

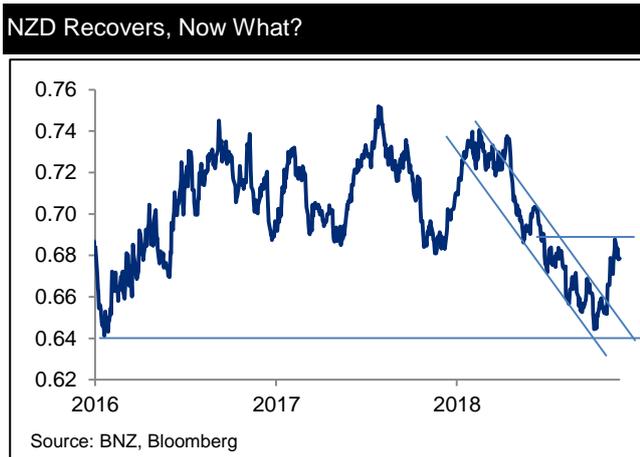
26 November 2018



NZD Recovers, Now What?

- **The downward channel for NZD/USD from April through to October looks to have been arrested, even against a backdrop of a “strong” USD. Positive domestic forces such as better data and upside to NZ rates during a time when the US monetary policy outlook has become more clouded have helped.**
- **Furthermore, there has been increasing optimism on US-China trade tensions. Growing expectations of a ceasefire to be agreed at this weekend’s Xi-Trump meeting explains some of the NZD’s outperformance through November. Our bias would be to fade any possible relief rally in the NZD post the meeting.**
- **Our short-term fair value model estimate has fallen to 0.6650, driven down by lower risk appetite and lower NZ commodity prices, taking the NZD from super-cheap to modestly over-bought. Despite a trade war ceasefire removing some potential near-term downside risk to the NZD, our message would be to tread carefully.**

The NZD has been the best performing major developed currency over the past month. After reaching a multi-year low of 0.6425 in early October, a strong rally has seen it rise to as high as 0.6884, a level not seen since June.



Of note has been the NZD recovery against a backdrop of a strong USD. The widely followed DXY USD index is currently less than 1% off its recent 18-month high. Renewed weakness in global equity and credit markets and a further plunge in oil prices have helped support the USD – its negative correlation with risk appetite and oil prices remains intact. The reason the USD hasn't been

even stronger probably reflects the market's attention on the Fed's outlook for monetary policy. Over the past fortnight the January 2020 Fed Funds contract – the best proxy for market pricing of Fed policy through to end-2019 – shows a 19bps fall in yield to 2.72%.

At a time when the market has questioned the extent of further Fed rate hikes, the market has priced out the chance of any further easing in NZ monetary policy, resulting in an increase in NZ-US interest rate differentials (eg the NZ-US 2-year swap spread), something we haven't seen for a while.

Underlying this theme, the NZ economic dataflow has generally been more positive than expected, while US activity and inflation data have been underwhelming. In NZ's case we seen a surprise plunge in the unemployment rate to 3.9% and evidence has been mounting that very weak business confidence was a head-fake – perhaps swayed by grumpiness at the new coalition government installed over a year ago now. Going against the grain of weaker global PMIs, the NZ PMIs for both manufacturing and services have risen over recent months. Any tightening by the RBNZ remains a distant prospect, but the market is no longer toying with the prospect of rate cuts and the market – rightly in our view – sees the chance of OCR rate hikes increasing from the second half of next year.

In the case of the US, real activity indicators point to weaker growth momentum, even if it is off a high base – we'd note here the clear slowing in the housing market, soft business investment indicators, the recent rise in initial jobless claims and the moderation in growth of the Conference Board's leading index. To that we can add the tightening in US financial conditions, with NAB's indicator pointing to the risk of a significant slowdown in GDP growth. Recent Fed officials – including new vice-Chair Clarida – have noted the slowing in global growth momentum and this was something the Fed needed to pay attention to. Both the recent plunge in oil prices and stronger USD trend will impart a significant downward force on headline inflation, with some likely spillover effect into weaker core inflation.

The market rightly questions whether the Fed will continue merrily along its gradual tightening path in the face of lower inflationary pressure and some softer activity indicators. A number of Fed speakers are out in force this week, including Chair Powell, vice-Chair Clarida

and NY Fed President Williams. Given that the market has recently been pricing out the extent of Fed rate hikes through to the end of next year, US rates and the USD would be sensitive to any signs of push-back to that view ahead of the next FOMC meeting just before Christmas.

