30 January 2018

Weak USD Threatens Our NZD Call

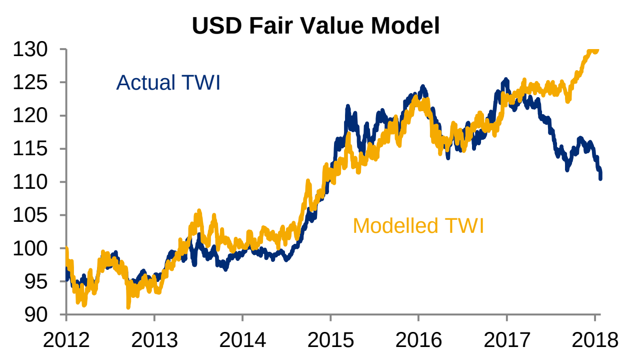
- **Sentiment for the USD has taken another lurch down this year despite more conviction on Fed rate hikes ahead. Other factors such as portfolio flows, fiscal policy and trade policy seem to have increased in importance. NZ-US interest rate differentials have been a weak force on the NZD for a couple of years now.**
- **With key technical support levels for the USD broken, even setting aside fundamental forces, there's a chance that the USD overshoots to the downside, which sees the NZD reach and/or exceed last year's high of 0.7558.**
- **However, it would take some convincing to sway us from our view that the NZD ought to be heading lower at some stage this year. We still see tighter global monetary policy, an eventual fall in risk appetite and some softening in NZ's terms of trade as key headwinds for the NZD this year**

In our opening currency piece for the year, *"NZD Review and Outlook"* we touched on a few themes including the weak USD story. We expand on this theme and the implications for the NZD.

Interest Rates No Longer a Key Driver of Currencies

The USD has been under significant downward pressure through January, taking it to 3-year lows on the key indices after a broadly-based selloff. What are the key driving forces and will they continue? Getting this call right is essential for our NZD/USD projections.

Times Have Changed – USD Model Broken



Source: BNZ, Bloomberg

Our simple USD TWI model – which suggests a positive relationship with real US-global rate differentials and a negative relationship with our risk appetite index– shows a breakdown in relationship from mid-2017. While recent strength in risk appetite is consistent with a weaker USD, the model estimate has trended much higher, driven by the higher US-global rate differential factor.

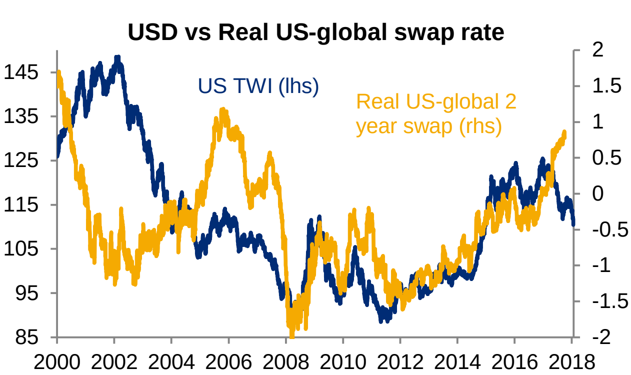
We can only hypothesise, but the mid-2017 breakdown in the model broadly coincided with ECB President Draghi's speech in Sintra, Portugal, which our NAB colleagues at the time described as a "game-changer". After removing the ECB's easing bias and upgrading the balance of risk on economic growth at the early-June policy meeting, Draghi spoke of a "strengthening and broadening recovery" in the euro area and that the ECB would need to adjust its policy parameters in line with the recovery. This was a clear signal of the end-game to the ECB's asset purchase programme.

From that time, rising short-term interest rates in favour of the US haven't mattered. The market opted to look further ahead and consider that the Fed ultimately wouldn't be the only major central bank tightening policy. Sure enough, the ECB did taper its asset purchase programme and the Bank of England and Bank of Canada raised rates. The Bank of Japan has communicated that policy hasn't changed, but the market has become sensitive to any future policy announcements regards its asset purchase programme and yield targets.

The bottom line is that current favourable USD-global rate spreads are no longer seen to be a positive force for the USD. The US monetary policy tightening cycle is mature in comparison to other countries – suggesting much more upside in future interest rates for other countries – and this has seen the USD move out of favour. Other factors which we move onto below are more in play.

