



Theme #5: Dingo unchained

- 2013 saw the largest fall in AUD/NZD in over 28 years. Behind the fall in the cross was a significant move in interest rate differentials.
- With the cross near record lows we think the risk / reward from here favors AUD/NZD upside. As a result we would be long AUD/NZD at current levels.

As shown in Figure 1, 2013 marked the 'worst' year for the AUD/NZD cross since at least 1986. Interestingly, in prior years when the cross has fallen over 10% the subsequent year sees a significant bounce back. The 13.5% fall in 1987 to 1.0959 was followed by a bounce of 23.5% in 1988; while the 12.7% fall in 2002 (to 1.0727) saw a 6.7% bounce in the following year. With the cross ending 2013 at 1.0850 after a 14.0% decline, history would suggest some likelihood of a significant move higher in AUD/NZD over 2014.

Of course there is much more to FX than history. From a more fundamental perspective we see a number of reasons to expect a move higher in the AUD/NZD cross through the course of 2014.

The first is valuation. As Figure 2 shows, the AUD/NZD cross has traditionally found a base around 1.05 (with just below here therefore likely to serve as a good level to set any stop). Our valuation metrics (as published in *Exchange Rate Perspectives*) also find NZD the most over-valued of the G10 currencies on a PPP and BEER basis. The NZD is around 33% 'expensive' on a PPP basis, versus the AUD which is 26% 'expensive'. On a BEER basis the NZD is 22% 'expensive', versus the AUD which is only 5% above 'fair-value'.

As far as 'big picture' drivers of the AUD/NZD cross are concerned, it is hard to go past interest rate differentials as shown in Figure 3. Looking a little more closely at the last few data points in that chart it also appears that AUD/NZD has 'overshot' interest rate differentials to the downside. Indeed, the current interest rate differential would appear to be more consistent with the cross trading around 1.13 versus its current level. We should not, of course, rule out interest rate differentials 'catching up' to the cross. That would require, however, markets to price even more tightening for the RBNZ, and/or easing from the RBA.

On the outlook for the kiwi central bank our central view remains that we will see 75bps of policy tightening over the course of 2014. Market pricing is a little more aggressive than that, with a little over 100bps of hikes priced for 2014. On the RBA the market is essentially priced for no change in rates in Australia over the coming year – something consistent

Figure 1: Large declines in AUD/NZD usually see bounces



Source: Deutsche Bank, Bloomberg Finance LP

Figure 2: The cross is also at an extreme



Source: Deutsche Bank, Bloomberg Finance LP

Figure 3: Interest rate differentials are the key driver



Source: Deutsche Bank, Bloomberg Finance LP