

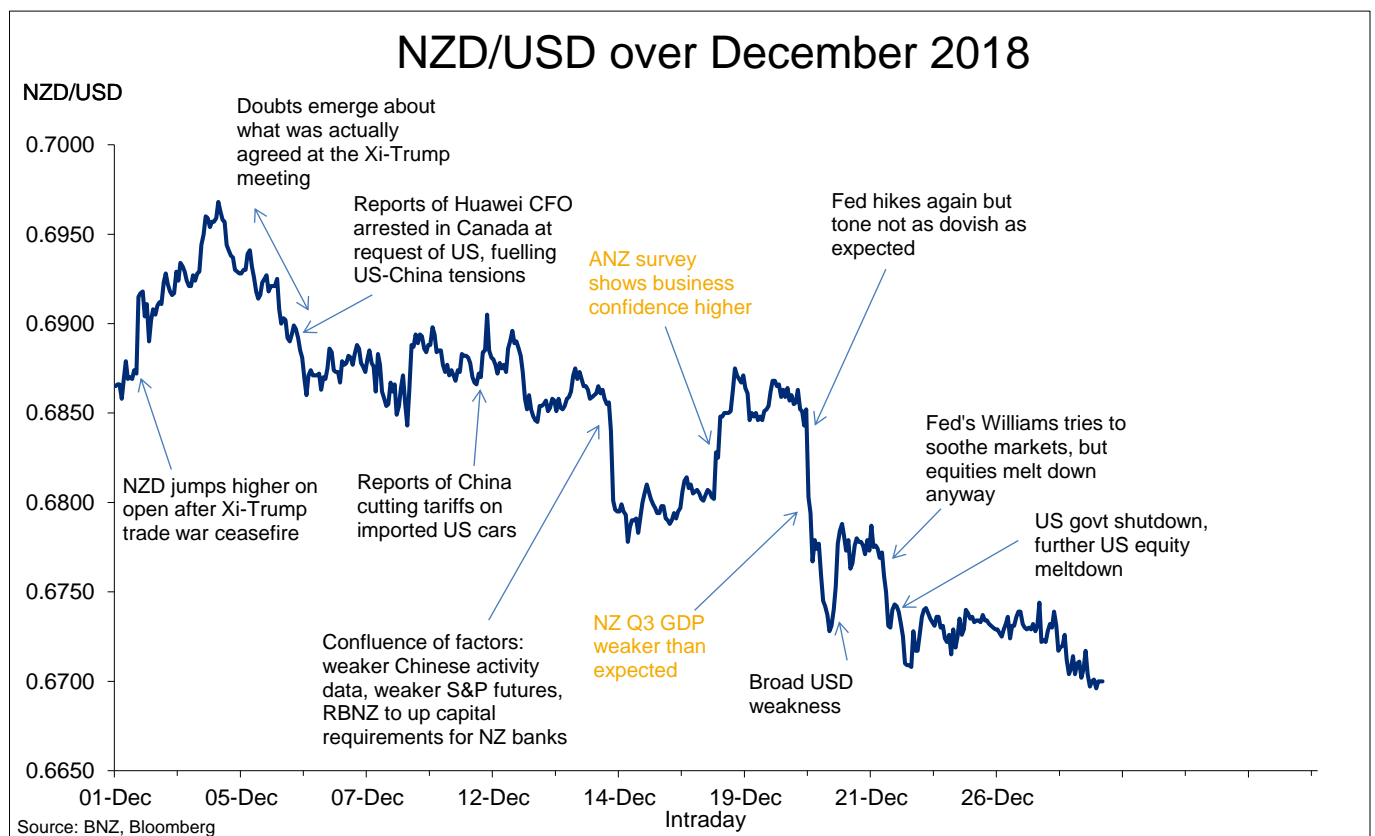
RESEARCH FINANCIAL MARKETS WRAP

28 December 2018



Plunge in risk appetite drags NZD lower in December

- Global equities plunge; Risk appetite index down to a multi-year low
- NZD underperforms alongside other commodity currencies and risk assets
- NZ rates down to multi-year lows



