Economic Weekly

25 January 2018

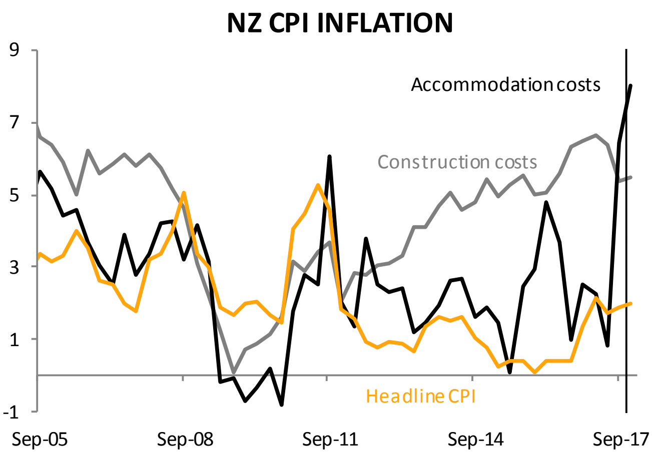
Inflation for some, not all

Holiday mode is on its way out and, to reflect this, the rate of data releases and events is picking up a notch this week. This week, Q4 CPI will be a key event in New Zealand (see the Chart of the Week below) sandwiched between the Bank of Japan (Tuesday) and the European Central Bank (Thursday night) meetings. **We also spend some time looking at how household wealth has evolved in recent years and the role the housing market has played in its growth**.

Key events and views

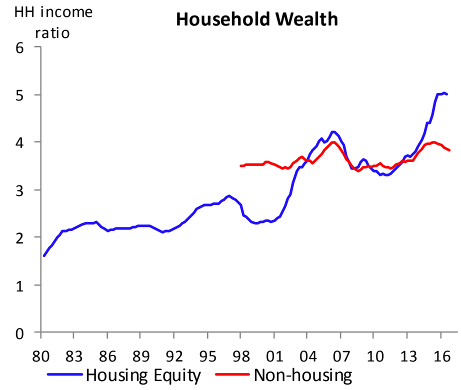
Chart of the Week: Changing History

This week provides the all-important snapshot of how NZ inflation is tracking through the release of the Q4 CPI. **In recent years, inflation has been very low** (a fate not confined to NZ). **More recently, there have been subdued signs of life in the CPI prints**. Our forecast suggests that annual CPI will hit 2% in Q4, the midpoint of the RBNZ's inflation target. **Why then do we expect the RBNZ will leave the OCR on hold until 2019?**



Although the headline CPI figure is expected to pick up, we believe this firming is not broad-based but is **confined to a few pockets of the economy where capacity pressures are particularly intense**. Annual accommodation costs and construction cost inflation is expected to remain elevated. Conversely, other transport, international airfares, audio-visual equipment and credit services are some examples of components where prices continue to fall, dragging on overall inflation. **And, while the inflation story remains a game of two halves, we will continue to expect the RBNZ to hold off raising the OCR.**

Key Insights this week

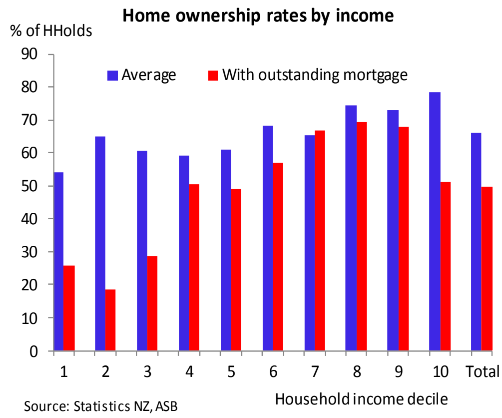


Source: RBNZ, ASB

The latest Reserve Bank of New Zealand estimates placed New Zealand's household wealth at approximately $1.4 trillion, which roughly translates into more than $290,000 for every resident New Zealander. Household net wealth has more than trebled since the late 1990's. Over that period, the four-fold increase in housing equity (the value of housing assets less the debt secured on it) has outpaced the more than doubling in non-housing net wealth and household disposable incomes. Housing equity is now more than 55% of household wealth, as opposed to around 40% 20 years ago.

