Weekly Commentary

18 April 2017

Early arrival

The inflation story in New Zealand has reached a new chapter. For several years, inflation had been persistently below the 2% midpoint of the Reserve Bank's target, reflecting the ample spare capacity in the economy, the strength of the New Zealand dollar, and low world oil prices. However, by the end of last year inflation had rebounded from near-zero levels to 1.3%. And various measures of core inflation, which strip out volatile aspects such as fuel prices, suggest that inflation pressures have been gradually picking up for the last year or so.

In one sense, this is a good thing – it shows that monetary policy works. Interest rates are typically thought to have their greatest influence on inflation over a 1-2 year ahead horizon. The RBNZ began to lower the Official Cash Rate in June 2015, and longer-term interest rates, in their usual pre-emptive manner, were falling by late 2014. So the lift that we've seen in underlying inflation is right on schedule.

In contrast, the rise in the headline inflation rate has been more abrupt. We expect it to rise to 2.0% in Thursday's CPI release, reaching that mark more than two years earlier than the RBNZ expected. That will no doubt raise questions about whether interest rates need to stay at super-low levels for much longer. Indeed, financial markets have for some time been anticipating OCR hikes by the first half of next year.

We remain more cautious on this matter. Much of the acceleration in the annual inflation rate is due to temporary factors; we expect the annual rate to ease back a bit over the rest of this year. We're also conscious that low interest rates need to remain low to ensure that the lift in domestic inflation is sustained.

In terms of the details of this week's CPI release, we expect a 0.8% rise for the quarter. With a fairly weak result in the March 2016 quarter dropping out of the calculation, this would lift the annual inflation rate from 1.3% to 2.0%.

There are two factors in particular that account for the pickup in inflation. The first is that petrol prices rose by 4% over the quarter, and were up 12% on a year ago. But this time last year marked the low point for world oil prices, which have rebounded by about 80% since then. That rate of increase is highly unlikely to be repeated over the rest of this year.

The second factor is that prices for some fresh produce such as carrots, apples and pears had unusually large seasonal spikes at the start of this year. At least part of this appears to have been weather-related, such as a delay in the carrot harvest in the North Island. If that's the cause, these price increases are likely to reverse completely as the season progresses – in fact, many of them were already pulling back by March.

These two factors alone – food and fuel – would be enough to push the annual inflation rate up to 2.1%. So our forecast actually implies a slight easing of inflation pressures across the other categories. In particular, we expect a dampening effect from the strong rise in the New Zealand dollar over last year. The passthrough from the exchange rate to retail prices typically takes the best part of a year, and there were tentative signs that this was starting to come through in the December quarter.

The RBNZ is likely to look through the more volatile aspects

Early arrival continued

of the CPI and focus on the more slowly evolving non-tradables component. Aside from some obvious areas of price pressure – namely housing construction – non-tradables inflation has not shown a significant uptick to date. That lines up with the sense that the economy has been running with ample spare capacity (again with the exception of construction). For instance, an unemployment rate of around 5% is above what most would consider to be a 'neutral' or non-inflationary rate.

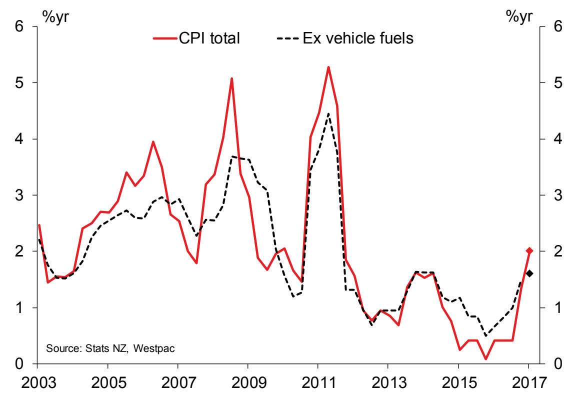
A key question for the RBNZ is whether the economy is growing rapidly enough to absorb that spare capacity, and generate a sustained lift in domestic inflation pressures. This is where we think there's reason for caution. As we noted earlier, interest rates have powerful effects on inflation – and that applies in both directions. Term interest rates have been rising since late last year, following two years of consistent declines.

The rise in mortgage rates, combined with tighter lending restrictions, is clearly having an impact on the housing market. The latest REINZ house sales figures confirm that nationwide house price growth has slowed substantially over the last six months, and prices in previous hotspots such as Auckland, Hamilton and Tauranga have flattened out altogether.

