

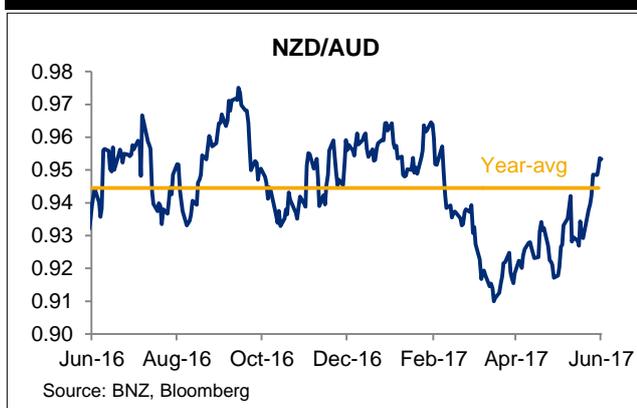
2 June 2017

NZD/AUD Finally Recovers; What's Next?

- NZD/AUD recovered strongly by 4% in May, correcting the pricing anomaly we saw develop through March-April. Signs of a pothole in Australian growth and much stronger relative NZ/Australia commodity pricing goes some way towards driving the cross back towards a fairer value.
- Our medium-term outlook of an eventual move towards parity remains, based on the macro outlook continuing to favour NZ over Australia.
- After the strong recovery, the near-term outlook is now cloudier, but our central forecast is that a period of consolidation around the mid-90s should play out.

Our view on the NZD/AUD cross rate hasn't changed, but given the big swing in that exchange rate this year, an update on drivers and thoughts seems appropriate. The cross began the year just over AUD 0.96, fell steeply from the end of January to mid-March to around AUD 0.91 and has since trended higher in a jumpy fashion to the current rate of just over AUD 0.95.

NZD/AUD Recovers Back to Annual Average



In our view the anomaly in pricing was the steep fall to AUD 0.91. That was never justified on fundamentals, in our view. AUD strength during February can be traced to a speculative rise in iron ore prices and RBA Governor Lowe dampening down market expectations for further rate cuts.

We view the recent recovery in NZD/AUD as taking the currency back towards a fairer level. Supporting the move has been a large, steady fall in iron ore prices back towards a more sustainable level. We could also point towards tighter liquidity conditions in China having a more justifiable negative impact on the AUD compared to the NZD and

strength in NZ commodity prices at a time when Australia's harder commodities are coming under some pressure.

The list can go on. Next week sees the release of Q1 Australian GDP data which are expected to be barely positive, with some risk of a negative outturn. By contrast, NZ's stronger terms of trade are driving a surge in income growth. Recent Budgets in the two countries also show contrasting fortunes. The Australian Budget surprised the market with a poorly thought through tax impost on its banking system to cover a hole in the fiscal accounts, while NZ's fiscal position improved to allow tax cuts, increased benefits, higher capex and net debt reduction.

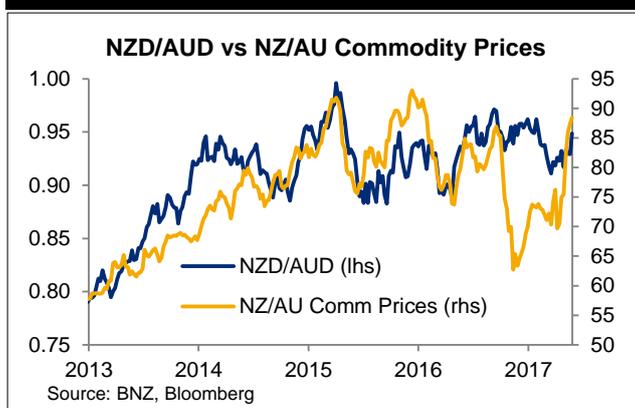
What do our models say?

Interpretation of our short term NZD/AUD models have required some careful judgement to make sense of the big swing in the cross rate.

Relative commodity prices between NZ and Australia have swung wildly, a reflection of the swings in iron ore and dairy prices. Relative pricing has moved in NZ's favour, with dairy and other "soft" commodity prices recovering at a time when the hard commodities have come under some pressure.

At face value, late last year and earlier this year one might have considered a cross of AUD 0.85 as a fairer price. But the market rightly "looked through" the overshoot of iron ore pricing to the upside and the overshoot of dairy prices to the downside. Neither was based on solid economic foundations. Current commodity price levels now seem more appropriate relative to fundamentals.

Big Swings in Relative Commodity Prices Recently



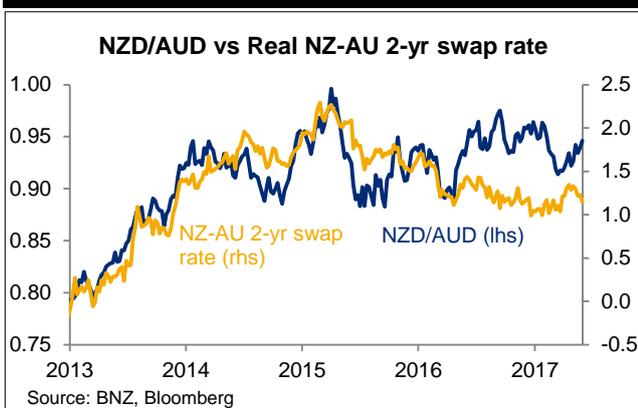
The link between NZ-Australian short term interest rates and the cross rate broke down early last year. Over longer time series, real rates matter more than nominal rates and NZ-AU rate differentials implied a lower NZD/AUD cross rate. At the time, we didn't give this much respect as we believed that NZ's economic fundamentals remained stronger than Australia's and ultimately we saw, and continue to see, more chance of the RBNZ tightening monetary policy ahead of the RBA.

