28 June 2017

A Delay to Expected NZD/USD Weakness

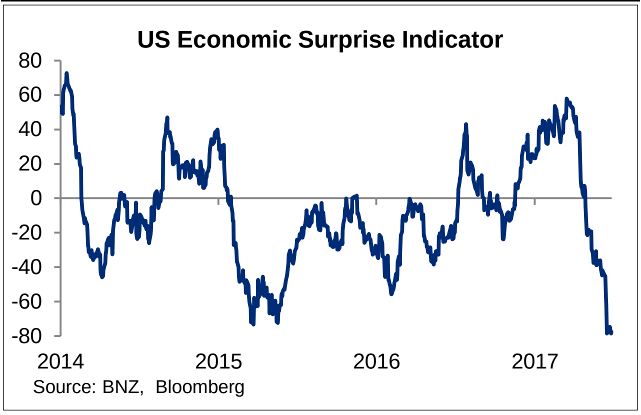
- A pushing out of the expected recovery in the USD sees our near-term NZD/USD forecasts revised up, pushing out the expected fall in NZD/USD by a quarter. NZ's terms of trade also look to be on a stronger path.
- Our end-Q3 NZD target is revised up a few cents to USD 0.71 and end-Q4 target nudged up a cent to USD 0.68. While the current NZD remains well below our short-term fair value estimate of around USD 0.75, there has been a wedge between actual and fair value all year. We aren't expecting the NZD to rise much further over the near term. The gap is more likely to be closed by fair value nudging lower, than the NZD appreciating further.

The NZD's recent strong appreciation from around USD 0.6865 just seven weeks ago has slowed as it approaches a key area of technical resistance around the 0.73 mark, a level it has yet to close above since February (using New York closes). After six consecutive weekly increases, the NZD could close this week down slightly.

Over that seven week period where the NZD has moved up by about 4 cents, our short term fair value model estimate has only risen by about 1 cent to 0.7540. We see much of the actual gain in spot reflecting a catch-up from significant and inexplicable underperformance over the previous few months.

Supporting the NZD's recovery has been specific USD weakness, linked to a weak run of economic data. Citigroup's US economic surprise index has shown a cliff-like performance over the past couple of months, plunging to its lowest level in six years, indicating just how underwhelming the run of US data has been, relative to expectations.

US Data Surprises to the Downside Last Couple of Months

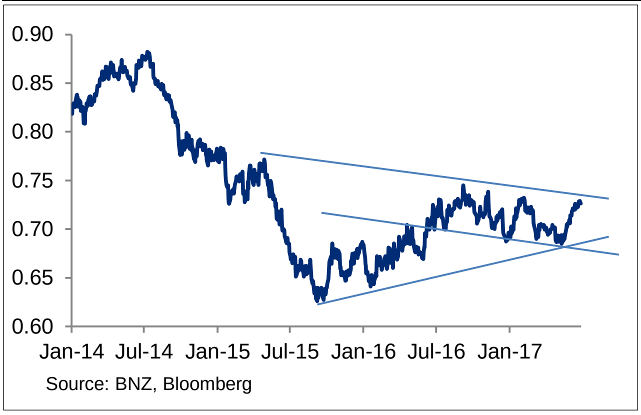


In the meantime, NZ's terms of trade continue to rise unabated. Fundamental support remains for the NZD in the form of rising NZ export commodity prices amidst weaker oil prices, a recipe for taking NZ's terms of trade to a fresh all-time high. CBA's NZ commodity price index in SDR terms has increased for seven consecutive weeks – a sign of the broadly based rise in NZ's export commodity basket, encompassing, dairy, meat, horticulture, forestry and seafood.

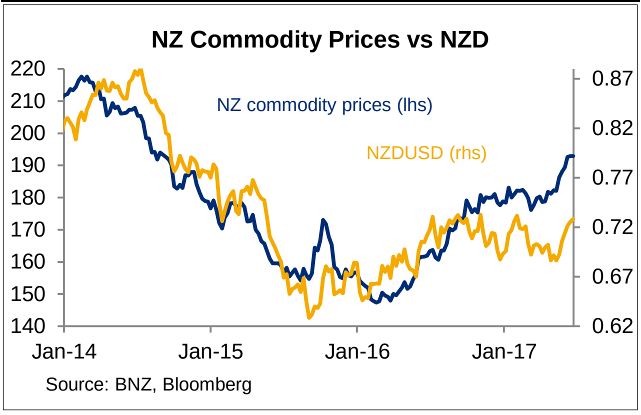
Soft USD data and a likely delay to the next Fed rate hike until December have pushed out the expected recovery in the USD. Combined, with stronger NZ terms of trade we push out by a quarter the expected fall in NZD/USD.

Our end-Q3 target moves up to USD 0.71 (previously 0.67) and Q4 is nudged up a cent to USD 0.68. While the NZD currently remains well below our short-term fair value estimate, there has been a wedge between actual and fair

NZD Meets Technical Resistance Around USD 0.73



NZ Commodity Prices Have Been Rising

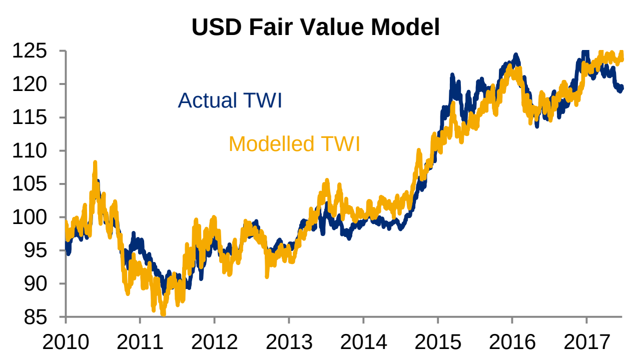


value all year, and we aren't expecting the NZD to rise much further over the near term. The gap is more likely to be closed by fair value nudging lower, than the NZD appreciating further. We expect fair value to be driven down by lower risk appetite and a modest reversal of NZ commodity prices. In that regard it is notable that whole milk dairy futures on the NZX have fallen over the past week or so, from around $3200 per tonne to $3000.

