NZD/GBP

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11 February 2019

Summary

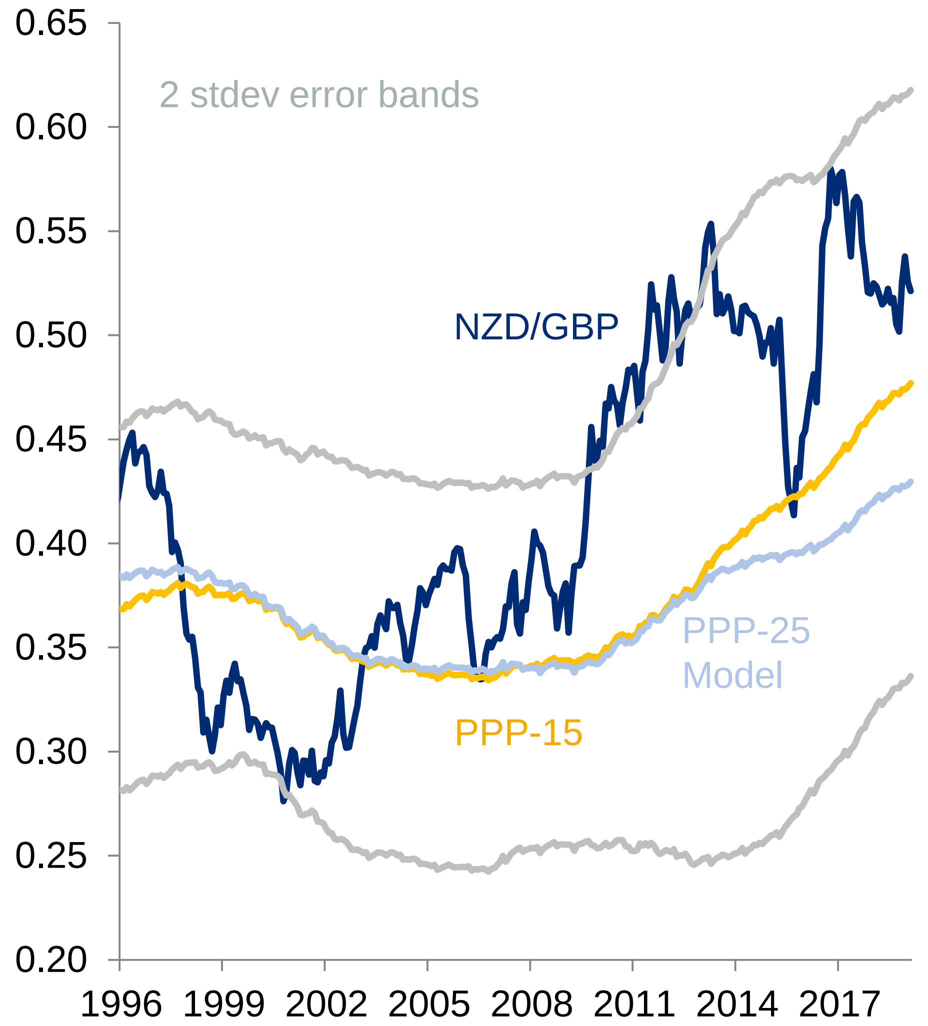
- GBP is super-cheap, driven down by Brexit uncertainty.
- Long term fair value for NZD/GBP is 0.43.
- Our short-term model suggests that in the absence of Brexit, current fair value is around 0.47-0.48.
- Brexit outcomes remain a key source of uncertainty for NZD/GBP.
- We assume a soft Brexit outcome that drives the cross down to 0.48 this year.

Technical picture

- The cross has traded a wide range over recent years and been volatile at times, with Brexit a key contributor.
- We judge a downward channel has been in play over the last couple of years.
- Bottom/top of channel is currently 0.4780-0.5460.

