NZD: The upswing begins?

• The NZD has broken up through the top of its 3-month trading range. We reiterate our positive NZD story, centred around an improving global backdrop and stronger NZ terms of trade. Recent positive NZ data, greater conviction that NZ rates have troughed and prospect for a “significant” fiscal easing are more recent additional supporting factors.

• Given lingering uncertainties, our NZD projections remain conservative, and we’d want to see some clarity on the US-China trade deal before considering any upgrade. Our current projections over coming quarters are centred about 0.65, before heading higher further into the future, consistent with a new higher 0.63-0.67 trading range developing.

Six weeks ago we became more positive on the NZD and questioned whether a sustained recovery was imminent (see “NZD: The makings of a recovery?”, 22 October 2019). We’ve been patient, and last night the NZD broke higher, out of the 0.62-0.6450 trading range evident since early August. Is this the beginning of the awaited upswing?

Over recent weeks, there has been some evident NZD strength under the surface, with the currency making fresh multi-month highs on the key crosses against the AUD, CAD, EUR and JPY.

The missing link has been enough USD weakness, but last night’s weaker than expected US ISM manufacturing data did the damage, helping NZD/USD break up through 0.65. This data point could be significant to the extent that it goes against the grain of more positive PMI data elsewhere. In contrast to the weak US ISM figure, the global manufacturing PMI rose for the fourth consecutive month to a seven-month high.

It is widely acknowledged that the USD is richly priced. For some time, our PPP models have shown the USD to be over-valued on a long-term basis against every single major currency we monitor. Short-term support for the greenback has come via a view that the US economy has been, and will continue to, outperform other major economies. Alongside higher relative US interest rates, the USD has looked rock-solid all year. More data like the weaker ISM indicator showing the US economy losing its relative advantage could set the USD on a much weaker path.
A strong USD has held back performance of the NZD. A corollary is that the strong USD has been a negative force for emerging market economies and their currencies. Even against a backdrop of improving NZD fundamentals, the NZD’s strong link with emerging market currencies – particularly since the US-China trade war began early last year – has been a restraining force. If the USD falls materialy from here, that would act like an easing in global financial conditions, supporting global growth, emerging market and commodity currencies.

Our more constructive view of the NZD six weeks ago was based on a few positive factors that had emerged, including reduced risk of a no-deal Brexit, the de-escalation of the US-China trade war, the more positive US yield curve, higher risk appetite, supportive NZ commodity prices and less conviction in RBNZ rate cuts. All these factors remain valid and, if anything, more positive NZD forces have emerged.

The thesis for a stronger NZD can be outlined as follows:

- The global economic backdrop is more supportive. The NZD can be viewed as a play on the global economic cycle and sign of an upturn in the global manufacturing cycle bodes well for some improved global growth momentum.
- NZ’s terms of trade are improving. These are already close to a record high (dating back 150 years) and export price momentum remains strong. The CBA NZ export commodity price index has risen for nine consecutive weeks, measured in world price (SDR) terms and is up over 8% since the end of August. The chart (right) shows how NZD performance has lagged over recent years against Citi’s NZ-US relative terms of trade index.
- NZ economic data have improved recently. The PMI and PSI no longer point to downside risk to GDP growth and are now more consistent with our view of real GDP growth closer to 2%. The ANZ survey showed business confidence and the key own-activity indicator rising to their highest level this year in November.
- Easier fiscal policy will help support the NZ economy. Last weekend, Finance Minister Robertson signalled a “significant” fiscal stimulus package, focused on infrastructure.
- Following the November Monetary Policy Statement, our RBNZ OCR projections are now consistent with a period of unchanged NZ monetary policy, suggesting that NZ rates have troughed. Low NZ rates remain a headwind for the NZD, but at least NZ-US rate spreads have stabilised.
- As mentioned earlier, the USD could be on a weaker path in the period ahead if the view gains traction that the US economy will no longer outperform from here.
Apart from the evident economic forces that are NZD-supportive, our short-term fair value model suggests that the NZD is very cheap – largely because the NZD has been insensitive to the improvement in risk appetite and NZ commodity prices. At the end of last week, fair value broke up through 0.70, although after last night’s risk-off session it has slipped back just below that big figure. In the context of the 15-year estimation period, the gap between spot and fair value is extreme.

CFTC data continue to point to significant speculative net short positioning, which could exaggerate any upside move if the rally in the NZD gains some momentum.

We’d be remiss not to offer the counter arguments to a stronger NZD. These would be centred on the apparent improvement in global growth momentum to be an illusion, or at least short-lived or not meaningful. The outcome of US-China trade negotiations could be crucial here. The next ramp-up in Chinese import tariffs imposed by the US is due to occur 15-December. If they are implemented, it would be a blow to the global economic recovery story. We remain hopeful that, at worst, the decision to impose additional punitive tariffs will be postponed whilst trade negotiations remain ongoing.

Whilst President Trump has repeatedly said that the trade deal is close, more recently “very close”, the lack of progress through November looks somewhat concerning. If the uncertainty of the trade war overhangs the US and China’s economy for months to come, then that would act as a restraining force on any incipient global recovery.

There’s always the chance we’re ringing the bell too early on the USD as well. A weak data print here or there doesn’t necessarily spell its demise. It’ll take a series of data releases to confirm just how soft the US economy might be relative to elsewhere. In the meantime, the USD enjoys support from relative interest rate support.

Given lingering uncertainties, our NZD projections remain conservative, and we’d want to see some clarity on the US-China trade deal before considering any upgrade. Our current projections over coming quarters are centred about 0.65, before heading higher further into the future, consistent with a new higher 0.63-0.67 trading range developing.

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