Focusing on a more recent period after the levels-break in the relationship, the link between rates and the cross rate might now be restored. The chart below uses the nominal 2-year swap gap over this shorter period.

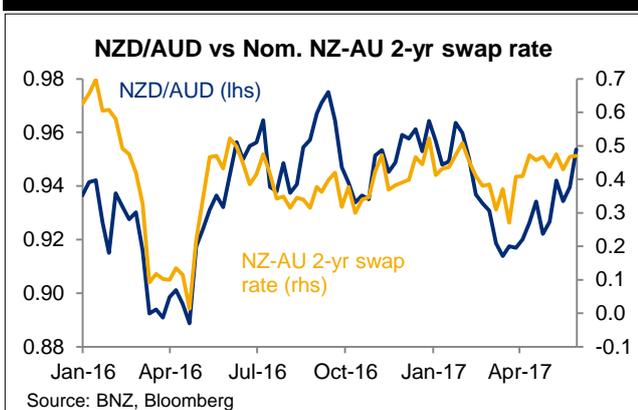
Relative commodity prices and interest rates, along with relative business confidence form the basis of one of our short term fair value models. This fair value model estimate has recovered at a faster pace than the actual cross and now shows only a modest valuation gap. Current fair value on this measure is around AUD 0.9350.

Our alternative short-term model which includes relative unemployment rates and doesn't contain relative commodity prices shows a much smoother fair value track – hovering between AUD 0.94-0.96 over the last couple of years.

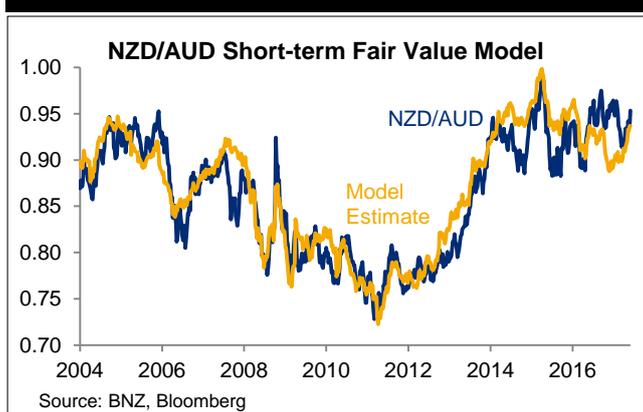
Reduced Correlation With Interest Rate Gap



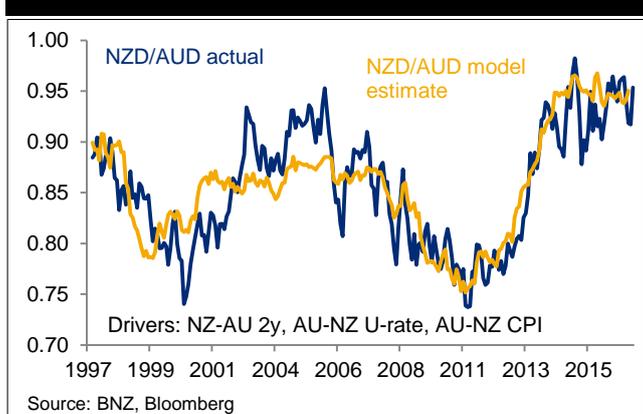
Rate Gap Link with NZD/AUD Might Be Restored



NZD/AUD Trading Near a Fair Level Now on This Model



NZD/AUD Fair Value on This Alternative Model



Outlook

Our forecasts haven't changed and we continue to have a positive medium-term bias towards the NZD/AUD cross rate. Officially, a move to parity is projected by early 2019, but given the typical error bands around forecasts, this could easily occur much earlier.

The key driver of this view is a better economic outlook in NZ versus Australia. This sees increasing pressure on NZ capacity relative to Australia (eg. a widening unemployment rate gap in NZ's favour), leading the RBNZ to tighten monetary policy ahead of the RBA. Relative terms of trade and relative fiscal comparisons also favour NZ over Australia.

Recent weakness in the AUD reflects the market adopting a fairly negative disposition towards the Australian economic outlook. Some even argue that the economy will be close to technical recession over Q1/Q2 this year. Negative growth in next week's Australian GDP figures would be the first leg of that double. Overlay that with weaker terms of trade as the country's key export commodity prices tumble, and the picture is even weaker in nominal terms.

By contrast, NZ's GDP figures are expected to improve, particularly in nominal terms. NZ nominal GDP growth is

likely to be in excess of 7% through calendar 2017. The 5.1% q/q boost to NZ's terms of trade highlights the income boost that will be sloshing around the economy over the period ahead.

We suspect that a lot of this good news story for NZ relative to Australia is already reflected in the exchange rate. A period of consolidation might well be upon us over the near-term, but the broad medium-term thrust remains towards the upside.

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