Long-term valuation model

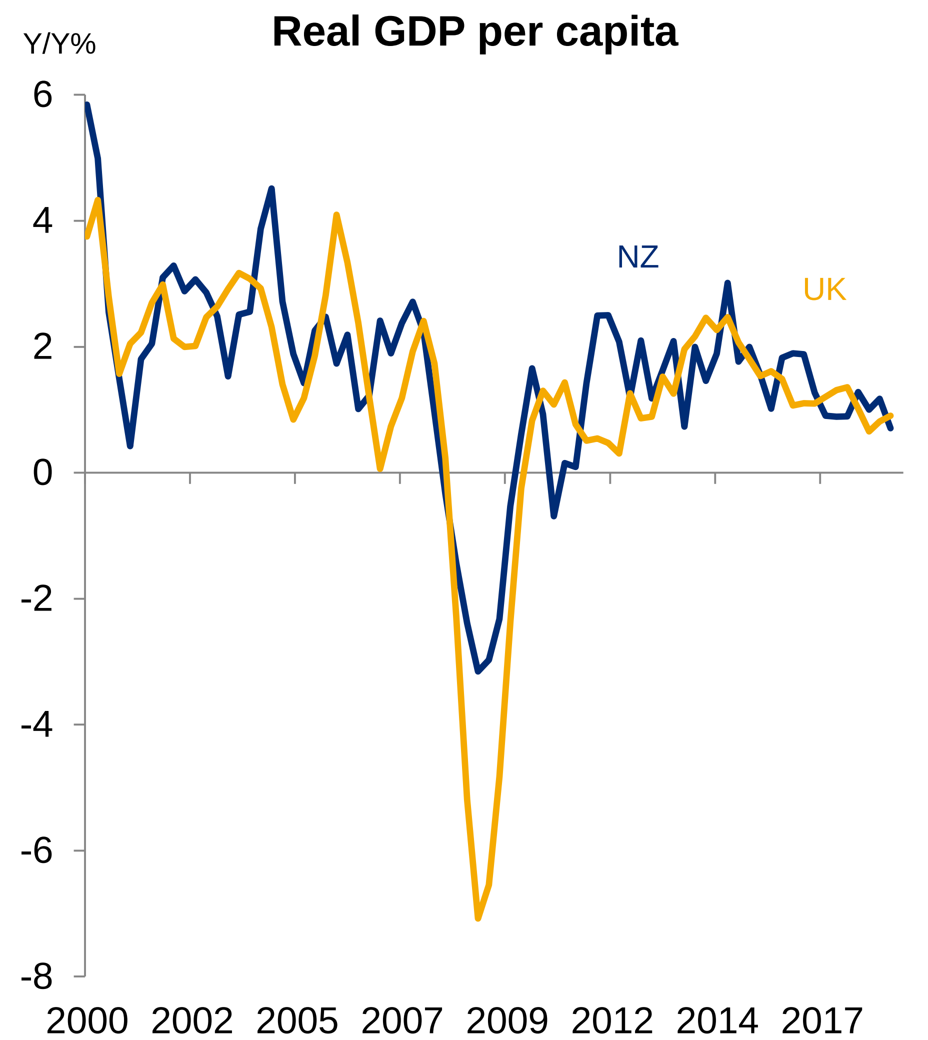
- The cross has been trading above our long-term purchasing power parity estimate for the best part of 15 years, reflecting strong NZ relative terms of trade.
- This dynamic should be sustained; we see NZ's terms of trade remaining strong.
- We usually prefer to use a 15-year moving average filter for our PPP estimates, but for this cross a longer time period seems more appropriate.
- Our PPP-25yr model estimate currently sits close to 0.43.



