13 March 2020

FX STRATEGY *Soundbites*

AUD & NZD – not done with the downside

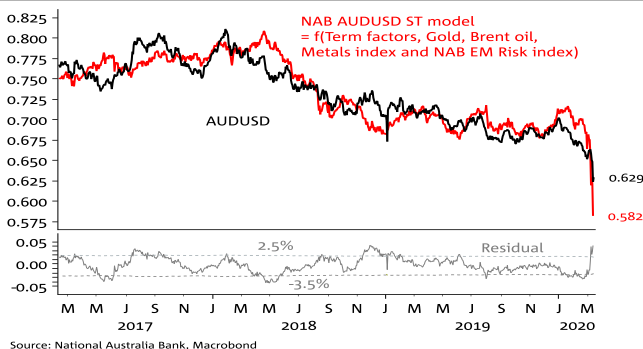
- **Stock market crashes and global recessions are historically very unkind to the AUD and NZD. So too are lower oil prices**
- **Measures of risk aversion have hit GFC-levels and are currently consistent with much lower levels for AUD and NZD, such that if they are sustained we are almost certainly not done with the downside on both AUD and NZD**
- **AUD will likely exceed its GFC lows of 60 cents while NZD could easily see levels as low as the mid-50s. On the premise that the low points for stock prices and other risk asset markets are seen before Q2 2020 is out, so too should the low points in AUD and NZD.**

Growing realisation that the spread of COVID-19 outside China and the intensification of efforts being made to contain it are pushing the global economy into recession has driven global equity markets into bear market territory. Other risk asset markets, particularly high yield credit, are showing similar strains, with spreads in the energy sector already back to their early 2016 peaks and approaching GFC wides because of the collapse in oil prices. These have now fallen beneath 'shut-in' (break-even) prices for much of the N. American shale oil sector.

The fact that risk aversion has expanded beyond equity markets into credit, Emerging Markets (EM) and even FX volatility is highly relevant for AUD and NZD. The EM risk index used in our AUD short term fair value model tries to capture the realisation that historically we need to witness a broad based - and persistent - spike in risk aversion for it to have a material impact on antipodean currencies. We currently look to be experiencing one of these episodes.

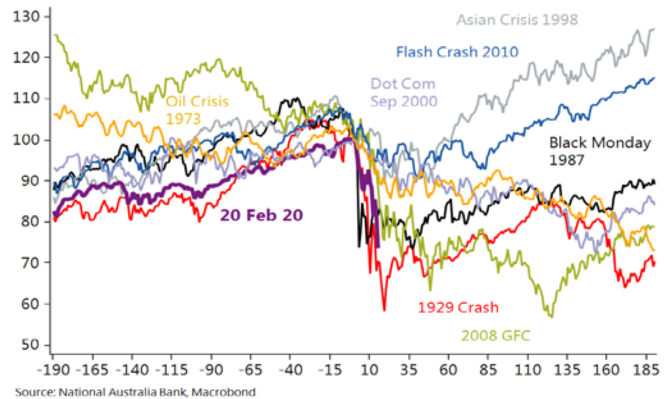
Put differently, if we do not see a rapid reversal in risk sentiment, the AUD and NZD are slated to fall further. As one indication of how far this might be, our short-term AUD/USD valuation model using Thursday's closing levels for commodify prices, interest rates and risk sentiment sits at around 0.58. It's fallen 10 cents in the space of a week, mostly due to the risk factor and, albeit to a much lesser extent, oil prices.

Chart 1: NAB AUD/USD short term fair value model



Source: National Australia Bank, Macrobond

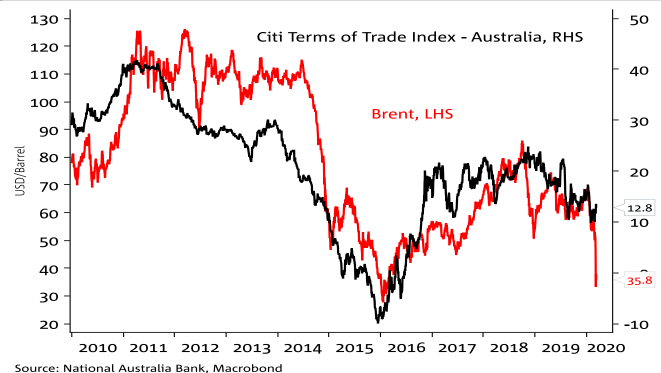
Chart 2: Stock market crashes



Source: National Australia Bank, Macrobond

Whether fresh announcements around the world of government support to help ameliorate the economic ill effects of their social distancing strategies proves capable of shoring up sentiment sooner rather than later will obviously be important from here. Announcements to date evidently have not, while comparisons between current US equity market performance and prior crashes don't inspire confidence that lows are close, certainly not if the valid comparisons are with the 2008 (GFC), 2000 (dotcom crash) or 1973 (Arab oil embargo) as some technical analysts are suggesting (Chart 1).

Chart 3: Oil and Australia's Terms of Trade



Source: National Australia Bank, Macrobond

On the commodity price front, both Saudi Arabia and Russia seem intent on pursuing their geopolitical agendas by pumping oil to the max for the next few months at least. The strong positive correlation between oil and broader commodity prices (even including dairy) suggests that more negative terms of trade pressures lie ahead for both AUD and NZD.

Finally, after some significant downward pressure on the USD in recent weeks from the combination of dramatically lower US yields, higher FX volatility and position unwinds, intensification of the risk-negative global backdrop looks like it is back offering support to the USD, a restraining factor for both AUD and NZD.

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H2 2020 AUD and NZD recovery thesis still valid?

