

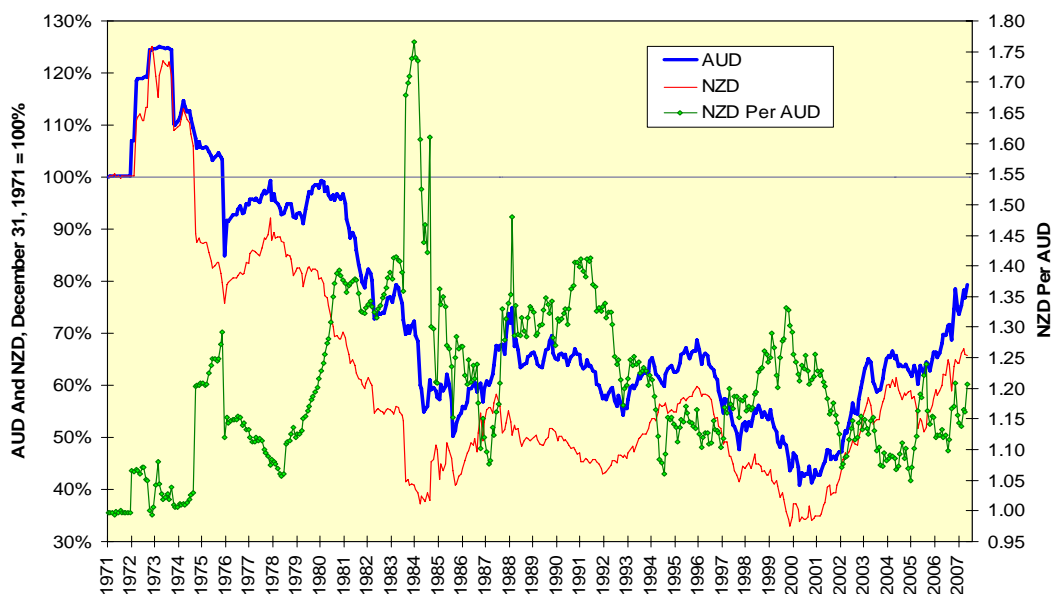
## Getting Carried Away With The Kiwi

We asked the question in March, “What’s Down With The Australian Dollar?” Unfortunately, any mention of Australia invites a comparison to New Zealand. We say “unfortunately” because outside of their location in the South Pacific, their membership in the British Commonwealth and their use of currencies named “dollars,” the two countries have little in common.

At this point, we bow in reverence to one aspect of their shared history. A combined Australian-New Zealand army corps bore much of the brunt of Winston Churchill’s failed Gallipoli campaign in 1915. The so-called Anzac corps’ losses created a sense of nationality in both then-British colonies that transcends more artificial attempts at nation-building and says much about what it actually means to be a nation in more than name.

But just as currency traders should not pair the Australian and Canadian dollars together out of their shared language and reliance on commodity exports, they should not pair the Australian and New Zealand dollars together out of geography. Besides, it is 1,380 miles by air between Sydney and Wellington. The New Zealand dollar (NZD, affectionately known as the kiwi) has followed a different track than the AUD. It has been gaining on the AUD steadily if spasmodically since the mid-1980s.

