21 April 2017

NZD/EUR: A Couple of Big Unknowns

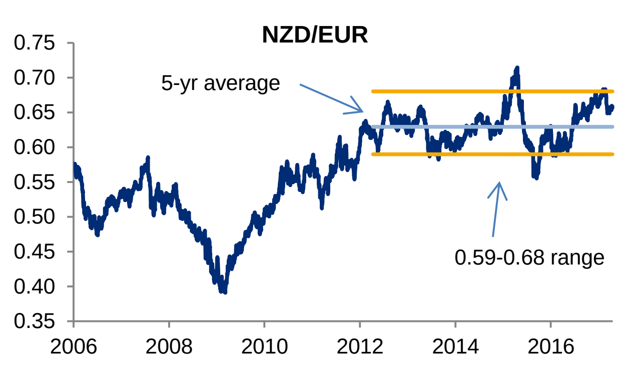
- NZD/EUR strength relative to our long-run fair value estimate of EUR 0.55 reflects NZ's relatively strong terms of trade and the ECB's highly accommodative monetary policy stance. Using a simple short-term model we can explain the current spot rate around EUR 0.66.
- Our projections show the cross holding up at, or above, current spot over the next six months, before facing headwinds and ending the year closer to EUR 0.64. However, our forecasts for EUR (and GBP) are under review pending the outcome of the French Presidential election and the surprise UK snap election announcement.
- The balance of risk is skewed to the downside over the medium-term, reflecting the likely strength of EUR once the ECB normalises monetary policy. The timing of ECB rate hikes is important, but uncertain. An offsetting factor is ongoing euro-area political risk, with the focus likely to turn to Italy late this year or early next year after the French Presidential elections are out of the way.

NZD/EUR Past its Peak?

NZD/EUR has been range-bound over the past five years, spending much of the time within a range of about EUR 0.59-0.68, with only very brief excursions outside that range. The average spot rate over the past five years has been just under EUR 0.63.

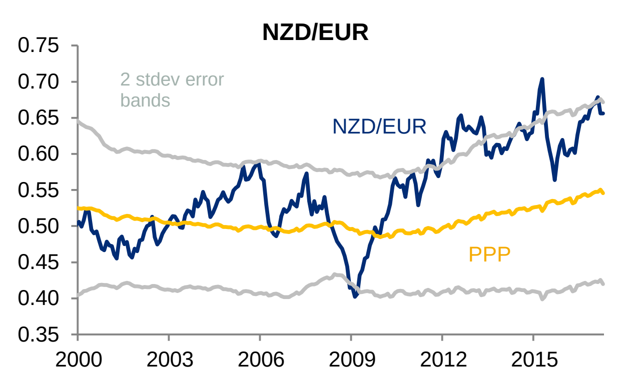
Earlier this year, it looked like the cross was on a roll, with EUR 0.70 threatened, but the combination of less concern that far-right candidate Marine Le Pen would win the upcoming French Presidential election and a generally under-performing NZD has since seen the cross rate fall to around the EUR 0.66 mark. Some emerging evidence of debate within the ECB about the extent of future monetary policy accommodation has provided a supporting role in dragging NZD/EUR lower from February highs of around EUR 0.6850.

NZD/EUR in Top Half of 5-year Trading Range



Source: BNZ, Bloomberg

NZD/EUR Expensive on Long-Term Model



Source: BNZ

Taking a long-term perspective the NZD/EUR cross rate, it is very expensive. Our purchasing power parity estimate has been drifting higher over time (a reflection of our modelling framework which uses a 15-year moving average filter) and currently sits around EUR 0.55. Thus the current spot rate is some 19% "over-valued" or equivalent to 1.7 standard deviations higher than long-term "fair-value". With the exception of 2015, the cross rate has been hovering around the plus two standard deviations mark versus fair value for much of the past eight years. With this in mind it is important to understand the explanation behind this trend.

