

Inflation momentum slowly starting to build

- This week the CPI release is expected to show inflation picked up 0.2% qoq in Q4, jumping to 1.1% yoy.
- Domestic capacity constraints are supporting inflation, but the high NZD continues to be a key drag.
- Market uncertainty will remain high as participants watch for Donald Trump's first moves as the US President.

This week brings the delayed release of [Q4 CPI](#), one of the first key pieces of NZ economic data in 2017. **New Zealand's inflation outlook has improved over recent months** and we expect Thursday's release to reflect this. We expect the CPI to register a **0.2% qoq increase, with annual inflation jumping to 1.1% (in line with the RBNZ's forecast)**. While the quarterly lift remains soft, the sharp increase in the annual rate is driven in part by a particularly soft CPI result in Q4 2015 dropping out of the annual calculation.

Domestic capacity pressures will continue to be a key driver of price increases. **Construction-related prices have risen sharply over the past two quarters** due to capacity constraints 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. **Higher petrol prices in Q4 will also provide a positive boost to inflation**. Further, 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 high NZD remains a key drag on tradable inflation** and on a trade-weighted basis the NZD remains higher than the RBNZ's forecast. **The sharp drop in the net percent of merchants increasing prices in the Q4 QSBO is further evidence of the high NZD weighing on import prices**. 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.

The RBNZ will undoubtedly be relieved to see inflation back within the 1 – 3% target band. However, with inflation only just within the band and recent NZD strength suggesting further downward pressure on tradable inflation to come, **we don't think the RBNZ will be counting its chickens just yet**. As a result, we continue to expect the RBNZ to leave the OCR on hold for the foreseeable future and think market pricing of an OCR hike by the end of 2017 is getting ahead of itself.

While the Q4 CPI will be a key event domestically, **US developments will continue to drive markets**. One such development; **Donald Trump is now the President of the United States of America and the new regime has officially begun**. While his inauguration on Saturday morning (NZT) had limited impact on markets, **uncertainty will remain elevated as we wait to see what Trump's first moves as President are**.

Foreign Exchange

- The NZD lifted against the USD last week, as the USD was weighed by policy uncertainty.

Interest Rates

- NZ interest rates consolidated last week and major moves may have to wait for Q4 CPI data.

Week Ahead

- Q4 CPI to be released Thursday.

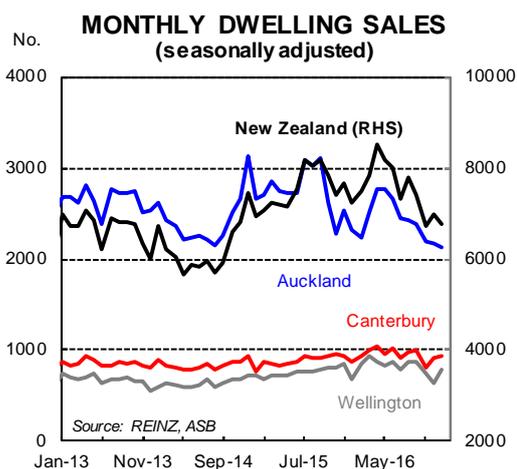
Week in Review

- Quarterly Survey of Business Opinion exceeds expectations, dairy prices flat, building consents fall.

Global Calendars

- Australia CPI, US and UK Q4 GDP.

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



Last week, **the final REINZ housing data for 2016 confirmed that both housing activity and prices had slowed over the end of 2016 – especially in Auckland**. The RBNZ's third round of LVR restrictions aimed at investors have taken some heat out of the market.

Looking into 2017, **we expect this trend of slowing growth to continue in Auckland as not only the LVRs, but higher mortgage rates and a degree of price resistance, come into play**. And while price growth is expected to slow, we are not forecasting any price falls. **Net migration was stronger anticipated over 2016 and we now think it will remain elevated into 2017**. As a result, demand will continue to outpace supply over 2017 and **we estimate that Auckland housing will remain undersupplied until 2025 which will continue to support prices**.

