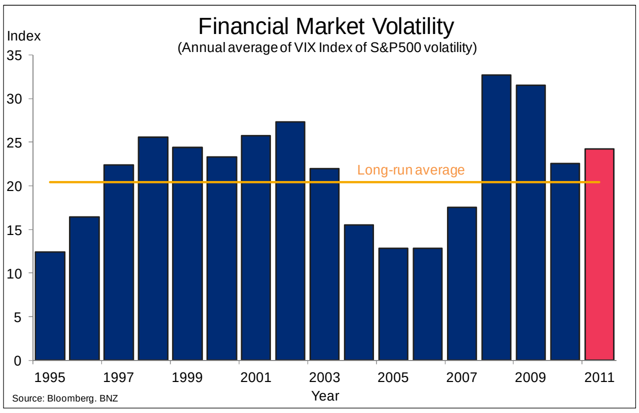
09 January 2012

Year of the Dragon to Bring More NZD Fireworks

- **Volatility the only certainty for the NZD as we head into 2012, the Year of the Dragon**
- **We expect the dour global backdrop to weigh on the NZD through the early part of 2012. We forecast the NZD/USD below 0.7500 by March.**
- **From around mid-year, we expect a modest NZD rebound tied to stabilising global growth and improving NZ economic conditions.**

2011 in Review

2011 was a turbulent year in many respects. Whether it was natural disasters, underwhelming global growth, or European debt ructions, "bad news" events certainly seemed to outnumber good. It's hardly surprising, then, that financial market volatility held well above the long-run average in 2011.



Given all this volatility, and negative news, it seems remarkable that the NZD/USD finished the year bang on where it started. Of course there were some big swings through the year. The NZD/USD spent the first part of the year in decline as devastating natural disasters in Christchurch and Japan knocked risk appetite for six and saw the RBNZ slash the Official Cash Rate to 2.5%.

However, in the second half the NZD staged a dramatic recovery as market attention shifted onto the US debt ceiling debate. The consequent USD slide eventually propelled the NZD/USD to a new post float high of almost 0.8850. The latter stages of 2011 were dominated by the various twists and turns of the European sovereign debt crisis. The resultant decline in global risk appetite tended to undermine the "risk sensitive" NZD/USD.

Roadmap for 2012

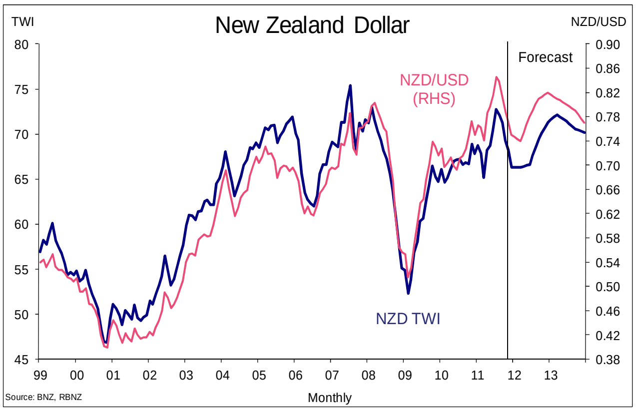
Moving into 2012, we expect the NZD will remain heavy over the first part of the year as global risk appetite remains in the doldrums and NZ interest rates bob around their recent lows.

However, from around the middle of 2012, we expect to see a modest resurgence in the NZD tied to stabilising global growth, improving NZ economic conditions, and rising local interest rates.

Formally, we forecast the NZD/USD at 0.7400 by the end of the March quarter, then appreciating gradually to reach 0.8200 by the end of the year. Put another way, 2012 is shaping up as another year in which currency volatility trumps any obvious trend.

Factors affecting the NZD/USD

	Short-term 3-6 months	Medium-term 6-12 months
Global Growth/Risk Appetite	↓	↗
Relative Growth Outlook	↘	↗
Interest Rate Differentials	→	↗
Commodity Prices	↘	→
Overall	↓	↗



The Global Backdrop

The global backdrop is expected to remain a drag on the NZD/USD through the first half of 2012.

Global slowdown to weigh on NZD/USD in Q1…

Whether or not Europe's problems escalate into a full-scale banking crisis, it is clear debt market strains are beginning to flow through into weaker global economic activity. The Euro-zone appears to have entered recession (we are forecasting Euro area GDP to decline in Q4 and Q1), while activity in the UK and Japan is slowing appreciably.

