

# Research Currency Research

19 January 2024

## The NZD in 2024

- As 2024 gets underway, there is no change to our view that the NZD/USD exchange rate is in a 0.60-0.64 trading range for the current quarter. Our projections remain consistent with a modest topside break later in the year.
- NZD/USD remains strongly linked to Fed Funds rate expectations two-years ahead. We see scope for US rates to fall a lot further, on a view that US monetary policy ultimately needs to head to neutral as inflation sustains around the 2% target.
- Our view remains one of broad USD weakness rather than an outright positive NZD view. We can think of many headwinds the NZD faces this year, including a sluggish world growth outlook, macro headwinds in China, NZ's economy remaining in a rolling recession, and the possible re-election of Donald Trump in November's US Presidential election.

The NZD has begun 2024 on a weak note, falling from above 0.63 on the first trading day of the year to a sub-0.61 level this week. We wouldn't read too much into the move, with this year's weakness exaggerated by the sharp 8½% rally through November-December last year. Seasonally, December is a strong month for the NZD while January is typically weak.

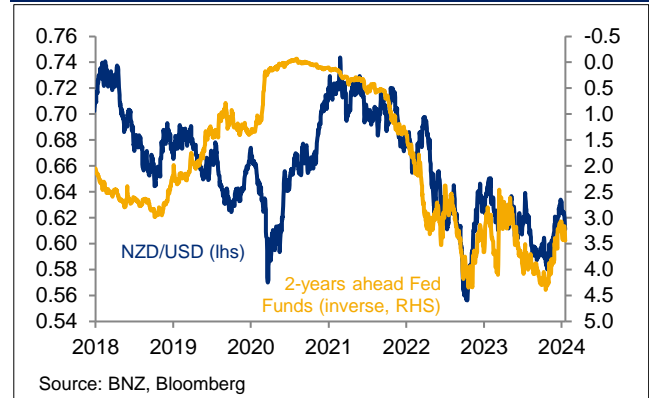
In early November we argued that the NZD was at a [major turning point in the cycle](#) on a widespread view that the Fed's tightening cycle was over. We were looking for the NZD to enter a new 0.60-0.64 trading range. That view has played out and, after the holiday break, we maintain that view.

### All about US monetary policy

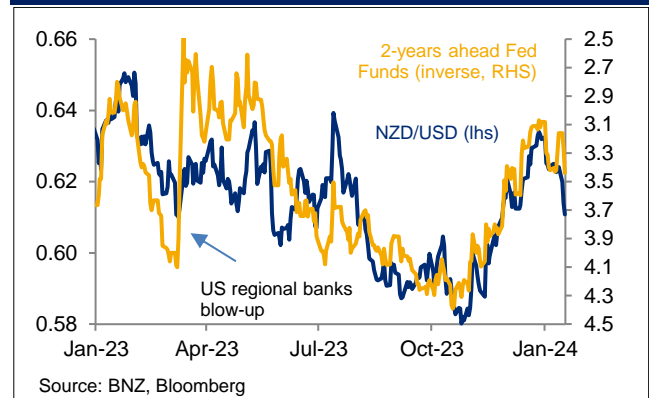
We continue to see the outlook for US monetary policy as a key driver of the NZD. Since 2021, the path of the NZD has been closely linked to expectations of the US Fed Funds rate two-years ahead. The strong correlation remains in play.

Market pricing is consistent with a significant easing in monetary policy over the next two years, taking the effective Fed Funds rate from 5.3% to 3.4%. While a nearly 200bps cut in rates seems like a lot, this must be seen in the context of a current Fed Funds rate that sits well above average – the average since 2000 has been 1.8% – and well above the FOMC's view of a long-run neutral policy rate of 2.5%.

