21 May 2018

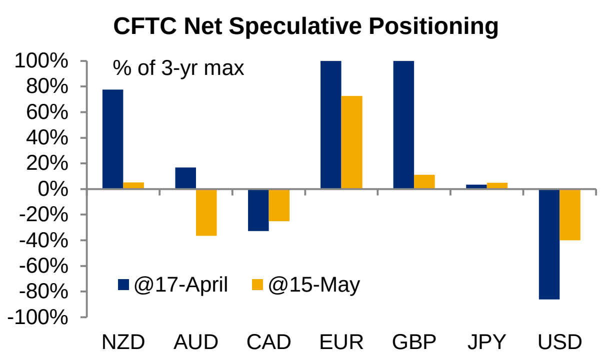
NZD: Enough Weakness For Now?

- **The NZD has fallen close to 7% since peaking in mid-April, exaggerated by poor positioning in both the NZD (too-long) and USD (too-short). Fundamental forces have been relatively steady over that time, with our model estimate hovering consistently in a 0.71-0.72 zone over that time.**
- **While NZ-US rate differentials remain on a declining trend and represent a headwind for the NZD, NZ's terms of trade show little sign of weakening and are a counteracting positive force at present. We are comfortable leaving our year-end target at 0.70.**
- **We still see strong technical support in a 0.68-0.69 zone. Fundamentally, the NZD doesn't "deserve" to go much lower than that. Clearly, we can't rule out a break of the lower edge of that support zone with the Kiwi-bears gathering and the USD still possibly in a mood to recover. But the more the NZD falls, the further it moves away from fundamentals.**

Market sentiment for the NZD has been poor, evidenced by the near-7% plunge since recently peaking on 12-April, from around USD 0.74 to below USD 0.69. Unjustified net long positioning near the peak has exaggerated the move, alongside the broadly based recovery in the USD.

The good news is that positioning in the NZD has now become more balanced, increasing the hurdle rate for a further significant sell-down from this factor. Indeed, we'd also argue that some of the USD recovery can be put down to a rejigging of speculative positioning. The scale of short speculative positioning in the USD is a fraction of what it was in mid-April, with traders reducing long positions in EUR and GBP alongside the NZD.

Net Long Speculative Positioning in NZD Cleaned-Out



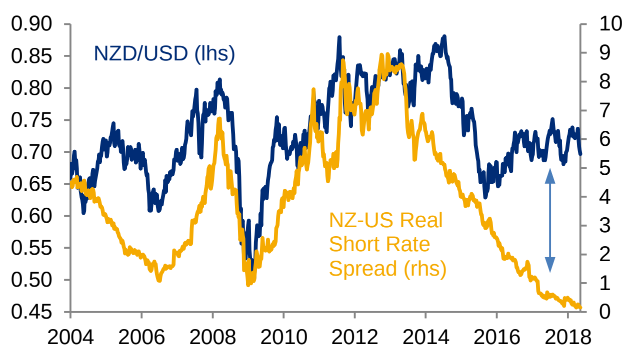
Source: BNZ, Bloomberg

Given the significant depreciation of the NZD one might naturally conclude that fundamental forces have also been in play. Sort of, is the answer. We'd argue that fundamental forces have been mixed, with the largely positive risk appetite backdrop and strong NZ commodity prices being supporting factors, while lower NZ rates versus the US continue to be a negative force.

Certainly, new RBNZ Governor Orr's first Monetary Policy Statement, wasn't helpful for the performance of the NZD. We have long seen NZ monetary policy as a clear headwind for the NZD, as the RBNZ remains decisively on hold against a backdrop of other major central banks either raising rates, reigning in QE policy or signalling future rate hikes. The comment upfront in the MPS that "the direction of our next move is equally balanced, up or down" was stark, and puts in writing which the Bank hither to was only prepared to suggest verbally.

It is clear that the trend fall in NZ-US rate spreads will continue, albeit more so at the short end of the curve than the long end and this represents a clear headwind for the NZD for some time to come.

