18 January 2018

NZD Review and Outlook

- **After underperforming last year, the NZD has begun 2018 on a stronger note, but this positive momentum isn't expected to be sustained. Tighter global monetary policy is expected to renew the headwind for the NZD over the medium-term.**
- **The domestic political risk premium priced into the NZD late last year has now completely faded and our models suggest the NZD is currently close to fairly priced. Weaker fundamentals are ultimately expected to anchor the NZD closer to the 0.68-0.70 for much of the year ahead. A current risk is that the lurch down in the USD since mid-December continues, delaying the expected retreat in the NZD.**
- **We have more conviction in the NZD depreciating this year against EUR and GBP, as occurred last year.**

2017 Review

The NZD underperformed last year, falling by 4.3% on a TWI basis and falling against 12 of the 17 currencies that make up the TWI basket. Of the key majors, the NZD only rose against the USD (+2%), with falls against EUR (-10%), GBP (-6%), AUD (-5½%), CAD, (-4%), CNY (-4%) and JPY (-1%).

At first glance, the underperformance of the NZD last year looks puzzling in the context of improved risk appetite and global growth indicators. Normally these variables would support commodity currencies like the NZD. However, as we illustrate in the next section, the tightening in global monetary policy might have played a role in a weaker NZD.

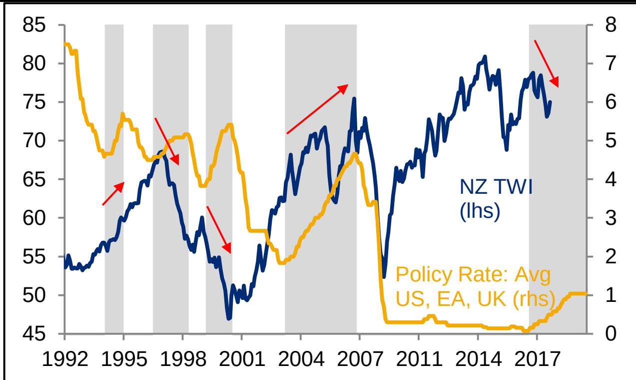
Furthermore, some specific NZ factors appeared to have been a factor in a weaker NZD. NZ GDP growth slowed through the year against an ever-improving global economic backdrop, with positive growth momentum in the US, Euro-area, Canada, Japan and Australia[1]. Weaker dairy prices restrained NZ commodity prices so that Citigroup's NZ commodity terms of trade index fell for the year, although the (broader) official SNZ terms of trade series showed a rise through to the September quarter. Reflecting NZ's weaker relative economic performance, NZ-global rate spreads contracted, making the NZD unattractive on a risk-adjusted carry basis. And in the final quarter of the year, NZ political forces weighed on the NZD, as a new centre-left government was formed.

Global policy tightening and the NZD

One of the themes that developed last year was a more concerted tightening in global monetary policy. While the Fed's tightening cycle began tentatively in December 2015, it kicked up a gear last year with three rate hikes. Meanwhile, both the Bank of England and Canada kicked off their tightening cycles. All three central banks are expected to tighten policy further this year. As we note later, we might see the ECB join in, taking its deposit rate to zero, alongside its reduced asset purchase programme, expected to end in September.

The chart below illustrates the historical link between global policy rates and the NZD, with the grey bars highlighting tightening cycles. The mid-1990s and late-1990s tightenings in global monetary policy coincided with a weaker NZD TWI and the current cycle appears to match that theme – the theory being that tighter global monetary policy eventually leads to weaker global growth which the NZD is sensitive to. This theory didn't fit the early 1990s episode, possibly because the NZD's starting point at that time was very cheap. And for the early-2000s tightening cycle, it coincided with a very strong NZ terms of trade trend which helped support the NZD. Neither of those two factors apply, or are expected to apply, in the current cycle.

Tighter Global Policy; Negative NZD This Cycle



Source: BNZ, Bloomberg

[1] We estimate that NZ real GDP growth was 2.9% y/y in the December 2017 quarter, down from 3.4% in the December 2016 quarter, against the grain of higher growth in the aforementioned countries.

The bottom line is that in thinking about the medium term outlook for the NZD, we are mindful that the tailwind from very easy global monetary conditions that have existed since 2009 is gradually morphing into a headwind for the NZD as central banks move towards policy tightening. To be sure, global monetary policy remains very easy and global growth currently remains strong, but those conditions will eventually fade.

NZD already prices a positive global story

The global economy is running at its strongest pace in more than six years and we hold a constructive view of the global economic outlook for 2018. Inflationary pressure might well be rising, but we see the global monetary policy normalisation process as a fairly pedestrian affair that supports growth over 2018. Global financial conditions remain very easy.

