ASB

Economic Weekly

29 January 2019

Inflation pressures remain steady over 2018

NZ Q4 CPI inflation was the key highlight last week, with annual inflation printing in line with market expectations and the RBNZ sectoral factor model (a measure of core annual inflation) remaining unchanged at 1.7%. We discuss the inflation data in detail from Page 2. This week is relatively quiet from a domestic perspective, but there will be plenty of action in offshore markets with a Fed policy announcement, further Brexit-related votes and headlines, Australian Q4 CPI inflation figures and potentially US Non-farm Payrolls and US Q4 GDP (US data releases may be delayed due to the US Government shutdown).

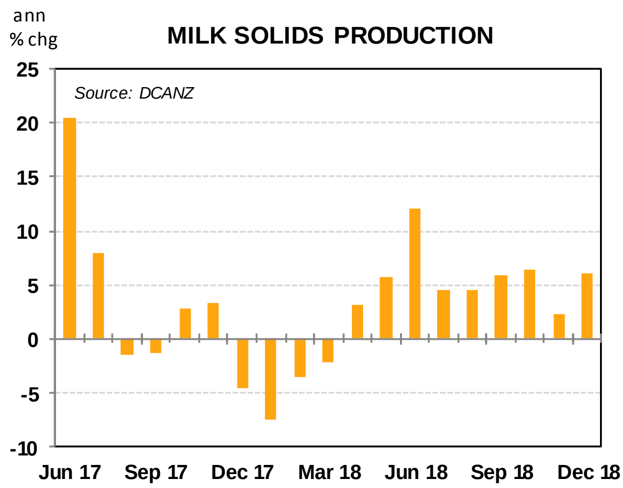
Key events and views

Chart of the Week: Dairy production still on record-setting pace

So far, **2018/19 dairy production has been very strong**. In the December month, production was 6.1% higher than 12 months ago. For the season to date, production is running 5.2% ahead of the 2017/18 season.   Relatively healthy soil moisture levels (in key dairy producing areas) suggest that production should kick on over the next few months. With that in mind, the risk of drought derailing production later in the season continues to recede.

On this basis, **we can reconfirm our 2018/19 season production growth forecast of 5%.** Indeed, this season is comfortably on track to set a new record. Note we are more bullish than many other forecasters who are generally forecasting nationwide production growth in the 3% to 4% range.

However, **our more bullish production forecast translates into a more careful milk price view**. We are sticking with our 2018/19 Fonterra forecast of $6.00/kg, for now, and suspect the recent run of solid dairy auction results will soon run out of steam.



Key insights this week: Q4 CPI Review

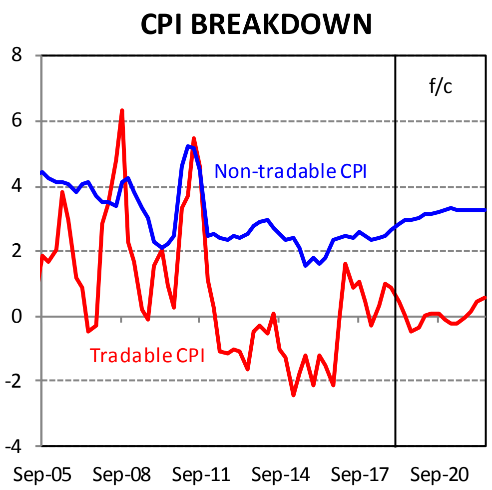
- The Q4 CPI lifted 0.1% qoq, with the annual inflation rate unchanged at 1.9%. This was slightly higher than our forecast but lower than the RBNZ's expectation.
- Both core and headline inflation remain close to 2% yoy, suggesting no immediate urgency on the RBNZ to move the OCR.
- Despite the recent slowing in economic growth and a weaker short-term outlook for headline inflation, we expect the RBNZ to remain patient. We continue to expect the RBNZ to leave the OCR on hold until August 2020.

Summary & implications

The CPI lifted 0.1% in Q4, to be 1.9% higher on an annual basis. However, the details of the release were surprisingly strong, with non-tradable and measures of underlying inflation all lifting. Further, there was evidence that pricing pressure is spreading beyond housing-related sectors. From the RBNZ's perspective, underlying inflation was stronger than expected and suggests that economic momentum over 2017 and early 2018 supported inflation. **However, given the recent slowdown in growth and the ongoing downside risks to the inflation outlook, we expect the RBNZ to remain patient for now.** We don't expect the RBNZ to raise the OCR for a considerable period of time, but today's release confirms that there is a high hurdle to rate cuts in the current environment**.**