Another recent important dynamic for the NZD through November has been a stream of positive headlines on the US-China trade war. The two countries are back at the negotiating table and the odds of a potential ceasefire to be agreed at this weekend's Xi-Trump meeting at the G20 summit has increased. This could take the form of no further tariff increases for as long as negotiations continue. If that is indeed the outcome, then risk assets like the NZD would be supported. But our bias would be to fade any possible post-meeting rally in the NZD. US-China tensions run much deeper than just "trade", with China's increasing global presence threatening US hegemony. We don't see President Xi backing away from his "Made in China 2025" strategic plan for the country and any "agreement" this weekend is more likely to be optical than real.

Given the NZD's recent outperformance, a positive trade deal outcome might already be priced into the NZD to a certain extent. Our short-term model shows the NZD moving ahead of our fair-value estimate (currently around 0.6650) from mid-November, for the first time in six months. The model estimate has been pulled down over the past couple of months by lower risk appetite and lower NZ commodity prices. Notably, the average winning price at the GDT dairy auction has either been flat or fallen at every fortnightly auction so far this season (beginning 1 June), with prices down a cumulative 20%. Our risk appetite index has fallen to a 2-year low.

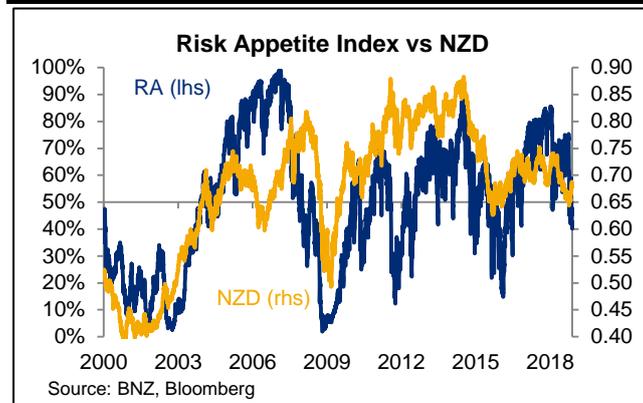
In sum, over the past six weeks, the NZD has moved from a heavily oversold position to a modestly over-bought position. Some of this will reflect some closing of historically large net short positions evidenced by the weekly CFTC commitment of traders report. A backdrop of lower risk appetite and lower NZ commodity prices makes us cautious in predicting further sustainable gains in the NZD through to year-end.

Our year-end and Q1'19 targets of 0.65 assumed a deteriorating US-China trade picture. There is obviously some upside risk to these targets if Trump has turned over a new leaf and wants a quick deal. A ceasefire might well last several months and would remove a key source of near-term downside risk to the NZD. But we are also guided by our short-term model estimate that says the NZD is looking a touch over-bought at current levels.

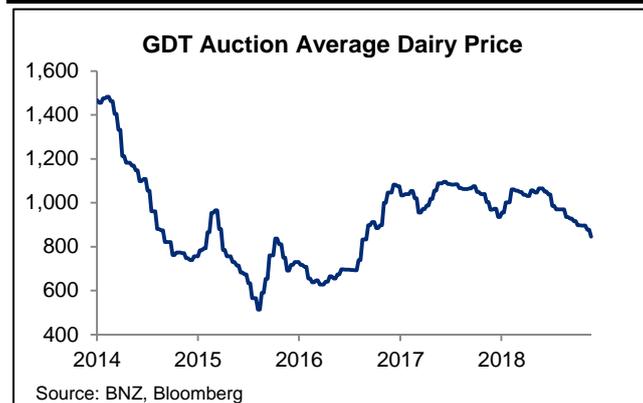
At 41%, our risk appetite index has only recently moved below the neutral 50% mark and could see a further reduction if credit spreads continue to widen. Meanwhile, in the context of slower global growth, NZ commodity prices continue to face headwinds.

We'll hold off any forecast changes until next month, by which we'll have further details on US-China trade developments. In the meantime, tread carefully.

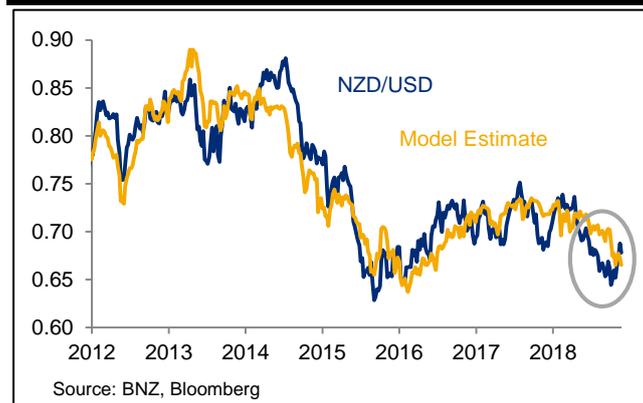
Risk Appetite Down to a 2-Year Low



Dairy Prices Have Fallen



NZD Goes From Super-Cheap to Modestly Over-Bought



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