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ASIA PACIFIC INSIGHT

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Australia Macro+ and AxJ FX/Rates Strategy

The RBA's Rock and a Hard Place; On Hold Until 2019

The RBA is stuck at 1.50%, unable to cut given housing risks, yet unable to follow the Fed's hikes given labour market weakness. Policy shifts further with MacroPru-2, and we now see the RBA on hold into 2019 while the market is pricing hikes. As a result, we lower our AUD forecast to 0.67 in 4Q18.

We believe the RBA cash rate is trapped between a rock and a hard place: Speculative conditions in established Sydney and Melbourne housing are the 'rock' preventing further rate cuts that are, in our view, needed to boost aggregate demand (in large part through a lower AUD). Meanwhile, the weak labour market and highly-geared household balance sheets are the 'hard place' preventing the cash rate from being hiked to tackle housing imbalances.

More reliance on MacroPru: Recent focus on cutting the share of interest-only mortgages is likely just the beginning of a two-step further tightening, with risk weights on investor/interest-only mortgages to increase materially, potentially as soon as June. This has macro implications, including tighter financial conditions, slower credit growth and tempered wealth effects. We see a cumulative -2ppt impact on household 'free' cash flow, and expect consumption to disappoint.

Macro – growth risks build: With monetary policy stuck and fiscal space underutilised, we think greater use of MacroPru will lower credit growth, slow the housing cycle (and wealth effects) and hold GDP down at our bottom-of-consensus forecast. Furthermore – we expect the resi construction downturn to push unemployment towards our well-above-consensus 6.4% forecast.

Rates – missing the price: The market is pricing the RBA to hike by August 2018, and by more than the Fed from 2019. We think this misses the fact that a 3% cash rate is equivalent to ~6.25% pre-GFC given world-leading household leverage. As a result, we like the front-end/belly of the AUD curve, and would look to enter 1y1y receivers around 2.10%.

FX – negative AUD carry: We believe the looming growth disappointments and a swing to negative rate differentials will pressure the AUD lower over 2018. With the removal of 50bp of RBA hikes in 2H18, our Global FX Strategy team lowers their 4Q18 AUD/USD forecast from 0.74 to 0.67.

Equities – UW the domestic cycle: The ASX200 outlook is oscillating around the perceived health of the domestic industrial cycle. Housing *is* the economy at present, and the slowdown underway means lower credit, income and consumption growth than consensus. We retain key UWs across Banks, Consumer, and Housing-Linked sectors. Focus should look back to Quality, Growth, FX-Earners and Resources for exposure to global reflation and value.

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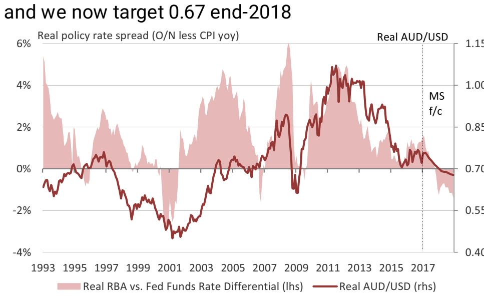
Exhibit 1: We expect MacroPru to buy time for RBA to stay at 1.50% into 2019; deeper real rate differential should mean further AUD/USD depreciation next year, and we now target 0.67 end-2018



Source: Bloomberg, RBA, Morgan Stanley Research Forecasts

Jesper Rooth is a fixed income strategist and is not opining on equity securities. His views are clearly delineated.

Summary: RBA on hold until 2019; focus turns to MacroPru

Investment Summary

Why change our RBA call now? With the announcement of 'MacroPru-2' on 31 March, the rates market is 'coming back' towards our call for another cut. However, we assess the implications of more speculative behaviour in Sydney and Melbourne housing and a more stability-focused RBA mandate and no longer see the Bank making a final cut to 1.25% in 3Q17. More importantly relative to market pricing, a slower for longer growth/inflation outlook also sees us remove the two hikes we had forecast for 2H18, leaving a bigger gap to the Fed Funds rate at the end of our forecast horizon.

What does the market expect? Market debate has been moving from the timing/depth of further RBA rate *cuts*, to how quickly the *hiking* cycle will come – given global reflation, frothy housing conditions and an accelerating Fed tightening cycle. Interest rate futures are pricing a first RBA hike in August 2018, then for the RBA to hike more sharply than the FOMC, and we believe this is reflected in the AUD's rebound from 0.72 at end-2016 to 0.75 currently.

Why do we think the RBA can't hike? We believe the RBA does not need to hike to rein in the housing market, as the MacroPru toolkit is just being rolled out, and can be highly effective given far-reaching regulatory powers and the concentrated banking system and mortgage market. The neutral policy rate (r*) is falling, and we see the RBA continuing to undershoot its inflation and full employment objectives given our forecast unwind of the apartment construction boom, which would lead unemployment to head up to around 6.4% (see Australia Macro+: Supervising a Housing Slowdown, 15 Feb 2017).

Where could we be wrong? Fiscal policy remains the key upside risk for jobs and growth, and is best placed to create the policy space for the RBA to hike rates. We believe we are seeing a global reflation and rotation from 'monetary to fiscal' as Budgets move away from austerity, but this may require the Australian government to lessen its political focus on retaining the AAA sovereign rating. On the flipside, if unemployment rises as we forecast, the RBA could continue its easing cycle in an attempt to maintain the precarious equilibrium in the housing market and buy time for a broader policy response (including a deeper fall in the AUD).

Exhibit 2: Summary and Investment Implications

RBA On Hold Into 2019 as MacroPru Activated - Why It Matters	
- Australia is lagging global reflation given fiscal austerity and a resources capex downturn	
- While the labour market is fragile, we see **further headwinds as apartment construction slows**	
- Housing dynamics have become increasingly speculative in Sydney and Melbourne, **preventing further cuts**	
- However, weakness in other property markets and household balance sheets mean **the RBA cannot hike rates**	
- We believe **MacroPru can be effective** in Australia, but has been operated too cautiously to date	
- Looking ahead, MacroPru-2 and further prudential steps are likely to **slow housing and leverage growth**	
- Lower for longer growth implies a **greater miss on the RBA's targets** of full employment and 2-3% inflation	
Investment Implications	
Macro	**GDP** – we are below RBA and consensus growth for 2017 and 2018. We would expect the street to move back towards MS through Q3 and Q4. **Labour Force** – we forecast unemployment to rise while consensus expects the rate to fall. A rising unemployment rate will challenge the markets' view on Australia's leverage to global reflation **Consumption** – retail conditions are mixed and the savings rate is tapped. A key difference in MS vs Consensus growth forecasts is around the outlook for the consumer. **Financial conditions** – even with an RBA on sustained hold, conditions are tightening through bank mortgage repricing and tighter credit availability - all making RBA lift-off more difficult
Rates	With the RBA on hold, receiving front-end/belly is our preferred delta risk. However, given the recent rally in DM rates, we caution around entry levels. We would look to **receive 1y1y around 2.10%**. Curve should steepen from here, a view we like to implement via **buying 3m10y OTM payors**. We generally like being long AUD rates vega, and suggest **buying 5y10y straddles**.
FX	We keep our bearish AUDUSD forecast of 0.70 for 4Q17 and lower our 4Q18 forecast from 0.74 to 0.67 **Sell AUD/USD**: Target 0.69, Stop 0.7760 **Sell AUD/CAD**: Target 0.97, Stop 1.03
Equity	**Limited Index upside** - ASX200 index returns have topped out. Add FX weakness and Australia remains anchored as a key UW in the regional country model. **Domestic Cycle Risks** – with a slowing housing market and genrally muted industrial earnings cycle we stay UW Banks, Housing Linked, Retail and REITs. OW sector positioning found in Materials, Healthcare, Global Earners and steeper yield-curve plays. **Key OW stock positions**: BHP, RIO, S32, EVN, QBE, TWE, DMP **Key UW stock positions:** WES, BLD, CSR, HVN, SGP, VCX, CBA

Source: Morgan Stanley Research
* Prices COB 7 April 2017 - WES: A$44.42, BLD: A$5.75, CSR: A$4.48, HVN: A$4.27, SGP,: A$4.75 VCX: A$2.89, CBA: A$84.77

The RBA's "Rock and a Hard Place" Conundrum

We believe the RBA cash rate is trapped between a rock and a hard place. Speculative conditions in established Sydney and Melbourne housing are the 'rock' preventing further rate cuts, that are in our view needed to boost aggregate demand (in large part through a lower AUD). Meanwhile, the weak labour market and highly-geared household balance sheets are the 'hard place' preventing the RBA policy rate from being hiked to tackle housing market imbalances. **We now see the RBA staying on hold at 1.50% into 2019**, removing our forecast cut (3Q17) *and* the two hikes forecast for 2H18. While consensus has been moving away from cuts, we think the rates market has moved too quickly to price in hikes, and see downside to the AUD as RBA/FOMC policy expectations shift.

Monetary policy is a blunt tool, with long and variable lags, and is not well-equipped to deal with sharply diverging conditions across sectors and regions. Since we increasingly see the cash rate stuck at 1.50%, we think the RBA needs to call in support from MacroPru and Fiscal policymakers. We believe MacroPru is effective in Australia, and can help the RBA hold rates right into 2019 (or cut them more deeply in a bear case) by mitigating unwanted effects on housing and balance sheets. Conversely, to help the RBA eventually exit from its record-low policy rate, we believe fiscal policy is well placed in Australia to boost aggregate demand, and can (subject to politics) target activity toward particular sectors and states.

In order to buy time to hold rates for even longer this cycle, we expect the RBA and Australia's Council of Financial Regulators (also including APRA, ASIC and Treasury) to **continue using MacroPru to contain housing risks**. The next steps announced on 31 March focused on cutting the share of interest-only mortgages from 39% to <30%, but we expect this to be just the first of a two-step further tightening, with risk weights on investor/interest-only mortgages to increase materially, potentially as soon as mid-2017. This has macro implications, including **tighter financial conditions, slower credit growth and tempered wealth effects**.

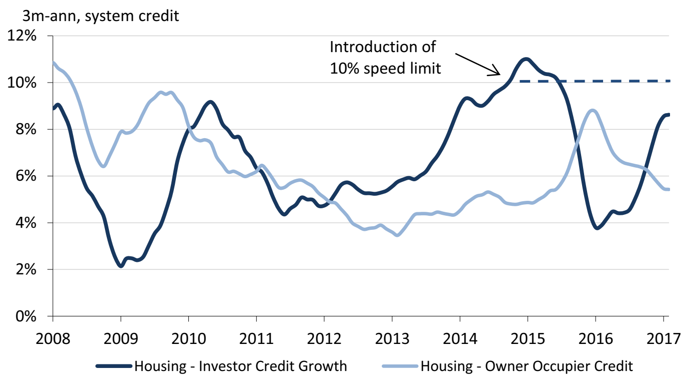
'The Rock' – Speculative housing dynamics in Sydney/Melbourne

Concerning housing and household leverage dynamics

Australian housing dynamics have become increasingly divergent across the two large cities (Sydney and Melbourne) versus the rest of the country, and between detached houses (underpinned by land values) and apartments (where a national oversupply looms). While the RBA has been quick to point out the varying conditions, we believe established Sydney and Melbourne housing is showing more signs of being in an unsustainable phase of investor-driven price growth.

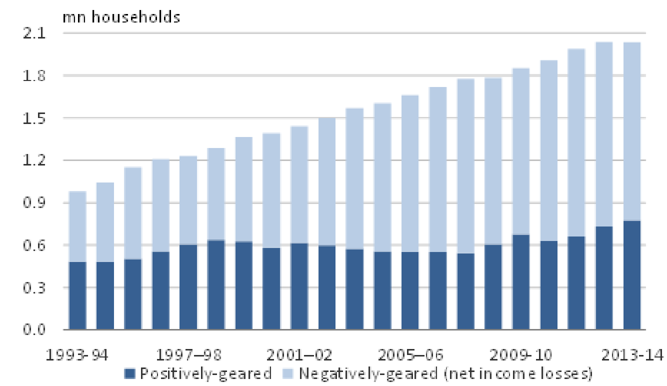
We have previously described these conditions as increasingly speculative, and while this may not equate to short-term flipping of property as in the heights of international booms (before busts), we do see evidence that Australian tax treatment of property (including the 50% CGT discount) is combining with growing (and arguably over-) confidence in the house price trajectory and reduced confidence in the after-tax returns from superannuation to direct more of households' savings into housing. With the typical Australian property investor using interest-only mortgages, levered at/near 80% LTV, and making a rental loss (ie. 'negatively geared'), we see this strategy as speculative in that its payoff is entirely dependent on capital gains.

Exhibit 3: Property investors re-engaging and pushing speed limit after MacroPru-1 slowed activity



Source: RBA, Morgan Stanley Research

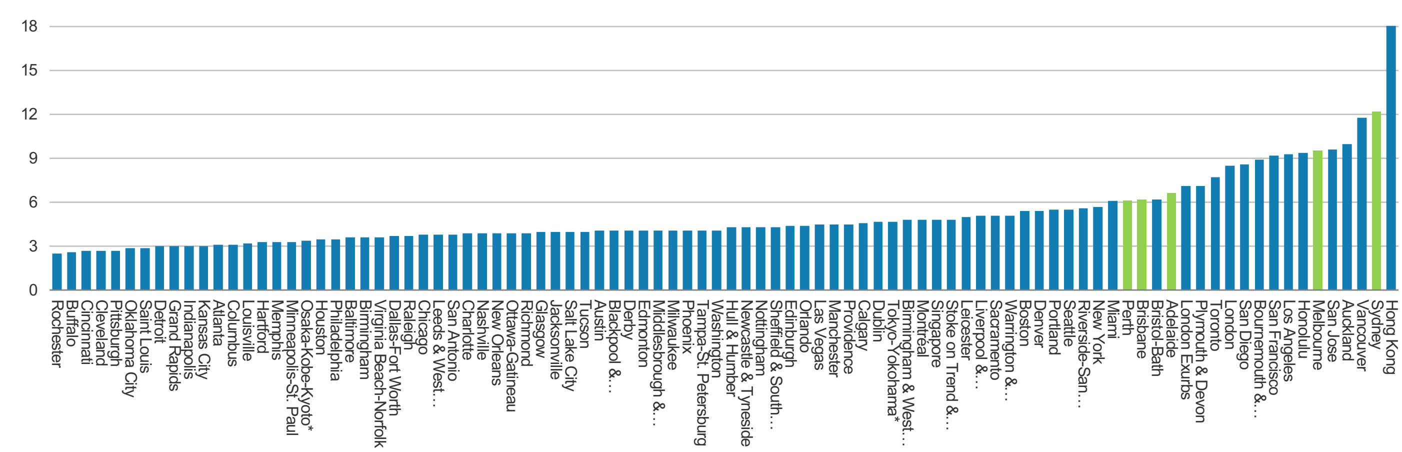
Exhibit 4: Over 2m Australian landlords (>20% of households), the majority of which are making investment losses in a play for tax-advantaged capital gains



Source: ATO, Morgan Stanley Research

As a result of this activity, Sydney and Melbourne housing markets have pushed well beyond the comfort levels of key regulators. Back in 2015, Treasury Secretary Fraser described Sydney and parts of Melbourne housing as in a bubble, while previous RBA Governor Stevens also shared concerns about the market (see 'Sydney housing 'unequivocally' in a bubble, says Treasury boss', ABC News, 1 June 2015). More recently, ASIC Commissioner Medcraft reinforced his concerns, publicly stating that "having lived through many residential mortgage markets, that I thought it was a bubble for a while, other people are catching up now" ('Scott Morrison flags property investor crackdown, ASIC's Greg Medcraft warns on housing 'bubble'', *ABC News*, 20 March 2017).

