

Economic Weekly

23 July 2018

NZ inflation up on fuel and housing costs

It is a relatively quiet week ahead for domestic markets, with just the NZ trade balance released this week. Offshore, the first estimate of US Q2 GDP growth will be keenly awaited with financial markets anticipating strong growth fuelled by Trump's tax cuts. Australia receives its Q2 inflation figures this week and we recap NZ's Q2 inflation release from last week in our key insights.

Key events and views

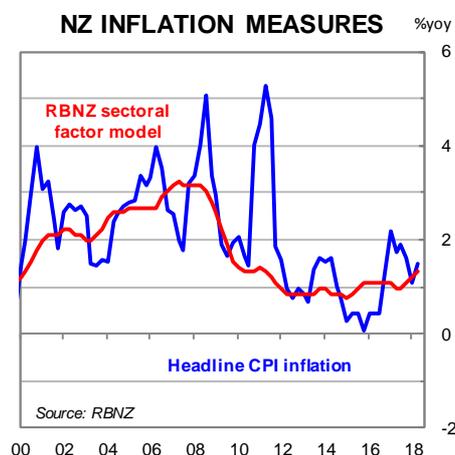
Key Insights	NZ Q2 inflation report suggests no urgency for the RBNZ.
Foreign exchange	NZD/USD lifts sharply following the lift in the RBNZ's sectoral factor inflation model.
Interest rates	NZ shorter-term interest rates start this week modestly higher.
Domestic events	We expect a small trade surplus in June.
International events	Australian Q2 inflation, US Q2 GDP and European Central Bank rate announcement.
Calendars	NZ and international calendar of upcoming economic events.

Chart of the Week: Underlying inflation trend is lifting

The **RBNZ looks at a range of inflation measures to assess the current inflation environment**. Given the variability in headline inflation (driven by shifts in international commodity prices and government policy changes), the **RBNZ has, over recent years, placed a lot of emphasis on the underlying trend in inflation, referred to as core-inflation measures**.

There are a **range of core-inflation measures**, including measures which exclude certain components, for example food and fuel. There are measures which remove the most extreme moves in inflation (trimmed means) and alternative measures of central tendency, such as median inflation. But **the measure which appears to receive the most emphasis from the RBNZ is its own sectoral factor model**.

The Q2 sectoral factor model showed a clear lift in core inflation, with Q1 also being revised higher and painting a picture of rising core inflation pressures over the past 6 months or so. With core inflation now on an uptrend, it's seen as very unlikely the RBNZ will consider cutting rates in the near future. Furthermore, assuming the uptrend in core inflation continues, there is greater certainty on the outlook for rate hikes.



Key Insights this week: Q2 Inflation confirms no rush for the RBNZ

Key points:

- The CPI rose by 0.4% in Q2, marginally lower than ourselves and the market were expecting. The annual rate of inflation rebounded to 1.5%.
- The majority of measures of core inflation rose over the quarter, but it remains too soon to tell whether this momentum will be maintained.
- Q2's result reiterates our view that the RBNZ will leave the OCR on hold well into 2019.

Summary & implications

The CPI rose by 0.4% qoq, taking the annual rate of inflation up to 1.5%. Although higher tradable inflation (petrol prices) looks set to lift headline CPI back up towards 2% by the end of the year, **it remains too soon to tell whether underlying inflation pressures will continue to build**. For example, the recent increase in downside risks stemming from soft business confidence and trade tensions means the RBNZ is likely to remain cautious for now. As a result we do not expect the RBNZ to change any policy settings as a result of the Q2 release. **We continue to expect the RBNZ to leave the OCR on hold until November 2019.**

