Maybank

FX Insight

NZD - Correction Due

FX

Global

Good News Priced In; Correction Lower

We expect NZD to correct lower in coming weeks, playing on the potential compression of NZ-UST bond yield differentials and potential inclusion of debt-to-income ratio to RBNZ macro-prudential toolkit (as early as in Aug-Oct-2017) amid accommodative monetary policy. In the upcoming RBNZ meeting (22 Jun, 5am SG/KL time), we expect the RBNZ to keep the OCR on hold at record low of 1.75%. Accompanying monetary policy statement is likely to remain "neutral" and re-emphasize the need for weaker exchange rate to achieve more balanced growth. We expect RBNZ to reiterate its stance in dismissing the recent rise in CPI as transitory and to voice its "displeasure" in the recent rise in NZD TWI.

A Re-Visit to NZD Fair Value

Our FX Tracking (shorter-to-medium term) model which aims to estimate the fair value range of NZDUSD based on 3 cyclical factors – the differential between NZ and US current account to GDP ratios; 10Y bond yield differentials between NZ and US adjusted for inflation and a reflation proxy defined as the ratio of World Equities (proxied by MSCI World Index) to World Government bonds (proxied by JP Morgan Global Aggregate Bond Index) suggests NZD is fairly valued at about 0.72.

Biased for NZD Downside; Buy NZDSGD on Dips

NZD was last seen at 0.7240 levels. Bullish momentum on daily chart is waning while stochastics is showing signs of falling from overbought conditions. A rising wedge formation appears to be in the making - typically a bearish reversal. These suggest downside risks. Correction should visit 0.7130 (23.6% fibo retracement of May low to Jun high) before 0.71 (200 DMA) and 0.7070 (38.2% fibo, 100 DMA). Our short term bearish view will be nullified on break above 0.7320. For NZDSGD, we see risk of retracement lower in the near term and could re-visit 0.9950(23.6% fibo retracement of May low to Jun high), 0.9880 (38.2% fibo). But bias remains to buy on dips. A move back towards 2017 high of 1.0430 should not be ruled out.

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Good News Already in the Price; Look for Kiwi to Correct Lower

NZD has risen more than 7% since mid-May (from 0.6820 to a high of 0.7320) to mid-Jun. And the strength has been underpinned by solid fundamentals - resilient growth owing to tourism and consumer spending, rising budget surplus, and improving dairy sector as well as market speculation that RBNZ may move to raise rates given that inflation has jumped above the mid-point of RBNZ's 1 – 3% target range for the first time since 3Q 2011.

We believe the above are already in the price and have been calling for corrective moves lower, playing on the potential compression of NZ-UST bond yield differentials and potential inclusion of debt-to-income ratio to RBNZ macro-prudential toolkit (as early as in Aug-2017) amid accommodative monetary policy.

Any persistent stock market correction in the face of Fed monetary policy tightening may also result in risk-proxies (the likes of AUD, KRW and NZD) unwinding (especially with NZD long position rising back to near-record highs for 2017) while USD rebound holds ground.

RBNZ to Keep Monetary Policy Accommodative; Wheeler May Voice Displeasure with TWI's Recent Rise

