28 March 2018

# NZD/AUD: Reverse Swing Ahead?

- **NZD/AUD has been in an upward trend for the past six months. The first part of the recovery was the fading of NZ political risk late last year; the second part might well be linked to poor AUD sentiment as US-China trade tensions escalate.**
- **Since 2014, the cross has traded within a 0.90-0.96 range for over 80% of the time. When we look at fundamental forces, we see this range remaining in play for the foreseeable future.**
- **Resistance is likely to build if the cross continues to drift higher. Trading in the expectation that the cross will be largely confined to a 0.90-0.96 range has proven to be a profitable strategy over recent years and hedging strategies for exporters and importers can continue to take advantage of this.**

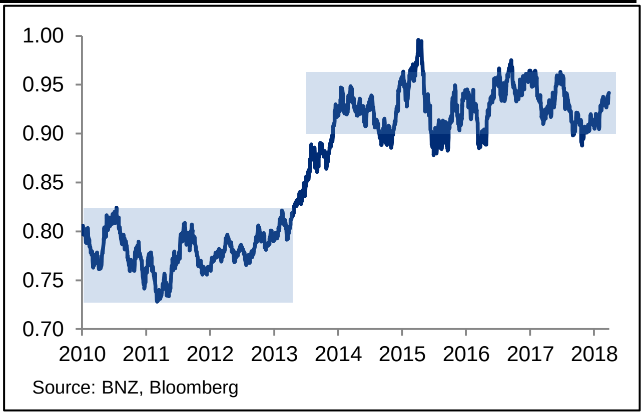
Our last major note on the NZD/AUD cross rate was back in August last year, where we toned down our exuberance for the cross and suggested an AUD 0.91-0.95 range through to the end of 2018. That view has largely played out apart from a downside breach late last year as NZ political risk dominated pricing, but this wasn't sustained.

Seven months later we maintain a similar view and find it hard to get excited about a possible sustained break out from the range seen since 2014. Over that time period the cross has spent more than 80% of the time in a range of AUD 0.90-0.96. The histogram (to the right) illustrates the point. A range of AUD 0.92-0.94 has been the most common level since 2014 while time spent above AUD 0.96 or below AUD 0.90 has been short-lived.

Over the past six months we have seen an upward trend develop, albeit from an oversold level of sub-AUD 0.89 after the new coalition government was formed. Over February-March we've seen a run up from AUD 0.92 to the current AUD 0.94 handle, a level not seen since July last year. Can the upward trend continue or will it peter out?

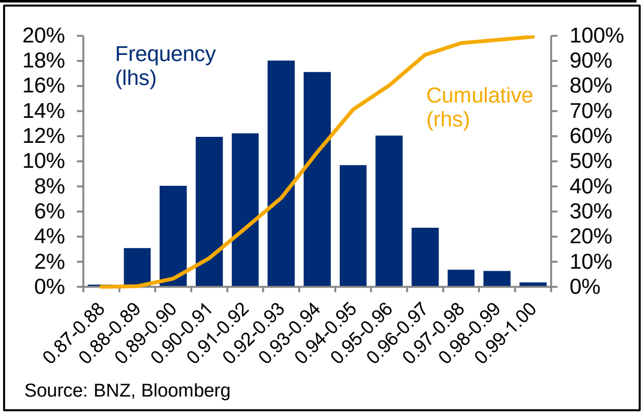
Speculative positioning can explain recent gyrations in the cross rate. We use CFTC data on net non-commercial NZD/USD and AUD/USD positions and scale the AUD data appropriately to create an indicator for implied net speculative NZD/AUD positions. This shows net NZD/AUD selling from mid-2017 through to Oct/Nov-2017 and a reversal of that positioning since then. The current level of the indicator implies net long NZD/AUD positioning for speculative accounts. By historical standards, positioning could increase a bit more, but would soon look to be fairly stretched, reducing any further upward pressure on NZD/AUD from this source.

