24 August 2017

NZD/AUD: A deserved fall on fundamentals

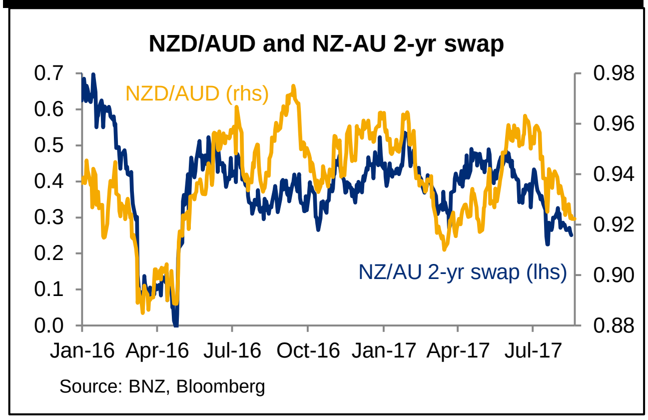
- NZD/AUD has fallen alongside our short term model estimate, given the recent strong outperformance of Australian commodity prices (metals surging ahead) and the toning down of NZ rate hike expectations.
- This fundamental shift needs to be respected, and our NZD/AUD projections have been downgraded accordingly alongside a material upgrade to NAB's AUD forecasts. Our short term FV model estimate, which can get kicked around by commodity prices, has fallen to 0.9170.
- We now see, broadly speaking, a 0.91-0.95 range for the cross through to the end of next year, with the higher end more likely prevailing later in the period. The near-term threat is a breach of 0.91 if metal prices continue to rally, alongside a possible knee-jerk reaction to any NZ political uncertainty.

Earlier this week, in conjunction with our colleagues at NAB, we made a modest broadly based downgrade to USD projections and, more significantly, an upgrade to AUD projections. This had the net effect of a modest upgrade to NZD/USD projections and a more notable downgrade to NZD/AUD projections.

Our broad message on NZD/USD remains unchanged and post revision we simply see a slightly gentler decline in the NZD to a sub-USD 0.70 level over coming quarters.

This view is contingent on a recovery in the USD from a significantly oversold level. The recent flow of US economic data has positively surprised, but the political shenanigans have been a distraction, resulting in the market pricing out any chance of Trump's pro-growth agenda seeing the light of day.

Narrower NZ-AU Rate Spread Hasn't Helped the NZD



Concern that the US debt ceiling negotiations become fraught remains a USD-negative force over the next couple of months, but once this risk is cleared the makings of a USD recovery are there, supported by the current oversold level, the positive economic backdrop, a possible turn around in sentiment regarding the US fiscal outlook (with tax reform crucial in this regard), and the possibility of further Fed hikes coming back in focus.

NZD/AUD downgraded

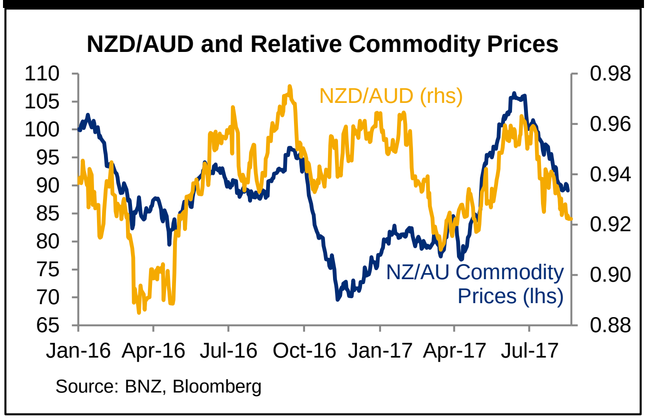
A more significant revision has been made to NZD/AUD projections, reflecting the more meaningful upward revision to our AUD profile.

We now see, broadly speaking, an AUD 0.91-0.95 range for the cross through to the end of next year, with the higher end more likely prevailing later in the period. Previously we had the cross exploring the top end of the 0.90s in the second half of next year, ahead of parity in 2019, but that somewhat exuberant view on the cross has been toned down.

There are good fundamental reasons to support this change in view. RBNZ tightening expectations have been pushed out and we now don't see the first rate hike until at least 12 months away, around August 2018. While that phasing is still expected to be ahead of the RBA, the timing gap in the hiking cycle is likely to be a lot closer than previously thought.

Admittedly, without knowledge of the make-up of the next government and outlook for fiscal policy, or knowledge of the next Governor, or knowledge of the next Policy Targets Agreement, we are flying blind here, but the prospect of an early tightening in monetary policy

NZD/AUD Recently Explained by Relative Commod. Prices



has diminished.

Relative commodity prices can often be a swing factor for the cross. The relative CBA indices of NZ and Australian commodity prices can explain the move in the cross up to AUD 0.96 in the June quarter and the recent move back down all the way to AUD 0.92.

Hard commodities like metals have had a much better run than the softs like dairy recently, supporting the downward move in the cross towards the bottom end of the range this year. There is some fundamental support for the upward trend in hard commodities, with solid demand against a backdrop of the strongest global economy in at least five years, and tighter supply conditions.

NZ commodity prices have performed well this year, but over the last few weeks have softened a little. Flat dairy pricing hasn't helped.

