MNI Insight: AUD/NZD FX: Cyclical Drivers Aren't Turning Around Yet

The AUD/NZD cross has stabilized somewhat in the past session around the 1.0900 level, but it remains below all key simple and EMAs.

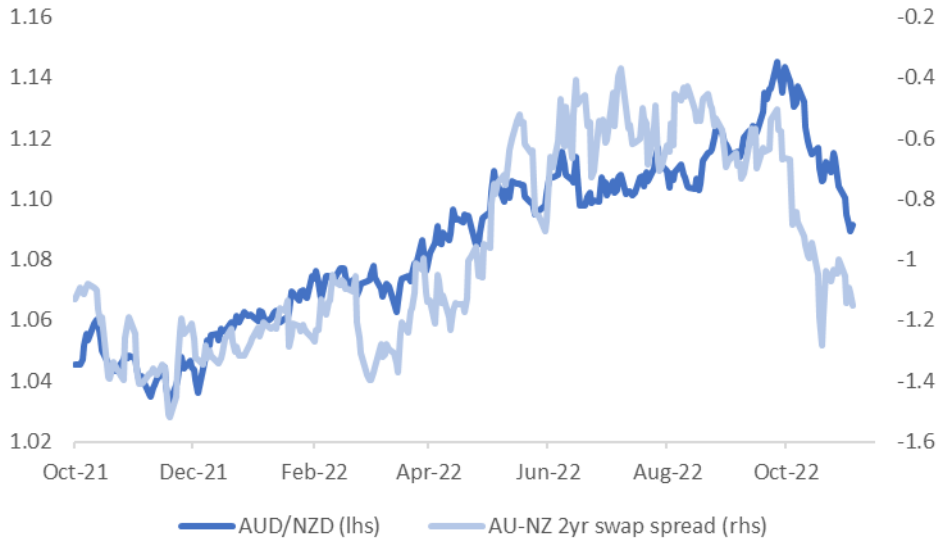
We wrote back in mid-September that the cyclical backdrop was turning less supportive for the AUD/NZD cross, see this link for more details. At the time the cross was trading just above 1.1200. We didn't peak until late September and closer to 1.1500. Current levels are a little over 5% off these late September highs.

Current cyclical drivers still pointing to headlines for the cross.

The first chart below overlays the cross against the AU-NZ 2yr swap spread. We are slightly above recent wides on this swap differential, but only modestly. Note the correlation between this 2yr spread and AUD/NZD has been 74.4% for 2022, which is above long run correlations between the two variables.

The picture doesn't change much if we utilize government bond yield spreads instead of swaps. The 2yr government bond yield differential is tracking through recent lows though. On a 10yr basis the spread is above recent lows, but NZGBs have outperformed recently as part of the WGBI inclusion, so that may be a factor.

Fig 1: AUD/NZD Versus AU-NZ 2yr Swap Spread



Source: MNI - Market News/Bloomberg

RBNZ Market Pricing Still Ahead Of RBA

There is certainly scope for the RBNZ to be more aggressive than the RBA when a cutting cycle eventually materializes. However, market pricing still has the RBNZ ahead of the RBA over the forecast horizon, see the second chart below. Note these expectations are sourced from the MIPR function on Bloomberg.