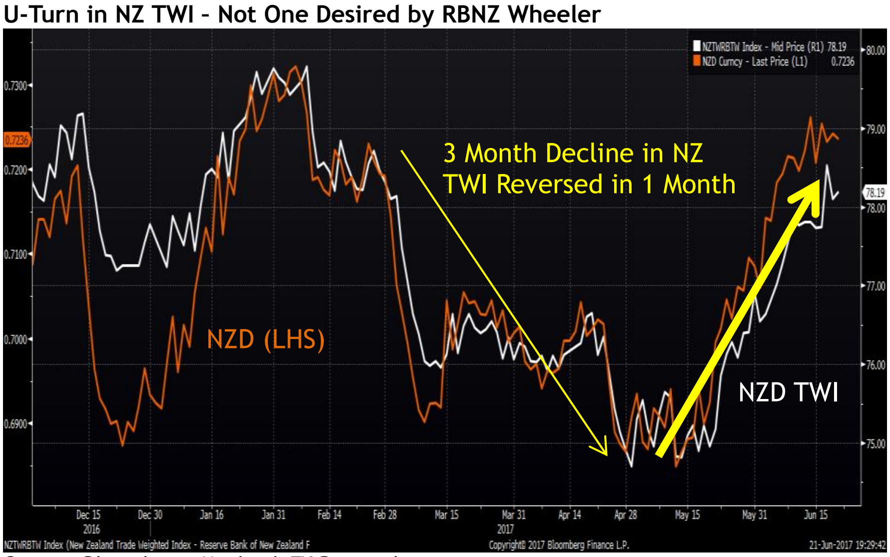
In the upcoming RBNZ meeting (22 Jun, 5am SG/KL time), we expect RBNZ to maintain an accommodative monetary policy, with OCR on hold at record low of 1.75%. Accompanying monetary policy statement is likely to remain "neutral" and re-emphasize the need for weaker exchange rate to achieve more balanced growth. We expect RBNZ to reiterate its stance in dismissing the recent rise in CPI as transitory as consumption and construction sectors are not leading to meaningful inflationary pressure.

Recent surprise misses in GDP numbers for 1Q 2017 and 4Q 2016 should also give RBNZ breathing room to not raise rates prematurely. 4Q 2016 GDP's surprise to the downside due to the drag on manufacturing and agricultural production (amid wet weather conditions) as well as mining sector (owing to closure of the Maari oilfield) while 1Q 2017 GDP surprise to the downside (+0.5% q/q vs. +0.7% Consensus expectation) was due to contraction in construction and dairy exports.

In RBNZ Governor Wheeler's testimony to parliament (11 May), he said that he was "pleased" with the 5% decline in TWI since Feb-2017 and if sustained, will help to rebalance the growth outlook towards the tradables sector.

But since the day he voiced about his pleasure with the decline in TWI, the TWI rose by nearly 5% in the past 1 month (while it took 3 months for TWI to decline). We expect Wheeler to voice his displeasure this time and re-emphasize the need for weaker exchange rate.

U-Turn in NZ TWI – Not One Desired by RBNZ Wheeler



Source: Bloomberg, Maybank FX Research

Inflationary Pressures from Traditional Drivers Modest in Current Episode

Recent RBNZ studies also showed that traditional drivers of inflation – high immigration and construction spending – are less inflationary in current episode vs. previous episodes of economic expansion.

RBNZ Bulletin (Vol. 80, No. 3 dated June 2017) shared that in previous economic expansions, the increase in demand from net immigration has outweighed the contribution to the supply capacity of the economy and has therefore been associated with an increase in overall capacity pressures, inflation and house price inflation.

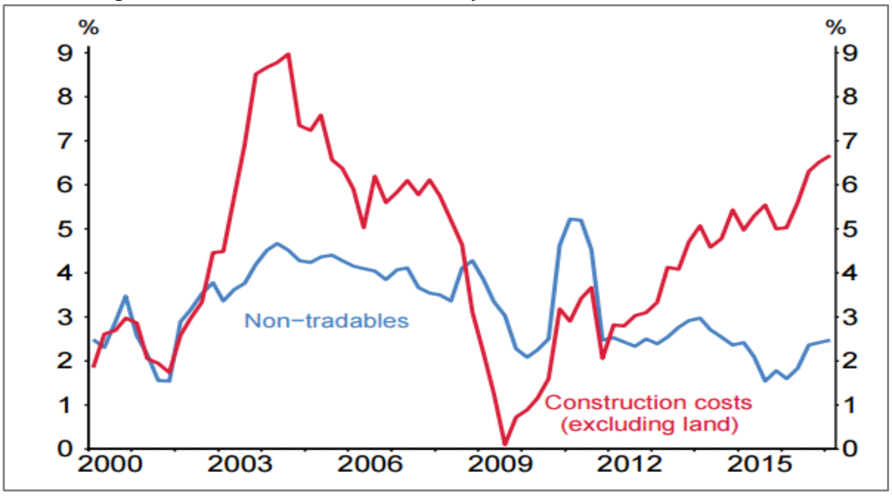
The recent round of strong immigration (at an annual rate of 1.6% of the working age population) is much larger than during previous economic expansions, and have also resulted in a net boost to demand and price inflation.