We're not sure how much further this relative "hards" versus "softs" commodity outperformance will continue over the short term. But our medium-longer term view has always been that soft commodities will outperform, based on the increased demand for protein as emerging market countries get richer. This continues to support our view of NZD outperformance the longer we look ahead.

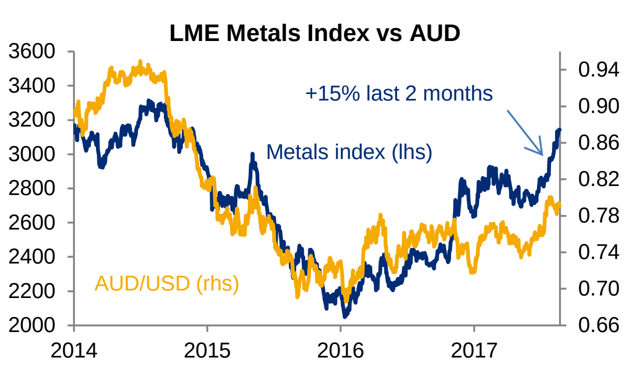
But the trend is your friend and if the recent surge in metal prices continues, then that would be a good reason for the cross to breach the year-to-date low around 0.91 and, depending on how much higher metal prices go, dare we say the 0.90 level could be breached? We see commodity prices as the big swing factor over the rest of the year. Monetary policy outlooks in both countries looks fairly steady as she goes, so we don't see interest rate spreads being much of a factor in the cross for the rest of the year and into early next year.

The other near-term threat to the cross is NZ political risk. We don't want to over-play this as we ultimately don't see a possible change of government as a material swing factor for the NZD. But there is always the potential for some knee-jerk reaction around the time of the 23 September election and in the subsequent weeks of coalition negotiations.

What our models say

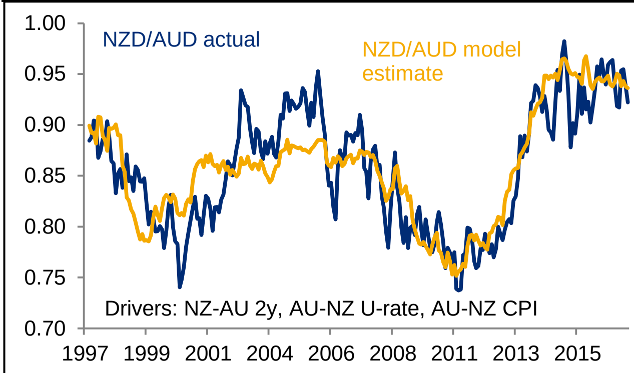
Our short term fair value model based on NZ-AU 2-year swap rates, NZ-AU commodity prices and NZ-AU business confidence indicates a current fair value of 0.9170. Fair value was as high as 0.9450 a couple of months ago, but the outperformance of Australian commodity prices and nudge down in NZ-AU rate spreads have driven the reduction. Our medium-term fair value model ignores the

Strong Run in Metals Prices Supports AUD



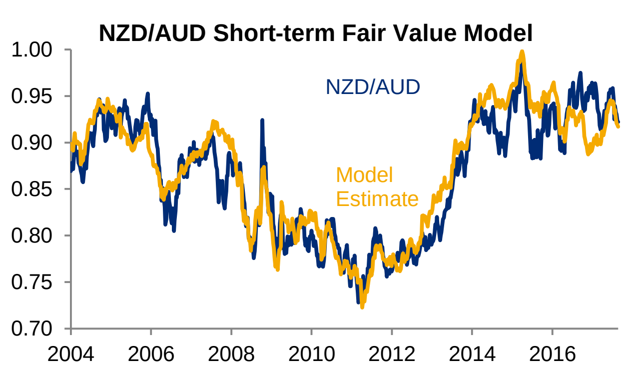
Source: BNZ, Bloomberg

Model 2: FV 0.9360



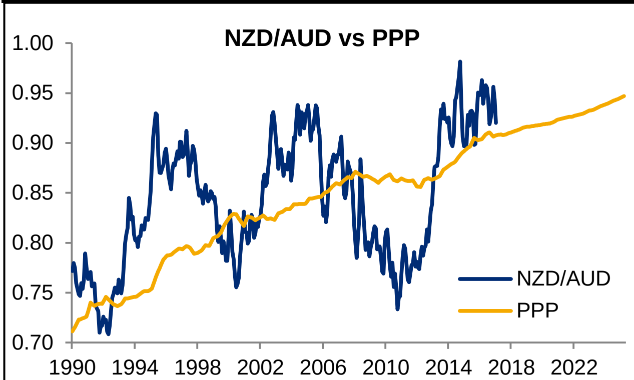
Source: BNZ, Bloomberg

Model 1: FV 0.9170



Source: BNZ, Bloomberg

Purchasing Power Parity Model FV around 0.91



Source: BNZ, Bloomberg

reduction. Our medium-term fair value model ignores the volatility created by relative commodity prices and uses

NZ-AU swap rates, the NZ-AU unemployment rate and NZ-AU CPI. Fair value on this model tends to be more stable and is currently 0.9360.

Our long-term fair value purchasing power parity model shows a fair-value level of 0.9070. The spot rate wouldn't normally be expected to trade at PPP, as the model ignores the economic cycle. Over time, the PPP level gradually increases, given NZ's lower inflation target relative to Australia.

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