

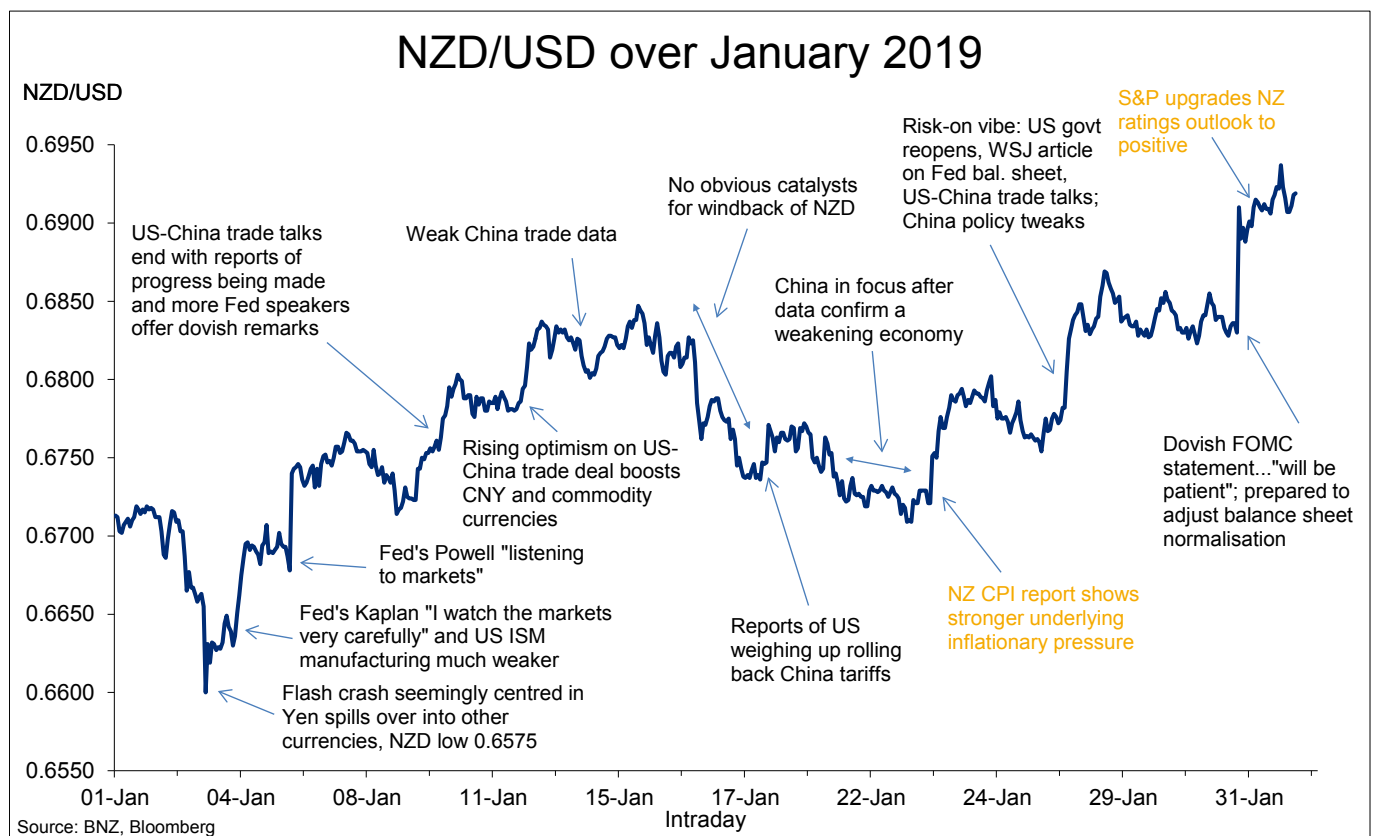
RESEARCH FINANCIAL MARKETS WRAP

1 February 2019



Strong recovery in risk appetite supports NZD

- Emerging market and commodity currencies like the NZD outperformed in January.
- Change in Fed guidance and positive US-China trade talk vibe supported a strong recovery in risk assets.
- NZ and global rates head lower.