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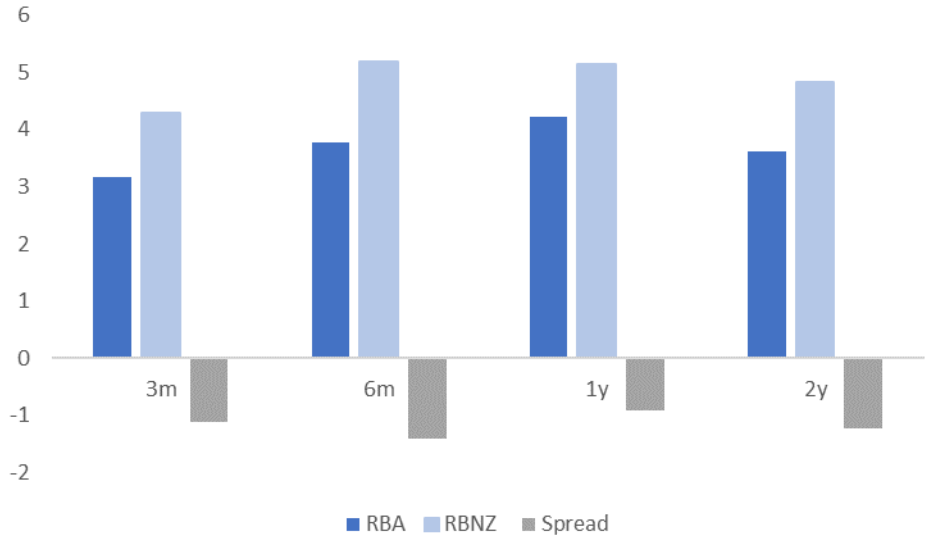
Fig 2: Market Expectations for RBA and RBNZ Policy Rates 2yrs Out



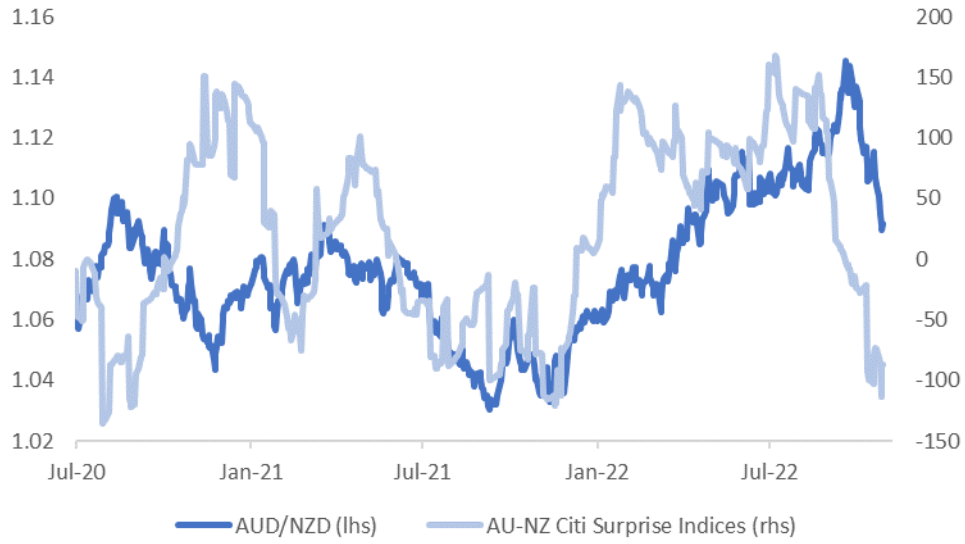
Source: MNI - Market News/Bloomberg

Relative Data Momentum Also in NZD's Favor

Relative data momentum also remains skewed in NZD's favor. The third chart below plots the AUD/NZD cross against the relative differences between the Citi Australian and NZ data surprise indices. We are around recent lows for this differential, at least using the last few years as a sample period.

A turn back higher in relative data surprises in AUD's favor could aid higher levels in the cross, as this differential led much of the rise in the cross rate earlier in the year and turned lower before we peaked in September. Such a backdrop would arguably favor higher AU-NZ rate differentials as well, all else equal.

