

Inflation surges through the inflation target mid-point

- Q1 CPI surpassed RBNZ and market expectations, lifting to a robust annual pace of 2.2%.
- Much of this lift is due to volatility in fuel and food, and annual inflation could slow (slightly) again over the next year.
- We still expect the first OCR increase in late 2018, earlier than the RBNZ’s Feb Monetary Policy Statement forecast.

The Q1 CPI increased more than expected with annual inflation now at 2.2%, stronger than ourselves, the market and the RBNZ expected. **Core measures of inflation (including the trimmed mean and weighted median) also reported annual rates of 2.2%**, highlighting that the overall lift in inflation is relatively broad-based. **The recent sharp recovery in inflation will come as a significant relief to the RBNZ.** The lift has taken inflation expectations back to the middle of the target band with it, removing one of the RBNZ’s key concerns of recent years.

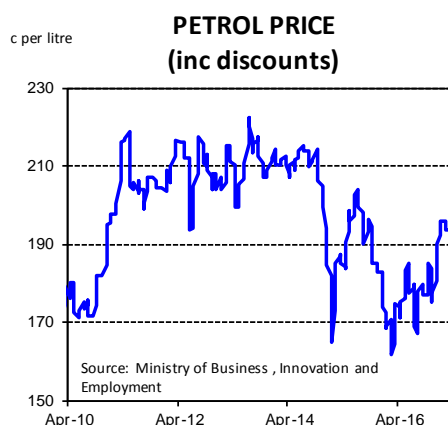
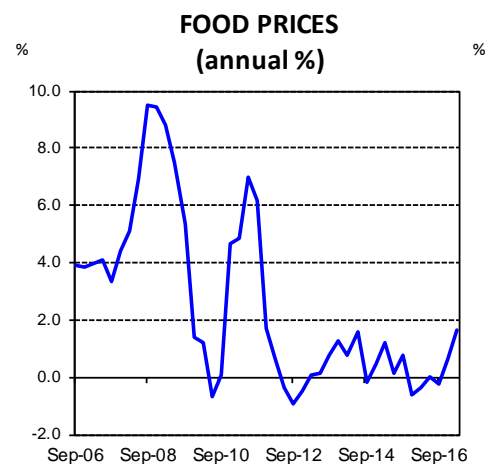
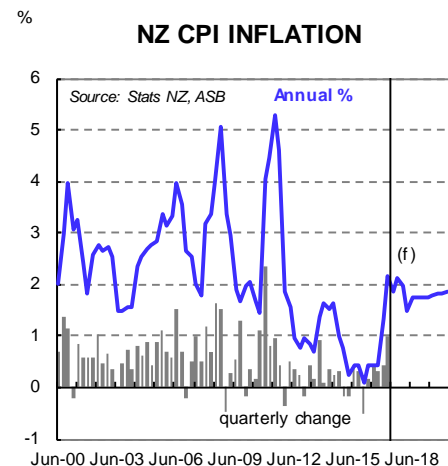
We expect the current lift in headline inflation will be temporary, as does the RBNZ, given there were several ‘one-offs’ in Q1. Nonetheless, we expect annual inflation to hover around 1.5% and 2% over the next few years. As such, **downside risks to inflation, especially those stemming from weaker inflation expectations, have significantly reduced over the past six months.** We continue to expect the RBNZ will lift the OCR in late 2018, around a year earlier than the RBNZ’s February view.

Q1 2017 CPI %	Actual	ASB	RBNZ	Market
CPI qoq	1.0	0.9	0.4	0.8
CPI yoy	2.2	2.1	1.5	2.0
Non-tradable qoq	1.0	1.1	0.8	
Non-tradable yoy	2.5	2.6	2.3	
Tradable qoq	0.8	0.6	-0.5	
Tradable yoy	1.6	1.5	0.4	

As expected, **food, tobacco, housing and transports were the key positive contributions** for the quarter. The lift in tobacco prices reflects the annual increase in tobacco taxes to discourage smoking. Food prices were unusually high in Q1. StatsNZ highlighted higher prices for apples and milk, both of which are benefiting from strong export demand which may be leading to higher prices locally. We expect food prices will remain elevated over coming months due to poor weather affecting crops. **The RBNZ will look through higher food prices to the extent they are driven by one-off events**, but to a lesser extent if they reflect stronger export demand.

Household contents and health price movements were higher than we expected. Health prices lifted as a result of higher prices for pharmaceuticals. **Airfares were another source of positive surprise**, with stronger than expected increases in domestic airfares (likely reflecting strong demand as a result of high tourist numbers) and a smaller (seasonal) fall in international airfares than we expected.

On housing, **rents were slightly higher than expected**, with the North Island excluding Auckland providing the strongest lift. This lift is likely to be stemming from Wellington, which has recently become supply constrained due to strong population growth. **Construction costs (i.e. prices for newly built houses excluding land) were softer than expected**, surprising given the strength in construction output and reported capacity constraints.



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