Australia, the next shoe to drop

Will Denyer & Simon Pritchard | GaveKal | 23 January 2015

Central bankers are ditching managerial gradualism in their monetary policy communication and are getting serious. Switzerland, Denmark, India and now Canada have all made surprise interest rate moves in recent days - okay, the European Central Bank continues to drip-feed its every thought to friendly journalists, but the sheer scale of the adjustment taking place in relative global prices means that policymakers must respond swiftly to events. Where might be the next shoe to drop?

The Bank of Canada's move this week to cut interest rates by 25bp to 0.75% sent the Canadian dollar to a six-year low against the US dollar. More rate cuts should follow as Canada has highly leveraged households which face an income squeeze due to the oil price plunge; Canada is a high cost energy producer and the sector is a far bigger part of the economy than in the US.

The immediate impact of BOC's move was to push the Australian dollar a cent lower against the US dollar. The move means that the Aussie has depreciated 14% since September, an adjustment that has allowed the economy to weather the collapse of the commodity bubble relatively well. However, 'down under' still looks like one of the holdout anomalies in global markets where the adjustment from a decade of mispriced assets has yet to fully play out.

Despite a big terms-of-trade hit, Australia still has some of the highest bond yields in the OECD. Are we to believe such returns are justified by domestic conditions or are they simply an echo of the long commodity boom? With mining and energy investments being dialed back, real disposable incomes must take a hit. The focus will then move to the hitherto Teflon real estate market. With the Reserve Bank of Australia likely to follow Canada with further easing, the question is whether real estate is stabilised by lower yields or hit by declining income levels.

To be sure, we are not saying that Australia faces some Greek tragedy. The mining boom may be over, but the biggest players are still profitable with iron ore at US$50 to US$60 a ton, so the red stuff will continue to flow out of Pilbara. Australia's banks may be reliant on offshore funding, but they do so in their own currency, which conveys huge advantages. As far as we know, the banks have limited exposure to riskier commodity credits and remain essentially funding machines for those 'quarter acre blocks' in suburbia and their inhabitants. The RBA is likely to adopt progressive easing through this year and it should not be forgotten that with each decline in the currency, the foreign bid, especially among Chinese investors, will strengthen for Australian real estate.

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Our point is less that Australia faces a crisis than a grinding adjustment in real wages that will see the Aussie dollar depreciate in tandem with much lower yields. Arguably, Aussie bonds offer the best value in the developed world with the 10-year yielding 120bp more than a Canadian equivalent and 80bp more than the US. Given that the commodity bust poses a greater threat to nominal Australian growth rates than most OECD countries, our bet is that Aussie government bond yields soon fall below US yields. At this point, foreign investors who have been playing the carry trade will flee, causing the Aussie dollar to take another leg down. Hence, a long-Aussie bond position should certainly be currency hedged.

Another option would be to short the Australian dollar against the US dollar or against the Loonie. The big fall in the Canadian dollar yesterday helped bring the currency back to near purchasing parity with the US dollar - the same cannot be said of the Aussie which remains overvalued on a PPP basis. This situation is a function of the Australian economy's freakishly high rates at both the short and long end which, as we have argued, seem unlikely to last. We struggle to see a more obvious trade in the major markets.

Figure 1: Australia offers one of the highest yields in the developed world
10-year government bond yields

Sources: GaveKal Data/Macrobond

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