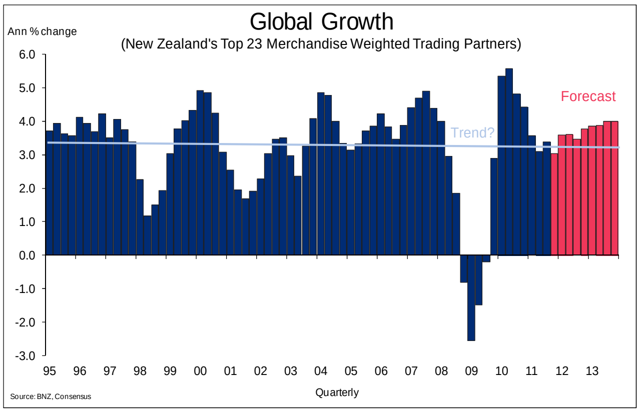
Previously speedy Asian economic growth has also begun to cool, reflecting earlier policy tightening and slowing demand out of Europe. Of course, closer trade ties mean the fortunes of Asia are now more important for NZ and the NZD than those of Europe (see our note *NZD/USD: What's the Link to Asia?).*

Slowing global growth and ongoing European debt dramas are expected to suppress investors' risk appetite and commodity prices through H1 2012, keeping the "risk sensitive" NZD/USD heavy.

A brief USD recovery early in 2012 will add to the downward pressure on the NZD/USD. The US economy appears to be bucking the weakening trend of the other big developed economies at present. Indeed, recent US labour market data and business surveys have been relatively buoyant. These improving economic conditions, along with elevated risk aversion, are expected to underpin the "safe-haven" USD through the first part of the year.

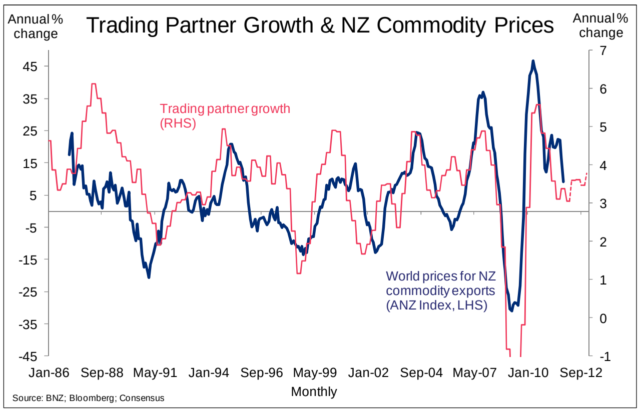
…before stability returns in H2 2012

Moving into the second half of 2012, we expect an improvement in the global backdrop to support the NZD. Crucial in this view is our assumption that Europe will be able to muddle through its current debt crisis and experience only a modest recession. Clearly, then, a full blown European banking crisis and/or severe recession is a major downside risk to our projections.



Our base case is that the global economy (outside Europe) will register relatively solid growth over the course of 2012. Encouraging in this regard, the most recent set of consensus forecasts suggest economic growth amongst NZ's trading partners will build from 3.0% in calendar 2011 to an above-trend 3.8% by the end of 2012.

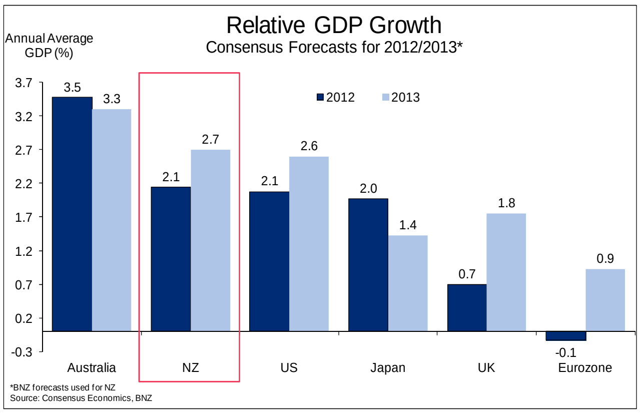
A recovery in global growth expectations over H2 2012 would restore investors' risk appetite, lift global commodity prices and boost demand for "growth-sensitive" currencies like the NZD/USD.



The Domestic Backdrop

Relative Growth

We expect NZ economic growth to stumble sideways through the first half of 2012, before picking up noticeably over the second half of the year. Driving this pickup will be pent up demand for residential and commercial construction, and some improvement in private consumption. However, the ongoing ructions offshore will have a dampening effect on other parts of the NZ economy.

