

8 June 2018



USD Outlook: It's Complicated

- **The USD recovery from mid-April looks largely played out for now and we look for a period of consolidation in the months ahead, which means a fairly stable NZD/USD as well.**
- **Some new modelling work on the USD suggests that one should be very wary of relying on US monetary policy and its outlook as a key driver of the USD. The transmission between US monetary policy and the USD can be complicated and unpredictable.**
- **Our core view remains unchanged. Both the USD and NZD face headwinds over the medium term which leaves our projected profile fairly flat, anchored around the 0.70 mark.**

After trending down from early 2017, the USD staged a decent counter-trend rally from mid-April through to late May, worth about 5% on the USD TWI-majors index and 6% on the DXY. It was a broadly based rally, accentuated by prior heavy short speculative positioning in the USD, emerging Italian political risk that weighed on EUR, poor data and negative Brexit headlines that weighed on GBP, and the lack of a renegotiated NAFTA deal that weighed on CAD. The counter-trend rally in the USD was instrumental in seeing the NZD fall from over 0.73 to below 0.69, itself accentuated by prior heavy long speculative positioning that has now been cleaned out.

The USD recovery looks like it has done its dash for now, with the level back to highs recorded towards the end of last year providing some technical resistance, more balanced speculative positioning, and some of the

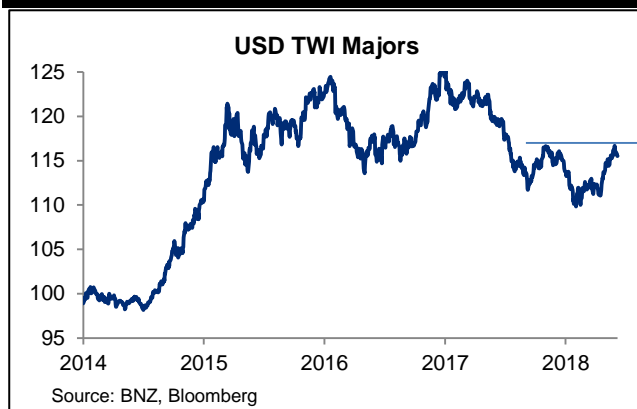
depressing factors that weighed on EUR and GBP now looking like they have more chance of reversing than pressing on. EUR is showing more signs of life as the market turns its attention away from Italy and towards the ECB meeting next week, and some better PMI indicators for the UK have breathed some life back in GBP. The NZD has also recovered back to a 0.70 handle, which our short term model suggests is a fairer price than the sub-0.70 levels recently tested.

Still, the outlook doesn't seem any easier to predict with lots of moving parts that have the potential to throw the USD in either direction. We've done some more modelling work on the USD which casts some light on how US monetary policy and its relative position to other major countries might be influencing the currency.

On many previous occasions we've pointed out how US-global rate differentials are no longer a key driver of the USD. The relationship broke down around early-mid 2017. Prior to that – at least since the 2008 GFC – one could reliably map US-global rate differentials closely against the performance of the USD. This is illustrated in the chart above, which also highlighted that prior to the GFC the relationship was a bit wobbly. To be glib, rate differentials can explain currency movements well until they don't.

With the rate differential model broken down, another explanation is required and earlier in the year we (and others) latched onto the view that the US widening twin deficits (fiscal and current account) might be a factor in the downward trend in the USD over the recent period not explained by higher relative US interest rates.

USD Recovery Over Now?



US Rate Differentials Less of a Factor for the USD



The story goes that the wider US fiscal deficit – driven by Trump’s tax reform package and increased spending required to kick the debt ceiling can down the road – came at a time of US economic capacity constraints that would flow through into a rising current account deficit as well. Higher government debt and more reliance on offshore capital flows to fund the US economy required both higher US rates and a weaker USD. With easier fiscal policy “baked in the cake” we still see this as a structural headwind for the USD.

