5 May 2017

NZD Looking Short-term Oversold

- Over the year to date the NZD has underperformed, against economic fundamentals which have remained supportive. These include high risk appetite and strong NZ terms of trade. Net speculative short positioning is the greatest in nearly two years.
- Thus, there is a low hurdle rate for the NZD to recover over coming weeks and months. That said, ultimately see NZD/USD and NZD/EUR ending the year at 0.67 and 0.59 respectively. Economic relativities are expected to encourage NZD/AUD to gravitate to the mid 0.90s.

NZD under pressure through most of 2017

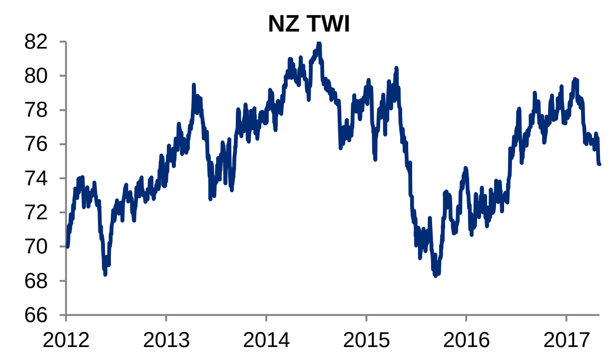
The NZD has recently been sold down to a level not seen since the middle of last year, unwinding the strength seen over 2H16 and through early 2017. As noted in our monthly wrap, in the three months ending April, the NZD TWI was down by just over 6%, with large falls on all the major crosses. These ranged from 5% against the AUD to 9% against GBP. The extent of the fall has surprised us, as it has gone against supportive fundamental forces.

Intra-year falls of over 5% are common – in fact they have occurred every year for the past five years. On daily closes, the TWI has seen the following intra-year drawdowns:

- 2012: -5.5%
- 2013: -8.2%
- 2014: -7.6%
- 2015: -5.9% and -15.0%
- 2016: -5.2%

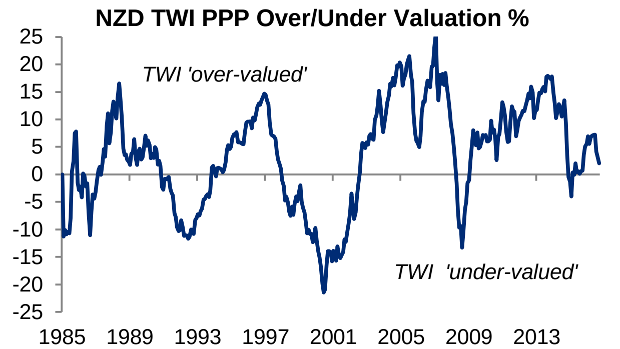
Those intra-year falls have all been in the context of a flat to higher TWI over that five year period.