Our fundamental view of an eventual USD recovery hasn't changed and the revision to NZD forecasts is more one of timing. A stronger USD would lead to lower risk appetite as it acts like a tightening in global financial conditions and would encourage lower commodity prices. These forces are NZD-negative.

Our USD model based on US-global rate spreads and risk appetite suggests that the USD (on a majors TWI basis) is about 3½% "over-sold". Historically, this model rarely shows a valuation gap of more than 4%. This suggests that risks to the USD are skewed to the upside over coming months, with recent selling pressure looking a little overdone.

USD Looking Oversold



Source: BNZ, Bloomberg

Another reason to be cautious about how high the NZD could reach in the short term is the impending 23 September election. This will come into focus as campaigning gets underway closer to the time. And there is a reasonable chance that the prevailing government might need support of NZ First. If previous guidance is anything to go by, negotiations in forming a new government could take several weeks. We see this as a potential headwind for the NZD late in Q3 and early Q4.

The RBNZ OCR Review came and went without much reaction. The Bank played an even hand, with only minor tweaks to the policy assessment and sticking to the facts with regards the NZD – noting the recent rise in the TWI was partly explained by higher export prices and that a lower NZD would help rebalance growth towards the tradeables sector.

The RBNZ (and RBA) stand out for their neutral policy tones at a time when the language of other central banks has moved towards indicating a removal of policy accommodation. In that camp we can add the US Fed, Bank of Canada, Bank of England and Norway's central bank. The ECB recently removed its easing bias and President Draghi is signalling an eventual removal of policy accommodation.

If the RBNZ holds the neutral policy line – something we expect through the rest of this year – against the shifting tide of other central banks, then the NZ-global rates differential plays to a softer NZD.

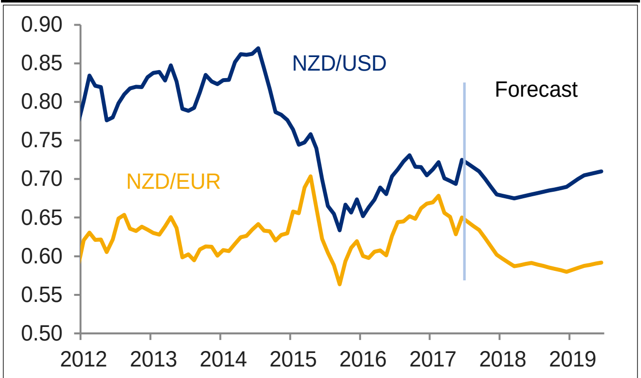
While fundamental forces for the NZD – such as high risk appetite and higher NZ commodity prices – have been supportive recently, the latest CFTC data suggest a surge in the number of net long speculative contracts in the NZD. Positioning has been mainly short NZD over recent months, but there has been sign of capitulation and the data now suggest the highest number of net long positions in over four years. This now makes the NZD more vulnerable to the downside than usual to any negative surprises.

The next key economic releases are the QSBO (4 July) and CPI (18 July), with not much else to look forward to over the next month or so. The latter will be keenly watched, in particular the core inflation measures. An average of four such measures calculated by Statistics NZ has already risen to 2.0%, while the RBNZ's preferred sector factor model core estimate has been static at 1.5% for the past 18 months. That said, the hurdle rate for the RBNZ to change its policy tone is fairly high at this juncture, we think.

Our forecast revisions have been coordinated with changes to NAB's currency revisions to the USD, so this sees only modest forecast revisions to the crosses.

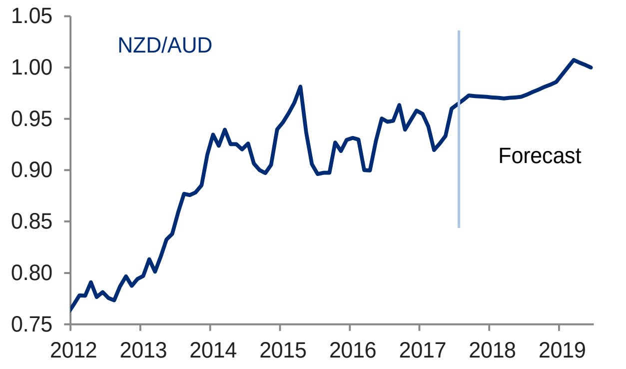
Our models suggest that NZD/AUD around the 0.95 mark is pretty fair. We have the cross settling around the 0.97 mark over the coming year. Our longstanding forecast of parity by late-2018, early 2019 remains unchanged.

Downside Potential for NZD/USD and NZD/EUR



Source: BNZ, Bloomberg

A Flat to Higher Outlook for NZD/AUD



Source: BNZ, Bloomberg

Our highest conviction call is EUR strength over the coming year which, combined with a softer NZD, sees NZD/EUR below the 0.60 mark by early next year. That view got some support this week with ECB President Draghi sounding more positive about the outlook that would allow a gradual removal of current policy accommodation.

The ECB's extremely accommodative stance with its ongoing bond buying programme has been instrumental in keeping the EUR under-valued by depressing euro-area rates. An unwinding of this force is highly supportive for EUR. In previous research we've noted that just moving the deposit rate from -0.4% to zero would be enough to drive our short term NZD/EUR fair value model estimate down to 0.55.

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