

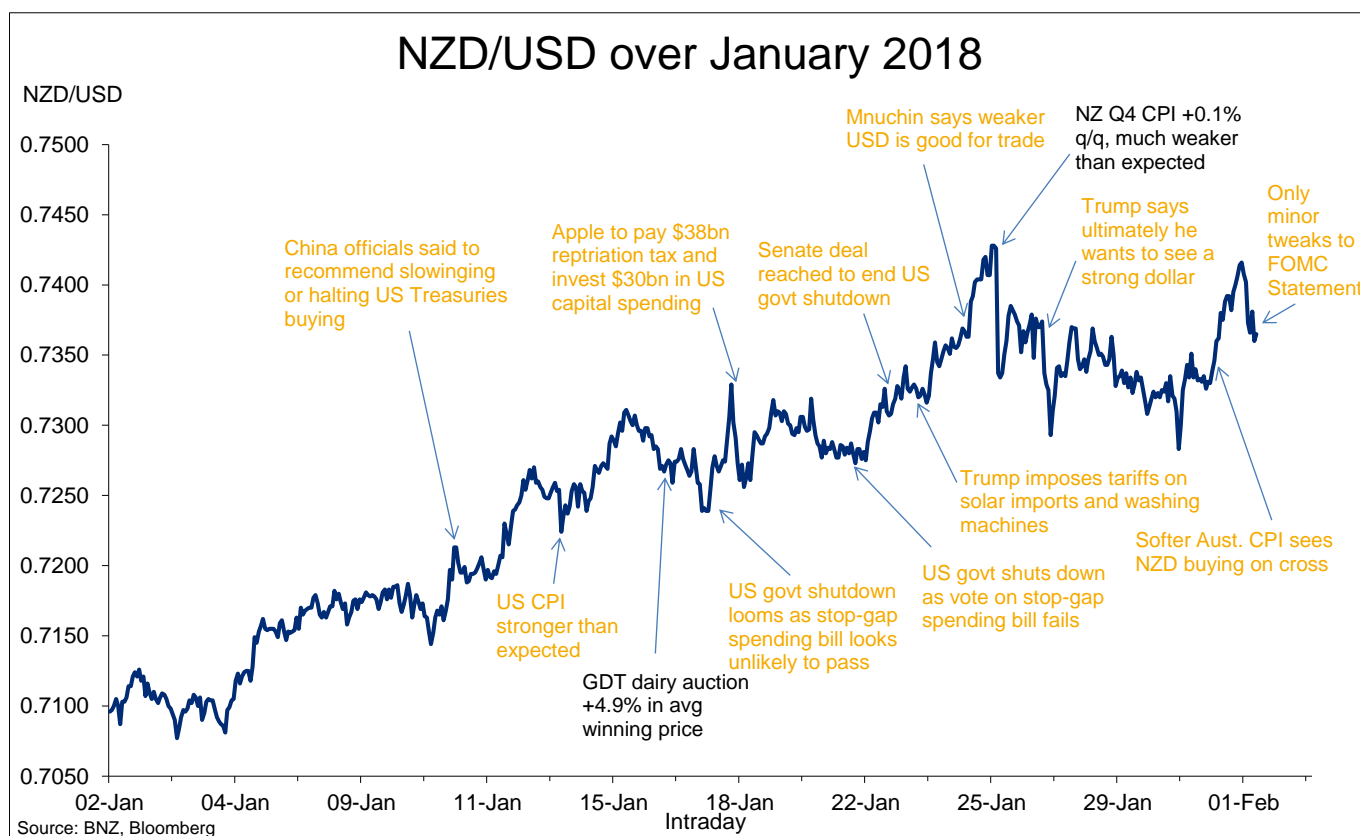
RESEARCH FINANCIAL MARKETS WRAP

1 February 2018



Bearish USD Sentiment Drives NZD Higher

- Another wave of USD weakness sees NZD up almost 4% for the month
- TWI up only 1% or so, reflecting some stability on the crosses
- Solid global economic backdrop supports higher equities and global rates