A Weak 2017 for the NZD So Far



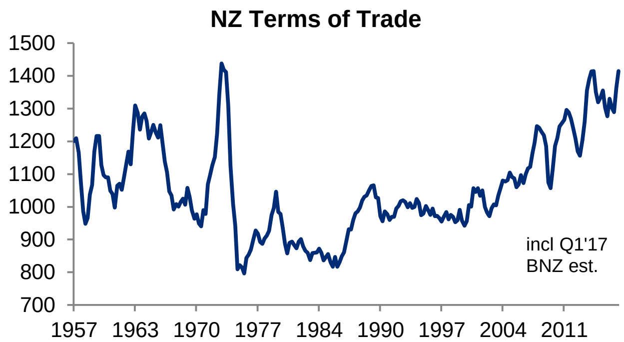
Source: BNZ, Bloomberg

TWI Close to Long-Term Fair Value



Source: BNZ

NZ Terms of Trade Nudging a Record High



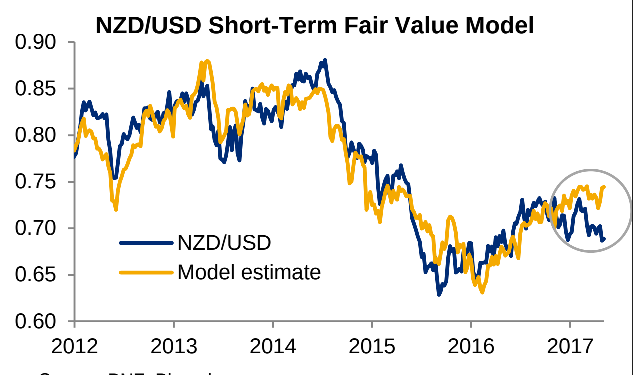
Source: BNZ, Bloomberg

NZD weakness has seen the TWI move down to within 2% of our long-term fair value estimate based on purchasing power parity. Of course, it has spent much of the time over the past 15 years above this long term estimate, a reflection of NZ's strong terms of trade. When the NZ's terms of trade are strong, the NZD should trade well above "fair value" in a longer term context. Our terms of trade estimate for Q1 puts it near record highs.

NZD weakness against solid fundamentals

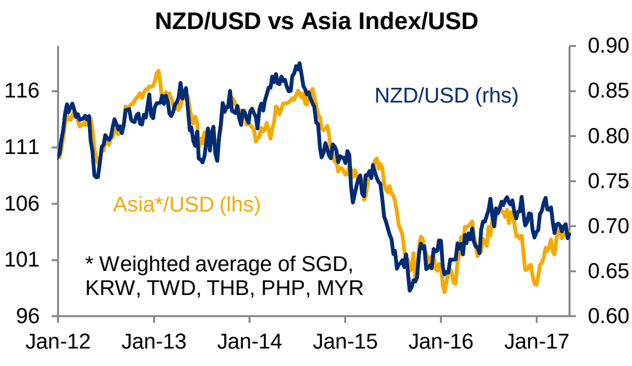
What makes the recent fall in the NZD more remarkable, compared to other episodes is that it has come over a time when fundamental factors have been generally supportive. This can be illustrated by our short term fair value NZD model. At the end of April, the gap between spot and fair value had extended to 8%, the largest gap since March 2009, or the depths of the GFC.

Gap in FV Model Estimate Unusually Large



Source: BNZ, Bloomberg

NZD and Asian Currencies Converge



Source: BNZ, Bloomberg

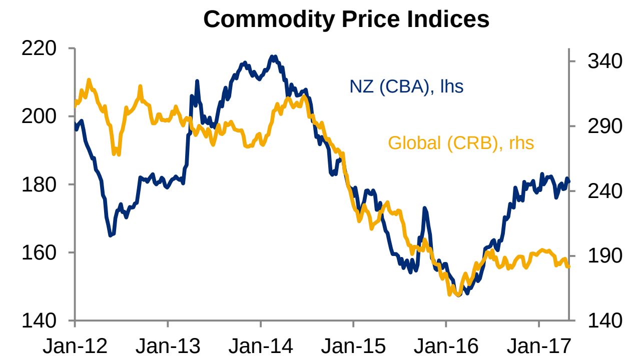
There is normally a positive correlation between our risk appetite index and the NZD but over the past few months it has been zero to slightly negative. The fact that our risk appetite index is hovering around a three-year high has, unusually, not been a positive factor for the NZD.

Various global commodity price indices recently reached fresh lows for the year and have been flat overall for the past year. Contrast that with the NZ export commodity price index which has managed to sustain the strong run up in prices seen through last year.

Some of the NZD's fall in early March can be attributed to a plunge in dairy prices, but whole milk powder prices have since recovered by around 20%, and that hasn't been reflected in a stronger NZD.

Some have attributed the weakness in the NZD over recent months to President Trump's "America First" trade policy. We don't find that explanation particularly satisfactory. If that was the case, then Asian currencies would also have been affected. Over the past few months, an Asian currency basket has managed to recover losses seen late last year as Trump has backed down on it pre-election trade rhetoric – China has not been deemed as a currency manipulator and widespread tariffs on China and Mexico imports have not been imposed.

