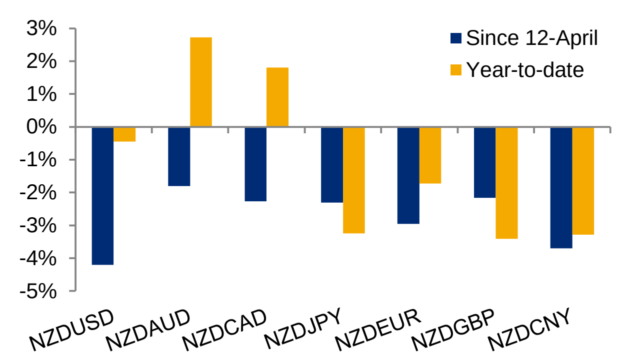
26 April 2018

NZD Back Down To Reality

- **We've previously noted the unjustified net long positioning in the NZD and so it hasn't taken much to see a broadly-based selloff in the NZD. The same positioning data goes a long way in explaining the USD breaking up through its recent range as well.**
- **The recent tumble takes the NZD from somewhat richly priced to just below our current fair value estimate of 0.7170. Strong fundamental and technical support is in a 0.68-0.69 range. That said, the technical relative strength indicator would argue that the speed of decline sees the NZD oversold.**
- **We haven't changed our end-Q2 or year-end targets of 0.72 and 0.70 respectively. We began the year with forecasts that the NZD would be weaker on all the major currencies this year bar NZD/AUD. And recent unjustified NZD/AUD strength meant that we ended up bearish on all the major crosses. We had more conviction on weaker NZD/EUR, NZD/GBP and NZD/JPY crosses than for NZD/USD. That remains the case today.**

The NZD has finally broken out of its well-established and fairly tight range held (roughly 0.72-0.74) since the first week of 2018. It has been a broadly based sell-off with the NZD down all on the major crosses. It has been a steady fall, with NZD/USD and NZD/EUR down for 9 consecutive days (on NY closes). From its peak on 12-April, the NZD has fallen by 2-4% on the various crosses.

NZD Weak Across The Board

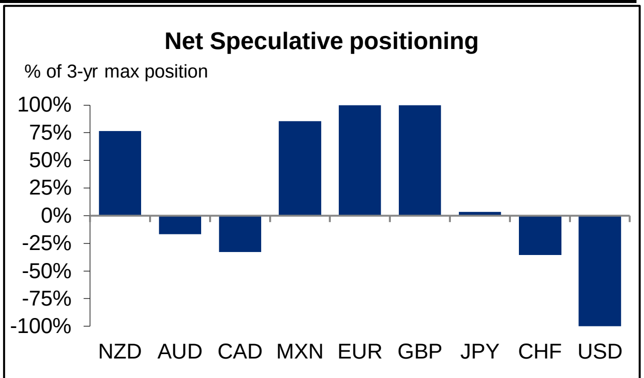


Source: BNZ, Bloomberg

We think that (unjustified) long positioning in the NZD has exacerbated the sell-off. As we noted last week[1], CFTC data pointed towards extreme net long speculative positioning in the NZD and this has historically pointed to a good short term sell signal. Through to Tuesday last week, traders had increased long NZD positions to 28k contracts, around 75% of the 3-year maximum position.

At the same time, positioning in other commodity currencies like AUD and CAD was slightly short. Building NZD positions and shortening up of AUD and CAD positions was evident in the outperformance of NZD/AUD and NZD/CAD through to mid-March/mid-April. In our view, this didn't seem justified when measured against fundamental factors[2].

Long NZD Positions Have Now Likely Capitulated



Source: BNZ, Bloomberg

We suspect that when the next set of figures is released at the end of the week they'll show a capitulation of sorts in those long NZD positions. The indicator has had a 100% track record in explaining subsequent NZD movement over 4, 12 and 24 weeks (5 episodes over three forward looking dates equals 15 observations). In the current episode, the peak level of long contracts occurred around 0.7340, meaning that if this indicator is true to form then it'll be a tough ask for the NZD to return to that level over coming months.

Recent price dynamics haven't just been about a weaker NZD though. The USD has also broken out of its trading range when looking at various USD indices. Over the past

[1] NZD Positioning Signal Reads Overbought?, 17 April 2018.