There are signs that the slower housing market is flowing through into consumer spending. Electronic card spending was weaker than expected in March, and notably, spending on durable goods such as household furnishings and electronics has fallen in seven of the last nine months.

We think that the rise in longer-term interest rates – assuming that it is sustained – will play a significant role in preventing the New Zealand economy from overheating. That in turn reduces the risk of inflation overshooting the target in the absence of RBNZ action.

Annual inflation

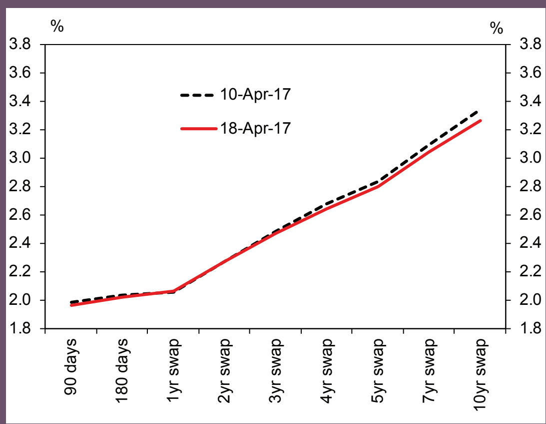


Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter terms. Three- to five-year rates seem high relative to where we think short-term rates are going to go over that time. That said, these rates are most likely to be pressured higher by global market trends, so borrowers who prefer the security of a longer term still have a chance to lock in at historically quite low levels.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



The week ahead

NZ Q1 CPI

Apr 20, Last: 0.4%, Westpac f/c: 0.8%, Mkt f/c: 0.8%

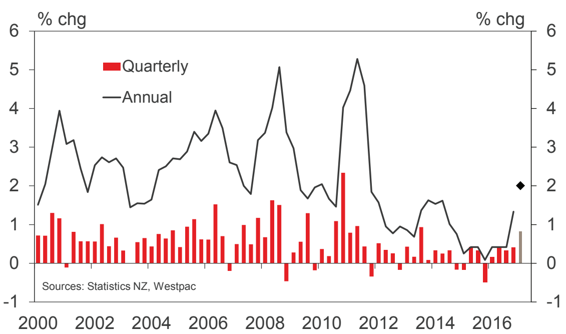
- We expect a 0.8% rise in the Consumer Price Index in the March quarter. This would lift annual inflation to 2% - the first time it has been at the mid-point of the RBNZ's target band since 2011.
- Inflation has been boosted by an unusually large spike in fruit and vegetable prices, as well as the rebound in oil prices over the past year. Neither factor will have a sustained impact on the rate of inflation.
- We expect that the RBNZ will recognise the influence of temporary factors on the March quarter, and will focus on the more slowly evolving, domestically focused components of the CPI. Consequently, we expect the RBNZ to leave the cash rate unchanged at 1.75% through 2017 and 2018.

Aus Mar Westpac–MI Leading Index

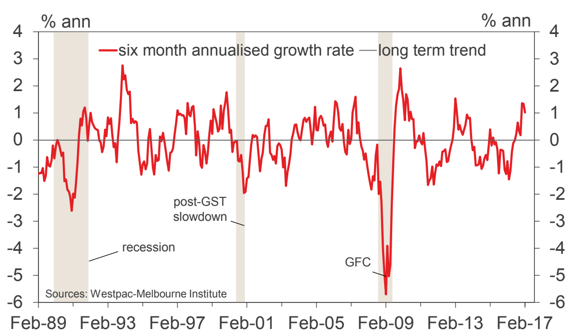
Apr 19, Last: 1.30%

- The Leading Index continues to point to above trend growth momentum, albeit with the pace moderating since the start of the year. The six month annualised growth rate in the Index, a guide to the pace of economic activity three to nine months into the future, fell from 1.34% in January to 1.02% in February.
- March will include positive component updates for the ASX200 (+2.7% vs +1.6% last month) and dwelling approvals (+8.3% vs +2.2% last month) with supportive reads from commodity prices (+0.5% in AUD terms vs +1.1% last month) and the yield spread (widened 4.5bps vs 2.7bps last month). However consumer sentiment related components were softer.

