5 July 2018

NZD 1H18 Review and Outlook

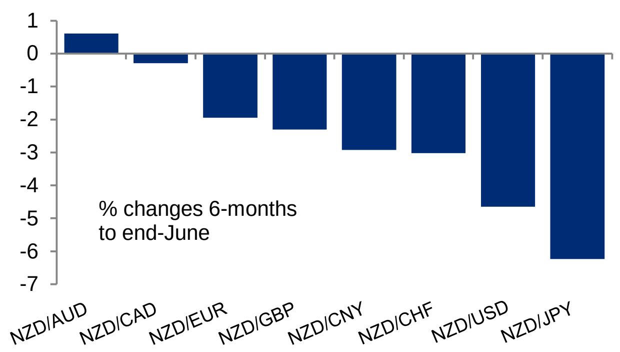
- **The NZD was generally weak over the first half of the year. Weaker NZ activity data, plunging business confidence and the pushing out of RBNZ policy tightening expectations didn't help. On the global side, the risk of weaker growth and much weaker emerging currencies spilled over into the NZD.**
- **The technical picture gives a mixed view on near-term prospects and we're not convinced on the merit of current net short speculative positioning giving a good contrarian signal at present.**
- **Fundamentally, global risks – namely the threat of further downside pressure on EM currencies – are the greatest near-term threat to the NZD. While our short-term model estimate currently sits near 0.70, we see downside risk to that over the second half.**
- **Our medium-term view remains negative for the NZD on a TWI basis.**

Quick Review of 1H18

With the first half of the year over it's an appropriate time to reflect on what's gone on and the outlook for the rest of the year and beyond. The chart below shows the performance of the NZD on all the key crosses over the first half of the year. The NZD saw a broadly based fall, with the largest falls against the USD and JPY and little change against other commodity currencies like the AUD and CAD.

Compared to our projections at the start of the year, we're happy to report that we got the sign right on all the crosses, no mean feat, although the mix of performance was slightly surprising[1]. The NZD didn't fall as much as expected against GBP and EUR while it fell by more than expected against JPY. Movements against USD and CNY were in line, while the NZD didn't rise as much as expected against AUD.

A Weak First Half-Year for the NZD



Source: BNZ, Bloomberg

The performance table provides some hints about driving factors of the NZD over the first half:

- That the NZD was weak across the board hints of domestic factors in play. Some soft NZ data, much weaker business confidence, and evolving expectations that the RBNZ is further away from tightening policy added to NZD weakness.
- The weaker performance of commodity currencies suggests some deterioration in the global economic outlook. Indeed, commodity currencies like the NZD and AUD fell alongside emerging market currencies which are seen as a higher (positive) beta play on the global economic cycle.
- Strength in USD and JPY stand out. The surprising strength of the USD recovery can be put down to relatively stronger US economic data and the country's higher inflation outlook that drove more conviction in the outlook for tighter monetary policy. The USD-negative twin deficit story got some airplay, but it wasn't sustained. JPY strength reflected weaker global risk appetite and dampened expectations that the BoJ's yield curve control policy would soon change, with inflation moving further away from target.

A weak start to 2H18

Early in the second half, the NZD has fallen further, reaching fresh lows against the USD and JPY and falling towards the bottom of the recent trading range against EUR and GBP.

Last month we outlined a more cautious view on the NZD for Q3, based on risks of the USD recovery continuing, ongoing downward pressure on EUR which the NZD has followed this year, and concern about the dynamics in emerging markets, another source of downside risk for the NZD. The key 0.68-0.69 support zone we have often referred to was breached towards the end of last week.

[1] We didn't factor in any tweaks to our forecasts during the half which makes us look better, but forecasting currencies is a bit of a mugs' game and we need all the help we can get.

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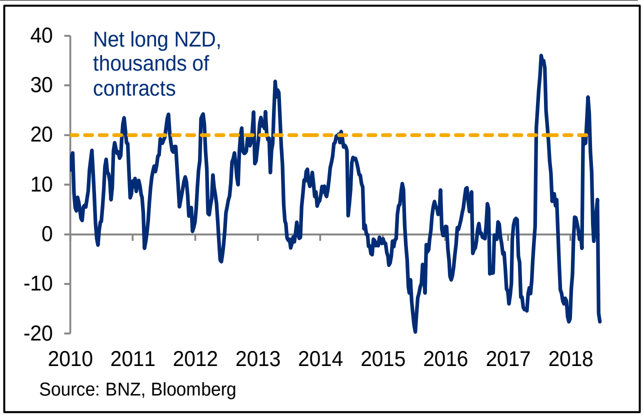
We are left wondering whether another lurch downwards is possible.

