16 July 2015

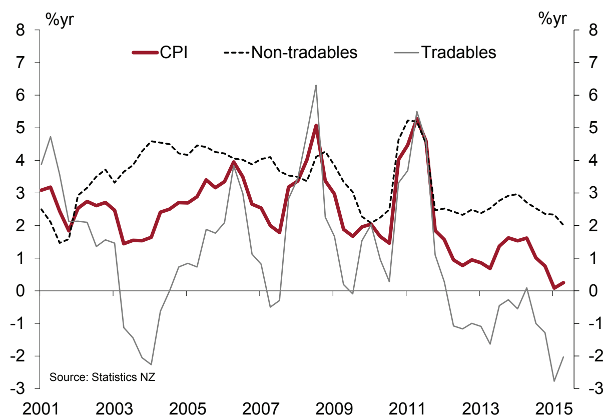
Westpac Institutional Bank

Pump priming

June quarter consumer prices rose 0.4%, annual inflation 0.3%

- The Consumer Price Index (CPI) rose by 0.4% in the June quarter, less than expected.
- A rebound in fuel prices at the pump and a lower exchange rate helped to lift the annual inflation rate to 0.3%.
- But outside of the housing market, domestic inflation pressures remain very subdued.
- The Reserve Bank has plenty of room to reduce interest rates further, particularly in light of weak dairy prices and signs of a slowdown in domestic activity.
- We now expect the OCR to be lowered to 2% by the end of this year. We expect a 25bp cut next week, but a 50bp cut can't be ruled out.

CPI inflation



Today's inflation figures highlight that the Reserve Bank has its work cut out for it, as it aims to bring inflation back towards the 2% midpoint of its target over the next couple of years. That task will become more difficult with a domestic economy that appears to have reached peak growth last year, and has shown some distinct wobbles in the last few months. The deteriorating outlook for dairy earnings is also a major concern, and we regard the 10.7% decline in dairy prices in last night's auction as very material. It is increasingly clear that a lower exchange rate is needed.

Consequently, we are changing our OCR forecast to a terminal rate of 2.00% by the end of this year (previously 2.50%). That profile implies at least one 50 basis point cut over the remaining OCR reviews this year – and indeed, there's a risk that this could be delivered as early as next Thursday's review. However, on balance our view is that the Reserve Bank will wait until September, and some evidence that the housing market is slowing, before delivering a larger rate cut.

Financial markets are currently pricing in a cash rate of just above 2.50% by year-end. We expect fixed-term interest rates to fall further in coming weeks as the case for deeper interest rate cuts gains credence.

CPI details

Consumer prices rose 0.4% in the June quarter, with a rebound in fuel prices accounting for all of the increase. Annual inflation rose from 0.1% to 0.3%, though this was still the second-slowest pace in over 15 years. The result was in line with the Reserve Bank's estimate, but slightly below the median market forecast of 0.5%, and quite a bit below our forecast of 0.7% (a gap that was unfortunately exaggerated by a quirk in the way that the figures are rounded).

The downside surprise for us was mainly down to a few large but transitory factors; in fact, we're inclined to leave our year-end inflation forecast unchanged. But that doesn't detract from the overarching story that domestic inflation pressures remain soft, with the significant exception of the housing market.

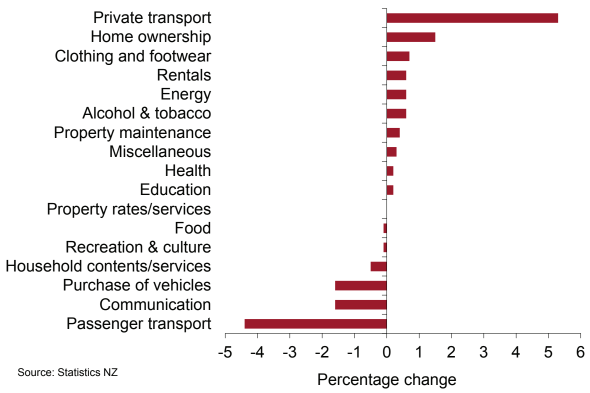
Non-tradables prices rose just 0.1% for the quarter, with the annual pace slowing to 2.0%, the lowest to date in this cycle. There were two significant contributors to this slowdown. The first, as we anticipated, was that electricity prices were little changed, compared to their usual seasonal increase. The second was a 13% plunge in domestic airfares, more than reversing the large gains in the two previous quarters. Lower fuel prices and the threat of competition on domestic routes appear to have done the trick.

Housing-related inflation remains a significant exception to the subdued trend, although even this is becoming increasingly isolated in Auckland. New dwelling prices in Auckland were up 7.6% on a year ago, while the pace of growth slowed to 4.0%yr in Canterbury. Rents are also under pressure in Auckland, accelerating from 2.6%yr to 2.9%yr – quite a rapid increase in the context of this series. Rents also continued to rise in Canterbury, but at a slower pace (up 3.5%yr).

The details of the CPI did provide one note of encouragement for the Reserve Bank: the falling New Zealand dollar is starting to have the desired effect on inflation. Prices of tradable goods and services rose by 1% for the quarter, led by fuel prices. However, the 0.1% fall in ex-fuel tradables was in line with our forecast, and consistent with the modest decline in the trade-weighted NZD over the last year. We're now seeing rising prices – or at least smaller price declines – in many import-heavy categories such as clothing, appliances and electronics.

That said, tradables inflation has remained soft to date. The annual pace has been running below zero almost continuously for more than three years, and was still running at a very soft -2%yr in June. The recent, more dramatic falls in the NZ dollar mean that tradables inflation is likely to turn positive again over the next year. This is crucial to the Reserve Bank's goal of bringing overall inflation back towards 2%, and we suspect the Reserve Bank will do what it feels is needed to encourage the NZD's decline.

Components of quarterly inflation



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