NZ Commodity Prices Better than Global Indices



Source: BNZ, Bloomberg

The market has actually taken a more optimistic view on US trade policy as Trump finds it increasingly difficult to achieve any of his policy objectives, and this would explain the rebound in Asian currencies, which are sensitive to global trade policy.

When we look at the NZD against an Asian currency basket, the NZD held up much better as Asian currencies were coming under pressure. Over 2017, the Asian currencies have recovered as Trump's trade agenda looks to have softened. The NZD has weakened during this Asian currency recovery.

We think that the RBNZ's neutral policy tone has been successful in containing rates and the NZD. We get an update from the RBNZ next week but its prevailing view is that there is an equal chance of an OCR cut or hike and any policy adjustment is expected to be far into the future, around late 2019.

That guidance looks likely to change, as inflation has significantly surprised the RBNZ on the upside and the weaker-than-expected NZD adds further upside to the RBNZ's inflation projections. The Bank is unlikely to embrace the market's view that a rate hike could come as soon as May next year, but incrementally through the year we see the Bank changing its tune towards a more hawkish tone.

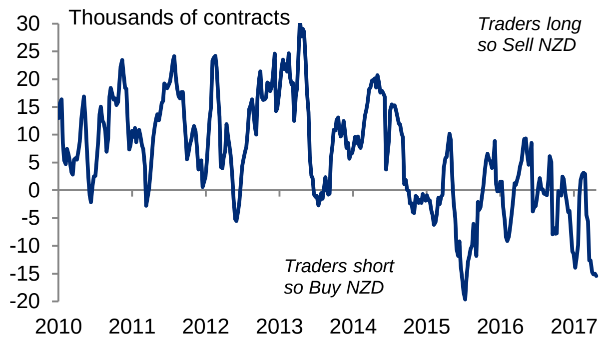
Speculative market is short NZD

As of last week, net speculative short positioning was the highest in nearly two years. Net short positions have been building up since early March over the period in which the NZD has been falling. We normally use this as a contrary indicator. If the hot money is short kiwi, then that sets up a low hurdle rate for a bounce on any positive news, as short positions get closed.

Outlook

Our year-end 2017 target for NZD has been USD 0.67 since August last year, a projection we have left unchanged. However, that was meant to be in the context of a weaker global economic environment, softer NZ commodity prices

Net Speculative Positioning is Short Kiwi



Source: BNZ, Bloomberg

and weaker risk sentiment, with our risk appetite index expected to fall towards a more neutral reading of 50%. Those fundamental factors have yet to play out.

We conclude that recent selling of the NZD has not really been justified and on that basis, we could well see a recovery of sorts into the low 0.70s over coming weeks and months. The stage then becomes set for the NZD to resume a weaker trend, towards our year-end target 0.67 on the back of the deterioration in the fundamental forces we expect. With the Fed in the midst of a tightening cycle, a more hawkish RBNZ in the second half of the year isn't expected to prevent slippage in NZD/USD.

It's a bit of a mixed view on the crosses. Our recently upgraded view of EUR sees NZD/EUR end the year around EUR 0.59. A positive view on EUR reflects diminished political risk following the market-friendly first round French Presidential election result and likely focus on ECB normalisation of monetary policy as the year progresses. With the ECB's highly accommodative monetary policy currently keeping a lid on EUR, expectations of a reversal of that stance could be significant, and overwhelm any murmurs of tighter NZ monetary policy.

We have no strong view on NZD/JPY and NZD/GBP crosses, with year-end targets within 2% of current spot.

NZD/AUD is expected to end the year on a stronger footing, with a return to the mid-0.90s. NZ's stronger labour market relative to Australia's was evident in this week's NZ employment figures. Relative unemployment differentials go a long way in explaining cyclical movements in the NZD/AUD cross rate. Ultimately that differential explains our view that the RBNZ tightens policy ahead of the RBA next year, supporting NZD/AUD.

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