$ Bloc: Carry on, carry off

- The combination of political risks and financial stability concerns have reduced the speculative carry attractiveness of AUD and NZD
- The yield advantage these currencies have typically commanded is set to deplete further in 1H18 with the RBA and RBNZ happy to sit tight on policy
- We see CAD as the 'darling of the dollar bloc' amid ongoing economic outperformance, policy divergence and reduced sensitivity to oil prices

Theme 1: Struck down by the curse of political risks

While 2017 has been marred by lingering US-centric geopolitical concerns, each of the dollar bloc currencies have had their own idiosyncratic political uncertainties to contend with – albeit the implications being more obvious and destabilising for some currencies relative to others. In particular, a new Labour-led coalition government in New Zealand – looking to employ policies such as curbing inward migration, deflating the housing bubble and shaking-up the RBNZ’s policy mandate – has seen NZD crosses command a significant political risk premium in recent months. For Canada, uncertainty over the future of NAFTA – and broader US trade policy – remains a major headwind; however, unlike the Mexican peso (MXN), we note that spot CAD price dynamics have not been as sensitive to noisy NAFTA-related headlines of late. The same can be said for Australia, where the joint citizenship saga – among other things plaguing the Turnbull government – hasn’t yet had any discernible knock-on effects for the economic outlook, or the AUD.

In keeping with the global trend, we do think that political uncertainty for the dollar bloc countries will ease over the course of 2018. However, there will be discrepancies over the timing and extent to which this will occur. On the following page, we provide a summary of our thinking on the political risks underpinning each currency for 2018.

Politics sporadically weighed on $-bloc FX in 2017

Risk premium derived from short-term financial fair value model

<table>
<thead>
<tr>
<th>Jan 17</th>
<th>Mar 17</th>
<th>May 17</th>
<th>Jul 17</th>
<th>Sep 17</th>
<th>Nov 17</th>
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<tr>
<td>NZD risk premium</td>
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<td>CAD risk premium</td>
<td>CAD risk premium</td>
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Note: CAD risk premium derived from USD/CAD financial fair value model; NZD risk premium derived from AUD/NZD financial fair value model

Source: ING, Bloomberg

Local risks have seen sharp shifts in FX sentiment

CFTC net speculative positioning (% of open interest)

Source: ING, CFTC positioning data as of Nov 2017
NZD Political Risks | The worst is behind us

While the policy uncertainty of a Labour-NZ First coalition has seen the NZD sell-off in recent months, we do expect the currency to stabilise as the dust settles on the new government. International investors are likely to remain sceptical in the near-term, not least because of the financial stability risks surrounding the government’s policy to ban overseas speculators from buying houses. Equally, the appointment of a new RBNZ Governor and a shift to a dual-mandate (full employment as well as price stability) may require a short-term uncertainty premium to be priced into NZ rates and the kiwi dollar.

CAD Political Risk | 'Trump the Protectionist' tail risk

Blink and you would have missed the tariffs enforced by the new US administration on select Canadian industries in 2017 (namely lumber and aircraft exports). With mid-term elections in the US next year – and a White House that has made little progress on key economic policies – there is risk that President Trump steps up his anti-trade policy threats to appeal to his electoral base. Add to this, the uncertainty of NAFTA’s outcome of NAFTA – and we could see the CAD command a bigger risk premium in 1H18. Ahead of this, the primary channel through which any CAD weakness will manifest is via a more pronounced pause in the BoC’s hiking cycle. It’s no surprise to see “a shift towards more protectionist [US] policies” flagged as the main tail risk to the central bank’s outlook.

AUD Political Risks | Weak government, policy delays

On a relative scale, politics in Australia could easily be disregarded – although we would view this as being somewhat negligent. While the next Federal election isn’t scheduled until 2019, the Turnbull government’s popularity has lately hit a new low, and while this has meant significant delays to any economic reforms and policies, the more immediate risk is whether the Australian PM manages to survive it out until the next election. Such fears may keep the AUD defensive in 1Q18, though we would expect any fallout in the currency from a potential spike in domestic political risks to be brief and limited.

Bottom Line: When it comes to political risks, we do think markets may be inflating the potential negatives associated with the new government in New Zealand. But even the smallest of concerns reduces the speculative carry appeal of AUD and NZD. Investors may be looking elsewhere – and potentially to CAD, where any US trade policy fallout remains a tail risk for now.

