RESEARCH

Corporate FX Strategy

26 October 2017

NZD Corporate FX Update

- **The NZ election outcome has hastened the expected move to below USD0.70. The NZD looks a little oversold from domestic political forces, against the backdrop of very high risk appetite and the supportive global economic backdrop. But a deteriorating dairy price outlook and chance that risk appetite falls from here curb any enthusiasm for a decent recovery. We see modest downside risk to our 0.69-0.70 flat line projection through to end-2018.**

The NZD has weakened against a backdrop of a recovery in the USD, as further Fed tightening looks well on track and slightly increased confidence that Trump will be able to get a tax reform programme into legislation.

Domestic political forces have not been kind to the NZD, as the Labour-led government is seen to be not as market-friendly compared to the previous administration. A broad outline of a change in economic direction has been provided, but there remains much uncertainty about the policy outlook, with the devil in the details. Our working assumption is that the market has over-reacted, as currencies are apt to do, but until the policy detail is released, then some sort of political risk premium will be built in the NZD.

Our short-term fair value model estimate remains close to USD0.73, supported by very high levels of risk appetite. However, recent falls in dairy prices and an outlook that sees further reductions – particularly for fats and skim-milk – will limit any possible recovery in the NZD, alongside the mood around the domestic policy agenda.

With changes to the RBNZ Act mooted, the market has made a judgment that monetary policy will be slower than previously expected in reacting to rising inflationary pressure. We disagree with that assessment. The look of new government's policies add to inflation risks ahead and support our view of tighter policy from the second half of next year.

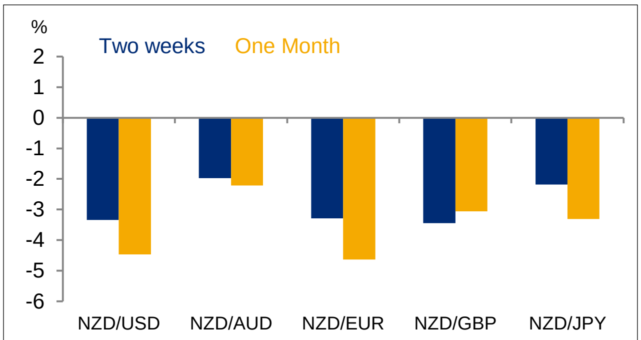
When we stress-test our model with a 10% fall in commodity prices, a 20 percentage point reduction in our risk appetite index and a 50bp narrowing in NZ-US short rate spreads, we get a fair value estimate of USD 0.68. It suggests that the market already prices in a lot of negative news for the NZD, which should limit further downside risk from here. Our projections for the NZD to track around USD0.69-0.70 through to the end of next year have remained unchanged for over two months now. We only see modest downward risk to this view so are not inclined to rush in and change our forecasts at this juncture. Exporters shouldn't be shy in using the current dip to add hedging cover.

BNZ Foreign Exchange Forecast Summary

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	NZD/CNY
Current	*0.69*	*0.89*	*0.58*	*0.52*	*78*	*4.56*
Dec-17	0.70	0.93	0.60	0.53	81	4.67
Mar-18	0.69	0.93	0.59	0.53	81	4.58
Jun-18	0.69	0.95	0.58	0.53	81	4.58
Sep-18	0.70	0.95	0.57	0.54	82	4.60
Dec-18	0.70	0.96	0.58	0.56	84	4.66
Jun-19	0.72	0.96	0.61	0.58	86	4.79
Dec-19	0.73	0.95	0.62	0.59	85	4.79
Jun-20	0.73	0.96	0.61	0.57	83	4.78
	AUD/USD	**EUR/USD**	**USD/JPY**	**GBP/USD**	**USD/CNY**	**TWI**
Current	*0.77*	*1.18*	*114*	*1.32*	*6.64*	*73.1*
Dec-17	0.75	1.17	116	1.33	6.67	75.3
Mar-18	0.74	1.18	118	1.30	6.64	74.5
Jun-18	0.73	1.20	118	1.31	6.64	74.5
Sep-18	0.73	1.22	118	1.28	6.62	74.9
Dec-18	0.73	1.20	120	1.26	6.65	75.7
Jun-19	0.75	1.18	120	1.24	6.65	77.5
Dec-19	0.76	1.17	117	1.24	6.60	77.4
Jun-20	0.76	1.20	114	1.28	6.55	77.3

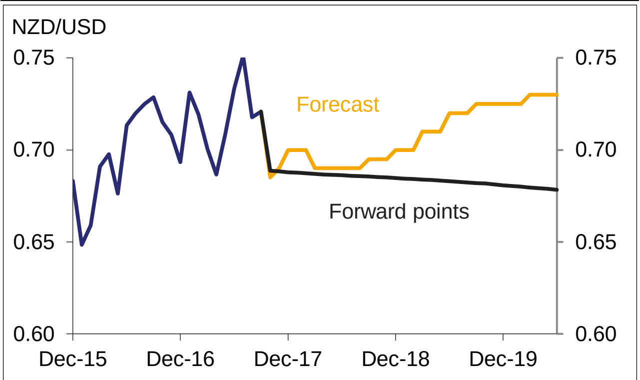
Source: BNZ, Bloomberg

NZD – Changes Over The Past Month



Source: BNZ, Bloomberg

NZD/USD: Downward Risk to Our Flat Profile Next 12m



Source: Bloomberg, BNZ

The Crosses

NZD/AUD: Our short term fair value estimate is around AUD0.91 so exporters would do well to pick up some cover in the high 0.80s, taking advantage of the domestic political risk premium that has been built into the NZD. While our projections show a lift in the cross, we'd assess downside risk at this juncture, with dairy prices moving lower just as hard commodity prices like metals show some recovery. Projected RBA and RBNZ rate hikes next year are similar in profile and timing, making that force currency-neutral. That said, the new NZ government's policies look inflationary so that's a risk we'll be watching closely.