However, the latest building consents data suggest that **developers are starting to respond with more high-density solutions in Auckland**. While this is a good sign, there **remains some time until the Auckland market rebalances**.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7169	0.7091	0.6905	0.6978	0.6524	DOWN	0.7105	0.7250
NZD/AUD	0.9481	0.9485	0.9553	0.9334	0.9319	UP	0.9380	0.9580
NZD/JPY	81.93	80.93	81.14	74.13	76.85	DOWN	80.50	83.50
NZD/EUR	0.6696	0.6683	0.6615	0.6356	0.6017	FLAT	0.6600	0.6750
NZD/GBP	0.5891	0.5895	0.5616	0.5313	0.4591	UP	0.5720	0.5900
TWI	78.6	78.1	77.1	75.0	72.0	FLAT	76.50	80.00

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

The **NZD lifted against the USD** over the past week, as the **USD consolidated recent gains**. **Uncertainty on the US policy outlook** has weighed on the USD. The market reaction to President Trump's inauguration was limited as his speech contained very little policy detail. This week's US Q4 GDP release is likely to be largely ignored by the market, as **participants remain forward looking** and **focusing more on upcoming fiscal stimulus and other policy changes by the new Trump administration**.

We expect the **Q4 CPI release to provide support to the NZD this week**, particularly against the AUD. Even our below-consensus pick of 0.2% qoq is enough to **firmly push annual inflation above the 1% RBNZ lower band threshold**, and remind market participants that further rate cuts from the RBNZ are unlikely. Meanwhile, we expect **Australian annual underlying CPI inflation to print at 1.6%**, which is below the RBA's target band.

The **NZD eased against the GBP over the past week**, as the GBP was supported by **positive Brexit sentiment following PM May's speech**. However, we expect the recent lift in the GBP to be reasonably short-lived. On Tuesday, the UK Supreme Court is expected to uphold the initial ruling that Article 50 must be triggered by parliament.

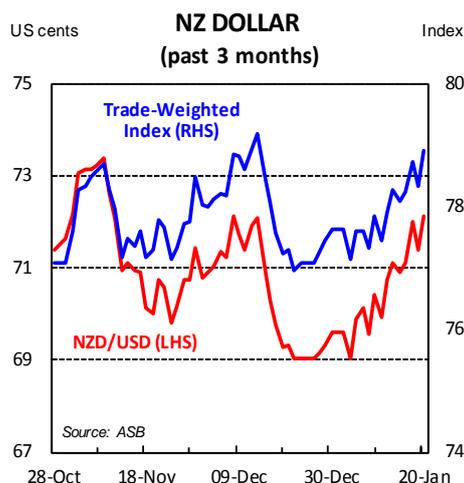
Short-term outlook:

Key data

Date

Time (NZT)

Market



AU Q4 CPI, %qoq

25/01

1.30 pm

0.7

NZ Q4 CPI, %qoq

26/01

10.45 am

0.3

UK Q4 GDP, %qoq

26/01

10.30 pm

0.5

US Q4 GDP, %sa, annualised

28/01

2.30 am

2.2

Key events: NZD: Q4 CPI (Thu). **USD:** Dec existing home sales (Wed); Q4 GDP (Fri).

AUD: Q4 CPI (Wed); Q4 trade prices (Fri). **JPY:** Dec trade balance (Wed); Dec CPI (Fri).

EUR: Jan PMIs (Tue); Jan German IFO business climate index (Wed). **GBP:** Supreme Court Brexit ruling (Tue); Jan CBU business optimism (Wed); Q4 GDP (Thu).