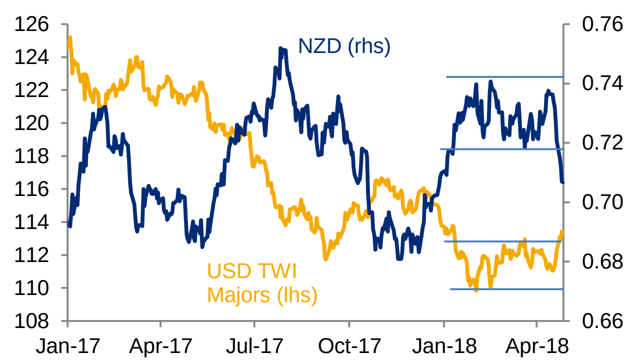
[2] See notes published at the end of March "NZD/AUD: Reverse Swing Ahead?" 28 March 2018 and "NZD/CAD: Canada (Home and) Dry?"26 March 2018 for more detail.

National Australia Bank

couple of weeks the USD has been the best performing of the majors, with the TWI (majors) up around 2%.

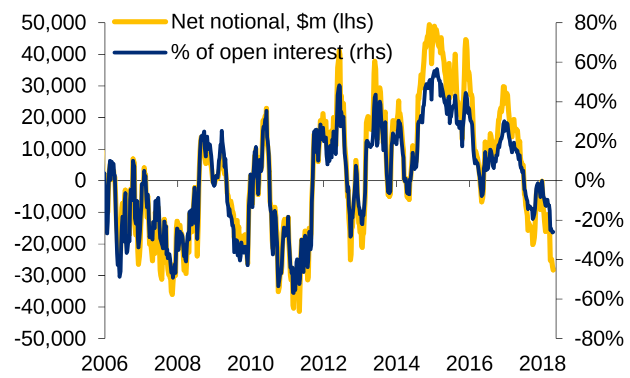
Theories abound why the USD has broken out but again we can point to poor positioning exacerbating the move. CFTC data pointed to heavy short USD positioning. In dollar terms, the latest data point showed the largest net short position since 2011.

NZD Breakdown; USD Breakup



Source: BNZ, Bloomberg

Heavy Short USD Positioning – Most Since 2011/12



When positioning is so lop-sided it doesn't take much for a reversal of fortunes as traders scramble to cover their positions. Some candidates for the USD reversal include:

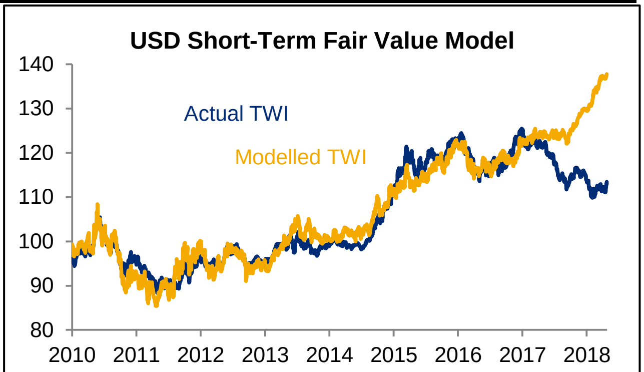
- Short positions becoming uncomfortably expensive as USD short-term rates (LIBOR) climb higher and higher.
- US 10-year Treasury yields reaching fresh highs for the year including a break-up through the psychological 3% mark, and US-global rate spreads drifting up further.
- The positive US data flow continuing against a backdrop of softer global indicators, particularly for the euro area.

While all these factors are USD-positive, a shake-out in positioning is the more satisfactory explanation for the recent reversal of the USD. A tipping point was reached and now the challenge is to work out where to from now?

In previous reports we have highlighted how the relationship between currencies and interest rates has broken down. This is best illustrated by our short-term USD fair value model which broke down in mid-2017. The model, with only two factors – the US-global real 2-year swap spread and risk appetite – has showed that the soft USD has clearly contradicted the path determined by rising US interest rates and (to a much lesser extent) the prevailing risk appetite conditions.

Will the previous relationship shown by the model return to haunt the market? If so, that would set the scene for an almighty broadly-based USD recovery from here, sending the NZD spiralling downwards.

Do We Still Ignore The Model Breakdown?



Source: BNZ, Bloomberg

In our latest GFXS publication, my NAB colleagues and I came to the conclusion of being sceptical that the USD has embarked on a strong and sustainable rebound. While momentum following the range break-out can extend USD gains over the short term, we still maintain that secular forces – namely the burgeoning twin fiscal and current account deficits – will ultimately stymie a significant USD recovery.

Looking at the recent behaviour of the NZD within our short-term modelling framework offers another source of context for recent currency movements.

Since the beginning of 2017, our short-term fair value estimate has stayed entirely within a range of 0.6950-0.7350. The model highlighted the discount that opened up for the NZD after NZ's September general election and the shock of the new Labour-led coalition government. This discount had completely closed by the end of January. Subsequently, the NZD traded on the rich side of fair value, against the backdrop of slightly weaker risk appetite and narrowing NZ-US rate spreads. It was in this context that we couldn't explain the ramping up of net long speculative positions.