Quick Outlook		December ranges
NZD/USD	Our projections for the next 6-months are anchored around 0.67-0.68, which in practice means a trading range within 0.65-0.70. Lower edge of the range would be more at threat if volatility continues, but gut feel says January will be better.	0.6695 – 0.6970
NZD/AUD	We expect the higher trading range that emerged in December to be sustained. NZ has a slight edge over Australia on economic fundamental drivers at present.	0.9370 – 0.9585
NZD/GBP	Our base case takes a constructive view on Brexit, meaning significant downside risk for the cross as GBP recovers. Still a few hurdles to navigate over the next few months though.	0.5280 – 0.5515
NZD/EUR	A constructive view on Brexit and GBP makes us optimistic on EUR due to spillover effects, which should see a lower cross if we're right.	0.5850 – 0.6120
NZD/JPY	Sensitive to risk appetite, as we saw during December. A flat to positive bias in January if the New Year begins on a more positive note for equity markets.	74.0 – 78.9
90-day BB	Flat, with little chance of monetary policy adjustment over coming months.	1.96% - 2.00%

(Figures in this report finalised around noon NZ time, 28 Dec.)

Commodity currencies like the NZD underperformed in December as risk appetite plunged and many global equity indices entered bear market territory.

The month got off to a positive start after a ceasefire in the trade war was agreed between Presidents Trump and Xi. Trump said that the US would not proceed with the planned increase in tariffs from 10% to 25% from 1 January. In return, China agreed to purchase a “very substantial” amount of agriculture, energy, industrial and other products from the US. The Presidents agreed to begin negotiations on “structural changes with respect to forced technology transfer, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft, services and agriculture”. If no agreement is reached after 90 days, then the previously proposed increase in tariffs would proceed.

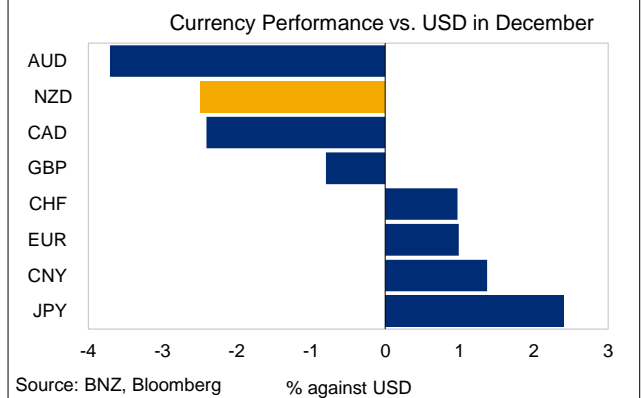
This news saw the NZD climb early in the month to reach a high of 0.6970. However, from that point the NZD trended lower, coinciding with a big fall in risk appetite, with our index falling from 51% early in the month down to as low as 26%, a level not seen in nearly three-years.

A combination of factors appeared to be in play, driving some key equity market indices into bear market territory, defined as a 20% fall from its previous peak. At one stage the S&P500 was down a massive 15% for the month, before a post-Xmas rally ensued. With a couple of trading sessions for the month remaining, a number of regional equity market indices are nursing big falls for the month, with the NZ and Australian markets escaping much of the damage.

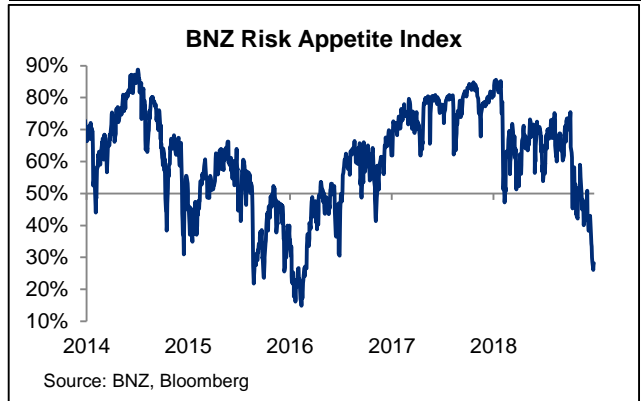
Investors saw a “wall of worry” which included (i) widespread evidence of a slowdown in global growth – with notable weakness in China and across Europe – and hints that this was spilling over into the US economy; (ii) parts of the US yield curve turning negative for the first time since 2007 and its role as a leading indicator of economic recession (iii) nervousness about US-China relations, in light of the arrest of the Huawei Technologies CFO in Canada at the request of the US (iv) the seemingly dysfunctional US government, with more members of the White House leaving and a partial shutdown over disagreement about funding for the US-Mexico border wall and (v) a more hawkish than expected FOMC statement after delivering a ninth rate hike this cycle and concern about Trump’s threat to fire Chair Powell.