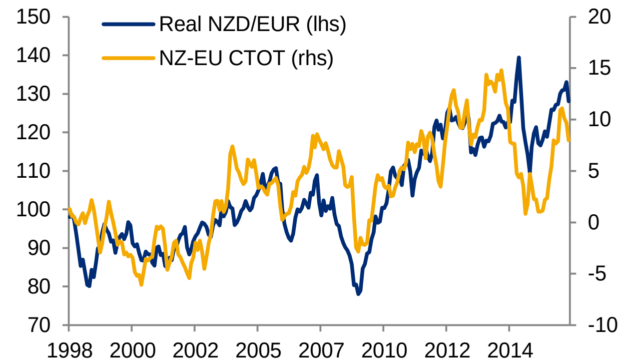
NZ Terms of Trade and Rate Spread Explain the High Cross

Strength in NZ's terms of trade relative to the euro-area (EA) and relative NZ-EA interest rates go a long way in explaining the apparent high value of the NZD/EUR exchange rate. This is illustrated in the next two charts, which show the real NZD/EUR exchange rate against relative NZ/EA commodity terms of trade and NZ-EA short term interest rates over the past twenty years.

NZ's terms of trade relative to the euro area are very strong, down from the peak of a few years ago but still well above average.

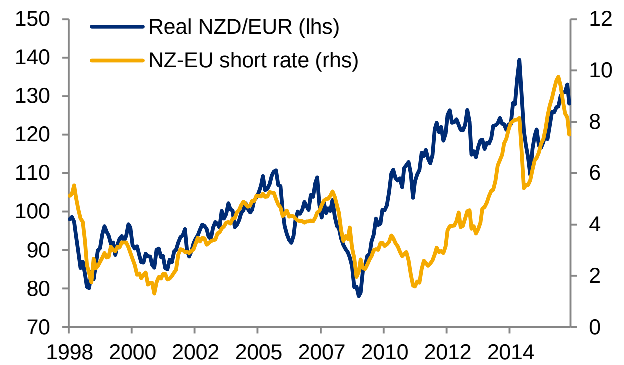
On the relative interest rate measure we use the 1-year swap rate for NZ and the shadow short rate for the euro as measured by the RBNZ's Krippner. We have to use the shadow short rate for the euro area as the relationship between the rates differential and the exchange rate broke down after the ECB pushed rates to zero and into negative

Relative Terms of Trade can Explain the High Cross



Source: BNZ, Bloomberg

Relative Interest Rates can Explain the High Cross



Source: BNZ, Bloomberg

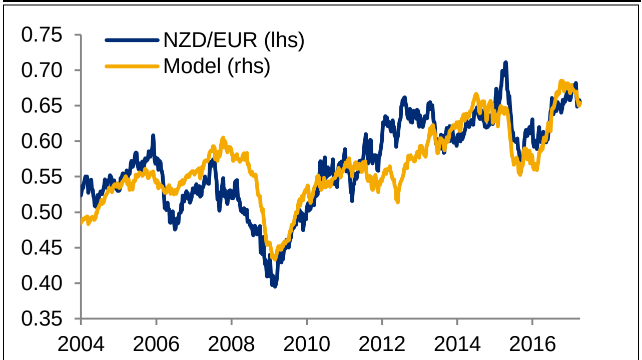
territory and embarked on its quantitative easing policy. There was a period between 2010-2012 when the cross rate was much higher than explained by relative interest rates, but that might be explained by the European debt crisis, the focus on Greece at that time and concern about the euro-area breaking up.

The current shadow short rate sits at minus 5.5% (not a typo!), suggesting that the NZ-EA short rate spread is around 750bps. This is indicative of how easy the ECB's current monetary policy stance is, with its ongoing bond buying programme artificially holding down yields right across the curve.

Short-Term NZD/EUR Fair Value Model

We constructed a simple NZD/EUR fair value model along the same lines as our NZD/USD model. NZD/EUR is positively correlated with our risk appetite index, NZ export commodity prices and the NZ-EA short rate spread. With a standard error of 6.8%, the fit isn't as good as our NZD/USD model which has a standard error of 4.2%. With a bit of tweaking, the fit of the model could probably be improved, but that wasn't the point of the exercise. Our main interest lies in what the model says about the cross rate when ECB monetary policy normalises.