Quick Outlook		January ranges
NZD/USD	Uncertain short-term outlook. The USD remains the key driver and sentiment is bearish, raising the spectre of fresh highs in the NZD if recent trends continue. But equally, we might be due for a reversal. Fair value close to 0.73.	0.7075 – 0.7440
NZD/AUD	Tightly range bound last couple of months and trading close to fair value so could see more of the same.	0.9030 – 0.9220
NZD/GBP	Could see some choppy trading as Brexit still in the headlines and PM May looking vulnerable. Still expect a transitional deal to be negotiated, which helps GBP and drives a weaker cross.	0.5140 – 0.5370
NZD/EUR	Has consolidated recently, but bigger picture is one of further downside risk ahead, as the strong euro area economy and subtle shifts in ECB policy support EUR.	0.5875 – 0.6050
NZD/JPY	Near the mid-point of the 12-month range, but threat of short-term downside if risk appetite heads lower from recent peaks.	79.20 – 81.55
90-day BB	Flat, with little chance of monetary policy adjustment over coming months.	1.87% - 1.89%

The key theme that pervaded markets in January was a very weak USD, following up on its poor performance through 2017. Key USD indices were down in the order of 3%, and breaking down through key technical levels in the process, opening up the risk of further deep losses.

The recent bout of weakness began mid-December, coinciding with the time when Trump looked to have the numbers to pass a tax reform package. But it wasn't just the concern about higher fiscal deficits and rising government debt that rocked the USD, a number of other factors can be pointed at.

Investors seemed prepared to take a longer-term perspective on forward monetary policy, seeing the US tightening cycle as mature compared to other countries. So despite increasing conviction that the Fed would raise rates by three times this year and US bond rates rising by more than most other countries, higher interest rate spreads couldn't support the USD. Linked to this theme, the broadening of the global economic recovery attracted flows away from USD assets.

The short government shutdown didn't help sentiment for the USD. While the government re-opened, a short-term deal means that we face another possible shutdown in February, while the debt ceiling still needs to be negotiated, with a March deadline approaching. The risk of rising US trade protectionism reared its head, as President Trump imposed tariffs on imported solar panels and washing machines, with steel and aluminium seen to be next in the firing line.

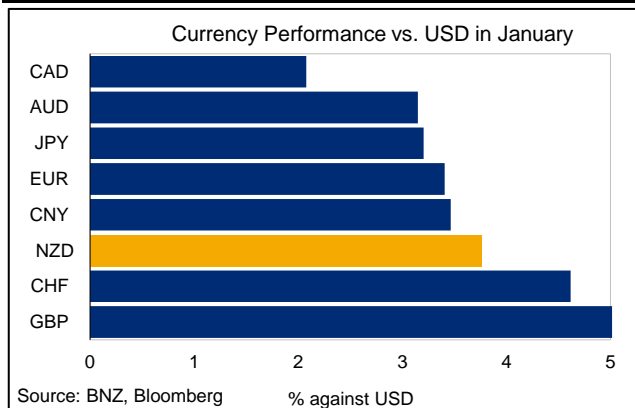
Communication around the US Administration's "strong dollar" policy, in place since 1995, was a shambles, with Treasury Mnuchin commenting that a weaker USD was good for trade. Both Trump and Mnuchin tried to back-pedal on these comments, but given the sensitivity around trade policy Mnuchin's comment were an unnecessary distraction and didn't engender confidence in the USD.

With a weaker USD acting like an easing in global financial conditions, the bull market run for global equities continued, with the World Index up 4% for the month, even with a wobble towards month-end. There seemed to be some fundamental support, with the reduction in US corporate taxes supporting stronger US earnings growth alongside the strong global economic backdrop.