Source: BNZ

Economic Growth

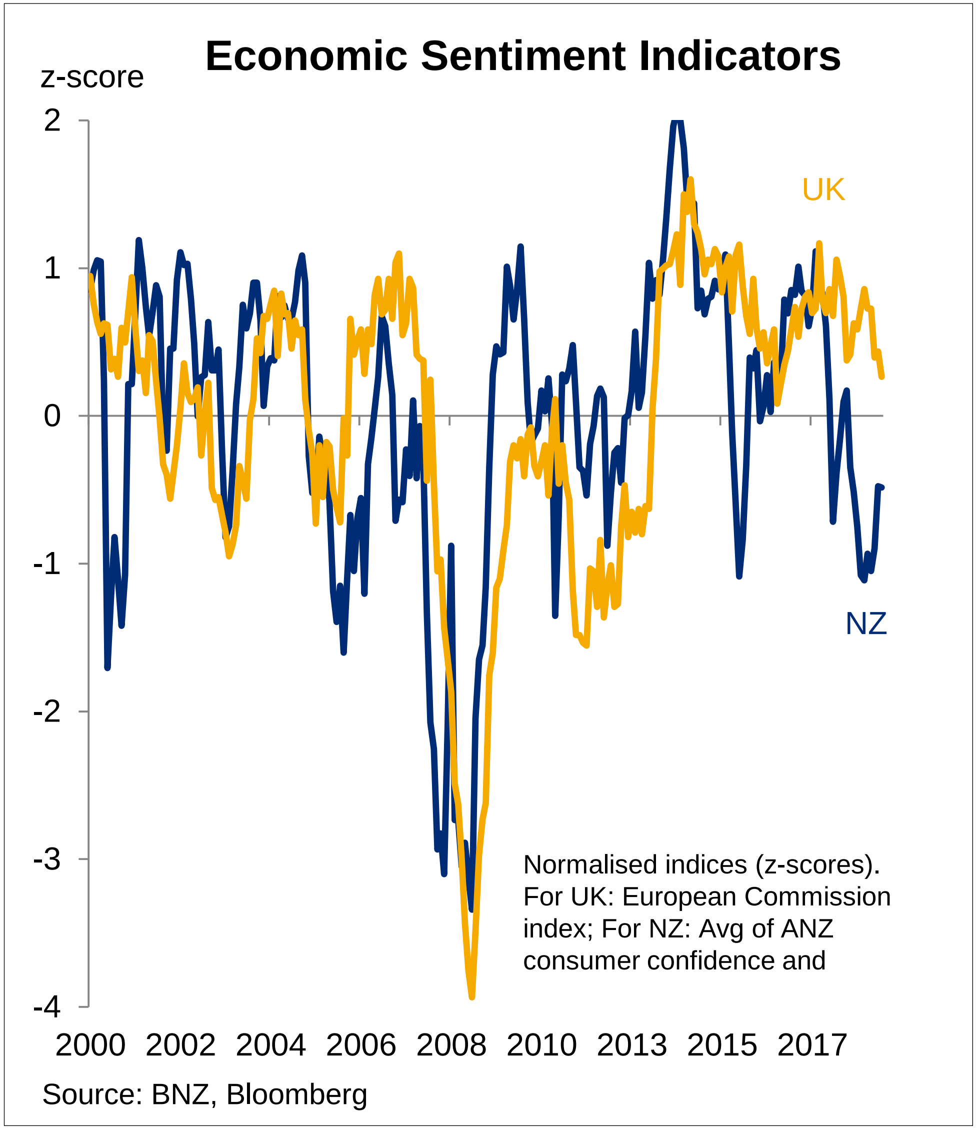
- NZ and UK GDP per capita growth rates have tracked closely together over the past five years.
- Brexit uncertainty has likely weighed on UK growth, but this has come at a time of a weaker NZ growth profile.
- While NZ growth is expected to track close to trend over the year ahead, for the UK the outcome will depend on how Brexit plays out over coming months.



Source: BNZ, Bloomberg

Economic Sentiment Indicators

- Economic sentiment (combining business and consumer confidence) is running stronger in the UK than NZ, despite Brexit uncertainty.
- In fact, UK economic sentiment, while slipping, is still above average.
- The NZ index has been weighed down by weaker business confidence since the September 2017 election.

