

NZD weakens across the board as expectations of RBNZ cuts build

- The NZD depreciated against all the major currencies in May, and slipped 4.5% on a trade-weighted basis.
- Bond yields rose in May, both here and abroad, but ended the month off their highs. Sharemarkets continued to lift.
- NZ 90-day bank bill yields declined during May and the market priced in increasing probability of RBNZ rate cuts.

Bond market volatility was a key theme of the month, particularly in Europe. Long-term bond yields were under upward pressure both here and abroad. However, yields are still below the 2015 highs recorded in the first quarter, and significantly below year-ago levels.

The ongoing economic weakness in Europe prompted the European Central Bank saying it would look to front-load its asset purchase scheme to boost the euro economy. However the focus throughout the month was on Greece and if it could repay its creditors. Encouragingly, Greece paid about €750 million to the International Monetary Fund (IMF) on May 11. However, further repayments are due in June, and the ongoing uncertainty kept investors on edge.

Global share markets were volatile in May, but most of the major indices ended the month in positive territory. Throughout May the Greek situation dominated news flows and weighed on sentiment. In addition, investors focussed on the timing of US interest rate hikes, volatility in bond markets and a further interest rate cut from the People's Bank of China.

On May 6, Fed Chair Janet Yellen warned high equity valuations could pose "potential dangers". The comments gave investors further reason to pause and assess both valuations, and the timing of US rate hikes. The FOMC minutes on May 20 suggested the Committee remained patient about waiting to raise rates (even if the FOMC statements no longer used the word). Nonetheless, a speech from Janet Yellen on May 23 articulated an expectation of rising rates by the end of the year.

The Reserve Bank of Australia cut the cash rate on 5 May. The lack of forward guidance on the outlook for future interest rate adjustments was interpreted by some as a sign the easing cycle was over, and the AUD and Australian swap rates rose after the announcement. The RBNZ does not hold a policy meeting in May. However, market pricing suggests strengthening convictions that the RBNZ will cut the OCR over the coming months. Labour market data for the first quarter released in May showed there was plenty of slack in the labour market, and wage pressure remains low. Falling dairy prices added to the pessimism. We now expect the RBNZ to cut the OCR later this year, most likely in September and October. And we can't rule out an earlier move. These developments helped the NZD weaken against all the currencies we monitor during the month.

| Date | Instrument | 31-May-15 | Month % | Quarter % | Year % | 5-Year % |
|----------------|---------------------------|-----------|---------|-----------|--------|----------|
| Cash | NZ cash rate | 3.50 | 0.00 | 0.00 | 0.50 | 1.00 |
| | NZ 90-day bank bill | 3.47 | -0.17 | -0.16 | 0.05 | 0.52 |
| | US 90-day bank bill | 0.28 | 0.00 | 0.02 | 0.06 | -0.25 |
| | NZ - US 90-day bank bill | 3.19 | -0.17 | -0.18 | -0.01 | 0.77 |
| Fixed | NZ 5-year gov't stock | 3.18 | 0.04 | -0.04 | -0.77 | -1.74 |
| Interest | NZ 10-year gov't | 3.63 | 0.19 | 0.34 | -0.63 | -1.97 |
| | NZ 10-year sw ap | 3.93 | 0.03 | 0.12 | -0.84 | -1.86 |
| | AUS 10-year gov't | 2.74 | 0.08 | 0.26 | -0.94 | -2.65 |
| | US 10-year gov't | 2.13 | 0.11 | 0.11 | -0.34 | -1.17 |
| Equities | NZ - NZX50 Capital (NZ\$) | 2995 | 0.7% | -2.2% | 8.0% | 50.8% |
| | AUS - All Ords (A\$) | 5775 | 0.0% | -2.1% | 5.5% | 29.7% |
| | JAP - Nikkei (¥) | 20563 | 5.3% | 9.4% | 40.5% | 110.5% |
| | UK - FT100 (£) | 6984 | 0.3% | 0.5% | 2.0% | 34.6% |
| | US - S&P500 (US\$) | 2107 | 1.0% | 0.1% | 9.6% | 93.4% |
| | WORLD - MSCI (US\$) | 1779 | 0.1% | 0.4% | 3.7% | 64.8% |
| | MSCI in NZD (NZ\$) | 2491 | 6.6% | 6.0% | 23.5% | 57.5% |
| Exchange Rates | NZD/USD | 0.7144 | -6.2% | -5.3% | -16.0% | 4.6% |
| | NZD/AUD | 0.9317 | -2.2% | -3.7% | 2.2% | 15.8% |
| | NZD/JPY | 88.40 | -2.1% | -1.8% | 2.4% | 41.6% |
| | NZD/GBP | 0.4659 | -5.6% | -4.7% | -8.3% | -1.3% |
| | NZD/EUR | 0.6521 | -4.9% | -3.1% | 4.4% | 17.6% |
| | NZ TWI | 74.88 | -4.5% | -4.5% | -6.9% | 10.8% |
| | EUR/USD | 1.0955 | -1.4% | -2.3% | -19.5% | -11.0% |

Equity indices are the respective end-of-month closes. Interest rates and exchanges rates are at 5pm NZ.

Cash

Low inflation and concerns about economic growth have seen a number of central banks ease policy settings this year. The Reserve Bank of Australia cut its cash rate for a second time this year in May. While the RBNZ has maintained the 3.5% Official Cash Rate (OCR) at each meeting since last July, the Bank moved to an explicit easing bias in April this year. During May, weak dairy prices, benign wage inflation data and a decline in business confidence all supported the view that the RBNZ would act on its easing bias and cut the OCR.

We also expect the RBNZ to cut the OCR later this year, with 0.25% cuts pencilled into our forecasts at the RBNZ's September and October meetings.