One can always point to significant threats to the outlook. The most obvious one is a war involving North Korea, but this represents a fat tail risk, rather than forming part of a central forecast. Another risk is a trade war initiated by President Trump. A full-on trade war would be nasty for the global outlook, but while some tensions might well prevail this year, our judgment is that these are more likely to be optical than real.

Away from political threats, on the economic front a break to the upside for inflation represents a reasonable threat, and could trigger a significant market correction. This threat is something that is more likely to build over time than appear in the immediate future.

The NZD already factors in this positive global backdrop and when we think about whether global forces could improve or deteriorate from here the risks seem skewed to the downside. Our risk appetite index recently reached its highest level since 2014. At 84% on a scale of 0-100% the downside risk seems obvious.

There's always the possibility that global growth momentum improves further, but we think that the odds favour some sort of flattening out period. Stable growth and (eventually) lower risk appetite represent headwinds for the NZD in the year ahead, relative to the positive growth and higher risk appetite dynamic seen last year.

After NZ's terms of trade reached a record high last year, surpassing the previous peak in 1973, we see downside pressure for 2018. While we think the terms of trade will remain elevated relative to history, we believe it will start tracking a bit lower from here, initially reflecting lower dairy prices and higher oil prices offshore. This is part of a general easing we see through 2018, as export prices are expected to edge a little lower while import prices push mildly upwards.

NZ-global rate differentials might be less of a negative force for the NZD than they were last year. Our NZ monetary policy projections see the RBNZ beginning a tightening cycle around August, with the balance of risk weighed towards a later than earlier start date. This puts the phasing of the tightening cycle behind the US, Canada, and UK, but ahead of the Euro-area, Japan, and in line with Australia, assuming the RBA also kick-starts a tightening cycle in the second half. Still, the carry on the NZD is well below historical norms and for much of the year isn't likely to be a positive factor for the NZD.

On relative growth, while NZ stood out last year as showing moderating growth at a time when growth in most other key countries was improving, this year NZ should slip back into the pack, broadly tracking sideways in terms of absolute growth momentum.

With the election, NZ political factors were a negative force for the NZD late last year, with a lurch down in the currency after the formation of the new government but, as expected, the domestic political risk premium embodied in the NZD now looks to have completely faded.

The Table below summarises the key drivers of the NZD this year compared to last year, with subtle shifts across various drivers.

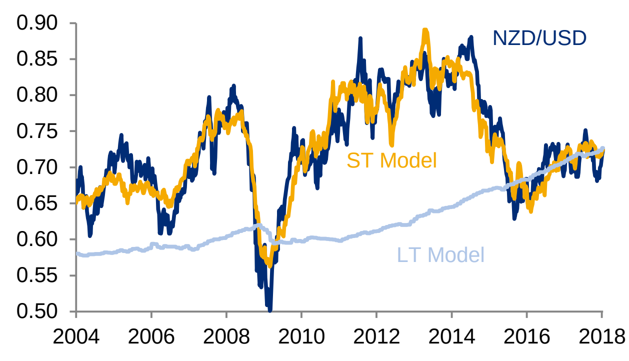
A Subtle Shift in Key NZD Drivers for 2018

	2017	2018
Global economic momentum	↗	→
Risk appetite	↗	↘
NZ Commodities (terms of trade)	↗	↘
NZ-Global rate differentials	↘	→
NZ Relative GDP	↘	→
NZ Politics	↘	→

NZD close to fairly priced on our models

The strong recovery in the NZD since mid-December sees the currency trade close to our fair value estimates, both short-term and long-term. During 2017, the NZD spent 75% of the time trading below our short term model estimate, leaving us scratching our head at times wondering why that was the case. Current fair value based on risk appetite, NZ commodity prices and relative NZ-US short-term rates sits at 0.7240. Our long-term fair value estimate based on purchasing power parity sits around 0.7270.

NZD Fairly Priced



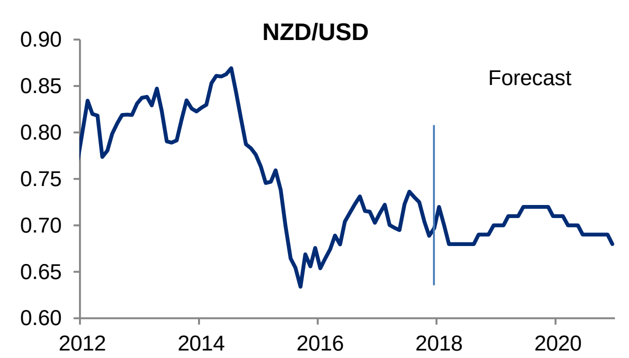
Source: BNZ, Bloomberg

NZD projected to be slightly lower from here

With the NZD trading close to fair value on our short term and long term models, our forecast doesn't show any "big call" for the kiwi. Our last published forecasts in December suggested an anchor for the NZD around USD 0.68-0.70 through much of 2018. The fact we see the NZD trading closer to the bottom end of the range evident last year reflects our view on the fundamentals ahead, with global factors less supportive (flat growth momentum, eventually lower risk appetite), lower NZ terms of trade this year and the NZD unattractive on a risk-adjusted carry basis.

