RESEARCH

Corporate FX Strategy

11 December 2017

NZD Corporate FX Update

- **After being re-rated lower over the past few months, our projections show the NZD spending much of the year ahead flat around USD 0.68-0.70. In practice that means the occasional flourish into the low USD 0.70s, but relatively short-lived, and maybe a look at USD 0.66 sometime through the next year.**

Underlying this projection is a sense that this is as good as it gets for the global economic cycle. In 2017, world growth is on track to record its best year since 2011, but economic momentum from here begins to flatten off. Reflecting this dynamic, NZ's terms of trade reached a record high in the September quarter and is expected to fall from here. There are already clear signs that NZ export commodity prices are in a topping out phase. We project about 5% downside to the index of NZ export commodity prices. Global forces, such as world growth momentum, commodity prices and risk appetite therefore represent a headwind for the NZD through the coming year, reducing the probability of the NZD trending higher next year.

Narrowing NZ-US interest rates, a feature of the past few years, is expected to continue as the New Year begins, but as the year progresses the trend is expected to be arrested. We project two hikes from the RBNZ in the second half of next year, albeit the risks are weighed towards a later than earlier start to the tightening cycle. Rate dynamics will eventually morph from a negative to a positive force for the NZD, but this is a story for later in 2018.

Our short term fair value model estimate currently sits in a USD 0.71-0.72 range, having drifted down over recent months on the back of weaker NZ commodity prices and a 50bps fall in the NZ-US 1 year swap spread. If we assume risk appetite falls from its way-above-average level to average, a 5% fall in NZ commodity prices and a 25bps narrowing in rate spreads, our fair value estimate falls to USD 0.65-0.66. This gives a sense of where the NZD could fall if recent trends continue and risk appetite takes a turn for the worst.

Indeed, despite the currency tracking below fair value, we assess the near-term risks to the downside, with drought conditions emerging over recent weeks. If it doesn't rain in the next few weeks, current anecdotes point to some serious stress developing in parts of the agriculture sector. It's a development we're monitoring closely.

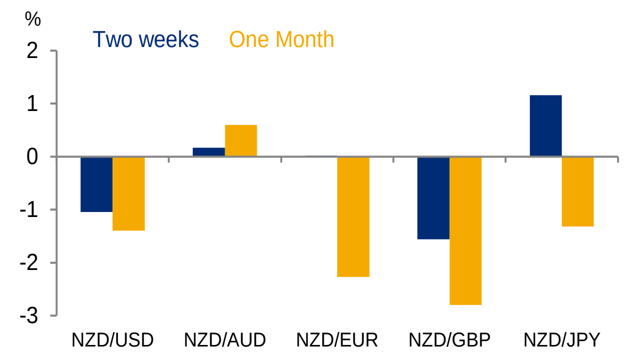
Exporters will have taken advantage of the recent fall in the NZD to top up some hedging, a sensible move in our view. Topping up hedging on further weakness seems appropriate, while importers should look to take cover on any moves back above USD 0.70.

BNZ Foreign Exchange Forecast Summary

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	NZD/CNY
Current	*0.68*	*0.91*	*0.58*	*0.51*	*78*	*4.53*
Mar-18	0.68	0.93	0.57	0.49	78	4.48
Jun-18	0.68	0.94	0.56	0.48	79	4.45
Sep-18	0.69	0.95	0.56	0.48	81	4.50
Dec-18	0.70	0.96	0.56	0.49	82	4.55
Jun-19	0.72	0.95	0.57	0.50	84	4.67
Dec-19	0.71	0.95	0.56	0.49	81	4.64
Jun-20	0.69	0.93	0.52	0.47	77	4.50
Dec-20	0.68	0.93	0.51	0.46	74	4.44
	AUD/USD	**EUR/USD**	**USD/JPY**	**GBP/USD**	**USD/CNY**	**TWI**
Current	*0.75*	*1.18*	*114*	*1.34*	*6.62*	*72.7*
Mar-18	0.73	1.20	115	1.40	6.59	72.3
Jun-18	0.72	1.21	116	1.41	6.55	72.2
Sep-18	0.73	1.24	117	1.43	6.52	72.9
Dec-18	0.73	1.26	118	1.44	6.50	73.6
Jun-19	0.76	1.26	116	1.43	6.49	75.0
Dec-19	0.75	1.28	114	1.45	6.54	74.3
Jun-20	0.74	1.32	111	1.48	6.52	71.9
Dec-20	0.73	1.34	108	1.48	6.53	70.9

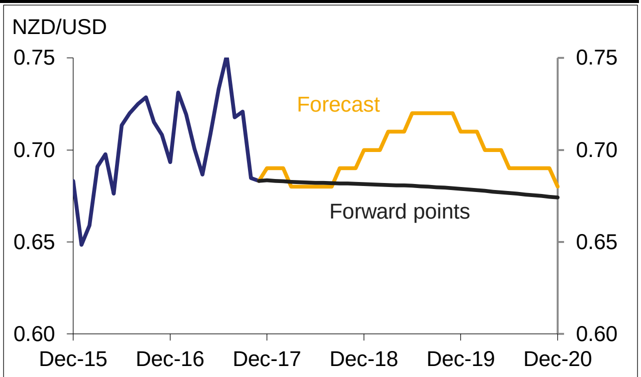
Source: BNZ, Bloomberg

NZD – Changes Over The Past Month



Source: BNZ, Bloomberg

NZD/USD: Flat through 2018



Source: Bloomberg, BNZ

The Crosses

NZD/AUD: A good strategy over the past four years has been to buy the cross at AUD 0.91 and below and sell at AUD 0.95 and higher. Our projections show the currency continuing to range trade in this zone with no strong view on the relative economic performance between NZ and Australia driving that view. Relative to central bank inflation targets, we see more likelihood of inflationary pressure developing in NZ compared to Australia, raising the prospect of the RBNZ being slightly ahead of the RBA in the next tightening cycle. That supports a slightly higher cross rate next year, although we suggest that exporters and importers continue to "play the range" for the year ahead.