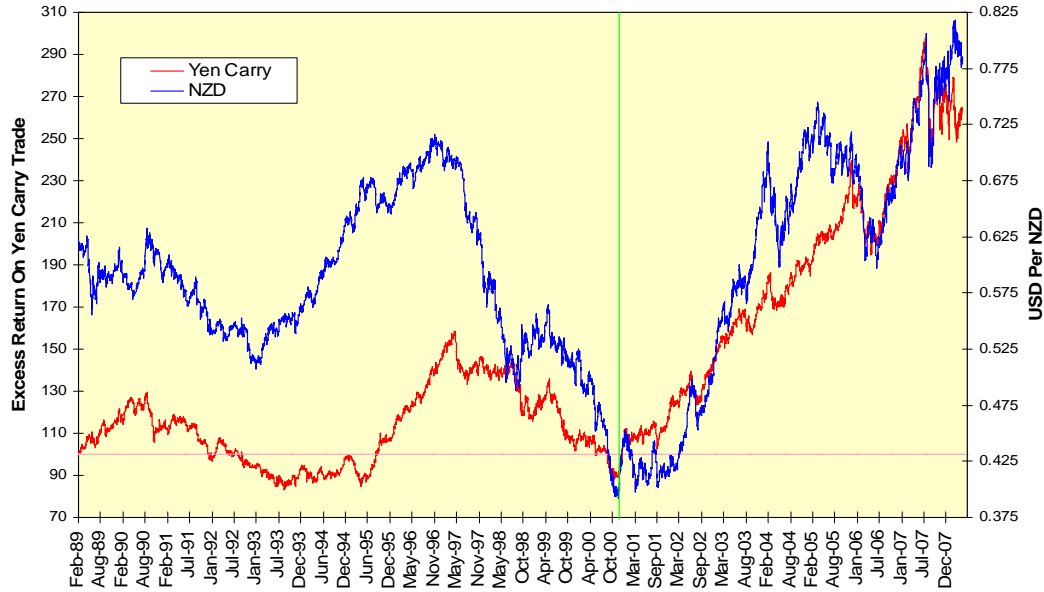
Australian And New Zealand Dollars



### The Yen Carry

If we are to discuss the kiwi in relation to any other currency, it should be the Japanese yen, not the AUD. The yen carry trade, discussed here last year (see “Looking At The Carry Trade,” June 2007) is the real driver of the NZD. In fact, a simple trade of borrowing the JPY and lending the NZD with no reversals and no neutral periods has generated an average annual excess return of 5.48% since February 1989.

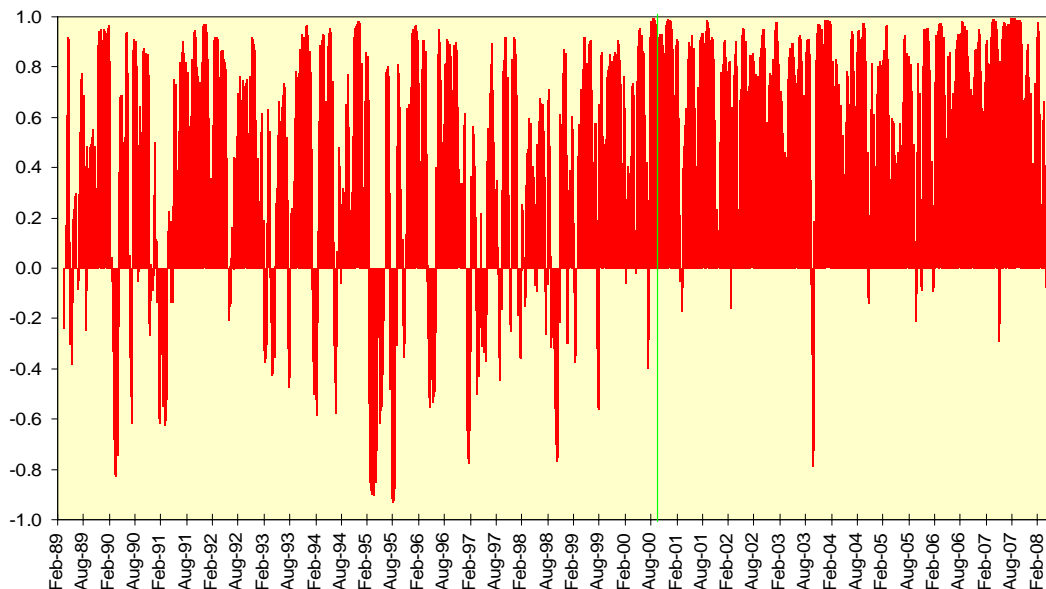
### Kiwi's Dependence On Yen Carry Trade Is Recent



How can such a naïve strategy work so well over a long period of time? The Reserve Bank of New Zealand and the Bank of Japan have interlocking neuroses; the rocks in the BOJ’s head fill the holes in the Reserve Bank’s. While the BOJ has spent much of the past twelve years engaged in a grand experiment of keeping short-term interest rates unnaturally low, the RBNZ has kept its cash rate quite high by global standards, 8.25% at present. This wide disparity between rates has created a chasm between Japan and New Zealand filled by capital flows into New Zealand. These flows did not accelerate in earnest until October 2000, marked with a green line both in the chart above and subsequently. The BOJ embarked on its aggressive policy of “quantitative easing,” or shoving excess reserves into Japan’s banks (see “The Yen Stands Alone,” March 2006) five months later.

