Trade Idea – Foreign Exchange

Kiwi recovery to subside

26th November 2015

Dairy prices prompt recent recovery

- Since mid-August, global dairy prices have staged a strong recovery as concerns over future production have lifted prices from historical lows. With New Zealand being the world’s largest exporter of milk, the surge has helped the NZD rise by 3% against the US Dollar over the same period (see Figure 1) and has delivered a boost to consumer and business confidence. Despite this, we believe that the recent NZD rebound will be short lived and at its next meeting (10th Dec) the Reserve Bank of New Zealand (RBNZ) will cut benchmark rates for the third time this year. Volatility in dairy prices, growing unemployment and depressed inflation will all press the RBNZ to act, which offers a good opportunity for investors with a short to medium term time horizon to build short exposure to the NZD against the US Dollar.

Figure 1: Dairy prices support NZD

Rebound to fade

- The rebound in dairy prices was instigated by an announcement from New Zealand’s multinational dairy giant, Fonterra Cooperative Group Limited, that it would be reducing the volumes of milk on offer at global dairy trade (GDT) auctions. The cut comes as Fonterra has reduced forecasts of future milk production due to “unknown weather impacts”. While the rebound bodes well for the economic situation in New Zealand it has already showed signs of waning, with milk prices falling considerably in recent auctions (falling 17% from their October peak, Source: Bloomberg). If dairy prices continue on their current downward trajectory, support for the NZD is likely to evaporate and push the currency lower, particularly against the US Dollar. Furthermore, the RBNZ would find itself under increased pressure to ease monetary conditions as farm incomes are compromised.
Unemployment and inflation outlook bleak

- The plunge in its primary export price has severely hampered New Zealand’s economic progress. The unemployment rate has climbed since the beginning of 2014 (currently sitting at 6%) while headline inflation has dropped to the lowest level in over 15 years (see Figure 2). RBNZ Governor, Graeme Wheeler, has also recently cited the potential deflationary impact that a continuation of recent NZD appreciation could have on inflation. We therefore believe that this economic context will encourage the RBNZ to cut benchmark rates at its upcoming meeting, despite the rampant house price inflation in Auckland. The very recent implementation of minimum deposit levels and the addition of more stringent capital gains rules suggest that the issue of soaring house prices will likely be tackled through regulation as opposed to interest rates.

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