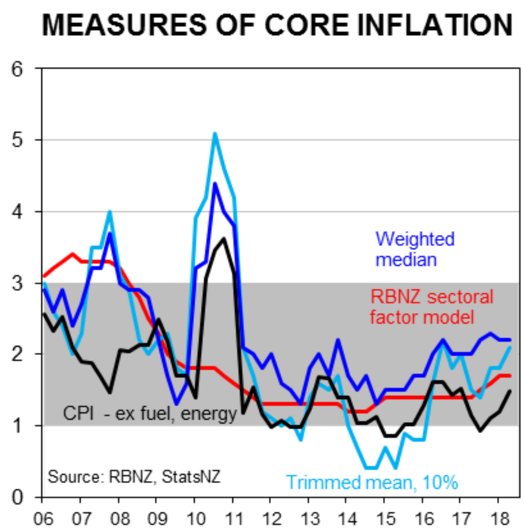
Underlying inflation measures hover around 2%

The CPI rose 0.1% qoq in the December quarter, slightly higher than our forecast, while lower than the RBNZ's 0.2% qoq forecast at the November Monetary Policy Statement.



CPI tradable prices fell 0.4% in Q4, (+0.9% yoy), which was more modest than we had expected. A softer than expected fall in petrol prices over the quarter (-0.6% qoq) weighed less on the headline CPI figure than we had expected. Prices for other vehicle fuels also unexpectedly rose 2.6% over the quarter.

Non-tradable CPI prices were also firmer than expected, rising 0.7% qoq (+2.7% yoy). The details highlighted relatively widespread price increases. **For a while now, non-tradable inflation had been largely contained to housing-related costs, but today's release suggests that these pressures are starting to spill out into the wider economy.** Prices from the health group rose 0.5% over the quarter, driven largely by a 1.2% increase in hospital services. Communication costs rose off the back of a 1.0% qoq lift in telecommunication services, and recreational and culture services also rose a strong 2.5% over the quarter, underpinned by broad-based increases amongst the components. These lifts came on top of still-strong increases in rents (+0.6%) and construction costs (+0.9%).



Various measures of underlying inflation produced by Statistics New Zealand firmed. Annual inflation from the 10% trimmed mean and weighted-median measures were both marginally above 2%, while CPI ex food, household energy and fuel lifted 0.6% over the quarter to be 1.5% higher annually. **However, annual inflation from the closely watched RBNZ sectoral factor model was unchanged at 1.7%,** the ninth consecutive year that inflation on this measure has been below 2%. **The upshot, however, is that inflation is firming on this measure, even if only at a gradual pace.** Over the last 9 years, the sectoral factor model has averaged 1.45%, but the last four quarters have seen the core model lift above this average. It suggests that the trend in underlying inflation is moving in the right direction, from the RBNZ's perspective.

However, the short-term outlook for headline inflation now looks modestly weaker. We expect lower fuel prices to have a more dampening impact on quarterly consumer price inflation in the first half of 2019. Our updated forecasts suggest that headline CPI inflation will move below 1.5% towards the second half of the year. **Moreover, economic momentum has slowed over H2 2018 and as a result, there is a risk that underlying inflation pressure could also ease in coming quarters.** Given the recent slowdown in economic growth and ongoing downside risks to the economic growth outlook, there is the risk that medium-term inflation slows from here and the OCR is cut. However, we think the RBNZ will remain patient for now. We continue to expect the RBNZ to leave the OCR on hold until August 2020.

Q4 2018 CPI %	**Actual**	ASB	RBNZ
CPI qoq	**0.1**	**0.0**	0.4
CPI yoy	**1.9**	**1.8**	2.0
Non-tradable qoq	**0.7**	**0.5**	0.4*
Non-tradable yoy	**2.7**	**2.6**	2.5
Tradable qoq	**-0.4**	**-0.6**	-0.1
Tradable yoy	**0.9**	**0.5**	1.0

**ASB estimate*

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6831	0.6725	0.6708	0.7334	FLAT	0.6700	0.6900	DOWN
NZD/AUD	0.9531	0.9420	0.9515	0.9062	FLAT	0.9400	0.9600	DOWN
NZD/JPY	74.67	73.59	74.15	79.71	FLAT/DOWN	73.5	75.5	FLAT
NZD/EUR	0.5977	0.5918	0.5854	0.5905	FLAT/UP	0.5900	0.6100	DOWN
NZD/GBP	0.9153	0.5220	0.5295	0.5185	FLAT/UP	0.5050	0.5300	UP
TWI	74.0	73.1	73.3	74.58	FLAT	73.5	75.5	DOWN

