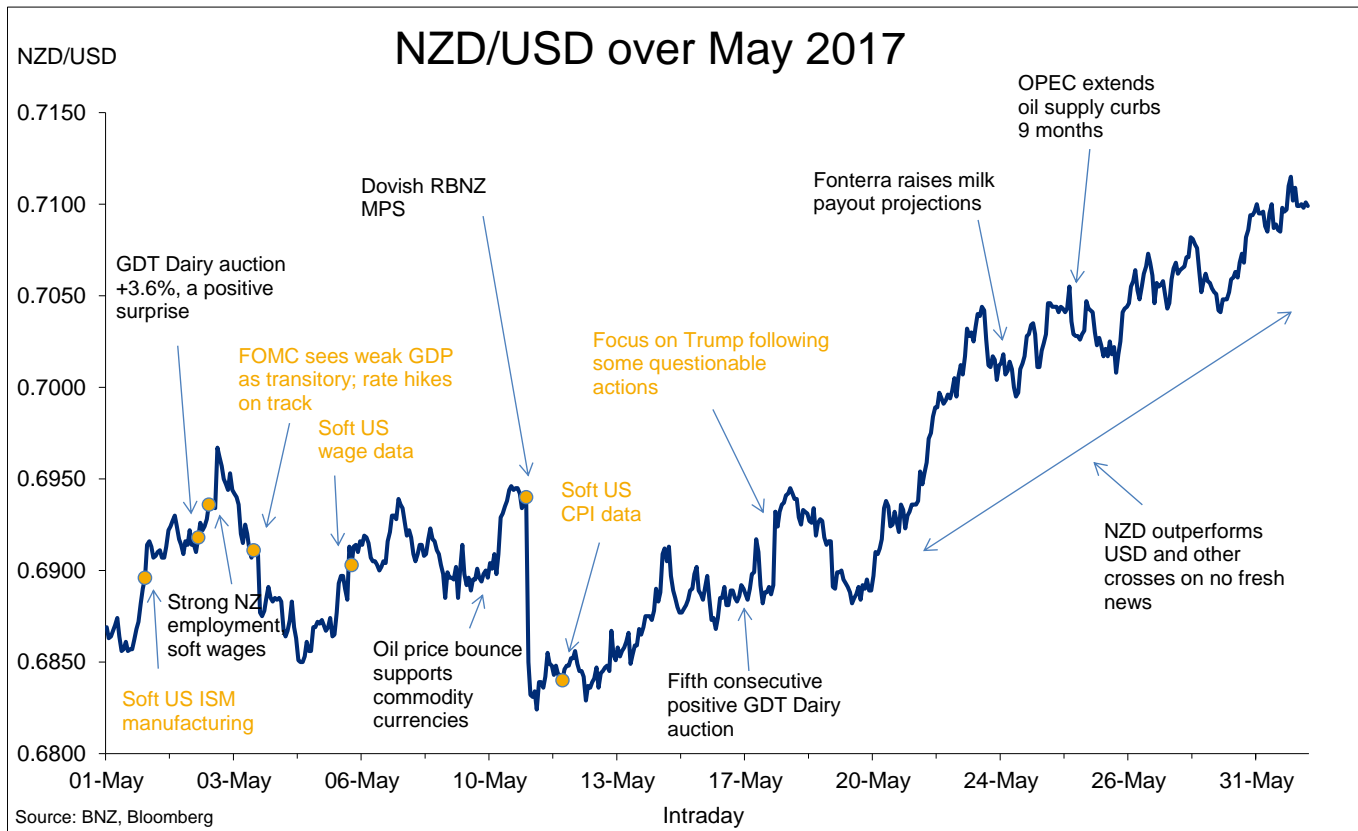


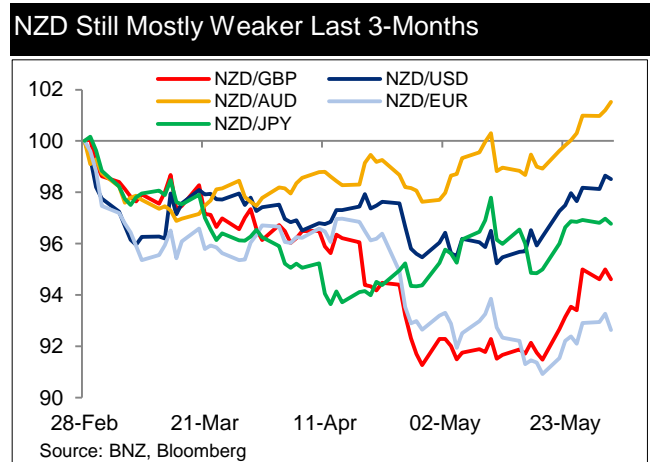
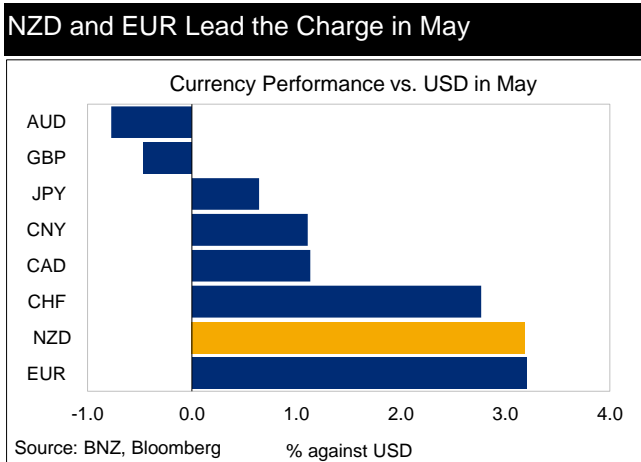
1 June 2017

## An Overdue Recovery in NZD

- NZD performs strongly in May, up 2½% on a TWI basis
- Supported by high risk appetite and rising NZ export commodity prices
- Downside bias to bond rates



Quick Outlook		May ranges
NZD/USD	Our model says the NZD is still cheap, but it's time for some consolidation after strength through late-May. Fed June hike is nearly fully priced but language about guidance will be crucial. Ultimately we see the NZD softer through the second half.	0.6820 – 0.7120
NZD/AUD	Fairly priced now and due for some consolidation after the strong run. We still see the cross moving higher over the medium term. Soft Australian GDP and activity data ahead will do the AUD no favours.	0.9145 – 0.9555
NZD/GBP	Fundamentally we dislike GBP with tough Brexit talks about to begin. Election on 8 June is a near-term risk event and a hung Parliament would add to recent downside pressure in GBP.	0.5275 – 0.5550
NZD/EUR	ECB is expected to gradually harden up its ultra-loose policy guidance over coming months. That dynamic provides support for EUR, providing downside risk for the cross.	0.6160 – 0.6395
NZD/JPY	Due for a bit of consolidation before upside risk later in the year as the yen softens.	76.30 – 79.35
90-day BB	Flat, with little chance of monetary policy adjustment over coming months.	1.97% - 2.00%



**A broad-based NZD recovery**

After months of puzzling over why the NZD was so weak this year against a backdrop of stronger fundamental drivers, we finally saw a decent recovery during May, with a rise on all the key crosses (except EUR) and the TWI up 2½%. While the global economic data flow was softer than recent trends, evidenced by falling economic surprise indices, world growth was still well on track to be the highest in over five years. This economic backdrop and a strong US earnings season, helped drive global equity markets to reach fresh highs, with a 3½% rise in the MSCI emerging markets index and a 1½% rise in the World (developed) markets index.

**Higher risk appetite and NZ commodity prices**

Low market volatility remained a theme, supporting positive market sentiment. The VIX index fell to pre-GFC levels, or sub-10, and credit spreads narrowed, driving our risk appetite index to a fresh 3-year high during the month. NZ commodity prices rose during the month with our preferred CBA index rising to a 2½-year high. Whole milk dairy prices sustained their strong April rally, encouraging Fonterra to raise its 2016/17 milk payout by 2½% to \$6.15 per kg of milk solids and setting an initial (high) payout forecast of \$6.50 for the 2017/2018 season.