NZD closely linked to Fed Funds expectations since 2021



...more so since the second half of 2023



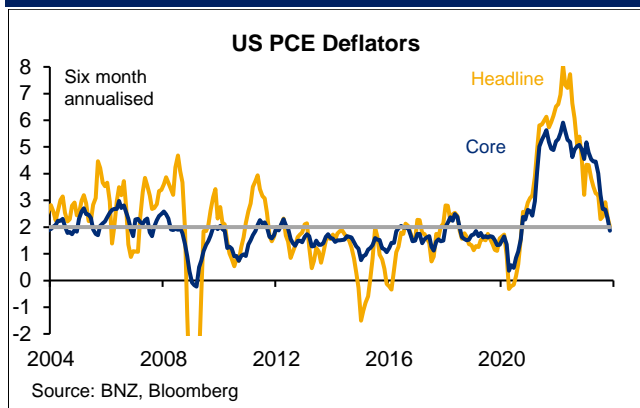
If policy were to be set at “neutral” within two years, then that would argue for 280bps of rate cuts, while if the policy rate was to fall to its average level since 2000, then that would argue for 350bps of rate cuts. If, at some stage, it looked like monetary policy needed to move to an “easy” stance, beyond neutral, then that would argue for even greater rate cuts to be priced.

Needless to say, we see a clear path for the 2-years-ahead Fed Funds rate to fall a lot further and, based on the relationship over the past few years this would argue for a weaker USD and a stronger NZD.

Still, the market's view of the Fed Funds rate two-years ahead can oscillate, as near-term policy expectations gyrate on incoming data. It is clear the Fed has an easing bias and the dataflow over coming months will determine the starting point and scale of the easing cycle.

Data released just before Christmas showed the US PCE deflator – the Fed’s preferred inflation target – fell to 2.0% on an annualised basis for the six months to November. The equivalent core measure fell to 1.9%. Clearly, if inflation continues at this rate over the next six months, then the Fed would have met its 2% inflation target for the full year. And yet monetary policy remains well in restrictive territory and the Fed’s December projections don’t anticipate inflation getting back to target until the end of 2026.

**US inflation at target on six-month annualised basis**



Fed Governor Waller, who the market respects given his prescient views on policy over the past year or two, said that “PCE inflation of 2 percent is our goal, but that goal cannot be achieved for just a moment in time. It must be sustained at a level of 2 percent...based on economic activity and the cooling of the labour market, I am becoming more confident that we are within striking distance of achieving a sustainable level of 2 percent PCE inflation. I think we are close, but I will need more information in the coming months confirming or (conceivably) challenging the notion that inflation is moving down sustainably toward our inflation goal.”

Inflation figures over coming months will be key in determining whether the US easing cycle can begin as soon as March. These figures will be critical for the path of the NZD and USD over the short term. We have more conviction that US monetary policy can ease significantly on a two-year view, compared to near-term expectations, meaning we are happy to stick to a constructive medium-term outlook for NZD/USD while accept the NZD could be choppy over the short term.

**A number of NZD headwinds still in play**

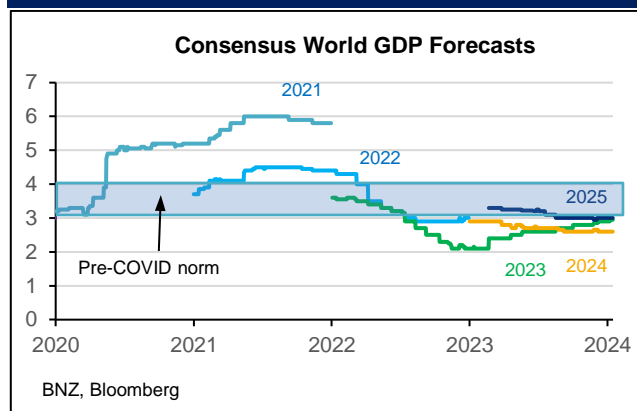
While the US monetary policy outlook is expected to be a key driver of markets including the NZD, other factors are worth noting that frame our outlook for 2024.

The economic outlook isn’t a naturally favourable one for the NZD, with the world economy facing another year of sub-trend growth and 2025 only looking marginally better.

The NZD historically performs best when world growth is improving, driving a higher commodity price dynamic.

The chart below shows Bloomberg consensus forecasts for world growth over time. Last year began with gloomy predictions for 2023, but that proved to be too pessimistic. Consensus forecasts for world GDP growth in 2023 were gradually revised higher, ending up just under 3%. But 2024 projections were gradually revised lower and currently stand at 2.6%. Next year’s growth projection is at 3%. Trend growth is considered to be around 3½%. On that basis 2022-2025 would represent four consecutive years of sub-par world growth. Since the end of 2021, the NZD has been in a downward channel, unsupported by this global macroeconomic growth backdrop.

