

OCR hikes closer, but still distant

- Consumer price inflation is finally back in the 1-3% target band.
- The RBNZ is likely to be a lot more confident about the inflation outlook going into next week's policy announcement.
- We now expect the OCR to start rising by late 2018, sooner than previously thought.

It was going to happen one day – **inflation surprising on the high side, and finally getting back into the 1-3% target band** after over 2 years of playing hooky. We think the **deeper details of Q4's inflation outcome will play a significant role in the RBNZ's thinking** as it assesses its view of the economy ahead of releasing next week's Monetary Policy Statement.

Inflation at the end of 2016 bounced up to 1.3%, ahead of the 1.1% both we and the RBNZ had been expecting. That isn't a dramatic surprise in itself, but the **composition of the increase did point to a broadening of inflation pressures**, including evidence the tourism boom is creating price pressure.

Heading into next week's RBNZ Monetary Policy Statement we expect the **RBNZ to have a lot more confidence in the inflation outlook**. By our estimates, **inflation will now be comfortably close to the 2% mid-point of the target band fairly early on in 2017** and persist near 2% thereafter. **That is a different story from expected** to spend most of 2017 with inflation still hanging awkwardly close to 1%, sustaining the recent wariness the RBNZ had over the risks of inflation failing to rebound within a comfortable timeframe.

With the inflation outlook suddenly looking a lot more comfortable to the RBNZ, it will have a reasonable influence on the RBNZ's thinking around future interest rate movements. The downside risks hinted at in November, particularly the international situation, now appear to be easily counterbalanced. **The RBNZ may go as far as foreshadowing next week that the OCR will rise in the long term, shifting from its view in the November MPS that the OCR would remain flat at its current level to at least the end of 2019.**

There are **still plenty of risks that inflation does struggle to sustain around a 2% level** over the next few years. **In particular is the overall impact Donald Trump's presidency will have on NZ's exports**: will the positive impact of any fiscal stimulus outweigh any negative impacts of greater trade protectionism? On the trade front Trump is already following through some of his trade protectionism threats through axing the TPP and taking a harder line with Mexico. Follow-through on threats to crack down on Chinese imports would be a risk to NZ's export outlook, however. **There has already been a de facto tightening through the NZD and through the Trump-induced jump in term interest rates. There is always the potential for that impact to strengthen.**

Stepping back, we do think the **local interest rate market has got well ahead of itself in pricing in a full OCR increase by the end of this year**. But we now expect the OCR to start rising by late 2018. That is still some way off, but sooner than the early parts of 2019 we had previously thought.

Foreign Exchange

- The NZD continued to lift against the USD as protectionist US policies weighed on sentiment.

Interest Rates

- NZ interest rates lift on offshore-led increases and stronger-than-expected NZ Q4 CPI result.

Week Ahead

- Q4 labour market data to be released Wednesday.

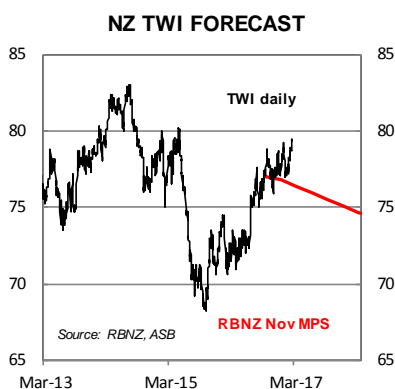
Week in Review

- Q4 CPI higher than expected, net migration at record highs, trade deficit lower than expected.

Global Calendars

- US Fed, Bank of England and Bank of Japan rate announcement; Eurozone CPI and GDP.

Chart of the Week: Auckland house price outlook - subdued but supported



Curb your Enthusiasm: the inflation picture has shifted quite a bit in a short period of time, but the RBNZ should be cautious nevertheless about rushing to lift interest rates. Most of the recent surprise, from the RBNZ's perspective, was from relatively strong tradables inflation, the part heavily influenced by the NZ dollar.