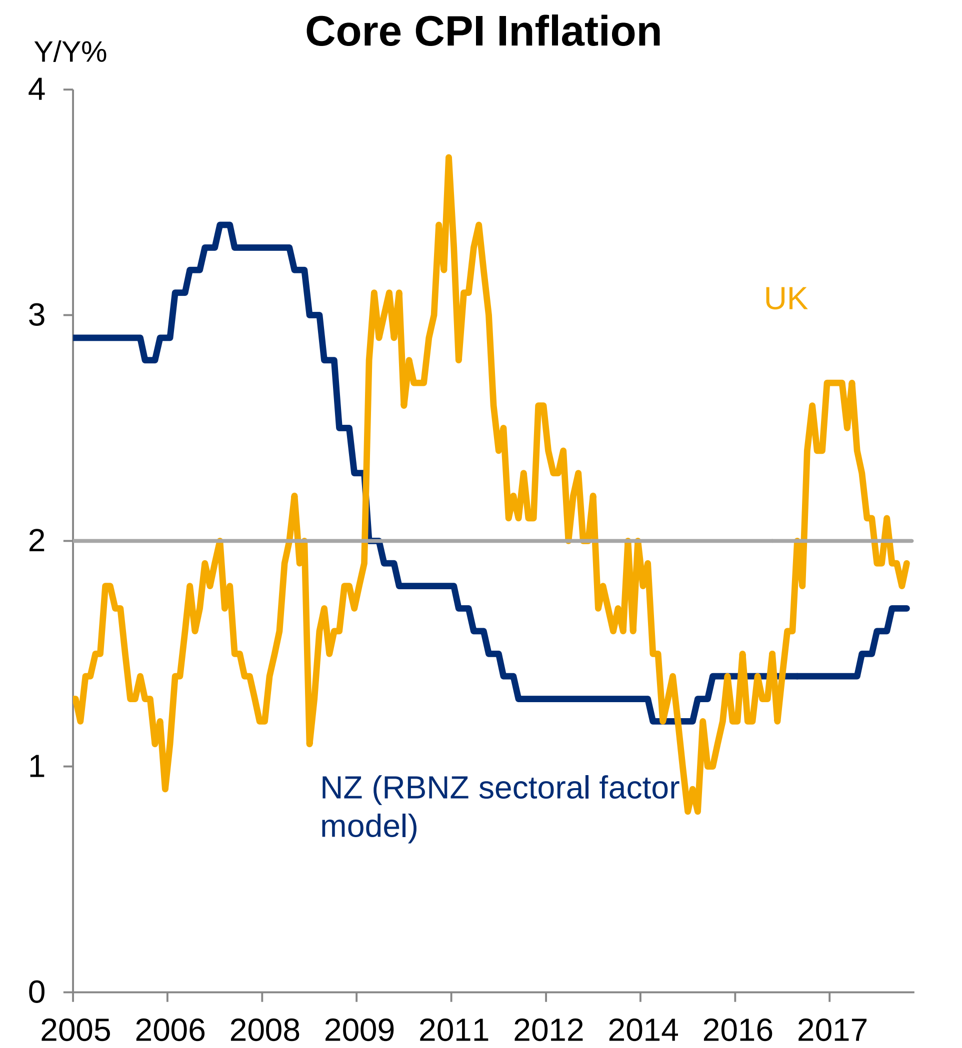


Unemployment Rates

- GDP growth in both countries has been strong enough to drive down unemployment rates over the past five years.
- Over the last few years, the rate of decline in the unemployment rates has been at a similar pace.
- In both countries, unemployment rates are around the 4% mark.

Inflation

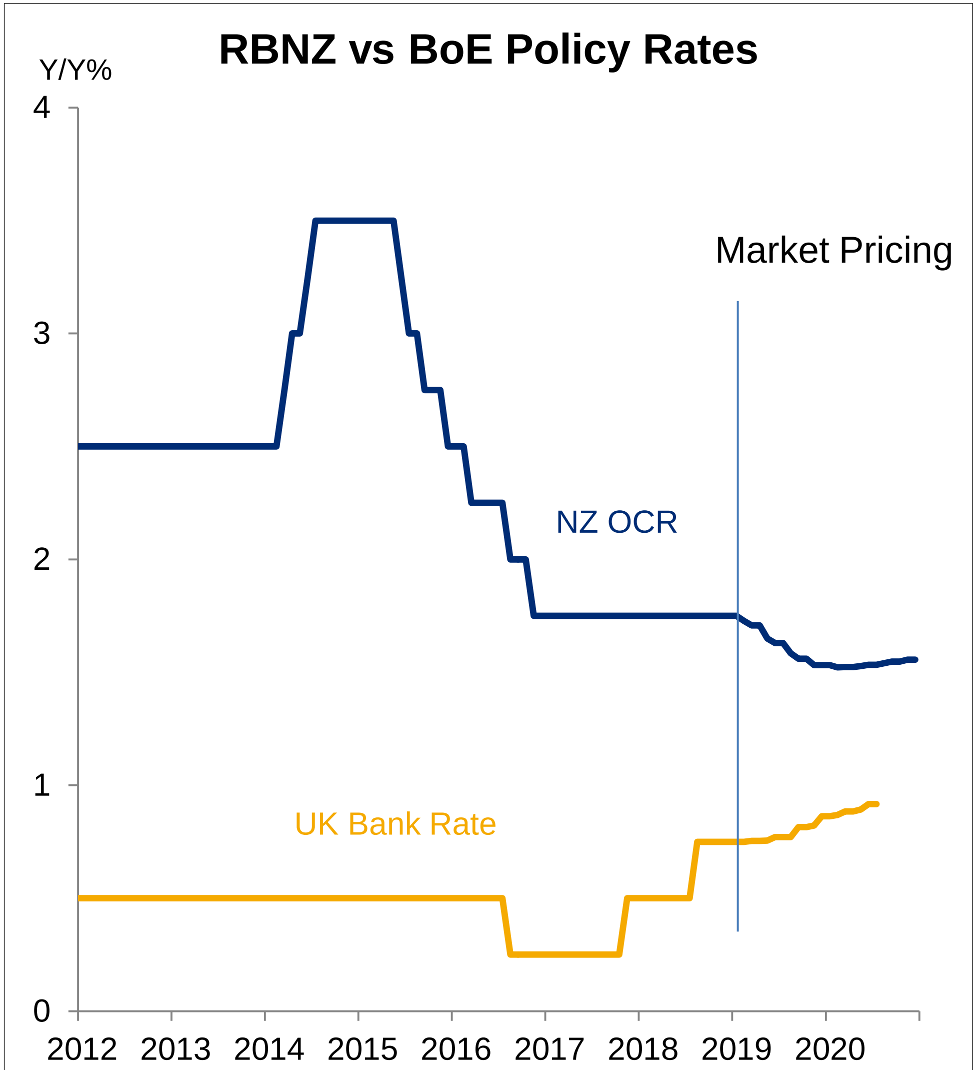
- The BoE has had more success in meeting its 2% inflation target than the RBNZ over the past couple of years, although the impact of the weaker GBP after the Brexit vote has now faded.
- NZ core inflation is rising, albeit slowly, towards 2%.



