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.

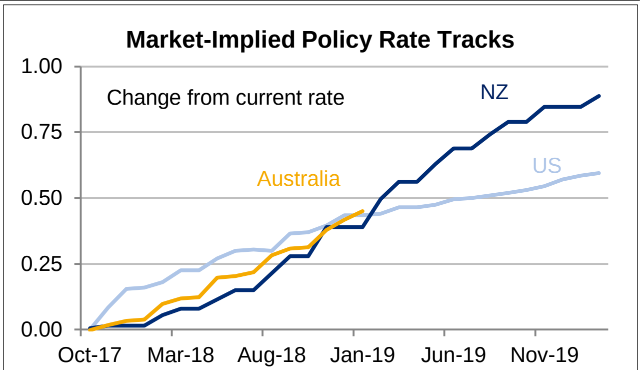
The recovery in the NZD has come despite the forthcoming election. We've always seen the election as a bit of red herring, despite the NZD moving up and down as the polls get updated. It's going to be a close race and we don't see any sustained implication for the NZD whichever way the result goes.

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.

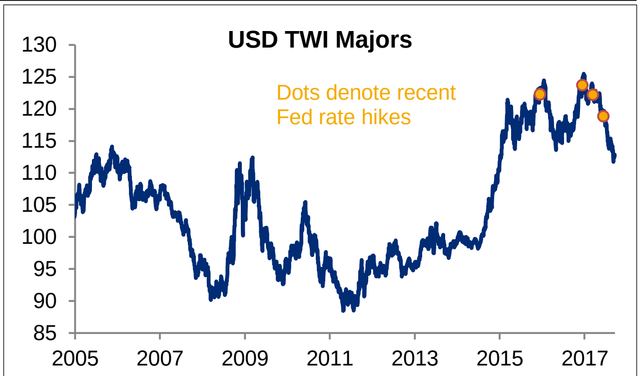
When it comes to analysing currency markets, central banks receive a lot of attention, but perhaps more so than

Market Expects Rate Hikes Ahead



Source: BNZ, Bloomberg

USD Lower During Fed Tightening Cycle



Source: BNZ, Bloomberg

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.

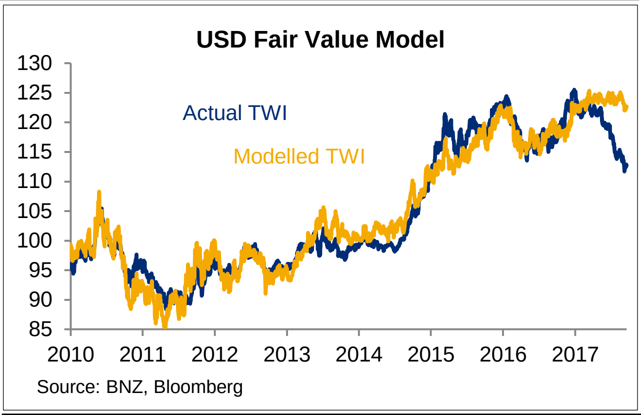
The link between NZ-US interest rate spreads and the NZD isn't particularly strong. The correlation between the NZ-US 2-year swap spread and the NZD is close to zero at present. Our research shows a better link when using real interest rate differentials than nominal differentials, but even these show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

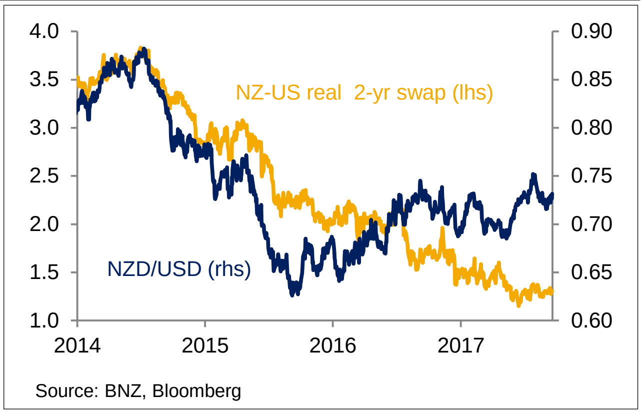
With the Bank of Canada in the spotlight recently after two rate hikes this cycle already, we took a closer look at NZD/CAD, rate spreads and relative terms of trade. The link between the NZD/CAD and NZ-Canada rate spreads has been fairly weak over the past few years. Relative (commodity) terms of trade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