A second way of illustrating just how much the yen carry trade has dominated the kiwi’s movements is a rolling 30-day correlation between the two series. Prior to the October 2000 period, this correlation was often negative; between October 2000 and March 2008, the correlation was not only positive nearly all of the time but actually hovered near its maximum value of 1.00. The correlation turned negative after March 2008 as the yen strengthened on global markets.

### Rolling 30-Day Correlation: Yen Carry Vs. Kiwi

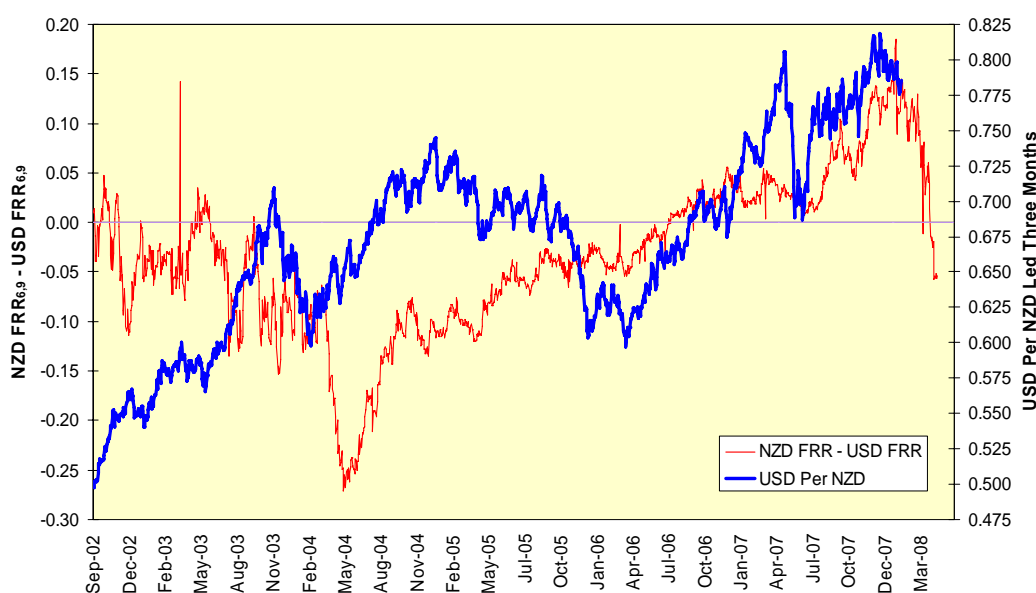


### Relative Interest Rate Expectations

As we did in the case of the AUD, we can turn now to relative expectations for short-term interest rates between New Zealand, the U.S. and Japan. The tool for this analysis is the forward rate ratios between six and nine months ( $FRR_{6,9}$ ). This is the rate at which you can lock in borrowing for three months starting six months from now divided by the nine-month rate. The more this ratio exceeds 1.00, the steeper the money-market yield curve and the stronger the expectation for higher short-term interest rates in the future. A wider  $FRR_{6,9}$  differential in favor of a given currency indicates traders expect interest rates for that currency to begin rising faster in that currency. Whenever the  $FRR_{6,9}$  differential between the NZD and the USD exceeds zero, the NZD should be supported thereby as its holders are expected to receive higher interest rates in the future.

The difference between the NZD and USD  $FRR$ s leads the movements in the NZD by three months on average. This differential grew steadily throughout the second half of 2007 as the Federal Reserve cut interest rates in response to the U.S. credit crunch. After the January panic low in equities, the  $FRR_{6,9}$  differential collapsed and turned in favor of the USD in late April 2008. This presages a significant weakening in the NZD into the late summer.