Technical factors offer a mixed perspective on the near-term outlook, with the key support level just under 0.68 broken on the way down. The next key level is the May-2016 low near 0.6675, with a break of that opening up significant downside risk, with the following support level south of 0.65. On the other hand, the NZD's recent sharp fall puts it into "oversold" territory on the relative strength indicator.

CFTC data show that net speculative positioning is close to historical extremes. Normally, this would be considered a good contrarian indicator and suggestive of a low hurdle rate for a near-term bounce higher in the NZD. However, at present one needs to be a little more careful in interpreting this, as low NZ interest rates compared to history makes it cheaper to short the NZD, making that a more attractive option. Pre-2015, the NZD was considered a high-yielding currency, so periods of shorting the NZD were infrequent and short-lived. Current low NZ rates, especially compared to the US, could see more frequent and longer periods of traders taking short positions reducing the inclination for a contrarian bounce.

Speculators Are Net Short NZD



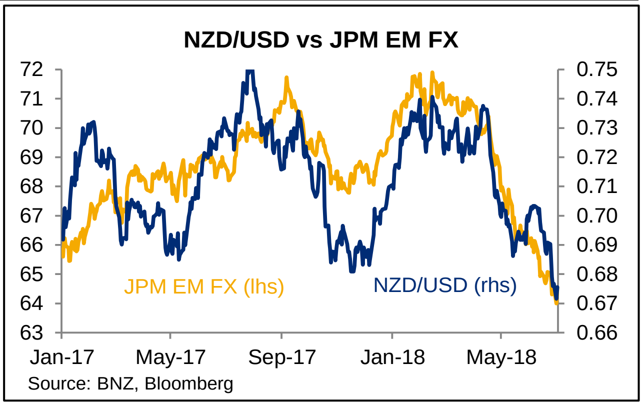
Source: BNZ, Bloomberg

The threat of emerging markets and CNY

Turning to a more fundamental perspective, the biggest near term risk we see for the NZD is the ongoing pressure seen in emerging market asset prices. Weakness in EM assets has coincided with the recovery in the USD. A stronger USD acts like a tightening in financial conditions, given emerging market exposure to USD-denominated debt. The escalation of trade wars, influenced by President Trump's policies, has added to the woes of EM, given their economic performance is strongly linked to growth in the global economy and trade.

The performance of the NZD has largely followed the performance of JP Morgan's emerging market currency index this year and we think that the correlation is likely to remain high over the near term.

Recent NZD Weakness Linked to Emerging Markets FX

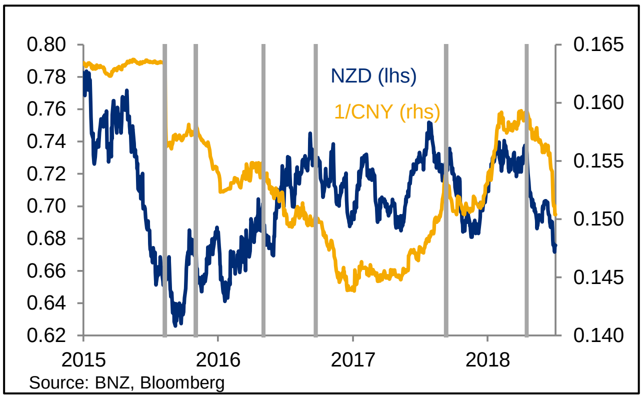


Source: BNZ, Bloomberg

The PBoC's recent cut to the reserve requirement ratio and its inclination to encourage a weaker CNY signalled that China's central bank recognised the recent weakness in activity indicators and the threat posed by escalating US-China trade tensions. But it also encouraged significant selling of the yuan that recently led to its biggest depreciation since the August 2015 episode.

The correlation between the NZD and CNY isn't particularly high on a week-to-week basis, but big turning points in CNY (towards the weak side) have typically spilled over into a weaker NZD.

Downdrafts in CNY Typically Negative For NZD



Source: BNZ, Bloomberg

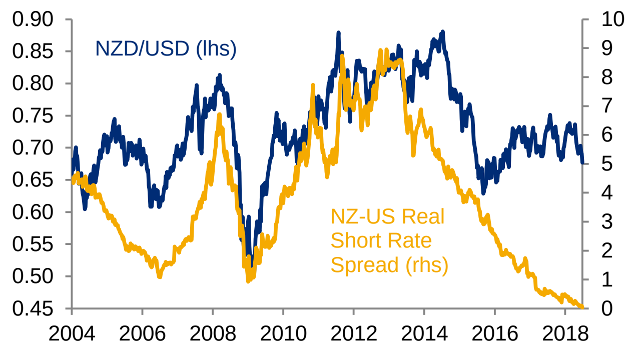
This week's comments by PBoC Governor Yi Gang that China would keep the yuan exchange rate basically stable at a reasonable and balanced level indicate that further downward pressure on the yuan from here might be met with some policy action. This provides some hope that we'll see a break in the selling pressure that has been inflicted on the CNY, emerging market currencies and the NZD over recent weeks. However, with a weaker economic and trade outlook for the global economy, market forces for these currencies still seem weighed to the downside.

