23 August 2010

Crossing the line

NZD/AUD exchange rate model update

- **NZ's economic data has been weaker than Australia's, and the interest rate spread has widened. Given these developments, it is unsurprising that NZD/AUD has depreciated.**
- **Our model suggests the NZD/AUD will remain below 80 cents for a while yet.**
- **The model is picking a turning point thereafter, with a sharp appreciation in NZD/AUD, based on the twin assumptions that NZ interest rates will rise faster and NZ GDP will grow more rapidly than Australia's.**

It was no surprise to see the NZD/AUD depreciate from 0.813 in July to 0.793 in August (month averages). The gap between Australian and New Zealand two-year swap rates has widened to 100bp, from an average of 82bp in July. At the same time, New Zealand's economic data has been weaker than Australia's. Westpac estimates that Q2 GDP growth was 1.2% in Australia, against 0.7% for New Zealand. Australia's export commodity prices have held up better than New Zealand's. And New Zealand net migration has been through a particularly weak spell.[1]

Our NZD/AUD model endorses the recent depreciation, in the sense that the predicted behaviour of the NZD/AUD is close to what has actually happened.

The latest model update suggests that the weak run for NZD/AUD will continue for a while yet. On a monthly-average basis, NZD/AUD is expected to remain around 0.79 through to October, depressed by NZD's sustained yield disadvantage, ongoing low net migration to NZ, and food commodity prices continuing to underperform 'hard' commodities. This combination is considered potent enough to keep the NZD/AUD far below its historical average.

The model is picking a turning point in NZD/AUD later this year. The NZD/AUD is projected to rise quite sharply, to 0.81 by the end of 2010 and 0.86 by the end of 2011. The model forecast is predicated on two key judgements. First, we assume that the interest rate differential between Australia and New Zealand will narrow. The RBA proclaimed itself on hold at its latest communiqué, while the RBNZ has signalled substantial OCR hikes. Markets have not priced in the RBNZ's plan, because they doubt the central bank's resolve. We do not share the market's scepticism. We expect the RBNZ will stick to its long-articulated hiking plan. If markets come to accept the RBNZ's plan, swap rates will rise and the NZD will look like a better yield proposition.

[1] NZ net migration is a useful leading indicator of the NZD/AUD exchange rate, probably because it is a useful leading indicator of NZ economic activity.

Figure 1: NZD/AUD history, fair value, and forecast

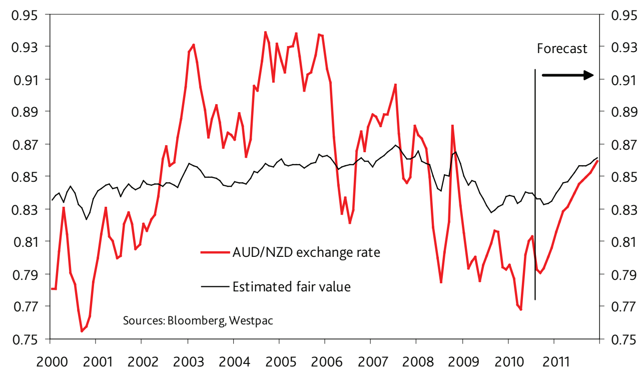
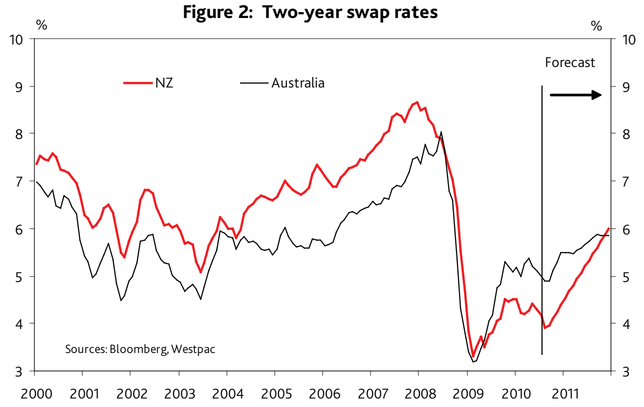


Figure 2: Two-year swap rates



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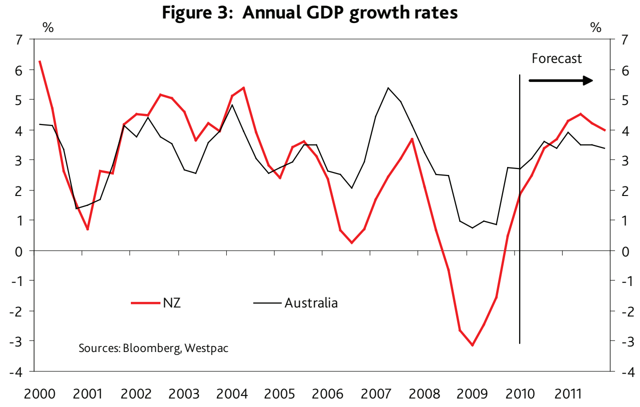
The second assumption is that NZ's GDP growth will exceed Australia's. The NZ economy is rebounding from a severe recession, and therefore has ample spare capacity to facilitate "easy growth". By contrast, Australia has enjoyed more consistent growth, so the economy may be running into capacity constraints. Westpac is forecasting NZ growth of 4½% through the year to June 2011, compared to 3½% in Australia. Historically, the country experiencing higher growth has tended to have the stronger exchange rate.

Figure 3: Annual GDP growth rates



Readers who do not share our view on relative growth and interest rate developments will, naturally, tend to have a less bullish view on NZD/AUD next year. For those readers, it is still worthwhile noting that NZD/AUD is 5% below our estimate of fair value, which stands at 0.836. Past behaviour suggests the cross is more likely to move towards fair value than away from it, which is the final reason our model is so keen on forecasting a turning point later this year.

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