Before moving on, we note that the link between rate differentials and the USD can break down for long periods of time. The chart below shows the fairly loose relationship between the USD TWI and US-global rate differentials from 2000-2008 (and the same applies looking as far back as 1990). Short-term interest rate differentials could well take a back seat to other factors as a driver of currencies in the years ahead.

Rate Differentials Aren't Always the Key Currency Driver



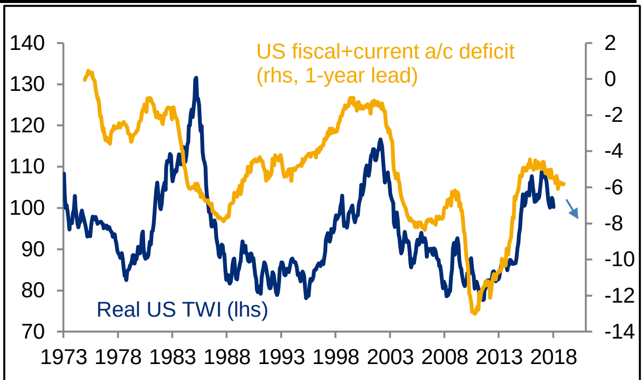
Source: BNZ, Bloomberg

Portfolio flows, fiscal and trade policy

Another way to phrase this is that the "carry" trade is dead and other factors are now much more important. Growth opportunities outside of the US have improved, which means that portfolio flows are being directed into other countries. This appears most obvious for the euro-area, as political risks in the region have subsided and the very strong growth dynamic for the region is attracting flows; and for emerging markets, as likewise the strong growth opportunities and apparently cheaper equity markets are seen as an attraction. "Follow the money" has become more profitable for currency traders than simply relying on higher interest rates to generate returns (the "carry").

US economic and trade policy seems to be another recent theme that has reduced sentiment for the USD. The most recent bout of USD weakness from mid-December onwards coincided with Trump's tax reform package getting the nod. Following this, the currency market became more focused on the negative aspect of the reform – the likely increase in the US fiscal deficit and government debt alongside the country's current account deficit, putting the track of the dual deficit on the radar. Historically, a rising dual fiscal plus current account deficit has seen broad based USD weakness.

Larger US Twin Deficit Historically Not Good for USD



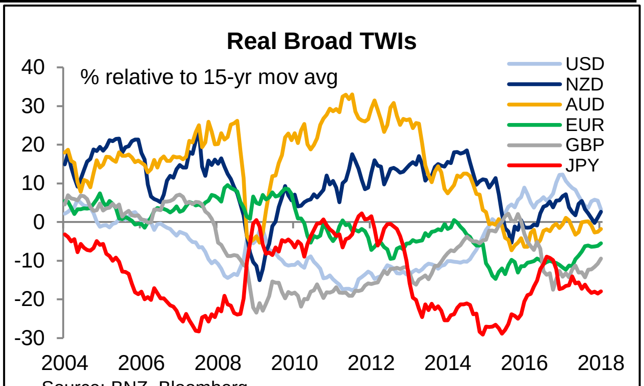
Source: BNZ, Bloomberg

As the focus turns away from monetary policy towards fiscal and trade policy, the market has become more sensitive to developments on the latter. We got a taste of this when Trump imposed tariffs on solar panels and washing machines. The key question is whether the move marks the start of a shift towards more protectionist trade policy or whether it was a symbolic gesture to appeal to a section of his constituency. We're backing the latter. A few tariffs here and there will have little overall economic impact but the sticker shock of such announcements is enough to generate some short-term currency volatility. To the extent that any move towards trade protectionism looks US-centric than global in nature, it seems to be a USD-negative development.

A full-on global trade war would be nasty for the global outlook and to the extent that the USD does better in a risk-off environment, that scenario might even be considered USD-positive. However, our judgement is that trade tensions are likely to be more optical than real and largely US-centric.

Our final point on the USD is that the starting point for the recent weakness has been a strong currency. When looking at real TWIs across the majors, the USD is coming from a point of strength. This stems from the USD's strong gains over 2014-15. On a TWI basis, EUR gained by around 10% last year, but this was from a position of weakness, and the real EUR TWI still remains below its 15-year average. JPY and GBP remain the cheapest majors on this metric.