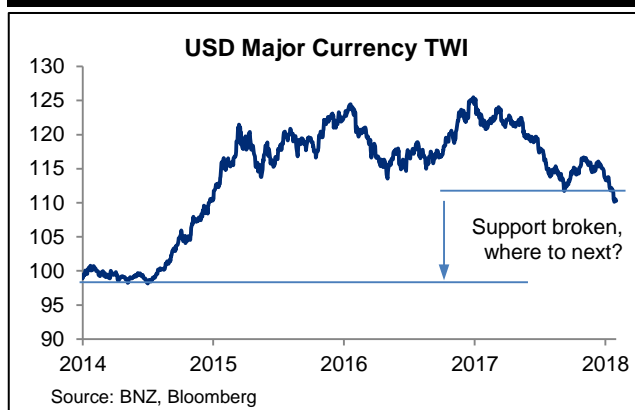
Global bond rates trended higher over the month, driven by the strong economic backdrop, and the threat of higher inflation alongside tighter global monetary policy. For a change, the US core CPI positively surprised. The US 10-year Treasury rate shot up through last year's high of 2.63% and with that technical level broken, a further stretch higher was easier to come by. The rate closed the month up a chunky 30bps at 2.71% after hitting a high of 2.75%.

Perhaps reflecting some nervousness about market valuations, rising bond rates and where the USD heads from here, market volatility indicators rose for the month, with clear upside across the VIX, MOVE and currency volatility indicators.

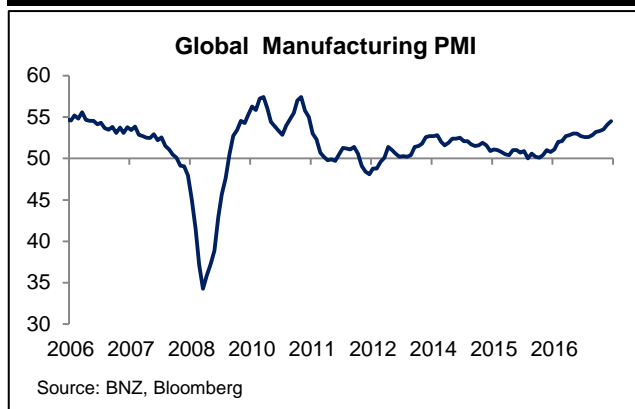
All Majors Rise Against a Weak USD



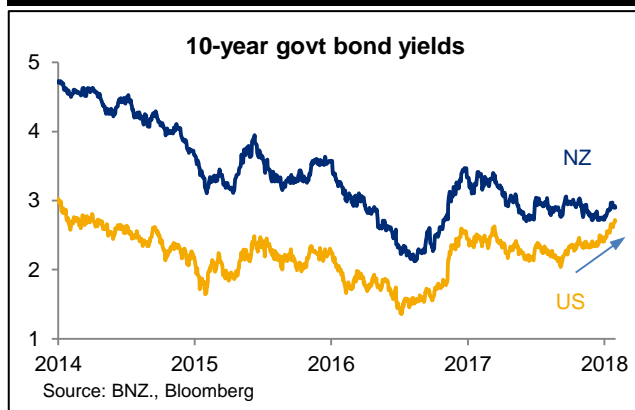
USD Remains Under Pressure



Global Growth Still Gaining Momentum



US Bond Rates Trending Higher



The NZD was a bystander amongst all this. The only key local market-moving release was a surprisingly low CPI return for Q4 (0.1% q/q, 1.6% y/y), which saw the NZD weaken and rate hikes priced out of the NZ curve for 2018. The first full expected tightening in monetary policy was pushed out from November 2018 to February 2019 and in a rising global rate environment the 2-year swap rate fell by 4bps to 2.18%.

The weaker USD and strong global growth supported commodity prices and dairy prices joined in this move. Both GDT dairy auctions during the month were positive, with a cumulative gain in average prices of over 7%. Drought conditions in NZ had some impact as reduced supply was on offer.

NZD/USD rose by nearly 4% for the month, which wasn't far out of line with other currencies, so monthly changes on the crosses were modest. Pre-NZ CPI, the high for the month was 0.7438, close to the intraday peak reached in September. NZD/AUD remained in a tight trading range, spending the second consecutive month largely confined to a 0.90-0.92 range.

China changed its policy for managing the currency, removing the "counter-cyclical adjustment", a previously used "smoke-and-mirrors" adjustment to reduce speculation in CNY. The change in policy suggested the PBoC was more comfortable in letting market forces dictate currency moves. NZD/CNY was flat for the month, as USD/CNY fell by over 3%.