Speakers: ECB: Draghi (tonight); Praet (Tue & Wed); Lautenschlaeger (Wed); Weidmann & Mersch (Thu). **BoE:** Governor Carney (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	1.97	2.00	2.01	2.30	2.72	FLAT
2-year swap	2.43	2.44	2.57	2.09	2.71	UP
5-year swap	3.01	2.98	3.18	2.19	3.05	UP
5-year benchmark gov't stock	2.65	2.54	2.78	1.92	2.71	UP
NZSX 50	7036	7069	6880	7307	6122	UP

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

After the dramatic moves of the last few weeks, **NZ rates took a bit of a breather last week**. This was especially the case at the short end. This was in part a function of the data calendar, with very little of note on the local release schedule. In addition international markets were a touch hesitant ahead of Donald Trump's inauguration at the end of the week.

At the long end there was a slight moderation, although after the major moves of the last couple of weeks, a step back of just a few points was, in context, not too major. Rates still remain some distance from levels seen just 6 months ago, powered by the swift turnaround in international markets as well as the end of the RBNZ's easing cycle. **US markets consolidated a touch ahead of the inauguration**. Now Trump is in power, the next few weeks could see moves powered by his economic policies, along with estimates of the Fed's reaction to his plans.

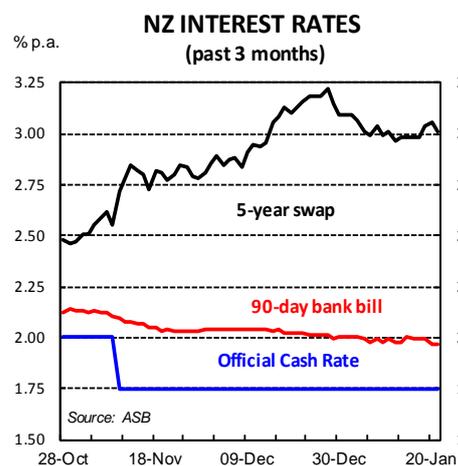
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US Q4 GDP, %sa, annualised

28/01

2.30 am

2.2

Comment: New Zealand's Q4 inflation release is the main event this week.

There is the possibility that markets will quieten in the lead-up to the release, while the fact it comes out on Australia Day could mean liquidity is a touch thin. Inflation is expected to return to the RBNZ's target band for the first time in just over 2 years, albeit only just, keeping rate cut talk off the table.

Further afield, **Q4 GDP data come from the UK and USA**. The former is expected to remain firm despite Brexit, although there is plenty of speculation it will be the last upbeat result for a while. US GDP could be overshadowed by Trump developments. **Australia's Q4 CPI comes on Wednesday** and another robust result is firmly expected.

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.

While the RBNZ remains concerned about the strength of the NZD, the inflation outlook has strengthened since September. Inflation is likely to be back within the 1-3% target band at the next read (due January 26) and economic growth is running at an above-trend pace. However, the RBNZ remains aware that the risks remain skewed to the downside. Interestingly, the RBNZ reminded that, if the NZD exceeds the RBNZ's assumptions going forward, it is the reasons for that lift that matter for any response. For example, stronger NZ fundamentals wouldn't imply a need for offsetting OCR cuts. However, further lifts in the NZD for other reasons, falling inflation expectations, bank funding costs and any deterioration in the global growth outlook could force the RBNZ into cutting the OCR below 1.75%.

We now 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.

Key international data for the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
Eurozone PMI, January	24/01	10:00pm	54.9	54.8	-
Australia CPI, Q4, %qoq	25/01	1:30pm	0.7	0.7	0.7
UK GDP, Q4, %qoq	26/01	10:30pm	0.6	0.5	0.7
Australia export prices, Q4, %qoq	27/01	1:30pm	3.5	11.5	13.5
Japan CPI, headline, %	27/01	12:30pm	0.5	0.2	0.2
US GDP, Q4, %saar	27/01	2:30am	3.5	2.2	3.0

We expect a moderate rise in **Australian CPI** and underlying rates, driven mainly by higher prices of imported goods and services.