Domestic forces negative for the NZD

NZ monetary policy continues to act as a headwind for the NZD. Against a backdrop of a rising Fed Funds rate, RBNZ monetary policy remains on hold and the June OCR Review came across as slightly more dovish than the May MPS encouraged by the Bank's change of language. The Bank said the OCR will remain at 1.75% "for now" (previously "for some time").

The market now prices in – for the first time since the end of the easing cycle – a small chance of a rate cut over the next six months. We don't think that the Bank will cut rates, but the near term risks slightly favour a rate cut than a hike over that timeframe, adding to downside pressure on the NZD.

No Interest Rate Support for the NZD



Source: BNZ, Bloomberg

The domestic data flow hasn't exactly been encouraging for the NZD. GDP growth has been running at 0.5-0.6% q/q from the second half of last year through to the March 2018 quarter, barely positive on a per capita basis.

Business confidence has fallen to a 7-year low. As noted in our post-QSBO write-up, while we continue to forecast a relatively robust economy, we are very concerned about the mounting downside risks to the expansion. Of particular concern is the impact that the business operating environment is having on the expected profitability of corporates. Heightened uncertainty and falling profitability are potentially a nasty cocktail for future economic growth. The correlation between profitability and economic output is scarily close. Current profit expectations suggest considerable downside risks to our growth forecasts.

NZD short-term fair value model

The NZD has undershot our short term model estimate, although the current 4% gap is not statistically significant, given the standard error of the model. For most of the year, our model estimate has hovered in a range of 0.70-0.72, with the latest reading at the bottom end of that range.

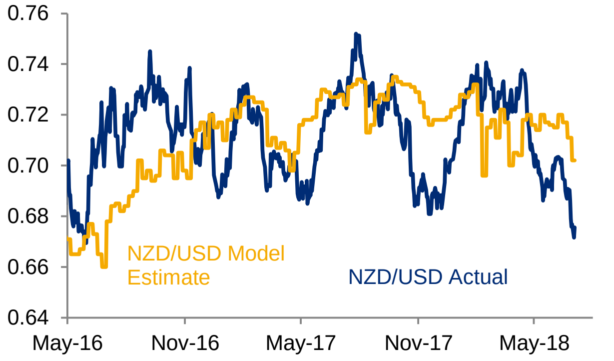
Looking at the factors in our model:

Risk appetite: Our index has fallen to 56%, down to the lower end of the range seen over the past 18-months, reflecting wider credit spreads (emerging market and high yield), while the VIX index is a few points above its 18-month average.

NZ commodity prices: These have recently come off cyclical highs but in a medium-term context they remain elevated and have generally been a supportive factor for our fair value NZD estimate.

Interest rate differentials: The NZ-US 1-year swap spread has been trending lower and has recently fallen close to zero, a reflection of the RBNZ keeping monetary policy unchanged while the US Fed maintains a gradual pace of tightening.

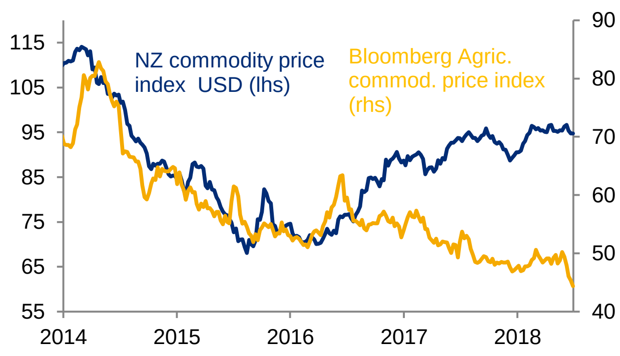
Kiwi has Undershot our Short-Term Model Estimate



Source: BNZ, Bloomberg

We see the outlook for all the model drivers to the downside. In a more uncertain global outlook with escalating trade wars, risk appetite probably deserves to trade lower. NZ commodity prices have significantly outperformed global agricultural product prices and the latter should ultimately enforce a downside bias to NZ pricing. We saw some evidence of that at the last GDT dairy auction.