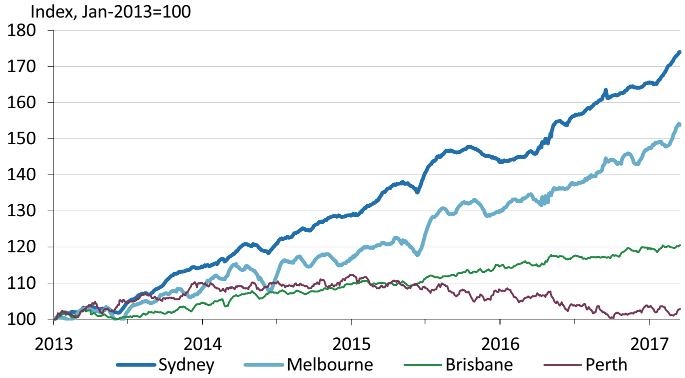
Exhibit 5: Australian cities feature at the expensive end of global comparisons, relative to income



Source: Demographia International Housing Affordability Survey (2017)

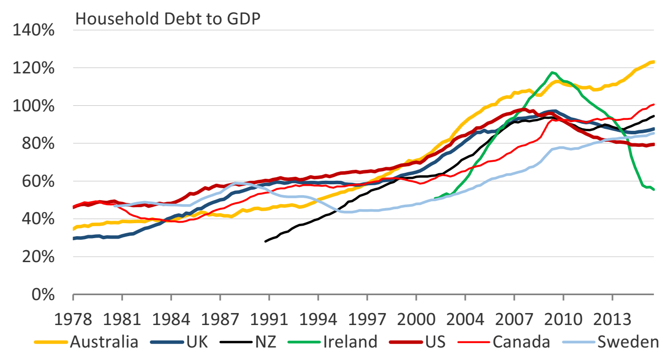
More importantly, given his role as chair of the Council of Financial Regulators, RBA Governor Lowe delivered a speech on 5 April 2017 that focused on housing imbalances, highlighting concerns about speculative behaviour ("rising prices have encouraged people to buy residential property as an investment in the hope of ongoing capital gains") and lending standards ("too many loans are still made where the borrower has the skinniest of income buffers after interest payments").

Exhibit 6: Sydney and Melbourne house prices have pushed beyond regulators' comfort levels



Source: CoreLogic, Morgan Stanley Research

Exhibit 7: Australian household leverage second only to Switzerland, and well above peers



Source: BIS, Morgan Stanley Research

Since 2013, Sydney and Melbourne house prices are up 80% and 70%, respectively, and now rank amongst the most expensive globally, relative to median incomes. Similarly, Australian gearing levels rank at the top of world, and well above peers. The broadest measure of household debt/GDP ranks at 123%, compared with a DM-average of 76% and peers between 80-100%.

RBA reaction function shifting? More focus on financial stability

The RBA has taken a distinctly stronger tone on financial stability over the past 18 months, most clearly around the transition to Governor Lowe (September 2016). The new Statement on the Conduct of Monetary Policy agreed with the Treasurer gave more emphasis to the potential for flexibility in the inflation target to support financial stability outcomes. Indeed, we believe the RBA's objective function can be summarised as a 'triple' mandate, although their relative priorities are likely to vary through the cycle:

- Full employment (and 'the economic prosperity and welfare' of Australians)
- Flexible inflation target: CPI of "two-point-something"..."on average, over time"
- Stability of the financial system

In testimony before the House Economics Committee on 24 February 2017, Lowe explored these trade-offs explicitly:

- "An argument could be made—and people argue this, including people on my own staff—that we could have lower interest rates today to try encourage a bit stronger growth in employment, get the unemployment rate down a bit and get inflation up a bit quickly. I think that is a respectable line of argument"

- "The counterargument is that further reductions in the interest rate in the current environment—this is not always the case, but in the current environment—would mainly work through getting people to borrow more. When they borrow more, that will probably push up house prices even more because they would mainly be borrowing for the purposes of housing, not to fund more consumption today, because they are dealing with the current high levels of debt and slow income growth"

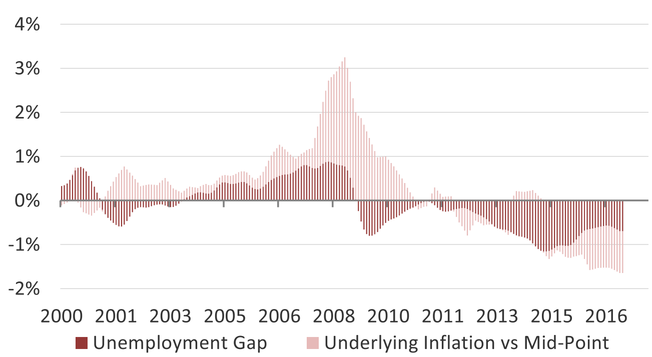
- "The issue we are discussing internally is: how much extra fragility would that create in the economy? With household debt as a share of household income already at a record high, is it really in the national interest to get a little bit more employment growth in the short run at the expense of creating vulnerabilities which could become quite dangerous in the medium term?"

Implication – RBA willing to miss inflation/employment target for longer

Given what seems to be a broader interpretation of the RBA's mandate, and a further increase in housing risks and household leverage, we believe the RBA Board will now accept a larger miss of its inflation and full employment targets. This is already becoming evident, as shown below, where we calculate that the sum of the employment gap and undershoot of the mid-point of the 2-3% inflation target is the largest since 2000. Furthermore, a Taylor rule calibrated with the IMF's estimate of a time-varying neutral rate (r*) shows the RBA cash rate about 50bp higher than a recommended 1.00% setting.

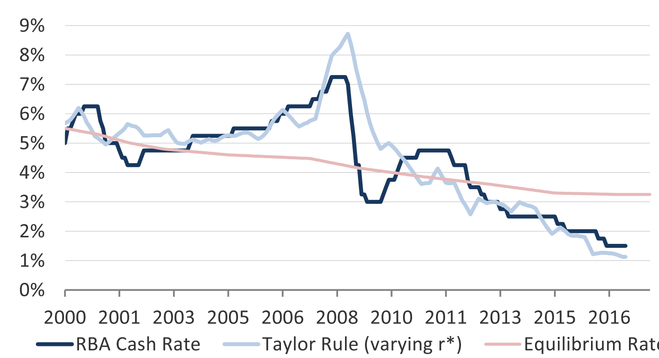
This interpretation still begs two questions: 1) what is the relative priority of the three targets? and 2) what is the threshold for further rate cuts? We think a sharply deteriorating labour market would prompt the RBA to make a final set of rate cuts, given the recession risk that would pose. *However*, current dynamics of a flat, or slowly increasing unemployment rate mean the RBA can buy time with MacroPru, in the hope that lagging the Fed tightening cycle will cause a lower AUD and a broadening growth transition. We discuss this approach in more detail in 'Breaking the Rock with MacroPru'.

Exhibit 8: Pressure building, as RBA's undershoot of full employment and inflation target widens



Source: ABS, RBA, Morgan Stanley Research

Exhibit 9: Neutral RBA rate falling, with IMF estimate ~3.25%. Incorporating this into a Taylor rule, cash rate would be 50bp lower, at 1%



Source: IMF, RBA, Morgan Stanley Research

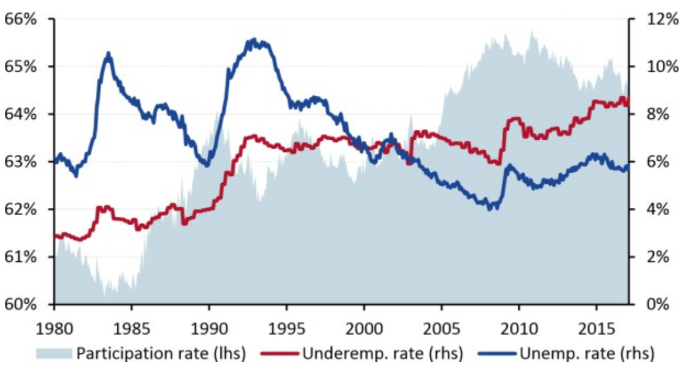
And the 'Hard Place' – Labour market weak and deteriorating

Labour market more fragile than headline suggests

Australian labour market indicators bear the scars of a persistent shortfall of demand, with unemployment trending back up to 5.9% in February, despite a renewed downtrend in participation as disaffected and aging workers drop out of the labour force. Underemployment looks widespread, with the ABS measure of Australians that would like to *work more* standing at a 40-year record high of 8.7%.

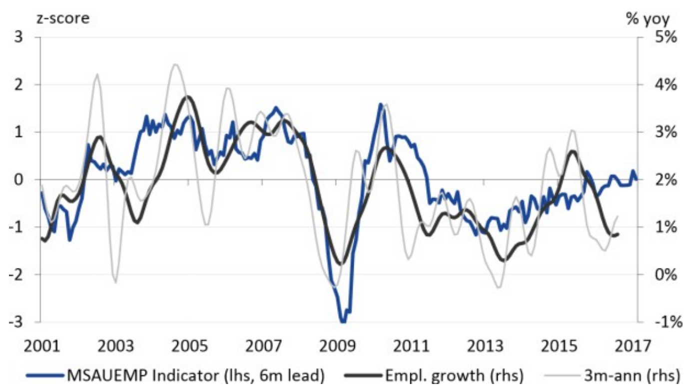
To some degree, we believe this captures the structural casualisation of the Australian labour market, but it also reflects cyclical conditions, as suggested by the -0.3% fall in full-time employment over the last 12 months. Furthermore, our short-term indicator of jobs growth, MSAUEMP, dipped in March and has yet to break into mid-cycle territory, after languishing for the past five years.

Exhibit 10: Unemployment edging back up, and likely to push through 6%, while underemployment stands at a 40-year high



Source: ABS, Morgan Stanley Research

Exhibit 11: Our short-term jobs indicator, MSAUEMP, has yet to break into mid-cycle territory

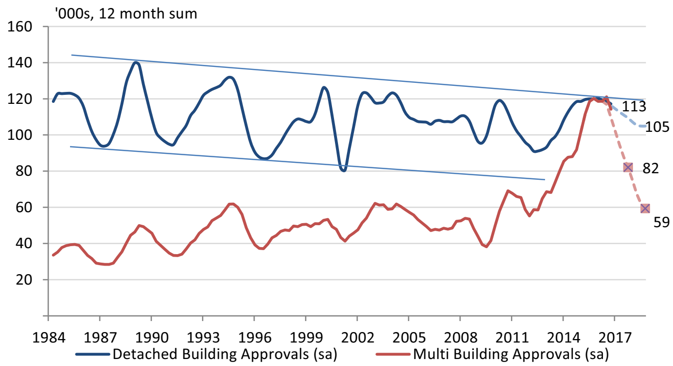


Source: ABS, Bloomberg, Morgan Stanley Research

With another surprise challenge ahead, on our forecasts

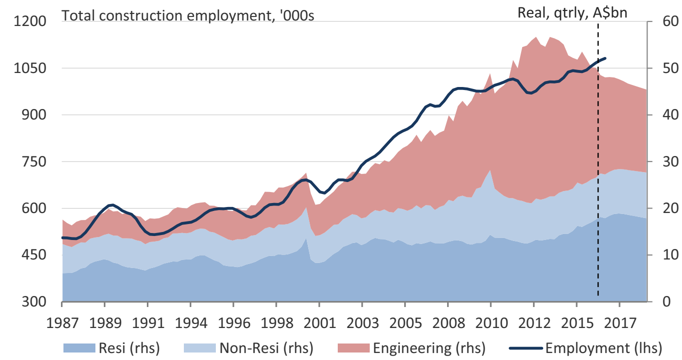
Looking ahead, we see a clear threat to unemployment from a pullback in the residential construction boom (largely apartments). The broader construction sector now employs over 9% of the labour force, above the peak of the resources capex boom. We believe the correction underway will displace ~150-200k largely full-time jobs (1.6% of the labour force), as per our analysis in Australia Macro+: Australian Housing: Stressing the Foundations (19 Oct 2016). Alongside broader weakness in GDP growth (MSe 2.1% for 2016 versus the RBA's 3% forecast), we expect this will push the unemployment trend up to ~6.4% in 1H18.

Exhibit 12: We forecast a sharp pullback in apartment construction, given tighter credit and oversupply



Source: ABS, Morgan Stanley Research Forecasts

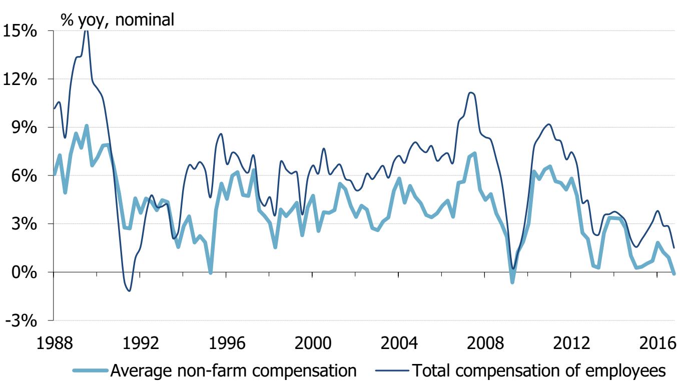
Exhibit 13: Construction employment set to fall as we struggle to see completions replaced at this pace



Source: ABS, Morgan Stanley Research Forecasts

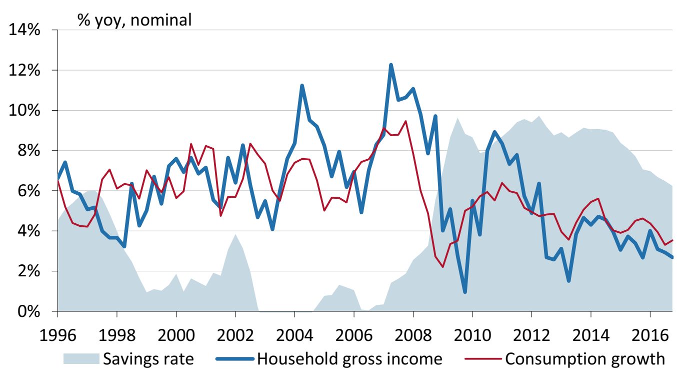
We believe the lack of jobs growth and broad-based underemployment explain the record low wage growth, which has broadened from a mining-specific adjustment into a broader stagnation in compensation and income growth. Over 2016, the average Australian saw a nominal pay cut, while also facing 5.4% inflation in the 18% of the CPI basket that we deem regulated (imposing a -1ppt drag on disposable income).

Exhibit 14: Australians on average seeing an annual pay cut, for just the third time on record



Source: ABS, Morgan Stanley Research

Exhibit 15: Australian consumers have tapped into savings to bridge their income shortfall



Source: ABS, Morgan Stanley Research Forecasts

Breaking the Rock with MacroPru

Australia's MacroPru Toolkit

Introducing the Council of Financial Regulators (CFR)

We believe MacroPru will become a more active part of the Australian policy landscape, under the stewardship of the Council of Financial Regulators, which cuts across the existing monetary and fiscal policy functions of the RBA and Treasury, whilst assisting the prudential and supervisory functions of APRA and ASIC. The Council is comprised of eight members – including the heads and a senior representative from each of these four agencies, with RBA staff providing secretariat support and the Governor serving as Chair.