NZD/AUD Range Trading Since 2014



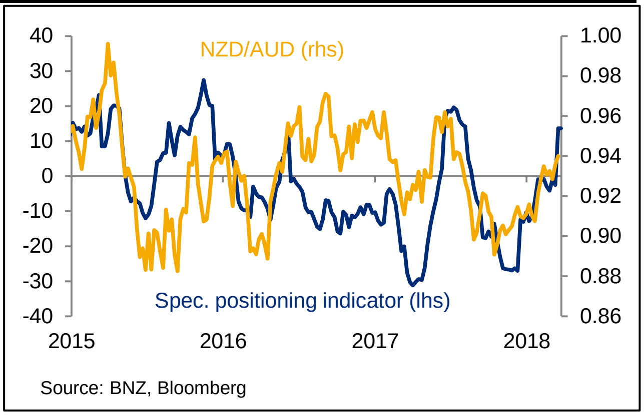

Source: BNZ, Bloomberg

Since 2014, Within 0.90-0.96 Over 80% of the Time




Source: BNZ, Bloomberg

Speculators Build Up Net Long NZD/AUD Positions




Source: BNZ, Bloomberg

In assessing fundamental forces on the cross rate, our favourite factors are relative NZ/Australia unemployment rates, relative interest rates and relative commodity prices. These do a good job over time in explaining variations in the cross rate.

We reckon the best single indicator that explains the cyclical behaviour of the cross rate is the difference in the unemployment rate between Australia and NZ. This indicator summarises a lot of information going on behind the scenes, particularly the relative growth dynamics in the two economies that feed through into relative inflationary pressure and relative monetary policy.

Longer time series charts are available on request, but the following three charts show the period since 2010. The gap between NZ and Australian unemployment rates has been range-bound between 0.3 and 1.1 every quarter since 2014 (with NZ's unemployment rate lower than Australia). This economic factor has been consistent with the cross rate being range-bound within the broad 0.90-0.96 range noted earlier. Over 2010-2013 was a period where Australia's unemployment rate was lower than NZ (nearly 1% on average) and that supported a much weaker NZD/AUD cross rate around AUD 0.75-0.80.

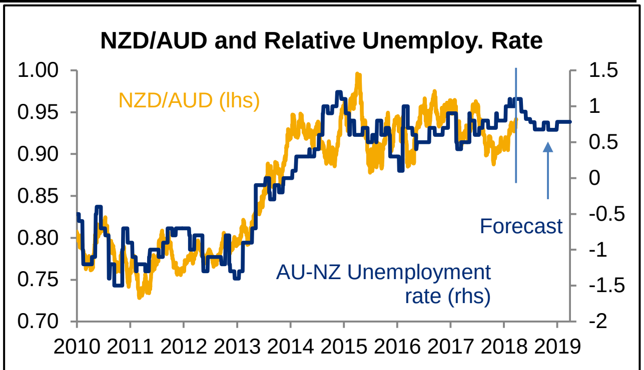
Our economic projections show downside potential for both the NZ and Australian unemployment rates through the next year, keeping the gap within its recent range and consistent with the cross rate continuing to range trade.

When we look at relative interest rates, we can't see much pressure on the cross rate either. The NZ-Australia 2-year swap rate has been relatively steady over the past year – some downward drift but not significantly so. We see the RBNZ and RBA in similar positions, waiting for inflation to pick up before tightening monetary policy. Forward rates are consistent with a fairly steady interest rate differential over the coming year, something we find hard to disagree with.

The other key swing factor for the cross rate is relative commodity prices. These are inherently difficult to predict. Since 2014 we've seen occasional gyrations in NZ and Australian commodity price indices, but some clear mean reversion, consistent with the range trading cross rate. We'd normally expect both NZ and Australian commodity prices to be driven by similar global macro forces. Our usual working assumption is to see similar price dynamics ahead unless there are some obvious differentiating forces between soft and hard commodities. None stick out at this juncture.