Quick Outlook		December ranges
NZD/USD	Momentum is currently higher, but US-China trade negotiations will be an important driver over the short-term. Positive news could see a test of 0.70 but resistance is just above that level and we'd be happier to call the range more like 0.67-0.70.	0.6575 – 0.6940
NZD/AUD	Some consolidation is evident after the strong run in Q4. We retain a positive bias and see a test of the 0.96-0.97 level over the coming six months, with NZ having the edge on fundamental forces.	0.9370 – 0.9895
NZD/GBP	Our base case takes a constructive view on Brexit, meaning significant downside risk for the cross as GBP recovers on either a pushing out of the timetable or a soft Brexit along the lines of PM May's proposal. Little Parliamentary support for a no-deal exit.	0.5150 – 0.5410
NZD/EUR	EUR has been out of favour on economic concerns, but a constructive view on Brexit and GBP makes us positive on EUR due to spillover effects. Neg. bias on the cross.	0.5800 – 0.6050
NZD/JPY	Further near-term upside bias if the rally in risk appetite continues, but we're getting pretty neutral at the current level and see some consolidation ahead.	69.0 – 75.5
90-day BB	Flat, with little chance of monetary policy adjustment over coming months.	1.88% - 1.97%

After a pall of gloom overhung markets in December and the last quarter of 2018, risk appetite bounced back strongly in January. Global equities rose by over 7%, credit spreads narrowed, commodity prices rallied and commodity currencies outperformed. Meanwhile, global bond rates were lower for the month.

The bounce-back in risk assets was accentuated by oversold market conditions evident in late-December as investors saw a “wall of worry”. Our risk appetite index began the year around 30% and by month-end was over 50%. A key trigger for the bounce-back was a backpedalling by the Fed on the policy outlook, while a more positive vibe over US-China trade talks played a supporting role, with both parties keen to come to some sort of agreement and end the trade war. Towards the end of the month, talks were taking place at a higher level but Trump indicated that a deal will depend on how his meeting with President Xi goes, likely late-February.

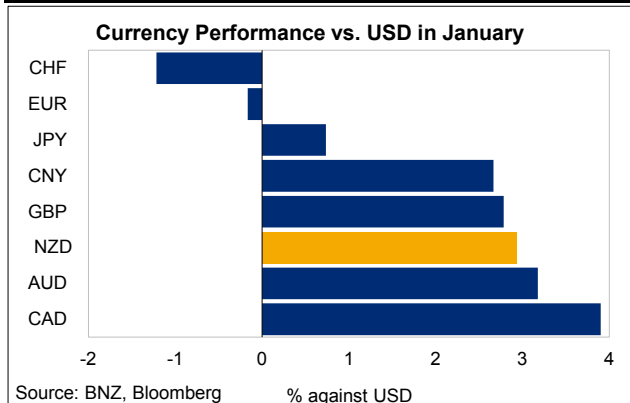
The Fed took on board the deterioration in financial conditions and changed tack accordingly. Early in the New Year, we saw what looked like a coordinated attempt by FOMC members to indicate they were watching the markets and this would be taken into account in their policy assessment. Fed Powell said that he was “listening to the markets”. By month-end this was officially confirmed, with the FOMC removing its tightening bias after its meeting, suggesting that the committee “will be patient” as it determines what future adjustments might be required to the Fed Funds rate. The FOMC also indicated it was prepared “to adjust any of the details for completing balance sheet normalization in light of economic and financial developments”.

The recovery in risk appetite took place against a backdrop of weaker global economic data. China’s softening economy was in focus, with GDP data confirming that growth had slipped to its weakest rate since the GFC. European PMIs continued to show signs of slippage after their poor run last year and GDP figures showed the weakest growth in 5 years, while Italy slipped into recession. The publication of some key US data releases was delayed by the US partial government shutdown, but a big fall in the ISM manufacturing index got the market’s attention. Many global companies noted the slowdown in China that was crimping their earnings.

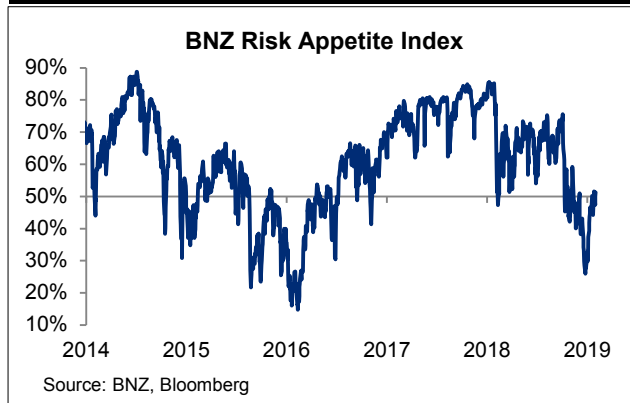
The USD struggled against a backdrop of stronger risk appetite and a more dovish Fed. It fell against all the other majors apart from CHF and EUR. Emerging market and commodity currencies outperformed, with the NZD, AUD and CAD showing strong gains. The better vibe on US-China trade talks supported CNY, although the cynics might suggest that the PBoC was happy to engineer a stronger currency ahead, and during, trade talks as a sign of good faith. Chinese authorities continued along the path of policy initiatives to help support growth, including a 100bp cut in the required reserve ratio for banks.

