

New Zealand: Central bank paves way for currency rebound in medium-term

A surprising hawkish tilt by the central bank doesn't just give a short-term respite to the battered New Zealand dollar, but also paves the way for a sustained recovery once virus-related fears dissipate



RBNZ surprises markets with upbeat tone

Minutes before the Reserve Bank of New Zealand published its monetary policy statement and economic projections overnight, markets were attaching a 60% implied probability of a cut by the second quarter. At the time of writing, that probability is 20%, increasing to 57% for the year-end tenors. This shows how investors were surprised by what was a robustly hawkish message from Governor Adrian Orr and the Monetary Policy Committee. Here are the key points of the statement:

- As rates were kept at 1% (widely expected), policymakers clearly pointed to a flat profile for the Official Cash Rate throughout 2020, also hinting at some scope for monetary tightening further ahead.
- The coronavirus risk was mentioned as a risk to the outlook (this was also expected), but the Bank made an extra step compared to other central banks (the Reserve Bank of Australia, to name one) in assuming the outbreak should have only a time-limited impact on domestic

activity.

- The Bank revised higher the large majority of its key economic indicators. It highlighted how the round of fiscal stimulus recently announced by the government should work in tandem with accommodative monetary policy to provide fuel to economic growth. Inflation is expected to stabilise around the target mid-point.

In essence, the message clearly indicates that the Monetary Policy Committee feels quite at ease with the current level of interest rates as it awaits more information to assess the impact of the coronavirus. It also reflects optimism that the supportive domestic backdrop may provide a sufficiently protective cushion to the external shock.

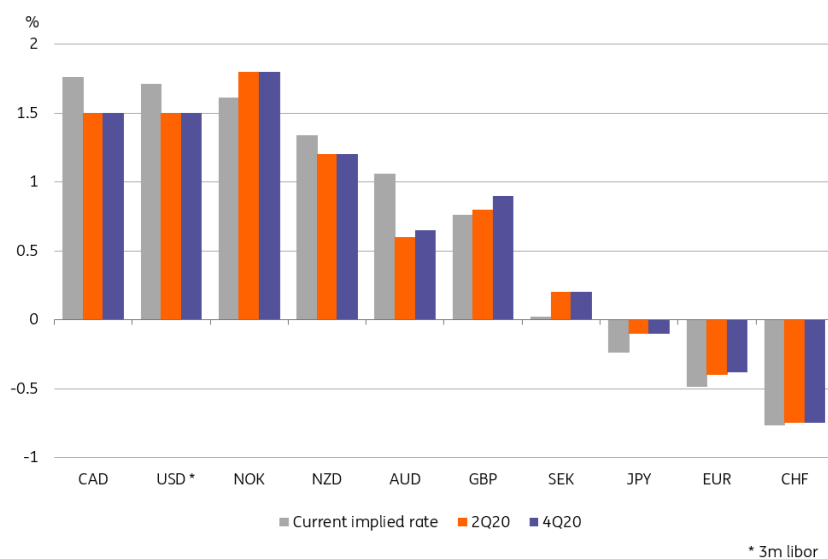
NZD set to recover in the medium-term

The repricing of rate expectations has inevitably triggered a jump in the New Zealand dollar, which had been among the major victims of the virus-related risk-off environment. After the RBNZ meeting, two different considerations must be made with regards to the NZD outlook, one for the short-term, one for the longer-term.

In the near-term, the virus remains the key story for NZD: the longer the outbreak keeps the Chinese economy in lockdown mode, the more concerns around the negative implications for highly-exposed economies such as New Zealand will mount, thereby putting a lid on any decisive NZD rally. As we have more than once highlighted, predicting the duration/spread/death toll of the virus is not our expertise, but for now, we simply highlight the complacency in equity markets, which suggests investors are perhaps too sanguine about the matter and we may see another leg lower in risk-related currencies. In other words, from a short-term point of view, the RBNZ's upbeat message may have only provided help which is time-limited amid a still unsupportive environment.

Looking at longer horizons, the reluctance signalled by the RBNZ around easing prospects likely puts a floor under New Zealand rates for the foreseeable future. The chart below outlines the different 3m implied yields currently priced by the markets along with our in-house forecasts for 3m interest rates in 2020. The NZD presents a quite respectable 1% yield – considering the average low rate environment – thereby preserving some carry appeal, which is set to fade for its closest peer, the Aussie dollar (we expect a Reserve Bank of Australia cut). This suggests that, once market sentiment stabilises, and barring a much harder than expected impact on the New Zealand economy (which could warrant an RBNZ cut) the NZD will likely see a more sustained recovery.

NZD to retain some carry attractiveness



Source: ING, Bloomberg

We continue to be cautious on the New Zealand dollar in the short-term on the back of the coronavirus, but we also stick to our view that AUD/NZD looks set for another leg lower (possibly breaking below 1.03) due to monetary policy divergence and Australia facing more downside risks (i.e. bushfires, higher impact of Chinese slowdown). For NZD to consistently outperform the US dollar, we'll need to wait for a significant stabilisation in global sentiment, after which the rate environment, economic resilience and medium-term undervaluation could drive NZD/USD to the 0.69 area at the end of 2020.

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