9 August 2018

NZD: At the whim of DJ Trump

- **We've become more nervous about the outlook for the NZD. Our working assumption made at the beginning of the year of no major impact from trade wars is becoming increasingly challenged.**
- **The scale of recent tariffs imposed has been modest to date. But if the US goes ahead and imposes another 25% tariff on $200b of Chinese imports, then that's a whole new level of risk for the global economy to consider. Any final decision might come early-mid September and that will be crucial for the NZD outlook. A US tax on all Chinese imports is the next possible threat to be actioned.**
- **Current NZD spot is about 6% below our short-term fair value model estimate, suggesting a growing discount reflecting the more uncertain outlook. We'd expect to see another lurch down in the NZD on any fresh tariffs on the scale proposed. Stress-testing our model, a move below USD 0.65 couldn't be ruled out in that event. On the other hand, a de-escalation of trade tensions could see the NZD recover towards 0.70. The outlook has become binary.**

The more dovish than expected RBNZ Statement today caused a notable fall in the NZD but we don't see small changes in the monetary policy outlook as a key driver of currencies at present – apart from today (!) where one-sided positioning in the rates market and technical factors for the currency have exacerbated the market reaction. Our focus is directly on the US-China trade war that appears to be escalating.

We have recently written about the downside risks to the NZD. Last month we noted the downside domestic forces for the NZD as well as the downside global risks, as the NZD was dragged lower by the pressures seen on emerging market currencies, in particular the yuan. See "NZD 1H18 Review and Outlook", 5 July.

Over the last week or so we've become even more concerned about the possible downside risk to the NZD. Our working assumption at the beginning of the year was that a global trade war was unlikely to develop. We thought that common sense would eventually prevail and risks of a trade war were seen to be more optical than real. Recent events are challenging that assumption.

To be sure, when we say global trade war, we really mean a US-China trade war that has widespread global ramifications. Recent US-EU trade talks have actually been positive and the risk of further import tariffs has been reduced as negotiations proceed. But it seems that President Trump is happy to dial down the trade talk rhetoric against other countries to focus his battle against "unfair" China trade.

The initial import tariffs the US imposed on China were narrow in scope – on washing machines, solar panels, steel and aluminium. This ramped up to 25% tariffs on $50b of goods, effective early July for $34b of goods and later this month for the remaining $16b.

Last week President Trump upped the ante, with a consultation period underway on a proposal to impose 25% tariffs on a further $200b of China imports (previously 10%). Public consultation ends 5 September and after that Trump will be free to direct his US Trade Office to make an announcement on the final decision. Thus, early to mid-September has now become a key focal point when thinking about the outlook for risk assets.

A series of tweets over the weekend by Trump makes a back-down difficult in the absence of any possible concession from China. Trump taunted China about how poorly it was recently doing. He espoused the virtues of imposing tariffs and how well they were working so far.

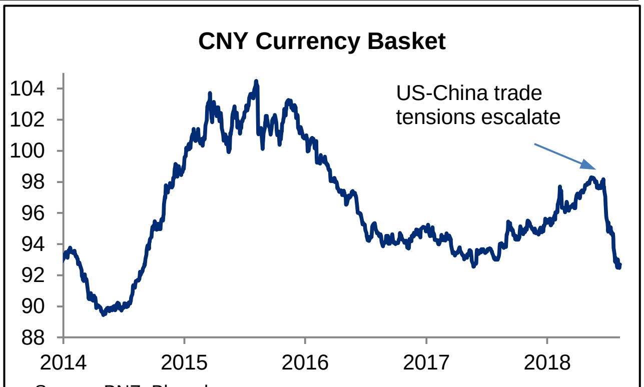
China has retaliated against the US tariffs, imposing a 25% tariff on $34b of US imports, selectively chosen to inflict the most political damage against Trump. This will be followed up by increasing that to $50b later this month to match the US-imposed tariffs. China has also proposed a 5-25% tariff on $60b of US imports "subject to the actions of the US", in reference to the proposed US tariffs on a further $200b of Chinese imports. China's response on tariffs is limited to the extent that it only imports about $135b of goods from the US.

Chinese media, often talk pieces on behalf of the government, have dialled up the rhetoric against Trump and US tariff policy, with one editorial reporting "China has time to fight to the end…time will prove that the US eventually makes a fool of itself." We think that China will not back down from the trade war easily and is comfortable taking a longer term perspective.

The market's response has been to drive down the value of the Chinese yuan, given the threat to China's economic outlook. The PBoC has attempted to limit the extent of CNY depreciation using a wide array of direct measures and has incrementally eased monetary and fiscal policy in response to the economic risks facing the country.

A weaker yuan and easier policy stance cushions the blow for China, although the authorities seem careful not to use the yuan as a blatant weapon against the US.

