NZD: The makings of a recovery?

- Recent positive news – a potential Brexit deal and de-escalation of the trade war – has breathed some life into the beaten down NZD. Is a sustained recovery imminent?
- The NZD is cheap on our short-term fair value model, and the discount could easily close if pending US-China trade war developments are positive.

The NZD has been in a consolidation zone over the past six weeks, with support/resistance defined by 0.6200-0.6450. That said, since the low on 1 October, the NZD has appreciated by over 3%. Is it safe to say that the low for the year has now been reached?

We can point to a number of fundamental factors that explain the recent uptick in the NZD. Risk appetite has increased, with our index up through 60%, taking it to a risk-loving level, owing to, amongst other factors:

- the handshake agreement between US President Trump and China’s Vice Premier Liu that potentially paves the way for a more meaningful détente in the US-China trade war.
- positive developments on Brexit that remove from the equation the most awful scenarios for the UK and GBP. We are left with soft Brexit or no Brexit scenarios.
- the US Fed is in the midst of expanding its balance sheet, taking control of short term rates and encouraging a steepening of the yield curve. To the extent that the yield curve is a useful leading indicator of economic recession, the risk of this outcome looks diminished.

Apart from higher risk appetite, less conviction in future RBNZ rate cuts might well be considered NZD-positive. Two things carefully monitored by the RBNZ are the global risks around the economic outlook and the behaviour of the RBA. The factors noted above must be considered as reducing the risk around the global economic outlook. Furthermore, market expectations for RBA easing have notably reduced, with less conviction that the Bank will cut again this year. This has spilled over into the NZ rates market, with the OIS curve no longer fully pricing a 25bps rate cut by the RBNZ next month.

NZ commodity prices remain a supportive factor for the NZD. BNZ’s Rural Wrap last week highlighted how primary product prices have been a pillar of strength, amidst the weaker global backdrop and associated key uncertainties about the outlook. Fonterra just lifted its projected 2019/20 milk payout by 30c to a $7.05 mid-point which, if met, would add another $450m of income to its dairy farmers.

Our short-term fair value model estimate for the NZD currently sits at USD0.6750, up from a low of about 0.65 a couple of months ago. The NZD has traded on the “cheap” side of our fair value for much of this year, which we have been explaining away by the number of overhanging global risks, with the US-China trade war being the key risk factor. If these global risks are truly diminishing, then the NZD has scope to recover a few more cents.

Source: BNZ, Bloomberg
There is widespread scepticism that the handshake “Phase 1” agreement between President Trump and China’s Vice Premier Liu has much meaning other than symbolising a temporary truce in the US-China trade war. However, a truce that sees the maintenance of the status quo might be enough to prevent further yuan weakness which hitherto has been instrumental in dragging down the value of the NZD.

Our 3 and 6 month targets for the NZD of USD0.6150 had assumed USD/CNY appreciating to 7.40 and to the extent that CNY is now kept in check, there is clearly upside risk to our published NZD projections.

A few months ago we published a “ready reckoner” which gave a fair-value estimate for the NZD based solely on the level of USD/CNY, based on the close association between the currency pairs since the trade war began last year. At the current USD/CNY level of 7.076, fair value for the NZD is 0.6430, with a one standard deviation range of 0.6260-0.6600. Based on current spot and that central estimate, this simple model still looks valid!

As has been evident for at least the last eighteen months, the fate of the NZD lies in the hand of President Trump. Trade talks are currently underway to work towards an agreement that can be signed at the APEC summit in Chile mid-November. An agreement looks attainable if Trump is willing to cancel the proposed increase in tariffs due mid-December.

More encouraging developments in the trade war and the recent easing in global monetary policy could breathe some life into the global economy and this dynamic would create the makings of a more sustainable recovery in the NZD. In that environment, we’d expect broadly-based weakness in the USD, adding to potential NZD/USD gains.

A positive short-term factor for the NZD is the evident speculative net short positioning, which is close to record levels on CFTC data. The recent 3% appreciation in the NZD will make traders increasingly nervous, and a closing of positions might have already been responsible for some of the uplift in the NZD over the past week.

The historically low NZ-US short term interest rate spread means that short NZD positions are profitable in an environment of a steady currency (NZD “carry” is negative). But even factoring this into account, speculative short positioning still looks overdone.

Overall, risks around the NZD are clearly not one-sided though. Current global economic momentum, which the NZD is sensitive to, remains to the downside. If data continues to disappoint and the trade war re-escalates then that would raise the chance of another lurch down in the NZD and a revisit of the 0.6204 low.

Domestic factors also remain a headwind, with low levels of confidence widely evident and GDP growth on a weaker, sub-trend path. We are going to need to see a recovery in business confidence and associated activity indicators soon otherwise we’ll be obliged to cut our GDP growth projections, which currently sit between 2-2½%. Recent business survey activity indicators like the ANZ/QSBO surveys and the PMI/PSI are more consistent with growth travelling around 1½%, well below RBNZ projections. This dynamic could keep the dovish tilt to the RBNZ’s policy outlook, even if global risks might be subsiding. Another RBNZ rate cut in November still seems likely at this juncture.

For now, our weaker NZD projections remain but we flag upside risk, with US-China trade war developments being the key swing factor. We don’t want to “jump the gun” but to the extent that the current risk-positive mood is sustained, the makings of a more meaningful recovery in the NZD could be developing.

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