The US 2s10s yield gap fell to as low as 10bps at one stage, while the belly of the US yield curve (around 2s5s) turned negative. After raising the Fed Funds by another 25bps to a range of 2.25-2.5%, the FOMC signalled “some” further gradual increases and gave a token nod to the implications of global economic and financial developments. Chair Powell reiterated that the rundown of the Fed’s balance sheet was on auto-pilot, another disappointment for the market. Over the course of the month, the market priced out almost a full hike out of the curve for 2019, while the Fed Funds curve began to price in a chance of a cut in rates from late-2019. The US 10-year Treasury rate trended lower through the month and traded as low as 2.72%, a level not seen since April.

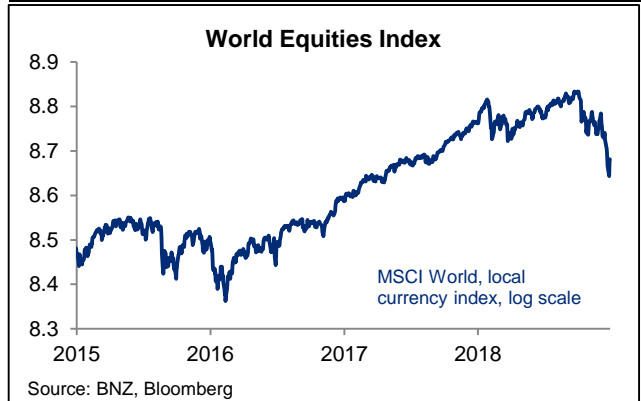
Commodity Currencies Underperform in December



Risk Appetite Plunges to Fresh Lows



Global Equities Under Pressure



US Yield Curve Flattening



The fall in risk sentiment was a key driver of the NZD for much of the month. Domestic drivers were largely absent, although the currency found some support after a rebound in business confidence and fell after softer than expected Q3 GDP data. Although not market-moving, the GDT dairy auctions during the month showed the first positive auction results since the season began 1 June. By contrast, oil prices continued to fall, with Brent Crude slipping below USD50 a barrel just after Xmas, taking its fall since early October to more than 40%. OPEC+ announced that it would cut production by 1.2m barrels per day but pessimism on oil prices reigned as excess supply conditions still looked to prevail.

In other domestic news, the RBNZ released a consultation paper proposing an increase in the amount of "Tier 1" capital that NZ banks need to hold from 8.5% to 16%, planned to take effect by 2020 and phased in over a five year period. The market saw this proposal as increasing the hurdle rate for any OCR hike, given the likely negative economic impact of the policy and the upward pressure on lending rates. Indeed, the market re-entertained the chance of OCR cuts that might be necessary to prevent higher lending rates. Rates were lower across the government and swap curve reflecting this domestic force in addition to downward global forces, with longer term rates falling to multi-year lows.

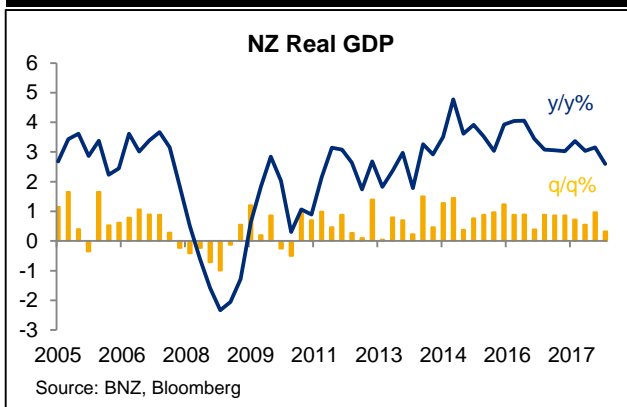
The NZD managed to hold its ground against other major commodity currencies but was lower against the other majors. Sentiment for the AUD was weak, given the global backdrop but also lingering concerns about its weaker housing market. NZD/AUD reached a fresh year-to-date high but met some resistance just under the 0.96 mark.

