4 October 2018

Headwinds Mount For The NZD

- **We have adopted a more cautious outlook for the NZD over the next few quarters. This reflects a number of factors including a significant downgrade to the CNY outlook by our NAB colleagues as China faces softer economic conditions as trade tensions with the US escalate; NZD-specific factors that remain challenging such as much weaker terms of trade as oil prices surge and dairy prices remain soft; and the risk that USD-strength endures for a while longer.**
- **A couple of months ago we highlighted USD0.63-0.64 as a plausible level if Trump went ahead with further tariffs on Chinese imports. We now pitch our central forecast for the next six months at USD0.65, which in practice means a plausible range of 0.63-0.67.**
- **As Australia's terms of trade benefits from higher oil prices, the near-term threat is that NZD/AUD challenges downside support at 0.90. The impact of our weaker NZD forecasts on the TWI is moderated to the extent our NZD/CNY profile is stronger.**

The NZD remains under pressure, reaching fresh multi-year lows and on an ominous downward trend that kicked off around mid-April. It's not yet safe to presume that the downward trend is over. We would need to see a convincing break above 0.6730 to have a little more comfort that the trend over the past five months has been broken and that doesn't look likely.

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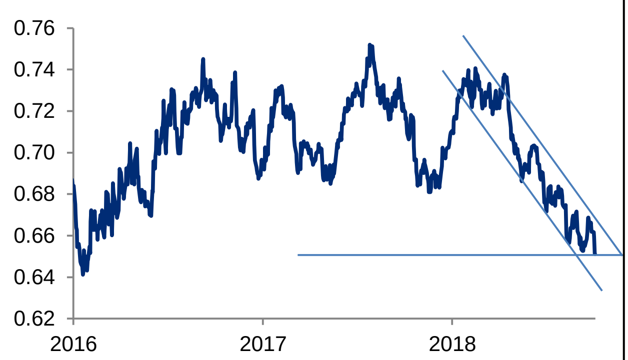
NZD Downward Trend Not Broken…Yet



Source: BNZ, Bloomberg

US-China tensions escalate

President Trump's long-awaited tariff decision in early September on another $200b of Chinese imports proved to be more moderate that initially feared, with 10% rates rather than the mooted 25% rates. However, the higher rate will apply from 1 January and it looks increasingly likely that eventually tariffs will be imposed on all Chinese imports, taking the figure to over $500b of imports.

Perhaps just as threatening is that the US-China trade war has now turned political, with a warship skirmish in the South China Sea, cancellation of high level US-China military meetings, and China refusing entry of US warships into Hong Kong amongst other events just in the last week or two.

The recent new NAFTA (USMCA) deal agreed by the US, Canada and Mexico included a specific clause that prevent these countries from signing trade deals with a "non-market economy". This was seen as another hit to China – a precursor to other trade deals that the US might sign with Japan and other countries.

Our Asia-based NAB colleagues project a greater political risk premium being built into Asian financial assets, including more pressure on CNY to depreciate. USD/CNY and USD/Asian currencies have been revised higher (the former to 7.20 by mid-2019) on the premise that the extended strife between the US and China will lead to reduced trade and capital inflows in China. Recent weaker macro indicators in China, reflecting the tariffs imposed, add to the case for a weaker CNY. The PBoC is expected to allow this to happen (in an orderly fashion), justified as part of its monetary policy actions to counter the weaker growth outlook.

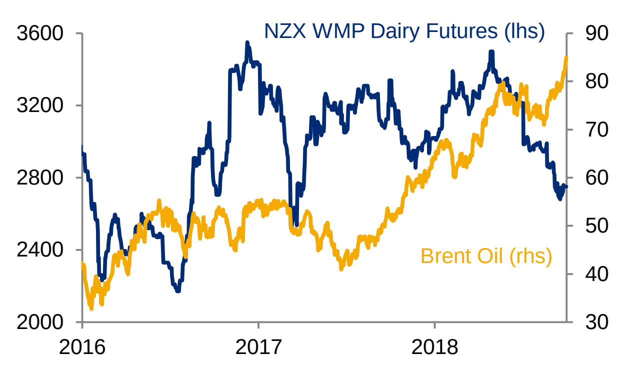
A weaker CNY and Asian currency dynamic represent a headwind for both the NZD and AUD, given the strong trade linkages with the region.

NZ's terms of trade under downward pressure

Another reason to maintain a cautious view on the NZD is that NZ's terms of trade have been recently under significant downward pressure. NZ's export commodity price index, measured in either USD or SDR terms, is down 6-7% since mid-June, driven by weaker dairy prices. Meanwhile, Brent oil prices have risen to their highest level since 2014 and are imparting significant upward pressure on import prices.

