

22 September 2017

## NZD: Rates a secondary force only

- **Central bank statements and expectations can kick around currencies over the very short term but we think other drivers are more important over the medium-term. Relationships between NZ-global rate spreads and the NZD have weakened over recent years.**
- **Risk appetite and commodity price trends are more important drivers of the NZD than interest rate differentials. Our monetary policy expectations don't have a significant bearing on our outlook for the NZD over the next year or two.**
- **High risk appetite - its highest level this year - supports the current level of the NZD. Our projections for a weaker NZD into year end and early next year assume that eventually risk appetite must surely fall from its giddy heights. A weaker commodity price dynamic is expected to give further weight to that view.**

The pummelling dealt to the NZD during August where it was down 5% on most of the crosses is now a distant memory. For September so far the NZD is up about 2% and the same on a TWI basis.

Short term movements can often be explained by central bank statements and expectations of policy ahead, as evident by GBP and CAD movements this month and a mild recovery in the USD after this yesterday's FOMC Statement.

The NZD has been caught up in this global trend, with local rates going up accordingly and market pricing for the first RBNZ hike brought forward to September 2018. But an added tailwind for the NZD recently has been the increase in risk appetite. Our risk appetite index reached

its highest level this year overnight to 83%, a reflection of the VIX index moving below 10 and low credit spreads.

As a result, our short term fair value NZD estimate has now reached 0.7625. Admittedly, that model has tended to over-estimate the NZD this year and if we adjust for the average valuation gap current fair value reduces to 0.7320.

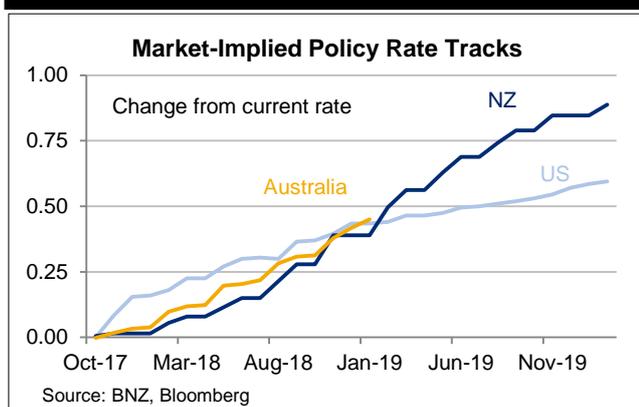
The recovery in the NZD has come despite the forthcoming election. We've always seen the election as a bit of red herring, despite the NZD moving up and down as the polls get updated. It's going to be a close race and we don't see any sustained implication for the NZD whichever way the result goes.

Turning back to monetary policy, market-implied rate tracks for the US, NZ, and Australia all show a period of tighter policy ahead. In the near term, the US is seen to have a greater chance of a rate hike, with another 25bps hike ahead of NZ and Australia. Based on current market pricing, the market sees a greater chance of the RBA moving earlier than the RBNZ, although the implied rate tracks are not materially different from each other through to early 2019.

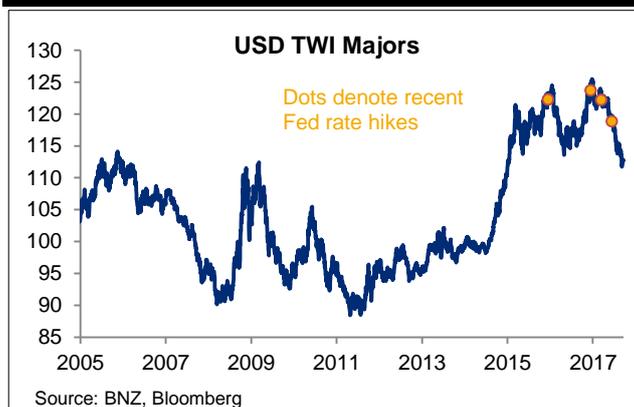
The implied US policy track curve is flatter, so that by late 2018-early 2019, cumulative pricing of rate hikes across the US, NZ and Australia is similar. With that in mind, monetary policy is unlikely to be a significant force on the dollar-bloc currencies over this period. There will be some variation in interest rate spreads over that time but they are unlikely to be material enough to have a sustained impact on the currencies.

When it comes to analysing currency markets, central banks receive a lot of attention, but perhaps more so than

Market Expects Rate Hikes Ahead



USD Lower During Fed Tightening Cycle



they deserve. Our working assumption is that central bank rate decisions often have short term impacts on currencies, as we've seen through September, but over time their influence is washed out by greater fundamental forces.