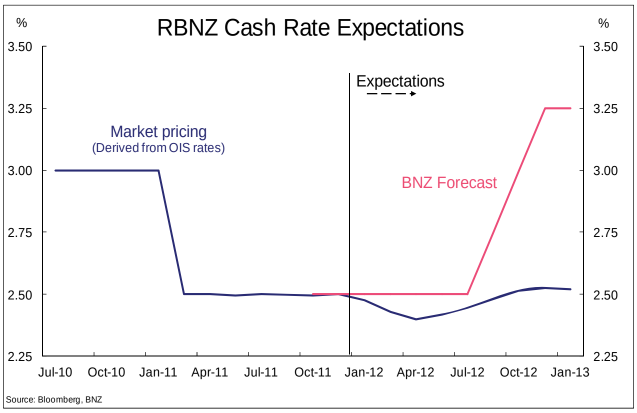


We expect annual growth of 2.1% for NZ in calendar 2012, rising to 2.7% in 2013. Importantly, even this less than impressive performance would see the NZ economy outperform most of its international peers (see chart above). This positive relative growth story should act in support of the NZD over H2 2012, particularly relative to the GBP and EUR, less so against the USD.

Interest Rates

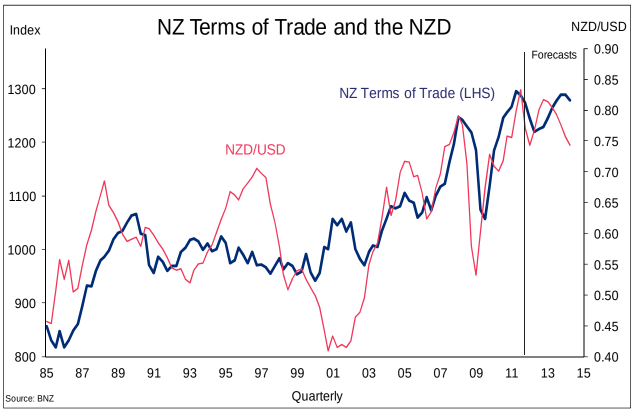
The RBNZ remains on a tightening bias but we think there is sufficient slack in the economy to stay the RBNZ's hand until late 2012. Still, by year-end we anticipate the OCR to be some 75bps higher than its current 2.50% setting (by comparison, market pricing suggests the OCR will remain at 2.50% for the foreseeable future).

In contrast, the US Federal Reserve is expected to keep rates at zero until well into 2013. As a result, NZ-US interest rate differentials should begin to widen through the second half of this year, bolstering the yield appeal of the NZD.



Terms of Trade

There's little doubt NZ's soaring terms of trade have been a source of structural support for the NZD in recent years. Indeed, we've been toeing the line that the structural appreciation underway in NZ's terms of trade has caused the long-run equilibrium of the NZD to shift up (perhaps into the 0.6500-0.7000 range).



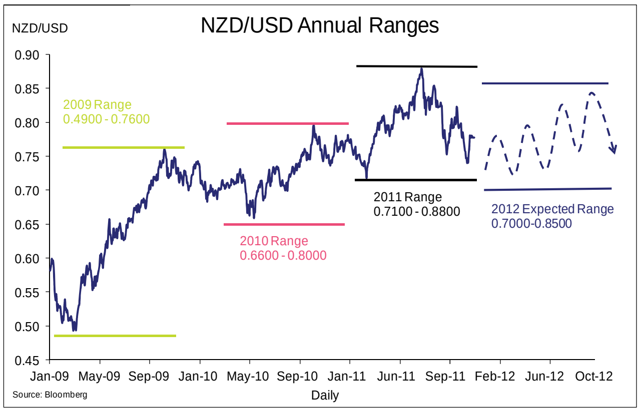
We expect the terms of trade to hold up at favourable levels through 2012, although we suspect the peak is behind us. The terms of trade are forecast to ease about 5% in 2012 driven by moderating Asian growth and increased global supply of the "soft" commodities NZ primarily exports. The risks around this forecast are skewed to the downside. Should Europe or Asia experience a faster-than-expected growth slowdown, a weaker terms of trade would be one of the key channels delivering a lower NZD.

Should NZ's terms of trade hold up as we expect in 2012, it's hard to envisage sustained declines in the NZD/USD. But equally, the lack of further upward impetus poses a high hurdle for the NZD/USD to retest 2011's 0.8850 post float high. The marked deterioration we expect to see in NZ's current account position this year should also act as a handbrake on sustained NZD appreciation.

Summary

We expect a downward correction in the NZD through early 2012, before a modest rebound kicks in later in the year. The broader point is that, while periodic bouts of risk aversion will knock the NZD/USD lower from time to time, folk should not expect a marked fall in the currency as long as NZ growth outpaces our trading partners and NZ commodity prices remain elevated.

Note, however, that we retain our caution of 2010 and 2011: volatility will likely continue to afflict currency markets. This is particularly so given uncertainty and nervousness about the global backdrop is likely to hang around for some time. So, while the NZD should spend most of the year on a gradual uptrend, trading ranges could be large. A 0.7000-0.8500 annual range, similar to the 2011 experience, seems reasonable to us.



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