19 May 2017

NZD: Peeling Back the Drivers

- Traditional key drivers like risk appetite and terms of trade have not had their usual influence on the NZD so far this year. The lack of NZD carry seems to have had more influence and the market is, for now, giving due consideration to the RBNZ's extended low rate guidance.
- US CPI and Trump's questionable actions have recently clouded the outlook for Fed policy and the USD. The USD looks a little oversold at this juncture if one believes that ultimately political risks will fade and inflation will recover.
- Overall, while some fresh news has injected more uncertainty about the outlook, we remain comfortable with our year-end target of USD 0.67.

Currency markets are typically buffeted by a range of factors and half the battle is working out what the key driving forces are. Those forces tend to vary over time, come and go in terms of their importance, and new factors to consider pop up from time to time.

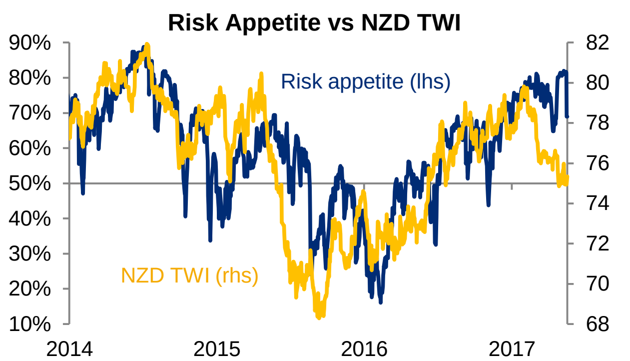
Indicators that have stood the test of time in terms of explaining the path of the NZD are (i) the state of the global economic cycle, which is typically linked to risk appetite; (ii) commodity prices or NZ's terms of trade; and (iii) NZ-global interest rate differentials.

These three factors form the basis of our simple short term fair value model. Last year, the first two factors dominated and the NZD was on an upward path for much of the year. For much of this year it seems that the third factor has gained some prominence and that has seen a generally weaker NZD.

The NZD typically performs well when the global economic cycle is turning up, risk appetite is high and NZ's terms of trade are improving. All of those factors have been in play this year, but that hasn't prevented the NZD being one of the worst performing major currencies this year. If we look at the year-to-date leader board, CAD, NZD and USD languish near the bottom, while EUR, GBP, JPY, AUD have outperformed.

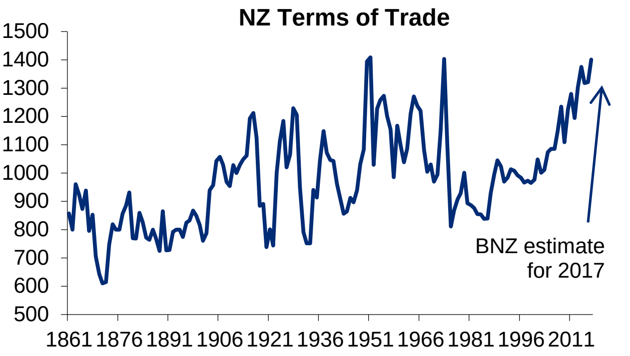
The positive link between risk appetite and the NZD has been broken and the correlation this year is close to zero. Last week our risk appetite index hit a three-year high of 82%, the same week that the NZD hit its lowest level for the year – around USD 0.6820, with the NZ TWI hovering near its low for the year just under 75.