Details

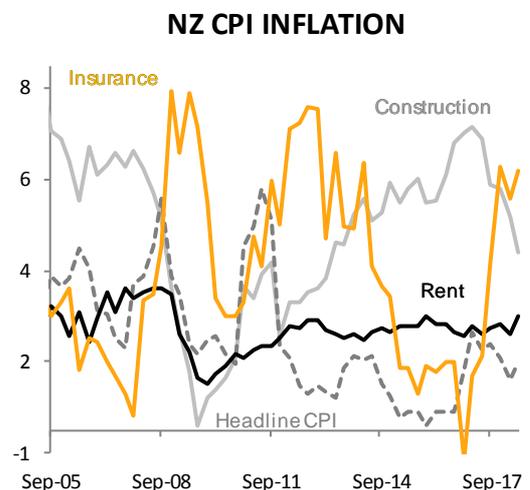
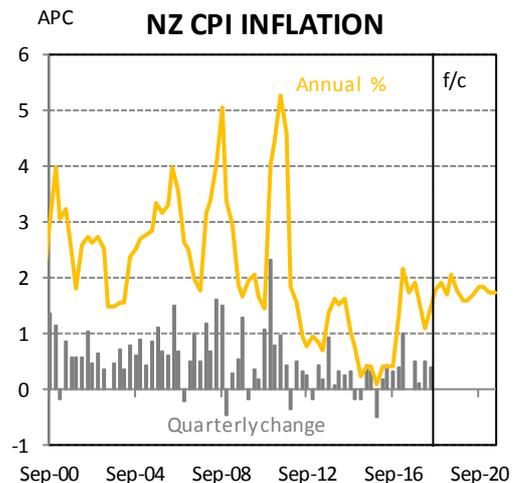
The CPI rose by 0.4% qoq in Q2, marginally lower than ASB's and the market's expectations, but in line with the RBNZ's forecast. As

widely expected, higher fuel costs drove much of the lift in tradable inflation over the quarter. The remaining strength was largely contained to housing costs (e.g. rent, construction costs and electricity prices). So far, the lift in petrol prices (the third quarter in a row for which petrol prices have increased) does not appear to have flowed through into other areas of the CPI. For example, passenger transport services costs fell over the quarter. We had been expecting the seasonal decline in domestic airfares to be more muted than normal, given the higher fuel costs and Air New Zealand lifting domestic prices in April. However, the 12.5% fall in domestic airfares was a lot sharper than we had anticipated. Road passenger transport prices also fell 5.9% qoq.

Outside of the lift in fuel prices, however, **tradable inflation pressures were muted in Q2**. Tradable ex-fuel prices fell 0.1% over the quarter to be -1.1% lower than in Q2 2017. Audio-visual equipment remains a key drag on tradable inflation pressures. However, according to Stats NZ, the outsized 15% fall was driven by quality improvements in televisions reflected as an effective price fall.

On the domestic, or non-tradable, side of the equation, **housing costs continue to be a key driver of inflation**. The 0.9% lift in the housing and household utilities group was largely in line with our 0.8% forecast. Rental prices lifted 0.8% over the quarter, with solid increases registered in most regions. In Wellington annual rental price growth lifted to 4.2%, the highest level since September 2008. Interestingly, construction costs appear to be accelerating in the smaller regions, while they continue to ease on an annual growth basis in Auckland and Wellington. Overall construction costs rose 1.1% qoq in Q2. Auckland construction costs rose 0.6% qoq whereas they rose 1.2% qoq for the rest of the North Island. In the South Island excluding Canterbury, construction prices are up 7.2% yoy.

Accommodation prices dipped in Q2, but remain higher on an annual basis. Accommodation costs fell 1.7% qoq, but were 11% higher than in Q2 2017, the highest annual rate of increase on record (dating back to June 2000). This



highlights not only that capacity constraints are boosting accommodation prices, but suggests that tight capacity is now pushing demand into the shoulder seasons as well.

As we stated in our preview, **core inflation remains the key measure from a policy point of view**. In Q2 the 10% trimmed mean measure lifted from 1.4% to 1.8% and the weighted median increased slightly to 2.3%. However, **the headline CPI excluding food, energy and fuel measure was flat over the quarter and only up 1.1% over the year**. That measure highlights that the current inflationary environment remains one that is contained to only a few sectors. However, they are sectors that arguably account for a large proportion of household spending. The RBNZ’s sectoral factor model (released at 3pm on CPI day) also rose from 1.6% qoq to 1.7% qoq in Q2. With a wide disparity between different core inflation measures at this point in time, we continue to expect the RBNZ to tread carefully. It is also worth noting that a lot of the current inflation is cost-push, rather than demand-pull inflation. This carries the risk of stifling spending and inflation in other sectors and reinforces the fact that the RBNZ is likely to feel no urgency to act as a result of Q2’s results.

