

28 February 2018



## Can the NZD weaken as the USD weakens?

- **The USD has been in a consolidation phase the past four weeks, following the downtrend trend kicked off from January 2017. This has seen a more stable NZD/USD but we still harbour much uncertainty about the outlook.**
- **Following the breakdown in the driving factors of the USD that worked well for much of the post-GFC period we develop a real long-term USD TWI model to provide a guiding light.**
- **After accounting for the most obvious economic influences on the USD there remains a significant unpredictable element to the greenback. In a long-term context, the USD still appears over-valued despite the decent fall over the past year. In thinking about further downside potential, “mean-reversion” could well be as dominant a force as the rising US twin deficits.**
- **Our weaker NZD narrative is based on, ultimately, a weaker global growth outlook and lower risk appetite in a rising global interest rate environment. There is a clear risk that we are far too early in this “global headwinds” call and that the weaker USD story continues to dominate over the year ahead.**
- **Thus, the short-medium term risk is that the NZD pushes higher, before it heads lower, making our year-end target of USD 0.70 unattainable. Indeed, based on our DXY forecasts a kiwi closer to the high 0.70s wouldn’t look out of place. It’s a risk that keeps us awake at night that exporters and importers should be aware of in making hedging decisions.**

In our last major note towards the end of January “[Weak USD Threatens Our NZD Call](#)”, the USD TWI had just fallen for the seventh consecutive week, the NZD had breached the USD 0.74 mark and we wondered aloud how much longer this could continue. As it turns out, the freefall in the USD has stopped, with the currency entering a period of consolidation. This has seen the NZD held largely within a USD 0.72-0.74 trading range over recent weeks.

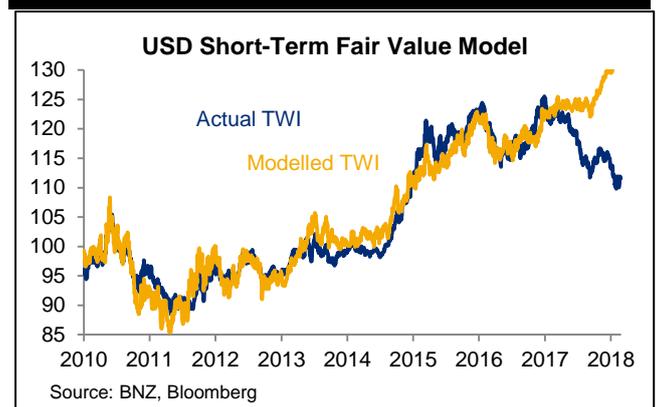
Despite some recent range-trading we still harbour much uncertainty about the NZD outlook and where the currency might end the year. Officially, we still see the NZD ending the year at USD 0.70 but we continue to keep an open mind. If we’re wrong, the most likely alternative scenario we see is one where the USD downturn continues to an extent that sees the NZD break up through last year’s high of USD 0.7558 and ending the year closer to USD 0.80 than USD 0.70.

### USD long-term currency model

As we illustrated in the aforementioned research note, interest rate differentials haven’t been a recent key driver of currencies – this applies whether we look at the USD TWI and US-global rate differentials or even simply the NZD and NZ-US rate differentials.

Our USD short-term fair value model – based on real 2-year swap rate differentials (US-global) and risk appetite – broke down mid-2017 after accurately explaining the path of the USD for the prior seven years.

### Short-term USD Model – Rest in Peace

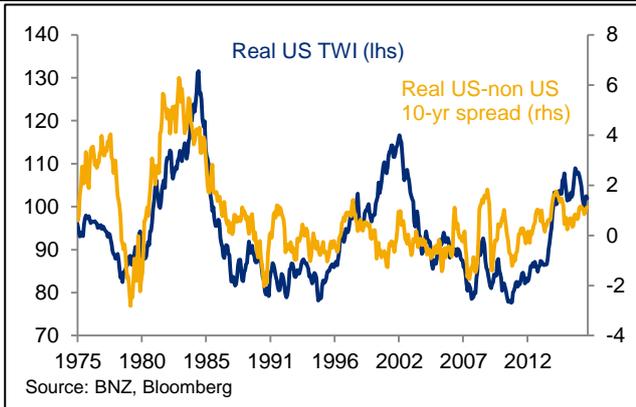


That led us to look at a longer term perspective and develop a “long-term” USD currency model. Here we look at the real USD (major currency) TWI and try to explain its behaviour over the last forty years.