Source: BNZ, Bloomberg

Monetary Policy

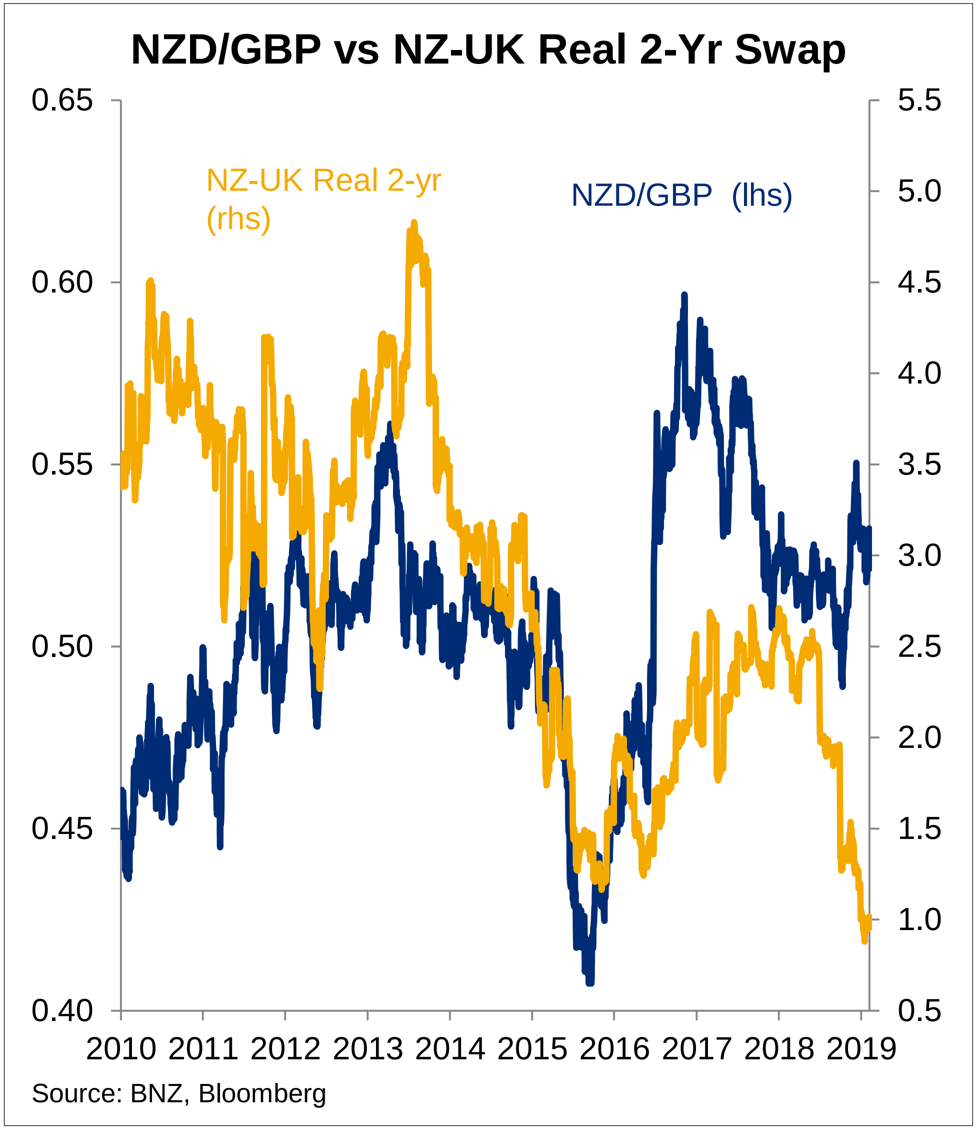
- The market is currently pricing almost a full 25bp rate cut in NZ by the end of this year.
- The market sees a small chance of higher UK rates over the next couple of years.
- On our core view of a soft (or no) Brexit outcome, we see the risk of higher UK rates.
- We also see the risks weighed towards higher NZ rates compared to dovish market expectations.