NZ 90-day bank bill yields declined during May. An OCR cut would put further downward pressure on bank bills and short-term deposit rates. The 11 June Monetary Policy Statement gives the RBNZ the opportunity to explain in great detail why it moved to an easing bias in April and (if it wishes) to signal the risks around that new stance. And we can't rule out the possibility of a June rate cut.

Fixed interest

Long-term bond yields were under significant upward pressure both here and abroad for the majority of the month, and bond markets were volatile, with large daily trading ranges recorded during the month. However, while international yields rose over the month, they remain at historically low levels overall.

The NZ 10-year government bond yield rose by an impressive 19bp, followed by an 11bp rise in the US 10-year bond and an 8bp rise in the Australian 10-year bond yield over the month.

Greece continues to be a dominant driver of sentiment in Europe as uncertainty pushes yields higher. Greek 2-year bond yields rose to over 22% by the end of May as investors became increasingly concerned about the chances of a Greek default. German Bunds also lifted over the month, with the 10-year yield recording a 12bp rise to close at 0.49%.

Equities

The US S&P 500 share index rose 1%. In Europe, the UK FTSE rose by 0.3%, while across the channel the MSCI index of European shares (ex-UK) rose by 0.1%, despite the Greek concerns weighing on sentiment.

In Asia, the Japanese Nikkei lifted by 5.3% over May, which took the annual lift in the index to a staggering 40.5%.

In addition to the Greek situation which dominated the month's news flows, investors were also concerned with the timing of US interest rate hikes, volatility in bond markets and a further interest rate cut from the People's Bank of China and the associated Chinese growth concerns.

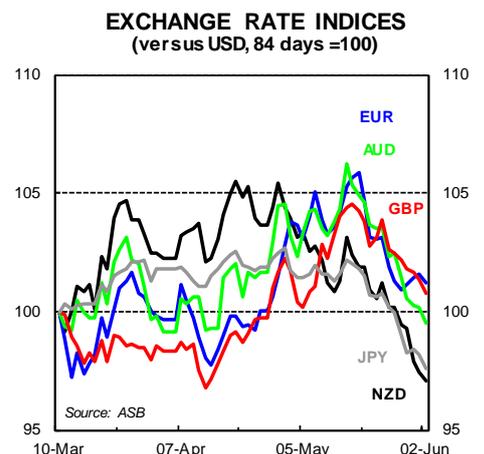
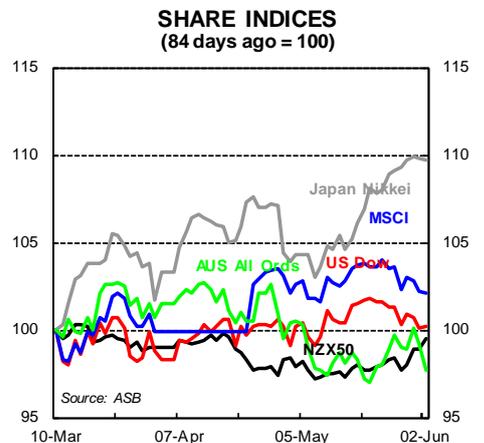
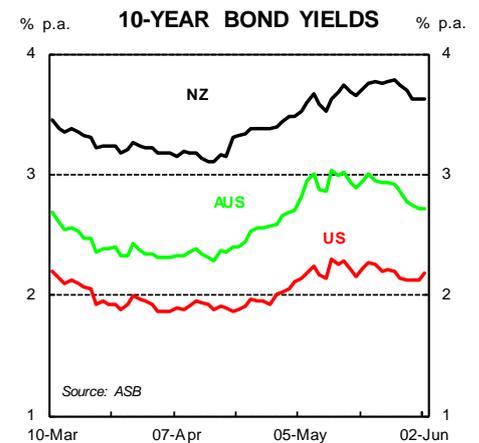
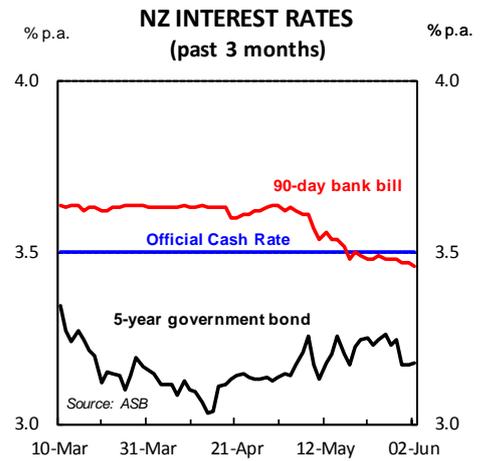
The Australian All Ords index was flat for the month, while the New Zealand sharemarket managed to gain 0.7%. Australasian share indices are still down around 0.2% for the three months ending in May.

Exchange rates

The NZD weakened against all the currencies we monitor during the month. The NZD fell 6.2% against a firming USD, and slipped 4.5% on a trade-weighted basis. The view that it is increasingly likely the RBNZ will cut the OCR has weighed on the local currency.

A firm USD also helped guide NZD/USD lower. The USD rose 2.4% on a trade-weighted basis during May. As well as outperforming the NZD, the USD posted strong gains against the AUD and JPY.

AUD/USD lifted ½ cent after the Reserve Bank of Australia (RBA) cut rates 25bps to 2.0% but dropped its easing bias. However, AUD/USD came under renewed downside pressure mid-way through the month following the RBA's release of its May meeting minutes and disappointing Q1 Australian capital expenditure (capex) data. Having got within ½ a cent of parity NZD/AUD slipped another 2% during the month to end May trading near 0.93.



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