NZ CPI inflation



Westpac-MI Leading Index



Data calendar

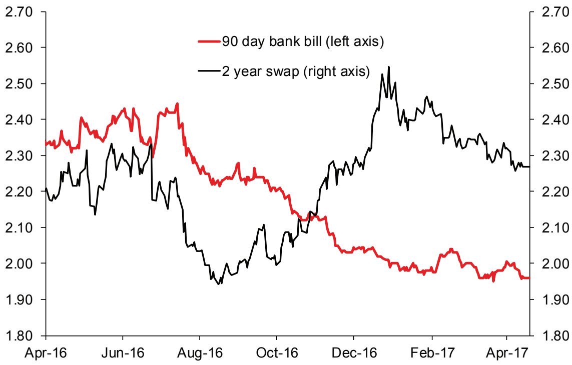
		Last	Market median	Westpac forecast	Risk/Comment
Tue 18					
Aus	RBA minutes	–	–	–	Rates on hold. Focus on prudential measures aimed at housing.
Chn	Mar property prices	–	–	–	Important time for Chinese housing market, with tier–1 rolling off.
US	Mar housing starts	3.0%	–2.2%	–1.0%	Higher interest rates have had little effect...
	Mar building permits	–6.0%	3.2%	2.5%	... starts and permits uptrend still intact.
	Mar industrial production	0.1%	0.4%	–	Yet to show strength evident in PMIs.
	Fedspeak	–	–	–	George Speaks at Bard College Conference.
Can	Mar existing home sales	5.2%	–	–	Strength centred on Toronto.
Wed 19					
NZ	GlobalDairyTrade auction	1.6%	–	–	Whole milk powder futures pointing to a decent rise in prices.
	Mar BusinessNZ PSI	58.8	–	–	Service sector conditions remain positive.
Aus	Mar Westpac–MI Leading Index	1.02%	–	–	Still tracking above trend but pace has moderated since late 2016.
	Mar new vehicle sales	–2.7%	–	3.0%	Industry figs point to solid bounce led by strong business sales.
Eur	Feb trade balance €bn	15.7	–	–	Jan saw import surge and weakness in French exports.
	Mar CPI, %yr (final)	1.5%	–	–	Down from 2.0%yr in Feb; core weak at 0.7%yr.
US	Fedspeak	–	–	–	Rosengren Speaks at Bard College Conference.
	Federal Reserve's Beige book	–	–	–	Detail on conditions across the 12 Fed regions.
Thu 20					
NZ	Q1 CPI	0.4%	0.8%	0.8%	Boost from food and fuel prices, annual inflation to rise to 2%.
Aus	Q1 NAB business survey	–	–	–	March monthly survey reported business conditions up 5pts to +14.
Eur	Apr consumer confidence	–5.0	–	–	Remains above average.
US	Initial jobless claims	–	–	–	Claims remained at historically low levels.
	Apr Phily Fed index	32.8	25.0	–	Feb's 43.3 was highest reading in 33 years. Has started to reverse.
	Mar leading index	0.6%	0.2%	–	Continues to point to around trend growth.
Fri 21					
NZ	Apr ANZ consumer confidence	125.2	–	–	Has moderated, but remains at firm levels.
Eur	Apr Markit manufacturing PMI (flash)	56.2	–	–	Strong readings in recent months...
	Apr Markit services PMI (flash)	56.0	–	–	... across manufacturing and services.
Ger	Apr Markit manufacturing PMI (flash)	58.3	–	–	Germany in even stronger form...
	Apr Markit services PMI (flash)	55.6	–	–	... though momentum more focused in manufacturing.
UK	Mar retail sales	1.4%	–0.2%	–	Rising inflation eroding households' purchasing power.
US	Apr Markit manufacturing PMI (flash)	53.3	53.5	–	Far less exhuberant than ISMs...
	Apr Markit service PMI (flash)	52.8	–	–	... although recent outcomes still consistent with solid growth.
	Mar existing home sales	–3.7%	1.3%	2.0%	Labour market and growth expectations offsetting rates impact.
	Fedspeak	–	–	–	Kashkari in Q&A at community economic development symposium.
Can	Mar CPI	0.2%	–	–	Underlying pressures remain well contained.