NZD/EUR Close to Fairly Priced on Short-term Model



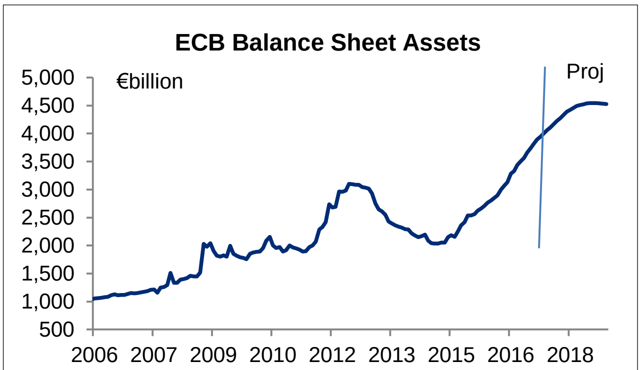
Source: BNZ, Bloomberg

The model suggests that current fair value for the cross rate is close to EUR 0.65. This means that current above-average levels of risk appetite, strong NZ terms of trade and very easy EA monetary policy justify the current rich pricing of the NZD/EUR exchange rate relative to our long-term fair value estimate.

As noted above, the ECB's monetary policy stance is highly accommodative. The central bank has been expanding its balance sheet at a rapid rate. Its current policy is to continue to buy bonds at a pace of €60bn per month through to the end of the year. While it hasn't indicated what happens after the end of the year, it is widely assumed that the ECB will taper its bond purchases. If we assume a gradual taper, then the ECB's balance sheet would start to flatten out by about mid-2018.

There remains some debate within the ECB about whether interest rates could or should be raised ahead of the end of its quantitative easing policy. Higher policy rates (the deposit rate is currently minus 0.4% and the lending rate is just above zero) and less bond purchases would have a significant impact on the yield curve and, in particular, the shadow short term rate. For example, a modest 40bps increase in the ECB deposit rate would see the shadow short rate rise in the order of over 550bps. The quantum of this highlights how distortionary the ECB's current monetary policy stance is on the yield curve and the euro.

Nearing the end game for ECB balance sheet expansion



Source: BNZ, Bloomberg

We can use the model to show the impact on NZD/EUR fair value of the ECB beginning to normalise monetary policy, along with our view of gradual RBNZ policy tightening from May 2018. For illustrative purposes we assume the shadow short rate rises in a linear fashion from minus 550bps to zero between end-June 2017 and end-June 2018 and onwards to +0.25% by the end of 2018. For RBNZ policy, we assume that the 1-year swap rate gradually rises, consistent with our assumed 75bps of OCR hikes beginning May-2018.

We also assume that risk appetite drifts slowly down to its average level of 50%, while NZ commodity prices remain unchanged.

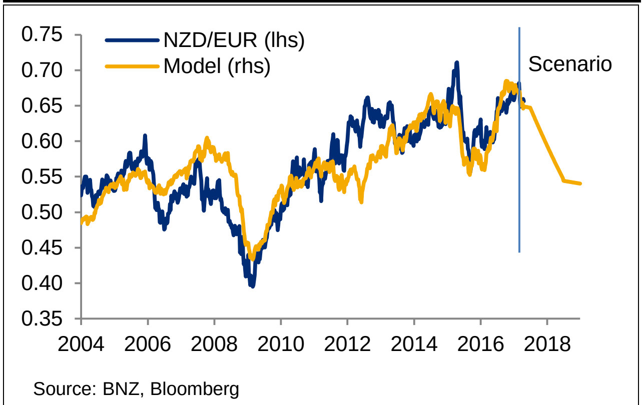
The model says that under this scenario the NZD/EUR cross rate heads steadily lower through to the end of next year, reaching around EUR 0.54, or close to our long-term fair value estimate. The message is that ECB monetary policy has had a significant impact on the euro and a change in policy stance is likely to have a significant positive impact on the common currency.

A big question is whether the ECB will be ready to change its policy stance later this year. While activity indicators in the euro area have recovered nicely over the past year and headline inflation recently reached 2%, core CPI inflation remains subdued at 0.7% y/y. The ECB wants to be confident that underlying inflation pressures are rising before considering changing its policy stance.