The recent NZD recovery since mid-December goes against that view, but we think it provides an opportunity for importers to take some cover at much better levels compared to late last year, while we think many exporters that appropriately hedged at sub-USD 0.70 rates can afford to wait for weaker NZD levels.

NZD Projected to be Range-Bound



Source: BNZ, Bloomberg

Weak USD story theme still lingers

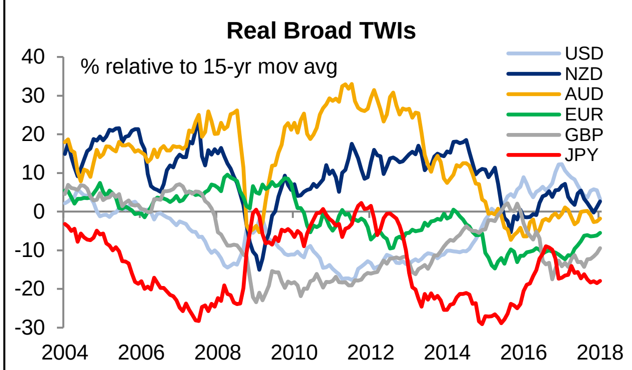
A key risk to our weaker NZD/USD view is that selling pressure for the USD continues. The USD took the prize as the weakest major currency last year and 2018 has begun in a similar vein.

A big question is whether the USD will continue to trend down through the year, or whether the USD has become oversold. The arguments for a weaker USD are as follows:

- Despite USD weakness last year, the real USD TWI (majors) is still "expensive" on a long-term PPP basis. Looking at real broad TWI indices (see chart below), the USD is still the "strongest" currency relative to its 15-year average.
- Despite current favourable USD-global rate spreads, the US monetary policy tightening cycle is mature in comparison to other countries. ECB, BoE, and BoJ are at the very early stages of dialling back "emergency" policy settings induced by the GFC. RBA and RBNZ policy rates remain at post-GFC lows and the odds favour them to begin a tightening cycle this year. Some 2½ rate hikes are priced into the US rates curve for 2018, whereas much less than this is priced in other countries.
- US tax cuts increase the US fiscal deficit, and add to the current account deficit. Historically, a rising dual fiscal plus current account deficit has seen broad USD weakness.

Our last published forecasts in December had accounted for a secular decline in the USD over the next few years when measured on a broad index, but the move is coming a lot quicker than expected.

USD Still Richly Priced vs Average



Source: BNZ, Bloomberg

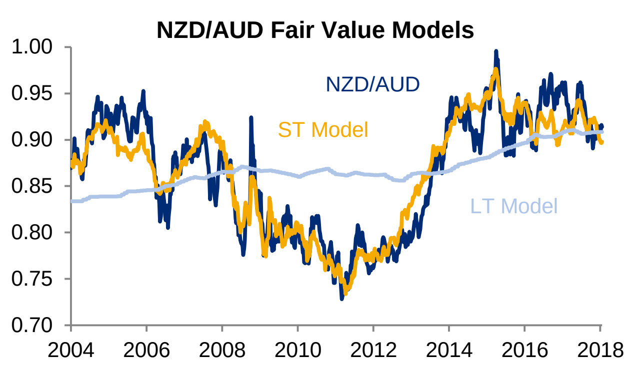
For now we stick with our forecasts of the NZD reverting towards a USD 0.68-.0.70 level for much of this year, but we're closely watching the lurch down in the USD since mid-December. Implicit in our current projection is that the USD has become oversold.

NZD/AUD another range-trading year

NZD/AUD has been range trading over the past 4-years, spending 85% of the time between AUD 0.8950-0.9600. Our projections suggest more of the same. Our short-term, medium-term and long-term NZD/AUD models show fair-value estimates currently sitting between AUD 0.90-

0.93. These models include variables like relative 2-year swap rates, relative commodity prices, relative unemployment rates and relative CPI.

