

# Harbour Investment Horizons

## Harbour Investment Horizon - NZD/AUD potential moves towards parity, but fundamentals anchored lower

### Harbour Investment Research

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The market and economic backdrop for the NZDAUD has changed noticeably since the RBNZ last cut interest rates in March.

The NZDAUD cross has moved to the upper end of its historic trading range. Although there may be short term momentum to the upside, economic fundamentals point towards a lower NZDAUD over the medium term.

In the last week we saw the AUD weaken after S&P lowered Australia's rating outlook to negative from stable. This reflected the view that without implementation of more forceful fiscal policy decisions, material government budget deficits may persist for several years without improvement. Later, the RBNZ Deputy Governor Spencer spoke on macro-prudential policy and housing risks. The market noted comments that while the CPI outlook will ultimately determine monetary policy, OCR cuts could pose a financial stability risk. The markets took that as a sign that the RBNZ is less likely to cut rates than was previously thought.

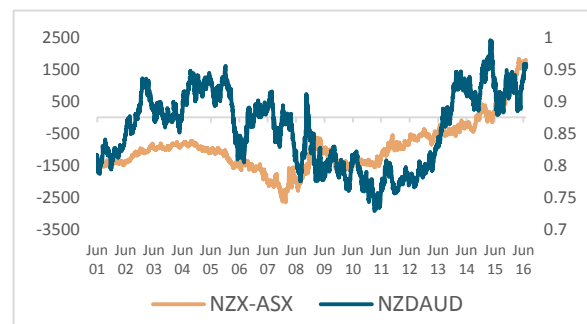
In this note we review some of the fundamental drivers of the NZDAUD exchange rate.

## Reasons why the NZDAUD is trading higher

### Relative equity prices

The New Zealand equity market has significantly outperformed its Australian counterpart. Strong asset prices and the inference of a stronger economy have lifted the NZD.

**Figure 1: NZDAUD and Equity Market Differentials**



Source: Harbour, Bloomberg

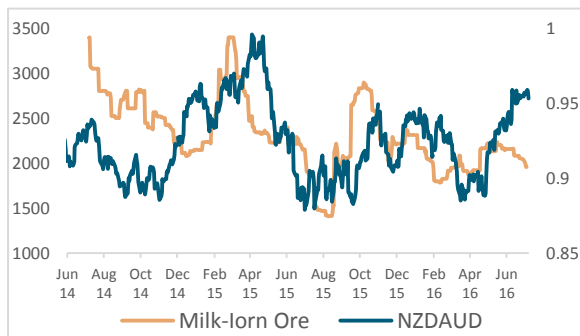
LHS spread differential between the NZX 50 Index and the ASX 300 Index. RHS NZDAUD.

Over the last year the Australian equity market has suffered from commodity price declines and risks around regulatory changes in the financials sector, while the New Zealand market has held up relatively well given its defensive nature and high yield.

## Commodities

Milk prices have been weaker than expected in 2016 with low volumes, while oil and iron ore recovered from 2015 lows.

**Figure 2: NZDAUD and Milk-Iron Ore Differentials**

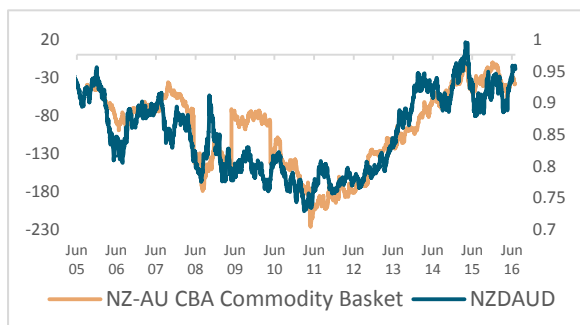


Source: Harbour, Bloomberg

LHS spread differential between global milk and global iron ore prices. RHS NZDAUD.

Although there has been a short term focus on milk and iron ore in currency markets, the commodities that make up a broad basket of New Zealand and Australian trade have performed more strongly for New Zealand than for Australia, potentially justifying an elevated NZDAUD cross.

