17 October 2018

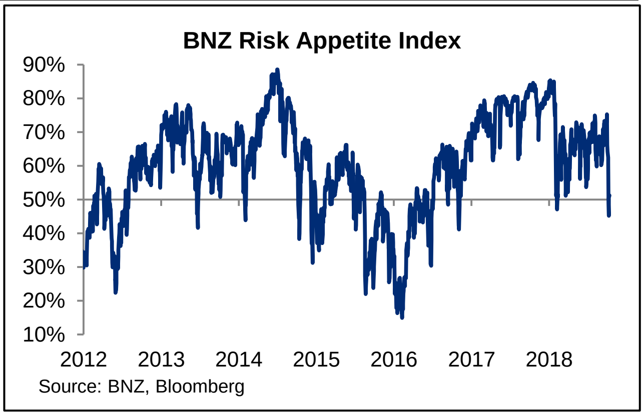
NZD downtrend over?

- **The NZD has had a better run over the past couple of weeks but we are hesitant to declare with confidence that the downward trend is over.**
- **The mild recovery in the NZD has been driven by a combination of technical and fundamental forces. And last week's price action highlighted how much negative news has already been priced into the NZD.**
- **Our revised FX forecasts of a couple of weeks ago had the NZD ending the current and next quarter at USD0.65, so that would be consistent with a period of consolidation ahead, or some arresting of the 6-month downturn. But we aren't overly confident that fresh lows won't be made over coming months and have some conviction that any rally is likely to be limited.**

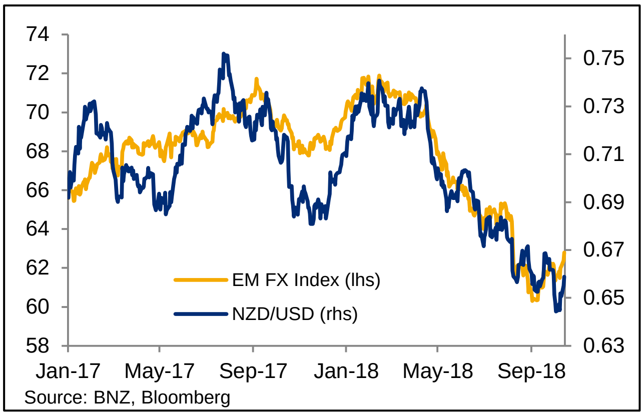
After reaching a low of 0.6425 in early October, the NZD has recovered 1½ cents, largely supported by a softer USD dynamic and better sentiment for emerging market currencies, while a stronger NZ Q3 CPI report helped at the margin.

While within the mix there's certainly a hint of better fundamental support for the NZD, speculative behaviour regarding positioning has also been in play. Much of the outperformance of the NZD last week seemed like a perverse performance in light of a significant correction in global equity markets and our risk appetite index – made up of the VIX index, emerging market credit and US high yield credit spreads – plunging from 64% to 51% (and reaching a fresh year-to-date low of 45% last Thursday).

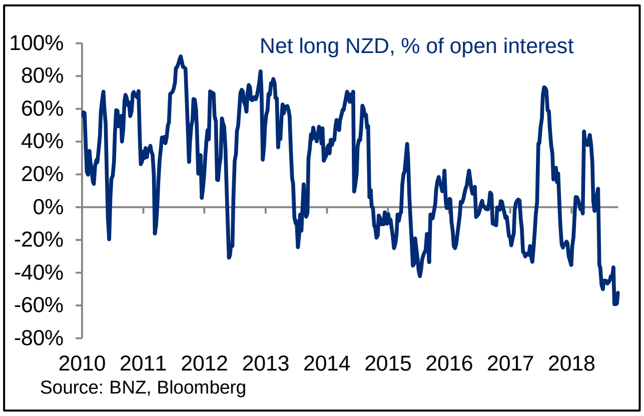
Risk Appetite Plunges



NZD Following Emerging Market Currencies This Year



NZD Positioning Has Been Extremely Short



The big risk-off move, centred in equity markets, likely triggered some short covering of positions across a range of assets and CFTC data has shown, for some time, large short positioning in the NZD. From record net short positions in the NZD as at a week ago, we'd expect to see less-extreme positioning when the next weekly batch of CFTC data is released.