Increasing household wealth has been cause for celebration for some. Around two thirds of the increase in housing equity has come via rising house prices, with the remainder due to additions/improvements to the housing stock. **Rising property values have boosted the balance sheets for homeowners** who have been on the housing ladder over that period. **Rising global equity values have also bolstered household balance sheets.**

These gains are unlikely to have been evenly distributed with the gains more positively skewed than for household incomes. According to a report from the New Zealand Ministry of Social Development (MSD), based on data from the 2015/16 Household Economic Survey produced by Statistics NZ, 10% of the wealthiest New Zealand households held around 50% of all household wealth, whereas the top 10% of household income earners receive a 25% share of all income. Lifecycle factors partly explain this, with households tending to build up assets over time, whilst annual incomes tend to peak in the 40's. While lower wealth is found disproportionately among younger age groups, they have more human capital and the potential to generate higher future incomes as well as the prospect of being able to inherit wealth. About three-fifths of all New Zealand net wealth is held by those over the age of 55 although they make up only a third of the population. As the accompanying chart implies, there are a sizeable portion of lower income homeowners that have considerable equity in their own homes. These groups typically include a larger proportion of retiree households. While this group has experienced sizeable capital gains given their high rates of homeownership, the trend decline in interest rates has proved to be a mixed blessing via its impact on their interest income.

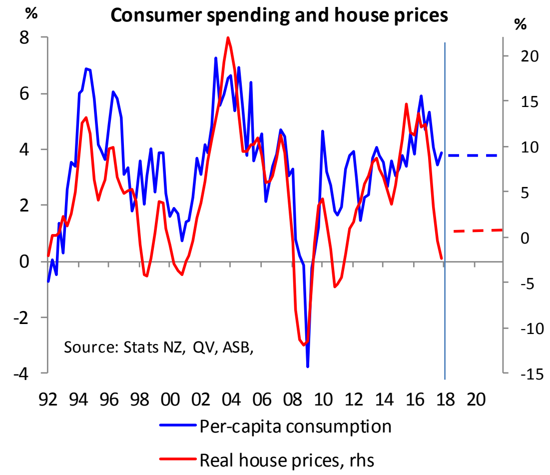


Source: Statistics NZ, ASB

RBNZ estimates suggest that around 8% of NZ households currently own investment properties, with rental properties accounting for around one quarter of housing equity and one-third of the private dwelling stock. Homeowners that are looking at trading down to cheaper dwellings have also benefitted. Prices for lifestyle properties, farms, industrial and commercial property have all strengthened to varying degrees over the period, benefitting property owners.

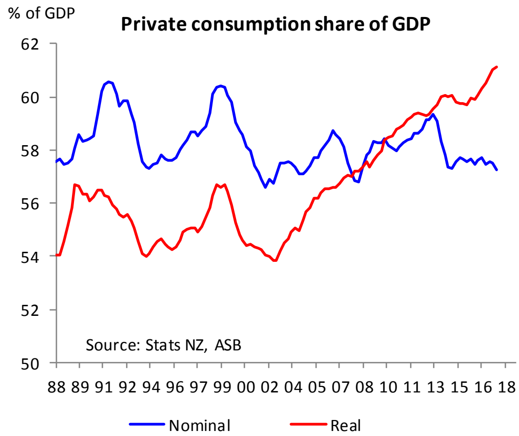
Others have not been so lucky. The low interest rate environment has bid up asset prices to historic highs, but proportionately fewer of the benefits have accrued to poorer households. Moreover, in the absence of a savings nest egg, Kiwisaver grant, inheritance, Lotto win or parental help, first home buyers face a more difficult task to get onto the housing ladder. A 20% deposit to purchase the median priced New Zealand dwelling is currently about $107,000, around 1½ times total annual household take-home pay. For Auckland, the 20% deposit jumps to $170,000. Homeowners who intend to trade up to more expensive dwellings typically face a bigger mortgage.

One of the puzzles of late had been why consumer spending had been so mild despite the tightening labour market, sizeable increases in housing equity (which historically is closely correlated to consumer spending), still–reasonable consumer sentiment and strengthening residential investment. It was thought that the global financial crisis (GFC) had elicited more caution from asset-rich consumers, wary of another downturn. Unlike the run-up to the GFC, the household sector in aggregate had not used the rising equity of their dwelling as an ATM.

