

Australian outlook deteriorates

After a nervy start to the week, financial market sentiment staged a comeback overnight. US and European share-market indices bounced 0.5-2.0% (S&P500 + 1.8%, Eurostoxx 50 0.7%) and the VIX index (a proxy for risk aversion) has reversed about half of Monday's spike. The feed through to other asset markets has been a little less enthusiastic though, with US bond yields barely higher than where they opened (the 10-year yield briefly hit a 5-month low sub 1.15%) and currency markets still showing a general preference for the safe-haven of JPY, USD, CHF.

There hasn't been any particular trigger for the reversal. The concerns about the spreading Delta variant remain. Relative to the situation on Monday morning, we're still in the same position where global growth is booming (we expect a 6.8% expansion this year) but the downside risks related to Covid are growing again (Australia being case in point, see below). Increased equity market volatility over the past two days looks to be just that, chop.

Notable overnight developments include: 1) tentative signs of a cooling in the US housing market – June housing starts rose 6.3% mom, but building permits continued to tail off (-5.1% m/m following a 3% fall the prior month); and 2) US Covid expert Fauci helping to soothe a few Covid-related nerves. He told a US Senate hearing that vaccines are still more than 90% effective in preventing hospitalisations and deaths owing to the Delta variant.

Dairy prices fell 2.9% at the GDT dairy auction overnight, with whole milk powder down a larger 3.8%. This was a slightly chunkier fall than we were expecting and points to downside risk on our current season Fonterra Milk Price forecast of \$8.20 kg/ms.

FX Update: The Aussie dollar remains in the headlines for all the wrong reasons. After sliding through most of yesterday the AUD/USD made a fresh 8-month low of almost 0.7300 overnight. This provided the usual weight on the NZD/USD which skirted briefly below 0.6900 (also an 8-month low) before recovering a little.

The toll on Australia from the latest Covid outbreak continues to rise with South Australia imposing a one week lockdown and Victoria extending its lockdown by a week. With NSW also in lockdown, all of this has brought about an unwelcome hit to the Aussie economic outlook. In the least, September quarter GDP looks set to contract significantly.

As we noted in Monday's FX weekly, a push up into the 0.9500s for NZD/AUD looks increasingly likely, particularly if the RBA needs to walk back elements of the policy outlook delivered in early July, at the same time as the RBNZ kicks-off a policy *tightening* cycle. This contrast hasn't been lost on the market; NZ-AU 2-year swap differentials are at the highest level in six years around +75bps.

Our CBA colleagues have been quick to update their policy outlook. They now expect the RBA Board to reverse its decision to taper its bond buying program from mid-September, *if* Greater Sydney and/or Victoria are still in lockdown at the time of the August Board meeting (3 August). They're still calling a November 2022 start to the RBA's tightening cycle, but this forecast is clearly also on thin ice given the escalating Covid situation.

Markets on this side of the Tasman haven't been too ruffled by the Aussie situation, so far. Admittedly, interest rate markets have backed off the post-CPI rate hike exuberance a little. Two-year swap yields are around 10bps off their post CPI highs and the odds of an August RBNZ rate hike are back down to around 65% from over 80%. But for the most part the RBNZ is expected to keep calm and carry on, sentiments we would agree with, at this stage.

Day ahead: Nothing of note in NZ. Our friends at CBA expect a 1.2% mom fall in Aussie (preliminary) retail sales figures released at 1:30pm (NZT). Offshore, it's all quiet tonight and indeed right through until the ECB meeting Thursday night.

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Currencies			Currencies			Commodities			Equities		
NZD/USD	0.6921	-0.2%	NZD/SEK	6.021	-0.1%	NZX WMP	3660.0	-2.4%	Dow	34512	1.6%
NZD/AUD	0.9440	-0.1%	NZD/DKK	4.370	-0.1%	Gold \$/o	1810.6	-0.1%	S&P 500	4323	1.5%
NZD/EUR	0.5875	0.1%	NZD/THB	22.7	-0.3%	WTI Oil \$/b	67.4	1.5%	NASDAQ	14499	1.6%
NZD/JPY	76.02	0.1%	AUD/USD	0.7332	-0.1%	Money Market (%)			FTSE	6881	0.5%
NZD/GBP	0.5078	0.1%	EUR/USD	1.178	-0.1%	90 Day BB	0.46	-0.02	CAC-40	6347	0.8%
NZD/CAD	0.8775	-0.7%	USD/JPY	109.8	0.3%	OCR	0.25	0.00	DAX	15216	0.5%
NZD/CHF	0.6376	0.1%	10 Yr Bond Yields (%)			ASB Swap Rates (%)			H.Seng	27259	-0.8%
NZD/HKD	5.379	-0.2%	NZ	1.63	-0.09	1yr	0.78	-0.01	Nikkei	27388	-1.0%
NZD/SGD	0.9454	-0.1%	US	1.22	0.03	2yr	1.00	-0.01	ASX200	7252	-0.5%
NZD/CNH	4.490	-0.1%	Aust	1.19	-0.06	5yr	1.38	-0.03	NZX50	12651	0.0%

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