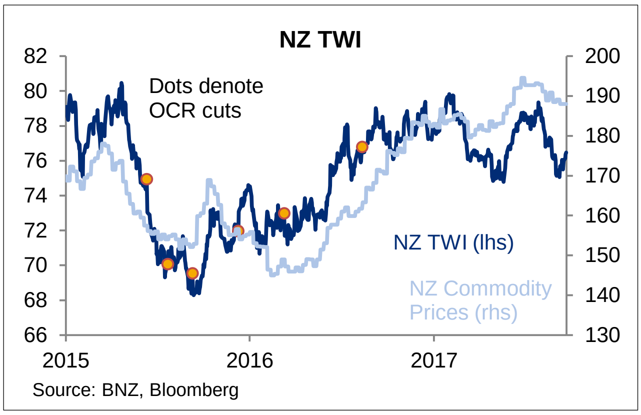
USD Model Has Broken Down



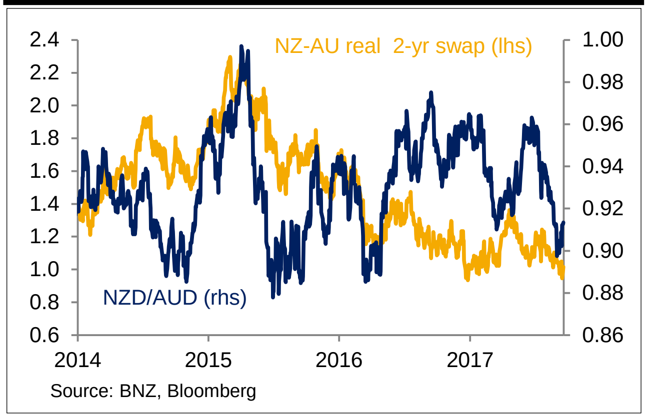
No Link Between NZD and Rate Gap in Recent Times



NZD Lined More to Commodities Than OCR Changes



NZD/AUD and Rate Spread Relationship is Weak



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.

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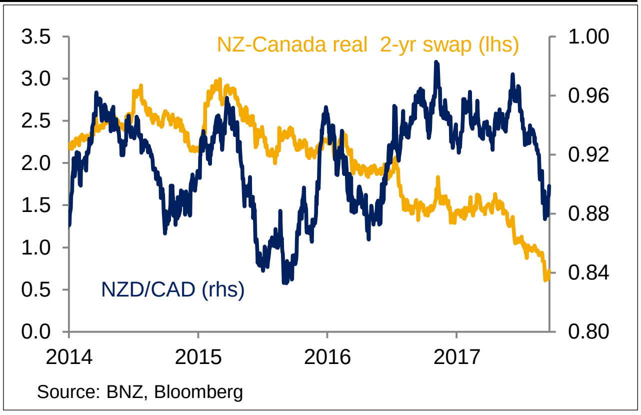
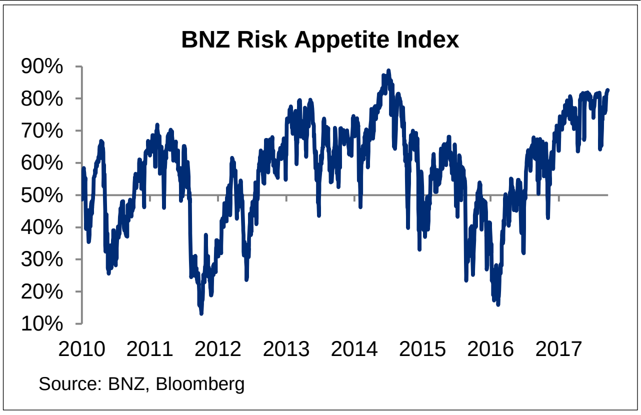
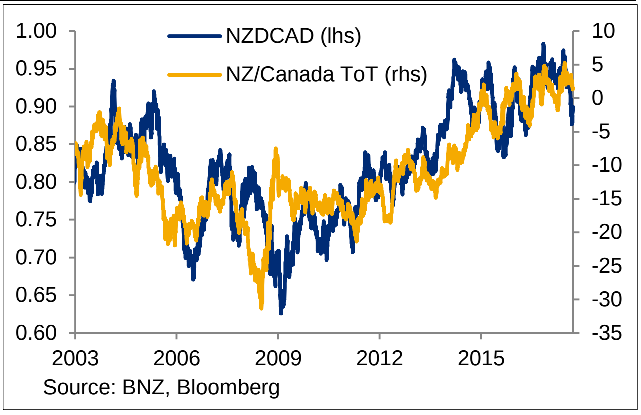
NZD/CAD and Rate Spread relationship is Weak



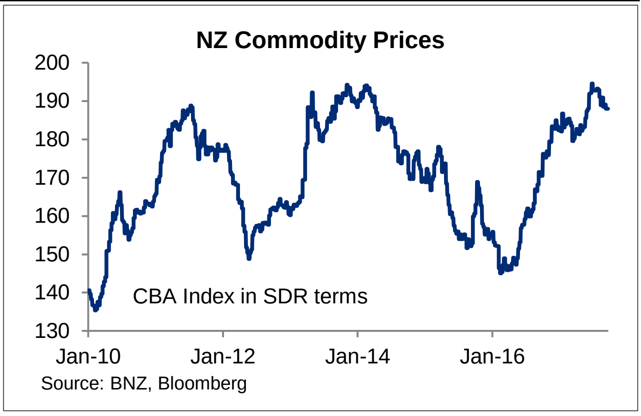
High Risk Appetite…For Now



Relative Terms of Trade Can Explain NZD/CAD



More Downside Than Upside Risk for NZ Commodities



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