NZ's (Low) Rates Are NZD-Negative



Source: BNZ, Bloomberg

If one just focused on NZ interest rates relative to other countries, then one might wonder why the NZD isn't trading at a lot weaker level. The chart above shows that the NZD is trading much stronger than "deserved", given that NZ-US interest rate spreads, whether looking at the short end or long end of the curve, are close to zero and well below historical norms.

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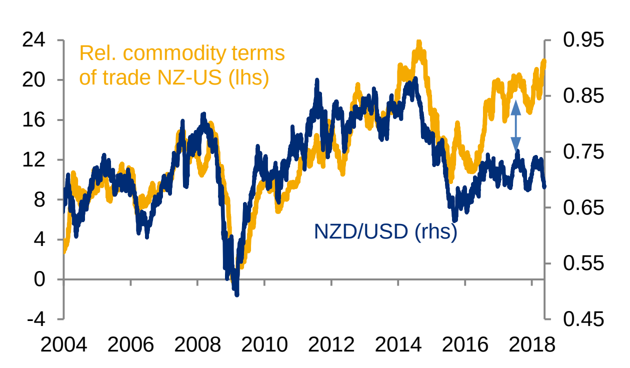
The reason that the NZD is much stronger than implied by relative interest rates is because other factors are NZD-positive. In particular, NZ's terms of trade dynamic remains positive. In the December quarter, NZ's official measure of the terms of trade reached a record high that dates back towards the founding of the country. While we expect Q1 data to show a dip in the terms of trade, they are looking like being stronger again in Q2, tracking close to the record high.

Despite higher oil prices, Citigroup's more narrowly based NZ *commodity* terms of trade index has been on an upward trend this year. When we calculate a relative commodity terms of trade index between NZ and the US, it correlates well with the NZD. Looking at the chart below, the NZD is much weaker than implied by this relative terms of trade index.

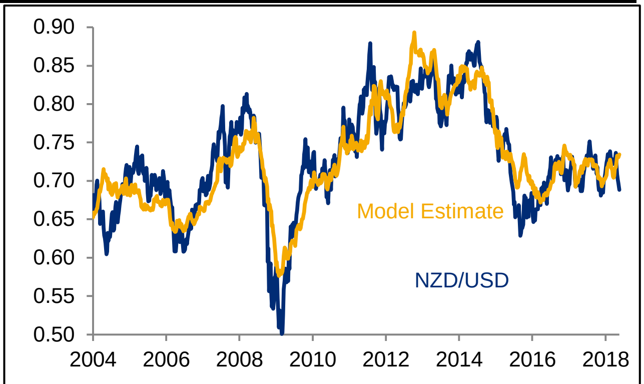
Strong Relative Terms of Trade is NZD-Positive



Source: BNZ, Bloomberg

So based on rate differentials, the NZD is "too strong" and based on relative terms of trade, the NZD is "too weak". We thought it would be an interesting exercise to put these two variables into a simple regression model for the NZD. When these two variables are put together, they can more adequately explain the behaviour of the NZD over the past few years. If anything, this model suggests that the NZD is slightly oversold, with fair value around 0.73. This is close to our official short term model estimate based on three-variables, which currently puts fair value around 0.72.

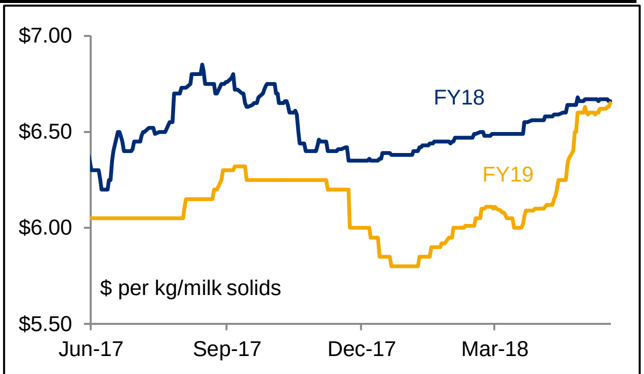
Two-Variable Model Can Explain NZD



Source: BNZ, Bloomberg

Alongside the positive global commodity price theme currently in play, NZ dairy prices have proven to be stronger than expected and this is resulting in upgrades to Fonterra's expected milk payout for next season. Milk payout futures are traded on the NZ Exchange and their profile illustrates the positive news regarding incomes for dairy farmers ahead. Positive world pricing and a weaker NZD have seen the (market-traded) expected payout for FY2019 increase by 15% this year.