GBP remained volatile, with uncertainty around Brexit remaining. UK PM May postponed the parliamentary vote on her Brexit deal, admitting that it would be defeated by a "significant margin". A number of permutations remained but there was little appetite for a "no-deal" Brexit and the ECJ ruled that the UK could unilaterally withdraw its Article 50 request to leave the EU. NZD/GBP moved up through 0.55 at one stage, but at the time of writing was back down to around 0.53.

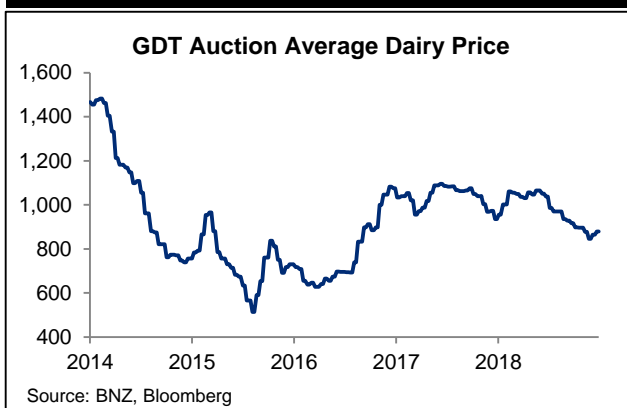
Italy's stand-off against the European Commission over its budget finally ended. The EC decided not to go ahead with sanctions against Italy after the coalition government trimmed some spending plans to reduce its deficit target down to a tad over 2% of GDP. The ECB confirmed that its QE programme would come to an end this month, as planned, while it will continue to reinvest the proceeds of maturing bonds for "an extended period of time" after rate rises commence. The ECB reiterated its forward guidance for the policy rate, saying rates would remain at current levels "at least through the summer of 2019." NZD/EUR went up through 0.61 early in the month but was back below 0.59 towards month-end.

NZD/JPY was down nearly 5% at the time of writing, with the fall in risk appetite the key driver. The US-China trade war ceasefire supported CNY, even as China economic data underwhelmed. US Treasury Secretary Mnuchin told reporters that the US got a "strong commitment" from China to deal with currency devaluation at the Xi-Trump meeting.

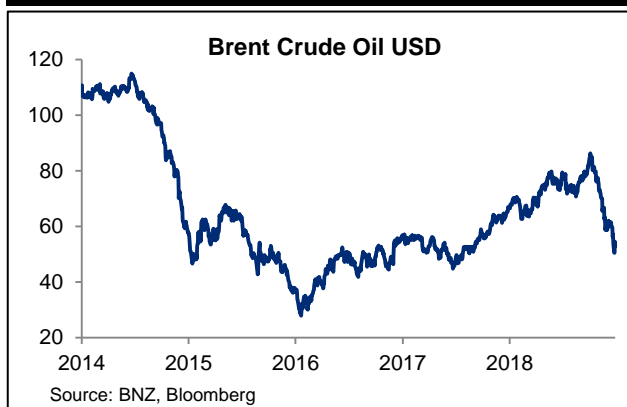
NZ GDP Growth Moderating



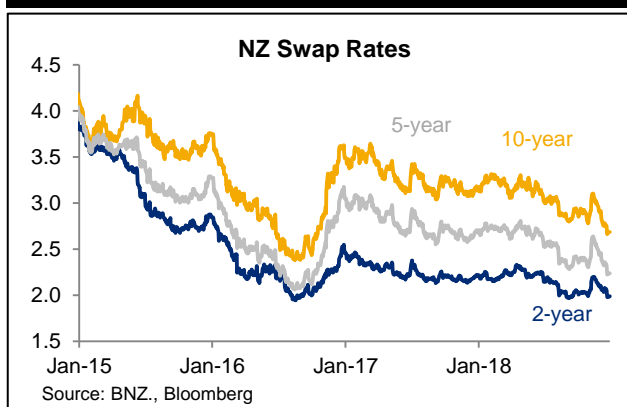
Tentative Signs of Dairy Prices Improving