We expect that tax policies of Donald Trump will strengthen the USD and reduce the NZD/USD as a result, boosting the competitiveness of NZ businesses exposed to that exchange rate.

However, for now the NZD remains stubbornly high. The RBNZ itself will need to be careful it doesn't sound prematurely excited about OCR increases, otherwise it risks further fuelling that strength – as has happened in the past.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7246	0.7204	0.6960	0.7226	0.6471	FLAT	0.7100	0.7300
NZD/AUD	0.9619	0.9511	0.9632	0.9488	0.9132	FLAT	0.9550	0.9750
NZD/JPY	83.26	81.84	81.07	73.97	77.80	FLAT	81.50	84.00
NZD/EUR	0.6787	0.6703	0.6618	0.6462	0.5923	FLAT	0.6720	0.6900
NZD/GBP	0.5762	0.5797	0.5677	0.5449	0.4503	FLAT	0.5750	0.5900
TWI	79.4	78.7	77.6	76.6	71.1	FLAT	77.00	80.00

^Weekly support and resistance levels * Current is as at 9.30 am Monday; week ago as at Monday 5pm.

Since Donald Trump's inauguration as US President last Saturday, **market participants have been almost entirely focused on his first policy actions in office.** Most recently, his **anti-immigration policy has seen sentiment fall** as market participants become more concerned about US protectionism than buoyed by Trump's pro-growth policies. Falling sentiment saw **recent USD strength pare back** and the NZD/USD trade back up above the 0.7200 level. **A stronger than expected NZ CPI result and a weaker than expected AU CPI result also supported the NZD late last week**, with the NZD/AUD hitting a high of 96.50.

While only a short week this week, there is plenty of data to keep market participants on their toes. **NZ Q4 employment and wages data tomorrow could further support the NZD** should the data show a firming labour market. On Thursday morning **the first US Federal Reserve rate announcement of 2017** is due and close attention will be paid to any changes in the Fed's outlook. Friday night's **US Non-farm Payrolls report could see renewed USD strength if the details outperform expectations.** However, **comments and/or policy decisions from President Trump will continue to be a key driver of market movements.**

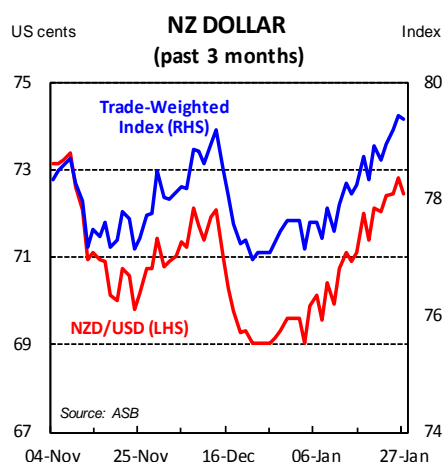
Short-term outlook:

Key data

Date

Time (NZT)

Market



NZ Q4 Unemployment Rate, %

01/02

10.45 am

4.8

NZ Q4 LCI wage growth, %qoq

01/02

10.45 am

0.5

FOMC Rate Announcement

02/02

8.00 am

no change

BoE Rate Announcement

02/02

1.00 am

no change

US Non-Farm Payrolls, 000's

04/02

2.30 am

+175

Key events: NZD: Net migration (today); Q4 employment & wages (Wed). **USD:** January Consumer confidence, Q4 ECI (Tue); FOMC meeting (Wed); January ISM (Wed); January Non-Farm Payrolls (Fri). **AUD:** Dec business confidence & Dec private credit (Tue); RBA commodity price index (Wed); trade balance (Thurs). **JPY:** BoJ meeting (Tue). **EUR:** Q4 GDP (Tue); Jan CPI (Tue); Jan retail sales (Fri). **GBP:** January PMI (Wed); BoE meeting & Inflation report (Thu).

Speakers: ECB: Weidmann & Mersch (Thu).