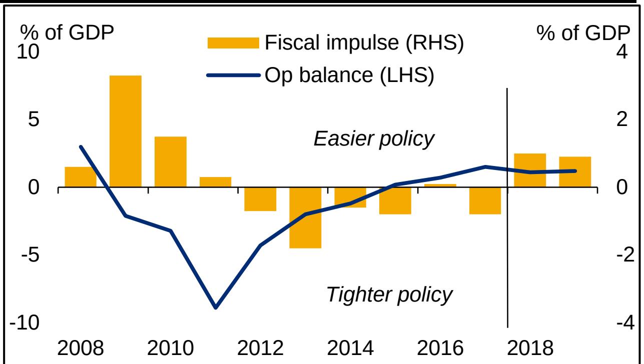
Milk Payout Futures Suggest Improved Farm Incomes



Source: NAB/BNZ, Bloomberg

The recent NZ Budget highlighted the positive fiscal accounts that underpin the economy. The government is in a strong position to deliver on pre-election spending promises. The fiscal "impulse" for the current and FY19 fiscal years are both around 1% of GDP, helping support domestic demand. Even with this easing in fiscal policy, net government debt to GDP will continue along a declining trend to around 20% of GDP, an enviable position by global standards that gives the government plenty of options in the years ahead – a stark contrast to the pressures on other countries' government accounts, including the US.

Projected Surpluses Even With a Fiscal Easing



Source: NZ Treasury, June years

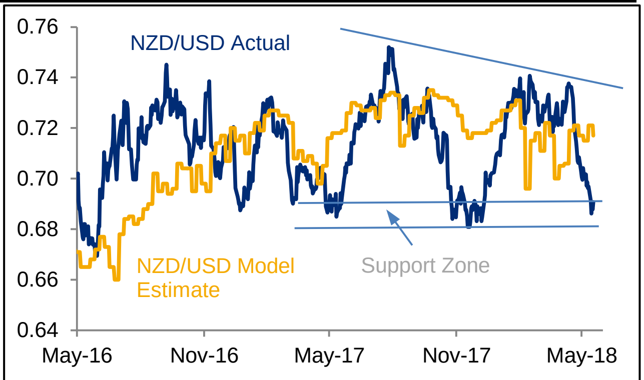
The significant depreciation of the NZD over recent weeks has taken it below our year-end target of 0.70. If the depreciation had reflected a turnaround in fundamental forces that had taken us by surprise, then we'd be happy to revise down our NZD forecasts.

But as far as we can tell, much of the move seems to reflect market sentiment and poor positioning. The market was far too positive on the NZD a month or two ago and sentiment for the USD got far too depressed. In terms of fundamental forces, some of the NZD weakness is fair to the extent that we have increased conviction of the RBNZ keeping policy on hold and increased conviction that the Fed will continue along its path of gradually raising interest rates. But a counterforce has been the strength of commodity prices, a supporting factor for the NZD.

The bottom line is that we see no good reason to change our NZD forecasts. These show the NZD anchored around the 0.70-0.71 mark for much of the rest of the year which in practice can obviously mean excursions outside of this zone. Our short term fair value model estimate has been relatively steady between 0.70-0.73 all year, reflecting the ebb and flow of fundamental forces.

We still see strong technical support in a 0.68-0.69 zone. Fundamentally, the NZD doesn't "deserve" to go much lower than that. Clearly, we can't rule out a break of the lower edge of that support zone with the Kiwi-bears gathering and the USD still possibly in a mood to recover. But the more the NZD falls, the further it moves away from fundamentals.

NZD Undershoots Our Fair Value Estimate



Source: BNZ, Bloomberg

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