Thus, while NZD/EUR could come under significant downward pressure as the ECB changes its policy stance, the timing of the ECB kicking off that process remains highly uncertain.

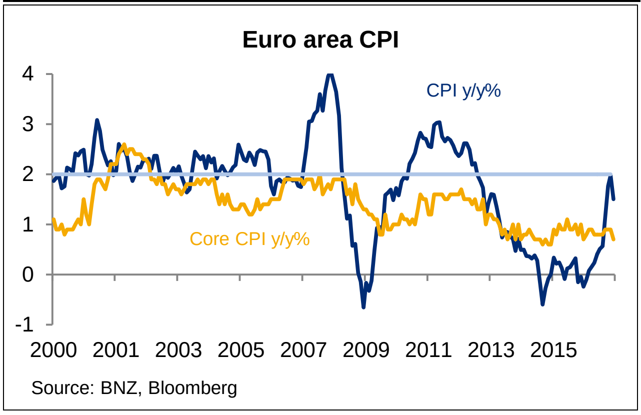
Another important consideration is that if the EUR surged ahead on the back of a change in policy, then the ECB might be forced to rein in its normalisation process. To that extent, the large and steady fall in NZD/EUR explained by the model is unlikely to prevail in practice. Any fall in NZD/EUR is likely to be at a more moderate pace, as EUR strength feeds back into the ECB's reaction function.

Scenario With ECB Beginning to Normalise Policy



Source: BNZ, Bloomberg

Euro-area Core CPI Inflation Still Very Low



Source: BNZ, Bloomberg

Political Risk Overhangs EUR

The other important factor for the euro is political risk. The immediate risk event is the French Presidential election, with the first round on 23 April and the two highest polling candidates going into a head-to-head battle on 7 May.

Support for the top four candidates is separated by only six percentage points. A bad scenario would be far-left (Melenchon) and far-right (Le Pen) candidates winning the first round of voting, making the second round vote a choice between two highly unappealing candidates for centrist voters. However, the most likely scenario is centre-left Macron facing Le Pen in the second round and Macron winning the race. Oddschecker has Macron at a 53% probability to win the race, well ahead of Le Pen at 23%, a distant second. That would be a euro-positive outcome relative to current pricing, while either a Melenchon or Le Pen victory would be significantly euro-negative.

After the French elections, Germany's Federal elections in September become the next focal point for euro area political risk. But we think that Italy's general election, which must be held sometime before May 2018 is a much more important risk event. The timing of the election could be late this year or, more likely, early next year.

The combination of the ECB tapering its bond purchases next year and Italian government upheaval, with the euroskeptic 5-Star-Movement likely to win a significant portion of the vote, could be significantly negative for Italian government bonds. This the last thing the country needs, with its underperforming economy, high government debt levels and banking system in a precarious state. Italy's woes could have a significant impact on the euro if talk of a euro-area break-up re-emerges.

Summarising the Outlook

We see ECB monetary policy and euro-area political risks as the two key forces on the NZD/EUR cross rate over the next couple of years. The starting point is a cross rate that is well above our long-term fair value estimate, with the ECB's highly accommodative policy stance a key factor behind that. Strong NZ terms of trade are an additional positive factor, and we see this dynamic prevailing, but this factor isn't a key influence on our projections.

Our short term projections have the cross at, or slightly above, current spot over the next couple of quarters, before heading on a downward path from later this year through 2018. However, our EUR forecasts are currently under review pending the outcome of the French Presidential election. A market-friendly outcome would see EUR revised higher and NZD/EUR projections revised lower.

Our current projections, which ultimately see NZD/EUR heading down towards EUR 0.63, are a bit of a half-way house affected by two opposing forces. If we put more weight on ECB rate normalisation then that could easily see the cross heading into the high 0.50s and breaking decisively outside of the bottom end of the 5-year range. But political risks are likely to overhang the euro-area until at least Italy's elections are out of the way. Furthermore, the cessation of ECB bond purchases particularly for vulnerable countries like Italy might not have a happy ending and euro-area break-up risks could easily rise and overhang the euro.

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