This can be illustrated by a chart of the USD major currency TWI and highlighting its path since the Fed stood out and began a tightening cycle well ahead of every other major central bank. Since that first tightening back in December 2015, the USD TWI has fallen by around 8%, with three additional hikes in the mix.

Our USD model which is mainly driven by US-global rate spreads also looks to have completely broken down. The difference between the actual USD TWI and estimate fair value has blown out to 8½% which is more than a 4 standard deviations event! Either the model is saying that the USD is extremely oversold or the model is broken. The truth is probably somewhere in between – that is, the USD is likely modestly undervalued and interest rate differentials are now a weaker factor in explaining USD currency movements.

The NZD is no different. Indeed, we have always thought of NZ interest rates and differentials to other countries as very much a secondary consideration in explaining the NZD. NZ-US interest rate differentials are one of the three variables in our short term fair value model, but the significance of that factor pales in comparison to the other two factors, risk appetite and commodity prices.

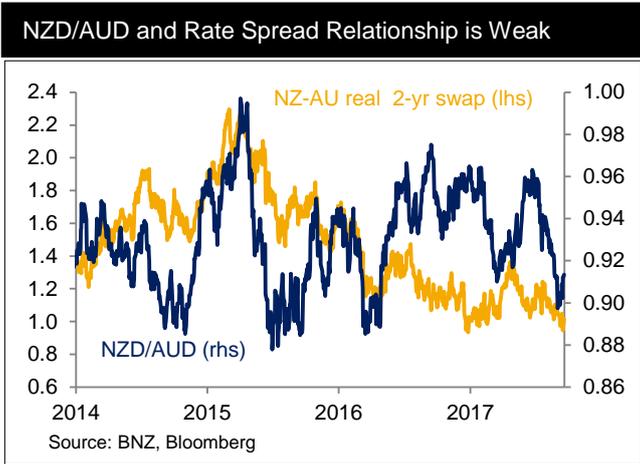
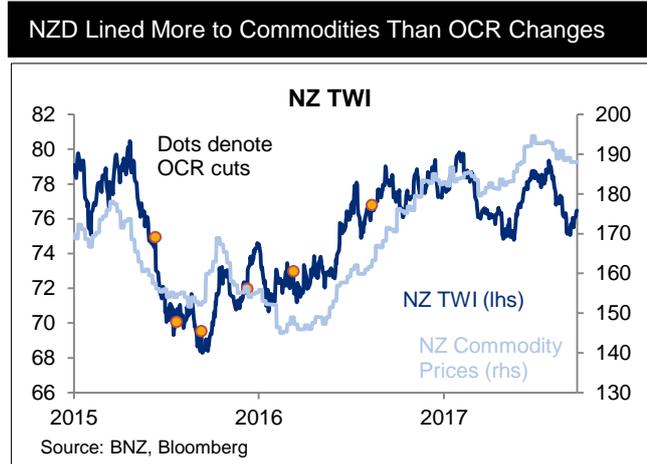
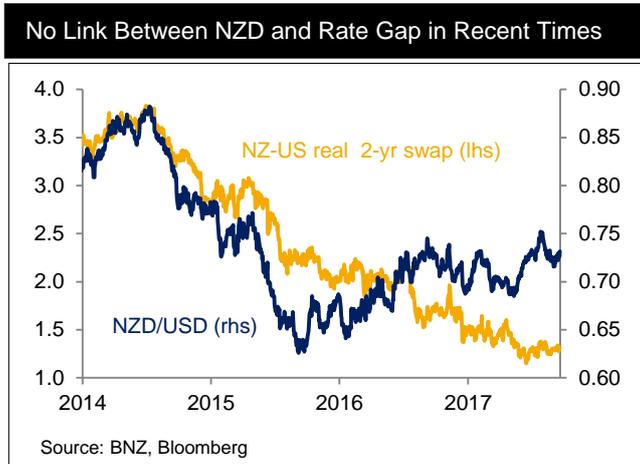
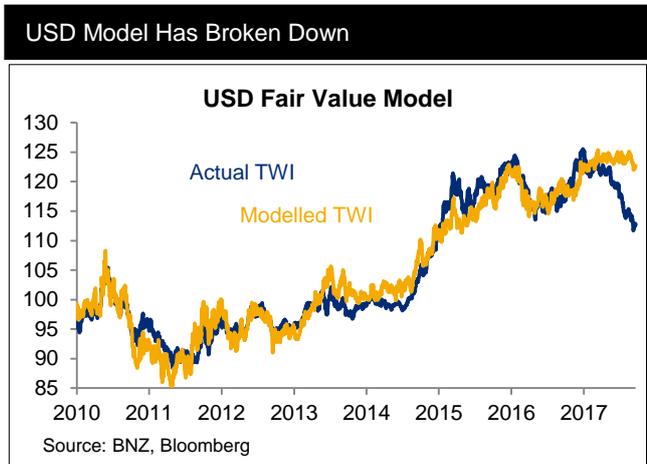
During the last easing cycle, the NZD spent much of the time trending higher, with a positive global growth dynamic and generally rising export commodity prices in the driving seat.