All up, Q2’s CPI release reinforces that the RBNZ will be comfortable leaving the OCR on hold for some time yet. The combination of increased downside risks and the offsetting lower NZ dollar suggests that the RBNZ will feel little pressure to adjust monetary policy settings any time soon. We continue to expect the RBNZ to leave the OCR on hold until November 2019.

Q2 2018 CPI %	Actual	ASB	RBNZ	Market
CPI qoq	0.4	0.5	0.4	0.5
CPI yoy	1.5	1.6	1.5	1.6
Non-tradable qoq	0.4	0.3	0.3*	
Non-tradable yoy	2.5	2.4	2.4	
Tradable qoq	0.3	0.9	0.6*	
Tradable yoy	0.1	0.7	0.4	

*ASB estimate

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6799	0.6773	0.6901	0.7422	FLAT	0.6620	0.6900	UP
NZD/AUD	0.9155	0.9119	0.9329	0.9401	DOWN/FLAT	0.9020	0.9350	FLAT
NZD/JPY	75.70	76.18	75.91	83.05	FLAT	74.70	77.00	FLAT
NZD/EUR	0.5796	0.5794	0.5941	0.6381	FLAT	0.5720	0.5900	FLAT
NZD/GBP	0.5179	0.5115	0.5202	0.5721	FLAT	0.5110	0.5260	DOWN
TWI	73.3	72.5	73.3	78.59	DOWN/FLAT	72.00	74.00	FLAT

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

NZD Recap

The NZD edged higher against the USD last week, with much of the recovery focused in the latter-half of the week.

Despite the CPI coming in slightly below market expectations, the move lower in the NZD/USD was relatively muted as a result of ANZ's below-consensus 0.1% qoq estimate (markets had positioned themselves for a soft result). Tuesday afternoon saw the NZD/USD lift sharply following the lift in the RBNZ's sectoral factor model (as discussed on Page 2). However, outside of short-term data-induced movements, trade tensions remain the key driver of currency movements. US President Donald Trump's comments late last week around Fed rate hikes, further tariffs and accusations of currency and interest rate manipulation saw the USD end the week on the back foot.

The risk-off tone supported demand for the Japanese Yen and saw the NZD/JPY fall to below 76 last week. The NZD/AUD and NZD/EUR ended the week largely unchanged.

Near-term outlook

The NZD is likely to take its direction from offshore movements this week, with little in the way of major NZ

economic data to cause volatility. Trade tensions will remain front of mind, with investors likely to grow increasingly wary of any further threats from the US President around additional tariffs or currency manipulation. In terms of data and events, Australia's Q2 CPI release on Wednesday and US Q2 GDP on Friday are the key releases. Australian CPI is expected to lift to 2.2% yoy, with underlying inflation a more subdued 1.9% yoy. A result either side of this is likely to cause some short-term volatility in the NZD/AUD. US Q2 GDP is also the other key event risk for the week. Market consensus is for GDP to have lifted 4% on a seasonally-adjusted annualised rate, reinforcing that the US economy remains on a solid growth trajectory. A result in line with consensus should be USD-supportive.

