7 September 2018

NZD Hedging: The end of the "free lunch"

- **Lower NZ-global rate differentials have eroded the "yield pick-up" that has historically been available to exporters and local fund managers from hedging foreign currency exposure.**
- **Focusing on NZ-US rate differentials, with US interest rates expected to rise further against a backdrop of steady NZ interest rates, exporters and local fund managers will face even worse forward NZD rates over the next 1-2 years.**
- **Even if hedging currency exposure appears less beneficial for exporters and local fund managers, there are still plenty of good reasons to do so to mitigate currency risk. But strategically we see some merit in exporters and local fund managers targeting a lower than usual hedging ratio over the next few years. The flip-side is that importers should see more benefit in hedging foreign exchange.**
- **Short NZD/USD positions now offer a positive carry and we are likely to see more enduring short positioning by speculative accounts than accustomed to over the past decade.**

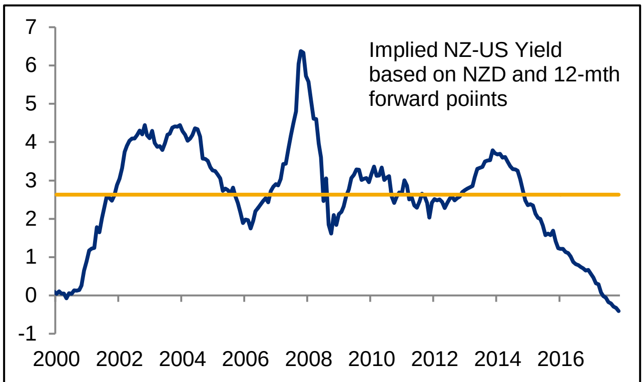
The gap between NZ and US interest rates has been on a declining trend over the past four years to the point where NZ rates have now settled below US rates across the yield curve. This has implications for exporters, importers and local fund managers as they think about their hedging requirements. It also has implications for the outlook for the NZD itself, as low rates act as a depressing force; and for speculators, who now get positive carry from short NZD positions.

For much of history, a positive NZ-US interest rate gap has been reflected in negative NZD forward points. That is, an exporter or local fund manager has typically been able to hedge USD receipts or assets at a lower forward NZD exchange rate. Call it a free lunch. To give an example, an exporter or local fund manager with offshore assets who hedged one-year forward USD exposure has been able to bank an average annual 2.6% "yield pick-up" since 2000.

The implied yield pick-up over time is illustrated in the following chart using the percentage gap between the spot rate and NZD 12 month forward rate. It pretty much traces the difference between the NZ 90-day bank bill rate and 3-month USD libor rate over time.

Exporters and local fund managers have often seen this yield pick-up as a benefit to hedging foreign exposure and this has made the decision to hedge easier. For importers, the opposite has been the case. Psychologically, it has been a

NZ-US Yield Pick-up Now Negative



Source: BNZ, Bloomberg

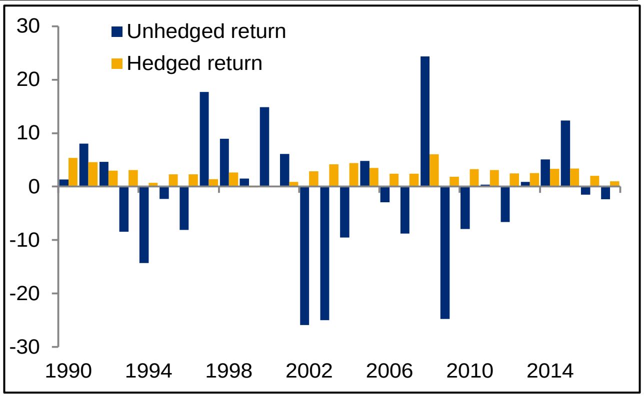
more difficult decision for importers to "lock-in" forward NZD levels lower than the prevailing spot rate.

Some charts in the Appendix show the implied yield pick-up when hedging other exchange rates. Exporters and local investors hedging JPY exposure have enjoyed a strong yield pick-up over the years (averaging 4.9% since 2000) and now face a lower, but still attractive, yield pick-up. For exporters and investors with AUD, EUR, GBP exposure the difference between the current yield pick-up and the average since 2000 isn't particularly material.