NZ Commodity Prices Outperform Global Ag. Prices



Source: NAB/BNZ, Bloomberg

Finally, the NZ-US short-term interest rate spread should continue to fall, as the RBNZ remains on hold and the Fed continues along a path of tightening.

We can predict what our fair value model estimate might look like in the period ahead with some reasonable assumptions. Assuming a 10% fall in NZ commodity prices, our risk appetite index falling 10 points to a slightly below long-term average 46%, and 50bps off the NZ-US rate spread would take fair value to 0.6650. While these aren't particularly aggressive assumptions, it illustrates how much bad news might already be priced into the NZD.

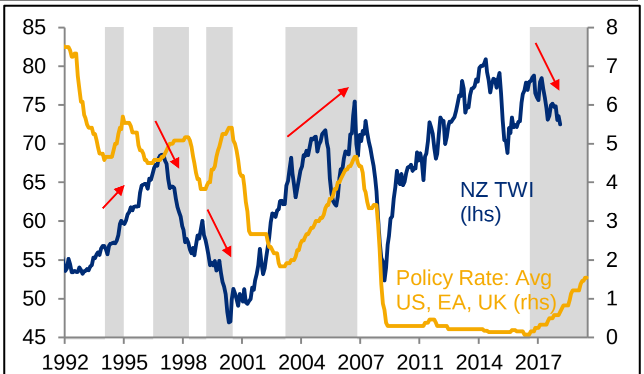
Big picture outlook

We began the year with a negative outlook for the NZD TWI and we maintain that view for the medium term. In our first currency research note of the year we published the following chart on the front page and it has also appeared in every client presentation done this year.

This cycle for the NZD is looking very much like the mid-1990s and late-1990s cycles, where tighter global monetary policy led to a weaker NZD TWI. The theory is that tighter global monetary policy eventually leads to weaker global growth which the NZD is sensitive to.

This theory didn't fit the early 1990s episode, possibly because the NZD's starting point at that time was very cheap. And for the early-2000s tightening cycle, it coincided with a very strong NZ terms of trade trend which helped support the NZD. Neither of those two factors apply, or are expected to apply, in the current cycle.

Tighter Global Policy Negative NZD This Cycle



Source: BNZ, Bloomberg

Our forecasts show some stabilisation in the TWI over the second half before slipping again through 2019 and 2020. However, our current forecasts don't incorporate some of the downside risks that have emerged for the NZD over recent weeks, so we are not wedded to that view.

And some positive spin to end

While much of this note has expressed the challenges for the NZD ahead, there are good reasons not to become overly bearish.

Against a backdrop of generally falling agricultural prices, NZ's commodity prices have held up much better. Prices for the likes of milkfat, lamb, forestry, and kiwifruit are performing much better than the likes of soybean, corn and wheat prices. The global theme of the past month of significant downside pressure on commodity prices including agricultural products hasn't really applied to NZ commodities, but the NZD has been sold down regardless. NZ's terms of trade likely remain close to a record high.

And while the run of NZ data has recently been soft, we see this as temporary, with fiscal stimulus helping support growth over the second half. Recent inflation data have also been soft, but we see CPI inflation reaching 2% before the end of the year and the balance of risk is for core inflation to head higher as well. Some higher inflation data could easily change perceptions about the next move by the RBNZ, helping to eventually support the NZD.

Much of the newsflow on global trade risks has been negative over the last month. Near term newsflow looks likely to remain negative on this front, as Trump signs off more tariffs at the end of the week and retaliatory action follows. But it wouldn't take much to turn sentiment. A softening of Trump's stance would do the trick and suddenly the world would look a better place and support commodity currencies like the NZD.

Quick summary of views on the crosses

NZD/USD: Looking short-term oversold but technical support is broken and sentiment remains heavy against the Kiwi. Could go either way short term but eventually we see the broad USD recovery losing steam and reversing course, helping NZD towards our year-end target of 0.70.

NZD/AUD: Close to fair value and near middle of the 0.90-0.94 range we see as an anchor through the year. More of the same, with similar economic & monetary policy outlooks. Any oscillations likely to reflect sentiment towards China, and this is expected to ebb and flow.

NZD/GBP: We haven't got to the point where Brexit risks disappear from the headlines, so still a bit jumpy for GBP until they do, but bias through the rest of the year remains to the downside.

NZD/EUR: Subsiding Italy risks have seen the cross reverse course seeing it back towards the bottom of the range, and the path of least resistance is for further downside pressure over the medium term as further subtle shifts in ECB policy support EUR.

NZD/JPY: We continue to see clear medium-term downside pressure for the cross as the Yen remains super-cheap. Any short-term bounces expected to be short-lived.

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