The link between NZ-US interest rate spreads and the NZD isn't particularly strong. The correlation between the NZ-US 2-year swap spread and the NZD is close to zero at present. Our research shows a better link when using real interest rate differentials than nominal differentials, but even these show a lack of correlation over the past couple of years.

The same goes for other NZD cross rates. The link between the NZD/AUD and the NZ-Australia 2-year swap spread has weakened over recent years. Relative commodity prices between NZ and Australia do a much better job explaining short term gyrations in the NZD/AUD cross.

With the Bank of Canada in the spotlight recently after two rate hikes this cycle already, we took a closer look at NZD/CAD, rate spreads and relative terms of trade. The link between the NZD/CAD and NZ-Canada rate spreads has been fairly weak over the past few years. Relative (commodity) terms of trade between NZ and Canada have much greater explanatory power for NZD/CAD, a relationship that has stood the test of time.

In summary, central bank policy decisions get a lot of attention by the market, largely because they can have short



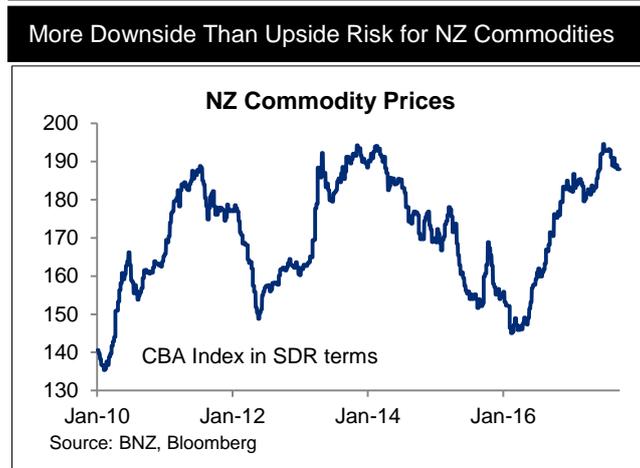
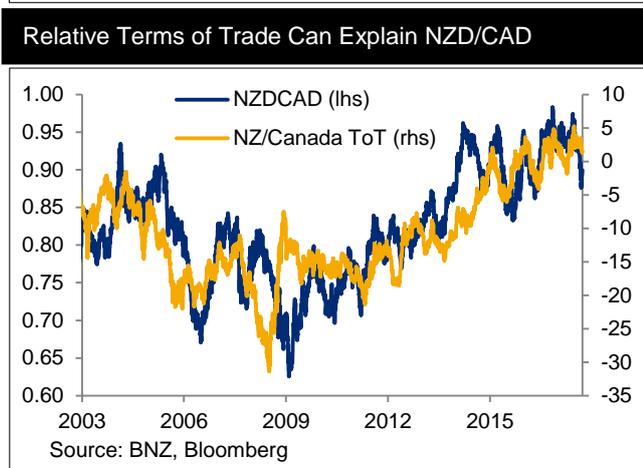
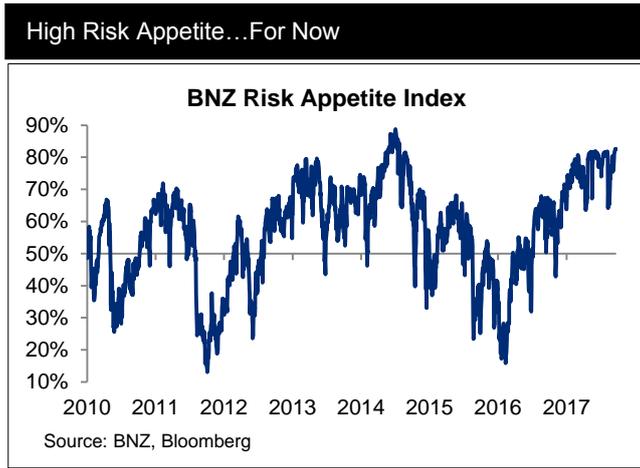
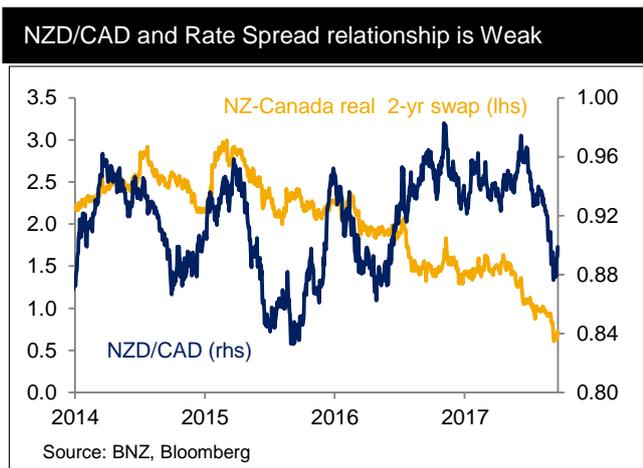
term implications for currency markets. But for investors and corporates with a longer term horizon, other factors are much more important in our view. Risk appetite and commodity price trends are more important drivers of the NZD than interest rate differentials. Our monetary policy expectations don't have a significant bearing on our outlook for the NZD over the next year or two.

