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bnz

NZD/AUD to sustain a higher range

- **With the long-anticipated Xi-Trump meeting now out of the way, we have made some revisions to our AUD and NZD forecasts. Our old forecasts were predicated on the US pushing ahead with more tariff action against China from Jan 1st 2019 and pre-dated the very strong NZ labour market report.**
- **Support for AUD from Sino-US trade developments could prove ephemeral, but in any event is offset by expected USD resilience, a somewhat weaker domestic economic backdrop (so RBA lower for longer) and market concerns related to the election.**
- **The NZD is still expected to soften through the next six months – we see more downside than upside risk – but show relative strength versus the AUD, given the more positive domestic backdrop and relative terms of trade performance. NZD/AUD looks to sustain a higher trading range through mid-2019.**
- **The AUD is still seen to be a 0.70-75 currency for the most part through 2019; NZD 0.67-0.70 and NZD/AUD 0.93-0.98.**

In our early October FX forecast update, we had the AUD falling back to 0.71 and NZD to 0.65 by year end, on the premise that the US would press ahead with lifting the tariff rate on $200bn worth of Chinese imports to 25% from Jan 1st and confirm it was extending tariffs early in 2019 to the whole gamut of Chinese imports.

The 90-day moratorium on further tariff action, following earlier market optimism that the December 1st Trump-Xi meeting would yield some sort of agreement, has offered support to both AUD and NZD and those prior year-end targets now look too pessimistic. However, recent gains may not prove durable; gains for AUD have already been undermined by domestic economic developments. By contrast, the NZD has been supported by a better flow of data, including the surprise plunge in the unemployment rate to 3.9%.

Certainly the US is not going to settle its differences with China in the next 90 days. These span geopolitical, technological and military considerations, not just economic and – to President Trump's chagrin – the China-US bilateral trade balance. In any event, China may yet seek to endorse a modestly weaker CNY next year, either as a foil to further tariff actions by the US, that may yet transpire, or as a by-product of divergent monetary policy trends as China takes further action to shore up growth, adding to capital outflow pressures. We have seen this year that a weaker CNY can easily spill over to weaker AUD and NZD exchange rates.

We do though expect that as 2019 wears on, the Sino-US trade issue will become less of a currency driver relative to economic fundamentals, and in particular the influence of relative G10 monetary policy considerations on the broad US dollar trend (plus, doubtless, some currently 'unknown unknowns').

As ever, a key to AUD and NZD performance will be the behaviour of the big dollar (USD). We are sympathetic to the view that a peak – or at least an extended pause - to the current 'gradual' Fed tightening cycle can occur at lower levels than implied by the current Fed median 'dot plot'. Yet the market has taken a lot out of the US curve in recent weeks and the USD has proved quite resilient. The USD still stands as the victor in any 'least ugly duckling' contest. That said, if during the first half of 2019 market confidence increases that the Fed is close to completing its tightening cycle then the USD stands to lose some cyclical support.

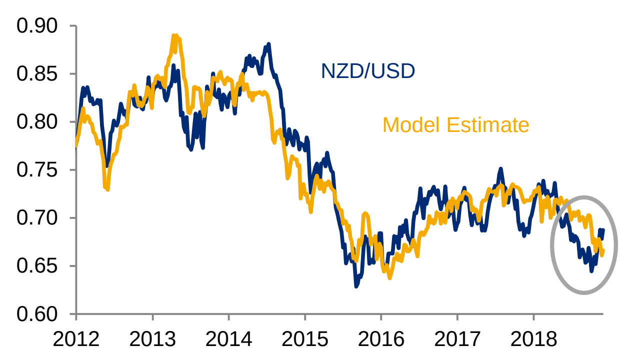
We also assume that secular forces, in particular a drag from rising 'twin deficits' will return to exert a negative influence at some point, bearing in mind too that the USD looks significantly overvalued on longer term metrics (e.g. as much as 15% on a PPP-basis on average against the major currencies). While near-term downside risk for the NZD and AUD lie to the downside in our view, our forecasts assume a weakening USD starts providing meaningful support to AUD and NZD in 2019, but likely not before H2.