As driving factors we looked at a real US-global interest rate spread, the twin (fiscal and current account) deficits and a measure of relative capacity pressure expressed as the US-global unemployment rate spread. For the global variables we use a weighted average of Germany, UK, Japan and Canada interest and unemployment rates.

The link between currencies and interest rate spreads needs no explanation. We would have preferred to use a short-term interest rate spread but over a forty year time period we found it easier to source long-term (10-year) interest rates. A positive correlation exists between the USD and the real US-global 10-year rate spread, with the rate spread variable doing a particularly good job in explaining USD strength during the early 1980s.

**USD Positively Correlated with US-Global Rate Differential**



**Widening Twin Deficits Lead to Weaker USD**



**US-Global Unemployment Rate Difference vs USD**



In previous reports we've highlighted the recent focus on the US twin deficits. Throughout the whole forty year period there isn't a consistent pattern between the USD and the twin deficits but, overall, historically a wider twin deficit has been detrimental to the USD. A wide twin deficit requires higher interest rates to attract foreign capital or a weaker currency, or a combination of both.

There is an inverse, albeit imperfect over time, correlation between the USD and relative US-global unemployment

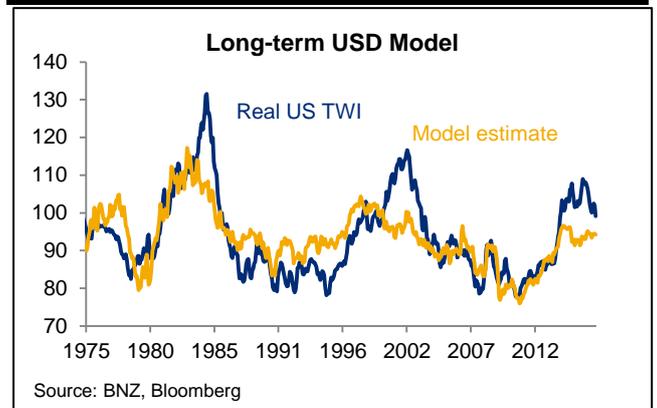
rates. A low US unemployment rate relative to the world would signal greater capacity pressures in the economy relative to others, leading to higher relative interest rates and a stronger USD.

With none of the variables doing a perfect job of explaining the USD over the various cycles of the past forty years, we put these three factors into a single regression model. The fit of the model isn't as high as we'd like it to be, with an  $R^2$  of 54% and a high standard error of 7½%. Furthermore, the model residual has a high correlation with the USD itself.

There are two obvious possible explanations for this. Firstly, currencies are apt to overshoot so we shouldn't beat ourselves up too much in not being able to explain particular strength in the USD in the mid-1980s, the early 2000s, and over the last few years. Indeed unexplainable USD strength in the mid-80s ultimately led to the Plaza Accord in 1985, where key governments agreed to devalue the USD against the Deutschemark and Yen.

Secondly, we might well be omitting relevant explanatory variables. This goes without saying, as currencies are driven by a multitude of factors. But it is difficult to find other variables that can neatly explain the USD. We experimented with TIC flow data, but the added explanatory power was marginal.

**USD Over-valued Relative to Key Economic Drivers**



The bottom line is that after accounting for the most obvious economic influences on the USD there remains a significant unpredictable element to the USD. Of note is that after accounting for the key influences on the USD, the current starting point is one where the USD looks "over-valued" to the tune of 6%. Eyeballing the chart, the cyclical pattern in the USD looks relatively uniform and fairly ominous if the downturn pattern follows previous cycles.

Somewhat frustratingly, we could have reached a similar conclusion by simply looking at the real USD TWI relative to average (since 1975), and noted that the USD trades about 7% above average.

