with the first tapering to occur in March 2014 but more recently the market has positioned for an earlier move. The recent negotiations over the debt-ceiling issue have encouraged the market to bring forward the timing of the start of tapering.

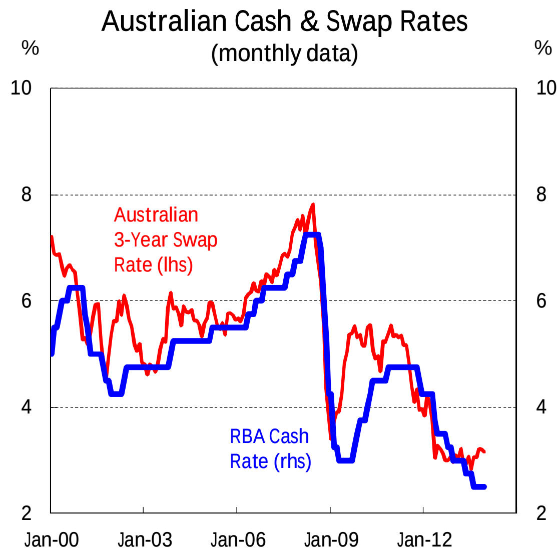
Whether the Fed moves sooner or later, it seems clear that the market is preparing for the tapering move. Once tapering starts, we can expect the Fed to gradually reduce the size of the quantitative easing program to nil over time. Tapering is also likely to start small.

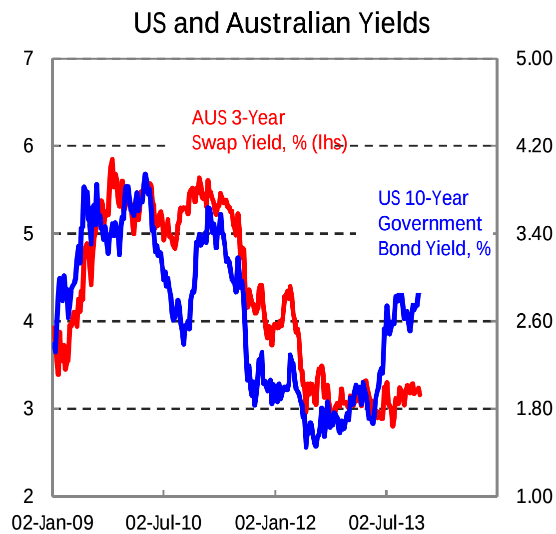
The Fed has begun its two-day meeting and a decision is expected 6am tomorrow AEST . If they do not taper, we expect they most likely will provide clearer communication around when they will.

Outlook for Market Rates

Yields at the middle to longer end of the yield curve in Australia are heavily influenced by US rates and have in recent months pulled higher by expectations that the US Federal Reserve could soon start scaling back on its bond-buying program. Australian swap rates across the curve have lifted, for example, by around 7-45 basis points since the RBA last cut the cash rate on August 6.

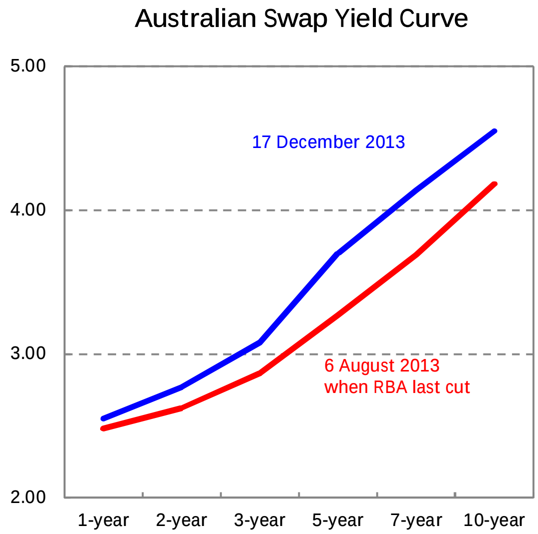
We feel that swap and government bond rates have bottomed and the bias will remain for these rates to move higher notwithstanding the recent pullback. It means those with exposures to debt might benefit from hedging these exposures if it suits their profile to do so.

