Why we think the NZD drop doesn't have legs

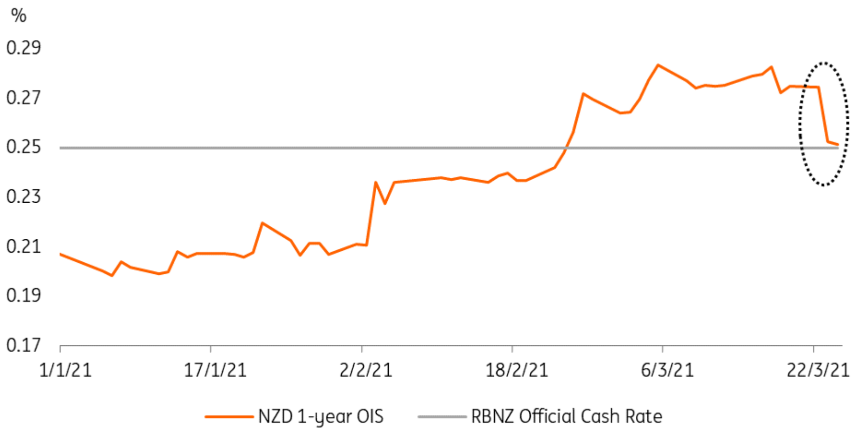
The New Zealand dollar fell significantly this week after a move by the government to curb the housing bubble caused a re-pricing of the central bank's hawkish expectations. We estimate NZD/USD is now 2.7% undervalued in the short term and a rate hike in the next year has been fully priced out, suggesting almost all the negatives are already in the price

No further room to fall for rate expectations

The New Zealand government took bold steps to address the country's surging housing prices by announcing on Tuesday the suspension of some tax incentives for investors speculating in the housing market. In February, those investors accounted for around 40% of purchases of houses in New Zealand.

Market moves after the announcement signalled a rather strong confidence that the measures will effectively curb the housing bubble in the country. This was quite evident in the rates and – by extension – in the FX sphere. Reserve Bank of New Zealand rate expectations dropped significantly as markets priced out the possibility of the Bank shifting to a more hawkish stance and possibly hike rates in the next year with the aim of curbing the housing bubble. The drop in the 1-year OIS segment (Figure 1) essentially reversed the increase seen in February, when the change in the RBNZ remit by the NZ government to include housing prices in policy considerations prompted a spike in rate-hike expectations. NZD/USD is down 2.80% from Friday's close.

Fig 1 - RBNZ rate expectations



Source: Refinitiv, ING

As shown in the chart above, markets have completely priced out any minimal probability of a rate hike in the next year. Despite the unexpected slump in 4Q GDP (-0.9% year-on-year), New Zealand still stands out as having had a relatively contained economic impact of the pandemic when compared to other developed countries. Furthermore, inflation and employment have showed encouraging signs of resilience. The latest CPI read (4Q20) saw YoY inflation unchanged from the previous quarter at 1.4%, not too far from the 2% central bank target. The RBNZ sees inflation back at target only in 2023, but the Bank's projections make the assumption that NZ borders will remain shut until the end of 2021, which may be an excessively pessimistic scenario considering the vaccination progress worldwide.

What counts in an FX perspective is that the risk of cuts by the RBNZ is extremely low, and markets will most likely not attempt to price in an OCR below the current 0.25%, which means the negative impact on NZD of the rate expectation re-pricing has likely worn off.

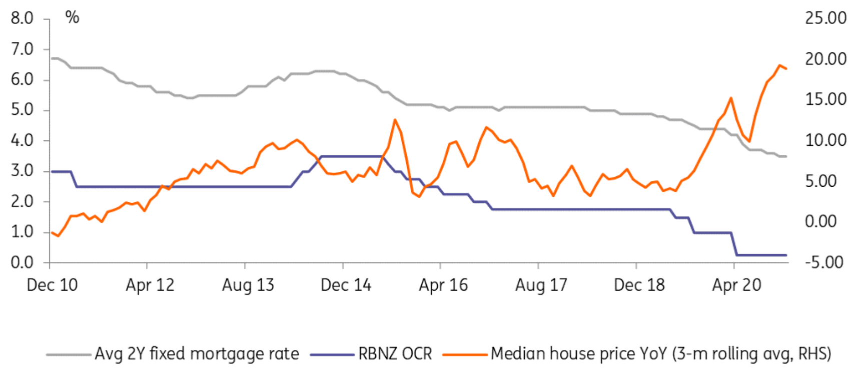
Don't be too quick to write off RBNZ tightening

Arguably, the resilience in inflation and employment are still valid points in favour of an earlier-than-expected tightening by the RBNZ. In addition, there is no certainty that the measures by the NZ government aimed at curbing surging house prices will be enough to fully serve the government's ambitions on improving housing affordability.

> *Resilience in employment and inflation may still point at earlier-than-expected monetary tightening*

New Zealand has the largest homeless population per capita in the developed world, and Prime Minister Jacinda Ardern has been increasingly engaged in addressing this issue. In a market perspective, we suspect investors may have moved too fast to think that the move by the government will take almost all responsibilities from the RBNZ when it comes to addressing the housing situation.

Fig 2 - Low yields' impact on housing prices



Source: RBNZ, ING

As shown in Figure 2 above, there was an evident impact on housing prices of lower mortgage rates – prompted by RBNZ rate cuts. The RBNZ efforts to re-impose loan-to-value restrictions on lending, even when paired with the tax measures just announced by the government, may fall short of fully achieving the government's goals on housing affordability.