Medium-term outlook

We believe the recent bout of USD weakness has ended and we have now further increased our near-term USD forecasts. **We expect the USD to remain supported due to the increasing divergence between the US economy (and resultant pace of Fed rate hikes) and the rest of the global economy.** Elsewhere, low inflation and wages as well as political developments have seen many central banks holding on to accommodative monetary policy stances or stalling tightening cycles. **The NZD TWI is expected to remain broadly supported** by NZ's solid economic outlook, strong NZ commodity export prices, 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

(end of quarter)

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
		<< actual		forecast >>				
NZD/USD	0.71	0.72	0.67	0.67	0.68	0.69	0.71	0.74
NZD/AUD	0.91	0.94	0.92	0.93	0.91	0.91	0.92	0.90
NZD/JPY	80	77	74	74	73	74	75	75
NZD/EUR	0.59	0.59	0.58	0.59	0.58	0.58	0.57	0.58
NZD/GBP	0.53	0.51	0.52	0.52	0.50	0.50	0.50	0.50
NZD TWI	74.3	74.3	72.5	72.3	72.3	72.4	71.9	73.1

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	1.92	1.93	1.96	1.94	FLAT	UP
2-year swap	2.15	2.14	2.25	2.22	FLAT	UP
5-year swap	2.54	2.53	2.66	2.76	FLAT/DOWN	UP
10-year swap	2.99	3.02	3.12	3.27	FLAT/DOWN	UP
10-year govt bond yield	2.80	2.84	2.95	2.92	FLAT/DOWN	UP
Curve Slope (2s10s swaps)	0.84	0.88	0.87	1.06	FLAT/DOWN	FLAT

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

Market Recap

NZ shorter-term interest rates start this week modestly higher, with the risk-off tone to markets helping to push down longer-term yields and flatten the curve. Local short-term yields nudged up as the CPI print was not as weak as had been speculated, with the RBNZ's estimate of annual core inflation from the sectoral inflation model hitting a seven-year high at 1.7%. The strong Australian jobs print also supported rates at the margin. **Geopolitics and trade remained the major influences for longer-term yields**, with the lowering of the fix on the Chinese yuan by the People's Bank of China (PBOC) triggering the recent market rally. Trade issues remain in focus, with obvious tensions evident at the G-20 meeting of finance ministers over the weekend. President Trump kept markets on their toes by stating that the next round of tariffs was ready to be implemented, and by accusing the EU and China of "manipulating their currencies and interest rates lower." Trump also voiced concern over the impact of higher US borrowing costs on the US economy, which has had little impact on US rates to date, with US 10-year Treasury yields ending the week slightly higher (2.89%), and still above NZ (2.79%) and Australian (2.61%) yields.

Near-term NZD interest rate outlook

With trade tensions and geopolitics in the foreground our bias remains for lower longer-term yields and flatter curves. We expect short-term rates to remain supported by the solid backdrop for core inflation, the lower NZD and pending increases in wage inflation, all of which support a high hurdle to a RBNZ rate cut. The Australian CPI is the major data release in our time zone this week. Market expectations are for a set of contained headline and core inflation prints (+0.5% qoq), with annual inflation from the core inflation measures expected to print below 2%. The key to the RBA raising interest rates is a pick-up the pace of wages growth, which still looks some way off. The ECB is widely expected to keep monetary policy unchanged this week and signal no urgency to change settings. A strong Q2 US GDP print looks to be mostly priced in, with the market expecting a strong 4.3% annualised print, and with 90% odds for a September Fed hike. Yields could rally if US data starts to show signs of softening.

Medium-term outlook

We expect the OCR to remain on hold until November 2019 (previously August), after which we expect a modest pace of tightening, and a low OCR endpoint of around 3.5% this cycle. We have also pushed back the timing of ECB rate hikes, which are now assumed to start in September next year (previously June 2019). While we expect four further Fed hikes through till the end of 2019 (four in total over 2018, two over 2019), by the end of this year we are likely to see Fed Chair, Jerome Powell, acknowledge that the Fed funds rate is close to neutral levels, which should cap US yields. **Our expectation of a flat NZD curve crucially depends on the assumption that local long-term yields remain reasonably well anchored to global counterparts and that the lift in global yields is modest.**