**Figure 3: NZDAUD and Commodity Differentials**



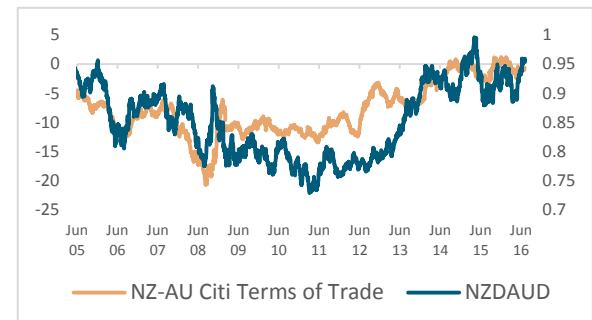
Source: Harbour, Bloomberg

LHS spread differential between CBA New Zealand Commodity basket and CBA Australia Commodity basket. RHS NZDAUD.

## Terms of trade

The terms of trade have been stronger for New Zealand than for Australia.

**Figure 4: NZDAUD and Terms of Trade Differentials**



Source: Harbour, Bloomberg

LHS spread differential between Citi New Zealand terms of trade and Citi Australia terms of trade. RHS NZDAUD.

With New Zealand's ratio of exports to imports remaining stronger relative to Australia, there has been higher relative demand for New Zealand Dollars globally and this has aided the strength in the exchange rate.

## Arguments for a higher NZDAUD near term

Currency traders often follow momentum, trading directionally on sentiment and risk, and we could see continued near term strength in the NZDAUD.

AUD weakness/NZD strength could easily be extended with the political gridlock in Australia. As the lack of consensus in the electorate and the Government's ability to create economic reform is reduced, the implications can be extrapolated into the broader Australian economy.

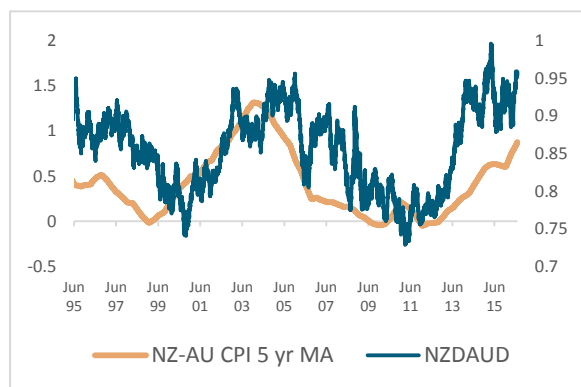
Australia and the AUD face further risks around China, as growth momentum has shown signs of fading. China's June PMI came in at 50, the private sector PMI printed lower, and further fixed asset investment has also slowed. Fiscal policy is critical to supporting growth.

# Why the NZDAUD is overvalued

## Inflation

Inflation is an important determinant of the exchange rate because most central banks have a mandate that targets inflation.

**Figure 5: NZDAUD and Inflation Differentials**



Source: Harbour, Bloomberg

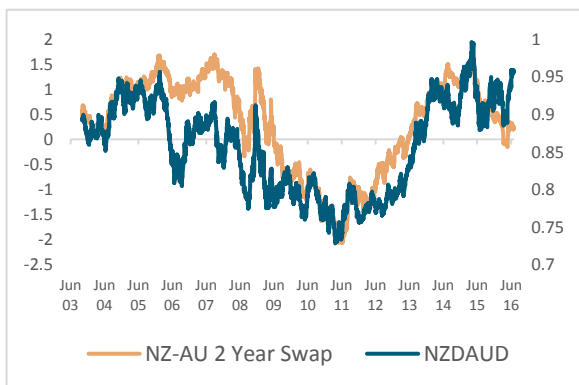
LHS spread differential between New Zealand CPI and Australian CPI on a 5 year moving average. RHS NZDAUD.

Both the RBNZ and RBA have target inflation bands and use their official cash rate as a primary tool to achieve their inflation goal.