**Strong rally late in the month**

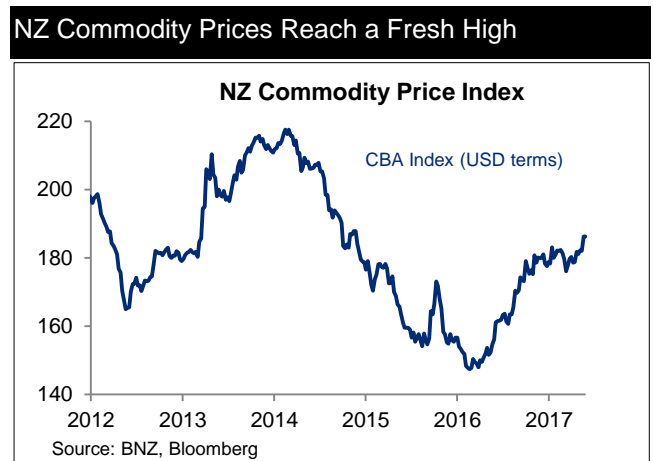
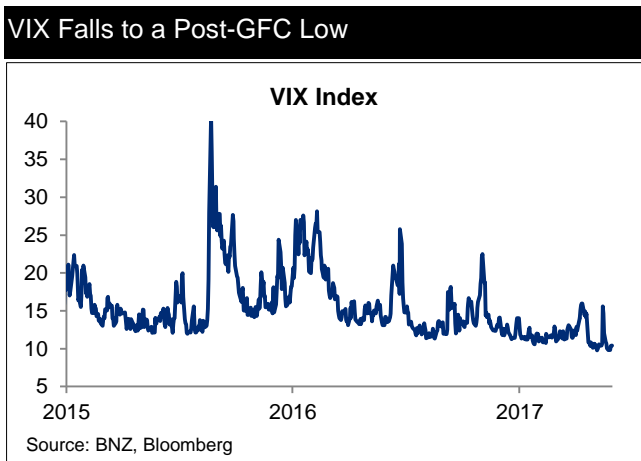
The market had ignored these positive dynamics that had been in play over recent months and we see the NZD’s outperformance reflecting some catch-up. It all seemed a bit odd really, with much of the NZD’s broadly based gains coming in the last ten days of the month, with no particular trigger for the move.

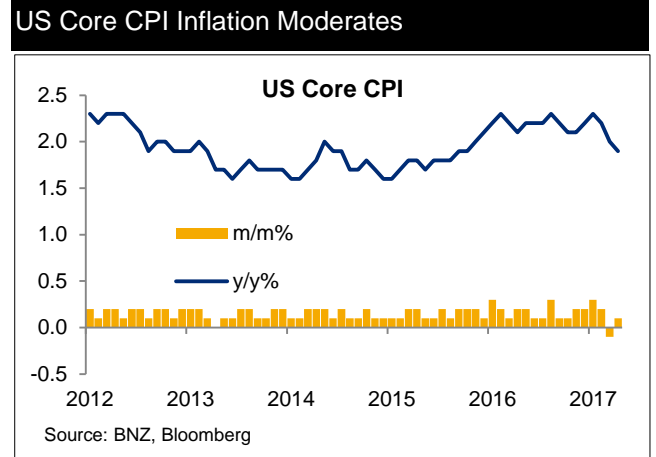
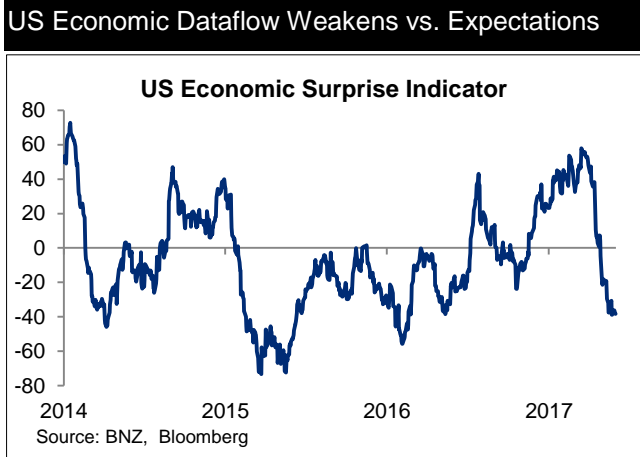
**RBNZ’s dovish MPS was a surprise**

Earlier in the month, the RBNZ surprised the market with a more dovish Monetary Policy Statement than expected. The consensus view leading up to the release was that data since the February MPS unambiguously pointed in the direction of much higher inflationary pressure than the Bank previously thought and that would lead the Bank to show a gentle lift in its OCR track towards the back end of its forecasts. In a shock move, the Bank “discovered” some disinflationary pressure that would offset the most obvious inflationary impulses. The rate track showed no possible hike until late-2019, an unchanged assessment from February. The NZD naturally fell on this assessment, but by month-end had more than recovered all of those losses, with the TWI probing two-month highs.