NZD/AUD Fairly Priced



Source: BNZ, Bloomberg

Our outlook for RBA and RBNZ monetary policy through 2018 is similar, with rate hike cycles kicking off for both in the second half of the year. This argues for NZ-Australia 2-year swap rate differentials to be range-bound. With a fairly steady rate differential the biggest swing factor in the cross rate is more likely to come from short-term commodity price gyrations, which are fairly unpredictable.

NZD/EUR and NZD/GBP to head lower

Our biggest call is for EUR and GBP to maintain their upward trend, which sends NZD crosses lower. Despite their outperformance last year, EUR and GBP real exchange rates remain below average, making them still cheap in a longer-term context.

The ECB is expected to continue to incrementally adjust its policy guidance, such that its asset purchase programme will finish by the end of September. We also look for the ECB to adjust its deposit rate from -0.4% to zero, in order to demonstrate that a negative rate was introduced as part of its emergency policy settings and, alongside the end of QE, a negative interest rate is no longer required. The market will be anticipating a formal start to a tightening cycle soon after, but the ECB will be keen to hose down those expectations, arguing that Fed-style rate hikes will not be required until well after the end of QE. Nevertheless, we see it difficult for the ECB to contain further enthusiasm for the EUR.

While we see EUR strength as all about future ECB monetary policy, we see GBP strength as a recovery from very cheap levels as a transitional deal emerges for Brexit, taking away the immediate threat of the March 2019 cliff-like scenario. Buying time provides some much needed breathing space and is expected to allow GBP to recover amidst improved business confidence, as market access to the EU is maintained for another few years.

Targets we have in mind for NZD/EUR and NZD/GBP through the year are EUR 0.56 and GBP 0.48 respectively.

NZD/JPY outlook more uncertain

Our NZD/JPY projections have the cross averaging just under 80 over calendar 2018, close to the middle of the range it traded last year.

But risks seem weighed to the downside for the cross. There is the chance that the currency follows the path that EUR made last year, rising strongly in anticipation of reducing monetary policy stimulus. This scenario could take USD/JPY down to 100-105 and NZD/JPY down to around 70. However, in this scenario meeting the 2% inflation target would remain even more elusive for the BoJ so the central bank ought to be trying its best to avoid any yen strength from here.

Our projections assume a de-emphasis of quantity targets as the BoJ maintains its yield curve control policy. And there's a chance the market over-reacts to any BoJ language changes here. But ultimately our forecasts assume that a stronger yen wouldn't be long-lasting, which keeps NZD/JPY range-trading around the 80 mark.

The other downside potential for the cross is under a scenario of a big negative global risk event which sees safe-haven flows into yen.

Exchange Rate Projections*

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	NZD/CNY
Current	*0.73*	*0.91*	*0.60*	*0.53*	*81*	*4.70*
Mar-18	0.68	0.93	0.57	0.49	78	4.48
Jun-18	0.68	0.94	0.56	0.48	79	4.45
Sep-18	0.69	0.95	0.56	0.48	81	4.50
Dec-18	0.70	0.96	0.56	0.49	82	4.55
Mar-19	0.71	0.95	0.56	0.50	83	4.61
Jun-19	0.72	0.95	0.57	0.50	84	4.67
Sep-19	0.72	0.95	0.57	0.50	83	4.70
Dec-19	0.71	0.95	0.56	0.49	81	4.64
Mar-20	0.70	0.94	0.54	0.48	79	4.57
Jun-20	0.69	0.93	0.52	0.47	77	4.50
Sep-20	0.69	0.94	0.52	0.47	76	4.50
Dec-20	0.68	0.93	0.51	0.46	74	4.44
	AUD/USD	**EUR/USD**	**USD/JPY**	**GBP/USD**	**USD/CNY**	**TWI**
Current	*0.80*	*1.22*	*111*	*1.39*	*6.43*	*75.3*
Mar-18	0.73	1.20	115	1.40	6.59	72.3
Jun-18	0.72	1.21	116	1.41	6.55	72.2
Sep-18	0.73	1.24	117	1.43	6.52	72.9
Dec-18	0.73	1.26	118	1.44	6.50	73.7
Mar-19	0.75	1.26	117	1.44	6.49	74.3
Jun-19	0.76	1.26	116	1.43	6.49	75.0
Sep-19	0.76	1.27	115	1.44	6.53	75.3
Dec-19	0.75	1.28	114	1.45	6.54	74.4
Mar-20	0.75	1.30	113	1.47	6.53	73.2
Jun-20	0.74	1.32	111	1.48	6.52	72.0
Sep-20	0.74	1.33	110	1.48	6.52	72.0
Dec-20	0.73	1.34	108	1.48	6.53	71.0

Source: BNZ, Bloomberg

*Forecasts as at 11-December. Next review 5-February.

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