## Monetary policy

Swap rate differentials measure market expectations of central bank policy. Although the RBNZ has significantly changed its stance from March, there are still significant rate cuts priced into the NZ 2 year swap rate, suggesting a lower exchange rate relative to Australia is justified.

**Figure 6: NZDAUD and Swap Rate Differentials**



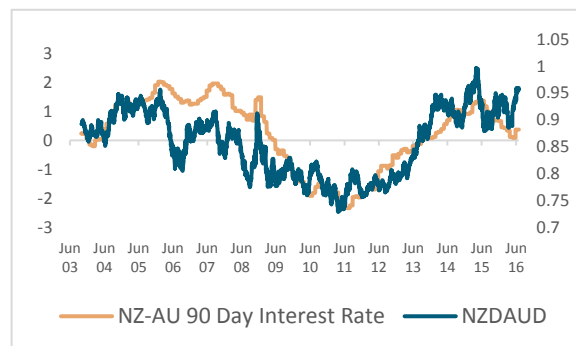
Source: Harbour, Bloomberg

LHS spread differential between New Zealand 2 year swap rates and Australian 2 year swap rates. RHS NZDAUD.

## Interest rates

Both short and longer term interest rate differentials between New Zealand and Australia point towards a lower NZDAUD fundamentally.

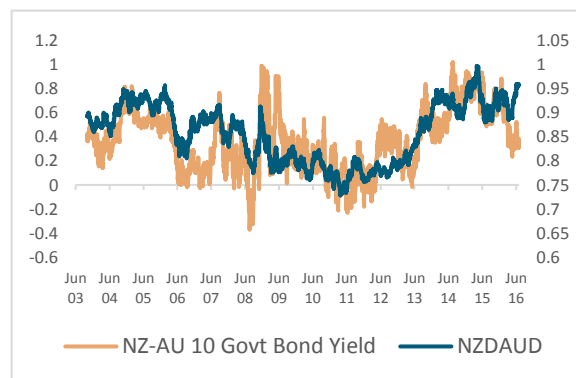
**Figure 7: NZDAUD and 90 Day Rate Differentials**



Source: Harbour, Bloomberg

LHS yield spread differential between New Zealand 90 day bank bill yields and Australian 90 day bank bill yields. RHS NZDAUD.

**Figure 8: NZDAUD and 10 Year Bond Differentials**



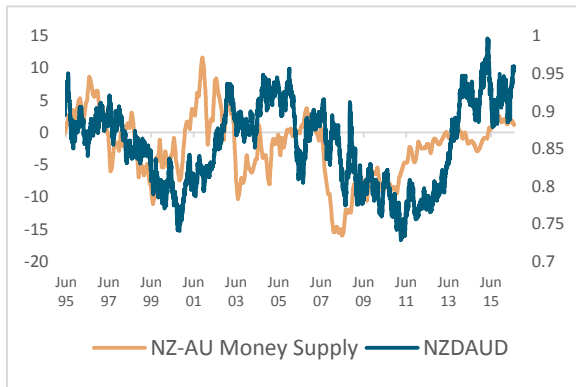
Source: Harbour, Bloomberg

LHS yield spread differential between New Zealand 10 year Government bond yields and Australian 10 year Government bond yields. RHS NZDAUD.

## Money supply

Money supply stimulates consumer spending which coincides with consumer confidence and is the largest part of aggregate demand.

**Figure 9: NZDAUD and Money Supply Differentials**



Source: Harbour, Bloomberg

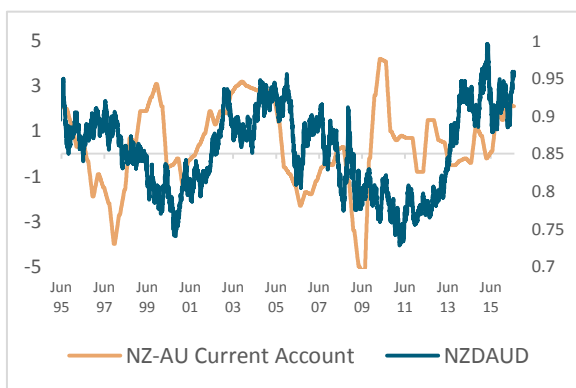
LHS spread differential between New Zealand M3 Money Supply and Australian M3 Money Supply. RHS NZDAUD.