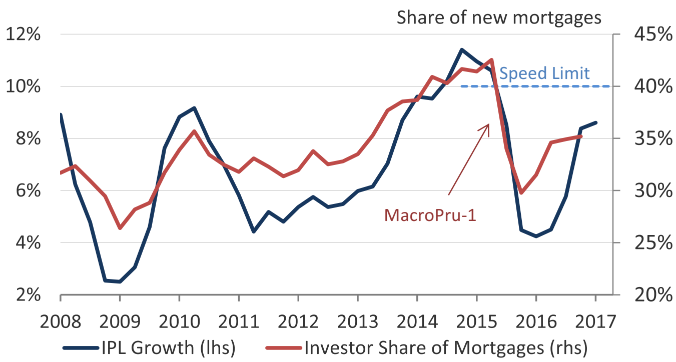
The CFR meets in person at least quarterly to "share information and views on the financial sector conditions and risks, discuss regulatory reforms and, if the need arises, coordinate responses to potential threats to financial stability". However, the CFR is non-statutory and has no separate legal functions or powers, instead relying on the fairly sweeping powers of its individual member agencies. As it stands, the Council will not have a single 'face' and presumably will agree policy actions through consensus.

The 'Council' Has Spoken – Action Taken

MacroPru-1 – Testing the Waters: It was not until late 2014 that the Council became involved on the front lines of credit allocation by the Australian financial system. In what we call "MacroPru-1", the CFR in December 2014 agreed a coordinated intervention by APRA to tighten lending standards and impose a 'benchmark' cap of 10% growth in investor-property lending, and for ASIC to investigate whether consumer credit code practices were being breached – especially for interest-only mortgages (for an initial summary, see Australia Financials: APRA's Mortgage Measures, 9 Dec 2014).

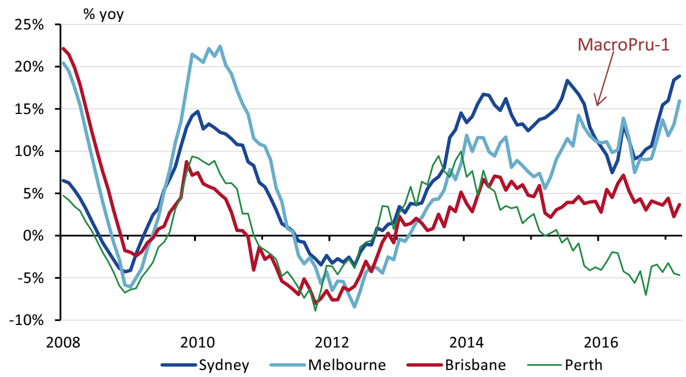
We believe this first round of measures had some success in reining in the housing market, as we summarised back in late-2015 (see Australia Macro+: Tracking the Housing Slowdown – Christmas Break, 22 Dec 2015). As examples, there was a material fall in the investor share of new mortgages – from 43% in 2Q15 to 30% by 4Q15, investor credit growth from 11% to 4% (3m-ann.), a pullback in auction clearance rates, as well as survey-based measures of house price expectations. As a result, price growth in Sydney slowed from an average of 16% p.a. in 2014 and 2015 to 7% over the year to March 2016.

Exhibit 16: MacroPru-1 had a notable impact on investor participation



Source: APRA, Morgan Stanley Research

Exhibit 17: Price trends slowed, for a short period



Source: CoreLogic, Morgan Stanley Research

However, a number of factors came together to cause the Sydney and Melbourne established house prices accelerate back to the current +20% and +17% yoy, respectively. These include another 50bp of RBA rate cuts in May and August 2016, the government's superannuation tax increases (which made housing relatively more tax-advantaged, especially if confidence in super tax treatment *into the future* was also impacted), and an increase in competitive intensity in mortgage lending – both amongst the banks and with the non-banks.

While these (and other) drivers cannot be individually quantified, our MSHAUS indicator framework shows that a further deterioration in fundamentals (supply/demand, rental conditions, affordability) was offset by a reduction in debt service following the RBA's 2016 cuts and a pickup in investor sentiment and participation – perhaps capturing the after-tax investment appeal of property (see Australia Macro+: Supervising a Housing Slowdown, 15 Feb 2017).

Exhibit 18: MSHAUS Housing Indicator Heatmap – Still weak outlook for construction and price growth, but debt service and investor sentiment improved between MacroPru rounds 1 and 2

	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
MSHAUS Indicactor	**0.09**	**0.23**	**0.14**	**0.35**	**0.38**	**0.43**	**0.38**	**0.20**	**0.06**	**-0.15**	**-0.20**	**-0.33**	**-0.37**	**-0.63**	**-0.87**	**-0.80**	**-0.75**	**-0.68**
Demand/Supply Balance	1.17	1.30	1.33	1.20	1.15	0.97	0.67	0.49	0.10	-0.23	-0.45	-0.72	-0.97	-1.10	-1.24	-1.02	-1.12	-1.20
Rental Conditions	0.73	0.51	0.57	0.52	0.41	0.30	0.04	0.02	-0.07	-0.22	-0.38	-0.49	-0.72	-0.96	-1.00	-0.99	-1.20	-1.26
Mortgage Serviceability	-0.97	-0.94	-0.75	-0.61	-0.52	-0.33	-0.24	-0.23	-0.22	-0.24	-0.25	-0.24	-0.05	-0.07	-0.20	-0.23	-0.17	-0.06
Housing Accessibility	-0.64	-0.67	-0.70	-0.71	-0.78	-0.77	-0.82	-0.86	-0.90	-0.95	-1.03	-1.16	-1.25	-1.32	-1.37	-1.32	-1.36	-1.40
Credit Supply	0.00	0.35	-0.21	0.53	0.57	0.72	0.84	0.49	0.47	0.17	0.30	0.11	0.16	-0.44	-0.92	-0.87	-0.63	-0.44
House Price Expectations	-0.44	-0.44	-0.13	-0.04	0.25	0.49	0.52	0.10	-0.21	-0.18	-0.43	-0.04	-0.37	-0.63	-0.96	-1.19	-1.03	-0.85

Source: Morgan Stanley Research

MacroPru-2 and the Evolving Framework

On 31 March, APRA and the CFR announced the next round of MacroPru measures, including:

1. A 30% cap on new interest only loans (IOLs), including limits on the volume of IOL at loan-to-value ratios (LVRs) above 80% and "strong scrutiny and justification" of IOLs with an LVR >90%
2. No change in the 10% "speed limit" on investment property loan (IPL) growth, but an expectation that it will be "comfortably" below this level

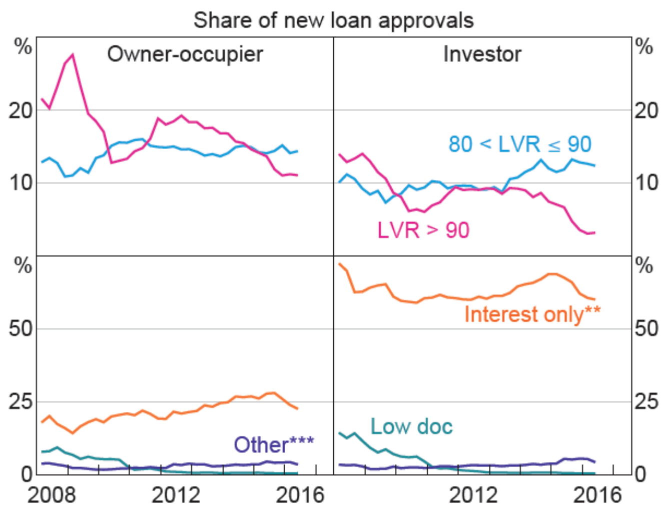
3. A review of serviceability metrics; and

4. Rrestraints on growth in higher risk lending, including high loan-to-income loans, high LVR loans and loans for very long times

On the surface, these steps seem cautious and could struggle to have a sustained impact on investment property lending (IPL) growth, or the rise in household leverage. That said, they come alongside recent out-of-cycle mortgage rate hikes by the banks (+23-38bp for investors), with the rationing of interest-only (IO) mortgages likely to have a disproportionate impact on investors, where ~65% of borrowers use IO periods to maximise tax deductions.

The market may also underestimate the degree to which Australian mortgage payments 'step-up' when rolling from the IO to P&I phase (at least +30% and often +50-70%, depending on tenors and headline rate). At an aggregate level, we calculate that a 10ppt fall in the share of IO mortgages to the new cap would reduce household free cash flow by around A$3bn (0.26% of income), with the average 14bp of mortgage hikes over the past fortnight absorbing another A$2bn (0.15%).

Exhibit 19: OO loans have seen falling LVRs, but a rising share of IOs until recently. Investor loans are structurally high users of IO-periods



* Series are break-adjusted for reporting changes
** Investor series is seasonally adjusted
*** 'Other' includes loans approved outside normal debt-serviceability policies and other non-standard loans

Source: APRA, RBA

Exhibit 20: Example mortgage structures, which see a 40-70% step-up in payments as borrowers move into P&I phase (% change not dependent on mortgage balance)

Mortgage Size	750,000	750,000	750,000
Fixed Term	3	4	5
Total Term	25	28	30
Mortgage Rate	4.50%	4.25%	4.00%
Ann. Pmt - IO	-$33,750	-$31,875	-$30,000
Ann. Pmt - P&I	-$53,765	-$49,902	-$47,505
Step-Up	**59%**	**57%**	**58%**

Source: Morgan Stanley Research

Longer Term – Restructuring Risk Weights & Operationalising MacroPru

Permanent risk-weight (incentive) restructuring coming: Looking further out, our Banks team has been making the case that the next (more permanent) round of supervisory action could be through increases to risk weights for investor lending (see Australia Banks: Mortgages: Time for Action, 2 Apr 2017). While increasingly out of consensus in this view, we note that APRA Chairman Byre's speech on 5 April essentially confirmed that these should be announced by mid-year. While his speech was clear that they would not create a 'dramatic' increase in capital requirements, he noted that "the capital adequacy framework needs to address the concentration in housing lending that has built up in the banking system over time".

Our Banks team expects higher risk weightings (RWs) for 'materially dependent' IPLs and IO loans, driving a potential 7-9ppt lift in the average mortgage RW, increasing capital requirements across the sector by A$12.5-16bn. This should address the fundamental incentive that banks currently have to grow their investor mortgage books (even more so than owner-occupier). And in order to maintain ROEs > 20% on IPLs in that scenario, our team notes that the banks may reprice these mortgages by another 30-80bp relative to the cash rate.

Operationalising MacroPru: There was an important theme running through the speeches from RBA Governor Lowe and APRA Chairman Byres' speeches following the MacroPru-2 announcements – that further steps could be taken (or not), depending on how conditions evolve. So while there was a long pause after the initial measures, we think that bank and regulatory reporting systems have been significantly improved and are now in a better position to cope with more dynamic underwriting requirements.

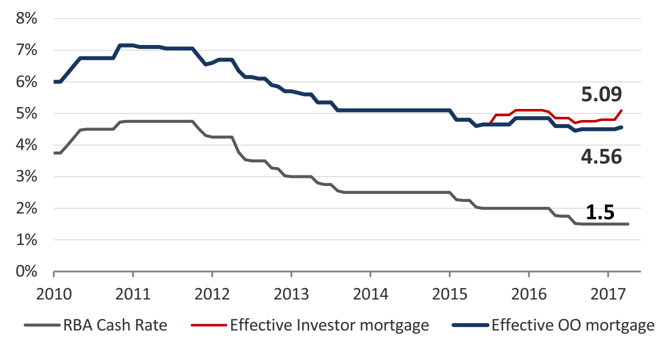
As we explored back in September 2015, we think Australia's concentrated banking system and mortgage market are very well suited for MacroPru, with the regulators having sweeping powers relative to more fragmented or constrained systems abroad (see Australia Macro+: Asia Insight: Australia's Housing Boom... Now Subject to Finance, 21 Sep 2015). In practice, the next steps will be to finalise risk weights and then to monitor the impact of mortgage repricing, as well as further tightening of lending standards through the imposition of the Household Expenditure Measure as a floor for living cost assumptions.

Beyond that, we could see any number of directions taken by APRA and the CFR – including imposing lending quotas or tighter standards by city, or across LTV or LTI levels. Another step that would be particularly effective in Australia would be to prevent or penalise the cross-collateralisation of investment property to ensure that deposits are paid from liquid assets (rather than adding to the gearing of existing properties).

MacroPru to Reinforce Housing Slowdown

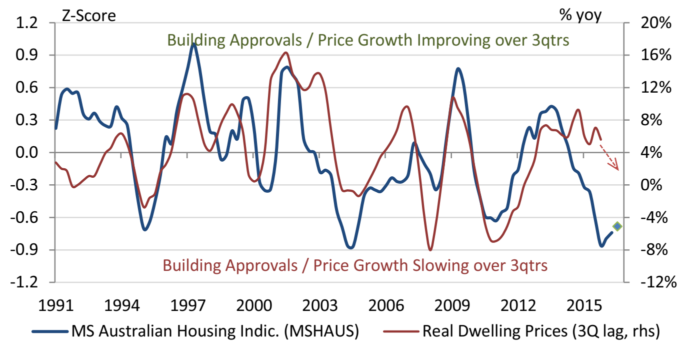
We believe the MacroPru-2 measures will combine with the mortgage repricing, tighter lending standards and some impact on sentiment from a reinvigorated round of regulatory 'jawboning' to mean slower price growth and a continued downturn in the broader housing cycle, as we previously envisioned in Australia Macro+: Australian Housing: Stressing the Foundations (19 Oct 2016).

Exhibit 21: Investors facing a 'tightening cycle', despite the RBA holding cash rates at 1.5%



Source: RBA, Morgan Stanley Research

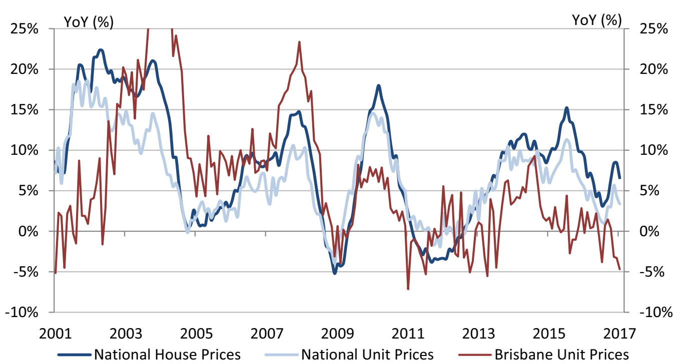
Exhibit 22: Proprietary MSHAUS indicator flags price trends flattening on tighter lending standards and weak fundamentals



Source: CoreLogic, Morgan Stanley Research

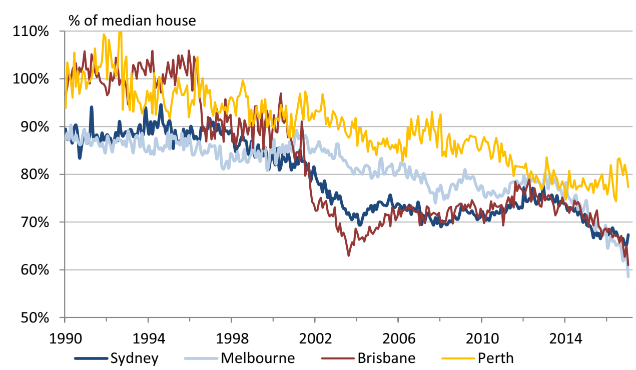
Of more interest is that these measures continue to build as the cycle starts to show signs of stress, particularly for off-the-plan apartments. Recent headlines span potential distress (see 'Brisbane apartments offered at 39pc discount in disputed fire sale', Australian Financial Review, 29 March 2017) and poor returns for new-builds more generally (see 'Off-the-plan buyers seeing losses and lacklustre growth', Domain.com.au, 28 March 2017). While price growth in established Sydney and Melbourne markets remains buoyant, apartment prices and rents look to be showing signs of oversupply. While we do not explicitly forecast price trends, our MSHAUS model captures weaker fundamentals, tightening lendings standards and a modest headwind from bank repricing to lead to flat real house price trends over its 3-4 horizon.