Early in the month, the BoJ reduced purchases of long-end JGBs at its QE operation. Some in the market speculated that this signalled a change in official policy or an imminent change in monetary policy, but officials hosed down that view, suggesting that it was simply an operational move and had no implications for monetary policy. NZD/JPY range traded mostly within JPY 79.50-81.50 for the month.

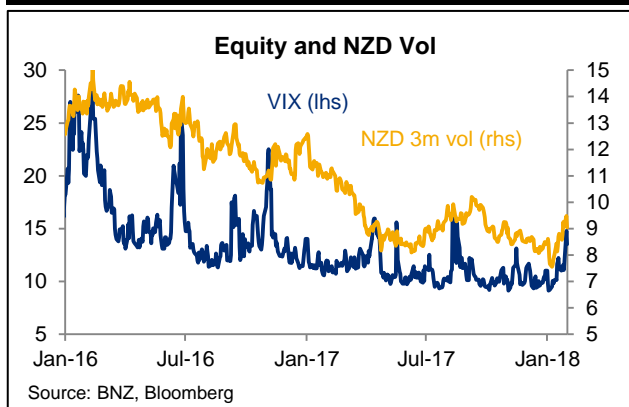
Of the majors, GBP was the strongest currency. Despite the underperforming economy versus the rest of the world and UK PM May's position still looking tenuous, market sentiment for GBP remains positive as we head towards a possible transitional deal on Brexit, possibly delaying the UK's exit from the EU for a few years. NZD/GBP fell by 1% for the month to below GBP 0.52.

NZD/EUR spent most of the time trading between EUR 0.59-0.6050. The ECB continued to be incrementally more optimistic on growth and inflation, although made no change to its policy guidance, leaving the market to speculate that the next tweak in its language would come at the March meeting. ECB President Draghi made no serious attempt to lean against the stronger EUR.

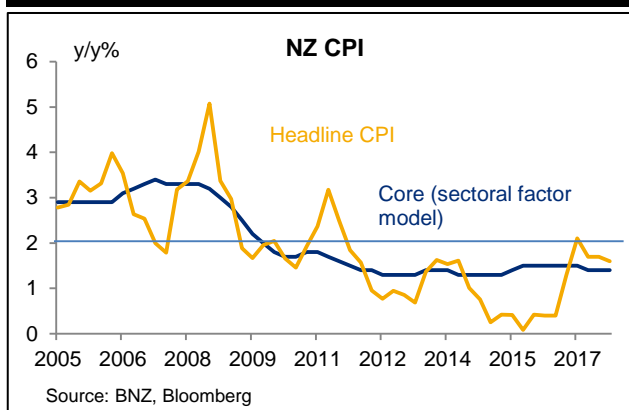
On a TWI basis, the NZD rose by just over 1%, with the soft USD explaining more than half of the increase. This took the currency back to levels before the swoon induced by the formation of the new government

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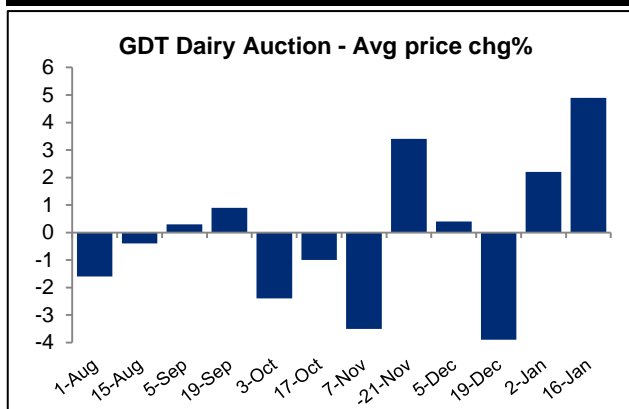
Volatility Picks Up in January