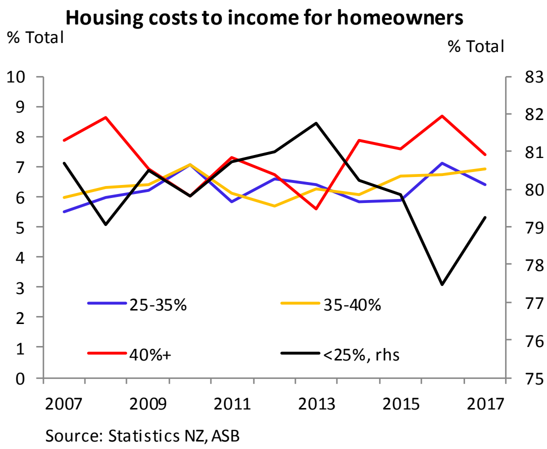


However, recent revisions have helped solve this puzzle. Upward revisions to consumer spending (and overall economic activity) have helped to reassert the historically close linkage between house prices and consumer spending.

There are, nonetheless, good reasons to expect the two to diverge over the next year to two. We expect a period of mild rises to house prices over 2018. Despite strong population growth, stretched affordability and policy changes, both here and abroad, are expected to prevent the housing market getting a fourth-wind since the GFC. Consumer spending volume growth, however, is expected to advance at a solid clip, supported by increasing labour incomes, the historically high terms of trade, still-low interest rates and a solid outlook for residential building. Much of the strong run-up in consumer spending volumes looks to be from consumers purchasing relatively more items experiencing relative price falls (e.g. consumer durables), with nominal consumption spending as a portion of nominal GDP around historical norms.



Could the housing market be due a significant correction? Complacency during a period in which global asset values are hovering around record highs, can be dangerous. However, in the current juncture, most homeowners still look reasonably well placed to meet mortgage commitments. According to Statistics New Zealand figures, close to four-fifths of all households who own or partly own their dwelling spend less than one-quarter of their before-tax incomes on housing. Only around 8% of households who own or partly own their dwelling have housing costs exceed 40% of household incomes, and these households tend to have considerably higher than average incomes. **If homeowners don't have to sell during a housing downturn, they won't.**



It would take a sizeable climb in mortgage interest rates coupled with a shock that significantly hit employment and local incomes to drive a significant fall in house prices. In the current goldilocks backdrop, it is hard to put an exact timeframe around when (or if) this might occur. **There is the risk, however, that a localised shock could cause significant disruption. Mortgage debt holdings tend to be heavily concentrated,** with RBNZ figures suggesting that around 8% of households hold about 40% of total housing debt.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.7281	0.7264	0.7019	0.7213	UP/FLAT	0.7100	0.7400	UP
NZD/AUD	0.9099	0.9145	0.9107	0.9511	FLAT	0.9000	0.9200	DOWN
NZD/JPY	80.56	80.43	79.55	82.65	FLAT	80.00	82.00	DOWN
NZD/EUR	0.5939	0.5954	0.5914	0.6749	FLAT	0.5800	0.6000	FLAT
NZD/GBP	0.5243	0.5286	0.5244	0.5832	FLAT	0.5200	0.540	FLAT
TWI	75.0	74.9	73.8	78.9	FLAT/UP	74.00	76.00	FLAT

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

NZD Recap

Generalised USD weakness remained the prevalent currency driver, with the USD index hovering around three-year lows. Despite the US government shutdown, the USD strengthened over the weekend, which pushed the NZD below 73 US cents, whilst the AUD eased toward 80 US cents. The NZD has remained broadly stable against other bilaterals, with the TWI currently sitting around 75, up about 1% since the end of 2017. The NZD has remained resilient despite compression between NZD and global yields (US 10-year Treasury yields are around 3½ year highs) and sub-par readings for NZ business sentiment. The supportive global backdrop, synchronised global upswing, and equity market strength, historically high export commodity prices and still-low measures of market volatility have provided strong tailwinds supporting the NZD.

Last week, we increased our European currency forecasts, most notably for EUR and GBP. We anticipate EUR/USD will lift towards levels around 1.2700 by Q4 2018, reflecting accelerating Eurozone economic growth and improving Eurozone inflation dynamics. We also anticipate GBP/USD will lift to 1.4200 by Q4 2018 on positive progression of Brexit talks and a weaker USD. The forecast changes have seen us modestly scale back our forecasts of the NZD against the euro and sterling. We still expect the NZD to end 2018 at around 75 US cents.

