with our own view. That said, the Australian rates market has a tendency to sell off considerably once it becomes clear than an easing cycle in Australia is over. (Figure 4). As to what might spark such a sell-off; an improvement in the labor market stands as one clear possibility. RBA action – and market pricing for the RBA – is often driven by conditions in the labor market. As Figure 5 shows, our tracking of 11 different monthly indicators of labor demand and sentiment suggests a pick-up in the pace of employment growth over coming months. All up, we therefore see the risks being skewed toward a narrowing of the front end interest rate differential between Australian and New Zealand, something that would be supportive of our long AUD/NZD stance.

Finally, it would be remiss of us not to consider the outlook for China when discussing any view on AUD, either against the USD or crosses. Our house view remains quite constructive on China, with GDP growth expected by DB to continue its recovery towards 8.6% in 2014. Despite the modest decline in the December PMI reading, our local economists note that the PMI's Q4 average reached 51.3, 0.5pts above the Q3 average which suggests that Q4 IP and GDP growth are unlikely to have decelerated from that seen in Q3. Looking forward, stronger external demand should see an acceleration of GDP growth over 2014. If this view on China is correct, then it should be supportive of the AUD given the tendency of the market to see the Aussie as a China proxy (see Figure 6).

We are; however, a little cautious about overplaying any impact that stronger growth in China may have on the AUD, given that Australia's key commodity export to China (iron ore) is likely to be moving into an oversupply situation this year. We should note here that while many analysts focus heavily on relative commodity prices when considering the AUD/NZD cross; we are inclined to think that the true importance of commodity prices is captured through the influence on interest rate differentials. In other words, we take the view that the impact of divergent commodity price trends is likely to have already been captured by interest rate differentials.

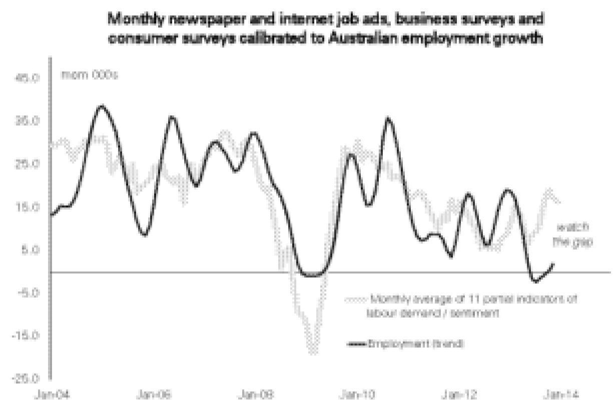
All up, some recovery following the sharp fall in 2013, the favorable valuation backdrop, and the risk that the interest rate differential moves in the AUD's favor over coming months has us long AUD/NZD.

Adam Boyton, Sydney, [redacted]

Figure 4: Once the RBA is 'done' easing, Australian rates usually (and often incorrectly) price a lot of hikes

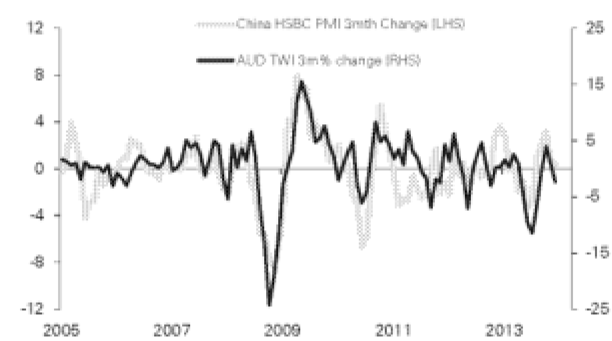
Source: Deutsche Bank, Bloomberg Finance LP

Figure 5: The labor market might be the catalyst



Source: Deutsche Bank, Bloomberg Finance LP, AIG, ANZ, NAB, DEWR, WBC-MI

Figure 6: Stronger growth in China could also help AUD



Source: Deutsche Bank, Bloomberg Finance LP