29 November 2017

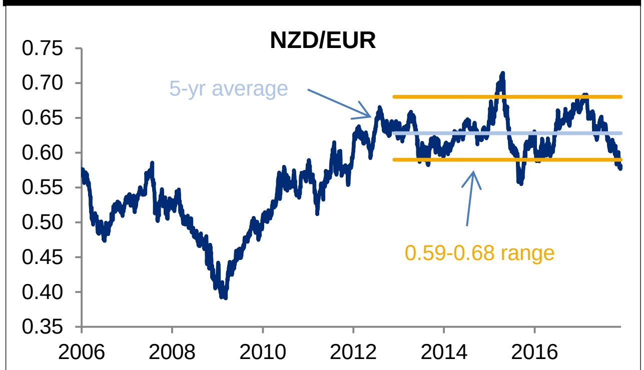
NZD/EUR: Downward trend intact

- **NZD/EUR has spent much of 2017 on a downward path and is currently down 12% year-to-date. But this move was from a very high level and the cross remains some 6% above our long-term purchasing power parity model estimate.**
- **The strong economic fundamental forces that have been in play over recent years and supported a rich NZD/EUR cross rate have been gradually unwinding. The ECB's gradual move away from quantitative easing and expectations of an eventual removal of the negative deposit rate, are likely to drive EUR higher and be the key factors supporting further weakness in the cross.**
- **The model we introduced earlier this year still shows fair value heading steadily lower to EUR 0.54 when the ECB's (shadow) policy rate reaches zero. The NZD/EUR downward trend still looks intact until we reach that sort of level. It would be prudent for corporates to take advantage of any short-term rallies to hedge positions in anticipation of further downside potential.**

Breaching the 5-year range

The NZD/EUR exchange rate has spent most of the last five years trading in a range of EUR 0.59-0.68. Since the end of February the cross rate has depreciated by 15% to take it just below the bottom of that broad range. The 5-year low (excluding the NZD flash crash in August 2015) of 0.5550 is the next level of technical support. A key question now is whether the fall in NZD/EUR has done its dash and the familiar range will be soon back in play, or whether the cross heads even lower.

NZD Near the Bottom of its 5-year Range

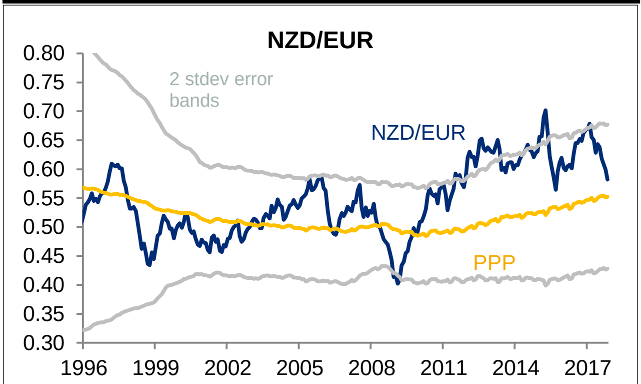


Source: BNZ, Bloomberg

Cross rate still richly priced on a long-term model

From a long-term perspective, the cross rate remains richly priced. NZD/EUR has been consistently above our rolling long-term purchasing power parity estimates for the past eight years. Our current PPP estimate is EUR 0.55.

NZD/EUR Still Trading Above Long-term Fair value

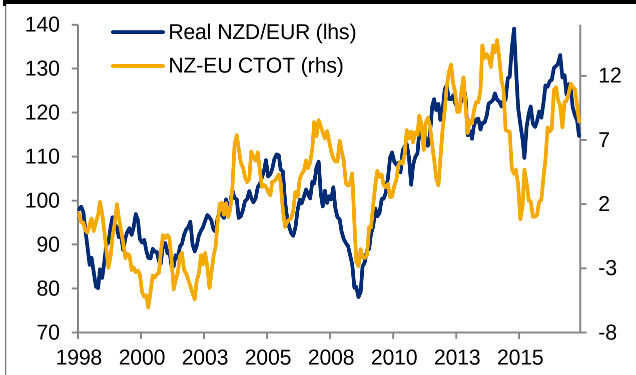


Source: BNZ

Strong relative terms of trade

NZ's strong relative terms of trade goes a long way in explaining why the cross rate has been relatively strong over the past eight years. The fall in NZD/EUR this year has been against a backdrop of more stable relative terms of trade using Citigroup's commodity terms of trade indices. Over the past few months, NZ's commodity terms of trade have slipped a little against the euro area.

Real Exchange Rate Has Tracked Relative Terms of Trade

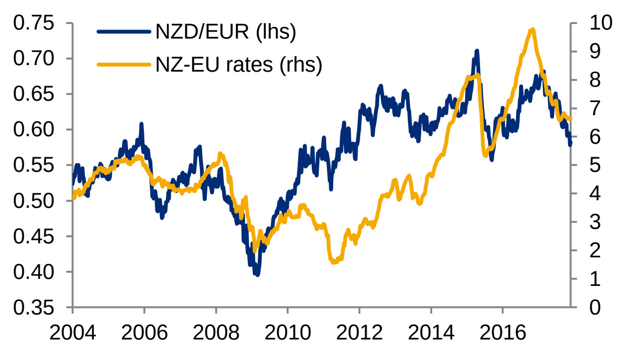


Source: BNZ, Bloomberg

NZ-euro area interest rates differentials narrowing

Since towards the end of last year, NZ-euro area interest rate differentials have been closing. We looked at spreads at both the short end (NZ 1-yr swap less Krippner's euro area shadow short rate) and mid curve (5-year swap rates) and the same conclusion can be reached. Declining rate spreads go a long way in explaining the weaker NZD/EUR exchange rate this year.