Near-term Impact

The focus will be on USD and global central banks. The USD is likely to remain on the back foot until a continuing resolution to the US government funding impasse can be achieved, with further confirmation on the strengthening global economy (The World Economic Forum is on this week, with the IMF also releasing global forecasts) also weighing on the USD. Both the Bank of Japan (Tuesday) and ECB (Thursday) are expected to leave policy settings unchanged this week, but any signs of policymaker concern over the strength in their respective currencies could see some retracement against the USD.

Local events are expected to have a fleeting impact. Any spike in the NZD and NZD yields from a firmer than expected NZ CPI inflation print is expected to be short-lived, given our expectation that core inflation will remain well below the midpoint of the 1-3% inflation target.

Medium-term outlook

Our medium-term bias remains a weaker USD, reflecting narrowing USD interest rate differentials as other central banks contemplate policy tightening ahead of the Fed. **The NZD is expected to remain broadly supported by** its solid economic outlook, strong NZ commodity export prices and historically high terms of trade and strong demand as global central banks/other real money managers continue to increase NZD exposures.

ASB foreign exchange forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
(end of quarter)			<< actual	forecast >>					
NZD/USD	0.73	0.72	0.71	0.72	0.73	0.74	0.75	0.76	0.79
NZD/AUD	0.95	0.92	0.91	0.90	0.90	0.90	0.90	0.90	0.90
NZD/JPY	82	81	80	79	78	78	79	79	79
NZD/EUR	0.64	0.61	0.59	0.60	0.59	0.59	0.59	0.60	0.60
NZD/GBP	0.56	0.54	0.53	0.53	0.53	0.53	0.53	0.53	0.54
NZD TWI	78.4	76.4	74.3	74.6	74.7	75.0	75.1	75.7	76.6

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.75	1.75	1.75	1.75	FLAT	UP
90-day bank bill	1.88	1.88	1.88	1.97	FLAT	UP
2-year swap	2.25	2.22	2.20	2.43	UP/FLAT	UP
5-year swap	2.79	2.73	2.69	3.01	UP	UP
10-year swap	3.30	3.23	3.16	3.50	UP	UP
10-year govt bond yield	2.97	2.87	2.75	3.25	UP	UP
Curve Slope (2s10s swaps)	1.05	1.01	0.96	1.07	UP	DOWN

** Current as at 9.30am Monday; week ago as at Monday 5pm*

Market Recap

NZ interest rates lifted across the yield curve, with increases **strongest at longer-end** resulting in further steepening in the curve over the past week. The lift in NZ and Australian interest rates largely followed moves in US yields over the past week, with US 10-year Treasury yields close to 4-year highs.

US treasury yields continued to rise as the investor sell-off continued over the past week. Investor sentiment in global bonds has shifted, as stronger global economic momentum points to less support needed from central banks and an **expectation that bond purchases will be reduced this year.**

Near-term NZD interest rate outlook

A timely resolution to the US government shutdown could see US yields nudge higher. **There is also some scope for volatility in longer-end yields** with announcements from both the Bank of Japan (on Tuesday) and ECB (Thursday night). The **market will be sensitive to commentary around bond-buying programmes**, with a hawkish tone likely to add further momentum to the recent bond sell-off (yields higher) and a fall in yields if comments are at the dovish end of the spectrum.

This week's domestic focus is NZ CPI on Thursday. Although annual CPI will likely print at 2% in Q4 2017, it remains our expectation for annual inflation to decline over the coming year. With core-inflation measures still subdued, we continue to expect the RBNZ will wait until 2019 to lift this OCR. **However, market pricing has three OCR hikes priced in by the end of 2019, which is slightly ahead of our view for the likely pace of rate hikes.** A stronger-than expected CPI will merely reinforce current market pricing, but if CPI prints weaker than expected there may be some scope for shorter-end yields to ease.

Medium-term outlook

Our core macro view is that the RBNZ will start lifting the OCR in early 2019. We expect a moderate pace of tightening by historical standards, and a low OCR endpoint of around 3.5% this cycle. **This should help push up short-term NZD rates and help to flatten the local curve. Our expectation of a flatter NZD curve crucially depends on the assumption that local yields remain reasonably well anchored to global counterparts and that the lift in global yields is modest.** With still considerable uncertainties over the persistence of low global inflation and a downward global risk profile, we expect long-term global yields to drift higher.