A record 13.5% rise in **Australian export commodity prices** is expected to deliver a 15% increase in the Q4 Terms of Trade. It will boost nominal Q4 GDP by 3%.

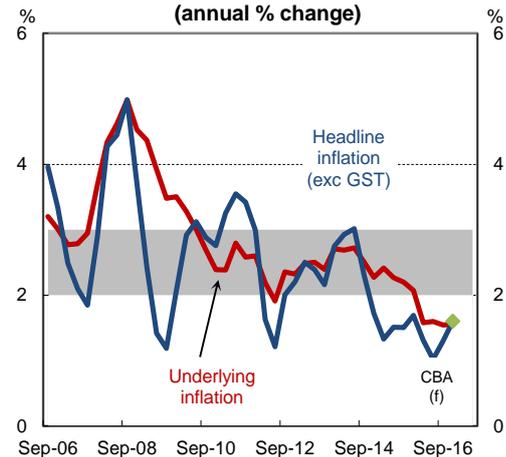
Already-released **CPI inflation** for Tokyo suggests that national headline inflation will slow again to 0.2%pa. We expect the **Bank of Japan's** core measure of inflation to have decelerated again to 0.1%pa – the lowest since September 2013. That is a long way from the BoJ's 2%pa target. The BoJ will be able to hold off from announcing more policy stimulus for only so long.

Eurozone manufacturing and services PMIs are expected to remain firm in January, consistent with further modest expansion in economic activity.

Encouraging **UK** retail sales volume growth and improving PMI surveys suggest **GDP** could grow at a quarterly pace of 0.7% in Q4. This would be in line with the Bank of England's November projection and slightly higher than consensus expectations of 0.5% qoq.

The surge in confidence since the **US** election in early November suggests upside risks to the FOMC's forecast for **Q4 GDP growth** of 2.0%saar.

CONSUMER PRICES (annual % change)



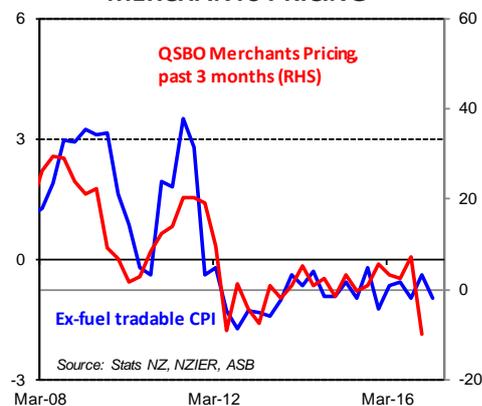
NZ Data Preview: a look at the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
CPI, Q4, % qoq	26/01	10:45am	+0.3	+0.3	+0.2

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 the year end is getting ahead of itself.

TRADABLE INFLATION & QSBO MERCHANTS PRICING



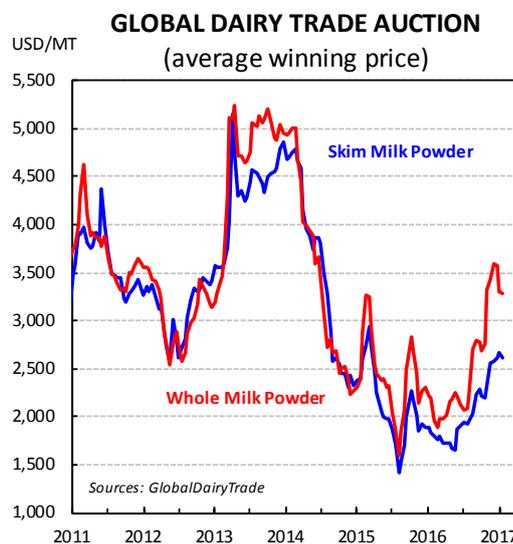
Data Recap: weekly recap

Data	Date	Actual	Market forecast	ASB Forecast
NZIER QSBO, General Business Confidence, net % s.a.	17/01	26.1	-	-
GlobalDairyTrade auction, whole milk powder, % change	17/01	-0.1	-	+ 1 to 3
Building Consents, November, residential, %mom	10/01	-9.2	-	-