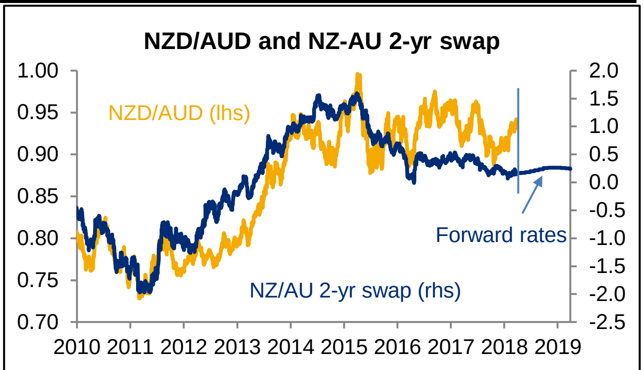
Our NZD/AUD short-term and medium-term fair value models incorporate these factors. They show no significant valuation gap at present, with fair value currently seen between AUD 0.91-0.94. The current spot rate is slightly above the top end of that range but not significantly so. Current spot isn't too far off our long-term fair value estimate of AUD 0.91 either.

**Relative Unemployment Rate in a Tight Range**



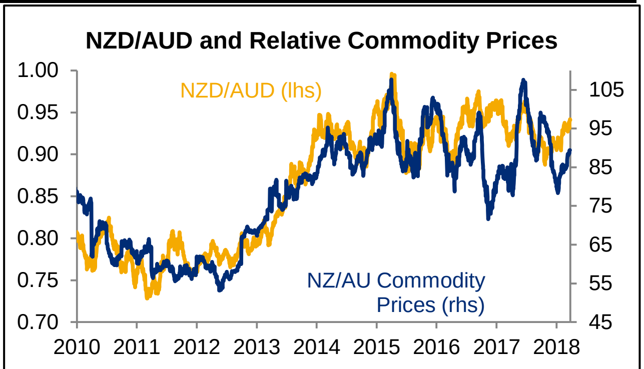
Source: BNZ, Bloomberg

**Steady Interest Rate Differential**



Source: BNZ, Bloomberg

**No Clear Trend in Relative Commodity Prices**



Source: BNZ, Bloomberg

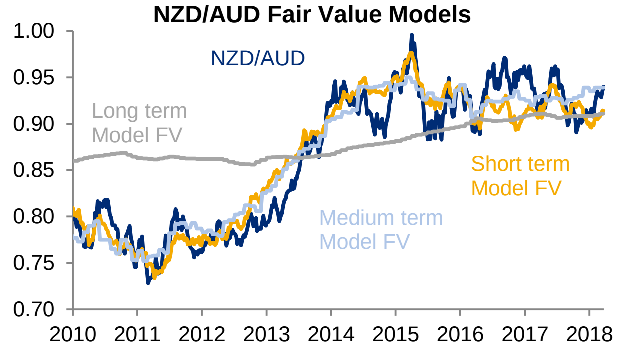
Going back to our original question, can the upward trend continue or will it peter out, our fundamental view is that there is no obvious trigger for a sustained break out of the range that has been intact for some time. Some of the upward move in the cross over the past six months reflects a recovery from the oversold level late last year, a slight tightening of the NZ labour market relative to Australia and NZ commodity prices slightly outperforming Australian prices this year.

Flows have supported the cross rate, with speculative accounts moving from short NZD/AUD positions to long NZD/AUD positions, we presume (but cannot know for sure).

Trump's economic attack on China to reduce the size of the bilateral US trade deficit has been a fairly new risk into the mix. The presumption is that a tit-for-tat trade war between US-China would be negative for global growth and have a greater impact on Australia than NZ. Anecdotal evidence suggests that some hedge funds have already used this development to sell the AUD and this may have contributed to recent strength in NZD/AUD. While trade developments are a clear negative risk factor for the world economy, they might also turn out to be a non-event.

Our prevailing view for this year has been that the cross will trade largely within a 0.90-0.94 range with brief skirmishes outside of the range likely. If the current upward trend continues, we'd suggest that resistance would build as we get closer to the 0.95-0.96 mark. Trading in the expectation that the cross will be largely confined to a 0.90-0.96 range has proven to be a profitable strategy over recent years and our view suggests this should continue. Exporters and importers can continue to play the range accordingly with appropriate hedging strategies to reflect that view.

NZD/AUD Fairly Priced on All Models




Source: BNZ, Bloomberg

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