New Zealand has stronger business and consumer confidence compared to Australia, and New Zealand has more relative money supply. However, the NZDAUD has run further than justified by fundamentals.

### Current account

The current account is the difference between a countries savings and investment, and is an indicator of economic health.

**Figure 10: NZDAUD and Current Account Differentials**



Source: Harbour, Bloomberg

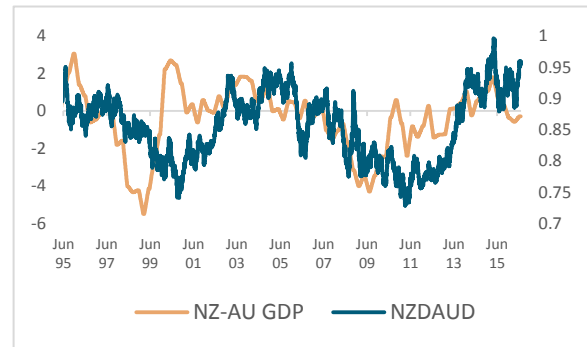
LHS spread differential between New Zealand Current Account scaled by GDP and Australian Current Account scaled by GDP. RHS NZDAUD.

While the differential between the New Zealand and Australian current account is higher than the historical average (the New Zealand deficit is less than the Australian deficit), it is lower than the NZDAUD which should drop back to lower levels.

### Gross domestic product (GDP)

GDP is a measure of a country's productivity of goods and services. New Zealand's latest GDP year on year print came in at 2.8% and Australia's came in at 3.1%.

**Figure 11: NZDAUD and GDP Differentials**



Source: Harbour, Bloomberg

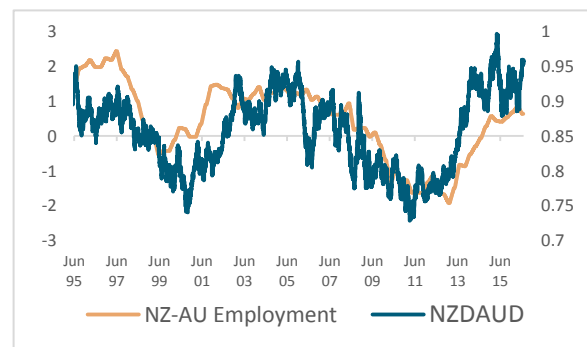
LHS spread differential between New Zealand year on year GDP and Australian year on year GDP. RHS NZDAUD.

The GDP differential for New Zealand and Australia is lower than the exchange rate, suggesting it should revert.

### Employment

While New Zealand and Australia have both printed an unemployment rate of 5.7%, the New Zealand job market is outperforming the Australian in relation to each country's long term sustainable rate.

**Figure 12: NZDAUD and Employment Differentials**



Source: Harbour, Bloomberg

LHS spread differential between New Zealand annual percentage employment and Australian percentage annual employment. RHS NZDAUD.

Employment feeds into consumer confidence, spending and inflation. The employment fundamentals are anchored lower than the NZDAUD suggests.

## NZDAUD fundamentals are anchored at lower rates long term

There is a lot of noise in foreign exchange markets. Currencies are sentiment driven in the short term and factors that are important one day cease to be important the next.

Rather than focus on events and binary outcomes, it is important to consider the fundamental economic relationships of relative economies and how the exchange rate is positioned in comparison.

Although there are some relationships (equity returns, commodities and terms of trade) that justify a higher NZDAUD, more fundamentals point towards a lower fair value than current levels.

The NZDAUD cross has moved to the upper end of its historic trading range. Although there may be short term momentum to the upside, economic fundamentals are anchored lower for the NZDAUD and we expect a reversal in the long term.

**Susanna Lee, Quantitative Research Manager at Harbour Asset Management**  
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