NZD TWI Down as Risk Appetite Remains High



Source: BNZ, Bloomberg

Very Strong NZ Terms of Trade



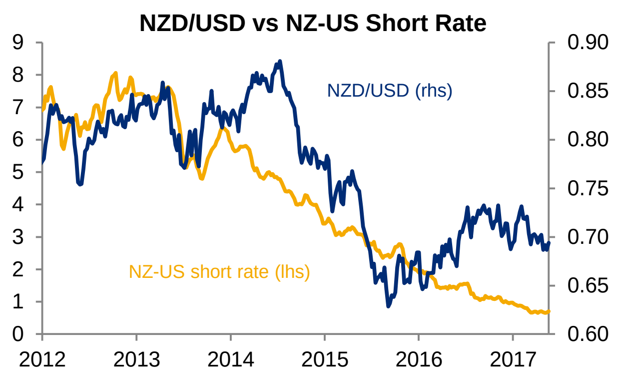
Source: Statistics New Zealand, BNZ

NZ's terms of trade are on track to make a record high in the current quarter. We won't know until much later in the year whether the terms of trade will exceed the 1973 peak or the 1951 peak. Neither might end up being exceeded, but that doesn't detract from the big picture of NZ's current strong terms of trade adding to nominal income growth in the economy. It's normally a positive force for the NZD, but not this year.

One possible explanation is that the market expects that risk appetite cannot be sustained at such a high level for much longer. Or that despite the upswing in global economic momentum this year, it won't be sustained – a weaker growth trajectory will hit commodity prices, and NZ's terms of trade will fall. If that's the case, then a softer NZD in the face of high risk appetite and strong terms of trade is more explainable.

The other possible explanation for a weaker NZD this year is that monetary policy has become a bigger influence on currency markets. Recall that the NZD and TWI actually trended higher throughout much of the RBNZ easing cycle of mid-2015 to late-2016. But currency markets can be fickle and they are showing some respect for the RBNZ's guidance of unchanged monetary policy for an extended period, over a time when the Fed is expected to be tightening policy.

NZ-US Rate Spread Matters Now, But Not 2016



Source: BNZ Bloomberg

NZ interest rate spreads against the US and other countries are at a historically low level and so the NZD "carry trade" is no longer appealing for many investors. This prognosis is unlikely to change anytime soon.

At the beginning of the year, our projections suggested a weaker NZD by year end on all of the crosses except for NZD/AUD, where we saw modest upside pressure. But this was expected to be in the context of much softer risk appetite, lower commodity prices and less supportive domestic factors. The NZD has fallen despite the more positive global backdrop than expected. If it is simply the case of the NZD falling ahead of time, in anticipation of projected weaker global forces, then our longstanding year-end target of USD0.67 might still be fair. But if NZ's correlation with risk appetite and commodity prices rises back to historical norms, and those globally driven factors deteriorate, then clearly that could set the scene for an even weaker NZD than currently projected.

USD Under Recent Pressure

There have been two complicating factors for the currency that have emerged recently. Firstly, another weaker-than-expected US CPI outcome has clouded the outlook for US Fed policy. And secondly, the spotlight is shining on Trump's recent actions, which could lead to impeachment, clouding the outlook for both US fiscal and monetary policy.

So far, Fed speakers have largely been consistent in their messaging – that the soft Q1 GDP data and weak CPI figures don't change the outlook for monetary policy.

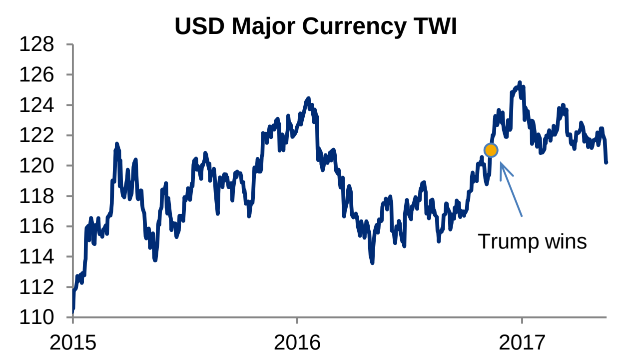
That said, we do wonder whether a third monthly undershoot in a row on inflation would see a more cautious tone on the rate outlook develop.

A string of questionable actions by Trump – his firing of FBI director Comey, release of highly sensitive intelligence to Russia, and allegations that he tried to influence the course of justice against his former national security advisor – are distractions that add to the likely delays for any of his pro-growth policies getting the necessary support.