NZD and AUD projections

	NZD/USD	NZD/AUD	AUD/USD
Current	*0.69*	*0.95*	*0.72*
Mar-19	0.68	0.96	0.71
Jun-19	0.67	0.96	0.70
Sep-19	0.69	0.94	0.73
Dec-19	0.70	0.93	0.75
Mar-20	0.70	0.92	0.76
Jun-20	0.71	0.92	0.77
Sep-20	0.72	0.92	0.78
Dec-20	0.73	0.92	0.79
Mar-21	0.72	0.92	0.78
Source: BNZ			

After a strong run through November, the current NZD spot rate sits above our short-term fair value estimate, which has settled into a 0.66-0.67 range over the past few weeks. The model estimate has been driven weaker recently by lower risk appetite and weaker NZ commodity prices. With risk appetite only slightly below neutral, there is still scope for this variable to be a downward influence on the model and the NZD. On the other hand, a sense that dairy prices might be bottoming out after a poor run over the previous six months gives some hope that NZ's commodity price index might find some support. Lower NZ-US short term interest rates remain a headwind for the NZD.

NZD Slightly Overbought



Source: BNZ, Bloomberg

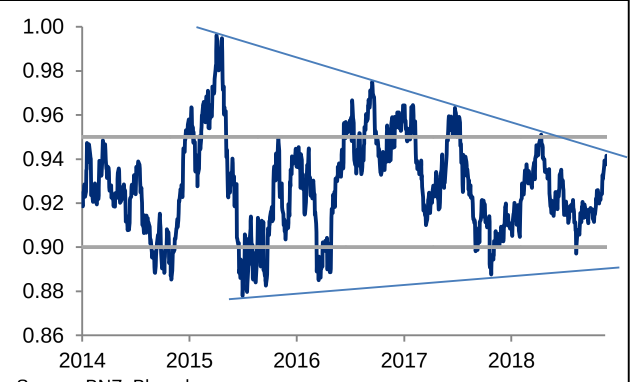
Our forecasts for the next 3-6 months are pitched around a central forecast of 0.67-0.68 for the NZD. This suggests that any run towards 0.70 or slightly higher is likely to be met with some resistance, while also allows for the chance of a return to 0.65 if the US-China trade war turns nasty again.

NZD/AUD to sustain a higher range through mid-2019

The NZD/AUD cross rate has spent much of the past five years in a 0.90-0.95 range. Our view through all of 2018 has been that the range remains relevant – predicated on the theme of "more similarities than differences" when comparing the NZ and Australian economies. While the cross has been range-bound, big swings have occurred previously when economic differences between the two countries have been greater. At present, there are still a lot of economic similarities between the two countries, but there are also some differences which we will point out.

Technically the cross is looking interesting, with the spot rate near the top of its trading range and having already taken out April's intra-day high to touch a fresh year-to date high of 0.9546 earlier today.

NZD/AUD Now Technically Interesting

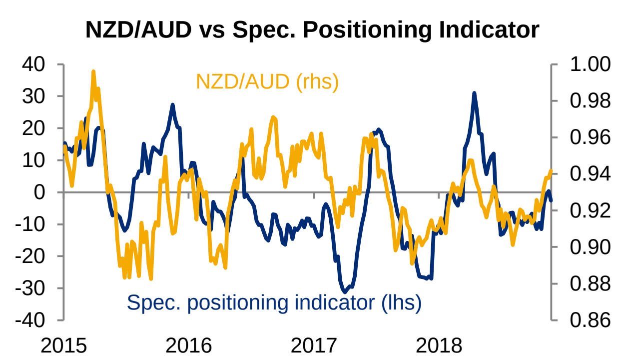


Source: BNZ, Bloomberg

From a fundamental perspective, we can see why the cross is trading so high. There is a lot of focus on Australia's very weak housing market as prices fall deeper into negative territory; economic momentum is softening relative to NZ; plunging oil prices are negative for Australia's terms of trade whilst positive for NZ's; underlying inflation is not moving closer to the RBA's target unlike NZ; and Australia faces some political uncertainty and a likely change of government next year.

A closing of short speculative NZD/AUD positions is also seen behind positive NZD/AUD momentum. Our speculative positioning indicator – based on scaling the weekly CFTC data – shows that short NZD/AUD positions have been closed over the past few months and the indicator is now near neutral.

Spec. Positioning Now Neutral on the Cross



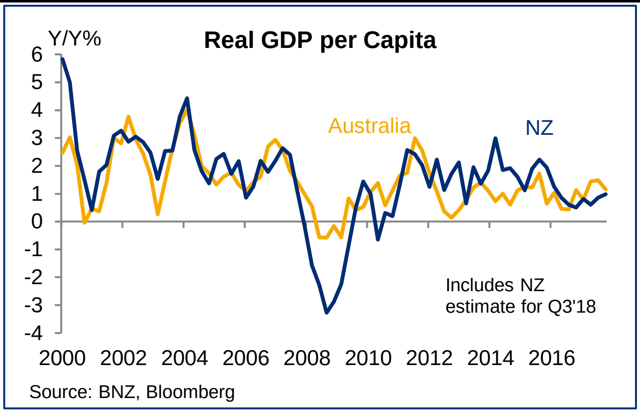
Source: BNZ, Bloomberg

Our usual call when the cross is near the top of the range would be to take the opportunity to sell the cross – importers take cover and exporters lighten up on exposure. But given the fundamental outlook, we think that the NZD can spend some time near the top of the range. Our updated forecasts have 0.95-0.96 being the new mid-point of a trading range that might well now be 0.93-0.98 through to the middle of next year.

