

Building on inflation

- We expect the CPI to register a 0.2% increase for 2016 Q4, with annual inflation jumping to 1.1%.
- Inflation pressures in the construction and services sector are growing, but the NZD remains a drag.
- We continue to expect the RBNZ to leave the OCR on hold for the foreseeable future.

We expect the CPI to print at 0.2% qoq in Q4, in line with the RBNZ’s forecast in the November MPS. **Capacity pressures are expected to be a key driver of price increases this quarter**, particularly in the **construction and services (tourism) sectors**. Higher petrol prices in Q4 will also provide a positive boost to inflation. While quarterly inflation remains soft, **annual inflation is forecast to increase to 1.1%** (back within the RBNZ’s target band for the first time in over two years). This sharp jump in annual inflation is driven in part by a particularly soft CPI result in Q4 2015 dropping out of the annual calculation.

Despite the lift in annual inflation, downside risks remain. The **NZD remains high on a trade-weighted basis and this will continue to be a drag on tradable inflation**, as indicated by the [Q4 QSBO results](#). The RBNZ may be relieved to see inflation back within the target band but, in our opinion, **enough downside risks remain for the RBNZ to keep the OCR on hold for the foreseeable future**. In our view, market pricing of an OCR *hike* by year-end is getting ahead of itself.

Our forecast is in line with the RBNZ’s forecast published in the November Monetary Policy Statement. This extends to the tradable and non-tradable breakdown. See the table below for our more detailed forecasts.

Key drivers of the Q4 result include:

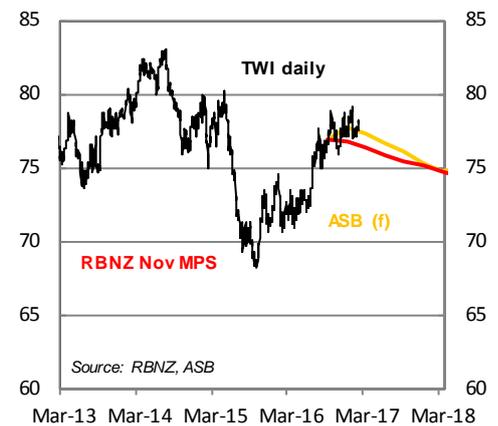
- **Higher prices in the capacity-constrained construction sector.**
- **A 4.7% lift in petrol prices over Q4.**
- **NZD strength weighing on import prices.**

Construction-related prices have risen sharply over the past two quarters and we expect this trend to continue. In addition, **capacity constraints are also beginning to bite in the services sector** (notably the tourism industry), as evidenced by the lift in pricing intentions and selling prices in the Q4 QSBO results. The lift in petrol prices in Q4 looks to be followed up by a similar gain in Q1 2017 which will help support the upward momentum in inflation going forward.

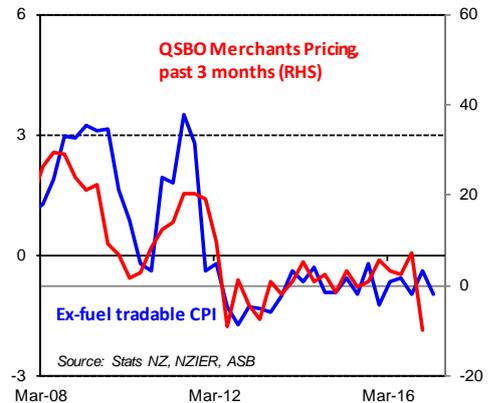
However, **the strength in the NZD remains a key drag on tradable inflation**. On a trade-weighted basis the NZD remains higher than the RBNZ’s forecast. The sharp drop in the net percent of merchants (who tend to be importers) increasing prices in the Q4 QSBO provides further evidence that the high NZD has weighed on import prices in Q4. **Food prices are also forecast to be a drag on inflation in Q4**. Q4 tends to be a seasonally weak quarter for food prices (particularly fruit and vegetables) and, as a result, the RBNZ will look through any weakness from this source.

On balance, the NZ inflation outlook has improved in recent months. While the strength in the NZD and QSBO merchant pricing suggests downside risks, solid economic momentum should continue to support domestically-generated inflation. However, until downside risks shrink and inflation pressures are comfortably back within the RBNZ’s inflation band, we do not expect the RBNZ to lift the OCR. As a result, we continue to expect the RBNZ to leave the OCR on hold for the foreseeable future.

NZ TWI FORECAST



TRADABLE INFLATION & QSBO MERCHANTS PRICING



CPI breakdown Q%	Jun-16	Sep-16	Dec-16
Food	0.3	0.4	-1.4
Alcohol & tobacco	0.3	-0.1	-0.7
Clothing & footwear	0.9	-0.2	-0.5
Housing & h/h utilities	1.0	1.1	0.7
H/h contents & services	-1.0	2.3	-1.6
Health	0.2	1.3	0.5
Transport	1.0	-1.9	2.9
Communication	-0.3	-0.5	-1.0
Recreation and culture	-0.7	0.7	0.2
Education	0.3	0.1	0.0
Misc. goods & services	0.3	0.5	0.4
CPI	0.4	0.3	0.2
Tradable	0.6	0.0	-0.1
Non-tradable	0.3	0.5	0.5
CPI Annual	0.4	0.4	1.1

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