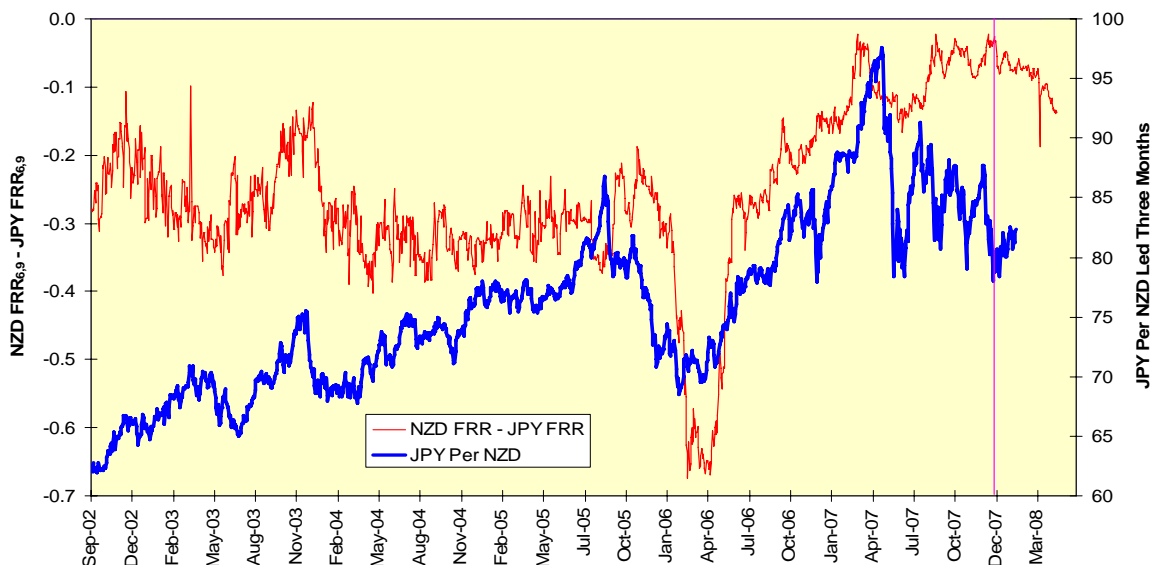
**New Zealand Dollar Has Lost Its Interest Rate Expectation Advantage Vs. USD**



A similar analysis between the NZD and JPY  $FRR_{6,9}$  yields a different picture. While traders debated throughout 2007 and into 2008 whether the Federal Reserve would cut rates and if so by how much, the debate with the BOJ was the opposite. Even as late as mid-August 2007, at the very height of the credit crunch, the BOJ was withdrawing excess liquidity from its current account. It was not until December 20, 2007, marked below with a magenta vertical line, that the BOJ confirmed it would not be raising rates for the foreseeable future.

Once this transpired, the  $FRR_{6,9}$  differential started to narrow and the NZD began to firm against the JPY. As this relationship also has a three-month lead time, we should expect the trend of a weaker NZD vis-à-vis the JPY to resume by the late summer.

### New Zealand Dollar Losing Its Interest Rate Expectation Advantage Vs. JPY

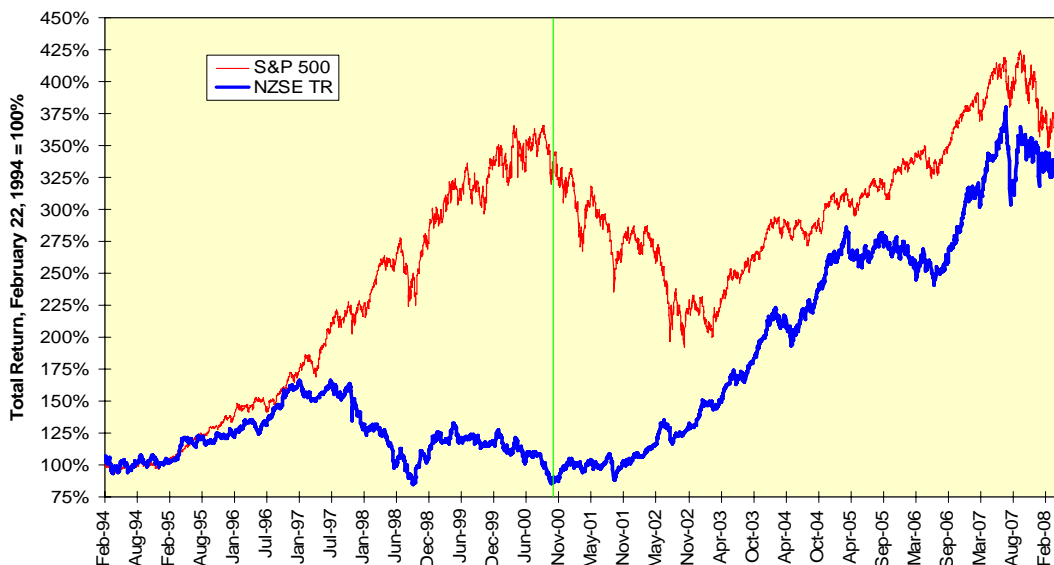


### Effect On Asset Returns

We discussed in a two-part article in April and May how stock market returns and currencies are linked. Indeed, next to interest rate differentials, returns on financial assets are the greatest single determinant of relative currency performance. Trade flows are the least important determinant, but they get the greatest attention in the headlines.