Exhibit 23: Apartment prices starting to lag detached, with Brisbane market looking weakest



Source: CoreLogic, Morgan Stanley Research

Exhibit 24: Ratio of unit to detached dwelling prices



Source: CoreLogic, Morgan Stanley Research

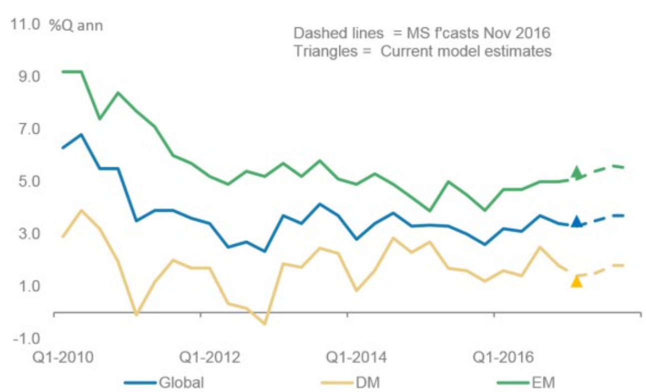
Art of Stillness – Why the RBA Won't Follow the Fed

Global reflation putting FOMC on faster path to neutral

While the Australian growth outlook remains challenged by the need to rein in a housing boom amidst already weak labour market conditions, we note the **global backdrop has materially improved** over the last year. A synchronised reflation spans the EM/DM divide, and appears to have been underway before the 2016 US election, and hence is unlikely to immediately stall on delays to the US reform agenda, as long as outright protectionist policies are not pursued (see Sunday Start: Can the Synchronous Recovery Be Sustained? 26 Mar 2017).

China has arguably been the largest driver of this growth recovery, and in the wake of the 2016 stimulus, we expect policymakers to promulgate further supply-side reforms, while prioritising growth stability as part of a longer-term adjustment to a more sustainable model (see Morgan Stanley Blue Paper: Why we are bullish on China, 14 Feb 2017).

Exhibit 25: Global and EM growth tracking above our 2017 Outlook forecasts



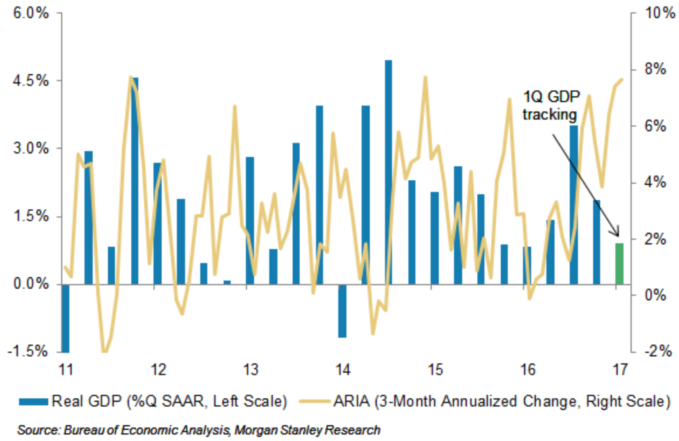
Source: CPB, OECD, Markit, national sources, Morgan Stanley Global Economics Research

Exhibit 26: Global trade set to improve sharply

Source: CPB, Morgan Stanley Global Economics Research

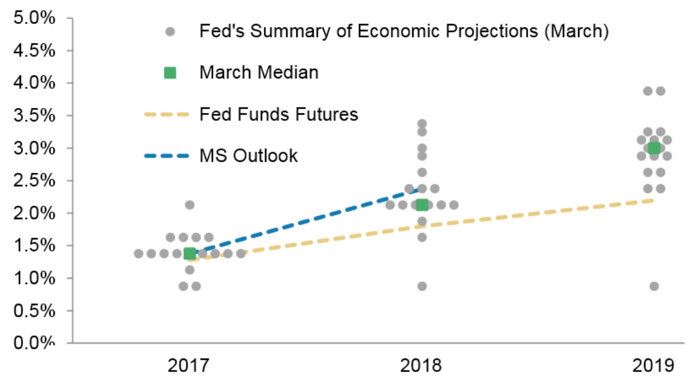
Progress on the Fed's dual mandate has also been a little better than hoped, and we now forecast core PCE of 2% over 2017 and 2018 (tracking at 2.1% from 4Q17-3Q18), with unemployment to fall to 4.6% in 4Q17 and 4.4% in 4Q18. As such, we believe stronger global growth and easier financial conditions will allow the Fed to chart a faster course back to neutral, and now expect hikes over 2017/18 to 2.25-2.50% (see US Economics & Rates Strategy: FOMC: Time for Change, 2 Mar 2017).

Exhibit 27: US Economics & AlphaWise Macro's ARIA tracker showing firm demand growth into 2017



Source: BEA, Morgan Stanley US Economics Research

Exhibit 28: Morgan Stanley now more hawkish than the market and the median FOMC member

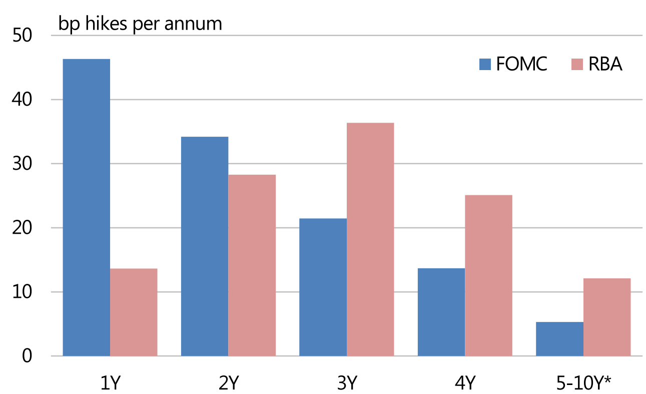


Source: Bloomberg, Federal Reserve, Morgan Stanley US Economics Research

Output gap & housing hysteresis mean RBA won't follow the Fed

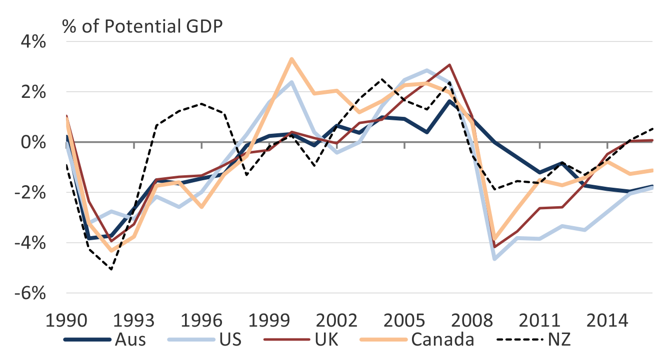
Markets remain skeptical on the Fed tightening cycle, with only around three more hikes priced over 2017-18, compared with six in our base case. However, we were *particularly surprised* to find that futures were pricing a more hawkish RBA than the Fed, from 2018 onwards. This upbeat view on Australia's leverage to global reflation was confirmed in our recent marketing through the US, Europe and Asia, where clients were looking for the +16% boost to Australia's terms of trade in 2016 to flow through to capex and hiring, with upwards pressure on wages supporting consumption, all of which would set the RBA on a normal tightening cycle.

Exhibit 29: Market far too hawkish on RBA beyond 2017, especially relative to the FOMC



Source: Bloomberg, Morgan Stanley Research

Exhibit 30: Australian output gap larger than peers, and likely to remain wide on our forecasts



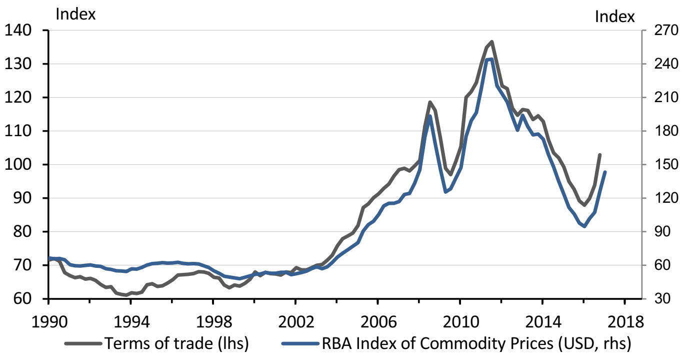
Source: OECD, Morgan Stanley Research

We think this analysis misses three key elements: 1) the **low resources-multiplier** over the next 12-18 months given austerity/deleveraging across miners and government; 2) the extent to which Australia is **lagging global reflation** with a still-high output gap, rising unemployment and record low wages and private-sector inflation; and 3) **policy hysteresis** as lower debt service costs have become embedded in housing market valuations and household leverage. We explore these themes below.

1) Less leveraged to reflation this cycle

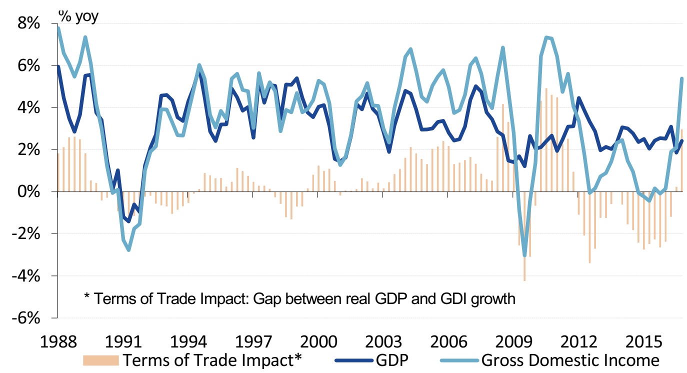
Australia has historically been geared to global growth cycles through its exposure to commodity exports, which equate to 11% of GDP (62% of total exports). Indeed, this 2016 reflation has seen commodity prices rise 57% from January 2016 to February 2017 (as measured by the RBA's Index, which reflects Australian export weights). This resulted in a +16% lift in the broader terms of trade over 2016, adding 4% to domestic incomes and boosting nominal GDP growth to 6.1% yoy.

Exhibit 31: Commodity prices and terms of trade



Source: ABS, RBA, Morgan Stanley Research

Exhibit 32: Terms of trade rebound has produced a surge in real national income, but we expect less pass through to activity

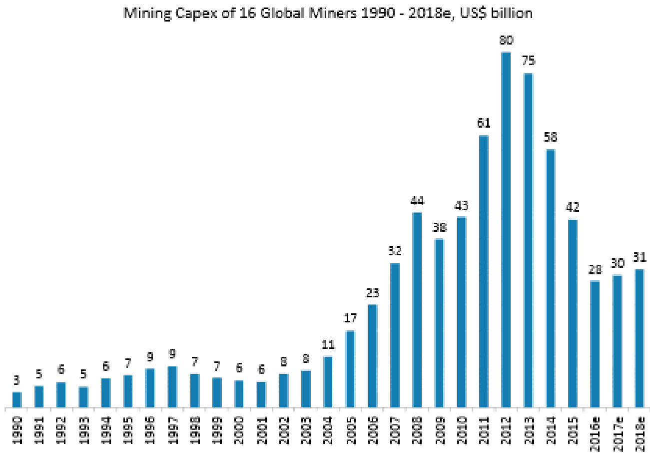


Source: ABS, Morgan Stanley Research

However, we see less Australian leverage to global reflation in 2017, given the direct beneficiaries (miners and government) are unlikely to recycle the revenue windfall back into hiring and investment. Instead, after the scarring balance sheet pressures faced just 12 months ago, our mining analysts see only a modest increase in sector capex – largely on maintenance. And panning back, the latest industry surveys point to another 20-30% fall in broader resources capex over FY18 as the completion of large-scale LNG projects more than offsets a likely trough in iron ore and coal activity (see Capex caution continues, 23 Feb 2017).

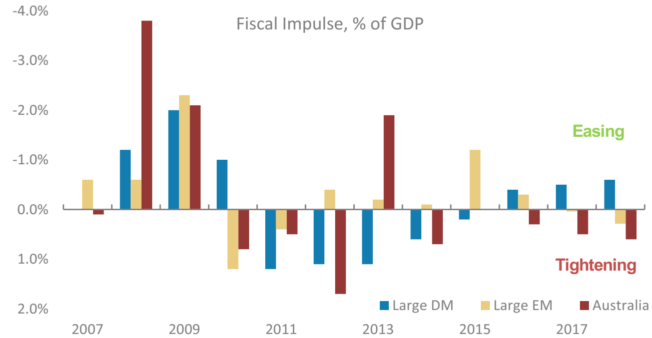
Meanwhile, Federal and State governments clearly have an opportunity to soften their path back to surplus, but we believe they will swap any corporate tax revenues and royalties in for proposed spending cuts that have failed to pass the Senate, or to shore up State fiscal profiles. The **political imperative to protect the AAA sovereign rating** seems to remain a key driver of Australia's reluctance to join the G20 pivot towards fiscal stimulus. On this front, S&P's move to negative watch in July 2016 has sharpened the government's focus on delivering a medium-term stimulus, and we will be watching pre-Budget (9 May) policy news flow closely, but remain skeptical of any material stimulus.

Exhibit 33: Our capex forecasts for 16 major miners show a modest recovery in 2017-18, but more focused on energy/copper outside Australia



Source: Bloomberg, Morgan Stanley European Metals & Mining Research

Exhibit 34: Australia looks to have missed two fiscal themes: The 'End of Austerity' (2013) and 'Monetary to Fiscal' (2016)

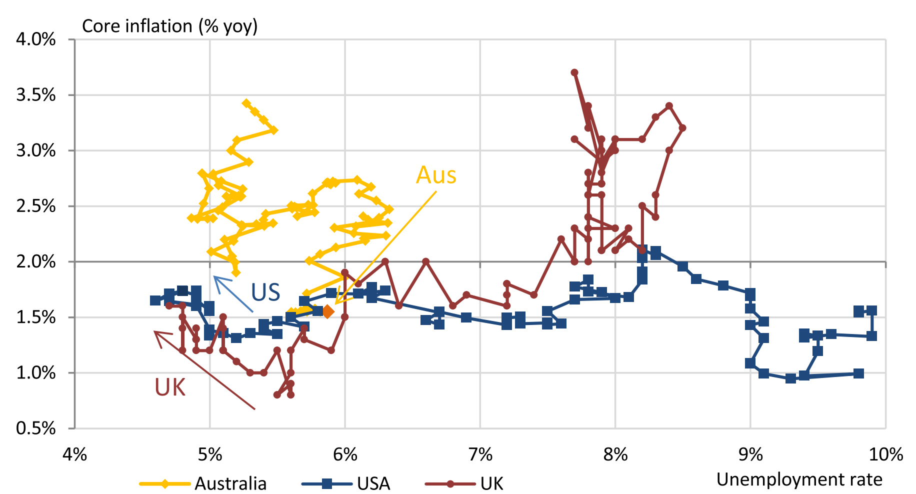


Source: Commonwealth Treasury, National sources, Morgan Stanley Global Economics Research

2) RBA well behind peers on traditional inflation/employment targets

We see weakness in the labour market and household balance sheets as the "hard place" preventing the RBA from following the Fed's rate hikes, especially while unit labour costs and private inflation measures are so weak. In comparison with unemployment falling into the 4's across the US, the UK and New Zealand (and under 3% in Japan), we have seen Australian unemployment drift up to 5.9%. As we explored earlier in The 'Hard Place' – Labour market weak and deteriorating, we expect the apartment construction slowdown to result in a further rise in unemployment, towards a peak of 6.4%.