Source: BNZ, Bloomberg

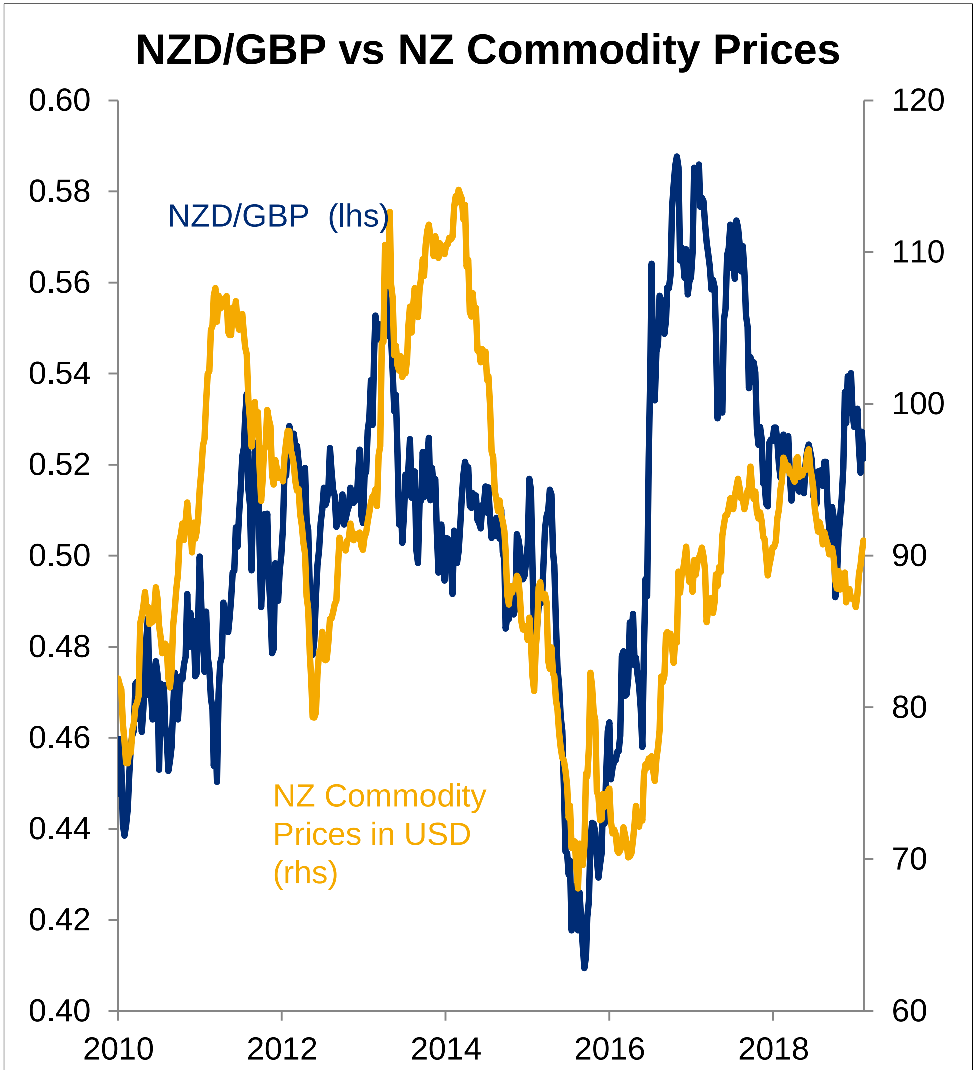
Interest Rate Differentials

- The relationship between NZ-UK interest rate differentials and the cross is not strong.
- Indeed, when included with other factors in an NZD/GBP fair value model, rate differentials don't add any value.
- NZ-UK real rate differentials are close to historical lows.