**World growth growth remains subdued**



Our constructive view on NZD/USD is more a reflection of broad USD weakness than outright NZD strength. This is reflected in our flat to weaker view of NZD crosses.

On a more positive note, a concerted easing in global monetary policy this year could see a better growth environment develop, that might see 2025 world growth forecasts revised higher and 2026 might well be a year of trend or above-trend growth. As FX markets are forward-looking, any move in this direction might ultimately prove to be NZD-positive, albeit a view to consider for later this year.

**China outlook not great**

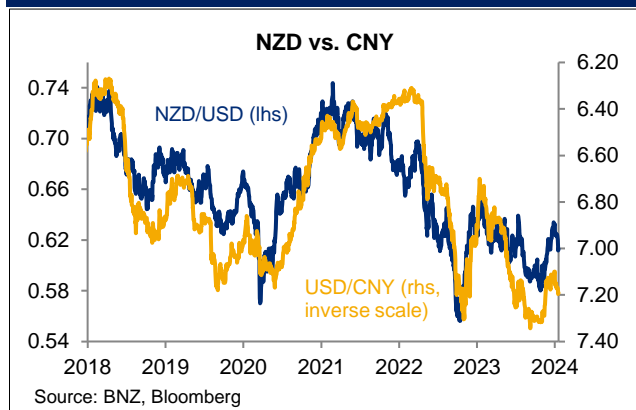
China’s economy remains moribund, with last year’s 5.2% growth outcome soft, considering the post-COVID reopening of the economy. Growth continues to be dragged down by the property sector and the government seems unwilling to write a blank cheque to prop up developers and drive a big turnaround for the sector. At Davos this week, Premier Li portrayed the recovery in growth as a success and stressed that officials did “not seek short-term growth while accumulating long-term risk”.

With a reluctance to provide significant policy support to drive the economy, China’s growth outlook remains

sluggish, a drag on CNY which, in turn, keeps the NZD in check.

The PBoC continues to push against further yuan depreciation, with a step-up this year to fix CNY at an increasing premium to market estimates. This protects, or limits, downside risk for the yuan and thereby limits downside risk to the NZD from this factor, but it is hard to be overly bullish the NZD with China’s weak macro outlook.

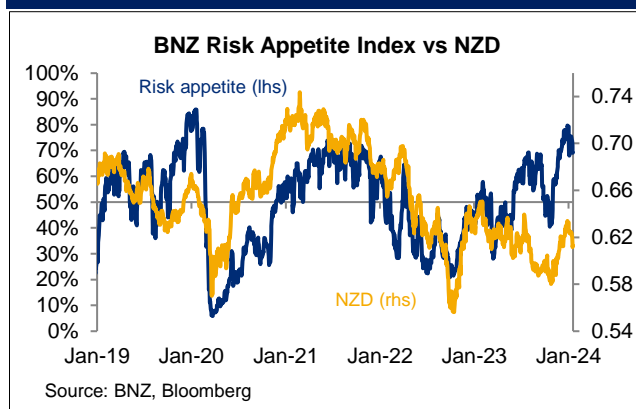
**A soft CNY would hold back NZD performance**



**Risk appetite has more downside than upside potential**

Last year ended with investors in a risk-loving mood, with our risk appetite index closing near 80%, putting it just in the top quintile. The sharp increase in risk appetite from 40% in October was instrumental in the recovery of the NZD from 0.58 to 0.63. This reflected the shift in market expectations towards thinking no more US rate hikes would emerge and much easier policy would follow in 2024. The Fed’s dovish pivot in December reinforced market expectations and added fuel to the lift in risk appetite.

**More downside than upside to risk appetite**



The new year has begun with a fall in risk appetite to 70%, coinciding with a 2-cent drop in the NZD. At 70%, risk appetite remains above the neutral 50% level, and suggests more downside risk than upside risk from here. As the chart shows, the NZD has been weaker than suggested

by risk appetite since May last year, which we would put down to the drag from China and other Asian currencies from that time.

It is possible that the gap between risk appetite and the NZD closes, but that probably requires the yuan to show a decent recovery. No obvious trigger comes to mind at this juncture.

