

26 March 2018



NZD/CAD: Canada (Home and) Dry?

- **CAD is benefiting from receding NAFTA fears**
- **AUD and NZD are suffering from rising US-China trade angst**
- **AUD/CAD and NZD/CAD are both substantially overvalued on a PPP basis**
- **The BoC will be further normalising policy well ahead of the start of RBNZ or RBA tightening cycles**
- **Persistent US-China trade angst and reducing NAFTA fears implies scope for 5+ % falls in both AUD/CAD and NZD/CAD crosses**

Last week we saw intensification of concerns over US trade actions against China and the likelihood of retaliatory measures from China against the US usurped the FOMC meeting as the key driver of market price action – in equities and FX at least. And Friday night saw higher Canada CPI inflation, with all key core measures now hovering around target at 2%. The Canadian dollar outperformed both the Australian and New Zealand dollars, with CAD proving to be the best performing G10 currency, with AUD and NZD both in the bottom four.

The price action speaks volumes about the greater vulnerability of the Australian and New Zealand economies relative to Canada in the event of a US-China trade war. It also speaks to a reduction in the discount previously applied by markets to the CAD on fears that NAFTA will either be torn up by the Trump administration or renegotiated on terms much less favourable to Canada.

Improved prospects for a renegotiated NAFTA are evident. An exclusion was granted to Canada (and Mexico) from

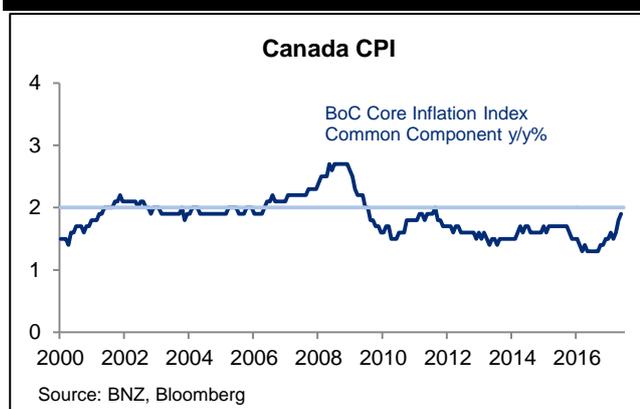
steel and aluminium import tariffs by the US, and this was also followed by the reported back-down by the US on earlier insistence that cars made in Canada and Mexico exported to the US must have at least 50% US-made content.

Positive news on NAFTA will undoubtedly remove one constraint on the BoC taking further steps along the road to monetary policy normalisation. Canada will also benefit from fiscal-charged US growth. This is at a time when incoming inflation indicators from New Zealand are suggesting the RBNZ is at least a year away from lifting rates and incoming Australian labour market data are reducing the likelihood of higher RBA rates this year. Meanwhile, Canada inflation data are showing clear signs of recovery, with the BoC's inflation target now essentially met alongside a backdrop of still-building inflationary pressure.

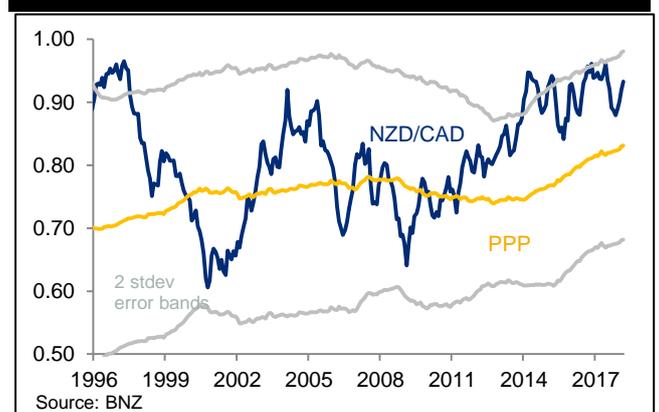
NAB/BNZ FX Strategy forecasts have AUD/CAD at 0.95 and NZD/CAD at 0.89 a year from now. These forecasts sit well above our estimates for 'fair value' based on Purchasing Power Parity that use our 15-year moving average framework. These currently sit around 0.91 for AUD/CAD and 0.83 for NZD/CAD, but would be even lower if we used a longer-term filter.

This highlights the risk that ultimately, AUD/CAD and NZD/CAD could be headed much lower than suggested by our current forecasts, which have lows of 0.94 and 0.88 respectively in 2019. We emphasise that these are big picture views.

Canada Inflation Essentially Back to Target



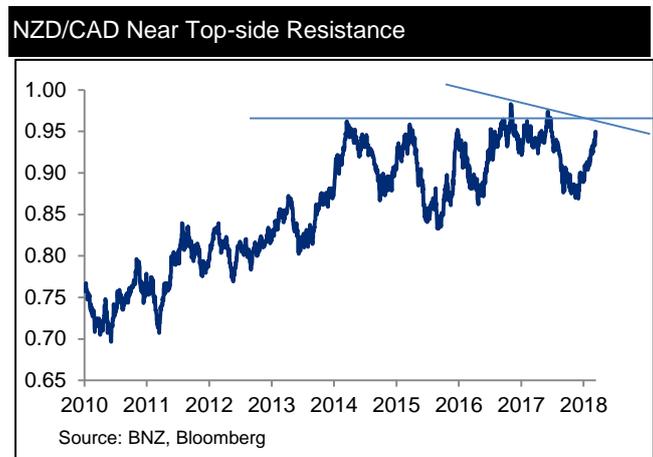
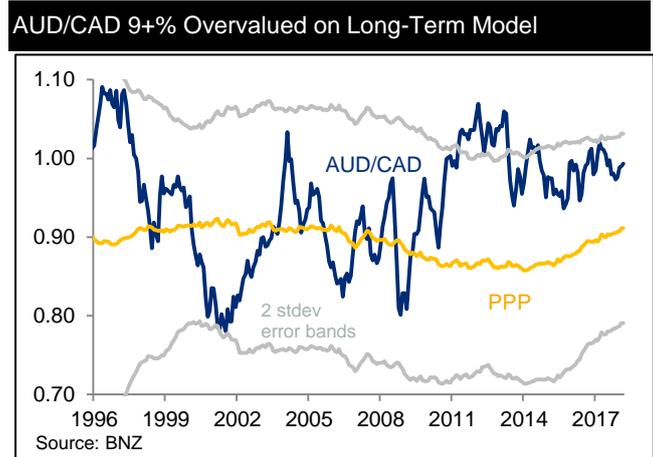
NZD/CAD 12+% Overvalued on Long-Term Model



That said, we use JPY volatility as the pre-eminent measure of risk aversion in FX markets. When abstracting from NAFTA-related volatility/weakness in CAD – by looking at the relative volatility of CAD/JPY, AUD/JPY and NZD/JPY in the period from 2010 until just before Trump’s election victory – we find that AUD/JPY and NZD/JPY show more downside volatility than CAD/JPY.

This plays to the view that if US-China trade related angst persists for a good while yet then both AUD/CAD and NZD/CAD have more near-term, as well as longer term, downside risk.

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