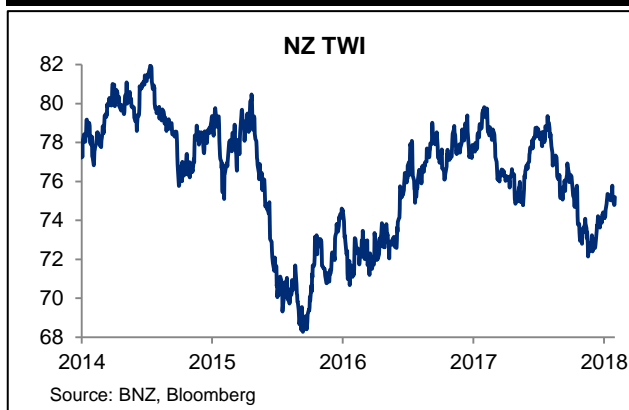
NZ Core Inflation Remains Suppressed



Positive Price Action in Last Two Dairy Auctions



NZ TWI Recovers From Late-2017 Swoon



Monthly Performance Table

	end-Jan	end-Dec	Change		end-Jan	end-Dec	Change
Currencies				NZ Rates			
NZD/USD	0.7365	0.7098	3.8%	OCR	1.75	1.75	0.00
NZD/AUD	0.9143	0.9091	0.6%	NZ 90day BB	1.89	1.88	0.01
NZD/EUR	0.5933	0.5910	0.4%	NZ 2yr sw ap	2.18	2.22	-0.04
NZD/GBP	0.5190	0.5252	-1.2%	NZ 5yr sw ap	2.72	2.68	0.04
NZD/JPY	80.41	79.94	0.6%	NZ 10yr sw ap	3.25	3.14	0.12
NZD/CNY	4.632	4.6222	0.2%	NZ Govt (4/21)	2.90	2.72	0.18
TWI	75.1	74.2	1.2%	NZ Govt (4/23)	2.40	2.24	0.16
AUD/USD	0.8055	0.7809	3.2%	NZ Govt (4/27)	2.90	2.72	0.18
EUR/USD	1.2414	1.2005	3.4%	Global 10 year bond rates			
GBP/USD	1.4191	1.3513	5.0%	US	2.71	2.41	0.30
USD/JPY	109.19	112.69	-3.1%	Canada	2.29	2.04	0.25
USD/CNY	6.29	6.51	-3.3%	UK	1.51	1.19	0.32
USD/CAD	1.2315	1.2571	-2.0%	France	0.97	0.78	0.19
USD TWI major	110.30	113.79	-3.1%	Germany	0.70	0.42	0.27
Asia DXY	111.95	109.78	2.0%	Italy	2.03	2.02	0.01
Equity Markets				Spain	1.42	1.56	-0.14
MSCI AC Wrld, loc.	1,216	1,167	4.1%	Portugal	1.95	1.91	0.04
MSCI World, loc.	6,628	6,386	3.8%	Ireland	1.13	0.66	0.47
MSCI EM, USD	2,732	2,522	8.3%	Japan	0.08	0.04	0.04
US S&P 500	2,824	2,674	5.6%	Australia	2.81	2.63	0.18
Euro STOXX 600	395.5	389.2	1.6%	Commodities (USD)			
Germany DAX	13,189	12,918	2.1%	WTI Crude	64.73	60.44	7.1%
France CAC 40	5,482	5,313	3.2%	Brent Crude	68.89	66.44	3.7%
UK FTSE 100	7,534	7,688	-2.0%	R/B CRB Index	197.4	193.9	1.8%
Aust S&P/ASX 200	6,038	6,065	-0.5%	Gold spot	1,345	1,303	3.2%
Japan Topix	1,837	1,818	1.1%	Silver spot	17.35	16.94	2.4%
China CSI 300	4,276	4,031	6.1%	Copper	320.0	330.0	-3.0%
NZX50	8,442	8,398	0.5%	Iron Ore	72.05	71.75	0.4%
Volatility: VIX	13.54	11.04	22.6%	Coking coal	228.00	236.00	-3.4%
3-mth Bill Futures				Thermal coal	104.00	101.00	3.0%
NZD Dec-18	97.88	97.77	0.11	Corn	361.5	350.8	3.1%
AUD Dec-18	97.99	97.97	0.02	Wheat	451.8	427.0	5.8%
USD Dec-18	97.62	97.86	-0.24	NZX Dairy WMP	3,190	2,985	6.9%
EUR Dec-18	100.26	100.24	0.02	NZX Milk Price 2018	NZD 6.45	NZD 6.38	1.1%
GBP Dec-18	99.07	99.22	-0.15				

Source: BNZ, Bloomberg

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