Commodity Prices

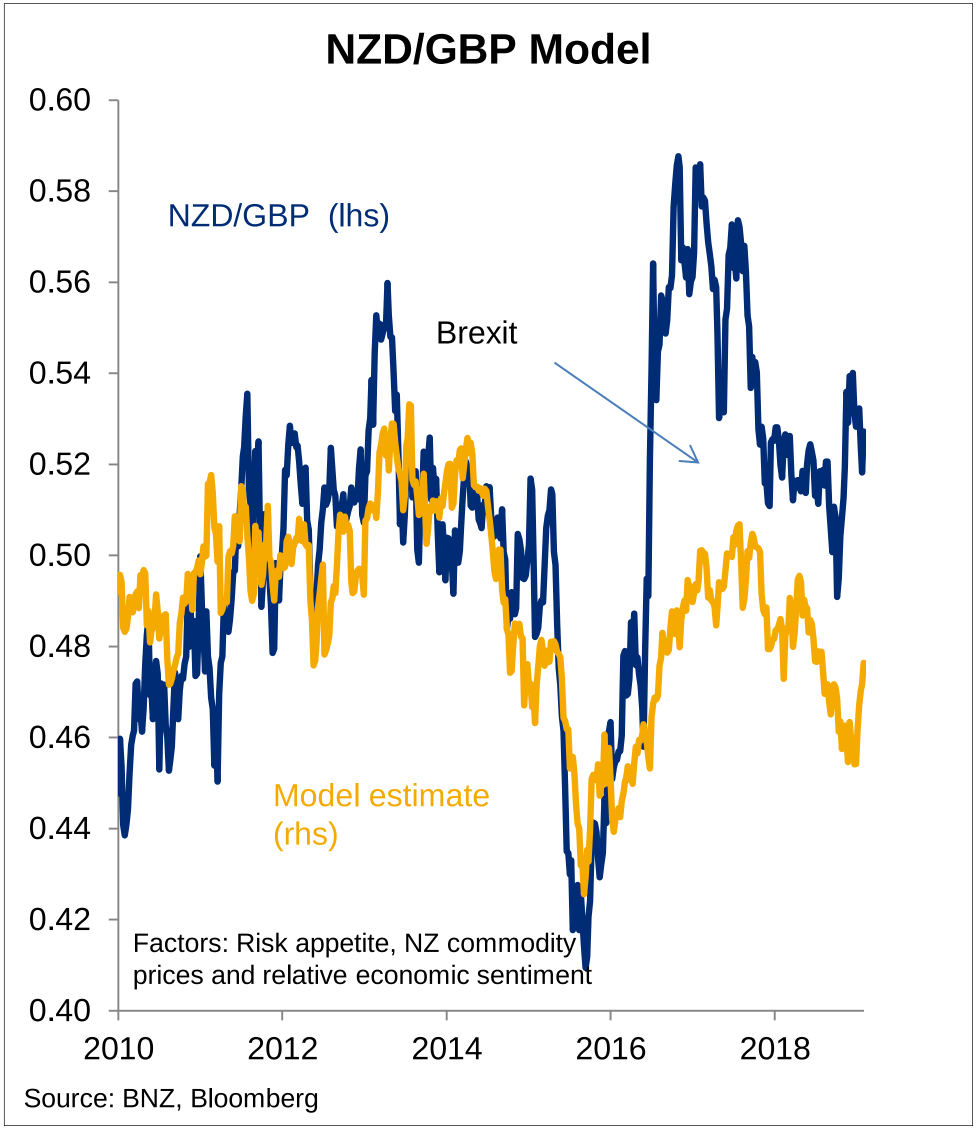
- There is a positive relationship between NZ commodity prices and the cross rate.
- Over the past couple of years, NZ commodity prices have largely tracked sideways.
- Current momentum is slightly to the upside, as dairy prices recover and demand for soft commodities remains robust.



Source: BNZ, Bloomberg

Short Term Valuation Model

- Brexit uncertainty has had a long-lasting negative impact on GBP.
- If not for Brexit, our fair value model suggests that the NZD/GBP "should" be trading around 0.47-0.48.
- A soft Brexit or no Brexit would likely see the spot rate fall towards the model estimate, closing the gap.