Theme 2: Central banks begin to embrace ‘lowflation’

With the synchronisation in growth across major economies set to be more nuanced in 2018, investors will be looking to put their capital to work in the global bright spots next year. Unfortunately, the G10 commodity-exporting countries do not sit in this category. The economic adjustment from the recent downturn in the global commodity cycle continues to prove painful.

While sluggish domestic growth looks to be slowly recovering – albeit largely due to the positive spillover effects from a stronger growth outlook in the rest of the world – low inflation remains a key anomaly for the dollar bloc central banks.

"Investors will be asking themselves which dollar central bank will be next to hike"

After the BoC’s recent experiment with tightening policy, we suspect investors – in an attempt to extract relative value opportunities – will be asking themselves which dollar central bank will be next to hike. Aside from the obvious outlook for inflation, we think there are two factors to consider for each economy: (1) the gap between current policy and the neutral interest rate (r*); and (2) the macro and financial stability costs of hiking.
(1) Depleting carry advantage of AUD and NZD set to continue

While currency markets can sometimes get caught up on the timing of central bank policy moves, we tend to believe that it is the overall level of monetary tightening that matters more for asset prices. The BoC, RBA and RBNZ have all downgraded their neutral interest rate estimates sharply since the commodity boom - which naturally lends itself to flatter domestic yield curves relative to historical averages. Moreover, it also depletes the overall carry advantage that these currencies can command. In a synchronised global tightening cycle, a latent RBA and RBNZ policy response would reduce the 'high-yielding' attractiveness of the AUD and NZD. Arguably, we are already seeing this story play out - and we would expect it to continue into next year as the RBA and RBNZ are among the last to join the normalisation party.

"Lower neutral interest rates in the dollar bloc countries lends itself to flatter domestic yield curves"

Lower r* means structurally flatter yield curves

<table>
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<th>Change since Jan 2014 (bps)</th>
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<tr>
<td>20</td>
</tr>
<tr>
<td>AU</td>
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<td>3.5%</td>
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Labels show latest central bank nominal neutral rate estimate

AUD and NZD losing their carry appeal as a result

<table>
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<th>Risk-adjusted swap rate differential (%)</th>
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<td>AU-US 5Y spread</td>
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Narrowing of AU-US 5Y rate differential in 2H17 has been somewhat striking

Source: ING, Bloomberg

(2) Dollar bloc central banks have larger ‘costs’ of tightening

In addition to the domestic ‘lowflation’ reasons for not hiking, dollar bloc central banks will remain wary of the macro and financial stability costs of an unwarranted sharp tightening of domestic monetary conditions. This will certainly be in the minds of the RBA and RBNZ – who will have seen the BoC’s experiment with policy tightening over the summer trigger a 10% rally in the trade-weighted CAD. This laissez-faire policy approach from the BoC is starting to bite, with the second-round effects of a strong CAD weighing on net exports and inflation. Another fear for policymakers is that a rise in short-term rates may be destabilising for their overheated property markets. Such financial stability concerns supports our view for flat – or at best gently rising – dollar bloc yield curves.

Bottom Line: Dollar bloc central banks will be at the dovish end of the spectrum in 2018, and this will see the theme of depleting carry advantage continue. Strategically, we quite like being long low-yielding European and Asian FX against AUD and NZD – as we enter an era of monetary convergence.

Theme 3: Shifting global resource demand patterns

Despite a potential pick-up in global growth next year, it’s clear that the start of another commodity super-cycle remains a far distant reality. Indeed, our commodity analysts continue to see specific supply and demand forces dominating the price narrative individual commodities.
CAD has lost its ‘oiliness’ in 2H17 as BoC policy becomes the primary driver

One thing that is evident is the changing role of commodity prices in driving short-term currency dynamics. Recently, we highlighted the structural breakdown in the correlations between oil and commodity FX. A range of factors can explain this:

- Supply-side-driven commodity price moves tend to have less of a fundamental impact on commodity-exporting economies – and by extension their currencies.
- Commodity volatility has been relatively benign versus interest rate volatility. The latter, due to more active central banks, makes monetary policy a bigger FX driver.
- To avoid another Dutch Disease, countries like Canada have been diversifying their export base – meaning the influence of any single commodity has been waning.

**Bottom Line:** CAD may not necessarily weaken if oil prices drift lower for supply reasons, while iron ore and coal will have conflicting implications for AUD. NZD still sensitive to any dairy price moves.

**Dollar Bloc FX Summary Graphic: 3 Themes for 2018**
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