*^ Weekly support and resistance levels * Current as at 11.25am Tuesday; week ago as at Tuesday 5pm*

NZD Recap

Currency markets started last week on a quiet note, helped by the US market being closed on Monday (21st) for Martin Luther King Jr day. The NZ Q4 CPI on Wednesday saw the NZD lift against the USD and AUD after the release was slightly stronger than expected (1.9% yoy, +1.8% expected). The NZD/AUD held onto its gains on Thursday, despite the slightly stronger than expected Australian employment report (unemployment dipped to 5%). There was also some volatility on the euro last week. The European Central Bank (ECB) left rates on hold as expected, but ECBs President, Mario Draghi's, cautious tone during the press conference weighed on the euro. Draghi noted that risks to the Eurozone had shifted to the downside, citing geopolitical factors, protectionism and financial market volatility. The NZD rose again over the long weekend (Auckland and Australian public holiday on the 28th), following a shift higher in the Chinese yuan, to finish the week higher against most major currencies we monitor.

Near-term outlook

Offshore catalysts will be the key driver of NZD movements this week. On Wednesday the UK House of Commons will vote on amendments to the Brexit deal. With the Brexit deadline fast approaching (29 March) market participants will be increasingly sensitive to Brexit developments. Elsewhere, high level China-US trade talks this week will also be in focus. Concerns are growing that the US-China trade war is having increasingly real-world consequences with corporate profits the latest perceived casualty. Finally, this week's US Federal Reserve rate announcement on Thursday morning will likely drive NZD/USD volatility on the day. Outside of these events, key data such as the Australian CPI (Wednesday), US Q4 GDP (Thursday) and US core personal consumptions and expenditure deflator (Friday) would also cause volatility in the NZD/USD and NZD/AUD.

Medium-term outlook

We have a strong USD outlook given the solid US growth outlook, high US Terms of Trade, and the weaker Chinese and emerging market outlook. We expect the NZD to oscillate in a 65 to 71 US cent range over the forecast period. Nevertheless, the NZD TWI should remain broadly supported by a solid growth outlook, our historically-high Terms of Trade and upwardly drifting NZ interest rates. The NZD/AUD has strengthened recently, but we expect the NZD/AUD to slowly grind lower over 2019 as the RBA is still expected to start tightening monetary policy ahead of the RBNZ. We expect the NZD to ease slightly over the projection period relative to EUR. The European Central Bank is expected to hike rates in September 2019, although slow growth in the Eurozone will limit the extent of ECB tightening. We also expect that Brexit risks will keep the GBP low against the NZD.

ASB foreign exchange forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.66	0.67	0.66	0.67	0.68	0.70	0.66
NZD/AUD	0.92	0.95	0.90	0.91	0.91	0.90	0.90
NZD/JPY	75	74	74	74	73	75	74
NZD/EUR	0.57	0.59	0.58	0.57	0.55	0.55	0.54
NZD/GBP	0.51	0.53	0.53	0.53	0.53	0.54	0.51
NZD TWI	72.1	73.5	72.0	72.4	72.3	72.9	70.2

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	1.91	1.88	1.99	1.88	FLAT	UP
2-year swap	1.91	1.92	1.98	2.18	FLAT	UP
5-year swap	2.12	2.15	2.23	2.70	FLAT	UP
10-year swap	2.58	2.62	2.67	3.22	FLAT	UP
10-year govt bond yield	2.33	2.33	2.39	2.92	FLAT	UP
Curve Slope (2s10s swaps)	0.67	0.70	0.69	1.05	FLAT	FLAT

** Current as at 9.55am today; week ago as at Monday 5pm*

Market Recap

NZ wholesale interest rates are lower than a week ago, with the curve under flattening pressure. Local and global interest rates briefly rose following the end of the 35-day partial US government shutdown on Friday. The underlying details of the NZ CPI were generally firmer than market expectations, despite contained core inflation from the RBNZ sectoral factor model (+1.7% yoy). **This week has seen global yields and equities ease amid concerns over global growth and fading optimism that a trade deal between the US and China will be struck**, with the People's Bank of China providing more policy support and with China reportedly seeking the World Trade Organisation block US tariffs. In an attempt to win UK parliamentary support, PM May has effectively abandoned the earlier agreement with the European Union (EU), by indicating she will strip out the Irish backstop. Weak economic data from the Eurozone **and the cautious monetary policy messages highlighted the risks of further pushing out of policy normalisation, supporting lower global yields**. The ECB held policy settings last week, but ECB President Draghi has vowed that the ECB would use all tools in its policy arsenal to support slowing growth.

