Trade Idea – Foreign Exchange

Kiwi strength sustainable?

7th April 2016

**Surprise cut fails to halt NZD rally**

- On March 10th the Reserve Bank of New Zealand (RBNZ) surprised markets with a 25bp interest rate cut, citing international weakness and falling inflation expectations as key drivers. Even with the element of surprise, the move failed to halt the NZD’s recent rally, with the currency appreciating a further 2.1%* in the following fortnight on a trade weighted basis, contributing to a broader 5.8%* rise over the past seven months. The NZD has been a key beneficiary of improving risk sentiment and growing demand for high-yielding assets; with its domestic government bonds offering the best return of the G10 currency group (see Figure 1). However, we believe that recent momentum will not be sustained; making current levels an attractive point to establish short positions to the NZD, particularly against the USD. The NZD/USD currency pair is approaching the peak of its recent trading range and the RBNZ appears set to implement further monetary easing measures at its upcoming meetings; factors which, in the short term, should see the NZD correct lower in coming weeks.

Figure 1

Yields remain relatively strong.

![Yields Chart](source: Bloomberg, ETF Securities)

**Falling inflation expectations arouses concern**

- The recent strength of the NZD has surpassed the expectations of the RBNZ by some margin (with the trade weighted exchange rate sitting 4% higher than December projections) and is exacerbating central bank concern that falling inflation could embed itself in expectations. The latest monetary report revealed that inflation expectation metrics monitored by the RBNZ have experienced a “material decline” in recent months (Figure 2); stoking fears that weakness could feed through to wage setting negotiations and trigger a deflationary spiral. At the press conference following the monetary policy announcement, the RBNZ Deputy Governor identified the deterioration in inflation expectations as the “primary motive” behind the decision to cut rates in March. These concerns increase the importance of Q1 inflation numbers due on April 17th, as a poor reading will increase the likelihood of further interest rate cuts at the RBNZ’s upcoming meetings and will place the NZD under pressure.

*All figures quoted are sourced from Bloomberg unless stated otherwise.

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Top of recent range

- A combination of dovish commentary from Janet Yellen and NZD strength has pushed the NZD/USD currency pair to the higher end of its recent trading range. From a technical perspective, since falling through the 0.69 level in June of last year the NZD/USD has struggled to breach this level for a prolonged period and so we see further gains to the upside as limited.

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