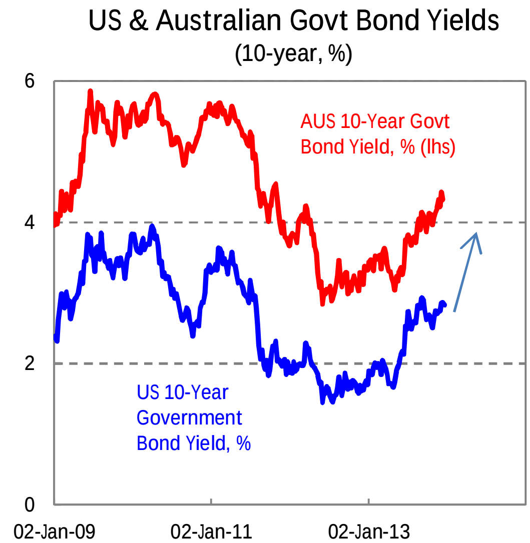




Market rates at the shorter end of the yield curve are heavily influenced by what market participants believe the Reserve Bank will do in the future. Recent updates from the Reserve Bank reveal it has retained an easing bias, which is a bias to cut the cash rate again if deemed necessary. However, for another rate cut to occur we expect that the threshold is higher and the data will have to be much weaker than the RBA is currently expecting. We believe the RBA would prefer the AUD to weaken to support growth rather than deliver another rate cut. We see this preference as one of the reasons behind the RBA's recent attempts to jawbone the AUD lower.

We remain comfortable with the view we have held for some time now, which is that the RBA will not need to cut rates further. However, we do expect the RBA to keep rates low for longer, which means the cash rate should remain steady for much of 2014. The expectation that the economy will not return to trend growth until well into 2015 supports this notion of rates staying low for longer.





It is worth noting that since 2002, Australian 3-year swap rates have peaked or troughed ahead of a shift in the cash-rate cycle by an average of 200 days. While think the average will be longer this time round, but we do not believe it will be as long as what consensus expect. The median expectation among economists according to a Bloomberg survey published on 13 December is that the cash rate will be on hold for all of next year. The RBA last cut on August 6. We think there is some risk that the RBA will start the rate-hiking cycle late in 2014.

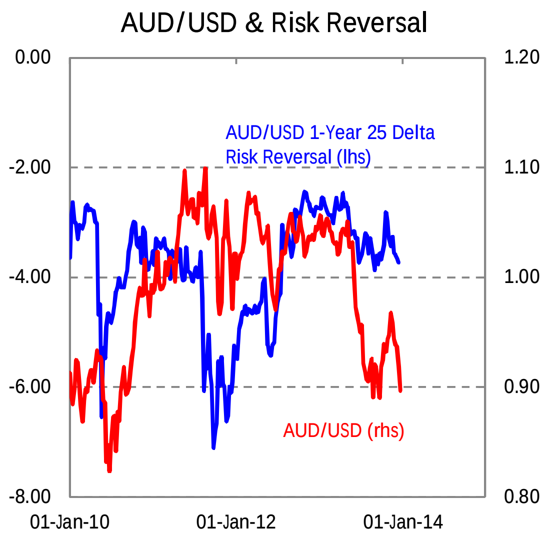
As the RBA has retained an easing bias, the trend higher in yields at the shorter end continues to be less than at the middle to longer end of the curve, causing a steepening of the yield curve. We expect these steepening pressures to continue in the near term.