We see the NZ-US yield pick-up to become increasingly negative over time. The US Fed is still in the midst of raising interest rates, with another two rate hikes likely this year and a good chance of further hikes through 2019. We see the RBNZ, on the other hand, keeping policy unchanged for an extended period – probably for another twelve months and possibly longer. Over the next twelve months or so, the current minus 0.4% yield spread could well widen to minus 1.5% or so. The free-lunch that exporters and local investors have enjoyed for so many years quickly morphs into a free lunch for importers.

While some exporters and local fund managers might be tempted to reduce target hedging ratios given the demise of the yield pick-up, that would leave them exposed to the volatility of the NZD (ie. any possible appreciation that might kill the profitability of doing business) and historically its movements dominate any potential yield differential. The chart below shows the annual "gain or loss" for an exporter or local investor deciding not to hedge at the beginning of each year against the return from hedging (the yield pick-up) and not being exposed to any foreign exchange movement. Going unhedged, for

FX Return is More Important Than Yield Difference

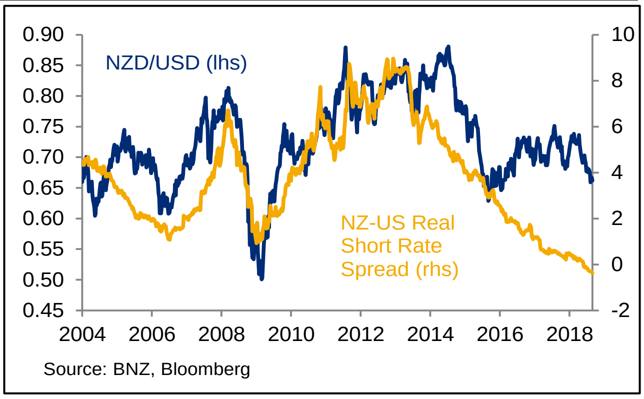


example, in 1994, 2002, 2003, 2009 would have resulted in some hefty double-digit "losses" as the NZD appreciated strongly in those years.

Even if hedging currency exposure comes at a greater cost for exporters and local fund managers, there are still plenty of good reasons to do so. But admittedly, given our outlook that NZ interest rates remain steady against a backdrop of higher US rates, some exporters and local investors might be tempted to keep hedging ratios lower than usual. In that interest rate environment, it is difficult to see the NZD "taking off" and strongly appreciating. Thus, we see some merit in exporters and local fund managers strategically targeting a lower than usual hedging ratio, with the low NZ-US rate differential likely to be a key variable that holds back NZD performance over the next couple of years. We see some merit in importers in targeting higher hedge ratios than they have typically maintained, with the added benefit of reduced costs.

The other implication of the flip in the yield pick-up is that it is now a cost to run long NZD positions and this can only encourage more pervasive short positioning to be adopted. This is evident when looking at CFTC data showing net speculative positioning (% relative to open positions) against the NZ-US 3-month bill rate

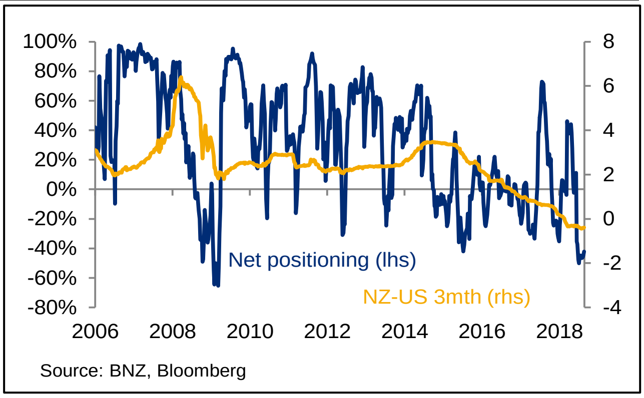
Lower NZ-US Rates Support Weaker NZD



Source: BNZ, Bloomberg

Historically, NZ has enjoyed higher rates relative to the US and this has encouraged the "hot money" to be long NZD and pick up the yield carry. Over recent years, the lower NZ-US rate differential has seen an increasing move towards