Another flash crash in currency markets took place on 3 January. The crash was seemingly triggered by selling of TRY and AUD against JPY on a Japanese holiday in illiquid market conditions around the New York close, that spilled over into the NZD. The NZD/USD reached a low of 0.6575 while NZD/JPY went below 69. AUD was harder hit, reaching 0.6740, taking NZD/AUD up to a high of 0.9895. Market conditions and pricing normalised pretty quickly.

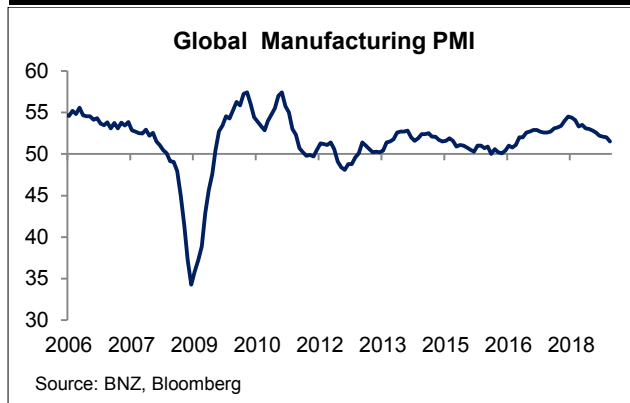
Most Currencies Higher vs USD in January



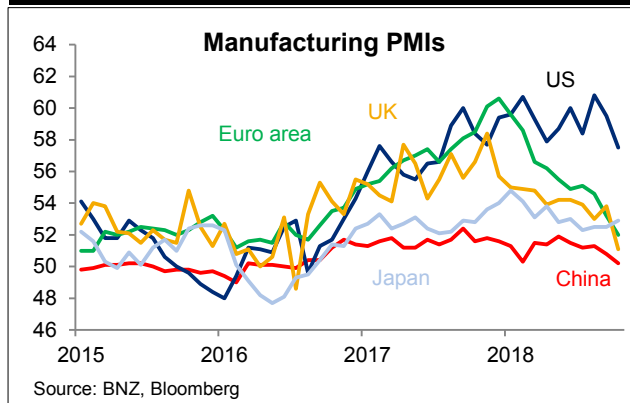
Risk Appetite Bounces Back to Neutral Zone



Clear Signs of Global Economic Slowdown



Manufacturing PMIs Now Falling Everywhere



NZD/USD ended the month nearly 3% higher. Domestic factors were largely absent from NZD currency performance apart from a stronger than expected Q4 CPI report being a supportive factor. NZ headline CPI inflation was soft for the quarter, largely as expected, but more importantly, key core measures showed higher inflationary pressure. The average of the four Statistics NZ measures of core inflation that we monitor increased from 1.7% to 1.9% y/y, while non-tradeables inflation rose to a 4½-year high of 2.7% y/y. The RBNZ’s estimate of core inflation based on the sectoral factor model remained unchanged at 1.7%, but there was enough supporting evidence to suggest that underlying inflationary remained on a higher plane.

Dairy prices showed signs of further recovery, helped by the falling EU skim milk powder stockpile. The GDT price index rose by 4.2% in the mid-January auction, the fourth successive increase after a series of price falls in the first half of the season.

NZD/AUD showed signs of consolidation around the 0.95 mark. The domestic vibe around Australia remained negative, with signs of weaker business confidence and house prices continuing to track lower, but on a more positive note “hard” commodities performed well, with iron ore and oil prices up strongly. The latter showed double-digit gains after plunging in Q4. Stronger oil prices were also supportive for CAD.