Exhibit 35: Australia lagging ~18 months behind US and UK on achieving full employment and 2% core inflation



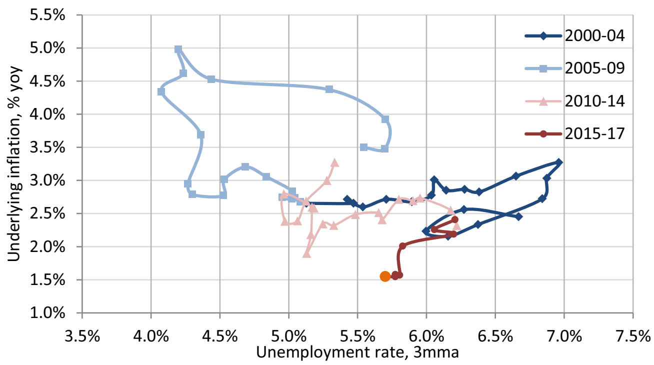
Source: ABS, Bloomberg, Morgan Stanley Research

Inflation trends also look behind the curve in Australia, consistent with wider output and employment gaps, a cautious (and price-sensitive) consumer and increasingly competitive retail environment, and our view that underemployment is also playing a role in suppressing wage growth to record-lows. Underlying inflation is running around 1.6% yoy in Australia, and while on the surface this is only a fraction below US core PCE of 1.8%, we would note:

1. Australia's inflation-target is higher, and inflation is currently 1ppt below its post-1996 average, while US core CPI at 2.2% is currently *above* its average over the same period (2.1%)

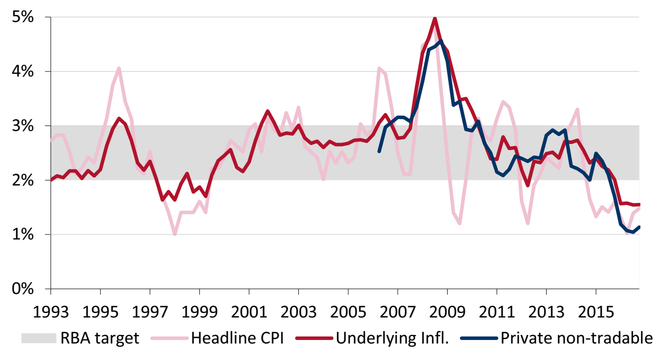
2. The Fed's 'target' of 2% core PCE inflation captures a different approach, and at 1.8% yoy, the US is also above its post-1996 average on this measure (1.7%). In comparison, the Australian PCE deflator is running at just 0.9% yoy, the lowest level in its 56 year history outside of brief periods in 1962 and 1999.

Exhibit 36: Australian Phillips Curve not just flat, but seemingly inverted – raising questions about strength of labour market



Source: ABS, Morgan Stanley Research

Exhibit 37: Private inflation trends even weaker than headlines, given >5% inflation across regulated / government-related sectors

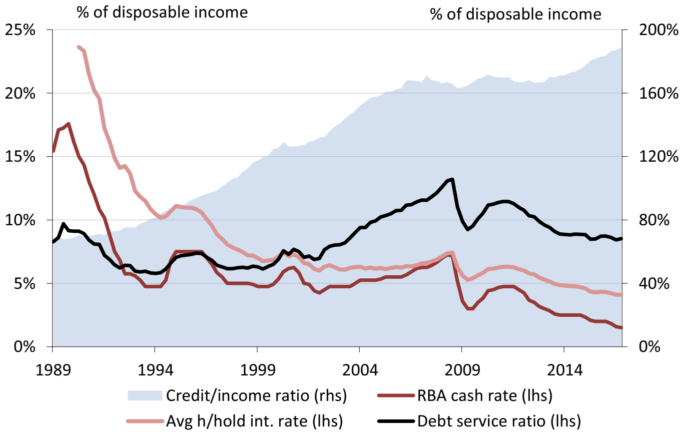


Source: ABS, Morgan Stanley Research

3) "New-neutral" falling as housing hysteresis sharpens bite of future hikes

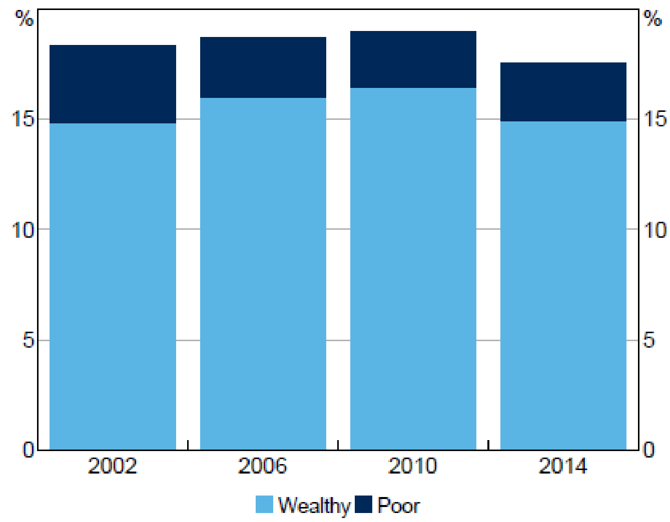
Monetary policy has always been particularly effective in Australia, given the rapid pass-through of RBA policy rates to (largely) floating rate mortgages, which make up a full 62% of private sector credit. However, we think consensus has not appreciated the degree of policy **path dependence (hysteresis) driven by this close connection between housing, household leverage and borrowing costs –** especially without the balance sheet restructuring seen through recessions abroad.

Exhibit 38: Debt service at 2003-levels, but only with the support of a 1.5% cash rate; RBA at 3% would take DSR +3ppt to 11.4%, well into tightening territory



Source: ABS, RBA, Morgan Stanley Research

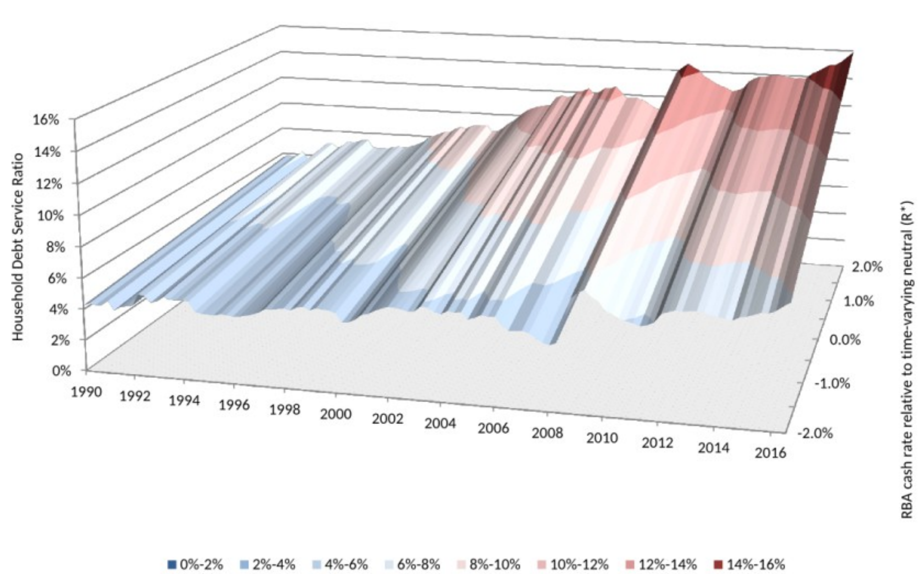
Exhibit 39: Around 18% of Australian households are 'Hand to Mouth', with little/no liquid assets



Source: La Cava, Hughson & Kaplan (2016), The Household Cash Flow Channel of Monetary Policy
*Note 'Wealthy (Poor) Households are those defined with positive illiquid net assets (eg. housing, superannuation)'

In simple terms, we think the lower policy rates go, and the longer they stay there, the more household leverage is accumulated – making future hikes more potent than otherwise. We believe this is an under-researched area in the literature, although work by La Cava, Hughson and Kaplan (2016) makes the case for a cash flow channel of monetary policy that works through liquidity-constrained households. They estimate that about 18% of Australian households are in such a position, despite the majority having some illiquid wealth, held in superannuation and housing.

Exhibit 40: Australian household sector far more interest-sensitive than historically – lending margins have widened and leverage is much higher



Source: Morgan Stanley Research

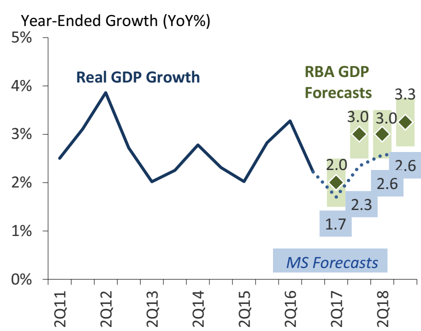
To put this in context, when the RBA cut rates to an 'emergency' low of 3% back in April 2009, the household debt service burden was lowered to 9% of incomes. Given the much-wider lending margins across the credit surface, and the rise in household leverage, today's 1.50% cash rate has debt service only a fraction lower at 8.5%. From here, any RBA tightening cycle would reach an equivalent 9% debt service after just two hikes, and on the same basis, **a 3% cash rate would be the equivalent of 6% pre-GFC**.

RBA Forecast – Now 'on hold into 2019'

Given the stronger than forecast Sydney/Melbourne house price trends, more-stretched household balance sheets and an RBA that is clearly tilting their reaction function towards a stability mandate, we **no longer expect the Bank to make a final cut in 3Q17**. But on the flipside, we had previously expected that cut to help bring an earlier fall in the AUD and engineer a more robust growth transition out in 2018 – putting the RBA in a stronger position to follow the Fed tightening cycle. Instead, we think a tighter near-term monetary policy, combined with a stronger MacroPru regime will mean slower growth and prolonged unemployment, and as a result we also **remove the 50bp of hikes forecast in 2H18**.

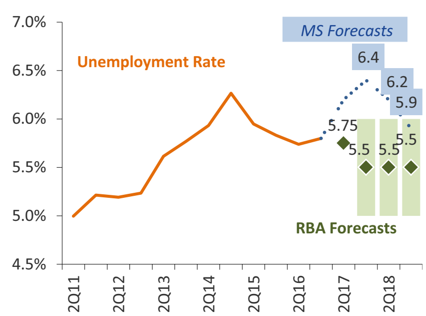
Our forecast for the RBA to hold rates at 1.50% into 2019 implies that it will balance a prolonged (but narrowing) undershoot of the 2-3% inflation target, alongside a more significant shortfall of full employment. As considered above, this would require the Board to be more focused than previously on financial stability objectives.

Exhibit 41: GDP forecast lagging RBA



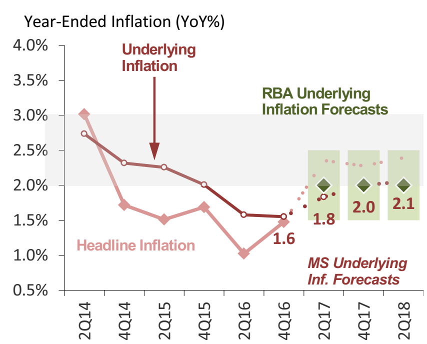
Source: RBA, Morgan Stanley Research

Exhibit 42: Unemployment profile higher



Source: RBA, Morgan Stanley Research

Exhibit 43: Inflation slowly recovering



Source: RBA, Morgan Stanley Research

Where could we be wrong? Upside on fiscal, downside on housing

Bull case around fiscal: In contrast, we continue to flag a fiscal stimulus as the largest upside risk over the next 18 months. A major infrastructure program would help Australia follow the broader G20 reflation, and could lead to a potential rotation from monetary policy through a tentative unwind of the last 50bp of rate cuts (taking the cash rate back to 2%). We have previously noted that up to A$80bn, or 5% of GDP worth of infrastructure projects could be fast-tracked, and the private sector multipliers around this program could help GDP growth accelerate above-trend. In this scenario, we see the RBA potentially hiking rates to 2.5% by end-2018.

Downside risks remain: The path of the AUD and housing dynamics will play a crucial role in the policy outlook, and both are notoriously difficult to forecast. Further AUD appreciation, or a more significant interaction between MacroPru and weaker fundamentals on housing, would push the RBA back towards cuts (which remain in our bear case). At the extreme, our bear case, which features a China/trade shock and domestic balance sheet recession, would prompt the RBA to cut rates to the effective lower bound (which we currently estimate at around 0.25%).

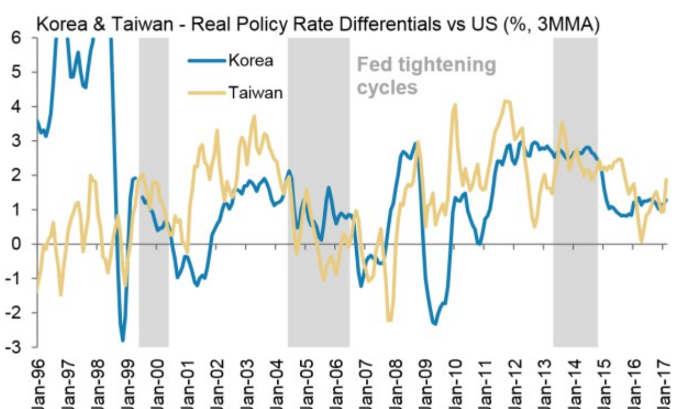
And what *should* they do? Even putting both these scenarios aside, a normative argument can be made that if fiscal stimulus is not provided in 2017, the RBA and APRA may be better placed using a more aggressive combination of rate cuts and MacroPru, to avoid what the IMF called 'dark corners' in their recent Article IV consultation. If successful, this would drive a sharper recovery of growth and inflation, while managing the greater financial stability risks incurred. We agree that the MacroPru framework should be further researched and developed without delay, but see fiscal policy and a reform agenda as the first-best policy tool to tackle Australia's growth challenges (see Australia in Transition: Asia Insight: Scoring a Difficult Transition, 24 May 2016).

Some parallels with Korea and Japan

Australia's challenges bear some resemblance to the imbalances seen in the Korean economy, where the BoK has also been working to manage rising household indebtedness. Our colleague Deyi Tan sees lower growth and lowflation playing out over the next two years, but also sees the more aggressive Fed tightening cycle helping ease *relative* financial conditions for the BoK (see South Korea Economics & Strategy: Why Our BoK Easing Call No Longer Looks Right, 5 Mar 2017).