> *Pressure on the RBNZ to hike rates for housing purposes is off now, but may come back on later*

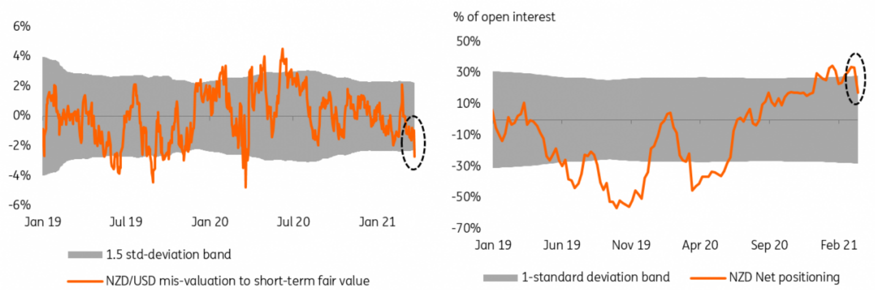
In other words, pressure on the RBNZ to hike rates for housing purposes is off now, but may come back on later, possibly once again from the government if the tax measures on speculative investing do not prove effective enough.

NZD/USD is undervalued in the short term

NZD/USD is undervalued by approximately 2.7% according to our short-term fair value model, which takes into account short-term rates, equity performance, shape of the yield curve, commodity prices and global risk appetite. As shown in Figure 3 below, the mis-valuation of NZD/USD is now below the lower-bound of its 1.5 standard deviation band: this means the undervaluation is at abnormal levels, and therefore suggests we could see a convergence of NZD/USD with its fair value model in the near term.

Part of the recent underperformance of NZD has also been likely due to the unwinding of some speculative long positions on the currency – as discussed in our latest G10 positioning note. As shown in Figure 4, the NZD net-long positioning has now moved back inside its one-standard-deviation band, and is therefore no longer abnormally high. The re-pricing of RBNZ rate expectations and the NZD underperformance this week may have prompted an even larger long-squeezing effect on the currency and we therefore expect any additional position-squaring-related downside risk for NZD to be more limited from now on.

Fig 3 & 4 - NZD/USD mis-valuation and positioning

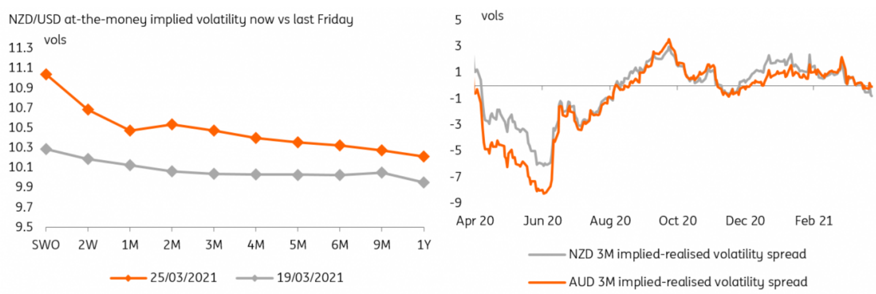


Source: ING, CFTC, Macrobond

Option market sees no idiosyncratic risks in NZD

The NZD/USD option market saw some wide moves following the big fall in the pair this week. As shown in Figure 5, the implied-volatility curve on NZD/USD has shifted higher when compared to last Friday's values, due to the drop in spot, with the increase in the short-end of the curve being particularly pronounced. This indicates that markets are expecting a period of higher volatility in NZD/USD in the short term and it is therefore more expensive to hedge against wide moves on the pair.

Fig 5 & 6 - Rising implied volatility but no signs of idiosyncratic risks for NZD



Source: Refinitiv, ING

However, when looking at the options' relative value– i.e. the difference between implied and realised (historical) volatility – the spreads across front-end tenors did not show any increase, meaning that markets are not pricing in volatility in excess of what is warranted from the historical moves in spot.

Comparing the NZD option market with the one of its closest peer AUD can provide an indication of how much NZD idiosyncratic risk is expected. In Figure 6 we show how the implied-realised spread for NZD/USD on the 3-month tenor is no larger (actually, marginally lower) than the one of AUD/USD. This indicates that markets are seeing no clear short-term idiosyncratic risks for NZD that could make it stand out from another commodity currency such as AUD, in line with our view.

Stabilisation before recovery?

Considering that short-term rates have reached the bottom (and may actually tick back up if markets start to re-price some RBNZ hawkishness), the material undervaluation in the short term and the more limited scope for further long-squeezing, NZD/USD appears to have most of the negatives in the price.

Given the highly positive beta of NZD (and the negative beta of USD) to global risk appetite, the near-term outlook for NZD/USD remains strictly dependent on external factors. Even if risk appetite remains choppy in the next weeks (possibly on the back of third virus wave concerns, especially in Europe), we think that NZD should experience more limited downside pressure than other pro-cyclical currencies, considering the factors highlighted above.

Beyond the very short term, some further stabilisation in the bond market will be needed to allow a rebound in commodity currencies and generate some fresh selling pressure on USD. We think yields will continue to rise in 2021 but possibly in a more controlled manner once investors feel yields are pricing the right amount of future inflation. This may happen already in 2Q21, and with the global reflationary narrative consolidating, we expect NZD to be at the forefront of any pro-cyclical rally.

> We remain in the view that NZD/USD will move above the 0.75 mark in the second half of the year. In the short term, the correction in the pair may struggle to go much further (for the reasons highlighted above) barring a material risk-off shift by the market, and the 0.6870 200-day moving average may prove to be a solid support even in case of a continuation of the current NZD weakness.

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