NZD/GBP: Our call on GBP has always had the feel of being a bit binary and we've revised up our GBP forecasts significantly, following the more positive vibe around Brexit negotiations. The scenario of a cliff-like exit for the UK from the EU without a trade deal in March 2019 now looks a lot less likely. We expect a transitional deal to be agreed early in the New Year which might extend the current trade arrangements for two years or even longer. This would provide the UK with some much needed breathing space and help take Brexit off the front pages. A fall in the cross below GBP 0.50 is now expected next year and exporters can afford to keep hedging lighter than usual if we're right.

NZD/EUR: A weaker NZD/EUR has been one of our highest conviction calls and remains so and we've taken the opportunity to revise our forecasts lower, with our medium-term forecasts into the low EUR 0.50s. Behind the trend is a strong euro-area economy relative to trend, fuelled by highly stimulatory monetary policy. The ECB's gradual move away from quantitative easing and expectations of an eventual removal of the negative deposit rate are likely to drive EUR higher. The significant epreciation this year was off a very high base so the spot rate still trades well above our medium-long term fair value estimates near the mid-0.50s. Importers should look to hedge exposure in the high 0.50s and exporters can afford to be patient with their hedging operations.

NZD/JPY: The BoJ remains far away from meeting its inflation target. Even though the central bank doesn't need to purchase as many JGBs to maintain its 0-0.1% yield target for the 10-year rate, ongoing balance sheet expansion with no foreseeable end-point should keep the yen cheaper than otherwise. BoJ Governor Kuroda is expected to be appointed for another term. Combined with Abe's recent landslide election victory, it suggests more of the same with regard to policy. Over the next year, our projections show the cross remaining range-bound, hovering around the JPY 80 level. As always, there are likely to be opportunities to buy dips on spells of negative risk appetite, which the cross is highly sensitive to.

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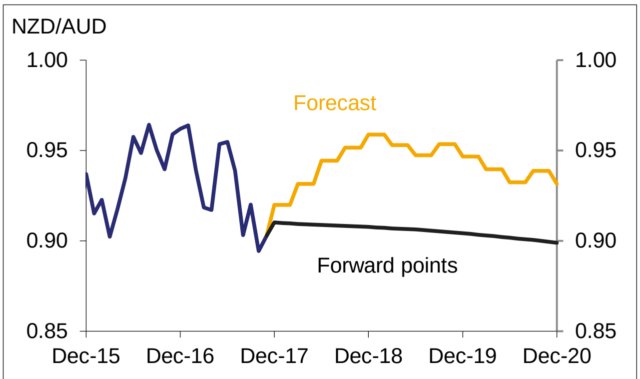
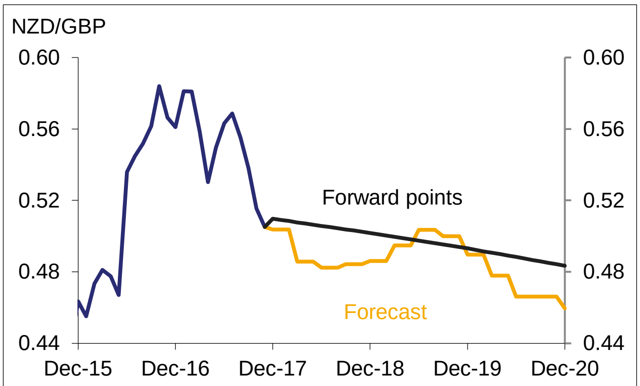
NZD/AUD: Range-trading around 0.90-0.95



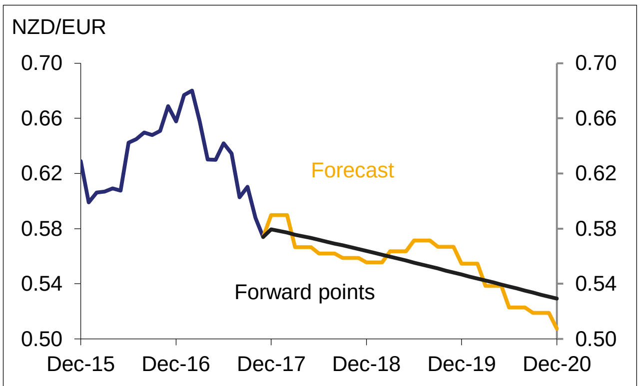
Source: Bloomberg, BNZ

NZD/GBP: Downside Potential As Brexit Risk Fades



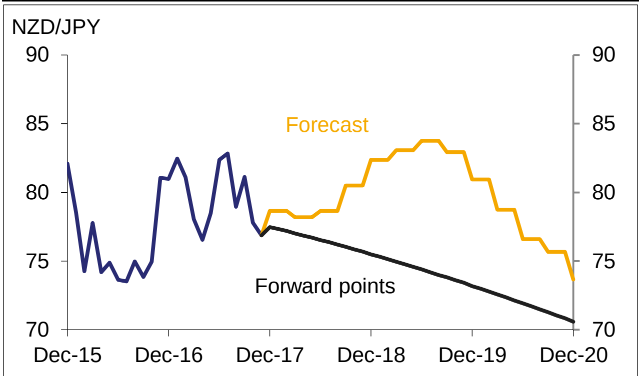
Source: Bloomberg, BNZ

NZD/EUR: Downward Trend to Continue



Source: Bloomberg, BNZ

NZD/JPY: Consolidation Around 80 Through 2018



Source: Bloomberg, BNZ

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