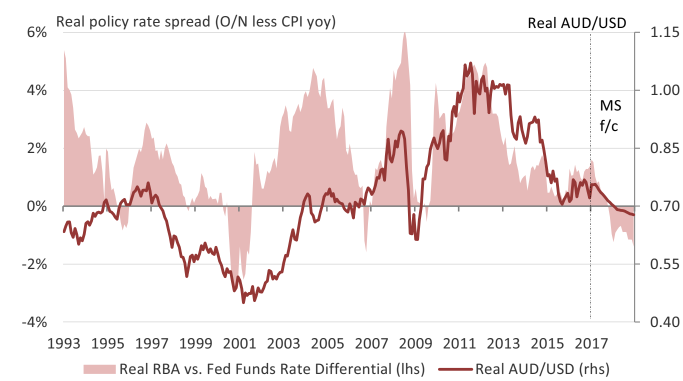
We see a similar starting point for the real policy rate differential, and expect the Fed's tightening cycle to cause a lower AUD and KRW – providing stimulus to trade-exposed sectors. A similar thesis plays out for Japan, where the BoJ's policy of yield-curve control establishes a strong linkage between the Fed, a weaker JPY and lower real yields (see Japan Economics and Strategy: Don't Fight the BoJ's YCC: 9 Key Questions and Implications for Markets, 15 Feb 2017)

Exhibit 44: Korean and Taiwanese real rates



Source: CEIC, Morgan Stanley Economics Research

Exhibit 45: Australian real rate differential to fall sharply



Source: Bloomberg, Morgan Stanley Research Forecasts

Implications – FX and Rates

FX Summary

The plateau in China-related commodities has recently eased some of the upward pressure on the AUD, however bulk commodity prices and interest rate differentials remain fundamentally opposing forces for the AUD. We model the relative importance of these two, and our analysis suggests rate differentials and expected policy rates are highly relevant for the AUDUSD cross. With further downside to commodities on the horizon, positioning and momentum, which have so far supported the AUD, may quickly be unwound. We remain sellers of AUDUSD with a 4Q17 target of 0.70. We lower our AUDUSD target for 4Q18 from 0.74 to 0.67 given our economists' revised outlook for the RBA. **We suggest selling AUD against USD and CAD.**

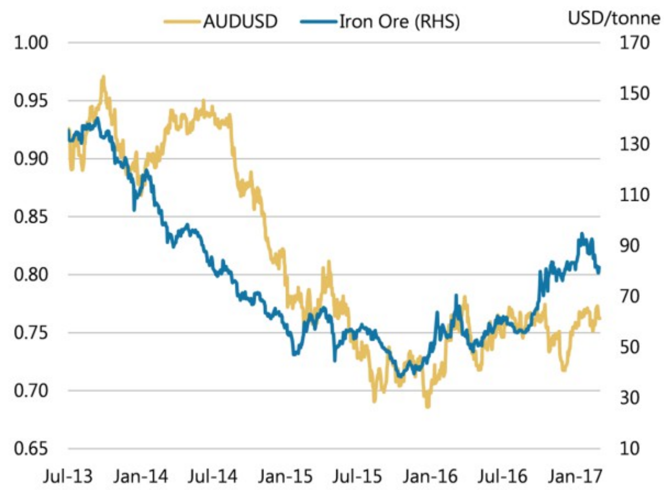
Rates Summary

With the RBA on hold, receiving front-end/belly is our preferred medium-term delta risk. However, given the recent rally in DM rates, we caution around entry levels at this stage. We would look to receive 1y1y on any back up in rates, but think receiver switches against USD continue to look attractive further out. The curve should continue to steepen from here, in particular if we see more weakness on the FX side. We like buying OTM payors on 10y tails to position for this, and highlight 6m10y ATMF+30bp payors. We generally like being long AUD rates vega, and suggest buying 5y10y straddles.

FX – AUD to Fall on Weakening Rate Differentials and Less Commodity Offset

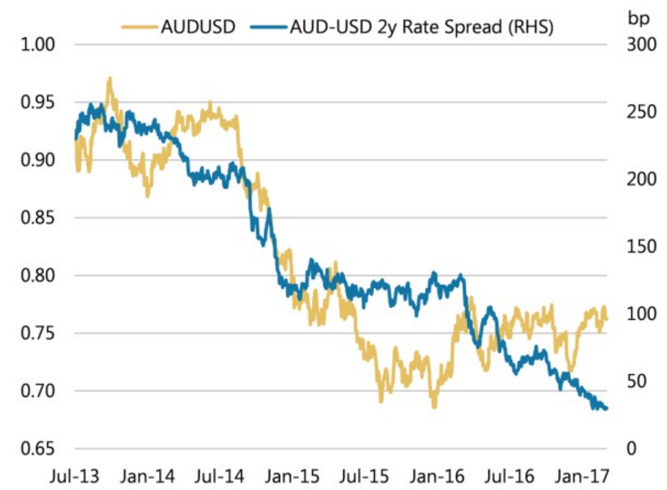
The plateau in China-related commodities has recently eased some of the upward pressure on the AUD. However, the strength in bulk commodities that are important Australian exports, such as iron ore, over the past 18 months remains a fundamentally opposing force to the AUD relative to rate differentials, as displayed in Exhibit 46 and Exhibit 47. Looking ahead, we think price action in iron ore is more likely to be a drag on the AUD, rather than provide support. Factors such as Vale's S11D roll-out and dormant supply in Australia should cap prices, in our commodity analysts' view (see metal&ROCK: The oil drag). Put together with the demand side, with the current rate of Chinese steel production and on-going steel capacity reform, our commodities team forecasts iron ore at $74/tonne by year-end, implying 11% further downside in 2017 and more to come in 2018.

Exhibit 46: AUDUSD vs. Iron Ore



Source: Morgan Stanley Research, Bloomberg

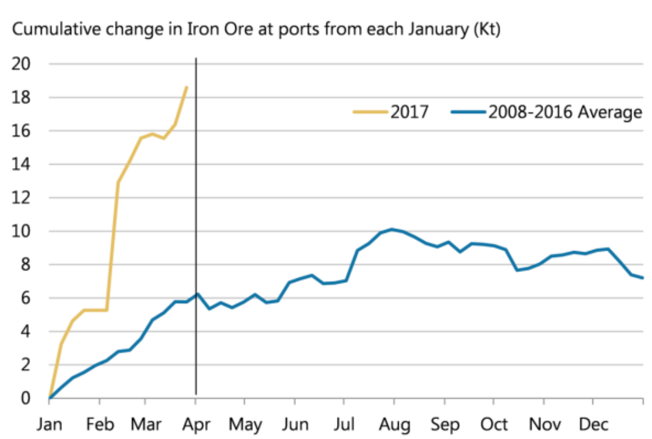
Exhibit 47: AUDUSD vs. 2y rates differential



Source: Morgan Stanley Research, Bloomberg

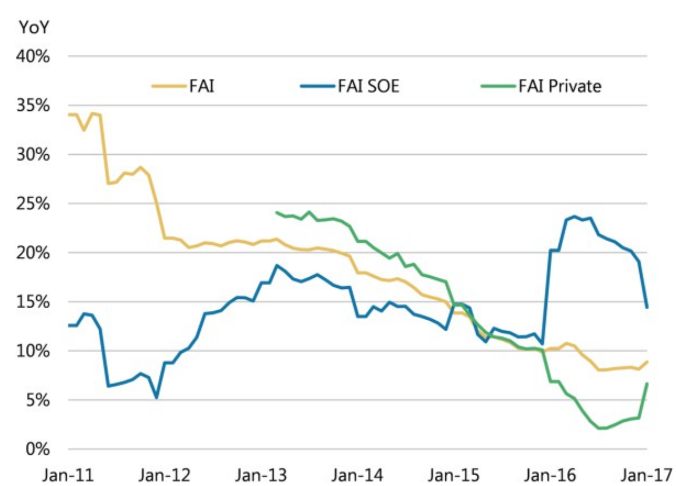
We have highlighted a number of times the fact that iron ore imported to Chinese ports has been running very high vis-à-vis consumption (see e.g. Supervising a Housing Slowdown), implying an inventory overshoot. While we recognize that part of this is driven by a rotation to imported iron ore, we also note that the build-up in inventory has tended to peak during Q1 (see Exhibit 48). Longer-term, factors such as the previously mentioned reform of the Chinese steel sector means excess capacity and the rotation away from commodity-heavy 'old China' sectors towards services should cap demand growth (see e.g. Why we are bullish on China). The decrease in SOE fixed asset investment and uptick in private fixed asset investment is evidence of this already playing out (see Exhibit 49), in our view.

Exhibit 48: Stock of iron ore at Chinese ports: build-up tends to be strong in 1Q



Source: Morgan Stanley Research, Mysteel, CEIC

Exhibit 49: China Fixed Asset Invesment (FAI)



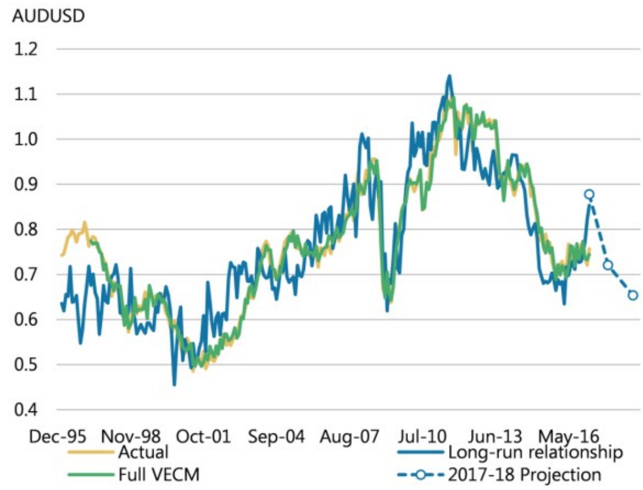
Source: Morgan Stanley, CEIC

We model fair value for AUDUSD of close to 0.70 for 4Q17 and at 0.66 for 4Q18, using commodities and rate differentials as our main inputs for the long-run equilibrium for the cross. The approach we take is similar to that outlined by the RBA. However, in order to get a higher-frequency reading on model fair value we use the RBA's Index of

Commodity Prices (capturing Australian export weights), as opposed to the quarterly terms of trade. A further difference lies in the fact that we include two separate interest rate factors, in order to capture both short-term interest differentials (3m bills) and expected changes in monetary policy rates (3m-2y curve slope). We find both load positively on the AUDUSD, and are highly statistically significant. We use inflation rate differentials as a fourth and final factor for the long-run equilibrium factors in an error correction model which also takes changes in AUDUSD implied FX vol and ASX returns as exogenous factors. Results are shown in Exhibit 50.

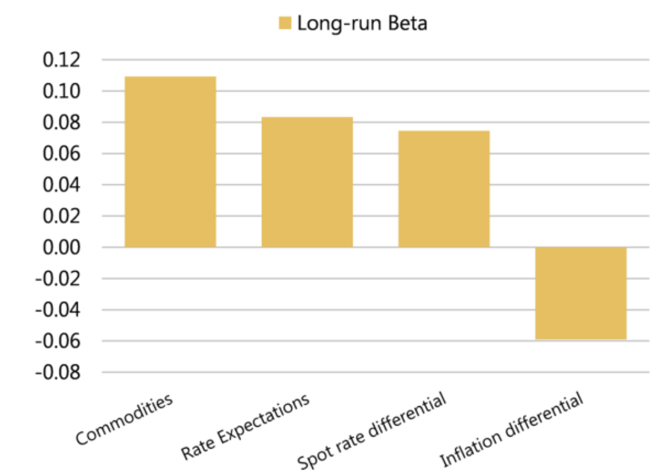
The '2017-18' series shows the long-run equilibrium implied by Morgan Stanley forecasts for the Fed, RBA and commodities – i.e. AUDUSD at 0.72 by 4Q17 and 0.67 by 4Q18. Exhibit 51 shows Betas from the long-run relationship – underscoring the importance of interest rate differentials, in our view.

Exhibit 50: Estimated AUDUSD fair value – currency looked through some of the sharp met coal rally



Source: Morgan Stanley Research

Exhibit 51: Long-run betas from fair value model



Source: Morgan Stanley Research. All inputs z-scored using a 20y look-back

Exhibit 52: Morgan Stanley AUDUSD Forecast

Source: Morgan Stanley Research, Bloomberg

Although our economists no longer forecast a final rate cut from the RBA this year, an RBA on-hold through the end of 2018 should act as a longer-term drag on the currency, in our view. On a cumulative basis, policy rate differentials should move 150bp in the USD's favour if Morgan Stanley forecasts for the Fed and RBA plays out. Despite the simplicity of this analysis, we think rate differentials should fully reflect the weakness in the domestic economy foreseen by our economists, namely a relatively loose labour market, the width of the output gap and the potential for a MacroPru-driven slowdown in the housing market. As such, we have decided to lower our 4Q18 AUDUSD forecast from 0.74 previously and now forecast 0.67 by the end of 2018.

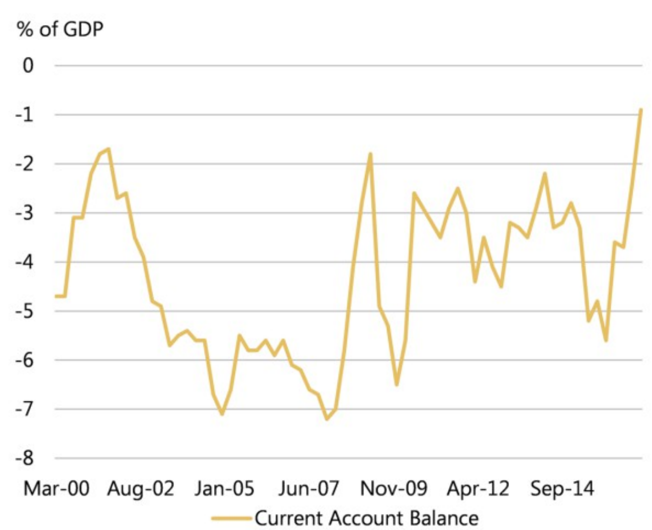
Where could we be wrong?

Our view on the AUDUSD foresees further significant weakness to come in bulk commodity prices. Should these prices stay elevated for some time, we would expect the impact on the domestic economy to grow over time. Thus far, we have argued that the increase in commodity prices should have a relatively small impact on the domestic economy given the extent to which Australian commodity producers are owned by foreigners (north of 60%), as well as the reluctance to ramp up investments in the sector given the focus on cash flow generation and balance sheet consolidation within the miners. In addition to the market looking through the sharp NDRC-driven met coal rally over year-end, this 'low multiplier' dynamic may also serve to explain why the AUD did not rally harder than it did in 1Q, as implied by the long-run equilibrium betas to commodities and interest rates (see Exhibit 50).

The surge in bulk commodities has already provided a significant boost to terms of trade and the current account (see Exhibit 53). However, while most of this is driven by the exports side, we also note that it is also a reflection of relatively weak import growth (Exhibit 54). This is indicative of the theme of domestic data showing no strong signs of a pick-up of activity outside the trade numbers, in our view.

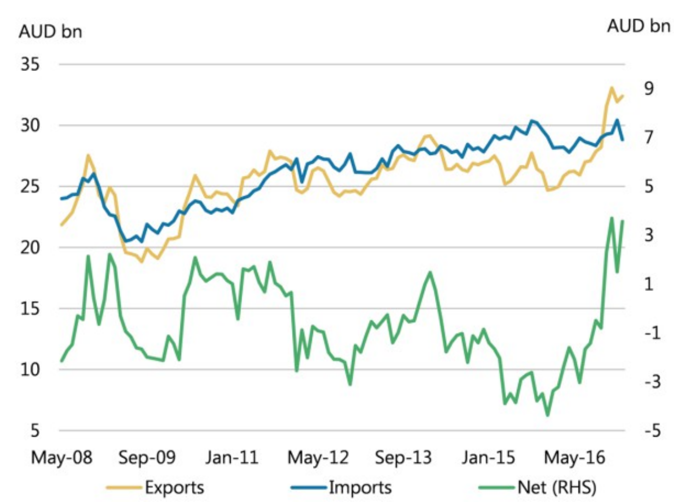
A further risk to our view is the Government's willingness to expand the fiscal deficit – for more on this see Art of Stillness – Why the RBA Won't Follow the Fed. The willingness and political feasibility of expanding the deficit may also be affected by potential credit rating downgrades, as maintaining the AAA rating has been an important focus of the political debate. In any case, we would expect only a small negative reaction to the AUD should the sovereign be downgraded, and an even smaller reaction in the rates market.