Medium-term outlook:

Last Quarterly Economic Forecasts

Our FX forecasts were updated in mid-December with the short- and medium-term outlook tweaked. Further out, the NZD is now expected to depreciate vs. the USD over the next 18 months. The driver is USD strength due to the expected fiscal stimulus US President-elect Trump is forecast to deliver. This spending should be inflationary, pushing the US Federal Reserve into lifting the Fed Funds rate faster than previously expected. Capital inflows to the US are also expected to support the USD.

Despite the revision, the NZD remains supported by relatively high Terms of Trade, relatively high interest rates, increased offshore investor demand and a structural improvement in the current account deficit. **Given these factors are NZD-supportive, combined with the fact the RBNZ signalled it had finished its easing cycle at the November MPS, we see little sustained downward pressure on the NZD.** Over 2017, we expect the NZD/AUD to remain in a relatively high range of 0.94-0.96.

We revised our GBP forecast lower in late October and have pushed the Pound a touch lower again in December's update. We believe the fundamental down-trend in the GBP will remain intact, and expect the NZD/GBP to continue to gradually lift toward the mid-0.60's by 2018.

In the near term we continue to see NZD/JPY hold above 70. Further out, the prospect for more BOJ easing should weaken the JPY, pushing NZD/JPY above 84 in 2017.

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	1.75	1.75	1.75	2.25	2.50	FLAT
90-day bank bill	1.98	1.98	2.00	2.25	2.70	FLAT
2-year swap	2.51	2.46	2.50	2.07	2.67	UP
5-year swap	3.13	3.04	3.09	2.17	2.99	UP
5-year benchmark gov't stock	2.64	2.64	2.68	1.82	2.72	UP
NZSX 50	7134	7067	6893	7357	6170	UP

^Weekly support and resistance levels * Current is as at 9.30am Monday; week ago as at Monday 5pm.

NZ interest rates continued to rise for most of the week, initially dragged higher with offshore moves then continuing to find support following the stronger-than-expected NZ Q4 CPI result. **Inflation was stronger than the RBNZ expected** when it published its November MPS and reinforces the market view that the next move in the OCR is up. **However, we still feel the market has got ahead of itself**, with any OCR hikes unlikely this year and then still taking place at a very muted pace, particularly given the effective tightening already delivered by the still-high TWI and rising mortgage rates.

Interest rates fell following the weekend in response to US President Trump's executive order on immigration which provoked unrest and rattled global market confidence.

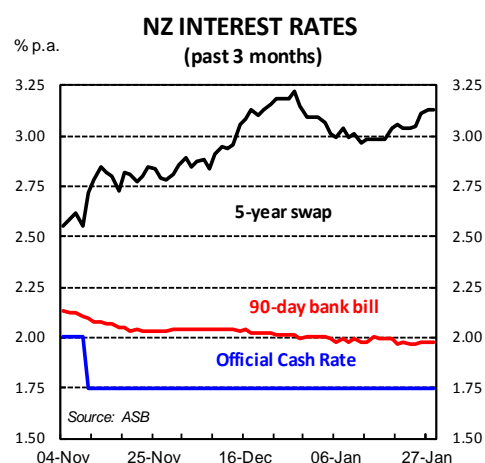
Short-term outlook:

Key data

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04/02

2.30 am

+175

Comment: The market focus will initially be on the **NZ Q4 labour market data release on Wednesday**. While the reliability of the HLFs survey remains compromised, we expect the market will play closer attention to moves in the wage data. On Thursday morning, attention shifts to the Federal Reserve rate announcement. **We expect the Fed to leave its policy rate unchanged but remain hawkish in tone**. Currently, the market sees a small risk of a hike. After the Fed, the main focus will turn to US Non-farm Payrolls employment data Friday night. On balance, **we expect a hawkish Fed will underpin further lifts in interest rates this week**. In saying that, a weak NZ labour report or continued weak global sentiment could potentially weigh on rates instead.

Medium-term outlook:

Last Quarterly Economic Forecasts

The RBNZ cut the OCR to a record-low 1.75% as widely expected, on November 10. In addition, **the RBNZ reduced its easing bias** to "numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly." At the same time, the RBNZ signalled with its new OCR forecast track that it was not expecting to cut interest rates any further.