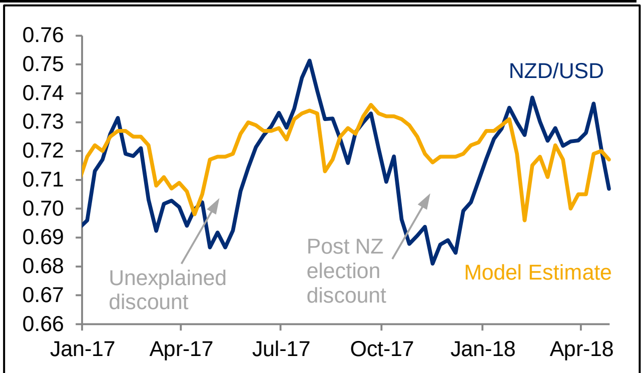
The recent tumble in the NZD now takes the spot rate just below our current fair value estimate of 0.7170. To justify an ongoing decline in the NZD we'd have to see some or all of weaker risk appetite, lower NZ commodity prices and lower NZ-US rate spreads. In the absence of any change in fundamental factors, a spot rate of 0.6850 would take the NZD to its largest discount to fair value seen over the past 18 months (excluding the unusual discount seen post the election). We see that level as possible, if the USD continued to rebound against those structural headwinds, but it wouldn't be our central forecast.

Strong technical support lies between 0.68-0.69 and we'd see that as a tough level to crack over coming months.

On the other side of the ledger, despite some justification for the recent sell-down of the NZD, the speed of decline has been rather vicious and various forms of relative strength indicators (RSIs) are in short-term oversold territory. This would argue for some base forming around current spot rather than a further immediate lurch down. One might even entertain a possible quick cent recovery.

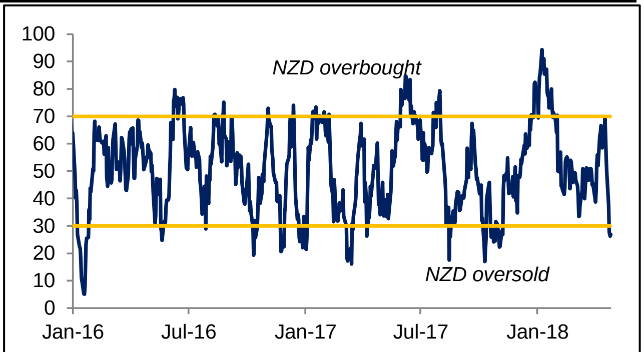
We haven't changed our end-Q2 or year-end targets of 0.72 and 0.70 respectively. We began the year with forecasts that the NZD would be weaker on all the major currencies this year bar NZD/AUD. And recent unjustified NZD/AUD strength meant that we ended up bearish on all the major crosses. We had more conviction on weaker NZD/EUR, NZD/GBP and NZD/JPY crosses than for NZD/USD. That remains the case today.

NZD Broadly Fairly Priced On Short-Term Model



Source: BNZ, Bloomberg

NZD Relative Strength Indicators Says "Oversold"



Source: BNZ, Bloomberg

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

ANALYST DISCLAIMER: The person or persons named as the author(s) of this report hereby certify that the views expressed in the research report accurately reflect their personal views about the subject securities and issuers and other subject matters discussed. No part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in the research report. Research analysts responsible for this report receive compensation based upon, among other factors, the overall profitability of the Markets Division of National Australia Bank Limited, a member of the National Australia Bank Group ("NAB"). The views of the author(s) do not necessarily reflect the views of NAB and are subject to change without notice. NAB may receive fees for banking services provided to an issuer of securities mentioned in this report. NAB, its affiliates and their respective officers, and employees, including persons involved in the preparation or issuance of this report (subject to the policies of NAB), may also from time to time maintain a long or short position in, or purchase or sell a position in, hold or act as advisors, brokers or commercial bankers in relation to the securities (or related securities and financial instruments), of companies mentioned in this report. NAB or its affiliates may engage in these transactions in a manner that is inconsistent with or contrary to any recommendations made in this report.

NEW ZEALAND DISCLAIMER: This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.

US DISCLAIMER: If this document is distributed in the United States, such distribution is by nabSecurities, LLC. This document is not intended as an offer or solicitation for the purchase or sale of any securities, financial instrument or product or to provide financial services. It is not the intention of nabSecurities to create legal relations on the basis of information provided herein.

National Australia Bank Limited is not a registered bank in New Zealand.