15 November 2012

FX Trade Recommendation

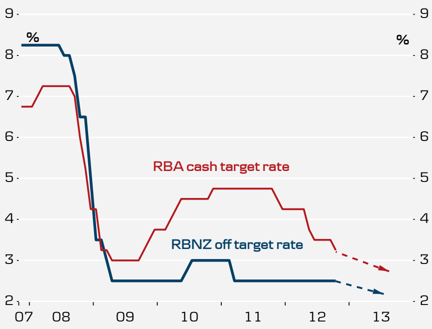
Long AUD/NZD – the next divergence trade

We recommend to buy AUD/NZD spot @ 1.2733 with a 1.3000 target and 1.2600 stop to position for continued divergence between Australia and New Zealand; this provides an approximate carry of 0.7% p.a. Although we remain bearish on the cyclical currencies as a whole for the near term due to US fiscal woes, we think there is scope for more aggressive pricing of the Reserve Bank of New Zealand (RBNZ) relative to the Reserve Bank of Australia (RBA) as Australia benefits from past rate cuts and a stabilisation in China. Long AUD/NZD could be viewed as the new divergence trade: partly playing a continued Aussie-Kiwi data gap and partly continued fiscal cliff concerns, favouring triple-A rated currencies.

Earlier this week we took profit in our 1M AUD/NZD risk reversal, see *FX Position Update*, 12 November, but we still like the pair and suggest positioning for further divergence between Australia and New Zealand. The discrepancy we are starting to see manifesting itself down under resembles that seen in the Scandi region in recent months, which has led to a sustained upward move in NOK/SEK that may not have much further to go. Indeed, AUD/NZD could become the new divergence trade, which is at the same time partly insulated from US fiscal cliff concerns. Thus, long AUD/NZD could be viewed as the new divergence trade, partly playing a sustained Aussie-Kiwi data gap and partly demand for triple-A assets amid fiscal cliff concerns.

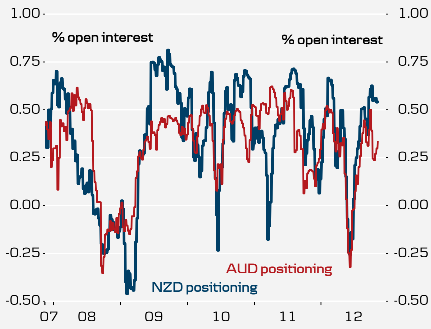
The data flow has moved in favour of AUD recently, as Australian data has become less bleak with decent employment growth and retail sales and, notably, Q3 inflation surprising on the upside. The data flow out of New Zealand has also been reasonable but a marked rise in the unemployment rate and dismal retail sales were seen in Q3. We expect to see Kiwi data deteriorate further as the boost from earthquake reconstruction gradually starts to wane and the burden of the strong NZD is felt. In contrast, Australia is set to benefit from the stabilisation in China that we see materialising in Q4; indeed, this has already been fuelling iron-ore prices.

RBA-RBNZ policy rate differential to favour AUD



Source: Reuters EcoWin, Danske Bank Markets

Speculative positioning



Source: Reuters EcoWin, Danske Bank Markets

Key points

- *We recommend to buy AUD/NZD spot @ 1.2736 with a 1.3000 target and 1.2600 stop . This provides an approximate carry of 0.7% p.a.*

AUD/NZD exchange rate

Source: Reuters EcoWin, Danske Bank Markets

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We believe the expected data divergence will feed through to the relative policy moves of the RBA and the RBNZ. The November RBA meeting at which, contrary to market expectations, the bank kept its cash target rate unchanged at 3.25% underlined that the RBA is becoming more complacent about the effect of past rate cuts and is alert to stronger-than-expected inflation figures. We still look for the RBA to be in easing mode but we believe the pace of rate cuts should decelerate somewhat; notably the market is already pricing almost three 25bp cuts over the next year. In contrast, only one cut is priced for RBNZ while we think there is scope for at least one more.

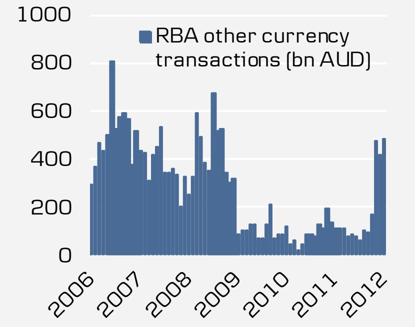
From a positioning point of view, AUD also looks interesting relative to NZD: speculative longs in Kiwi are at stretched levels whereas those in Aussie are still somewhat below the highs seen earlier this year.

In terms of ratings, the current environment of fiscal woes should benefit AUD relative to NZD given the triple-A sovereign rating of the former compared with New Zealand's AA (S&P, Fitch).

It should be noted, however, that intervention talks are looming in relation to both the RBA and the RBNZ. Over the last three months, RBA has stepped up its 'other outright currency transactions', fuelling speculation that the RBA may increasingly be looking to curb AUD strength. At the same time, the new RBNZ governor Graeme Wheeler appears to be rethinking the policy toolbox listing a *set of conditions* to be met for the RBNZ to consider, stressing, however, that these are not satisfied at present. Although Wheeler has also been keen to point out that the rate instrument is not ideal for dealing with unwanted currency moves, we think the RBNZ will start to cut rates during the course of 2013.

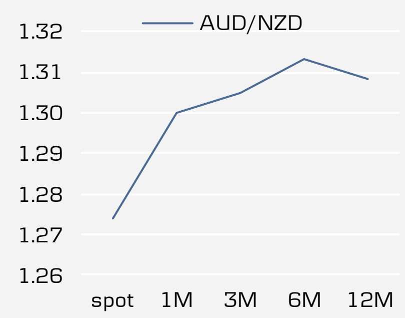
For the commodity currencies on the whole we expect fiscal woes to prove a headwind via-à-vis the USD ahead of New Year but the improvement in the cyclical environment that we look for should prove positive in early 2013 together with healthy risk appetite fuelled by past ECB and Fed policy commitments. However, beyond the 6M horizon a challenging environment with focus on low growth for long, questioning of the Chinese growth potential and weaker commodity prices should weigh. Thus, in the near term, commodity currencies are not the place to be vis-à-vis the USD, making relative bets more attractive; long AUD/NZD is our preferred option in this respect.

RBA intervention



Source: Bloomberg, Danske Bank Markets

Danske AUD/NZD forecast



Source: Bloomberg, Danske Bank Markets

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