This combination suggests that NZ's terms of trade are falling and could easily fall further from here. This factor can explain some of the weaker NZD trend over recent months.

Oil Prices Going Up But Dairy Prices Going Down

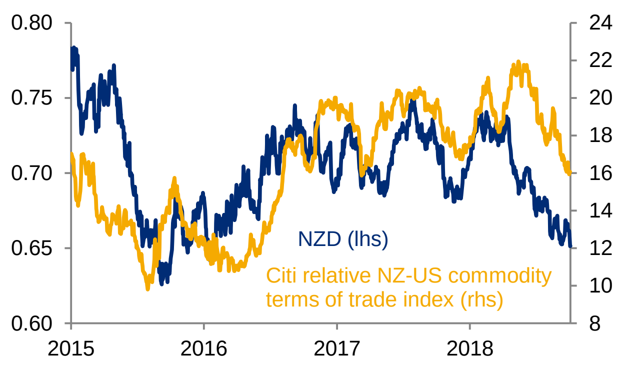


Source: BNZ, Bloomberg

On the positive side, we expect international dairy prices may soon find some support after NZ milk production passes its peak over the coming month or so and look for some mild price improvement through 2019. But if some pundits are right that Brent oil can reach $100 per barrel then NZ's terms of trade would fall further.

Citi's commodity terms of trade indices incorporate the daily gyrations of commodity prices. We calculate a relative NZ-US commodity terms of trade index and graph that against the NZD. It shows a good relationship, as we'd expect.

Weaker NZ Terms of Trade Can Explain Weaker NZD



Source: BNZ, Bloomberg

No NZD support from monetary policy

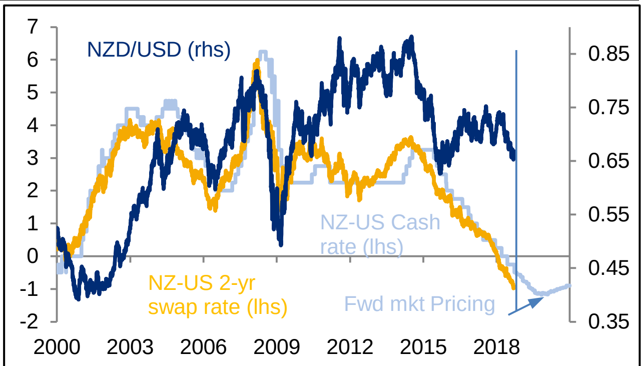
Last week's RBNZ OCR Review came and went with little surprise, with the Bank simply confirming its view that it expects to keep the OCR unchanged through into 2020 and it is not willing to rule out the possibility of rate cuts. The RBNZ indicated little change to its economic projections despite the recent much stronger than expected Q2 GDP report. It sees downside risks to the growth outlook remaining.

Recent strong US economic releases are consistent with the Fed continuing along its path of gradually raising interest rates. Market pricing of the Fed Funds rate over the next couple of years still sits below the median projection of the FOMC to the tune of about 50bps by the end of 2020. If the Fed's view is correct, then upward pressure on US rates across the curve can continue.

Meanwhile, weak NZ business confidence continues to overhang the local market and remains a threat to the growth outlook. Consumer confidence is drifting lower in the face of higher petrol prices – up 10% over the past quarter and 20% over the past year. This represents a significant hit to consumer spending power. While we still see the RBNZ on hold, the bigger near term risk is easier than tighter policy, as priced into the OIS curve.

With NZ monetary policy on hold against a backdrop of further tightening in US monetary policy, we'd expect to see ongoing downward pressure on NZ-US rate spreads, and these to remain a key headwind for the NZD over the next 6-12 months.

NZ-US Rate Spread a Negative Force on the NZD



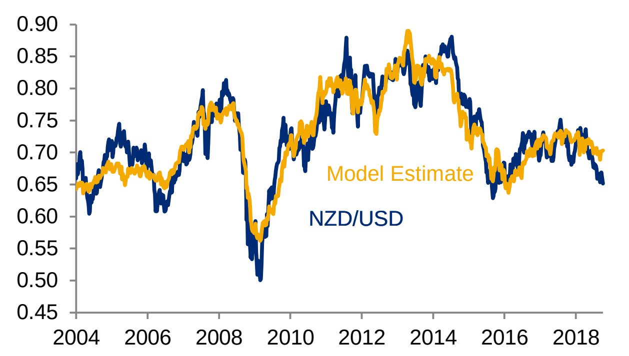
Source: BNZ, Bloomberg

NZD discount to fair value has widened

Our short-term NZD fair value model estimate is still much higher than spot and sits around 0.70, supported by a backdrop of above-average levels of risk appetite. Our risk appetite index increased by 8 percentage points to 73% through September, driven by the low VIX index and narrowing emerging market and high yield credit spreads.

