Economic Note

2019Q3 CPI Review

16 October 2019

Mixed messages from CPI print

- Consumer prices rose 0.7% qoq in Q3 (1.5% yoy), slightly firmer than RBNZ and market expectations.
- Despite annual non-tradable inflation hitting an 8-year high, annual core inflation measures barely budged, and remained clustered around 2%.
- We believe a combination of domestic and global catalysts continue to hold down NZ inflation. We expect a further 50bps of OCR cuts by early 2020 and a 0.50% OCR trough this cycle.

Q3 2019 CPI %	Actual	ASB	RBNZ	Market
CPI qoq	**0.7**	0.6	0.5	0.6
CPI yoy	**1.5**	1.4	1.3	1.4
Non-tradable qoq	**1.1**	0.8	0.7	
Non-tradable yoy	**3.2**	2.8	2.7	
Tradable qoq	**0.1**	0.3	0.1	
Tradable yoy	**-0.7**	-0.5	-0.7	

Summary and implications

Today's inflation outturn was slightly firmer than the August Monetary Policy Statement (MPS) pick and the market consensus, with annual non-tradable inflation hitting an 8-year high despite construction cost inflation cooling. Annual readings from the core inflation measures produced by Statistics NZ barely budged, with signs of increased discounting taking place. We expect a stable 1.7% yoy print for the RBNZ's estimate of core inflation from the sectoral factor model (released 3pm today), with risks appearing to be broadly balanced. The inflation starting point is firmer and the RBNZ appears confident that the economy will respond to the OCR cuts already delivered. However, we expect increasing spare capacity in the NZ labour market and economy in general to dampen subsequent medium-term inflationary pressure. The OCR looks set to move lower still, and we expect 25bp cuts in November and February 2020, taking the OCR to a record low 0.50%.

Tradable non-tradable split widens

The CPI rose 0.7% qoq in the September quarter, slightly firmer than the market median and the August Monetary Policy Statement pick. Annual CPI inflation eased to 1.5% (1.7% yoy in 2019Q2). Part of the increase was seasonal, with seasonally-adjusted estimates showing a 0.5% quarterly increase, and the ninth consecutive quarter in which increases in non-tradable prices (+3.2% yoy) have been firmer than for tradables (-0.7% yoy).

Non-tradable prices rose 1.1% qoq, with annual inflation surging to a new 8-year high (3.2% yoy). Housing group prices (+1.2% qoq, 3.0% yoy) remained at the bow-wave for inflationary pressure, with higher local authority rates (4.9% qoq), and solid increases for rents (0.8% qoq). However, construction cost inflation continued to cool, with a

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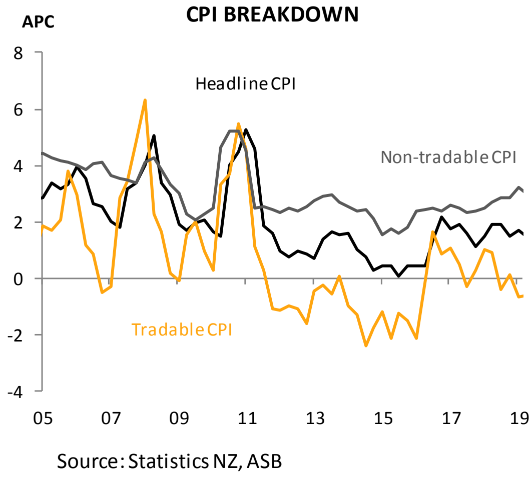
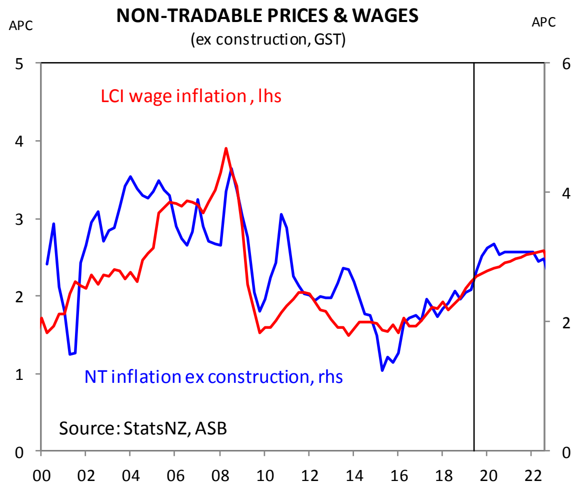
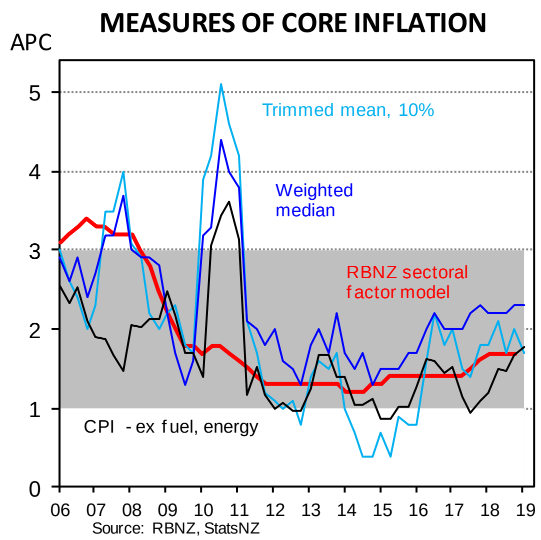


