Economic Update

CPI Preview – Q3 2016

13 October 2016

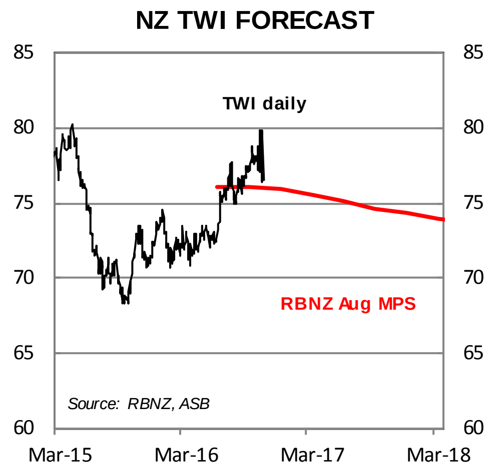
ASB

Annual inflation to bottom out in Q3

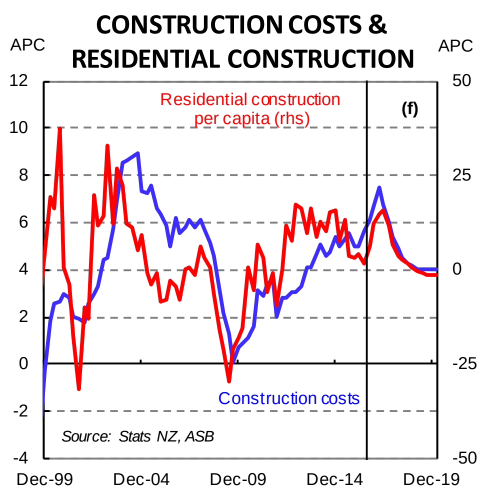
- We expect the CPI to be flat in Q3, lowering annual inflation to just 0.1%.
- In addition to one-off deflationary impacts, underlying inflation pressures remain benign.
- We continue to expect the RBNZ to cut the OCR in November, with risks of an additional cut in 2017.

We are expecting a flat Q3 CPI result on Tuesday and for annual inflation to fall to 0.1%. The key driver behind this quarter's fall in inflation is the one-off reduction in ACC vehicle licencing fees. Previous strength in the NZD, a further fall in petrol prices and falling rents over Q3 have also combined to weigh on inflation over the quarter.

Construction costs are the sole strong spot in the current inflation story (excluding housing inflation). Construction costs lifted strongly in Q2 and, as capacity pressures remain present, we are expecting further price increases over Q3**. However, outside of the construction sector, price pressures remain elusive.** Our forecast is slightly lower than the RBNZ's August MPS forecast of 0.2% yoy and, in our opinion, a 25bp OCR cut in November is a given. However, a result closer in line with our forecast increases the risks of an additional OCR cut next year, especially if combined with a fall in long-term inflation expectations.



Q3 2016 CPI %	Previous	ASB	RBNZ
CPI qoq	0.4	**0.0**	0.1
CPI yoy	0.4	**0.1**	0.2
Non-tradable qoq	0.3	**0.2**	0.4
Non-tradable yoy	1.8	**2.0**	2.2
Tradable qoq	0.6	**-0.3**	-0.2
Tradable yoy	-1.5	**-2.5**	-2.3



Key drivers of the Q3 result include:

- **A 20% fall in ACC vehicle licencing fees in Q3.**
- **A 4.5% reduction in petrol prices over the quarter.**
- **Previous NZD strength weighing on import prices.**

In addition, tenancy bond data from MBIE suggest that rents have fallen over the quarter and annual council rate increases (which occur in Q3) have been muted**. Overall, there are very few components delivering inflationary pressures this quarter.**

On the tradable side, a combination of recent strength in the NZD and low petrol prices will have weighed on inflation. Further, the latest QSBO survey data showed a net 5% of firms cut prices in Q3, suggesting broader factors will also weigh on inflation pressures.

Non-tradable inflation is likely to be supported by construction prices. Construction inflation will continue to be a key driver of non-tradable inflation going forward as capacity constraints push costs higher.

We expect inflation will 'bottom out' in Q3 and expect to see inflation slowly begin to climb from here on out. Domestic pressures will lift inflation as ongoing economic growth and a tightening labour market boost non-tradable inflation. However, within a context of excess global capacity and a high NZD, tradable inflation will continue to be a drag on headline inflation for some time yet.

CPI breakdown Q%	Mar-16	Jun-16	Sep-16
Food	1.2	0.3	0.4
Alcohol & tobacco	3.7	0.3	0.3
Clothing & footwear	-0.4	0.9	-0.2
Housing & h/h utilities	0.6	1.0	1.0
H/h contents & services	1.7	-1.0	-0.2
Health	-0.1	0.2	0.4
Transport	-3.6	1.0	-3.4
Communication	0.4	-0.3	-0.8
Recreation and culture	-0.9	-0.7	0.2
Education	2.5	0.3	0.0
Misc.goods & services	0.2	0.3	0.3
CPI	**0.2**	**0.4**	**0.0**
Tradable	**-0.9**	**0.6**	**-0.3**
Non-tradable	**1.0**	**0.3**	**0.2**
CPI Annual	**0.4**	**0.4**	**0.1**

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