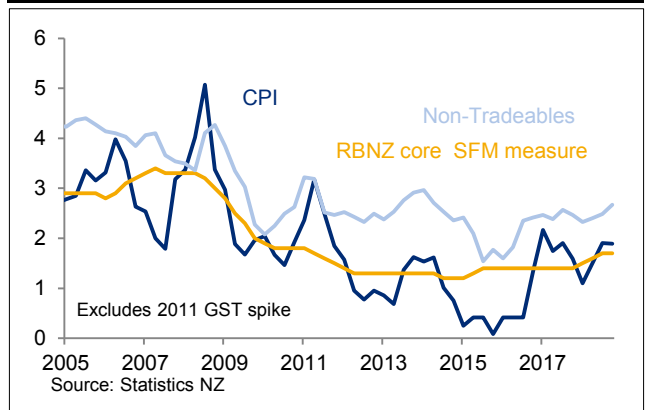
GBP remained volatile but outperformed, making good gains against the USD and EUR. NZD/GBP was little changed for the month. The market took a more optimistic view of Brexit negotiations, even though a lack of visibility remained at month-end. A risk of a no-deal Brexit seemed to diminish, with a seemingly lack of Parliamentary support for that option even though strong divisions remained about the preferred final outcome.

EUR was weighed down by a continued run of poor data, which suggested fading growth momentum and the lack of an inflationary pulse. The ECB left policy and guidance unchanged, but President Draghi downgraded the economic outlook with risks to growth now seen to the downside, reflecting global trade tensions, Brexit and financial market volatility. The euro underperformed alongside the USD, seeing NZD/EUR up 3% for the month.

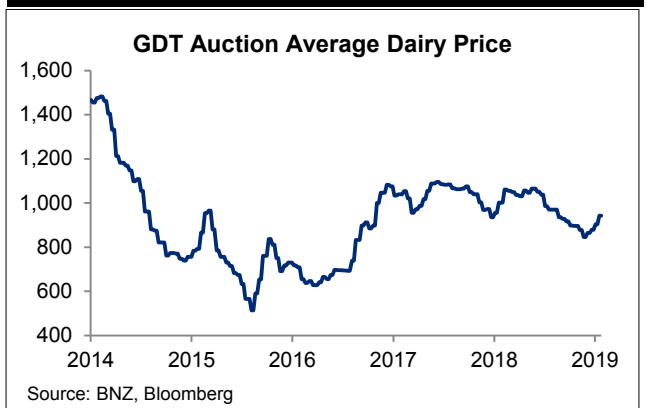
NZD/JPY rose by 2% for the month on higher risk appetite, recovering less than half of the fall seen in December. The BoJ lowered its inflation forecasts yet again, with the annual figure for March 2020 slashed to 0.9%, or 0.6% once the government’s initiative to cut education costs for young children is implemented. Inflation is expected to pick up to 1.4% the following year, still far from the 2% target, highlighting how policy will likely remain super-easy for some time yet.

In the rates market, despite higher inflation and the better risk backdrop, the OIS market priced in a greater chance of an RBNZ rate cut later in the year, with the November meeting priced at 1.63%, compared to 1.68% at the beginning of the month.

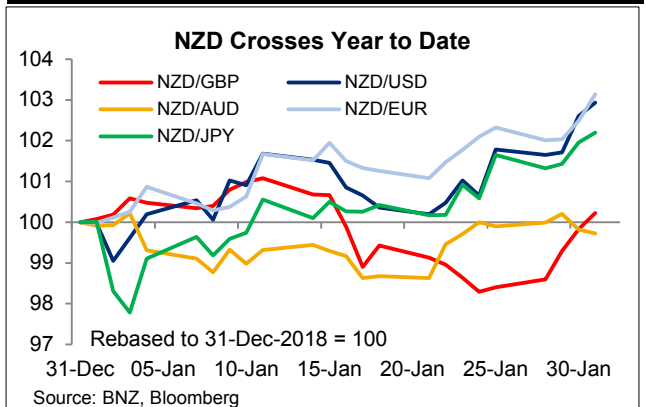
NZ Core CPI Measures Nudging Higher



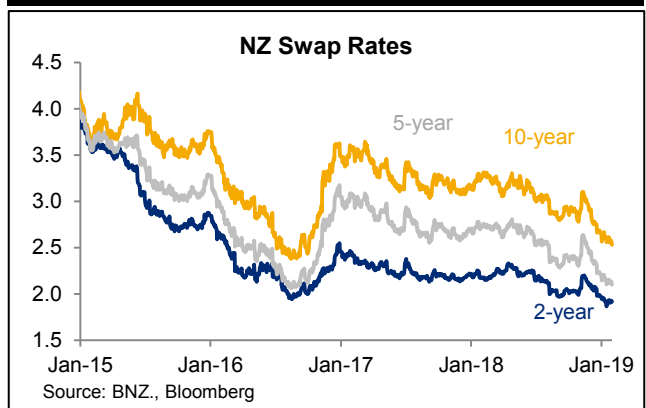
Dairy Prices Recovering



NZD Higher vs USD, EUR and JPY to Start the Year



NZ Rates Probe Multi-Year Lows



Furthermore, local banks raising funds offshore helped put downward pressure on the 90-day bank bill rate. This fed through into a lower 2-year swap yield, which reached a record low of 1.86% mid-month. NZ swap and government yields were lower across the curve, with lower global rates supporting this trend. The US 10-year rate fell 6bps to 2.62%, supported by the change in the Fed's guidance.