On the contrary, the extent seems much more modest. RBNZ attributed this to two reasons: (1) current immigration cycle has a larger share of younger migrants (17-29 years old) and they tend to have a small impact on net demand and inflation than older migrants (Vehbi, 2016)[1] and (2) weakness in Australian labor market resulted in higher unemployment and less inflation pressure (Armstrong and McDonald, 2016)[2] than if migrants were being drawn by strength of NZ economy or for other reasons.

Large construction spending should typically result in rising price pressures. But in the Canterbury rebuild after two large earthquakes in Sep-2010 and Feb-2011, the degree of spillover from construction costs to CPI was much less than expected. According to RBNZ studies, domestic and foreign labour markets as well as immigration policy appear to have been flexible to prevent a dramatic increase in national wages and inflationary pressure.

Looking ahead, construction sector (accounts for 6.5% of GDP) is expected to peak sometime this year as residential investments slowed. A report released by Building and Construction in NZ 2017-18 noted that the longest and strongest construction sector growth phase for NZ will peak soon but activity levels will remain high for some time. We also noted that new residential building consents fell 7.6% m/m in Apr and construction sector saw its first contraction (-1% q/q) in 1Q for the first time in 6 quarters. 1Q inflation breakdown also showed that though construction costs rose by 6.7% in the year to Mar-2017, the quarterly rate of construction cost inflation moderated over late-2016 and early-2017 due to slower growth in residential investment. Should residential investment continue to moderate, the inflation pressure contributed by construction sector could pose smaller risk.

Moderating Construction Cost Inflation May Moderate the Rise in Core Inflation



Source: Statistics NZ, RBNZ, Maybank FX Research

[1] Vehbi, Tugrul (2016), 'The macroeconomic consequences of the age composition of immigration', Reserve Bank of New Zealand Analytical Note, AN2016/03

[2] Armstrong, Jed and Chris McDonald (2016), 'Why the drivers of immigration matter for the labour market', Reserve Bank of New Zealand Analytical Note, AN2016/02.

Potential Inclusion of Debt-to-Income Limits May Weigh on NZD

We started to caution for the potential inclusion of debt-to-income (DTI) limits being added to RBNZ's macro-prudential toolkit since early this month when RBNZ published a consultation paper seeking feedback on debt to income limits. In fact we first cautioned for the risk of inclusion in Jun last year. RBNZ is not new to the use of macro-prudential tools. Back in 2015 and 2016, the RBNZ have on multiple occasions actively used these tools to address imbalances in the housing market which were contributing to financial stability risks.

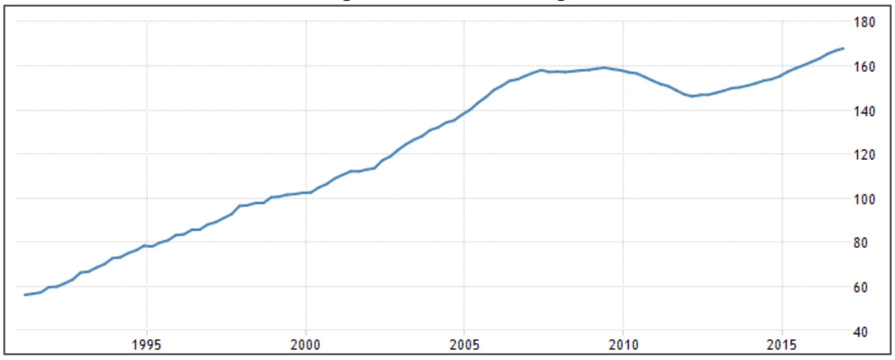
RBNZ's Use of Macro-Prudential Tools since 2013