We'd be hesitant to get more aggressive than that given the predominance of economic similarities, but we think that the differences are relevant enough to sustain a slightly stronger trading range for the cross.

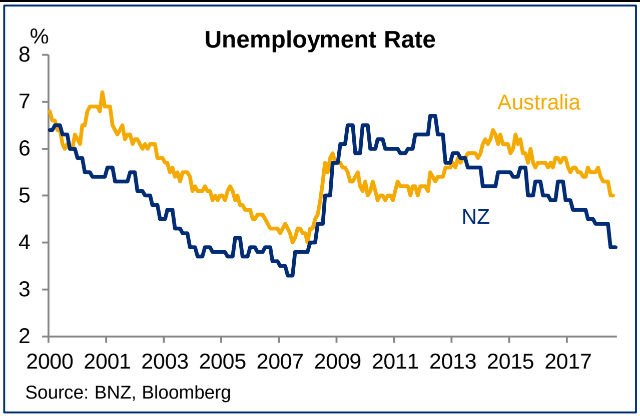
Looking at the similarities, the NZ and Australian economic cycles remain broadly in sync. The Australian economy outperformed NZ earlier in the year but that dynamic appears to have switched over in the second half. Easier NZ fiscal policy from 1 July is one factor that supports this view.

Economic Cycles Broadly in Sync

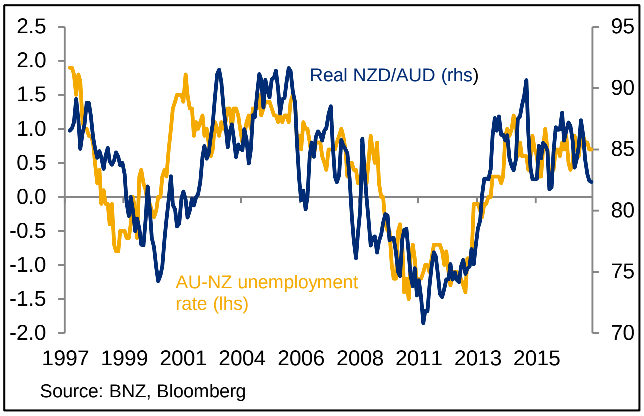


Over the past five years, NZ and Australia's unemployment rates have been falling at roughly similar paces. The gap in unemployment rates is our favourite indicator to explain any major cyclical differences in the two economies that might be associated with pressure on the exchange rate. The trading range for the past five years is well explained by the lack of variation in the difference between NZ and Australia's unemployment rate over that time.