The economic and inflation outlook has strengthened since the November Monetary Policy Statement. Higher dairy prices (and Fonterra's milk price forecast revision) will add to the positive NZ growth outlook. Meanwhile, annual inflation returned back into the RBNZ 1-3% target band in Q4 2016 (see our CPI review [here](#)) and lifted more than the RBNZ expected, to 1.3%. Coupled with the RBNZ's strong view for domestic inflation pressures, we expect the RBNZ is likely to revise inflation outlook higher at the upcoming February MPS. However, the RBNZ must weigh these developments against tighter financial conditions via a still-high TWI and rising mortgage rates (in part due to rising bank funding costs).

We continue to expect the RBNZ to remain on hold for the foreseeable future. However, recent events, including Donald Trump's successful US Presidential campaign, have increased the degree of uncertainty. Market pricing has now turned to the timing of rate hikes, which is likely to be a focus at the upcoming February MPS. We believe that the market has got ahead of itself as the economic outlook remains dependent on low interest rates.

Key international data for the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
Eurozone GDP, Q4, %qoq	31/01	11:00 pm	0.3	0.5	0.4
Australia Private Sector Credit, December, %mom	31/01	1:30 pm	0.5	0.5	0.4
Japan Monetary Policy Announcement, lower bound, %	31/01	-	0.0	0.0	-
Eurozone CPI, January, %yoy	31/01	11:00 pm	1.1	1.5	1.5
Australia Dwelling Prices, January, %mom	01/02	12:00 pm	1.4	-	0.5
China manufacturing PMIs, January, index	01/02	2:00 pm	51.4	51.2	>50
Australia Trade Balance, December, \$bn	02/02	1:30 pm	1.24	2.0	3.0
Bank of England Rate Announcement, %	02/02	1:00 am	0.25	0.25	0.25
US Federal Reserve Rate Announcement, lower bound, %	02/02	8:00 am	0.50	0.50	0.50
US Non-farm Payrolls, January, 000s	04/02	2:30 pm	156k	175k	168k

The stock of **Australia's private sector credit** is forecast to grow by a modest 0.4% in December. It remains the dominant driver of overall credit growth.

The **Bank of Japan is unlikely to change policy** at this week's meeting despite a recent modest pickup in inflation.

Australian dwelling prices rose solidly in December on firm auction clearance rates. Daily price data are pointing to a more moderate 0.5% lift in January.

China's PMI continues to indicate economic expansion well above the key pivot of 50.0. China's recent policy stimulus, commodity inventory rebuilding and firmer U.S. economic and European economic activity have all assisted China's relatively firm economic growth.

Australian commodity prices rose sharply over Q4 2016; we expect to see a bumper surplus of around \$3bn in December.

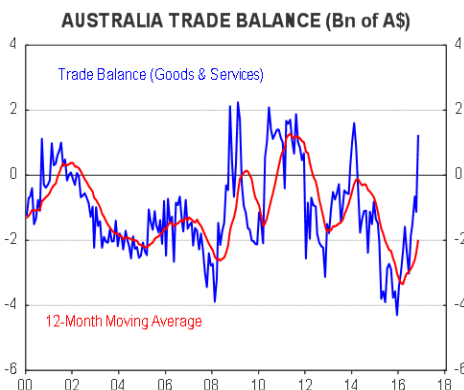
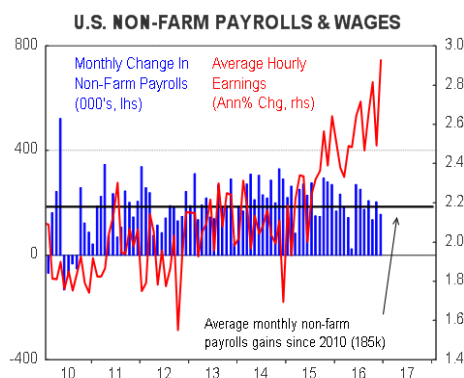
The first **estimate of Eurozone Q4 GDP** should roll in at 0.4% (qoq), slightly faster than last quarter's 0.3% increase, to maintain annual GDP growth at 1.7%. The Eurozone economy continues to improve in response to ultra-easy monetary policy and a firmer global economy. We see modest upside risks to Eurozone GDP growth.