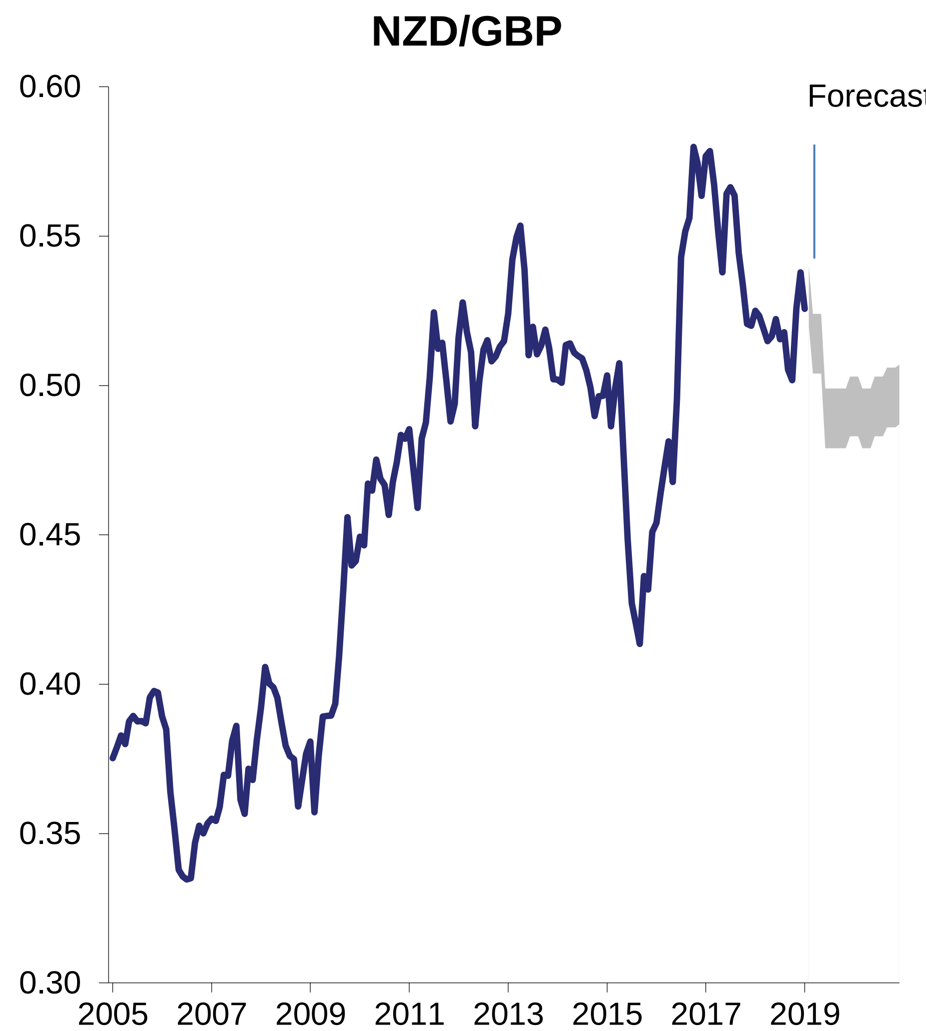
Brexit Risks – Two-sided for the Cross

Lots of permutations: Here are some key ones with possible currency targets once the dust settles:

- PM May's EU Withdrawal Agreement (or something close to it)
  - Our central view, a soft Brexit, NZD/GDP 0.47-0.49
- Eventual second referendum; Brexit avoided
  - Our next-best guess, NZD/GBP 0.43-0.47
- A less benign outcome to May's deal eg Norway+ or Canada style FTA
  - Brexit but with less benefits, NZD/GBP 0.54-0.56
- No-deal; WTO rules apply; Uncertainty over rules prevails
  - Little Parliamentary support for this, NZD/GBP 0.59-0.63
- General election; currency crisis
  - Possible if things get out of control, NZD/GBP 0.62-0.65

Forecasts

- Brexit is the key driver of our forecasts.
- We assume a soft Brexit outcome that drives the cross down to 0.48.
- Timing remains somewhat elusive, as some delays in removing the fog of Brexit could occur.
- As the previous slide shows, a wide range of outcomes is still entirely plausible, with a move above 0.60 on the worst scenarios.



Source: BNZ, Bloomberg

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