Date	Macro-Prudential Policy Tool
Oct-2013	Banks were required to restrict new residential mortgage lending at LVRs over 80 percent (a deposit of less than 20 percent) to no more than 10 percent of the new commitments.
Nov-2015	To address concerns with investors and the Auckland area, 3 groups of restrictions were created: (i) For investor loans in Auckland, only 5 percent of total new loans could be granted with a LVR above 70 percent, (ii) for other loans in Auckland, only 10 percent of total new loans with a LVR above 80 percent could be granted, and (iii) for loans outside Auckland, only 15 percent of total new loans with a LVR above 80 percent could be granted.
Oct-2016	Geographical differences were removed and the restrictions to investors were tightened. On investor loans, only 5 percent of a bank's total lending to residential property investors can be to borrowers with a deposit less than 40 percent of the house value. On owneroccupier lending, only 10 percent of a bank's total lending to owner-occupiers can be to borrowers with a deposit less than 20 percent of the house value.

Source: IMF, RBNZ, Maybank FX Research

We see reasonably high likelihood of inclusion, possibly as early as in Aug-Oct this year especially with household debt to income surging to historical high of 167.90% in 4Q 2016. Past episodes of introduction of prudential tools lead to lower NZD, and we expect a similar round of effect, if DTI is introduced.

Household Debt to Income Surged to Historical High



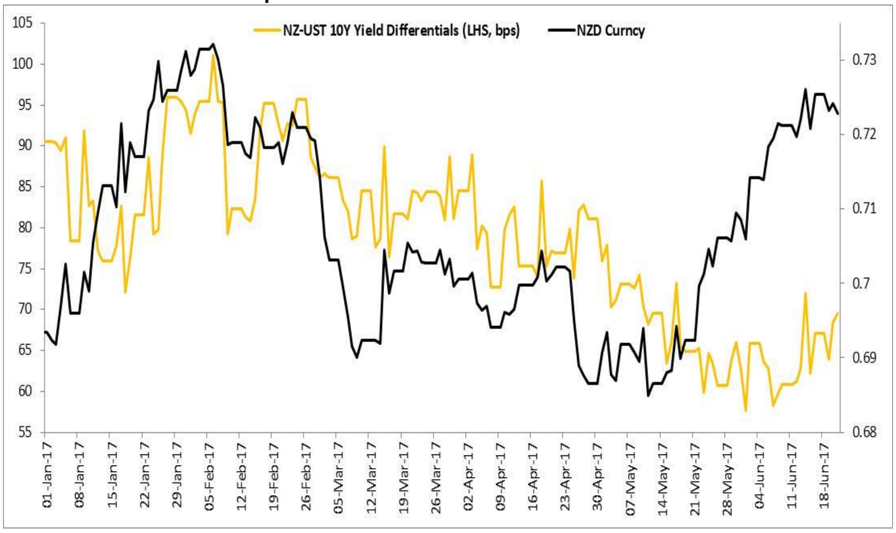
Source: RBNZ, Maybank FX Research

Potential Compression of NZ-UST Yield Differentials to Weigh on NZD

NZDUSD has largely traded in line with NZ-UST yield differentials but the recent rise in the NZD appears to be out of step with NZ-UST yield differentials. Potential monetary policy divergence between the Fed (determined to normalize monetary policy) and RBNZ (remains on easing bias and is not in any urgency to raise rates) could narrow the NZ-UST yield differentials further and this should weigh on the NZD.

The recent FoMC meeting (15 Jun), Fed Chair Yellen and Dudley's speech (19 Jun) suggested a more hawkish Fed (than what markets expected) that seems determined to normalize monetary policy. Fed retained its forward guidance and detailed balance sheet reduction plans. Fed Chair Yellen's dismissal of the moderation in price pressures as transitory and believes that the tightness in labor market should translate into higher wage cost going forward. We believe upside surprise to US data should make the case for vols to rise and financial conditions to tighten. This should result in markets re-positioning for higher UST yields and USD strength over time.