Interest Rate Gap Closing



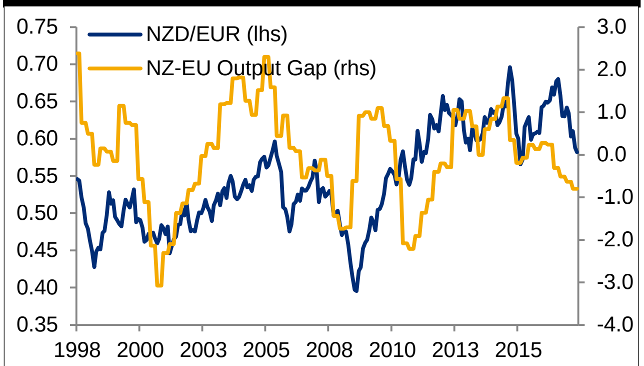
Source: BNZ, Bloomberg

Euro-area economy running hot compared to potential

The declining interest rate spread can be explained by relative economic performance. Real economic indicators suggest that the euro area economy is booming, as evidenced by the suite of PMI indicators and a record level reached by Germany's IFO business climate index. Meanwhile, NZ economic growth has been solid, but unspectacular.

We looked at relative output gaps, calculated by simple HP-filters on real GDP series. NZ's output gap relative to the euro-area has been falling and can explain a weaker NZD/EUR exchange rate. It suggests that the euro-area economy has been running stronger relative to potential growth compared to the NZ economy. Ultimately that means higher euro-area rates compared to NZ.

Euro-are Economy Heating Up Compared to NZ



Source: BNZ, Bloomberg

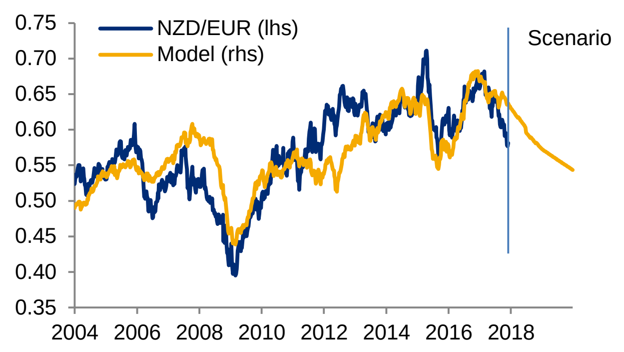
Meanwhile, the ECB is (arguably mistakenly) fixated on achieving its 2% inflation target which means that it continues to expand its balance sheet. Its purchase of euro-area bonds will halve from 1 January to €30bn a month but it has outlined a plan to continue buying euro-area bonds right through to at least September 2018 to keep interest rates suppressed. In a free market, euro-area interest rates would be a lot higher than they are currently. The market is not stupid. By suppressing rates, we see the ECB as simply putting more upward pressure on the euro. The euro is moving up well in advance of higher interest rates, as the currency does the heavy lifting to act as an automatic stabiliser for the economy.

In our last major note on NZD/EUR in April we introduced a model that explained the cross rate using risk appetite, NZ commodity prices and relative NZ-euro area short rates. At the time NZD/EUR was at 0.65 and we illustrated a scenario where the cross could head lower to EUR 0.54 simply on the basis that the ECB deposit rate heads from a modestly negative level to zero (on Krippner's shadow short rate model, the effective policy rate heads from minus 4½% to zero).

That scenario is playing out before our eyes. We update the model and illustrate what the future holds making some appropriate assumptions. The model still says that the EUR 0.54 level becomes fair value if the ECB takes its (shadow) policy rate to 0% and risk appetite heads down to a more normal level of 50% over the next year or two. Clearly, the model estimate would even be lower if we assumed a more normal policy rate for the euro-area.

The cross rate is moving down towards the 0.54 level faster than implied by the model, as the market anticipates the ECB's likely policy moves well ahead of time.

NZD/EUR Model Estimates Still Tracking Lower



Source: BNZ, Bloomberg

The bottom line is that on a 6-month to 24-month view, we see further downside potential for the NZD/EUR exchange rate. Fundamental forces can easily explain a move down towards the mid-0.50s and currencies are apt to overshoot, both on the upside and downside. Over that timeframe, we wouldn't be surprised to see the 2015 level of 0.5550 broken and sustained for a while. Strong euro-area growth, fuelled by over-stimulatory monetary policy and a central bank happy to allow those conditions to be sustained, are the key factors for our still-bullish EUR outlook.

It would be prudent for corporates to take advantage of any short-term rallies to hedge positions in anticipation of further downside potential. Given the short-term unpredictability of exchange rates, one wouldn't rule out a return to a EUR 0.60 handle, but as time passes the pressure is expected to revert towards the downside.

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

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