The NZD is perennially vulnerable to a “risk-off” event and one can never rule this out in any given year. There are a number of candidates for lower risk appetite, including geopolitical risks in the Middle East or China-Taiwan, some US banking or commercial real estate blow-up, or a big US equity market correction. We’d be more comfortable with a positive NZD outlook if risk appetite was currently at a much lower level.

**NZ domestic forces soft**

While global forces typically drive the NZD, domestic forces have been mainly a headwind. That looks set to continue. Growth performance has been shocking, with GDP per capita contracting by around 3%, which is as bad as the low during the GFC. The NZ economy is in the midst of a rolling recession, and the growth outlook remains subdued for 2024. BNZ Economics projects growth close to zero for 2024 (Dec qtr y/y%), which would represent another significant contraction on a per capita basis.

At the November MPS, the RBNZ threatened to raise rates again, but with such a weak economy, and as disinflationary forces continue, we continue to see the next move as an easing. The market has priced in “only” 90bps of easing this year, which is modest against the 140bps priced in the US. Relative to the US, currently the NZ economy faces weaker growth momentum but stronger inflation pressure. Ultimately, we see NZ’s weak economy feeding through into much lower inflation. Relative to market pricing, we see more chance of NZ-US short rate spreads narrowing, which could be seen as a headwind to NZD/USD performance. But, as we note in the first section, it is US monetary policy that has been in the driving seat for the currency market and rate spreads have played only a secondary role.

**US Presidential Election**

Donald Trump destroyed his opposition in the first Republican caucus in Iowa, setting himself up as the strong favourite to face President Biden in the November Presidential Election. According to oddschecker.com, betting markets put the probability of a Trump victory at 45% and a Biden victory at 33% (the residual being other candidates who have yet to be ruled out). The chance of Trump winning must therefore be taken seriously by markets.

One of Trump’s key policies is placing a tariff on all US imports. While Trump’s previous Presidential term was

anti-China, with tariffs largely confined on imports from China, a more widespread imposition of tariffs is clearly anti-trade. In theory we should expect tariffs to be partially offset by a currency appreciation in the tariff-imposing country, so Trump’s policy at face value would be USD-positive.

Adding to this case is that markets could easily adopt a risk-off stance on a likely Trump victory, which would add to USD-strength. Thus, overall we see the re-election of Trump, or expectations thereof, as ostensibly negative for the NZD. We aren’t yet willing to factor this into our projections – let’s see how Trump’s court proceedings play out – but highlight this as a downside risk to our NZD/USD projections.

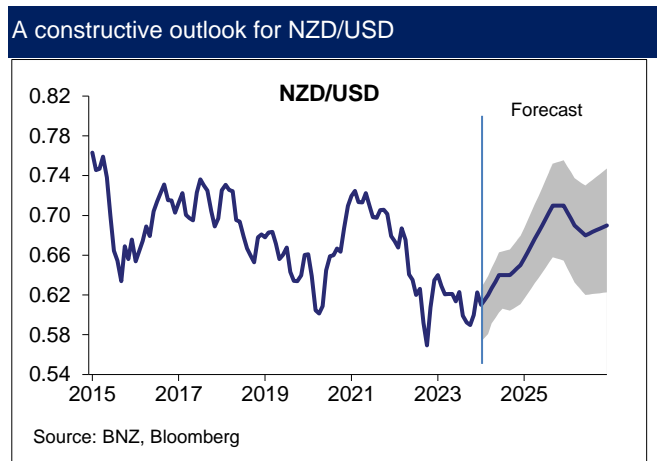
**No change to NZD/USD projections at this stage**

Our NZD/USD projections remain unchanged. Our end-Q1 target of 0.62 is consistent with our view of a 0.60-0.64 trading range over the short term. We have the NZD lifting to 0.64 for end-q2 and end-Q3 and 0.65 for end-Q4. These projections are consistent with an eventual topside break later in the year.

As mentioned earlier, our projections are more driven by an expectation of broad USD weakness than a particularly

strong outright view of the NZD. Despite the USD showing significant weakness towards the end of last year, it remains richly priced on long-term metrics like purchasing power parity. The Fed kick-starting an easing cycle is a key requirement for broad USD weakness to develop.

The tone of the previous sections highlighted the headwinds still facing the NZD and this is reflected in our NZD cross forecasts, which remain flat to lower.



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