Trade wars and big rate cut drag down NZD

- In August the NZD underperformed, alongside the yuan, as the US-China trade war escalated
- Global and NZ rates fell to fresh record lows

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<th>NZD/USD over August 2019</th>
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The overarching theme for August was the escalation in the US-China trade war after early in the month President Trump planned further punitive import tariffs. Further escalation later in the month reinforced weaker risk appetite. Global equity markets showed solid falls while global rates plunged to fresh record lows in many cases. Commodities fell and commodity currencies underperformed, alongside a weaker CNY.

The month got off to a bad start with President Trump tweeting his plan for punitive 10% tariffs on the remaining $300bn of Chinese imports from 1 September. This followed a week of trade talks that made no progress and the Fed cutting its policy rate by 25bps at the end of July (1 August, NZ time). While Trump ended up delaying the new tariff impost on at least half of the goods until 1 December, later in the month China retaliated with its own package of increased tariff rates on certain goods, including oil, soybeans and autos. Trump then upped the ante again, raising tariff rates further and threatened to use emergency powers to stop US companies dealing with China.

After the first tariff announcement, the market pushed USD/CNY up through the symbolically important 7.00 level and the PBoC didn’t make an attempt to push it back down below 7. This sent an important signal to the market that a sustained move above 7 would now be tolerated to counteract the impact of the tariffs. Throughout the month the PBoC attempted to set a stronger USD/CNY reference rate (ie at a lower level) using its “counter-cyclical” adjustment factor in an attempt to control the rate of depreciation of the yuan and reduce speculative behaviour. The US Treasury designated China as a “currency manipulator”, no doubt at the behest of Trump, even though the PBoC’s actions over recent years, if anything, have been keeping the yuan artificially strong.

USD/CNY still drifted higher through the month, with the market apt to sell yuan on the back of deteriorating China growth prospects. USD/CNY rose 3.9% for the month, the most significant monthly yuan depreciation since 1994. Ongoing protests in Hong Kong and increasingly violent clashes between protesters and police didn’t help sentiment, with the risk of Chinese military intervention unsettling markets.

The escalation of the trade war came as a shock to the market, which hitherto had expected a ceasefire to remain in place over the foreseeable future. Any hope for a global economy recovery was well and truly quashed, with the heightened trade war seen to put more downward pressure on global growth. Global equites ended the month down 2% but a more violent reaction was seen in global bond markets.

All roads led to expectations of central banks offering more stimulus. Fed Funds rate pricing pushed below 1% for the end of next year and into 2021 and this fed through the entire yield curve. The 2-year Treasury rate ended the month down 37bps to 1.50% and the 10-year rate fell by 52bps to 1.50%. The 2s10s yield curve went negative for the
first time this cycle, an early warning signal of a possible forthcoming economic recession. While the 10-year rate didn’t fall below its historical low of 1.32% in mid-2016, the 30-year rate made a record low of 1.90%.

European bond yields plumbed new depths in negative territory, with Germany’s 10-year Bund down 26bps to minus 0.70%. The amount of global bonds trading in negative territory (mainly in Japan and continental Europe) rose up through the USD17 trillion mark.

The escalation of the trade war and degradation of global growth prospects spooked the RBNZ into delivering a shock 50bps easing in the OCR to 1.0% compared to widely held expectations of 25bps. The Bank maintained an easing bias and Governor Orr said that the bank was looking at the “full suite” of unorthodox measures if needed and that it was easily within the realms of possibility that “we may have to use negative interest rates in the future”. However, he added that cutting rates more now decreases the chance of needing unconventional policy measures.

By month-end the OIS market was pricing in a terminal OCR rate of just over 0.50%. The global backdrop and larger rate cut supported a hefty fall in rates across the yield curve, with record lows reached. The 2-year swap rate finished the month down 33bps to 0.91%, while 10-year swap fell 45bps to 1.20%. NZ’s 10-year government rate traded below 1.0% and ended the month down 39bps to 1.07%.

While the shock-size of the rate cut was intended to boost confidence and promote business investment and spending, it had the opposite effect. Our anecdotal evidence from a range of businesses was that confidence had been dented by the rate cut and the ANZ business outlook survey showed the weakest business confidence since the GFC, with many activity indicators falling commensurately.

The NZD was one of the weakest of the major currencies, reflecting its tight relationship with the CNV since the trade war began early last year. The weaker outlook for global growth pushed most industrial and agricultural prices lower and commodity currencies underperformed. The 50bps rate cut added to downside pressure for the NZD. NZD/USD fell by 3.8% to 0.6310 since the GFC, with many activity indicators falling

CHF and JPY outperformed, reflecting their preeminent status as safe-haven currencies during times of market turmoil and angst. This saw NZD/JPY down about 6% for the month, probing levels not seen since 2012.

USD indices ended the month on a strong note, with the DXY index breaking 99 and making a 15-month high. EUR broke down through 1.10. With soggy euro area activity data, core inflation below 1.0%, expectations of further ECB easing and further Italian political drama all undermining the currency.
GBP held up surprisingly well considering heightened uncertainty as the Brexit date of 31 October approaches. Boris Johnson played a hand of political brinksmanship, seeking the Queen’s permission to suspend Parliament for almost five weeks in the run-up to 31 October, reducing the chance of any legislation to prevent a no-deal Brexit.

The RBA left policy unchanged after two back-to-back rate cuts but maintained an easing bias. Governor Lowe said that “it is reasonable to expect that an extended period of low interest rates will be required”.

AUD was weaker, along side the yuan, but outperformed the NZD, after the RBNZ’s surprisingly large easing.

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