At the end of the month NZ's long-term foreign currency debt rating was affirmed by S&P at AA while the outlook improved to positive from stable, reflecting stronger government fiscal accounts.

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Monthly Performance Table							
	end-Jan	end-Dec	Change		end-Jan	end-Dec	Change
Currencies				NZ Rates			
NZD/USD	0.6916	0.6719	2.9%	OCR	1.75	1.75	0.00
NZD/AUD	0.9507	0.9533	-0.3%	NZ 90day BB	1.93	1.97	-0.04
NZD/EUR	0.6043	0.5859	3.1%	NZ 2yr sw ap	1.92	1.97	-0.05
NZD/GBP	0.5278	0.5266	0.2%	NZ 5yr sw ap	2.10	2.21	-0.11
NZD/JPY	75.33	73.71	2.2%	NZ 10yr sw ap	2.53	2.65	-0.12
NZD/CNY	4.635	4.6220	0.3%				
TWI	74.4	73.5	1.2%	NZ Govt (4/23)	1.75	1.86	-0.11
AUD/USD	0.7273	0.7049	3.2%	NZ Govt (4/27)	2.07	2.20	-0.13
EUR/USD	1.1448	1.1467	-0.2%	NZ Govt (4/29)	2.26	2.36	-0.11
GBP/USD	1.3109	1.2754	2.8%				
USD/JPY	108.89	109.69	-0.7%	Global 10 year bond rates			
USD/CNY	6.70	6.88	-2.6%	US	2.63	2.69	-0.06
USD/CAD	1.3125	1.3637	-3.8%	Canada	1.88	1.97	-0.09
USD TWI major	117.60	119.31	-1.4%	UK	1.22	1.28	-0.06
Asia DXY	106.80	105.38	1.3%	France	0.55	0.71	-0.15
				Germany	0.15	0.24	-0.09
Equity Markets				Italy	2.59	2.74	-0.15
MSCI AC Wrld, loc.	1,162	1,083	7.3%	Spain	1.19	1.41	-0.22
MSCI World, loc.	6,381	5,948	7.3%	Portugal	1.62	1.71	-0.10
MSCI EM, USD	2,322	2,163	7.4%	Ireland	0.87	0.90	-0.03
US S&P 500	2,704	2,507	7.9%	Japan	0.00	-0.01	0.00
Euro STOXX 600	358.7	337.7	6.2%	Australia	2.24	2.32	-0.08
Germany DAX	11,173	10,559	5.8%				
France CAC 40	4,993	4,731	5.5%	Commodities (USD)			
UK FTSE 100	6,969	6,728	3.6%	WTI Crude	53.79	45.41	18.5%
Aust S&P/ASX 200	5,865	5,646	3.9%	Brent Crude	61.89	53.80	15.0%
Japan Topix	1,567	1,494	4.9%	R/B CRB Index	179.6	169.8	5.8%
China CSI 300	3,202	3,011	6.3%	Gold spot	1,321	1,282	3.0%
NZX50	8,985	8,811	2.0%	Silver spot	16.06	15.50	3.7%
Volatility: VIX	16.57	25.42	-34.8%	Copper	278.5	263.1	5.8%
				Iron Ore	84.45	69.65	21.2%
3-mth Bill Futures				Coking coal	204.50	211.50	-3.3%
NZD Dec-19	98.11	98.03	0.08	Thermal coal	99.00	102.05	-3.0%
AUD Dec-19	98.16	98.13	0.03	Corn	376.5	375.0	0.4%
USD Dec-19	97.39	97.35	0.04	Wheat	516.5	503.3	2.6%
EUR Dec-19	100.25	100.25	0.00	NZX Dairy WMP	2,880	2,800	2.9%
GBP Dec-19	98.98	98.89	0.09	NZX Milk Price 2019	NZD 6.27	NZD 6.07	3.3%

Source: BNZ, Bloomberg

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