15 May 2017

NZD Corporate FX Update

- Commodity currencies have been out of favour over recent months and the NZD has been swept down, despite NZ's softer commodity basket outperforming. Additionally, the RBNZ remains relaxed about the inflation outlook and the Bank is unlikely to rush into firmer policy guidance.
- NZD weakness has been realised sooner than previously expected. We nudge down our short-term forecasts and leave our year-end target at USD 0.67 but flag downside risk to that as well.

The NZD reached a fresh low for 2017 last week despite a backdrop of positive risk appetite and near-record terms of trade. Unusually, the correlation between our risk appetite index and the kiwi has been insignificantly different from zero this year.

Commodity currencies have been out of favour for the past few months and against that backdrop the weakness of the NZD is somewhat more explainable. But the market has not differentiated between hard and soft commodities. NZ's export commodity basket, heavily weighted by meat and dairy, has shown prices sustaining at a high level, after the strong run in 2016.

With the NZD's link with risk appetite and NZ commodity prices seemingly broken, the gap between the spot rate and our short-term fair value estimate (which is well into the 0.70s) has widened. We are doubtful that NZ's terms of trade can make further gains while risk appetite seems surely bound to fall later this year. But the diminished correlation of these variables with the NZD should moderate any possible downside impact later in the year.

That said, we are less hopeful that the gap between spot and fair value will close and we have reduced our near-term NZD forecasts accordingly. We have maintained our year-end target of USD 0.67, but flag downside risk to our 6-9 month projections. Essentially, the downdraft to the NZD we expected over the second half has occurred earlier than previously expected.

The RBNZ has made it clear that it has no intention of tightening policy in the foreseeable future. With the hurdle rate increased for the RBNZ to give a nod to tighter future policy, one supportive force we saw for the NZD has been stripped away. We still think that the Bank will raise rates in 1H18, but rather than give an early signal of possible rate hikes ahead next year, the Bank's likely stance is to delay any signal for as long as possible. In the meanwhile, the US Fed is expected to be gradually raising rates, a negative factor for the kiwi.

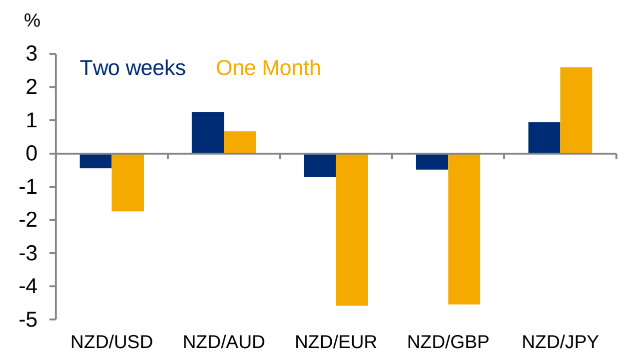
Importers should actively consider lowering previously-held targets and hedge exposures in the high 0.60s. Exporters can afford to be more patient and we see opportunities for better hedging levels over the next six months.

BNZ Foreign Exchange Forecast Summary

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	NZD/CNY
Current	*0.69*	*0.93*	*0.63*	*0.53*	*78*	*4.74*
Jun-17	0.68	0.93	0.62	0.52	78	4.71
Sep-17	0.67	0.94	0.60	0.52	78	4.66
Dec-17	0.67	0.96	0.59	0.53	79	4.67
Jun-18	0.68	0.97	0.59	0.54	82	4.79
Dec-18	0.69	0.99	0.58	0.57	84	4.88
Jun-19	0.71	1.00	0.59	0.57	84	4.98
Dec-19	0.73	1.00	0.59	0.57	83	5.04
	AUD/USD	**EUR/USD**	**USD/JPY**	**GBP/USD**	**USD/CNY**	**TWI**
Current	*0.74*	*1.09*	*113*	*1.29*	*6.90*	*75.1*
Jun-17	0.73	1.10	114	1.31	6.92	75.0
Sep-17	0.71	1.11	116	1.29	6.96	74.8
Dec-17	0.70	1.13	118	1.27	6.97	75.1
Jun-18	0.70	1.15	120	1.25	7.05	75.6
Dec-18	0.70	1.19	122	1.22	7.07	76.6
Jun-19	0.71	1.20	118	1.25	7.02	78.1
Dec-19	0.73	1.23	114	1.27	6.90	78.7

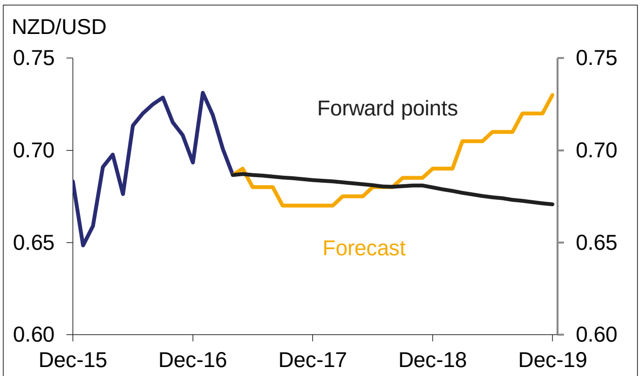
Source: BNZ, Bloomberg

NZD – Changes Over The Past Month



Source: BNZ, Bloomberg

NZD/USD: Consolidation Ahead of Weakness Late-2017



Source: Bloomberg, BNZ

The Crosses

NZD/AUD: With short-term downgrades to both AUD and NZD, our view on the cross is little changed. For exporters, a buy on dips strategy remains relatively attractive, with the currency trading below its annual average of just above AUD 0.94. We still see the medium-term bias being one of upward pressure. This is based on our view that NZ faces increased capacity pressures in the economy relative to Australia, ultimately leading to the RBNZ tightening policy ahead of the RBA. Furthermore, we prefer the outlook for soft commodities over hard commodities and that should support the cross.