Risk appetite is impossible to forecast, but it is mean-reverting, so it would be highly unusual for it to be

sustained at such a high level for an extended period of time. A fall in risk appetite to a more normal level represents a downside risk factor for the NZD.

Commodity prices are also difficult to forecast, but after their strong run from early 2016 the vulnerability is to the downside, and this represents a downside risk for the NZD over the medium term.

[jason.k.wong@bnz.co.nz](mailto:jason.k.wong@bnz.co.nz)



## Contact Details

### BNZ

**Stephen Toplis**

Head of Research  
+(64 4) 474 6905

**Craig Ebert**

Senior Economist  
+(64 4) 474 6799

**Doug Steel**

Senior Economist  
+(64 4) 474 6923

**Jason Wong**

Senior Markets Strategist  
+(64 4) 924 7652

### Main Offices

**Wellington**

42-52 Willis Street  
Private Bag 39806  
Wellington Mail Centre  
Lower Hutt 5045  
New Zealand  
Phone: +(64 4) 473 3791  
FI: 0800 283 269

**Auckland**

80 Queen Street  
Private Bag 92208  
Auckland 1142  
New Zealand  
Phone: +(64 9) 976 5762  
Toll Free: 0800 081 167

**Christchurch**

111 Cashel Street  
Christchurch 8011  
New Zealand  
Phone: +(64 3) 353 2219  
Toll Free: 0800 854 854

### National Australia Bank

**Peter Jolly**

Global Head of Research  
+(61 2) 9237 1406

**Alan Oster**

Group Chief Economist  
+(61 3) 8634 2927

**Ray Attrill**

Head of FX Strategy  
+(61 2) 9237 1848

**Skye Masters**

Head of Interest Rate Strategy  
+(61 2) 9295 1196

**Wellington**

Foreign Exchange +800 642 222  
Fixed Income/Derivatives +800 283 269

**Sydney**

Foreign Exchange +(61 2) 9295 1100  
Fixed Income/Derivatives +(61 2) 9295 1166

**London**

Foreign Exchange +(44 20) 7796 3091  
Fixed Income/Derivatives +(44 20) 7796 4761

**New York**

Foreign Exchange +1 212 916 9631  
Fixed Income/Derivatives +1 212 916 9677

**Hong Kong**

Foreign Exchange +(85 2) 2526 5891  
Fixed Income/Derivatives +(85 2) 2526 5891

**ANALYST DISCLAIMER:** The person or persons named as the author(s) of this report hereby certify that the views expressed in the research report accurately reflect their personal views about the subject securities and issuers and other subject matters discussed. No part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in the research report. Research analysts responsible for this report receive compensation based upon, among other factors, the overall profitability of the Markets Division of National Australia Bank Limited, a member of the National Australia Bank Group ("NAB"). The views of the author(s) do not necessarily reflect the views of NAB and are subject to change without notice. NAB may receive fees for banking services provided to an issuer of securities mentioned in this report. NAB, its affiliates and their respective officers, and employees, including persons involved in the preparation or issuance of this report (subject to the policies of NAB), may also from time to time maintain a long or short position in, or purchase or sell a position in, hold or act as advisors, brokers or commercial bankers in relation to the securities (or related securities and financial instruments), of companies mentioned in this report. NAB or its affiliates may engage in these transactions in a manner that is inconsistent with or contrary to any recommendations made in this report.

**NEW ZEALAND DISCLAIMER:** This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.

**US DISCLAIMER:** If this document is distributed in the United States, such distribution is by nabSecurities, LLC. This document is not intended as an offer or solicitation for the purchase or sale of any securities, financial instrument or product or to provide financial services. It is not the intention of nabSecurities to create legal relations on the basis of information provided herein.

**National Australia Bank Limited is not a registered bank in New Zealand.**