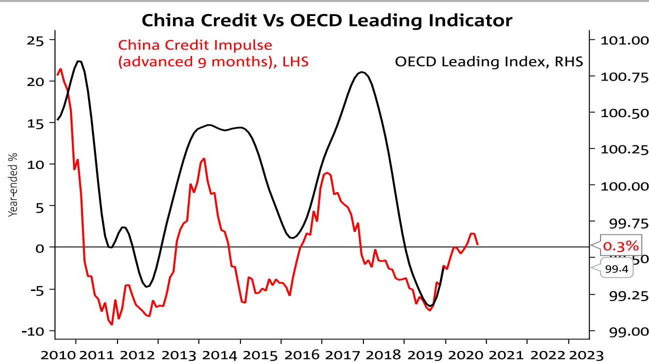
Under many assumptions, some of which could prove to be heroic, we see AUD and NZD realising lows for this cycle sometime during Q2 then firming in H2 2020. We'll finalise our new quarter-end point forecasts in the next edition of the *Global FX strategist* to be published next week, but which currently suggest could be below 0.60 for AUD/USD and in the mid-to-high 0.50s for NZD.

First and foremost, we will need to see some sign that the global rate of new infections of COVID-19 is starting to moderate, whether due to the onset of summer temperatures in the northern hemisphere or because social distancing policies are being adhered to and seen to be working. We'll also need evidence that fiscal and monetary policy measures currently being rolled out are succeeding in supporting economic activity in Q2 relative to Q1, and that there is political willingness to persist with them through the second half of the year at least.

China – FIFO?

A view we hold with a little more confidence is that Chinese factories will be back to operational normalcy and Chinese citizens going about their business much as they were pre-COVID-19 (we'll be watching to see whether the West Australian rock lobster catchers are back at sea and exporting their catch to China in much the same volume as 2019 as one indication!). This will be vital both for the full reconnection of intermediate supply chains (albeit foreign demand for intermediate and final exports will inevitably be sub-par for several quarters at least) as well as domestic activity. Both would be expected to lend a level of support to commodity export prices relevant to Australia and New Zealand.

Chart 4: China's credit impulse leads global growth



In this respect, we don't want to lose sight of the significant China credit easing that occurred in 2019 (reversing earlier deleveraging efforts and which was the key driver of the 2019 China growth slowdown, more so than the trade war). The lead-indicator properties of credit growth to the Chinese and global economies offers compelling reason to be more positive about the China and global growth outlook as and when COVID-19 dissipates as the dominant economic and market force (Chart 4).

In short, the shift in relative US growth in favour of rest of world outperformance, which was our start of the year premise for a better showing by most G10 currencies vs the USD, could yet come back into play before year end. Even so, it's unlikely that in these circumstances the AUD/USD will be any higher than say 0.65, assuming it first falls below 0.60. Similarly, we see scope for NZD/USD to end the year at or above 0.62, from sub-0.60 in H1.

What about AUD/NZD?

In our 5 March research note "NZD behaviour in a global recession" we imagined the NZD and AUD seeing similar weakness in the global recession scenario and thereby remained comfortable with our projection of the AUD/NZD cross drifting up a touch to about 1.06. Since then a number of fresh considerations must be taken into account. The plunge in oil prices and likelihood of further downward pressure after the OPEC and Russia alliance broke up is negative for Australia's terms of trade, but positive to NZ's terms of trade, a negative force for the AUD/NZD cross.

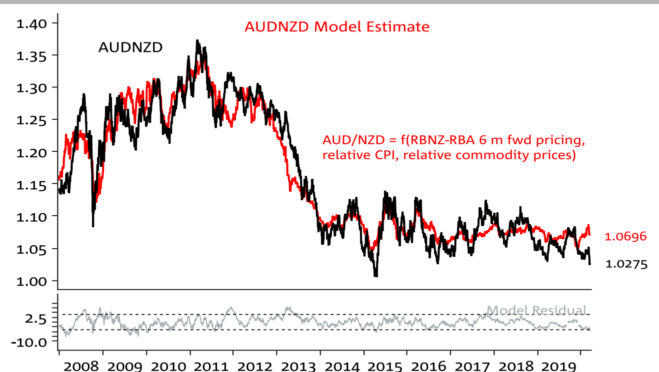
Furthermore, the deeper global recession scenario plays to monetary policy in both countries being put to its limits. This means an RBA policy rate that likely falls no lower than 0.25%, and unconventional policy taking the form of yield curve control. In NZ's case, the RBNZ sees a negative policy rate (possibly as low as minus 0.5%) as the first port of call for unconventional policy, ahead of receiving fixed rates in the swap market to drive a flatter curve. Therefore, the NZ-Australian short-end rate differential can still compress significantly and this would be a positive force for the AUD/NZD cross.

Another point of differentiation between the NZ and Australian outlooks is the drought in the NZ North Island that could turn quite nasty from an economic perspective, adding to the recessionary impulse from COVID-19. The next few weeks will be crucial, namely whether rain falls in this region as autumn gets underway. A more severe drought would be positive for AUD/NZD.

These three factors all have potential to swing the cross around over coming months. If the relative terms of trade story dominates then that could trigger fresh lows in the cross towards parity. If the relative interest rate story becomes a focus, then a move to parity could be avoided and the cross might find some ability to appreciate away from the edge of its recent trading such that our previous expectation of 1.06 could remain valid. The NZ drought remains an additional wildcard.

In sum, while there are times when the cross can be steady with "nothing to see", it feels like there are enough big potential forces to keep traders on edge and create some volatility. Levels between 1.00-1.07 look plausible for the cross over the next six months.

Chart 5: AUD/NZD vs. fair value model



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