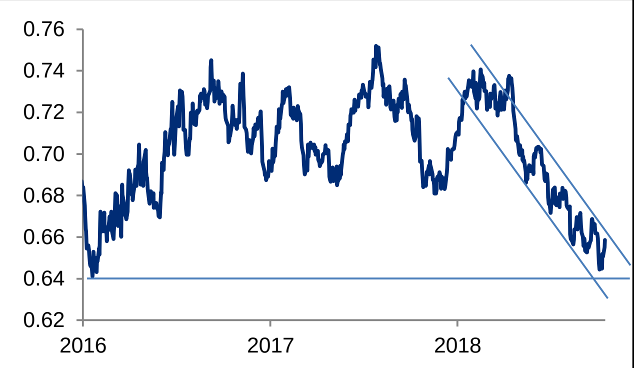
On the fundamental side of the equation, improved sentiment for emerging market currencies – which the NZD has closely followed this year – has been in play and to the extent this theme can continue, provides a more optimistic backdrop for the near-term NZD outlook. Underlying this dynamic has been strong recoveries in currencies across Turkey, Brazil, South Africa and Argentina for various idiosyncratic reasons which we won't dive into. Furthermore, US-China trade wars have been out of the limelight, with Trump *not* kicking off a public consultation period for further tariffs on the remainder of Chinese imports – perhaps thinking he's done enough for now ahead of a likely meeting with President Xi next month at the G20 summit, or some reluctance to push ahead as the remainder of imports are largely consumer goods, with more direct impact on the US economy.

But sentiment is fickle and some of the macro headwinds facing emerging markets haven't disappeared overnight. Indeed, we still see the main source of downside vulnerability for the NZD stemming from such global forces.

The path of least resistance for USD/CNY is an eventual move above the psychological 7 mark and this applying downward pressure for Asia-Pacific currencies at such time. In our projections we don't have this happening until early next year, but the threat is ever-present and will depend on the resolve of the PBoC to support CNY. The outcome of the above-mentioned Trump-Xi meeting might well be a key factor in how CNY fares over coming months.

To the extent that technical factors might be in play behind recent NZD support, it might be too early to declare that the downtrend in the NZD is over. Trendline resistance sits around 0.6630 but we'd want to see a break of previous resistance at 0.6730 to be more confident that the downtrend has been broken.

NZD Downward Channel Not Yet Broken



Source: BNZ, Bloomberg

NZ's terms of trade are still facing downward pressure, as dairy prices retreat on stronger supply dynamics against a backdrop of the trend rise in oil prices. There has not been a positive GDT dairy auction result since this NZ dairy season started on 1 June. The GDT Price Index is now 14% lower than a year ago.

Last week's risk-off event saw oil prices retreat from recent highs, but this might have more reflected some pare-back of speculative long positions than any adjustment justified on fundamentals for that market.

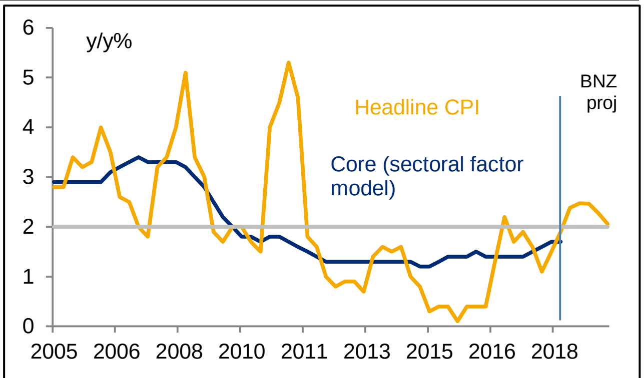
Domestic factors such as easy NZ monetary policy and the slump in business confidence have been a factor in the NZD's underperformance this year, but we do wonder for how much longer this can be the case. Recent hard data point to NZ economic growth holding up just fine. Indeed, we cannot find any hard evidence to corroborate the slump in business confidence or own-activity expectations suggested by the ANZ survey. Recent strength in Q2 GDP and electronic card transactions suggest positive economic momentum.

NZ's Q3 CPI report this week showed headline inflation rising to 1.9%y/y, with the average of core measures steady around 1.7-1.8%. Importantly for monetary policy, annual non-tradeables inflation was 0.2% higher than the RBNZ projected, alongside the 0.5% miss in headline inflation. The inflation data follows much stronger Q2 GDP data than the RBNZ expected and other activity data holding up nicely.

Inflation is expected to move higher and spend some time well above the 2% mark at least through 2019. This should ultimately change the balance of risks the RBNZ sees on policy and as time passes we see the market pricing out the current modest easing pricing into the OIS curve. To be sure, NZ rates are below USD rates across the whole curve and are a headwind for the NZD, but at some point a less dovish RBNZ might be expected to offer some NZD support.

In sum, the mild recovery in the NZD has been driven by a combination of technical and fundamental forces. And last week's price action highlighted how much negative news has already been priced into the NZD. Our revised FX forecasts of a couple of weeks ago had the NZD ending the current and next quarter at USD0.65, so that would be consistent with a period of consolidation ahead, or some arresting of the 6-month downturn. We aren't overly confident that fresh lows won't be made over coming months and have some conviction that any rally is likely to be limited.

CPI Inflation Heading Higher



Source: BNZ, Bloomberg

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

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