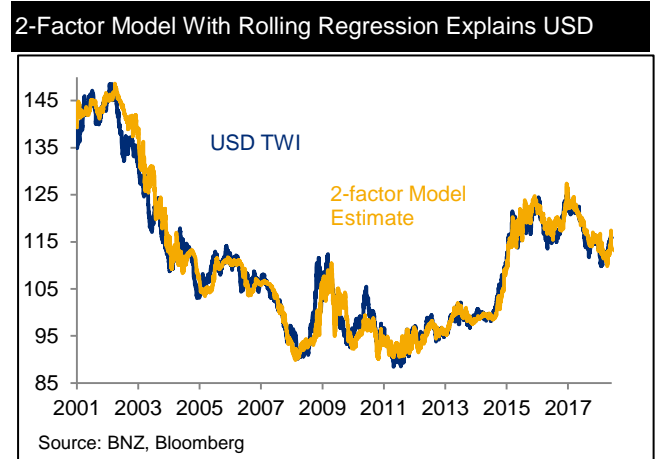
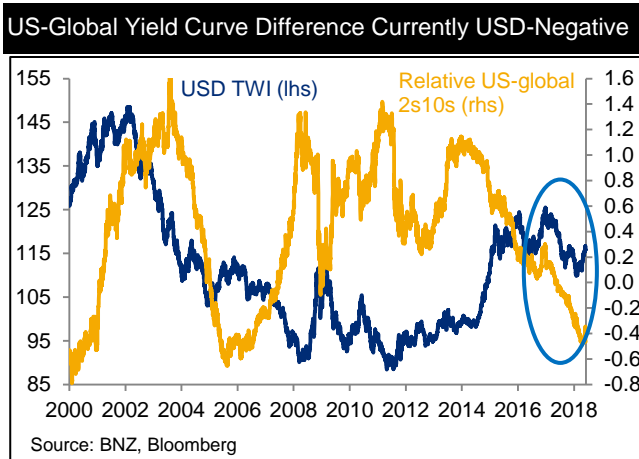
But one needn’t resort to such economic logic to explain why the USD has trended lower from early 2017 against the economy’s rising rate differential. One can simply look at the behaviour of the relative yield curve in the US.

The US yield curve has been flattening relative to the rest of the world (G7 ex US) for the past few years and as that trend has continued it has become a more important downward force on the USD. In other words, US monetary policy tightening is well advanced compared to other major countries so the US yield curve is a lot flatter. This signals growth headwinds for the US in the years ahead relative to other countries, which is USD-negative.

The relationship between the relative US-global yield curve and the USD varies significantly over-time. There have actually been other times when a relatively flatter US yield curve has been associated with a stronger USD.

A good way to map the changing relationships is to do a rolling regression model. We try to model the USD TWI with two factors – the relative real US 2-year swap rate against other G7 nations and the relative US 2s10s yield curve slope relative to other G7 nations. We use a 1-year rolling regression, which will offer a glimpse on how the factors change over time in explaining the USD.

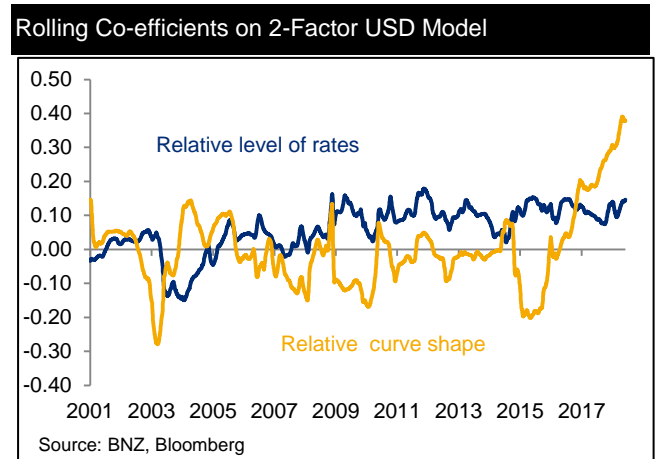
The first point to note is that this 2-factor model does a good job of explaining the USD over time. This is obviously aided by the responsive nature of the model, over the rolling 1-year horizon. Of more interest to us is how the coefficients on the factors change over time.