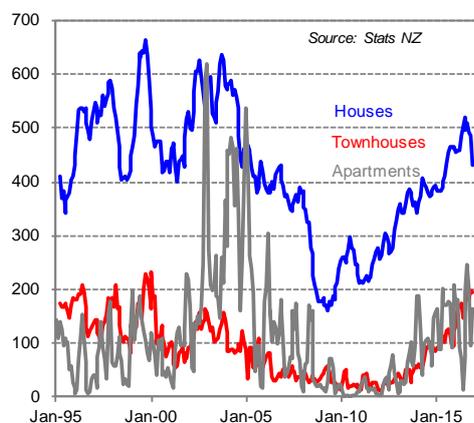
The NZIER Q4 Quarterly Survey of Business Opinion showed business confidence held up better than we had expected. Business confidence remained steady while own-activity expectations eased slightly. In contrast, the ANZ monthly survey reported a more substantial fall in confidence and own-activity expectations over the quarter. Some moderation in confidence is not surprising, given the unexpected outcome of the US presidential election and the Kaikoura earthquakes. Meanwhile, labour market indicators remain tight and inflation indicators moved in the right direction from the RBNZ's perspective. There are **no implications to our OCR view**; we continue to expect the RBNZ will leave the **OCR on hold at 1.75% for the foreseeable future.**

Dairy prices were largely flat at last week's auction. Overall prices ticked marginally higher (up 0.6%), but key WMP prices were largely flat (-0.1%). SMP prices fell 1.6%. Meanwhile, milk fat prices were firm with AMF and butter lifting 3.7% and 1.6%, respectively. **The result cements recent WMP weakness.** At the previous auction, WMP dropped 7.7%, although a lack of buyers hinted that the fall could have been put down to a "holiday effect". However, even though buyers returned to last week's auction, prices stayed low. So we can put down the weakness to another factor - **recent increases in WMP offer volumes.** For example, the WMP volumes on offer in this auction were 17% higher than forecast as at the start of December.

Residential building consents fell 9% in November. However, on closer inspection it appears this decline is **largely due to earthquake disruption in Wellington** – where seasonally-adjusted (ASB estimates) residential consents fell over 50% in the month. Once processing capacity and application demand have returned to normal, we expect Wellington's strong upward trend to continue. Elsewhere, building consents lifted. **Auckland consents lifted 6%** (ASB seasonally-adjusted estimate) on the back of a large chunk of **apartment and retirement village unit consents.** The trend in Auckland stand-alone housing consents appears to be slowing, a sign that **developers are starting to respond with more high-density solutions in Auckland.**



AUCKLAND RESIDENTIAL CONSENTS
(3 month moving average)



Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Last	Forecast	
							Market	ASB
Mon 23 Jan	~	JN	Cabinet Office Monthly Economic Report for January					
	13:30	AU	Lending Finance	Nov	~	~	~	~
	17:30	JN	All industry activity index	Nov	m%ch	0.2	~	~
	18:00	JN	Supermarket sales	Dec	y%ch	0.8	~	~
	18:00	JN	Leading index CI	Nov F	Index	102.7	~	~
Tue 24 Jan	03:00	CH	Conference Board China December Leading Economic Index					
	10:30	NZ	Performance services index	Dec	Index	57.9	~	~
	11:30	AU	ANZ Roy Morgan Weekly Consumer Confidence	Jan	Index	119.3	~	~
	13:30	JN	Nikkei Japan PMI manufacturing	Jan P	Index	52.4	~	~
Wed 25 Jan	12:30	AU	WBC leading index	Dec	m%ch	0.0	~	~
	12:50	JN	Trade balance	Dec	¥bn	536.1	~	~
	13:00	AU	Skilled vacancies	Dec	m%ch	0.0	~	~
	13:30	AU	CPI	Q4	q%ch	0.7	~	0.4
	15:00	NZ	Credit card spending	Dec	m%ch	-4.2	~	~
Thu 26 Jan	~	AU	Australia Day Holiday					
	10:45	NZ	CPI	Q4	q%ch	0.3	0.3	0.2
	12:50	JN	PPI services	Dec	y%ch	0.3	~	~
	14:30	CH	Industrial profits	Dec	y%ch	14.5	~	~
Fri 27 Jan	12:30	JN	Natl CPI	Dec	y%ch	0.5	~	~
	13:30	AU	PPI	Q4	q%ch	0.3	~	0.4
	13:30	AU	Export price index	Q4	q%ch	3.5	~	7.0
	13:30	AU	Import price index	Q4	q%ch	-1.0	~	-1.6
	18:00	JN	Natl CPI ex fresh food, energy	Dec	y%ch	0.2	~	~

*P = Preliminary

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Last	Forecast	
							Market	ASB
Mon 23 Jan	10:00	EC	Euro Area Third Quarter Government Deficit					
	14:50	UK	Bank of England bond buying operation					
	15:00	EC	Consumer confidence	Jan A	~	-5.1	~	~
Tue 24 Jan	09:00	EC	Markit Eurozone manufacturing PMI	Jan P	Index	54.9	~	~
	09:30	UK	Public finances (PSNCR)	Dec	£bn	13.5	~	~
	14:45	US	Markit US manufacturing PMI	Jan P	Index	54.3	54.0	~
	15:00	US	Existing home sales	Dec	\$mn	5.6	5.5	~
	15:00	US	Richmond Fed manufacturing index	Jan	~	8.0	~	~
Wed 25 Jan	16:00	EC	ECB's Praet speaks at Panel in Rome					
	11:00	UK	CBI trends total orders	Jan	~	0.0	~	~
Thu 26 Jan	12:00	US	MBA mortgage applications	Jan	%	0.8	~	~
	14:00	US	FHFA house price index	Nov	m%ch	0.4	0.3	~
Thu 26 Jan	09:30	UK	BBA loans for house purchase	Dec	~	40,659	~	~
	09:30	UK	GDP	Q4 A	q%ch	0.6	~	~

	11:00	UK	CBI retailing reported sales	Jan	~	35.0	~	~
	13:30	US	Advance goods trade balance	Dec	\$bn	-66.6	-64.0	~
	13:30	US	Wholesale inventories	Dec P	m%ch	1.0	~	~
	13:30	US	Retail inventories	Dec	m%ch	1.0	~	~
	13:30	US	Chicago Fed National Activity Index	Dec	Index	-0.3	~	~
	13:30	US	Initial jobless and continuing claims	Jan	~	~	~	~
	14:45	US	Markit US services PMI	Jan P	Index	53.9	~	~
	15:00	US	New Home Sales	Dec	000	592.0	585.0	~
	15:00	US	Revisions: Conference Board LEI					
	15:00	US	Leading index	Dec	%	0.0	0.5	~
	16:00	US	Kansas City Fed manufacturing activity	Jan	~	11.0	~	~
Fri 27 Jan	09:00	EC	M3 money supply	Dec	y%ch	4.8	~	~
	13:30	US	GDP annualized	Q4 A	q%ch	3.5	2.1	~
	13:30	US	Personal consumption	Q4 A	%	3.0	2.4	~
	13:30	US	GDP price index	Q4 A	%	1.4	2.1	~
	15:00	US	Uni. of Michigan sentiment	Jan F	~	98.1	98	~
Sat 28 Jan	~	IT	Bank of Italy Governor Visco speaks in Modena					
	02:03	UK	Nationwide house PX	Jan	m%ch	0.8	~	~

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