Fig 3: AUD/NZD Versus Relative Citi Surprise Index Differential



Source: Citi/MNI - Market News/Bloomberg

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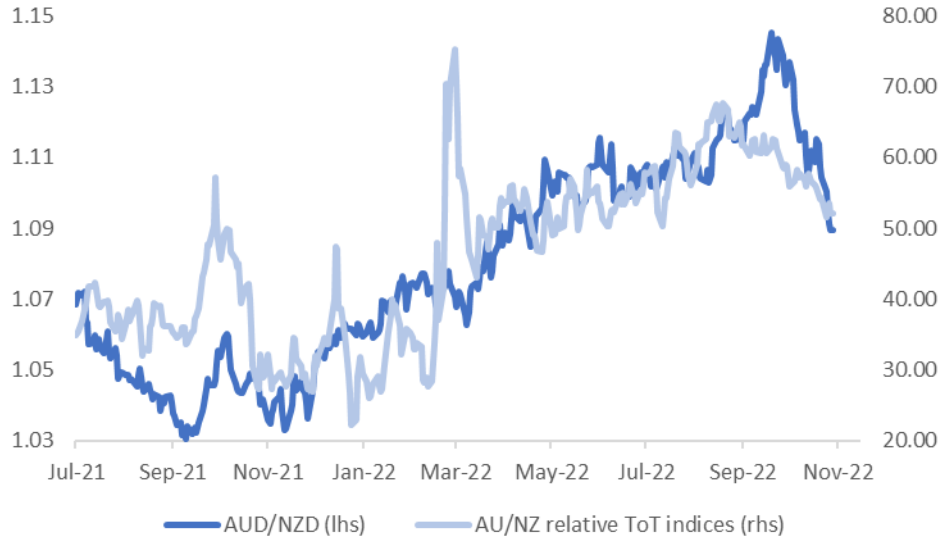
Likewise for Commodities

In the relative commodity space, Australian commodity prices have come off more than the equivalent basket for New Zealand. The fourth chart below plots the cross against the AU – NZ Citi terms of trade differential. This differential has had a 71.6% correlation with the cross this year. It's not surprising to see AU's commodity basket underperforming in an environment of concerns around the global growth outlook, and amid China's weaker growth backdrop.

Fig 4: AUD/NZD Versus Relative Citi ToT Proxies



Source: Citi/MNI - Market News/Bloomberg

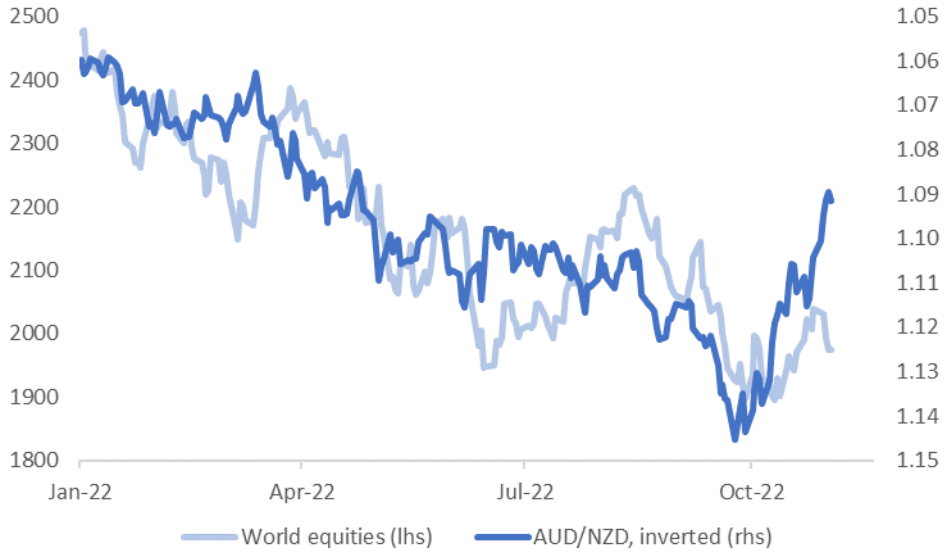
An improved China outlook, driven by a shift away from the Covid-zero policy, would arguably have more upside for Australia's commodity basket relative to NZ's. This risk has to be balanced against broader global headwinds, which could still keep cyclically sensitive commodity prices on the back foot as we progress into 2023.

Renewed Global Equity Market Weakness Could Cap NZD Outperformance

The final chart is the cross against global equities. Note the cross rate is inverted on the chart. Through much of September and early parts of October, the sell-off in global equities was positively correlated with higher AUD/NZD levels. This fitted with the relative current account positions for Australia and NZ. NZ's large deficit, relative to Australia's healthy surplus position, should leave NZD more vulnerable to global risk off episodes.

A renewed downtrend in global equities may curb recent NZD outperformance, particularly if September correlations hold.

Fig 5: AUD/NZD Versus Global Equities



Source: MNI - Market News/Bloomberg