Low NZ Rates Support Move to Net Short NZD Positions



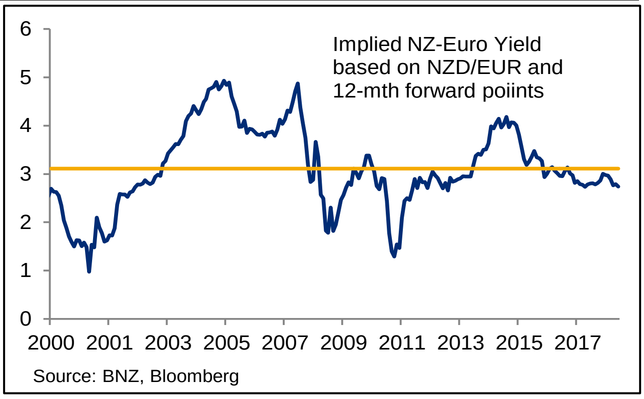
Source: BNZ, Bloomberg

short NZD positioning. Whereas previously we would have suggested that the current level of short positioning might threaten a short squeeze and therefore a contrarian view might be appropriate, short NZD positioning in the current environment could well be sustained for an extended period. Short NZD positions can now be run a lot longer than previously, given they now generate a positive yield carry. Unlike the current status quo, this positioning indicator is likely to be a much better contrarian signal when net positioning is long NZD than short.

jason.k.wong@bnz.co.nz

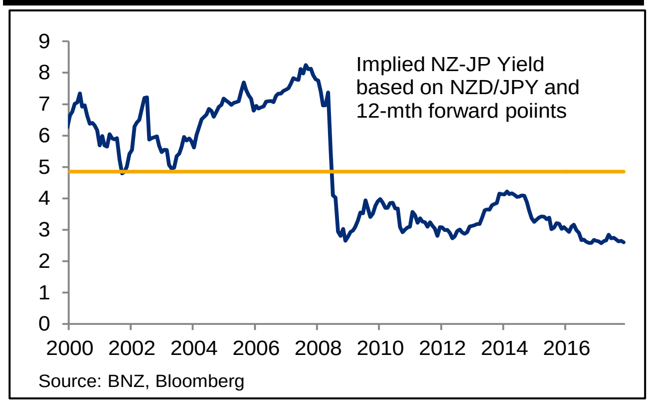
APPENDIX

NZD-EUR Yield Pick-Up Similiar to Average



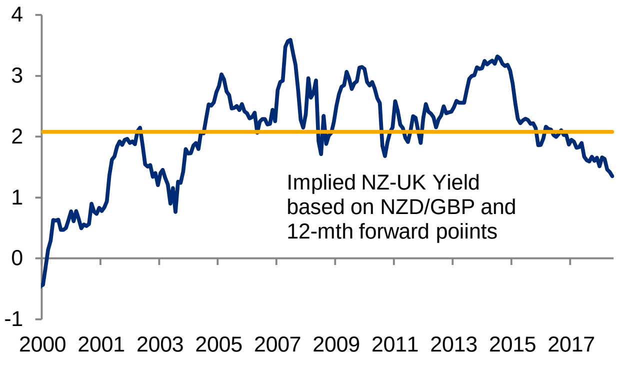
Source: BNZ, Bloomberg

NZD-JPY Yield Pick-Up Below Average



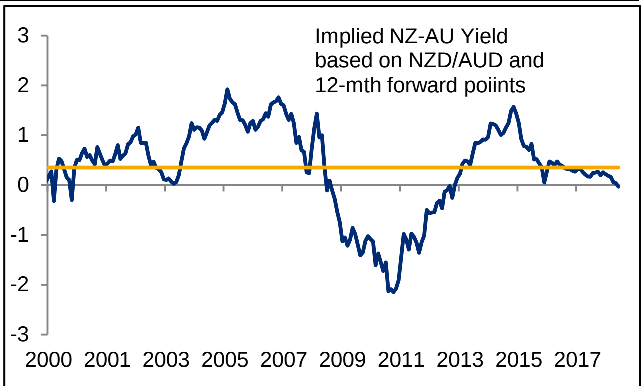
Source: BNZ, Bloomberg

NZD-GBP Yield Pick-Up Moving Below Average



Source: BNZ, Bloomberg

NZD-AUD Yield Pick-Up Back Near Zero



Source: BNZ, Bloomberg

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