ASB interest rate forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
(end of quarter)			<< actual	forecast >>					
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50
NZ 90-day bank bill	1.96	1.96	1.88	1.9	1.9	2.0	2.1	2.3	2.8
NZ 2-year swap rate	2.33	2.21	2.21	2.3	2.4	2.5	2.7	2.8	3.3
NZ 10-year Bond	2.97	2.96	2.75	3.1	3.2	3.3	3.4	3.4	3.6

Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
CPI, Q4, %qoq	25/1	10.45 am	+0.5	+0.4	+0.5

We expect Q4 CPI to print at 0.5% qoq, with annual CPI inflation firming to 2.0% (the second time annual inflation has reached at least 2% in the last year). This lift reflects a number of one-off movements, rather than stronger underlying inflation. For example, the sharp jump in petrol prices over the quarter accounts for nearly half of the quarter's lift in inflation. On top of that, the shift to updated CPI weightings has added to Q4 inflation at the margin. A contained backdrop for overall inflation should encourage a prolonged period of stability in OCR settings. The next move in the OCR is most likely to be up, but this still looks to be a 2019 story.

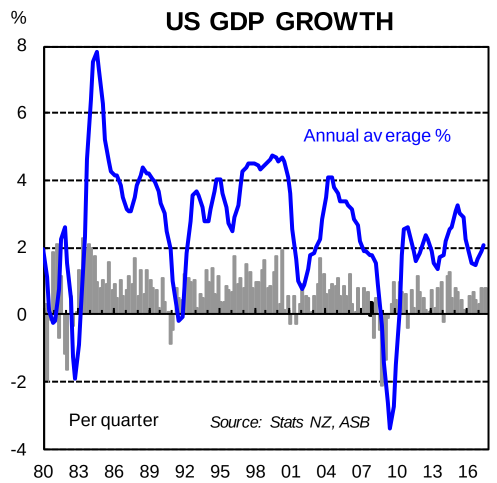
Major International Events for the week ahead

Data	Date	Time (NZT)	Market	ASB
Bank of Japan Interest Rate Announcement, %	23/01	-	-0.1	-0.1
UK Unemployment, November, %	24/01	10.30 pm	4.3	4.3
European Central Bank Interest Rate Announcement, %	26/01	1:45 am	0.0	0.0
Japan CPI, December, Headline, %yoy	26/01	12:30 pm	1.1	1.2
UK GDP, Q4, %qoq	26/01	10:30 pm	0.4	0.4
US GDP, Q4, %qoq	27/01	2:30 am	3.0	3.0

Despite market speculation of near-term policy tightening, we expect no change in **monetary policy** by the **Bank of Japan** this week. Japanese inflation and inflation expectations are simply too low for policy tightening.

Higher energy prices will push up most **Japanese inflation** measures. However, excluding fresh food and energy prices , Japan has very little inflation pressure.

We anticipate the December **UK employment** report will show low UK unemployment around 4.3%, and average weekly earnings of around 2.3%.



We anticipate the **European Central Bank** will leave **rates** unchanged at -0.4% (deposit rate) and 0.0% (refinancing rate).

We anticipate Q4 **UK GDP** growth will print around 1.5% yoy and 0.4% qoq. There is an upside risk to UK Q4 GDP growth, reflecting the modest improvement in UK productivity growth.

With US consumer and business confidence high, retail and capital spending have accelerated. Net exports are also declining, possibly in response to the weaker USD. Overall, **US economic growth** appears to have accelerated in the second half of 2017.

Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Last	Forecast Market	Forecast ASB
Tue 23	~	JN	BOJ 10-year yield target	Jan	%	0.0	~	~
	~	JN	BOJ outlook report					
	~	JN	BOJ policy balance rate	Jan	%	-0.1	~	~
	08:30	NZ	Performance Services Index	Dec	Index	56.4	~	~
Wed 24	10:50	JN	Trade balance adjusted	Dec	¥bn	364.1	~	~
	11:30	JN	Nikkei Japan PMI manufacturing	Jan P	Index	54.0	~	~
	13:00	NZ	Credit card spending	Dec	m%ch	0.8	~	~
Thu 25	08:45	NZ	CPI	Q4	q%ch	0.5	0.4	0.5
Fri 26 Jan	10:30	JN	National CPI	Dec	y%ch	0.6	~	~
	10:50	JN	BOJ Minutes of Policy Meeting					
	12:30	CH	Industrial profits	Dec	y%ch	14.9	~	~