NZD's Rise is Out of Step with NZ-UST Differentials



Source: CEIC, Bloomberg, Eviews, Maybank FX Research

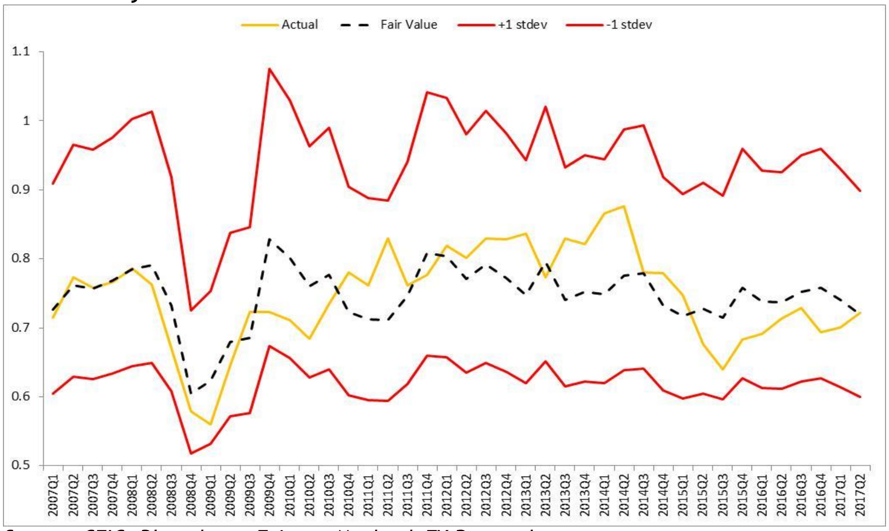
NZD Fairly Valued at 0.72

Our FX Tracking (shorter-to-medium term) model aims to estimate the fair value range of NZDUSD based on 3 cyclical factors – the differential between NZ and US current account to GDP ratios; 10Y bond yield differentials between NZ and US adjusted for inflation and a reflation proxy defined as the ratio of World Equities (proxied by MSCI World Index) to World Government bonds (proxied by JP Morgan Global Aggregate Bond Index).

We run multiple regressions for NZD/USD bilateral currency pair, on quarterly frequency data starting from 1Q 2006, using the independent variables mentioned above.

Our model estimated NZD fair value at 0.7190 with a range of 0.60 for the lower bound and 0.90 for upper bound (based on 1 standard deviation). Based on our FX Tracking model, current level of NZD (spot ref: 0.7240) is well within our fair value range estimates but is only modestly overvalued relative to the fair value point estimate.

NZD is Fairly Valued Based on Our Model



Source: CEIC, Bloomberg, Eviews, Maybank FX Research

NZD Technicals Suggest Correction

NZD was last seen at 0.7240 levels. Bullish momentum on daily chart is waning while stochastics is showing signs of falling from overbought conditions. A rising wedge formation appears to be in the making – typically a bearish reversal. These suggest downside risks. Correction should visit 0.7130 (23.6% fibo retracement of May low to Jun high) before 0.71 (200 DMA) and 0.7070 (38.2% fibo, 100 DMA).

NZDSGD was last seen around 1.0050 levels. Bullish momentum on weekly and daily chart remains intact but daily stochastics suggests the cross is in overbought levels and may retrace lower in the short term. Retracement lower could re-visit 0.9950(23.6% fibo retracement of May low to Jun high), 0.9880 (38.2% fibo). But bias remains to buy on dips. A move back towards 2017 high of 1.0430 should not be ruled out.

NZDMYR was last seen at 3.1050 levels. Bullish momentum on weekly and daily chart stays intact but stochastics suggests overbought signals on the daily chart. We do not rule out short term retracement towards 3.09 (200 DMA), 3.08 (23.6% fibo retracement of May low to Jun low). Resistance at 3.1150.

NZDUSD Potentially Breaking Out of Rising Wedge – Bearish Reversal

Source: CEIC, Bloomberg, Eviews, Maybank FX Research

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