Oil Prices Slump After Strong Rally



NZ Rates Probe Multi-Year Lows



Figures as at noon NZ time, 28 December:

Monthly Performance Table							
	end-Dec	end-Nov	Change		end-Dec	end-Nov	Change
Currencies				NZ Rates			
NZD/USD	0.6700	0.6872	-2.5%	OCR	1.75	1.75	0.00
NZD/AUD	0.9527	0.9418	1.2%	NZ 90day BB	1.98	1.98	0.00
NZD/EUR	0.5860	0.6078	-3.6%	NZ 2yr sw ap	1.97	2.09	-0.12
NZD/GBP	0.5299	0.5394	-1.8%	NZ 5yr sw ap	2.22	2.44	-0.22
NZD/JPY	74.30	78.02	-4.8%	NZ 10yr sw ap	2.67	2.90	-0.23
NZD/CNY	4.600	4.7865	-3.9%	NZ Govt (4/21)	2.24	2.40	-0.16
TWI	73.5	75.1	-2.2%	NZ Govt (4/23)	1.87	2.01	-0.15
AUD/USD	0.7032	0.7306	-3.8%	NZ Govt (4/27)	2.24	2.40	-0.16
EUR/USD	1.1431	1.1317	1.0%	NZ Govt (4/29)	2.40	2.56	-0.16
GBP/USD	1.2643	1.2749	-0.8%	Global 10 year bond rates			
USD/JPY	110.90	113.57	-2.4%	US	2.77	2.99	-0.22
USD/CNY	6.87	6.96	-1.4%	Canada	1.99	2.27	-0.27
USD/CAD	1.3620	1.3292	2.5%	UK	1.31	1.36	-0.06
USD TWI major	119.76	119.60	0.1%	France	0.69	0.68	0.01
Asia DXY	104.96	104.46	0.5%	Germany	0.23	0.31	-0.09
Equity Markets				Italy	2.75	3.21	-0.47
MSCI AC Wrld, loc.	1,073	1,168	-8.1%	Spain	1.38	1.50	-0.12
MSCI World, loc.	5,890	6,453	-8.7%	Portugal	1.68	1.82	-0.15
MSCI EM, USD	2,123	2,220	-4.4%	Ireland	0.89	0.91	-0.03
US S&P 500	2,489	2,760	-9.8%	Japan	0.02	0.09	-0.07
Euro STOXX 600	329.6	357.5	-7.8%	Australia	2.35	2.59	-0.25
Germany DAX	10,382	11,257	-7.8%	Commodities (USD)			
France CAC 40	4,599	5,004	-8.1%	WTI Crude	44.61	50.93	-12.4%
UK FTSE 100	6,585	6,980	-5.7%	Brent Crude	52.97	58.71	-9.8%
Aust S&P/ASX 200	5,591	5,667	-1.3%	R/B CRB Index	170.5	181.7	-6.2%
Japan Topix	1,502	1,667	-9.9%	Gold spot	1,275	1,221	4.5%
China CSI 300	2,991	3,173	-5.7%	Silver spot	15.23	14.20	7.2%
NZX50	8,773	8,824	-0.6%	Copper	266.8	277.8	-4.0%
Volatility: VIX	29.96	18.07	65.8%	Iron Ore	69.00	64.77	6.5%
3-mth Bill Futures				Coking coal	226.50	216.00	4.9%
NZD Jun-19	98.02	98.01	0.01	Thermal coal	101.55	101.70	-0.1%
AUD Jun-19	98.06	98.06	0.00	Corn	374.5	377.8	-0.9%
USD Jun-19	97.31	97.09	0.22	Wheat	510.5	515.8	-1.0%
EUR Jun-19	100.30	100.30	0.00	NZX Dairy WMP	2,800	2,715	3.1%
GBP Jun-19	99.00	98.97	0.03	NZX Milk Price 2019	NZD 6.07	NZD 6.07	0.0%

Source: BNZ, Bloomberg

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