Unemployment Rates Currently Falling at a Similar Pace

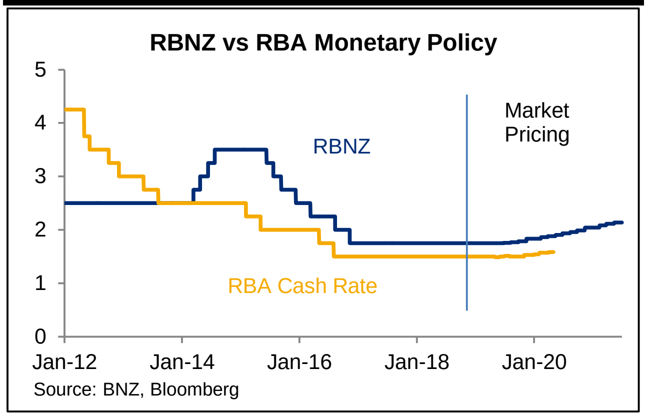


Unemployment Rate Gap Can Explain NZD/AUD Cycle

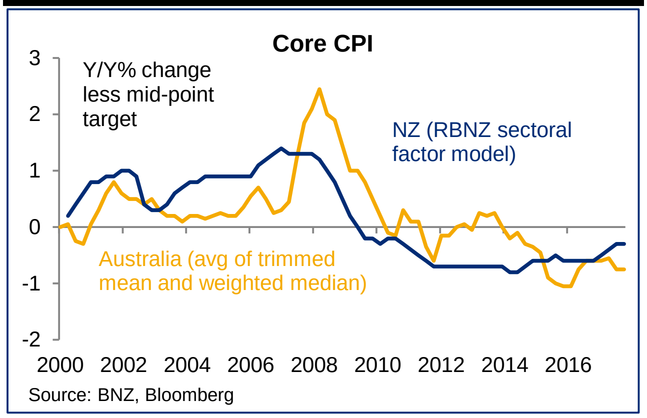


The similar economic performance and outlook is also reflected in market expectations for RBA and RBNZ monetary policy. The market expects both central banks to keep policy on hold for some time yet, with a slight bias towards higher rates through 2020. It's far too early to quibble about which central bank might raise rates first, but looking at core CPI inflation rates versus targets, NZ is closer than Australia. On that basis, one might believe the RBNZ will lift rates before the RBA.

Similar Monetary Policy Outlooks



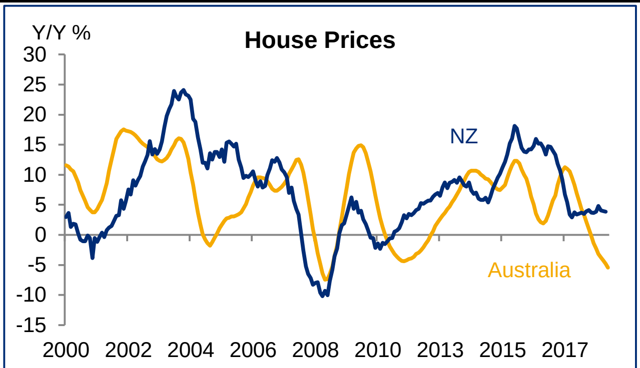
RBNZ Closer to Meeting Inflation Target Than RBA



A clear difference between NZ and Australia at the moment is with the housing market. On Corelogic figures for Australia, house prices across the state capitals are down 5½% yoy, with larger falls for Sydney and Melbourne. On REINZ data, house prices are holding up, running around 4% pa.

The weak Australian housing market can be explained by tighter lending standards given increased regulatory oversight, the withdrawal of foreign money, and higher mortgage rates independent of cash rate changes. NZ's housing market hasn't been buffeted by the tightening of credit supply seen in Australia, it has also been less impacted by foreign money and mortgage rates recently fell to historical lows. We see the Australian housing market continuing to underperform, potentially spilling over into consumer spending and holding the RBA back from tightening policy. Another easing in the RBNZ's LVR restrictions from 1 January is positive for the NZ housing market at the margin.

Australia Going Through a Bigger Housing Downturn

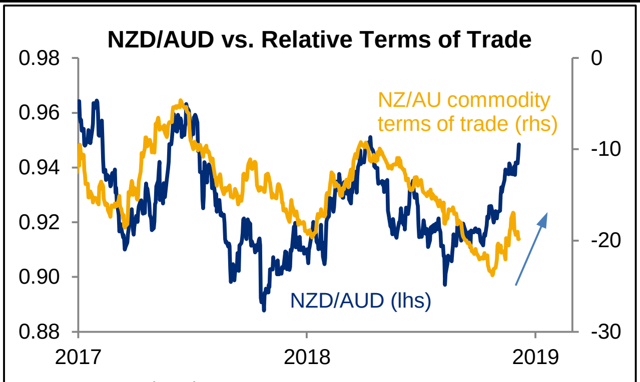


Source: BNZ, Bloomberg

NZ's commodity terms of trade relative to Australia have recently improved, given the big fall in oil prices – a positive factor for NZ and a negative factor for Australia (with LNG contracts linked to the price of oil). It is difficult to see much prospect for a recovery in oil prices, amid the over-supply conditions that are likely to linger, even with OPEC production cuts in the offing.

Much weaker dairy prices over the past six months have driven NZ's commodity terms of trade lower, but dairy prices might well have bottomed. There were widespread increases in prices in this week's GDT dairy auction, the first positive auction this season. Momentum currently favours further improvement in NZ's terms of trade relative to Australia.

NZ's Terms of Trade Improving Vs Australia



Source: BNZ, Bloomberg

Finally, a key difference as we head into 2019 will be a focus on Australian politics, with a Federal election likely in May. Polls point to a change to a Labour government, and that will result in some uncertainty about the direction of economic policy. NZ's election result a year ago shocked the market and resulted in a few months of significant NZD weakness against our fair value estimates. We wouldn't expect to see a similar impact on the AUD, as a change of government wouldn't be a surprise, but the market might still take a cautious view on the AUD around the time.

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