USD Not Cheap in a Longer Term Context



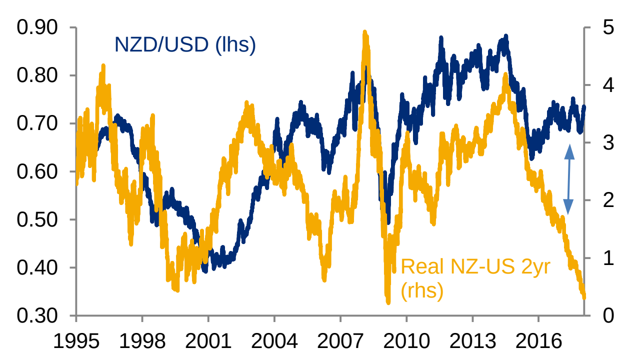
Source: BNZ, Bloomberg

NZD Implications

We noted earlier how higher relative US interest rates no longer seemed to be a driving force for the USD. When looking at the NZD/USD exchange rate, the same applies – since as far back as 2015 there seems to be little apparent relationship between falling NZ-US interest rate differentials and the NZD. Since the end of 2015, the gap between the real NZ and US 2-year swap rate has been falling steadily – down by nearly 200bps – and yet the NZD/USD has moved higher over this timeframe. Across the short end of the yield curve, NZ rates now trade below US rates.

In terms of our model framework, we can explain the NZD's appreciation since the end of 2015 by the surge in risk appetite (from 40% to over 80% on the BNZ risk appetite index) and a 25% increase in NZ commodity prices. These forces have more than offset narrower NZ-US rate differentials.

Link between NZD and NZ-US Rate Differential Broken



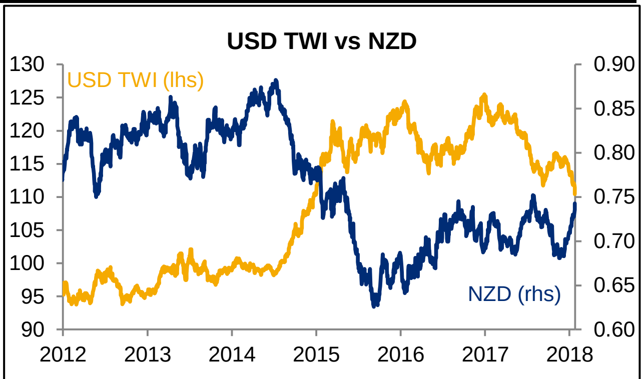
Source: BNZ, Bloomberg

We look for three Fed rate hikes this year and none from the RBNZ. How might that affect the NZD? Very little, we'd suggest, with that view already largely reflected in market pricing, notwithstanding the now-loose relationship between rate differentials and the NZD.

It goes without saying that the behaviour of the USD will largely determine how the NZD tracks this year. Between 2011 and 2014, the NZD spent much of the time trading in a range of USD 0.75-0.88. This coincided with a period of poor USD sentiment when the USD was stuck in an under-valued zoned as the chart below shows.

While our forecasts, in conjunction with NAB colleagues, are currently under review and new forecasts, if changed, will be published next week, our current year-end target of USD 0.70 assumes that sentiment for the USD eventually improves. If we're wrong and the recent trend continues, then it follows that the NZD could breach the 0.80 mark.

Largely a Mirror Image



Source: BNZ, Bloomberg

The next few weeks could be crucial. With key technical support levels for the USD broken, even setting aside fundamental forces, there's a chance that the USD overshoots to the downside, which sees the NZD reach and/or exceed last year's high of 0.7558.

However, it would take some convincing to sway us from our view that the NZD ought to be heading lower at some stage this year, at least on a TWI basis. We still see tighter global monetary policy, an eventual fall in risk appetite and some softening in NZ's terms of trade as key headwinds for the NZD this year.

jason.k.wong@bnz.co.nz

Contact Details

BNZ Research

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

Nick Smyth
Interest Rate Strategist
+64 4 924 7653

Main Offices

Wellington
Level 4, Spark Central
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
PO Box 1461
Christchurch 8011
New Zealand
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 Fixed Income Research
+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