Eurozone inflation is set to lift to 1.5% (yoy) in January, its highest level in three-and-a-half years. It is significant jump from 1.1% (yoy) the previous month. The increase will be driven by higher energy prices as well as some core inflation measures driven by a continued expansion in economic activity. We see a risk the ECB ends its ultra-easy quantitative policy early in H2 2017.

The **Bank of England is likely to leave interest rates unchanged** at Thursday's meeting. However, because recent economic and inflation data have been stronger than expected, the quarterly Inflation Report due at the same time, will likely result in an increase in the BoE's GDP and inflation forecasts.

The **US Federal Reserve Meeting is sure to have a hawkish tone**, reflective of recent stronger U.S. economic data and President Trump's coming fiscal stimulus. U.S. core inflation has been at or above 2.0% for fourteen consecutive months; the unemployment rate at 4.7% is at or close to full employment. We expect the FOMC to lift rates later this year (June and December) with the risk of an additional (third) rise in 2017.

Consensus is for a 168k lift in January **U.S. Non-farm Payrolls**, up from last month's 156k increase. Private sector payrolls are set to drive jobs growth, with President Trump's planned fiscal stimulus only set to lift public sector jobs growth later in 2017. The unemployment rate should remain steady at 4.7%.

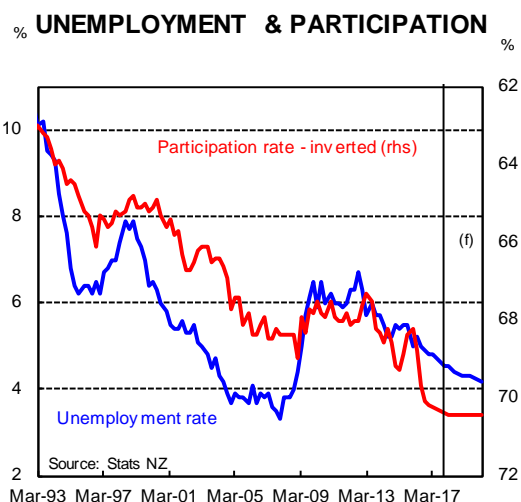
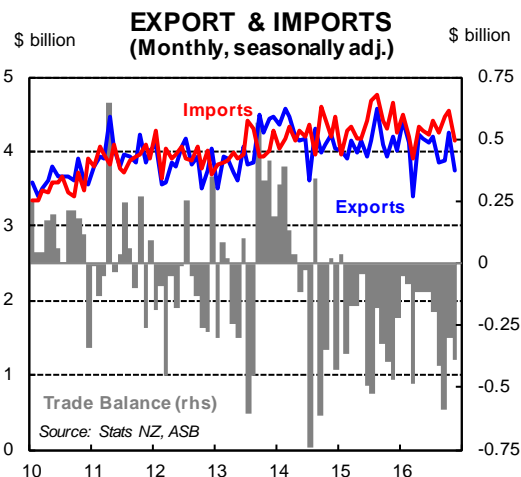


NZ Data Preview: a look at the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
RBNZ Credit Growth, December, household, %mom	31/01	3:00 pm	+0.6%	-	-
Employment, Q4, %qoq	01/02	10:45 am	4.9%	-	4.8%

Household credit growth has passed its peak and is expected to keep slowing. This slowing has largely been due to the latest investor-focussed LVRs weighing on housing activity and housing credit growth. **Agricultural credit growth** has stabilised recently after slowing over the first half of 2016. We expect growth to remain steady at these lower levels as dairy farmers, in particular, will remain cautious about debt levels. **Business credit growth** has sustained moderate growth over 2016 and is expected to remain steady going forward, supported by robust economic growth.