Near-term NZD interest rate outlook

We have a neutral bias for local interest rates. Our OCR view suggests markets will likely continue to trim the 13bps of RBNZ rate cut expectations priced in. However, with NZ annual headline CPI inflation likely to remain well below 2% over 2019, we expect markets to remain biased towards a lower OCR. Australian CPI inflation is expected to remain low (CBA: 1.6% yoy), dampening Australian yields. **There is scope for volatility in both local and global yields.** The outcome of trade meetings this between the US and China will be pivotal. On Thursday, the FOMC is expected to hold monetary settings, with Fed Chair Powell to emphasise "patience" in resuming policy tightening at his press conference. Tomorrow, UK MPs will debate and vote on the revised Brexit deal, which risks being rejected by the EU. Q4 US GDP, the PCE deflator, Non-farm Payrolls and the ISM manufacturing survey, along with Eurozone Q4 GDP will be closely watched. NZ long-term yields remain low on an outright basis, with 10-year bond yields (2.33%) well below US counterparts (2.74%). Despite mixed result from last week's tender of the NZ 2039 bond, **slowing global growth and the downward risk profile could further dampen longer-term yields lows and flatten curves.**

Medium-term outlook

Given our low outlook for core inflation, we expect the OCR to remain on hold until August 2020. Our view is that the medium-term inflation outlook will not be strong enough to trigger OCR hikes. Proposed higher bank capital requirements will likely tighten financial conditions, although the hurdle to OCR cuts still remains reasonably high. **We expect a historically-low OCR endpoint of just 2.75% this cycle** (from late 2021). NZD long-term yields are expected to gradually firm and move above US counterparts, but mild RBNZ tightening, contained NZ inflation, and the strong allure for NZ assets should cap NZ yields at low levels.

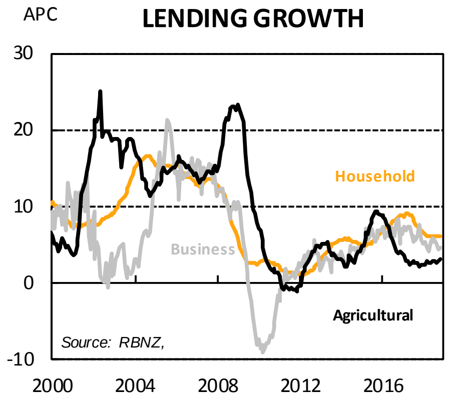
ASB interest rate forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.75	1.75	1.75	1.75	1.75	2.25	2.75
NZ 90-day bank bill	1.9	2.0	2.1	2.1	2.1	2.5	3.0
NZ 2-year swap rate	2.0	2.0	2.3	2.4	2.7	3.0	3.2
NZ 10-year Bond	2.7	2.4	2.9	3.0	3.3	3.4	3.4

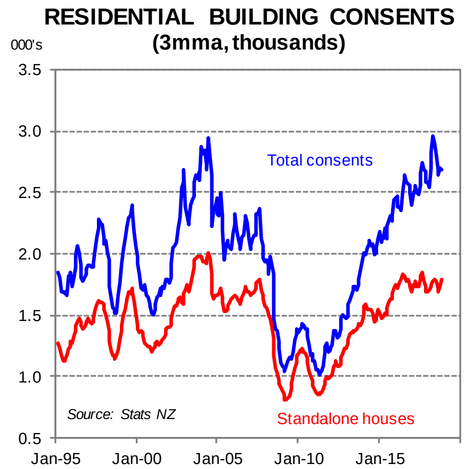
Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
RBNZ Credit Aggregates, Household, Dec, %mom	31/1	3:00 pm	0.6	-	-
Building consents, residential, Dec, %mom	4/1	10.45 am	-2.0	-	-

Household credit growth is expected to slow slightly in December, after a stronger than expected November result. We expect weak sales activity in the housing market over November/December to dampen mortgage credit growth. Agricultural credit growth has been gradually increasing and we expect this trend to continue. Business credit growth has been subdued, reflecting soft business confidence. With no strong turnaround in business confidence yet evident, we expect business credit growth to remain below recent averages.

Residential consents fell 2% in November and consents issued are likely to remain subdued in December (reflecting the relatively short number of working days in December ahead of the Christmas break in 2018). Residential consents have remained broadly flat over the past six months, albeit down on the highs earlier in 2018. We expect residential housing construction to remain relatively elevated for some time in order for housing supply to catch up with pent-up demand. Meanwhile, there are no signs of a slowdown in commercial construction demand despite weak business confidence levels seen over the year. Non-residential consents typically fall during January and February, and sometimes this weakness can start early in December.





Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
AU CPI, Q4, %qoq	30/1	1:30 pm	0.4	0.4
EU GDP, Q4, %qoq	31/1	11:00 pm	0.2	0.2
US GDP, Q4, %saar	31/1	2:30 am	2.6	2.5
US Fed Fuds Rate, %	31/1	8:00 am	2.25-2.50	2.25-2.50
US PCE deflator, Dec, %yoy	1/2	2:30 am	1.7	1.6
EU CPI, Jan, %yoy	1/2	11:00 pm	1.4	1.5
US Non-farm Payrolls, Jan, 000's	2/2	2:30 am	180	150
US ISM Manufacturing, Jan, index	2/2	4:00 am	54	53.5

**Originally published by CBA Global Markets Research on Friday 25h January 2019 at 1.30pm.*

AU Q4 CPI: We expect headline inflation to lift by 0.4% qoq in Q4. This result would see the annual rate of inflation fall to 1.6%. A 2.4% qoq fall in petrol prices will weigh on headline inflation this quarter. We expect a stronger 0.5% lift in underlying inflation in Q4, which would see the annual rate tick down to 1.8%. Low inflationary pressures mean that the RBA is likely to sit of the side-lines for most of this year.

FOMC policy announcement: We expect the FOMC to keep monetary policy unchanged because the US and global economic outlook has deteriorated. We expect Chair Powell to emphasise “patience” in resuming policy tightening at his press conference.

US Q4 GDP: The US government shutdown has reduced the amount of official economic statistics released in the past month. Nevertheless, the data and surveys released so far indicate US economic growth has slowed from Q3’s strong 3.4% rate.

US PCE deflator: We estimate the large falls in retail gasoline prices pushed headline inflation lower in December to 1.6% yoy. But core inflation should remain at 1.9% yoy, or even lift to 2.0% yoy, because the tight labour market is pushing up wage growth.

US Non-farm Payrolls: Following December’s very strong increase in Non-farm Payrolls, we expect payrolls to expand by a still-solid 150,000 in January. This will be enough to push the unemployment rate to only 3.8% and for average earnings to accelerate again to 3.4% yoy.

US ISM Manufacturing Index: The regional manufacturing surveys suggest the national ISM eased again in January after the very large slump in December. But, at 53.5pts, the ISM would still comfortably be in expansionary territory.

Eurozone Q4 GDP: High-frequency leading indicators and the slowdown in external demand are consistent with muted GDP growth of around 0.2% qoq in Q4.

Eurozone CPI: Lower energy prices point to a further slowdown in headline Eurozone CPI inflation towards 1.5% yoy in January from 1.6% yoy the previous month. But an improving wage growth dynamic suggest core CPI inflation will remain sticky near 1% yoy in January.

Key Forecasts

ASB NZ economic forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
	<< actual	forecast >>					
GDP real - Q%	0.3	0.5	0.8				
GDP real - A%	2.6	2.4	2.6	2.5	3.3	3.0	2.9
GDP real - AA%	3.0	2.8	2.7	2.5	3.0	3.1	2.9
CPI - Q%	0.9	0.1	0.1	0.5			
CPI - A%	1.9	1.9	1.5	1.6	2.0	1.8	2.1
HLFS employment growth - Q%	1.1	0.1	0.5	0.4			
HLFS employment growth - A%	2.8	2.4	2.4	2.2	1.7	1.6	1.4
Unemployment rate - %sa	3.9	4.2	4.1	4.1	3.9	3.8	3.7
Annual current account balance as % of GDP	-3.6	-3.9	-3.8	-3.9	-3.9	-3.7	-3.8

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	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.75	1.75	1.75	1.75	1.75	2.25	2.75
NZ 90-day bank bill	1.9	2.0	2.1	2.1	2.1	2.5	3.0
NZ 2-year swap rate	2.0	2.0	2.3	2.4	2.7	3.0	3.2
NZ 10-year Bond	2.7	2.4	2.9	3.0	3.3	3.4	3.4

ASB foreign exchange forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.66	0.67	0.66	0.67	0.68	0.70	0.66
NZD/AUD	0.92	0.95	0.90	0.91	0.91	0.90	0.90
NZD/JPY	75	74	74	74	73	75	74
NZD/EUR	0.57	0.59	0.58	0.57	0.55	0.55	0.54
NZD/GBP	0.51	0.53	0.53	0.53	0.53	0.54	0.51
NZD TWI	72.1	73.5	72.0	72.4	72.3	72.9	70.2

ASB Economics & Research			Phone
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5657
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
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Economist	Kim Mundy	kim.mundy@asb.co.nz	(649) 301 5661
Publication & Data Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

www.asb.co.nz/economics

@ASBMarkets