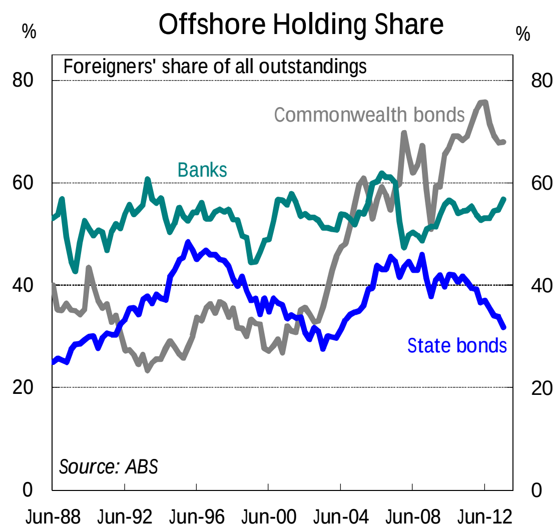
AUD Outlook

The quantitative easing program in the US has also helped keep the US dollar low by in effect debasing the currency. Market expectations that tapering is nearing has encouraged a rise in the US dollar and the AUD/USD has been spurred lower as a result. It is because US long-term interest rates have trended higher in anticipation of a tapering of quantitative easing. As yields rise, capital is attracted to America from riskier parts of the world, helping to push the USD higher.

The USD is in long-term bear trend and has been since early 1985 but the USD index can still rise as much as 20% and keep this bear trend intact.

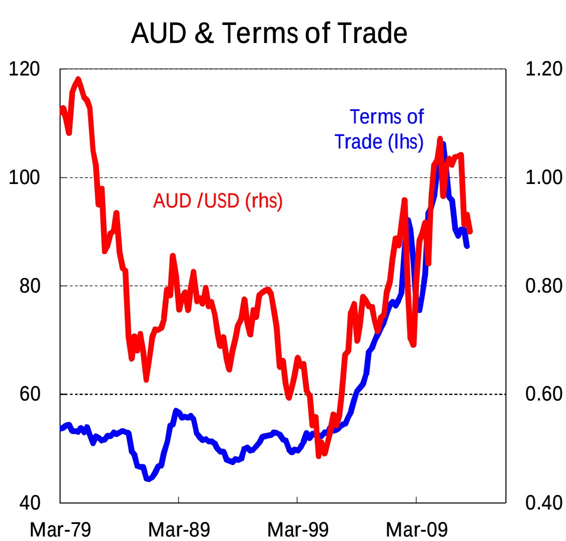
Market participants are fully priced for a move higher from the USD when tapering occurs and so the risk of being short the AUD is growing. This risk is highlighted when we examine the AUD/USD risk reversal, defined as the implied volatility for call options minus the implied volatility for put options on the base currency with the same delta.

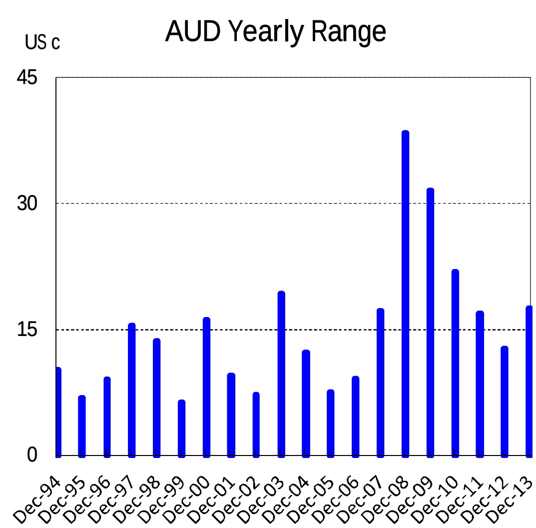




While over the medium-term, we expect the stronger USD and falling terms of trade to pressure the AUD lower, we also believe that the characteristics of the AUD have altered. These characteristics suggest to us that the downside is limited for the AUD.

The AUD no longer has the characteristics it once held a decade back. Indeed, we saw evidence of this through the GFC and afterwards. Indeed, the fact that the buyers of the AUD have now changed to include those wanting the AUD for reserve purposes means the AUD should have a higher floor. It is reflected in the large rise of US debt held by offshore buyers. With Australia one of only nine countries rated AAA, the attraction of the AUD remains.





It is worth remembering that the AUD can trade in a wide range in any one year and next year is unlikely to be any exception. Indeed, over the past ten years the AUD has averaged a trading range of 18.5 US cents.

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