Exhibit 53: Australia Current Account Balance (BoP)



Source: Morgan Stanley Research, Bloomberg

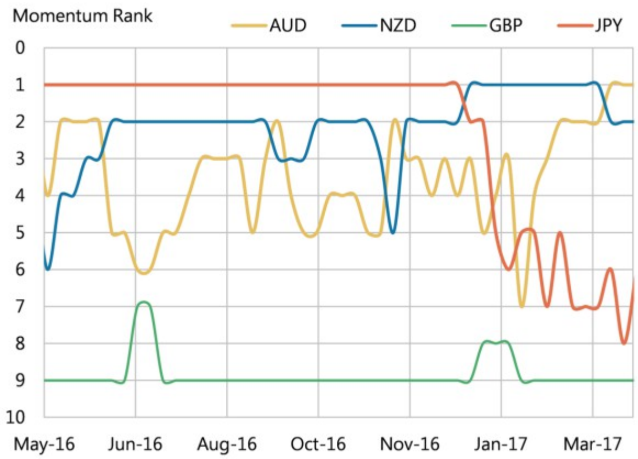
Exhibit 54: Australia Exports and Imports of Goods & Services



Source: Morgan Stanley Research, Bloomberg

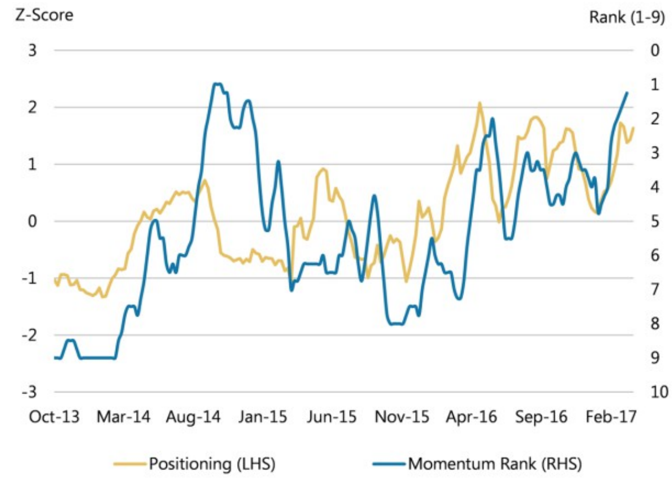
Aside from support from commodities, we think momentum and positioning are further factors behind recent AUD strength on the crosses. In Exhibit 55 we show the result of applying a momentum ranking strategy within G10 FX (ex. USD). The momentum factor identifies trends over a 9-month look-back, as well as short-run deviations from this trend, similar to that applied in the MS eBMI (see here), and ranks currencies from 1 (strong) to 9 (weak). As shown in Exhibit 56, the momentum rank has tended to correlate relatively highly with positioning in the AUD, in particular over the past 12 months. If commodities price action softens further, we think there's scope for both of these factors to reverse quickly.

Exhibit 55: G10 Momentum Strategy: Now favours AUD



Source: Morgan Stanley Research

Exhibit 56: AUD momentum rank vs. CFTC positioning



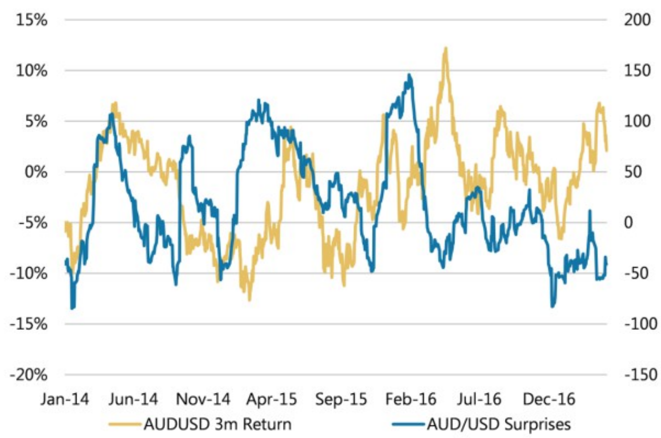
Source: Morgan Stanley Research, Bloomberg

Sell AUDUSD: target 0.69, stop 0.7760
Sell AUDCAD: target: 0.97; Stop: 1.03

Outside of selling the AUD against the USD, we suggest tactically selling AUD against CAD. In many respects, Australia and Canada are facing similar economic challenges: coming out of a commodity and investment slump, soaring house prices in major cities and central banks with low interest rates. Recently however, we have seen economic data out of Canada continue to outperform expectations, unlike in Australia (see Exhibit 58). The AUD/CAD rally since February is no longer justified on this measure. By the end of 2018, the market prices 36bp of hikes in Canada and 23bp in Australia.

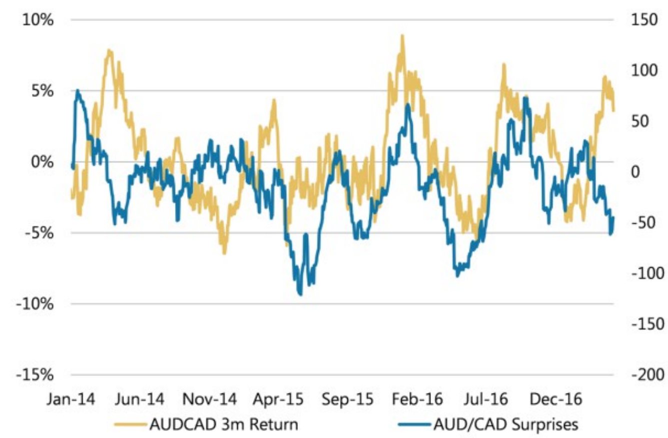
Inflation has not yet picked up significantly in either country, but we think the future possible path for downside is more significant in Australia. In contrast, Canada's growth outlook is looking up, with Jan GDP beating expectations by coming in at 2.3%Y (versus 1.9% expected). Lastly, we highlight terms of trade differentials. Commodity markets can be volatile, but iron ore prices underperforming oil recently is also not reflected in AUD/CAD. Port Hedland in Australia has reported a 2% decline in iron ore exports for March. AUD/NZD long positions built since February also look vulnerable. The risk to this view is a renewed rebound in iron ore prices in response to increased Chinese demand. These risks also apply to the AUDUSD trade, which is also exposed to a less hawkish Fed than we forecast.

Exhibit 57: AUDUSD vs. economic surprises



Source: Morgan Stanley Research, Bloomberg

Exhibit 58: AUDCAD vs. economic surprises

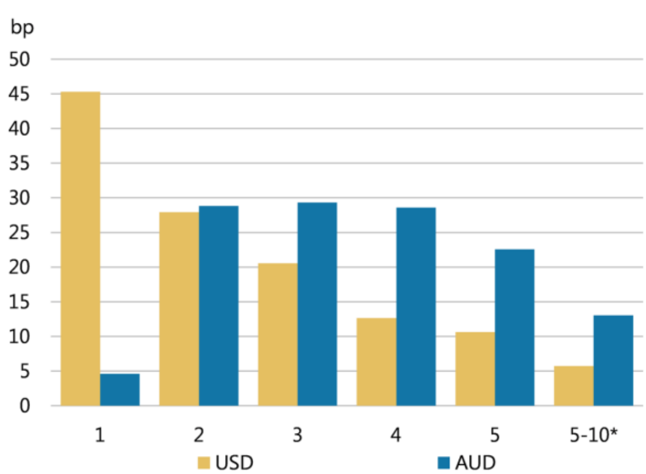


Source: Morgan Stanley Research, Bloomberg

Rates – Market still pricing too much for RBA; Looking at steepeners and straddles

Australian rates have rallied significantly over the past month, pulling the front-end back towards levels seen around the US election. Despite the pullback, we view market pricing for the RBA as too aggressive. Contrasting the flat outlook projected by our economists for 2017 and 2018, the market prices close to 35bp in cumulative hikes from now and until 1Q19 (see Exhibit 59). Beyond that, the relative curve shape compared to the US is even steeper, with little priced for the Fed beyond the 2y point. While we continue to view received positions in the front-end as our preferred delta exposure in AUD rates, we would caution against current entry levels, and instead focus on more protected vol trades. For those looking to enter received positions at the moment we would highlight 1y1y as the sweetspot in terms of rolldown (see Exhibit 60).

Exhibit 59: Annual hikes priced for the RBA and the Fed



Source: Morgan Stanley Research, Bloomberg. Note: forward OIS swaps

Exhibit 60: Vol-adjusted rolldown

Vol-adjusted Rolldown

	3M	6M	9M	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y
3M	-90%	-45%	-5%	15%	44%	37%	34%	33%	29%	27%	24%	23%
6M	10%	30%	40%	49%	49%	42%	37%	35%	32%	28%	25%	24%
9M	45%	49%	55%	56%	46%	42%	36%	34%	30%	27%	24%	23%
1Y	51%	59%	58%	58%	43%	41%	35%	32%	29%	26%	23%	22%
2Y	45%	39%	34%	33%	35%	33%	30%	27%	24%	22%	20%	
3Y	32%	35%	36%	36%	32%	31%	25%	22%	20%	19%		
4Y	32%	30%	29%	29%	28%	24%	19%	17%	16%			
5Y	27%	27%	26%	25%	22%	18%	14%	14%				
6Y	21%	19%	18%	17%	14%	12%	11%					
7Y	12%	12%	11%	11%	9%	11%						
8Y	8%	7%	7%	8%	10%							
9Y	11%	12%	13%	13%								

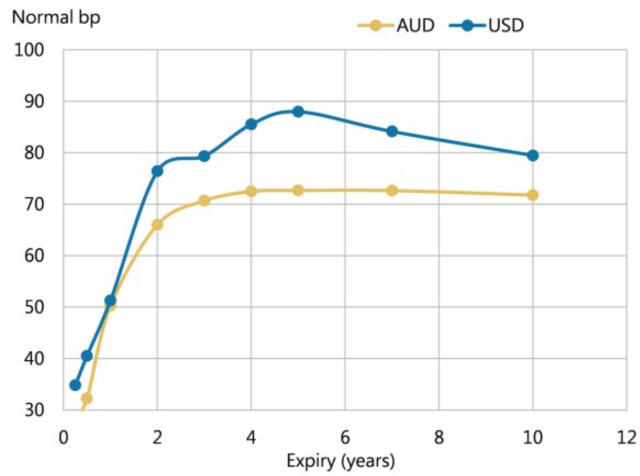
Source: Morgan Stanley Research

Given the cheap levels of AUD vol in general, and in particular compared to the US, we like fading the path priced for the RBA via receiver switches against USD. Exhibit 61 highlights this cheapness on short-tails (1y), which thus stands in contrast to the relatively steeper curve shape priced for AUD in short-tail forward rates. We like the 3y1y point in particular, which allows one to strike the USD receiver some 12bp out of the money for zero cost, while earning an equivalent amount of rolldown over the first year (see Exhibit 62).

Trade idea: Buy AUD 3y1y ATMF receiver vs. 3y1y USD ATMF-12bp receiver for zero cost

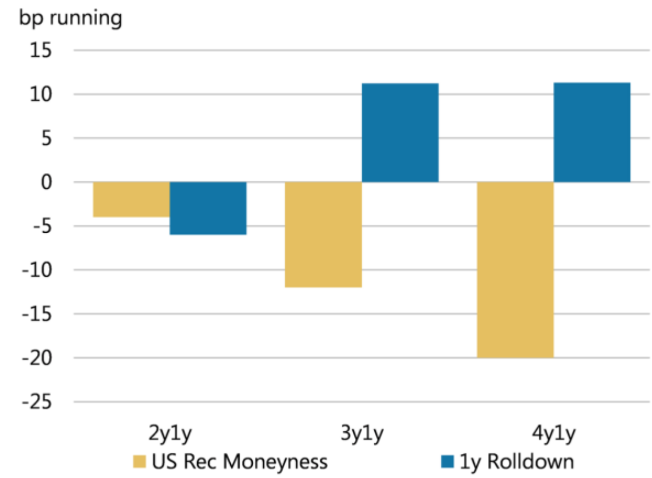
The risk to the trade is that US rates outperform AUD rates, and/or that US vol reprices higher relative to AUD.

Exhibit 61: Implied vol: Expiry curve on 1y tails



Source: Morgan Stanley Research, Bloomberg

Exhibit 62: Zero cost AUD receiver switch against USD: moneyness and rolldown



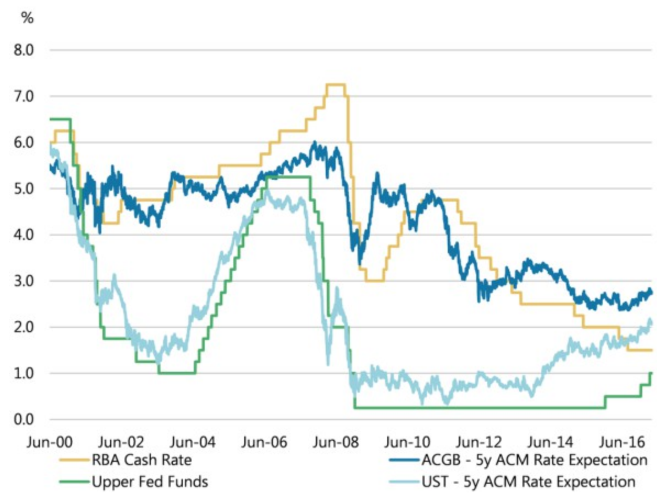
Source: Morgan Stanley Research

The longer-term outlook for Australia rates is slightly more positive in the sense that longer-term rates should be able to continue to trade with a premium over G4 for quite some time. Indeed, market pricing suggests that 'neutral' real rates in Australia are still higher than in G4, as shown in Exhibit 63. 1% for 10y forward, 1y real rates would imply terminal nominal rates of around 3.5% using the mid-point of the RBA's inflation band. This pricing is largely consistent with output from term structure models such as the ACM, which implies that 5y nominal rate expectations are close to 3%, some 70bp above UST equivalents.

Exhibit 63: 10y forward, 1y real rates

Source: Morgan Stanley Research, Bloomberg. Note: 10y1y nominal zero coupon swaps less 10y1y inflation swaps

Exhibit 64: ACM: 5y rate expectations for ACGBs and UTs



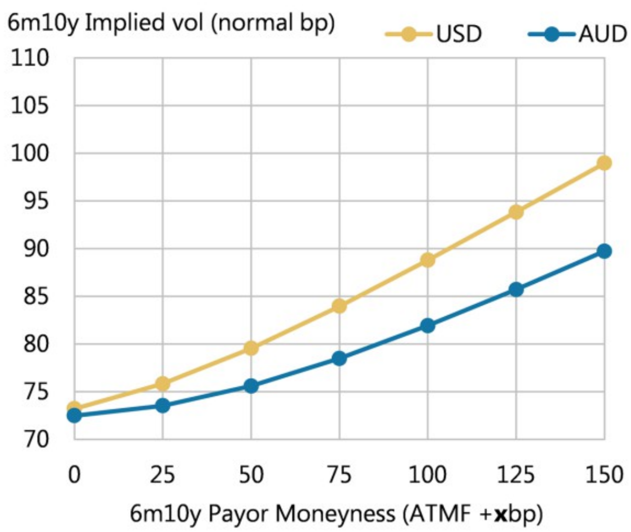
Source: Morgan Stanley Research, Bloomberg

A more positive long-run outlook for real rates in Australia should imply that the longer end of the curve remains very reactive to price action in G4 rates markets. This could be idiosyncratically magnified for Australia should the AUD weaken as we forecast, creating an inflationary impulse that should see a steeper nominal curve in our view. We note that this view is inconsistent with pricing in the vol market, where AUD gamma payors are trading at a significant discount vs. USD (see Exhibit 65). Isolating historical episodes of sharp sell-offs in US 10y rates, we find that Aussie 10y has tended to increasingly underperform the larger the sell-offs have been in US rates, as shown in Exhibit 66.