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Last	Forecast Market	Forecast ASB
Mon 22	13:30	US	Chicago Fed National Activity Index	Dec	Index	0.2	~	~
Tue 23 Jan	10:00	GE	ZEW survey current situation	Jan	~	89.3	~	~
	10:00	GE	ZEW survey expectations	Jan	~	17.4	~	~
	10:00	EC	ZEW survey expectations	Jan	~	29.0	~	~
	15:00	US	Richmond Fed Manufacturing Index	Jan	Index	20.0	18	~
	15:00	EC	Consumer confidence	Jan A	~	0.5	~	~
	15:00	US	Senate Holds Confirmation Hearing for Fed Nominee Goodfriend					
Wed 24	09:00	EC	Markit Eurozone manufacturing PMI	Jan P	Index	60.6	~	~
	09:00	EC	Markit Eurozone services PMI	Jan P	Index	56.6	~	~
	09:00	EC	Markit Eurozone composite PMI	Jan P	Index	58.1	~	~
	09:30	UK	ILO unemployment rate 3 months	Nov	%	4.3	~	~
	14:45	US	Markit US composite PMI	Jan P	Index	54.1	~	~
	14:45	US	Markit US services PMI	Jan P	Index	53.7	~	~
	14:45	US	Markit US manufacturing PMI	Jan P	Index	55.1	54.5	~
	15:00	US	Existing home sales	Dec	m%ch	5.6	-2.3	~
Thu 25 Jan	09:00	GE	IFO current assessment	Jan	~	125.4	~	~
	12:45	EC	ECB main refinancing rate	Jan	%	0.0	~	~
	12:45	EC	ECB marginal lending facility	Jan	%	0.3	~	~
	12:45	EC	ECB deposit facility rate	Jan	%	-0.4	~	~
	13:30	US	Wholesale inventories	Dec P	m%ch	0.8	~	~
	13:30	US	Initial jobless and continuing claims	Jan	~	~	~	~
Fri 26 Jan	09:30	UK	GDP	Q4A	q%ch	0.4	0.4	0.4
	13:30	US	GDP annualized	Q4 A	q%ch	3.2	3.0	3.0
	13:30	US	Durable goods orders	Dec P	%	1.3	0.9	~
	13:30	US	Core PCE	Q4 A	q%ch	1.3	~	~

Key Forecasts

ASB NZ economic forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
	<< actual	forecast >>							
GDP real - Q%	1.0	0.6	1.0	1.2	1.1	1.0	1.0		
GDP real - A%	2.8	2.7	3.3	3.8	4.0	4.3	4.4	4.0	3.4
GDP real - AA%	3.3	3.0	3.0	3.2	3.4	3.9	4.1	4.2	3.5
CPI - Q%	0.0	0.5	0.5	0.4	0.2	0.5	-0.1		
CPI - A%	1.7	1.9	1.9	1.3	1.5	1.6	1.0	1.3	1.7
HLFS employment growth - Q%	-0.1	2.2	-0.6	1.0	0.7	0.5	0.6		
HLFS employment growth - A%	3.1	4.1	2.7	2.5	3.3	1.6	2.8	2.3	1.8
Unemployment rate - %sa	4.8	4.6	4.9	5.0	5.0	4.3	4.1	4.0	3.7
Annual current account balance as % of GDP	-2.7	-2.6	-2.6	-2.2	-2.4	-2.6	-2.6	-2.5	-2.4

Q% = percentage change on previous quarter

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

ASB interest rate forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
(end of quarter)			<< actual	forecast >>					
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50
NZ 90-day bank bill	1.96	1.96	1.88	1.9	1.9	2.0	2.1	2.3	2.8
NZ 2-year swap rate	2.33	2.21	2.21	2.3	2.4	2.5	2.7	2.8	3.3
NZ 10-year Bond	2.97	2.96	2.75	3.1	3.2	3.3	3.4	3.4	3.6

ASB foreign exchange forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
(end of quarter)			<< actual	forecast >>					
NZD/USD	0.73	0.72	0.71	0.72	0.73	0.74	0.75	0.76	0.79
NZD/AUD	0.95	0.92	0.91	0.90	0.90	0.90	0.90	0.90	0.90
NZD/JPY	82	81	80	79	78	78	79	79	79
NZD/EUR	0.64	0.61	0.59	0.61	0.61	0.61	0.61	0.61	0.60
NZD/GBP	0.56	0.54	0.53	0.53	0.53	0.54	0.54	0.53	0.54
NZD TWI	78.4	76.4	74.3	74.9	74.9	75.3	75.4	75.8	76.6

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