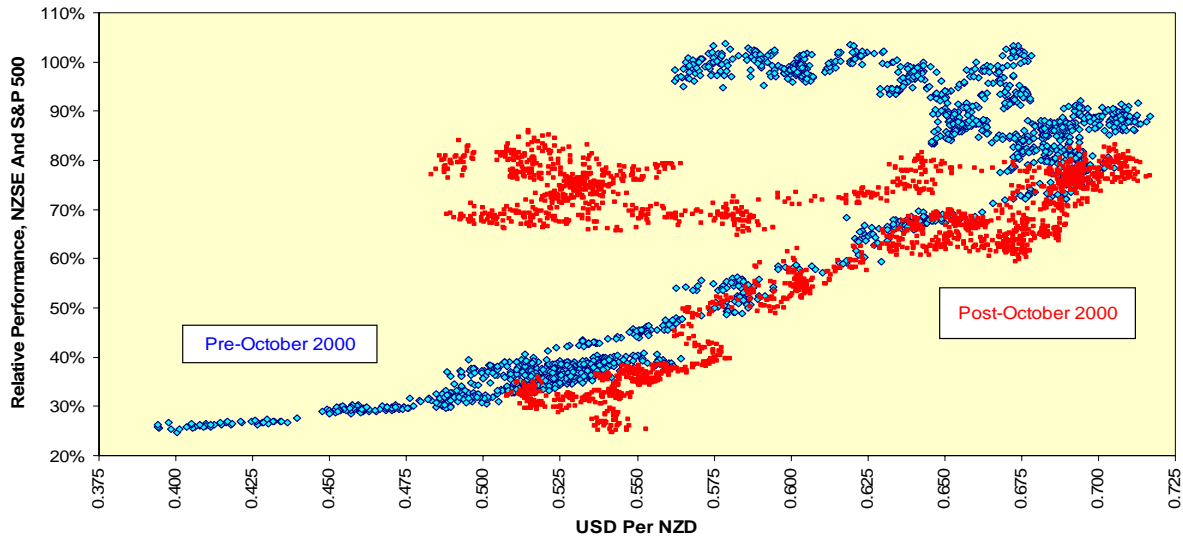
The situation in New Zealand has been something of a tail wagging a dog. The New Zealand All Ordinaries index (NZSE) expressed in USD terms lagged the S&P 500 badly between 1994 and 2000. Once the yen carry trade turned on, the NZSE started to outperform the S&P 500 until the March 2008 panic low in the U.S. While financial flows created superior relative performance prior to the Federal Reserve's extraordinary liquidity injections, that trend has ceased for the duration under the weight of highly stimulative American monetary policy.

### New Zealand Is A Slow And Steady Underperformer



But, in an interesting twist, the relative performance of the NZSE before October 2000, depicted in blue markers, was more of a function of the NZD than was the case post-October 2000. The explanation here is fairly simple: The very same global financial flows that propelled the kiwi and the NZSE higher propelled the S&P 500 higher as well. The relative performance of the two stock indices could remain locked in a tight zone across a wide range of currency values.

### New Zealand's Relative Performance Independent Of NZD In Carry Trade Era



#### The Obvious Risk

The sensitivity of the NZD to the yen carry trade makes the unit a miner's canary – kiwi? – for BOJ policy changes. We saw in May-June 2006 and again during several 2007 episodes how both the NZD and the NZSE reacted to perceived changes in Japanese short-term interest rates and liquidity.

That is the bad news. The good news is fears of an end of the yen carry trade have existed since the trade opened in 1995; the author has written on such an eventuality since 1996. One day it will be true, just as one day the sun will cease to shine. Until then, the simple trade is to stay long the NZD against the JPY.