The 6-7% discount between the spot rate and our short-term model estimate is large in a historical context and suggests that a lot of bad news is already priced into the NZD. The market likely sees the same fundamental headwinds that we can see. We'd also note that at this juncture, our model estimate is a little overstated to the extent that only NZ commodity prices are included and thus the current significant impact of oil is excluded.

NZD Discount to Short-Term Fair Value Builds



Source: BNZ, Bloomberg

NZD forecasts downgraded

In light of the increasing headwinds for the NZD, AUD CNY, and other Asian currencies we have downgraded our projections. Back in August we wrote about 0.63-0.64 as a plausible level if Trump went ahead with further tariffs against China. Since then, oil prices have skyrocketed and weaker NZ terms of trade have been added into the mix.

In our last NZD Corporate Update we left our forecasts unchanged and suggested a 0.65-0.70 range for the NZD over the next year or two but we now pitch our central forecast for the next six months at 0.65, which in practice means a plausible range of 0.63-0.67.

We are always reluctant to move our projections far from our short term fair value model estimate, but in this case the surge in oil prices (not accounted for by the model) is a consideration as well as the fact that the model estimate has been held up because risk appetite is currently so high. Risk appetite can be fickle and the gap between spot and fair value would be less significant if it was running at a more normal level.

BNZ/NAB FX Projections Summary

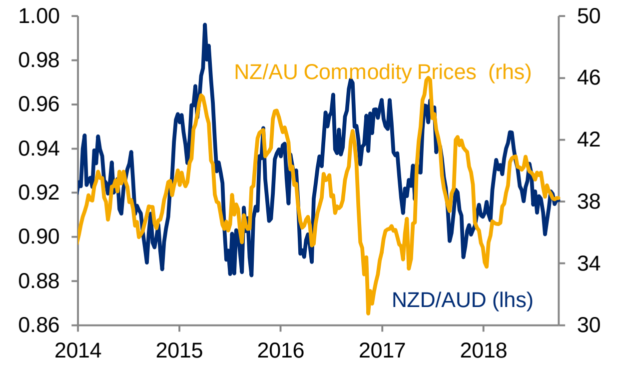
	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	NZD/CNY
Current	*0.65*	*0.92*	*0.57*	*0.50*	*75*	*4.47*
Dec-18	0.65	0.91	0.55	0.51	73	4.46
Mar-19	0.65	0.90	0.54	0.51	72	4.62
Jun-19	0.66	0.90	0.54	0.51	73	4.75
Sep-19	0.68	0.91	0.54	0.51	73	4.90
Dec-19	0.69	0.92	0.53	0.49	73	4.93
Mar-20	0.70	0.92	0.53	0.49	73	4.97
Jun-20	0.70	0.91	0.52	0.48	71	4.90
Sep-20	0.70	0.92	0.52	0.47	70	4.83
Dec-20	0.69	0.92	0.50	0.45	68	4.69
	AUD/USD	**EUR/USD**	**USD/JPY**	**GBP/USD**	**USD/CNY**	**TWI**
Current	*0.71*	*1.15*	*114*	*1.29*	*6.87*	*71.5*
Dec-18	0.71	1.18	112	1.26	6.90	70.8
Mar-19	0.72	1.20	110	1.28	7.10	71.4
Jun-19	0.73	1.22	110	1.30	7.20	72.6
Sep-19	0.75	1.25	108	1.34	7.20	74.2
Dec-19	0.75	1.30	106	1.40	7.15	74.5
Mar-20	0.76	1.32	104	1.43	7.10	74.9
Jun-20	0.77	1.34	102	1.46	7.00	74.0
Sep-20	0.76	1.36	100	1.49	6.90	73.5
Dec-20	0.75	1.38	99	1.52	6.80	72.1

Source: BNZ, Bloomberg

Thinking about the NZD/AUD cross rate, Australia benefits from rising oil prices as LNG export prices are linked to the price of crude oil. Gyrations in NZD/AUD can be swayed by relative commodity prices, as we have seen so far this year. If oil prices continue to rise and dairy prices underperform, then the risk is that NZD/AUD could nudge lower through the rest of the year. Until now, we've had a 0.91-95 range trade view for the cross this year, but it wouldn't be hard to see a sub-0.90 level come back into the picture if oil prices keep rising, and our central forecast over coming quarters is now pitched around 0.90.

Our projections continue to show weaker NZD/EUR and NZD/JPY cross rates over the coming year. NZD/GBP remains too hard to call. The impact of weaker NZD forecasts on the TWI is moderated to the extent that our NZD/CNY profile is stronger.

Relative Commodity Prices Can Drive NZD/AUD



Source: BNZ, Bloomberg

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