Trade idea: Buy AUD 6m10y ATMF+30bp payors for 82c

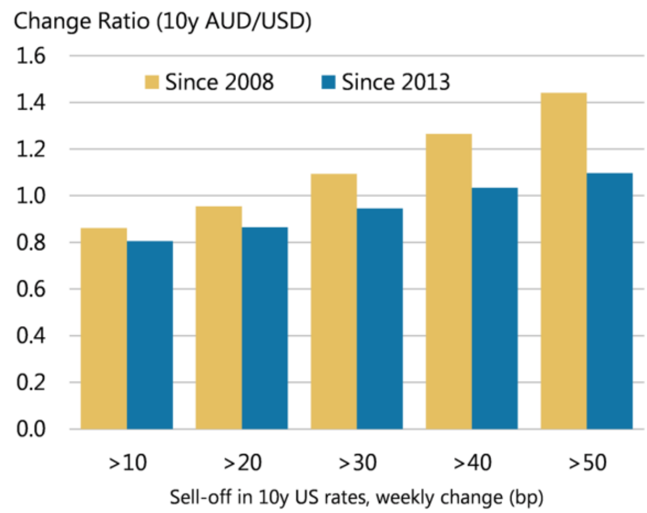
The risk to the trade is that 10y expires below the 3.25% strike, in which case losses are limited to the premium spent.

Exhibit 65: AUD and USD 6m10y Payor vol



Source: Morgan Stanley Research

Exhibit 66: Past sell-offs in US rates: AUD vs. USD



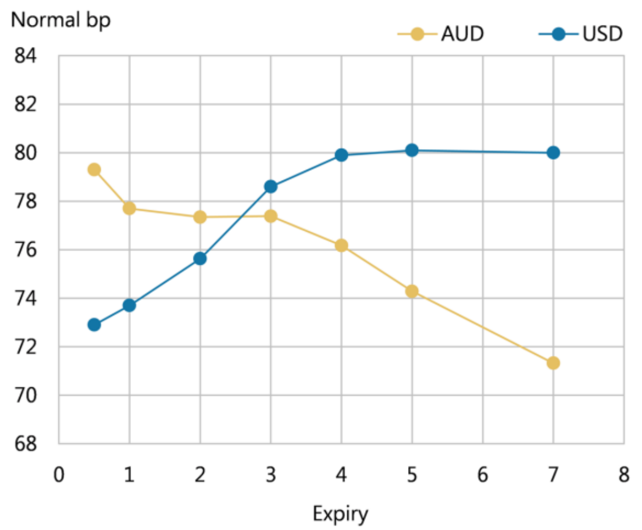
Source: Morgan Stanley Research, Bloomberg

Longer-term expiries in AUD rates vol have sold off hard over over Q1 and mostly trades at or below all-time lows (since 2010). As such, we view current levels as attractive to get long vol, in particular in the areas of the surface where the expiry curve is inverted only a few years out, like 10y tails (see Exhibit 67). Implementing this view via forward vol structures like 1y3y10y makes sense to us, as does buying vanilla 5y10y straddles. Furthermore, 20y tails appear event cheaper at current levels, but we recognize that liquidity may be a major obstacle in this part of the grid (see Exhibit 68).

Trade idea: Buy 5y10y straddles at 71 normal bp

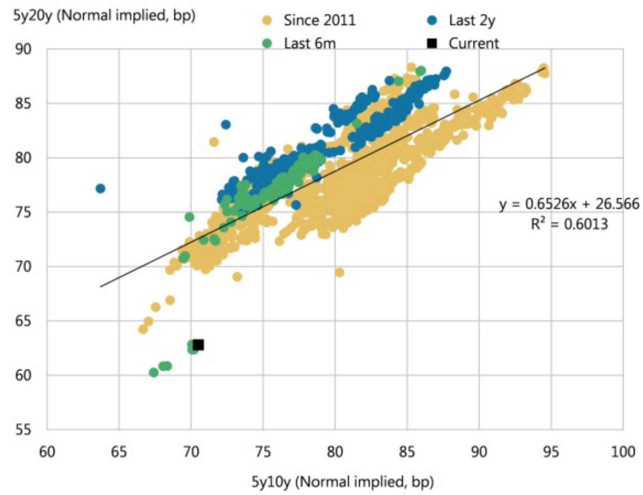
The risk to trade is a continued sell-off in DM macro vol, as well as AUD-specific weakness related that may be induced by structured product issuance.

Exhibit 67: AUD and USD expiry curves on 10y tails



Source: Morgan Stanley Research, Bloomberg

Exhibit 68: 5y20y vs. 5y10y vol



Source: Morgan Stanley Research, Bloomberg

Exhibit 69: Summary of recommended trades

Trade	Entry Date	Level	Rationale	Risks
Buy AUD 6m10y ATMF+30bp Payors	10-Apr-17	82c	AUD 10y rates have a historical tendency to underperform in sharp sell-offs, which isn't reflected in vol pricing	10y expires below the 3.25% strike, in which case losses are limited to the premium spent.
Buy AUD 5y10y straddles	10-Apr-17	71bp	Vol levels close to historical lows	Vol generally reprices lower and/or expiry curve continues to invert
Short AUDCAD	6-Apr-17	1.0124	AUD data has disappointed vs. G10. Risks of deleveraging in China are rising as policymakers tighten monetary policy in order to address financial stability risks.	Increase in fiscal spending from China and US and supply side reforms in China continue to support commodity prices and imports from AUD
Buy AUD 3y1y ATMF receivers vs. sell USD 3y1y ATMF-17bp receiver for zc	27-Jan-17	0.00	We think longer expiry vols on short tails in AUD have to reprice higher to reflect the priced-in RBA cycle, or the RBA cycle will have to be moderated relative to the Fed, or both.	US rates outperform AUD rates, and/or AUD implied vol underperforms US.
Short AUDUSD	27-Jan-17	0.7540	AUD data has disappointed vs. G10. Risks of deleveraging in China are rising as policymakers tighten monetary policy in order to address financial stability risks.	Increase in fiscal spending from China and US and supply side reforms in China continue to support commodity prices and imports from AUD
Buy AUD 1y3y10y Forward vol	12-Dec-16	73.00	Expiry curve on 10y tail is sharply downward sloping, providing attractive roll-up.	Vol generally reprices lower and/or expiry curve continues to invert
Receive AUD 2y2y vs. USD	5-Dec-16	53.00	Carry/roll has been brought back to the table in AUD front-end rates, but we see the RBA cutting rates in 3Q17 while the Fed delivers 2 hikes over 2017	Fed hiking cycle is re-priced lower while the RBA is priced higher, which could happen if the expected US fiscal stimulus disappoints, while Chinese growth surprises to the upside, causing the RBA to tighten.
Receive AUD 1y1y vs. 5y5y	5-Dec-16	153.00	Intermediate sector of AUD curve can continue to underfperform in-line with G4 rates, while the front-end does relatively better.	Global term premia re-price lower, driven by lack of fiscal stimulus or a deterioration in Australian growth prospects.

Source: Morgan Stanley Research

Forecast Summary

Exhibit 70: Morgan Stanley Australian Economic Forecasts

		1Q16	2Q16	3Q16	4Q16	1Q17e	2Q17e	3Q17e	4Q17e	1Q18e	2Q18e	3Q18e	4Q18e	2015	2016e	2017e	2018e
Real GDP by expenditure																	
Real GDP growth	**% qoq**	**1.1**	**0.8**	**-0.5**	**1.1**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.7**				
	% yoy	**2.5**	**3.1**	**1.9**	**2.4**	**1.9**	**1.8**	**2.7**	**2.3**	**2.5**	**2.6**	**2.6**	**2.6**	**2.4**	**2.6**	**2.1**	**2.6**
Household consumption	% qoq	0.9	0.5	0.4	0.9	0.4	0.5	0.6	0.6	0.6	0.6	0.6	0.6				
	% yoy	3.1	2.9	2.3	2.6	2.1	2.2	1.9	2.1	2.2	2.3	2.3	2.3	2.8	*2.5*	1.7	2.3
Government consumption	% qoq	1.0	2.0	0.2	0.0	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6				
	% yoy	3.7	4.3	4.4	3.2	2.7	1.3	2.2	2.3	2.4	2.4	2.4	2.4	2.9	*4.1*	2.5	2.4
Total Consumption	**% qoq**	**0.9**	**0.8**	**0.3**	**0.7**	**0.4**	**0.5**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**				
	% yoy	**3.2**	**3.3**	**2.8**	**2.8**	**2.3**	**2.0**	**2.0**	**2.1**	**2.3**	**2.3**	**2.3**	**2.3**	**2.8**	***2.8***	**1.9**	**2.3**
Private dwelling investment	% qoq	3.7	1.9	-1.3	1.2	2.0	0.5	-0.5	-1.0	-1.0	-1.0	-1.0	-1.0				
	% yoy	8.4	11.8	5.9	5.6	3.8	2.4	0.0	-1.5	-2.5	-3.5	-3.9	-3.9	9.7	7.1	0.8	-3.5
Private business investment	% qoq	-2.5	-4.5	-1.3	1.7	-0.9	-0.8	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2				
	% yoy	-10.4	-13.0	-10.2	-6.5	-4.9	-1.3	-3.5	-2.2	-1.7	-1.1	-1.0	-0.9	-9.2	-12.3	-5.1	-1.2
Public investment	% qoq	-0.5	13.4	-7.8	7.7	1.2	1.2	1.3	1.3	1.3	1.3	1.3	1.3				
	% yoy	0.6	11.2	11.3	11.9	13.9	1.7	5.1	5.2	5.2	5.2	5.2	5.2	-2.9	14.2	8.1	5.2
Total Investment	**% qoq**	**-0.4**	**0.5**	**-2.7**	**2.6**	**0.3**	**-0.1**	**0.0**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**0.0**				
	% yoy	**-3.9**	**-3.0**	**-2.7**	**-0.1**	**0.6**	**0.0**	**-0.8**	**-0.4**	**-0.4**	**-0.3**	**-0.4**	**-0.3**	**-3.9**	**-3.0**	**-0.9**	**-0.3**
Net export contribution	qtr % pt	1.1	-0.1	0.0	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2				
	yr % pt	1.5	2.2	0.9	1.1	0.3	0.6	0.9	0.9	0.9	0.9	1.0	1.0	1.4	1.2	0.9	0.9
Nominal growth, inflation, unemployment & policy rates																	
Nominal GDP growth	**% qoq**	**1.0**	**1.3**	**0.7**	**3.0**	**2.4**	**0.6**	**0.1**	**0.2**	**0.4**	**1.0**	**1.3**	**1.3**				
	% yoy	**1.9**	**3.3**	**3.1**	**6.1**	**7.6**	**6.8**	**5.3**	**3.3**	**1.4**	**1.8**	**2.9**	**4.0**	**1.7**	**3.7**	**5.6**	**2.5**
CPI (headline, nsa)	% qoq	-0.2	0.4	0.7	0.5	0.4	0.6	0.8	0.4	0.6	0.5	0.8	0.3				
	% yoy	1.3	1.0	1.3	1.5	2.1	2.4	2.4	2.3	2.5	2.4	2.3	2.3	1.5	1.3	2.3	2.4
CPI (underlying, nsa)	% qoq	0.2	0.5	0.4	0.4	0.5	0.5	0.7	0.3	0.6	0.5	0.8	0.4				
	% yoy	1.6	1.6	1.5	1.6	1.9	1.8	2.1	2.0	2.0	2.1	2.2	2.3	2.2	1.6	2.0	2.1
Unemployment rate	**%, eop**	**5.7**	**5.8**	**5.6**	**5.8**	**6.0**	**6.2**	**6.4**	**6.4**	**6.4**	**6.2**	**6.0**	**5.9**	6.0	5.7	6.3	6.1
RBA target rate	**%, eop**	**2.00**	**1.75**	**1.50**	**1.50**	**1.50**	**1.50**	**1.50**	**1.50**	**1.50**	**1.50**	**1.50**	**1.50**	**2.00**	**1.50**	**1.50**	**1.50**
AUD/USD	**eop**	0.77	0.73	0.72	0.74	0.75	0.76	0.73	0.70	0.69	0.69	0.68	0.67	***0.70***	***0.74***	***0.74***	***0.69***

Source: ABS, RBA, Morgan Stanley Research Forecasts

Macro+ Model Portfolio

Exhibit 71: Morgan Stanley Australia Macro+ Model Portfolio

Sector	Company	Security Ticker	ASX 200 Weight (%)	MS Weight (%)	Active Weight (%)	Price close of 07 Apr 17 (A$)
Financials			**47.1**	**39.8**	**-7.3**	
Banks			**29.3**	**25.2**	**-4.1**	
	ANZ Bank	ANZ	6.0	8.1	2.2	31.41
	Commonwealth Bank of Australia	CBA	9.4	8.1	-1.3	84.77
	Westpac Banking Corporation	WBC	7.4	9.0	1.6	34.24
Diversified Financials			**4.7**	**4.0**	**-0.8**	
	Macquarie Group	MQG	1.9	4.0	3.9	87.93
Insurance			**4.8**	**5.6**	**0.8**	
	Insurance Australia Group	IAG	0.9	2.4	1.5	5.98
	QBE Insurance Group	QBE	1.1	3.2	2.1	12.89
Real Estate			**8.3**	**5.0**	**-3.3**	
	Aveo Group	AOG	0.1	1.5	1.5	3.18
	Goodman Group	GMG	0.8	3.5	2.7	8.04
Cyclical Industrials			**13.5**	**16.7**	**3.2**	
Consumer Non-Staples			**4.6**	**6.1**	**1.6**	
	Domino's Pizza	DMP	0.3	2.2	2.0	60.12
	Mantra Group	MTR	0.1	1.6	1.5	2.84
	Tabcorp	TAH	0.3	2.4	2.1	4.83
Housing Linked			**2.4**	**2.2**	**-0.2**	
	James Hardie	JHX	0.6	2.2	1.6	20.90
Industrials & Transport			**6.5**	**8.3**	**1.8**	
	Aconex	ACX	0.0	1.2	1.1	3.92
	Brambles	BXB	1.0	2.7	1.7	9.37
	QUBE Holdings	QUB	0.2	2.4	2.2	2.56
	Orora	ORA	0.2	2.1	1.9	2.90
Defensive Industrials			**23.7**	**19.6**	**-4.1**	
Consumer Staples			**7.2**	**6.7**	**-0.5**	
	Graincorp	GNC	0.1	1.4	1.3	8.77
	Invocare	IVC	0.1	1.7	1.6	14.22
	Treasury Wine Estates	TWE	0.6	2.7	2.1	12.02
	Woolworths	WOW	2.2	0.9	-1.3	26.52
Health Care			**7.0**	**8.8**	**1.8**	
	Cochlear	COH	0.5	2.6	2.1	139.31
	CSL	CSL	3.8	3.7	-0.1	128.46
	Sonic Healthcare	SHL	0.6	2.6	2.0	21.52
Telcos, Infrastructure & Utilities			**9.5**	**4.1**	**-5.4**	
	TPG Telecom	TPM	0.1	2.2	2.1	6.72
	Telstra	TLS	3.5	1.9	-1.6	4.56
Resources			**15.7**	**23.9**	**8.3**	
Metals & Mining			**11.4**	**15.5**	**4.0**	
	BHP Billiton	BHP	5.1	7.8	2.7	24.59
	Rio Tinto	RIO	1.7	4.0	2.4	60.01
	South32	S32	1.0	2.6	1.6	2.91
	Evolution Mining	EVN	0.2	1.1	0.9	2.28
Energy			**4.2**	**8.5**	**4.2**	
	Origin Energy	ORG	0.8	2.7	1.9	7.31
	WorleyParsons	WOR	0.1	2.2	2.1	11.04
	Woodside Petroleum	WPL	1.5	3.5	2.0	32.97
Cash			**0.0**	**0.0**	**0.0**	
TOTAL			**100.0**	**100.0**	**0.0**	

Source: Bloomberg, Morgan Stanley Research

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