NZD/GBP: Near term GDP projections were raised after the surprise UK election announcement. While, a stronger UK government might have slightly more negotiating power in any Brexit deal at the margin, EU leaders hold all the ace cards. The UK faces a long road ahead before one can be certain about its future economic direction. We expect a hard line to be pursued by EU negotiators. Real wages in the UK are falling as the GBP collapse pushes up inflation, not a positive sign for consumer spending. Uncertainty should hold back investment. It is not a good outlook for GBP, but on the positive side market positioning is still significantly short. We expect the recent recovery in GBP to eventually fade, setting the scene for NZD/GBP recovering from early next year.

NZD/EUR: With the EUR-supportive French Presidential election out of the way, political risk in the euro area has faded for now and focus turns to ECB monetary policy. We expect the ECB to gradually shift its tone from next month and cautiously guide policy towards a less accommodative stance. We see this trend as positive for EUR and NZD/EUR is expected to slide into the high 0.50s later this year. Next year, Italian elections become a source of significant political risk, with an election more likely to be held in 1H18 and 2H17. This could prove disruptive at a time when the ECB might be tapering its asset purchases (eg for Italian bonds). It is too early to factor this potentially volatile time into our projections, but we are mindful of the risk to EUR at that time.

NZD/JPY: Fading geopolitical risk has seen the yen unwind its gains earlier in the year and helped NZD/JPY recover, even in the face of general weakness for the commodity currencies. We fundamentally don't like the yen as the BoJ is far, far away from meeting its inflation target, so any monetary policy normalisation remains a distant prospect. That said, if the link between risk appetite and the cross reasserts itself, then any move lower in risk appetite from a 3-year high towards a more normal level is negative for NZD/JPY. Any dips in the cross towards the mid-70s provides exporters an opportunity to hedge at a reasonable level, given our core outlook.

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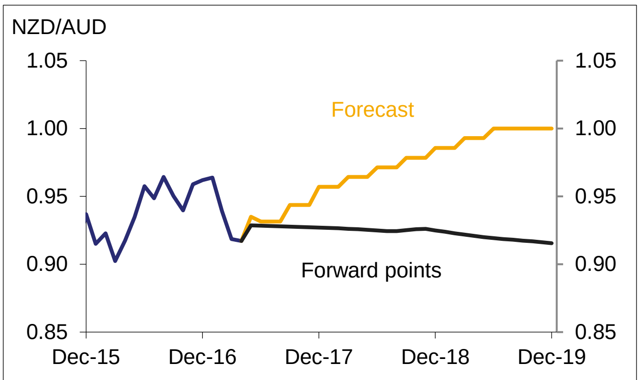
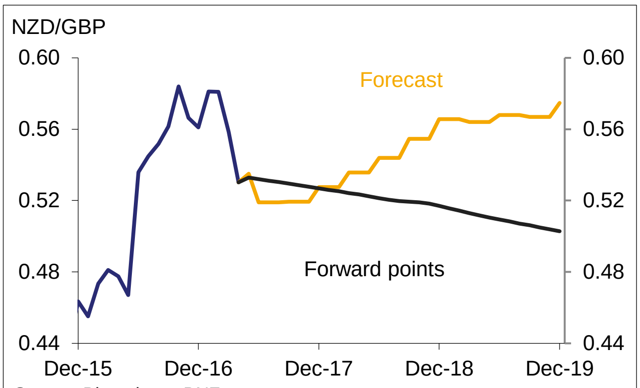
NZD/AUD: Flat, Before Upside Bias Resumes



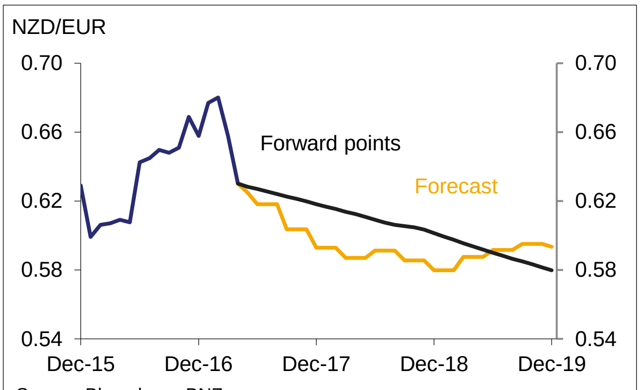
Source: Bloomberg, BNZ

NZD/GBP: Consolidating for Rest of 2017



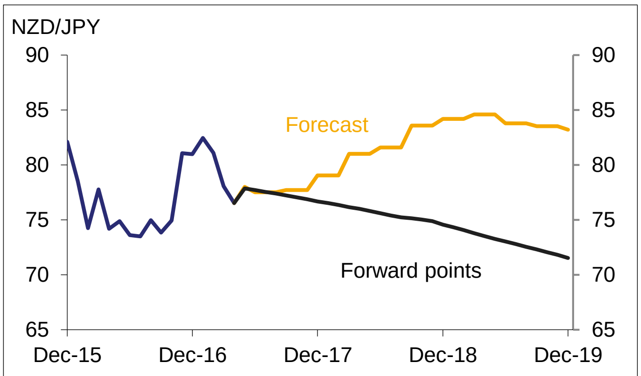
Source: Bloomberg, BNZ

NZD/EUR: Lower by Year-End as ECB Comes Into Play



Source: Bloomberg, BNZ

NZD/JPY: Flat, Before Upside Bias Resumes



Source: Bloomberg, BNZ

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