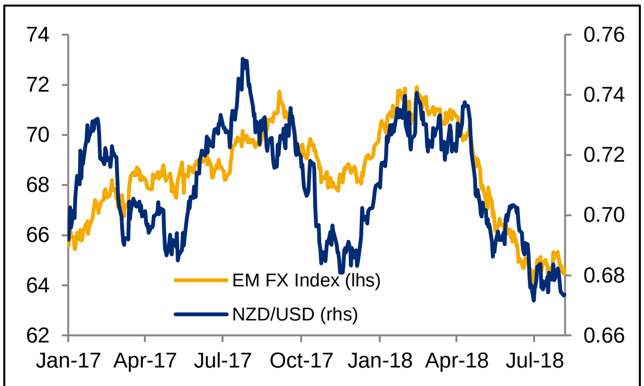
CNY Much Weaker as US-China Trade Tensions Upped



Source: BNZ, Bloomberg

The path of the NZD has been closely linked to the fortunes of emerging market currencies this year, which includes the performance of the Chinese yuan. We think that the correlation will remain high over the short term as trade tensions remain a focus for the market.

Recent NZD Weakness Linked to Emerging Markets FX

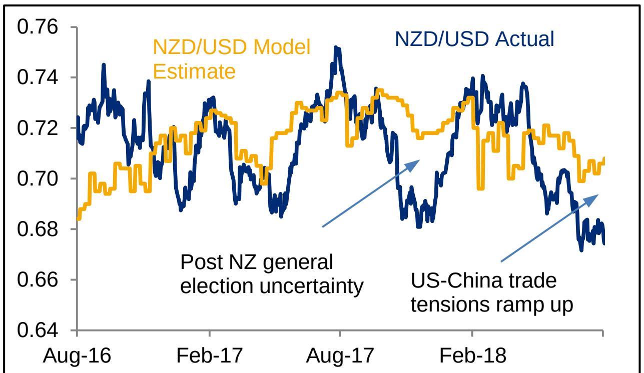


Source: BNZ, Bloomberg

In terms of the performance of the NZD against our short-term fair value model estimate, a discount of 6% has opened up. BNZ's risk appetite index which is one of three factors in the model is up to 75%, a six-month high, with the VIX back down below 11 and credit spreads (EM and HY) narrowing from their June highs. NZ commodity prices are off their highs seen a couple of months ago, but remain at a robust historical level. Narrower NZ-US rate spreads remain an ongoing negative force on the model estimate.

Taking all these factors into account, the model estimate currently sits close to USD 0.71. This is down modestly from the 0.73 level estimated at the beginning of the year, but up from the 0.6950 nadir in February when market volatility spiked up. The current 6% discount is the highest it has been all year. We see the discount to fair value that has opened up for the NZD primarily a reflection of the escalating US-China trade tensions and risk to the global outlook.

Discount to FV has Opened Up for the NZD



Source: BNZ, Bloomberg

CFTC positioning data suggests that the number of net short NZD contracts is about as high as it has ever been. Of course, shorting NZD/USD is unusually cheap, with US rates now higher than NZ rates (there is now positive carry on short NZD positions). This dulls the usual contrarian signal that would normally apply to this indicator.

We see the near-term outlook for the NZD as somewhat binary. If the current proposed 25% tariffs on $200b of Chinese imports don't see the light of day then that would be clearly NZD-positive. That would represent a de-escalation of US-China trade tensions. In that scenario we'd be more comfortable with a view that the NZD could recover a little into year-end, supported perhaps by the market re-focusing attention on the negative medium-term structural forces that seem evident for the USD.

If the proposed tariffs go ahead then despite the prevailing discount for the NZD, we'd see plenty of scope for further downside pressure. It would increase the chance of Trump following through with his threat to impose fresh tariffs on all Chinese imports (about $525b of trade). US equities have so far been bullet-proof against the rising global risks and we'd expect to see a fall in risk assets across the board, increased volatility and wider credit spreads. A step up in tariff policies could see our risk appetite index head a lot lower. Despite being at the epicentre, the USD would be expected to rise and this, alongside a weaker global economic outlook, would see NZ commodity prices fall in world price terms.

Stress-testing our model – a risk appetite index of 40%, a 10% fall in NZ commodity prices and a 25bp narrowing in the NZ-US 1year rate (something that we expect anyway) – sees our fair value estimate drop to around 0.65. Adding in a potential discount to that, it wouldn't be hard to see the NZD move below USD 0.65 on this scenario.

We can only hope that US businesses currently feeling the wrath of tariffs imposed to date – and there are many small businesses in that boat – get in the ear of President

Trump. The National Association of US Manufacturers is urging President Trump to get Beijing back at the negotiating table. That is the sensible solution. We await the next 4-6 weeks with trepidation.

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