As the earlier charts forewarned, the coefficient on the relative level of rates variable is relatively stable over the post GFC period at around 0.1. So a 10bps increase in US short-term rates relative to global rates lifts fair value of the USD by about 1%. In the pre-GFC period, interest rate differentials seemed to matter a lot less and the coefficient averages close to zero (see chart below).

More interesting is the coefficient on the relative yield curve slope. Over the past 12 months it is the highest it has been since 2000 and recently coming in at a chunky 0.4. Prior to 2017, the coefficient oscillated between minus 0.2 to +0.1 and averaged slightly below zero. In other words, while we can point to the flattening US yield curve relative to the rest of the G7 as a key driver of the weaker USD from 2017 onwards, the yield curve in general is a fairly unpredictable driver of the USD.

While the shape of the yield curve typically reflects monetary policy and growth expectations, in the current chapter we must also contend with quantitative easing policies which are distorting the signal of yield curves. These include central bank balance sheet expansion still on-going in the Eurozone and Japan, the reduction in the Fed’s balance sheet and associated cross border equity and income flows. These might be a factor in blowing out the coefficient of the relative yield curve in the model.



Overall, the results suggest that one should be very wary of relying on US monetary policy and its outlook as a key driver of the USD. The US monetary policy outlook is likely only one factor, and historically at times not even a strong factor, in predicting the path of the USD.

The transmission between US monetary policy and the USD can be complicated and unpredictable. Looking forward, rates dynamics might be expected to have opposing forces on the USD. On the negative side, the rates advantage of the US will eventually fade as the US tightening cycle eventually draws to a close and other central banks tighten policy. On the positive side, the current flattening pressure of the US curve relative to other countries will turn around. However, in this case there's no guarantee that the positive coefficient on the relative yield curve will be sustained – history suggests that the yield curve's significance in influencing the USD will fade.

In summary, we have a clear view on what the outlook for global monetary policy looks like – US monetary policy is much closer to the end of the tightening cycle while other G7 countries have barely begun – but that doesn't make the outlook for the USD any easier to predict.

Our base case remains that the USD will eventually face headwinds via relative monetary policy factors, while the

projected path of the twin fiscal and current account deficits remains a structural headwind for the USD. This sees USD indices trending lower on a 1-2 year view.

One topical source of uncertainty about the outlook is how US-global trade talks develop. At face value, increasing US trade protectionism looks like a USD-negative factor as well. We can't think of any country that got richer by putting up trade barriers. The counter argument might be that Trump is playing a masterful game which will end up positive to the US (and global economy) as other countries reduce trade barriers and the US is first in the queue to take advantage of that. However, amidst the current US-global trade tensions, that seems a long bow to draw at this stage.

While we see USD headwinds ahead, at the same time we hold a similar view for the NZD TWI over the same horizon. This view is based on likely headwinds developing via a global economic slowdown and associated resistance to further commodity price gains.

The net result is a relatively flat NZD/USD profile over the rest of the year and into next year. For at least the last nine months our year-end target for NZD/USD has been 0.70 and we maintain that view

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

New York

Foreign Exchange +1 212 916 9631
Fixed Income/Derivatives +1 212 916 9677

Sydney

Foreign Exchange +61 2 9295 1100
Fixed Income/Derivatives +61 2 9295 1166

Hong Kong

Foreign Exchange +85 2 2526 5891
Fixed Income/Derivatives +85 2 2526 5891

London

Foreign Exchange +44 20 7796 3091
Fixed Income/Derivatives +44 20 7796 4761

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.