modest 0.6% Q3 increase, and with annual construction cost inflation slowing to a 7-year low (2.8% yoy). There were a scattering of price increases throughout the non-tradable regimen. Prices for recreation and cultural services (+1.2% qoq), and the impact of higher ACC levies on private transport services (+6.6% qoq), were notable, with further increases for insurance (1.2% qoq), a solid 3.1% increase for early childhood education and with domestic airfares rebounding 15.7% in Q3 after their 12.9% Q2 fall.

The firming evident in non-tradable inflation is consistent with what we have observed on the wage front. **Both are linked to the pace of economic activity**. Judging by weak business and consumer sentiment, the economy will have its work cut out for it to be able to maintain sufficient momentum so as to keep the labour market tight and wages on the rise.



Tradable prices rose just 0.1% qoq. (-0.7% yoy). Rises for food prices (1.3% qoq), were balanced by falls for prices for communications (-1.1% qoq), apparel (-0.6% qoq), petrol (-0.8% qoq), new car purchases (-2.1% qoq) and international airfares (-0.7% qoq). Notwithstanding the lower NZD, there were only scattered signs of an imminent pick-up in tradable prices, with price rises for electrical appliances and audio-visual equipment. **Moreover, as signalled by business surveys, firms are still under pressure to lower prices.** According to Statistics NZ, 14% of retail items were discounted in the September 2019 quarter (12% in Q2), with discounting more commonplace across many of the CPI groups. Slightly more than one-third of all prices surveyed actually fell in the September CPI (33.7%), as opposed to the 50.2% of surveyed items experiencing an increase. Despite the firmer starting point for headline and non-tradable inflation, the fact remains that annual CPI inflation has now been below the CPI inflation target midpoint for the last 2 ½ years, and annual movements for tradable price sub 2% for the last 8 years.



Underlying inflation measures continued to depict a contained inflation backdrop. Annual inflation from the 10% trimmed mean eased back to 1.7% (from 2.0% yoy in Q2), while inflation from the 50% weighted median was steady at 2.3% yoy (2.3% yoy). Inflation from the CPI ex food, household energy & fuel ticked up to 1.8% yoy (1.7% yoy in Q2), but has not been above 2% since the GST-induced lift in 2010/2011. Today's 3pm RBNZ estimates for core inflation will provide a critical stock-take of the inflation pulse. We expect another stable 1.7% yoy print for the sectoral factor model estimate for core inflation, with risks broadly balanced.

The RBNZ remains confident that the economy will respond to the 75bps of OCR cuts already delivered over 2019 and that annual medium-term inflation will settle around 2%. **Given our concerns over the domestic and global outlook, we are not so sure.** We expect growing spare capacity in the NZ labour market and economy in general to increase, dampening medium-term inflationary pressure. The OCR looks set to move lower still, with a 25bp cut in November and a follow-up 25bp cut in early 2020 taking the OCR to a record low 0.50%.

Market reaction

Despite the CPI report being marginally firmer than RBNZ or market expectations, market reaction was modest. Yields on the 2-year NZ swap edged up prior to the release and firmed 1-2 points just after 10:45am before easing back to where they were prior to the CPI release (0.90%). The NZD firmed modestly after the CPI release to be up 20 pips against the USD (0.6310 USD) but has subsequently eased back to 0.6300 USD.

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