NZD/GBP: GBP is more difficult than usual to predict, with binary outcomes depending on how Brexit negotiations proceed. We'd recommend fully hedging known cashflows to mitigate against swings in the cross. An expected BoE tightening in November is well-priced by the market, and the bigger question is how will the economy cope with tighter monetary conditions against the backdrop of soft growth and heightened uncertainty about the outlook. Lingering uncertainty about the UK outlook can continue for many years to come, even if the worst-case scenario of a cliff-like hit in March 2019 post-Brexit can be avoided.

NZD/EUR: We maintain our view of a weaker cross as the ECB looks to taper its asset purchase programme from early next year. Rate hikes are still a distant prospect but a turning point in ECB monetary policy, which was instrumental in keeping EUR depressed, has been reached. Against a strong euro-area economic backdrop, the ECB will be trying to contain enthusiasm for the euro as it begins the long process of policy normalisation. After the significant fall over the past nine months, trading might become choppier, rather than one-way. Exporters can afford to keep hedging cover lower than usual and of course the opposite applies for importers.

NZD/JPY: We fundamentally don't like the yen as the BoJ is far, far away from meeting its inflation target. Even though the BoJ doesn't need to purchase as many JGBs to maintain its 0.1% yield target for the 10-year rate, ongoing balance sheet expansion with no end in sight adds to the medium-term downward pressure on the yen. Abe's decisive victory at the snap election suggests more of the same in terms of easy monetary and fiscal policy settings. A return of US 10-year yields towards the higher end of this year's range is helping drive a softer yen. NZ's political risk premium has provided a dip in the cross for exporters to buy into. Our projections show a fairly flat profile around 80 over the next year, but there are likely to be opportunities to buy dips on spells of negative risk appetite, which the cross is highly sensitive to.

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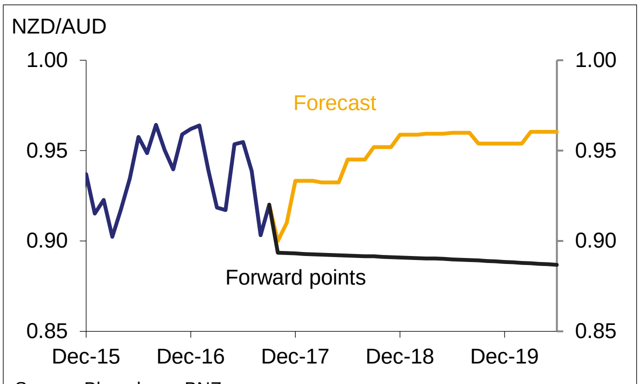
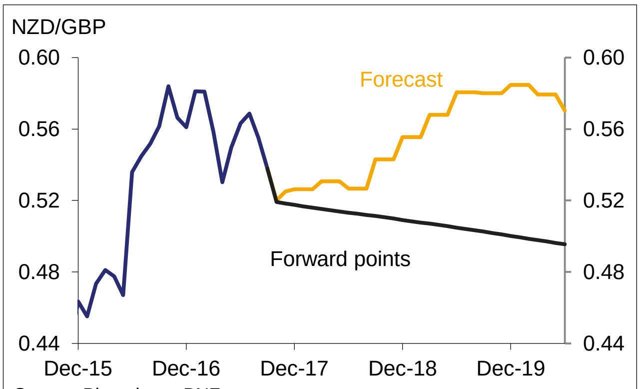
NZD/AUD: Downward Risk to Our Profile



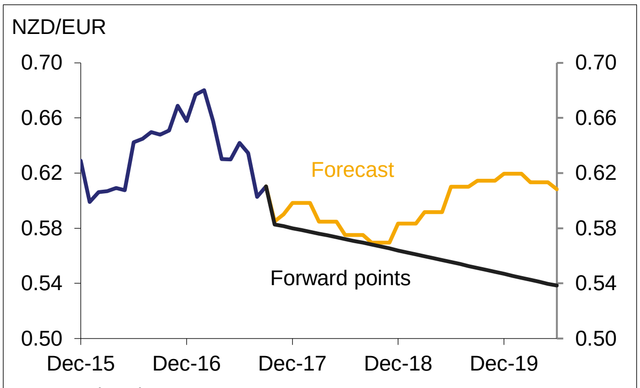
Source: Bloomberg, BNZ

NZD/GBP: Flat Outlook But Binary Outcomes Feasible



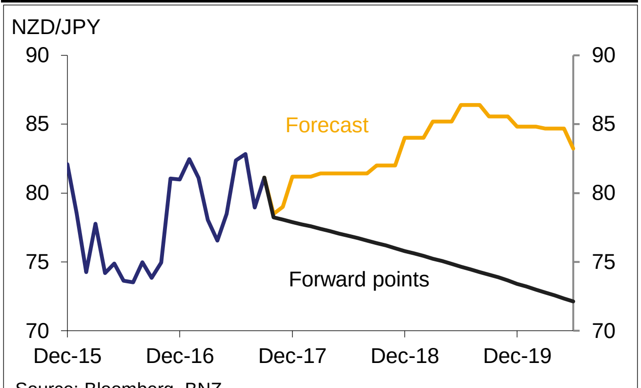
Source: Bloomberg, BNZ

NZD/EUR: Downward Trend to Continue



Source: Bloomberg, BNZ

NZD/JPY: Consolidation around 80



Source: Bloomberg, BNZ

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