NZD/AUD: Back to fair value

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Summary

• The NZD/AUD cross has (justifiably) moved back down below its 5-year average of 0.9320 and is now closer to fair value.

• In-sync NZ and Australian economies and monetary policy argue for a range-trading environment to sustain over the foreseeable future. We see 0.91-0.92 as an area of support.

• Exporters should look to lock in some cover on any forays below 0.92. Importers have had ample opportunity to lock in cover above 0.95 this year. We might struggle to regain that level through the rest of the year, so look to reduce target levels for any future hedging.
Technical picture (I)

- The cross rate been mean-reverting since the beginning of 2014 and has recently plunged from well-above to below its 5-year average (of 0.9320).
- We see 0.91-0.92 as a support zone.
- With the cross back below average, exporters with a longer-term focus should be alert to opportunities to buy cover on further weakness from here.
Technical picture (II)

- Since 2014 the cross has spent 74% of the time between 0.91-0.96 and another 10% of time between 0.90-0.91.
- Thus, since 2014 forays below 0.90 or above 0.96 have been limited.

Source: BNZ, Bloomberg
Long-term valuation model

Our long-term PPP model estimate has hovered around 0.90-0.91 for the past few years.

Upward drift over decades reflects NZ’s lower inflation record than Australia, as per the lower central bank target.

Taking a long-term perspective, the tight trading range since 2014 is somewhat unusual.

But only a significant change in NZ vs. Australian economic prospects would cause a break-out, something we can’t see at present.

Source: BNZ, Bloomberg
Speculative Positioning

- Our indicator, which scales the CFTC data appropriately, suggests speculative short NZD-AUD positions building recently.
- We’re not at extreme levels yet, but further short positioning would add to the chance of a contrarian bounce-back in the cross.
Economic Growth

• The NZ and Australian economic cycles are currently in sync.

• Real GDP per capita growth has been better in NZ than Australia over the past 12 months (0.5% vs -0.2% y/y).

• The growth outlook for both countries looks similar to us, with sub-trend growth over the coming year.

• ...suggesting mean reversion behaviour in the cross rate should continue.

Source: BNZ, Bloomberg
Business Conditions

- Standardised business conditions indicators suggest below-average levels of activity for both countries.
- On a rate of change basis, the deterioration in Australian business conditions has been sharper compared to NZ over the past 18 months.
- We can’t find a robust link between relative business confidence and the cross rate.
Unemployment Rates

- The unemployment rate is our favourite indicator to monitor cyclical pressures on the cross rate – it summarises capacity pressures in the economy and pressures on interest rates.
- Over the past five years, NZ and AU unemployment rates have been trending lower at roughly similar paces.
- But recently the unemployment rate has ticked higher in Australia, adding to the case for a more dovish RBA outlook versus the RBNZ.

Source: BNZ, Bloomberg
Unemployment Rate Differential

- The difference in unemployment rates can single-handedly satisfactorily explain broad NZD/AUD cycles over the past 20 years.
- A relatively steady unemployment rate gap can explain the trading range environment for the cross over the past 5 years.
- The AU-NZ unemployment rate gap is currently at the top of its 5-year range, and could move even higher next year, one support factor for the NZD/AUD cross.

Source: BNZ, Bloomberg
Housing Market

- Heightened fear about the Australian housing market earlier this year has faded, with RBA rate cuts supporting the market.
- Monthly house price inflation in Australia is now positive, so the annual change will recover quickly.
- This dynamic has been instrumental in the downward correction in the NZD/AUD cross recently, with this rare economic divergence now old news.
Inflation

• The RBNZ is currently much closer to meeting its inflation target compared to the RBA.
• Other things constant, the RBA should be more inclined to cut rates further than the RBNZ.
• A relatively tighter labour market in NZ would support that view.

Core CPI

Source: BNZ, Bloomberg
Monetary Policy (I)

• In both countries the near-term risk is clearly one of further rate cuts.
• We expect at least two more 25bps cuts by the RBA and at least one more cut by the RBNZ.
• From a current equal policy rate of 1%, the market sees the RBA’s cash rate moving below the RBNZ’s. Given the previous chart on inflation, this seems fair.

RBNZ vs RBA Cash Rates

Source: BNZ, Bloomberg
Monetary Policy (II)

- Relative interest rates haven’t been a key driver of NZD/AUD volatility over the past couple of years, with policy tracks fairly similar over that time.
- Looking at the expected policy rate in six months’ time, the difference between NZ and Australian rates shows relatively little movement.
- Given similarities in the policy outlook, relative interest rates aren’t expected to be a key driver of the cross rate over the foreseeable future.
Relative Commodity Prices

- Relative NZ/Australian commodity prices can kick around a bit and drive short-term variations in the cross rate.
- NZ’s relatively stronger commodity prices since late 2018 have been a positive factor for the cross, but that move has recently been reversing.
- Momentum errrs towards further relative NZ/AU commodity price weakness. Higher oil and gold prices would facilitate that.
Short Term Valuation Model

- The recent NZD/AUD downward correction has driven the cross close to our current short-term fair value estimate of just under 0.93.
- With steady interest rate differentials, relative commodity prices are likely to be the key driver of fair value from here.
- Currencies are apt to overshoot fair value, so further downward pressure is possible, but we see 0.91-0.92 as a support zone.
Forecasts

- Our forecasts over the foreseeable future are anchored around 0.93-0.94.
- In practice, this means the trading range in play since 2014 is expected to remain in place.
- Exporters should look to lock in some cover on any forays below 0.92.
- Importers have had ample opportunity to lock in cover above 0.95 this year. We might struggle to regain that level this year, so look to reduce target levels for any future hedging.
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