**USD on the soft side**

The USD itself was generally soft, with the USD major currency TWI down 1.7% for the month. The NZD met some resistance towards 0.71 at the end of the month and closed over 3% higher. Some softer US economic data, including inflation indicators, created some doubt about the path of future





**Doubts about Fed hike path**

Fed rate hikes. FOMC minutes from the May meeting put a June rate hike by the Fed in the spotlight, but the messaging was softened to the extent members thought “it would be prudent” to ensure that evidence confirms the transitory nature of the Q1 slowdown. The clear message is that further rate hikes beyond June are data dependent. Weakness in the USD also likely reflected a political risk premium built in after investigations began into President Trump’s link to Russia interference in last year’s election. With Trump fighting fires the market took the view that his pro-growth strategy was under threat and further delays were likely for any fresh policy initiatives.

**US political risk emerges**

**AUD whacked on lower commodity prices**

The AUD had a poor month, which saw NZD/AUD up through 0.95 and 4% higher, reaching levels not seen since early February. Unlike “soft” commodity prices, which were well supported, prices for key Australian export commodities like iron ore fell in the order of 17%, taking prices down to a more sustainable level after reaching speculative highs earlier this year. The AUD wasn’t helped by Australian data releases which pointed to a soft patch in growth over Q1 and Q2, and Moody’s credit rating downgrade for China.

**GBP election risk**

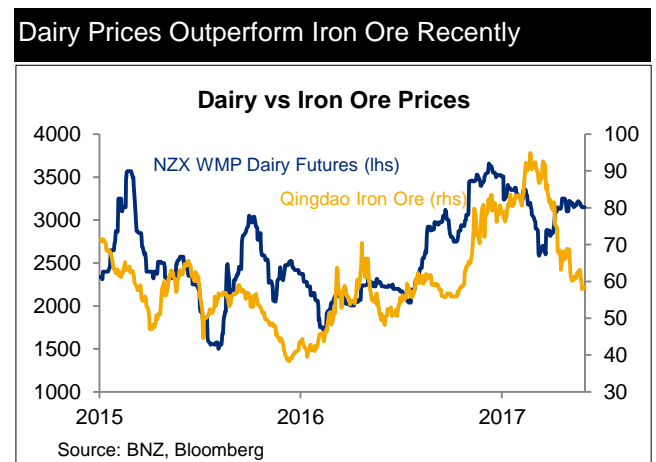
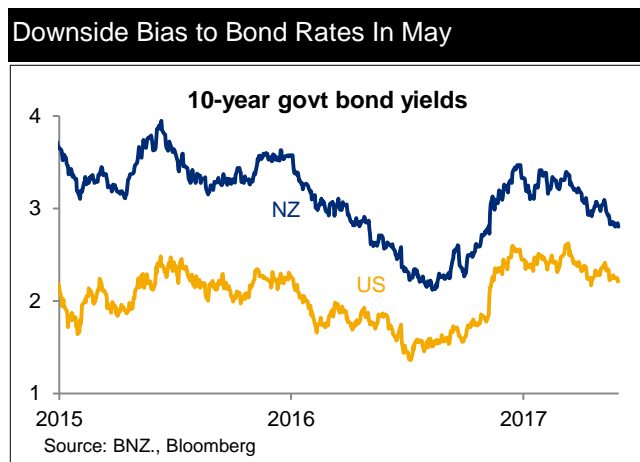
GBP was another poor performer. Economic data pointed to a softer growth picture after surprising strength post the Brexit referendum. Furthermore, PM May’s call for a snap election looked increasingly a poor decision as political polls pointed to a closing of the gap between the Conservatives and Labour Party, ahead of the 8 June general election. NZD/GDP rose by nearly 4% to 0.55.

**Focus for EUR moves to ECB policy stance**

With immediate political risk out of the way in the euro-area after the market-friendly French Presidential election result, the EUR performed well as the market’s focus turned to the ECB’s next move. Expectations of less dovish language at the ECB’s policy meeting in early June supported the euro. Rising US political risk supported the yen alongside encouraging Japan economic activity releases. However, inflation in Japan remained subdued, muting any possibility that the BoJ would be likely to change its policy stance anytime soon.

**CNY under more govt. control**

Alongside a generally soft USD, CNY traded in a tight range until it looks like the PBoC intervened to drive the currency higher. Reports followed that China was changing its yuan fixing formula. This would make it less affected by market pressures and gives the PBoC more control, shifting further away from its aim of creating a freely-floating currency. USD/CNY ended the month down over 1%.