In Q4, we expect the jobless rate to dip to 4.8%. This despite a small upward move to the labour participation rate, to 70.2% from 70.1%. **We expect wage inflation to firm a touch, although remain fairly muted.** That modest growth is a function of continued firm net migration, with more record highs posted through Q4, while the low inflation environment is also tempering the extent of wage increases. As the labour market continues to tighten we look for more solid wage growth further down the track. This will be the third release under the new labour definitions in the HLFs and the results should be more settled now. However, while comparisons with Q2 and Q3 2016 are possible, further prior period comparison is not straight forward, given the extensive changes made to the HLFs survey by Stats NZ. The QES and LCI data are unaffected by the changes.



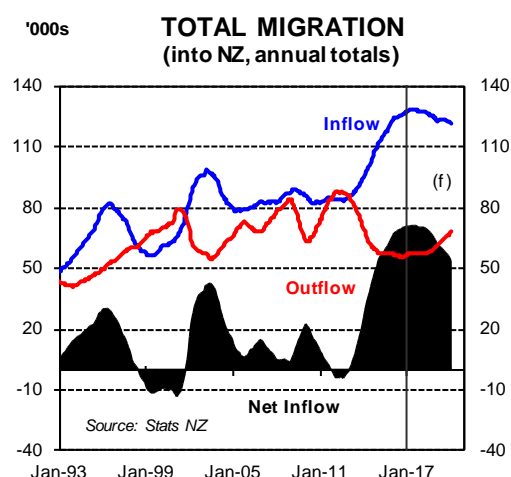
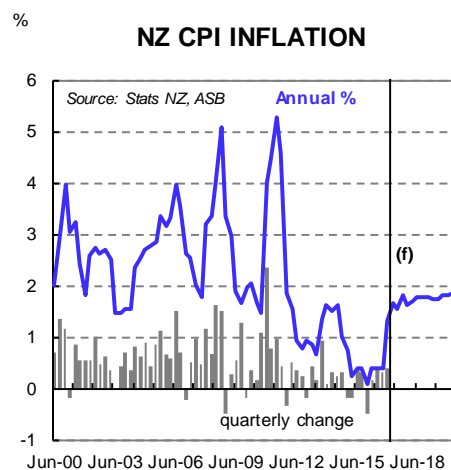
Data Recap: weekly recap

Data	Date	Actual	Market forecast	ASB Forecast
CPI, Q4, % qoq	26/01	+0.4	+0.3	+0.3
International Travel & Migration, December, Annual Net Migration	31/01	70,588	-	-
Trade Balance, December, \$m	30/01	-41	-98	+50

The CPI rose by more than expected in Q4, up 0.4% qoq and 1.3% yoy, higher than we and the RBNZ had forecast. While non-tradable inflation was largely in line with expectations, tradable inflation was less of a drag on inflation than expected. Underlying inflation pressures appear to have lifted, something which the RBNZ will be relieved to see. The impact of the tourism boom is also increasingly evident. This result **confirms that further OCR cuts are well off the table**, barring some major development. But, with inflation only just within the target band for the first time in over two years and the high NZD a key downside risk, **we expect the RBNZ to leave the OCR on hold for the foreseeable future.** As a result, OCR hikes this year, as priced into wholesale interest rates, still seem premature.

Net migration is continuing to run at record annual highs as arrivals hold around recent historic highs. Over the 12 months to December New Zealand has gained another 70,588 people, inching higher from November and marking another month above the 70,000 level. The monthly gain did see a very small decline, to 6,010 from 6,190, but that still marks 4 consecutive months above 6,000. Total arrivals were only just below 11,000 and held around the 6-month average, indicating there is no sign yet of a slowdown in those wanting to come to New Zealand.

NZ's trade deficit for December was slightly lower than market expectations. The \$41m deficit was the sixth in a row. Both export and import values fell 0.9% over the month compared to December 2015. Despite the export value fall, higher dairy prices are beginning to filter through, with December dairy export values up \$109m (8.0%) on December 2015. We expect lifting dairy export values to lift the trade balance over 2017.



Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Last	Forecast	
							Market	ASB
Tues 31 Jan	11:30	AU	ANZ Roy Morgan Weekly Consumer Confidence		Index	117		
	12:30	JN	Jobless Rate	Dec		3.1	--	
	12:50	JN	Industrial Production MoM	Dec P	%	1.5	--	
	13:30	AU	NAB Business Conditions	Dec	Index	5	--	
	13:30	AU	Private Sector Credit MoM	Dec	%	0.5	0.5	0.4
	15:00	NZ	Money Supply M3 YoY	Dec	%	5.9	--	
	17:00	JN	Vehicle Production YoY	Dec	%	6.6	--	
		JN	BOJ Short-term Policy Rate		%	-0.10	--	

Wed 1 Fed	10:45	NZ	Unemployment Rate	4Q	%	4.9	--	
	14:00	CH	Non-manufacturing PMI	Jan	Index	54.5	--	
	18:30	AU	Commodity Index AUD	Jan			--	
Thurs 2 Feb	13:30	AU	Trade Balance	Dec	A\$	1243m	A\$1500m	A\$3000m
	13:30	AU	Building Approvals MoM	Dec	%	7.0	-2.5	-2.5
	18:00	JN	Consumer Confidence Index	Jan	Index	43.1	--	
Fri 3 Feb	12:50	JN	BOJ Minutes of Dec. 19-20 Meeting					
	13:00	NZ	ANZ Commodity Price	Jan			--	
	13:30	JN	Nikkei Japan PMI Services	Jan	Index	52.3	--	
	14:45	CH	Caixin China PMI Mfg	Jan	Index	51.9	51.8	

*P = Preliminary

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Last	Forecast	
							Market	ASB
Tues 31 Jan	00:01	UK	GfK Consumer Confidence	Jan	Index			
	10:00	EC	Unemployment Rate	Dec	%	9.8%		
	10:00	EC	GDP SA QoQ	Q4 A	%	0.3%		
	10:00	EC	CPI Estimate YoY	Jan	%	1.1		
	13:30	US	Employment Cost Index	Q4				
	15:00	US	Conf. Board Consumer Confidence	Jan				
Wed 1 Feb	09:00	EC	Markit Eurozone Manufacturing PMI	Jan F	Index	55.1	--	
	09:30	UK	Markit UK PMI Manufacturing SA	Jan	Index	56.1	--	
	13:15	US	ADP Employment Change	Jan		153k	160k	
	14:45	US	Markit US Manufacturing PMI	Jan F			--	
	15:00	US	ISM Manufacturing	Jan	Index	54.7	54.8	
Thurs 2 Feb	09:00	EC	ECB Publishes Economic Bulletin					
	10:00	EC	PPI MoM	Dec				
	12:00	UK	Bank of England Bank Rate		%	0.25	0.25	
	13:30	US	Nonfarm Productivity	Q4 P				
Fri 3 Feb	09:00	EC	Markit Eurozone Services PMI	Jan F	Index	53.6		
	09:00	EC	Markit Eurozone Composite PMI	Jan F	Index	54.3		
	09:30	UK	Markit/CIPS UK Services PMI	Jan	Index	56.2		
	10:00	EC	Retail Sales MoM	Dec	%	-0.4%		
	13:30	US	Change in Nonfarm Payrolls	Jan	000	156		
	14:15	US	Fed's Evans Speaks on Economy and Policy in Olympia Fields					
	14:45	US	Markit US Services PMI	Jan F		--		
	15:00	US	ISM Non-Manf. Composite	Jan	Index	57.2		

ASB Economics & Research

			Phone	Fax
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659	(649) 302 0992
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853	
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778	
Economist	Kim Mundy	kim.mundy@asb.co.nz	(649) 301 5661	
Economist	Daniel Snowden	daniel.snowden@asb.co.nz	(649) 301 5657	
Publication and Data Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660	

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ASB Economics
ASB North Wharf, 12 Jellicoe Street, Auckland

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