**Model sensitivities**

Despite its limitations in explaining the past, the model might still be a useful analytical tool in thinking about where the USD heads from here.

The model coefficients are as follows:

- A 1 percentage point increase in the twin deficit leads to a 1% fall in the USD TWI;
- A 25bps increase in the real US-global 10-year rate spread leads to a 1% rise in the USD TWI;
- A 0.5 percentage point fall in the US-global unemployment rate leads to a 1% lift in the USD TWI.

We project about a 3 percentage point increase in the US twin deficits from 5½% of GDP to 8½% of GDP. Much of this is “baked in the cake” given the easing in fiscal policy that is in train, unless there is a significant offsetting “supply-side” impact of the tax cuts, or if the current account response to the rising fiscal deficit deviates from that predicted. The model says that the impact on the USD of this scale of deterioration in the twin deficit is about a 3% depreciation. That move could be reduced if US rates increased relative to the world. A 75bp rise in the US-global 10-year spread, for example, would completely eliminate the negative impulse on the USD from the rising twin deficit. Alternatively a fall in the US unemployment rate could offset some of the negative impulse from the rising twin deficits.

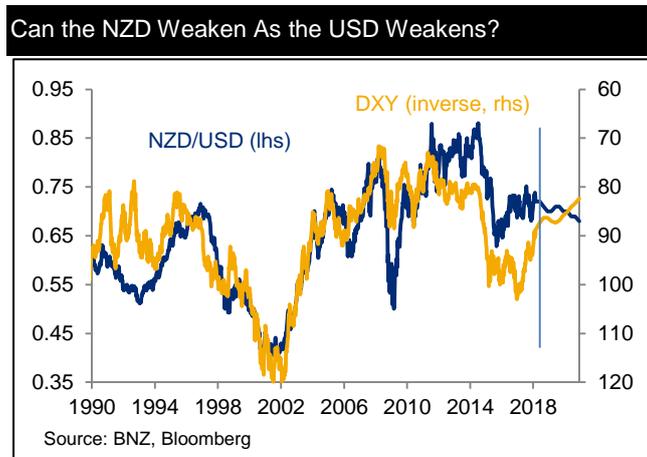
Interestingly, the model implies – through the current “strong” apparent level – that the USD could fall by more than 3% (in fact, closer to 6%), just simply via mean reversion, in the absence of any fundamental economic forces. In previous notes we’ve pointed out how the USD is a “strong” currency, trading above historical norms. In the end, the “mean reversion” impact could well be larger than the impact of the rising twin deficits.

**NZD Implications**

Despite the recent consolidation phase the USD has entered, we think it is too early to say that the worst is over for the greenback. The charts still look fairly ominous, the USD still looks “over-valued” in a long-term context, and the rising twin deficits look to act as fundamental headwind in the years ahead.

Our DXY projections, in conjunction with our colleagues at NAB, show a depreciating USD from current spot by 4% in 2018 and by 8% through to the end of December 2020. This takes the real USD TWI from a strong level, down to a little below its long-term average.

Against this weaker USD backdrop our current projection for the NZD in the low USD 0.70s through to the end of next year and the high USD 0.60s by the end of 2020 is unusual in a historical context. A weaker DXY is usually associated with a stronger NZD/USD exchange rate. The weekly correlation since 1990 between DXY and the NZD is minus 76%. At face value, one of the forecasts seems wrong – can the NZD weaken in the context of a broadly weaker USD?



Our weaker NZD narrative is based on, ultimately, a weaker global growth outlook and lower risk appetite in a rising global interest rate environment. There is a clear risk that we are far too early in this “global headwinds” call and that the weaker USD story continues to dominate.

If that is the case, then the NZD would join other major currencies in making gains against a softer USD backdrop, at least through the current year before global growth pains emerge. In this scenario, the NZD pushes on higher, perhaps rounding out the year closer to USD 0.78. It’s a risk that keeps us awake at night and it would be prudent for exporters and importers to be aware of this risk as well in making hedging decisions.

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