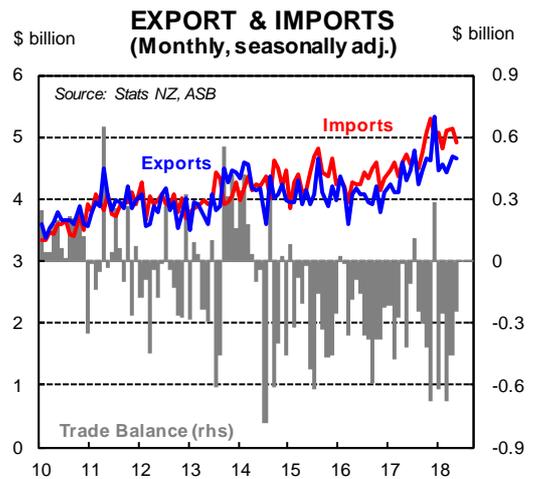
ASB interest rate forecasts

(end of quarter)	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
		<< actual		forecast >>				
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50
NZ 90-day bank bill	1.88	2.0	2.0	2.0	2.0	2.0	2.5	3.0
NZ 2-year swap rate	2.21	2.2	2.1	2.2	2.3	2.3	2.7	3.2
NZ 10-year Bond	2.75	2.7	2.9	2.9	3.0	3.0	3.2	3.5

Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
Trade Balance, June, \$m	25/07	10.45 am	294	200	100

We expect a small trade surplus in June. Looking over the month, we expect export values to remain firm on the back of stronger meat export prices. Meanwhile, we expect import values to lift on the back of the rise in oil prices over June. Looking at the annual balance, we expect the deficit to widen to \$3.74 billion from \$3.6 billion in May.



Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
Eurozone Manufacturing PMI, July, points	24/07	8:00 pm	54.7	54.5
Australia Inflation, Q2, %qoq	25/07	1:30 pm	0.5	0.6
Australia Export Price Index, Q2, %qoq	26/07	1:30 pm	-1.3	flat
Australia Import Price Index, Q2, %qoq	26/07	1:30 pm	1.9	2.0
ECB Interest Rate Announcement, %	26/07	11:45 pm	0.0	0.0
US GDP, Q2, seasonally adjusted annual rate	28/07	12:30 am	4.0	3.6

*Originally published by CBA Global Markets Research on Friday 20th July 2018 at 1.10pm.

Inflation in Australia is still soft although the inflationary pulse is lifting. We expect the headline inflation rate to rise by 0.6%, bringing the annual rate to 2.3%, comfortably within the RBA's 2-3% target range. Despite the pickup in headline inflation, we expect to see underlying inflation pressures staying fairly soft, with a likely 0.5% rise over the quarter. This would keep the annual rate at 1.9%. A large lift in petrol prices is expected to explain most of the difference between headline and underlying inflation rates.

We expect **Australian export prices** to be broadly unchanged over Q2 with commodity prices posting a very small fall. **Import prices** are expected to rise around 2% as the Australian dollar depreciated over the quarter. These figures only cover trade in goods and do not include services. Nonetheless they imply a small fall in the terms of trade over Q2.

The **Eurozone** manufacturing and services **PMIs** have fallen considerably from very high levels. We expect a further small decrease in the PMIs over July.

We (and the consensus of economists) **expect no change in monetary policy from the ECB**. In our view, the ECB is at least one year away from beginning the long process of tightening monetary policy. Excess slack in the labour market will keep inflation in wages and prices subdued and discourage tightening over the near term.

We expect strong growth in the US economy over Q2. The tax cuts are now passing through the economy and encouraging increased spending. Partial indicators show real personal spending accelerated from the weakness in Q1, capital goods shipments increased strongly by 1.9%, and net exports added significantly to growth.

Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Previous	Forecast	
							Mkt	ASB
Tue 24 Jul	12:30	JN	Nikkei Japan PMI manuf.	Jul P	Index	53.0	~	~
Wed 25 Jul	10:45	NZ	Trade balance	Jun	NZD	294	200	100
	13:00	AU	Skilled vacancies	Jun	m%ch	-0.9	~	~
	13:30	AU	CPI	Q2	q%ch	0.4	0.5	0.6
Thu 26 Jul	13:30	AU	Import price index	Q2	q%ch	2.1	1.9	2.0
	13:30	AU	Export price index	Q2	q%ch	4.9	-1.3	0.0
Fri 27 Jul	10:00	NZ	ANZ consumer confidence	Jul	Index	120.0	~	~
	10:00	NZ	ANZ consumer confidence	Jul	m%ch	-0.8	~	~
	11:30	JN	Tokyo CPI	Jul	y%ch	0.6	~	~
	13:30	AU	PPI	Q2	q%ch	0.5	~	~
	13:30	CH	Industrial profits	Jun	y%ch	21.1	~	~