New Zealand forecasts

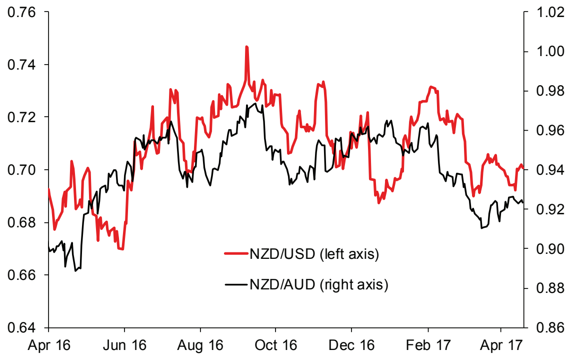
Economic Forecasts	March years				Calendar years			
% change	2015	2016	2017f	2018f	2015	2016	2017f	2018f
GDP (Production) ann avg	3.4	2.4	3.1	3.3	2.5	3.1	3.2	3.4
Employment	3.2	2.0	5.3	2.1	1.4	5.8	2.3	1.5
Unemployment Rate % s.a.	5.4	5.2	4.9	4.7	4.9	5.2	4.7	4.7
CPI	0.3	0.4	2.0	1.5	0.1	1.3	1.8	2.1
Current Account Balance % of GDP	-3.5	-3.1	-2.5	-2.1	-3.4	-2.7	-2.0	-2.7

Financial Forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	2.00	2.00	2.00	2.00	2.00	2.00
2 Year Swap	2.40	2.40	2.40	2.50	2.60	2.70
5 Year Swap	3.00	3.10	3.15	3.25	3.35	3.50
10 Year Bond	3.30	3.50	3.60	3.65	3.75	4.00
NZD/USD	0.69	0.68	0.67	0.66	0.64	0.63
NZD/AUD	0.91	0.91	0.91	0.91	0.92	0.93
NZD/JPY	81.4	80.2	80.4	80.3	79.7	79.4
NZD/EUR	0.66	0.66	0.66	0.66	0.65	0.64
NZD/GBP	0.57	0.57	0.56	0.56	0.54	0.53
TWI	76.2	75.8	75.4	74.9	74.2	73.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 18 April 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.84%	1.90%	1.83%
60 Days	1.90%	1.94%	1.90%
90 Days	1.96%	1.99%	1.96%
2 Year Swap	2.27%	2.32%	2.30%
5 Year Swap	2.80%	2.92%	2.98%

NZ foreign currency mid-rates as at Tuesday 18 April 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7008	0.7000	0.7012
NZD/EUR	0.6584	0.6565	0.6533
NZD/GBP	0.5577	0.5578	0.5660
NZD/JPY	76.35	77.99	79.00
NZD/AUD	0.9233	0.9170	0.9116
TWI	76.24	76.22	76.44

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.5	2.6	2.8
CPI inflation % annual	2.7	1.7	1.7	1.5	2.2	2.1
Unemployment %	5.8	6.2	5.8	5.7	6.3	6.2
Current Account % GDP	-3.4	-3.0	-4.7	-2.7	-0.6	-2.5
United States						
Real GDP %yr	1.5	2.4	2.6	1.6	2.2	2.4
Consumer Prices %yr	1.5	1.6	0.1	1.3	2.1	1.8
Unemployment Rate %	7.4	6.2	5.3	4.9	4.5	4.4
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.7	-2.8
Japan						
Real GDP %yr	1.4	0.0	0.5	0.6	0.8	1.0
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.7	1.6	1.2
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.0	1.9	1.5
China						
Real GDP %yr	7.7	7.3	6.9	6.7	6.6	6.0
East Asia ex China						
Real GDP %yr	4.2	4.1	3.7	3.7	3.8	3.8
World						
Real GDP %yr	3.3	3.4	3.1	3.3	3.5	3.5
Forecasts finalised 13 April 2017						

Interest Rate Forecasts	Latest	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.77	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.50	2.85	3.00	3.05	3.15	3.25	3.40	3.40
International								
Fed Funds	0.875	1.125	1.125	1.375	1.625	1.625	1.875	1.875
US 10 Year Bond	2.24	2.55	2.75	2.85	3.00	3.10	3.30	3.30
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
AUD/USD	0.7530	0.76	0.75	0.74	0.72	0.70	0.68	0.66
USD/JPY	109.03	111	112	114	116	117	118	118
EUR/USD	1.0666	1.05	1.04	1.03	1.02	1.01	1.00	0.99
AUD/NZD	1.0789	1.10	1.10	1.10	1.09	1.09	1.08	1.06

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