**Downside bias to rates**

The low inflation theme permeated through global bond markets, with the major central banks no closer to meeting their inflation targets. US Treasury rates had a downside bias, with dampened expectations of US fiscal stimulus given ongoing political distractions being another factor. The US 10-year rate fell by 8bps to 2.20%. NZ's rate curve showed a flattening bias. NZ's Budget showed a strong fiscal position that allowed tax cuts and benefit increases while reducing net debt at the same time. A projected path of declining NZ government bonds on issue supported the local rates market. The NZ-US 10-year rate spread fell below 60bps, a level not seen since 1999.

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**Monthly Performance Table**

	end-May	end-Apr	Change		end-May	end-Apr	Change
<b>Currencies</b>				<b>NZ Rates</b>			
NZD/USD	0.7085	0.6866	3.2%	OCR	1.75	1.75	0.00
NZD/AUD	0.9536	0.9171	4.0%	NZ 90day BB	1.97	1.99	-0.02
NZD/EUR	0.6300	0.6301	0.0%	NZ 2yr sw ap	2.22	2.31	-0.09
NZD/GBP	0.5496	0.5302	3.7%	NZ 5yr sw ap	2.71	2.89	-0.18
NZD/JPY	78.48	76.54	2.5%	NZ 10yr sw ap	3.19	3.38	-0.18
NZD/CNY	4.831	4.7294	2.2%	NZ Govt (4/20)	2.08	2.29	-0.21
TWI	76.6	74.7	2.5%	NZ Govt (4/23)	2.46	2.71	-0.25
AUD/USD	0.7430	0.7488	-0.8%	NZ Govt (4/27)	2.78	3.05	-0.27
EUR/USD	1.1244	1.0895	3.2%	<b>Global 10 year bond rates</b>			
GBP/USD	1.2890	1.2951	-0.5%	US	2.20	2.28	-0.08
USD/JPY	110.78	111.49	-0.6%	Canada	1.42	1.55	-0.13
USD/CNY	6.82	6.89	-1.1%	UK	1.05	1.08	-0.04
USD/CAD	1.3500	1.3653	-1.1%	France	0.73	0.83	-0.10
USD TWI major	119.58	121.64	-1.7%	Germany	0.30	0.32	-0.01
Asia DXY	106.26	105.42	0.8%	Italy	2.20	2.28	-0.08
<b>Equity Markets</b>				Spain	1.54	1.64	-0.10
MSCI AC Wrld, loc.	1,058	1,040	1.8%	Portugal	3.04	3.52	-0.49
MSCI World, loc.	5,818	5,728	1.6%	Ireland	0.77	0.84	-0.07
MSCI EM, USD	2,162	2,086	3.6%	Japan	0.04	0.01	0.03
US S&P 500	2,412	2,384	1.2%	Australia	2.39	2.58	-0.19
Euro STOXX 600	390.0	387.1	0.7%	<b>Commodities (USD)</b>			
Germany DAX	12,615	12,438	1.4%	WTI Crude	48.32	49.62	-2.6%
France CAC 40	5,284	5,267	0.3%	Brent Crude	51.04	52.37	-2.5%
UK FTSE 100	7,520	7,204	4.4%	R/B CRB Index	179.8	181.7	-1.1%
Aust S&P/ASX 200	5,725	5,924	-3.4%	Gold spot	1,269	1,268	0.1%
Japan Topix	1,568	1,532	2.4%	Silver spot	17.33	17.22	0.7%
China CSI 300	3,493	3,440	1.5%	Copper	258.0	259.7	-0.6%
NZX50	7,419	7,379	0.5%	Iron Ore	57.02	68.80	-17.1%
Volatility: VIX	10.41	10.82	-3.8%	Coking coal	146.00	175.00	-16.6%
<b>3-mth Bill Futures</b>				Thermal coal	73.45	83.55	-12.1%
NZD Dec-17	97.98	97.89	0.09	Corn	372.0	366.5	1.5%
AUD Dec-17	98.35	98.26	0.09	Wheat	429.3	432.3	-0.7%
USD Dec-17	98.61	98.52	0.09	NZX Dairy WMP	3,150	3,100	1.6%
EUR Dec-17	100.31	100.29	0.03	NZX Milk Price 2018 NZD	6.35	6.25	1.6%
GBP Dec-17	99.64	99.60	0.04				

Source: BNZ, Bloomberg

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