*P = Preliminary

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Previous	Forecast	
							Mkt	ASB
Mon 23 Jul	15:00	EC	Consumer confidence	Jul A	~	-0.5	~	~
	15:00	US	Existing home sales	Jun	\$mn	5.4	5.5	~
	18:00	UK	BOE's Broadbent Speaks in London					
Tue 24 Jul	09:00	EC	Markit Eurozone manufacturing	Jul P	Index	54.9	54.7	54.5
	09:00	EC	Markit Eurozone services PMI	Jul P	Index	55.2	56.5	55.0
	14:45	US	Markit US manufacturing PMI	Jul P	Index	55.4	~	~
	15:00	US	Richmond Fed Manufacturing	Jul	Index	20.0	18.0	~
Wed 25 Jul	09:00	EC	M3 money supply	Jun	y%ch	4.0	~	~
	15:00	US	New home sales	Jun	000	689.0	670.0	~
Thu 26 Jul	12:45	EC	ECB main refinancing rate	Jul	%	0.0	~	0.0
	13:30	US	Advance goods trade balance	Jun	\$bn	-64.8	-65.3	~
	13:30	US	Initial jobless and continuing	Jul	~	~	~	~
	13:30	US	Durable goods orders	Jun P	%	-0.4	2.7	~
	16:00	US	Kansas City Fed Manufacturing	Jul	~	28.0	~	~
Fri 27 Jul	13:30	US	GDP annualized	Q2 A	q%ch	2.0	4.0	3.6
	15:00	US	Uni. of Michigan sentiment	Jul F	~	97.1	97.3	~

Key Forecasts

ASB NZ economic forecasts

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
		<< actual	forecast >>					
GDP real - Q%	0.6	0.5	1.0	1.0	0.8			
GDP real - A%	2.9	2.7	2.7	3.1	3.3	3.3	3.1	3.0
GDP real - AA%	2.8	2.7	2.7	2.9	3.0	3.1	3.1	3.0
CPI - Q%	0.1	0.5	0.4	0.8	0.2			
CPI - A%	1.6	1.1	1.5	1.8	1.9	1.7	1.6	1.7
HLFS employment growth - Q%	0.4	0.6	0.5	0.5	0.5			
HLFS employment growth - A%	3.7	3.1	3.7	2.0	2.1	1.9	1.6	1.6
Unemployment rate - %sa	4.5	4.4	4.4	4.3	4.2	4.2	4.3	4.2
Annual current account balance as % of GDP	-2.7	-2.8	-2.6	-2.3	-2.1	-1.5	-2.0	-2.1

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

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
		<< actual	forecast >>					
(end of quarter)								
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50
NZ 90-day bank bill	1.88	2.0	2.0	2.0	2.0	2.0	2.5	3.0
NZ 2-year swap rate	2.21	2.2	2.1	2.2	2.3	2.3	2.7	3.2
NZ 10-year Bond	2.75	2.7	2.9	2.9	3.0	3.0	3.2	3.5

ASB foreign exchange forecasts

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
		<< actual	forecast >>					
(end of quarter)								
NZD/USD	0.71	0.72	0.67	0.67	0.68	0.69	0.71	0.74
NZD/AUD	0.91	0.94	0.92	0.93	0.91	0.91	0.92	0.90
NZD/JPY	80	77	74	74	73	74	75	75
NZD/EUR	0.59	0.59	0.58	0.59	0.58	0.58	0.57	0.58
NZD/GBP	0.53	0.51	0.52	0.52	0.50	0.50	0.50	0.50
NZD TWI	74.3	74.3	72.5	72.3	72.3	72.4	71.9	73.1

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