Investigations into Trump's actions are likely to take time, creating an overhang of US political uncertainty. It is early days, but the recent spike up in the VIX index could be indicative of a rockier time for markets ahead. This all feeds back into the Fed's reaction function. A big tumble in equity markets and a significant, sustained increase in market volatility would add to the risk of a prolonged pause in the Fed's tightening cycle.

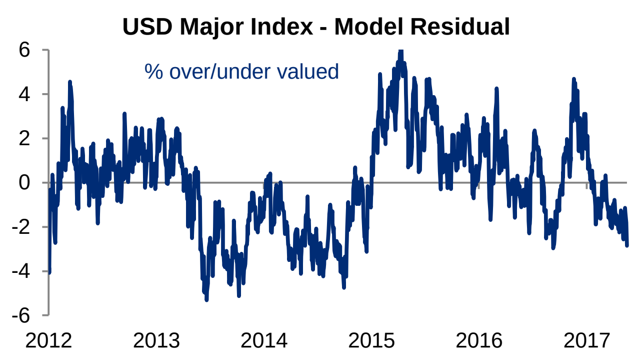
Our simple USD model based on US rate spreads (real 2-year swap rate differentials) and risk appetite shows that the USD is about 3% below fair value, the largest gap in 8 months. That suggests the USD is moving into "oversold" territory. The USD has now effectively unwound the Trump-election rally. That rally was predicated on Trump's pro-growth policies which were USD supportive. At the current juncture, it's probably fair to say that expectations are low for any of Trump's growth policies to be enacted.

USD Unwinds Trump-Win Rally



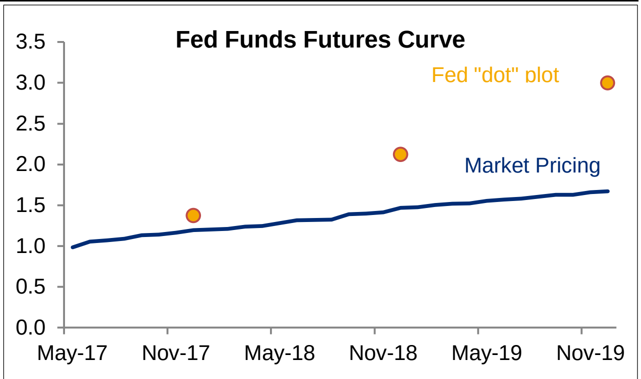
Source: BNZ, Bloomberg

USD Index About 3% Oversold



Source: BNZ, Bloomberg

Fairly Modest Tightening Priced Into US Rates



Source: BNZ, Bloomberg

US monetary policy expectations have really been dampened by the run of soft US data (particularly inflation indicators) and Trump's policies being priced out of the curve. Little more than two rate hikes are now priced into the Fed Funds futures curve through to the end of next year.

The combination of an oversold starting point and a fairly modest rate hike profile priced in over the next 18 months suggests that any further downside risk to the USD from here should be limited. Over time, it seems that the greater risk is a recovery in the USD, that takes it from near the bottom of the leader board year-to-date to near the top over the next six months.

Forecast Summary

Over May, 0.6850 has proven to be an area of good technical support. The December and March lows were between 0.6850-0.6900, adding to the case that 0.6850 is a key support level.

This week's surge in the VIX index has reduced our short-term fair value estimate to around 0.7250-0.7300. We doubt that the fair value gap will be closed by the NZD recovering to that level and resistance is likely to set in between 0.70-0.71.

Assuming the angst over investigation into Trump's affair passes over, the path of least resistance is likely to be a softer NZD/USD. We think that a good rule of thumb is to look through all the political news and focus on the economic fundamentals. Certainly, recent soft US CPI data need to be respected, but if this proves to be a short term phenomenon then the market clearly under-prices the risk of further Fed tightening through the end of next year.

Overall, while some fresh news has injected more uncertainty about the outlook, we remain comfortable with our year-end target of USD 0.67.

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