25 January 2018

Seeing Through the CPI's New Clothes

- **Q4 CPI "shockingly" slows to 1.6% y/y**
- **Principally as tradables inflation sags anew**
- **Core inflation measures mixed**
- **We don't see low inflation as any sign of trouble**
- **Still, we delay our OCR hike call to February 2019**

It's rare for the Consumers Price Index to miss market expectations by more than a point or two. So today's 0.3% deviation, to the downside, could be seen as "shocking". It meant annual CPI inflation dipped to 1.6% instead of staying at 1.9% as the market, and we, expected.

Sure, the RBNZ, in its November Monetary Policy Statement (MPS), was looking for 1.8%, and, more to the point, a slowdown to just 1.5% for Q1 2018. However, it also forecast annual CPI inflation to pop back up to 2.1% in Q2 2018 (and to stay around the middle of the 1.0 to 3.0% target band over the remainder of the forecast horizon). Today's CPI outturn undermines this profile, at least for the foreseeable future.

Granted, it remains to be seen what the Bank will project on the CPI at its 8 February MPS. However, for what it's worth we now expect annual inflation to subside to 1.2% in Q1 (as a chunky quarterly gain from a year ago drops out) and stay there in Q2. This is 0.3% lower than we previously thought – as we largely "accept" the miss in Q4, and with a mind to the way the upward creep in the exchange rate in the New Year (so far) will keep downward pressure on tradables prices within the CPI.

Speaking of which, it was the tradables part of the NZ CPI that drove the "disappointment" in the Q4 CPI – at least relative to our expectations. This, in particular, related to relatively big falls in the prices of clothing, along with other items with strong import content or competition, for example appliances, home-wares, new cars, and medical supplies.

Food prices fell only slightly more than we figured, based on the monthly food price index (confirming no dramas on the transition to the new weights).

Indeed, in general, we don't believe the recent re-weighting of the CPI had much, if anything, to do with the surprisingly low outturn for the December quarter. It wasn't as if the new weights should have been any

Consumers Price Index - 2017 Q4				
	Actual	Mkt Pick	May MPS	Q3
CPI - qtly % chg	**+0.1**	+0.4	+0.3	**+0.5**
CPI - ann % chg	**+1.6**	+1.9	+1.8	**+1.9**

surprise to anyone – they were published back on 12 December. It seemed more a case of the extent of deviation in some of the CPI components.

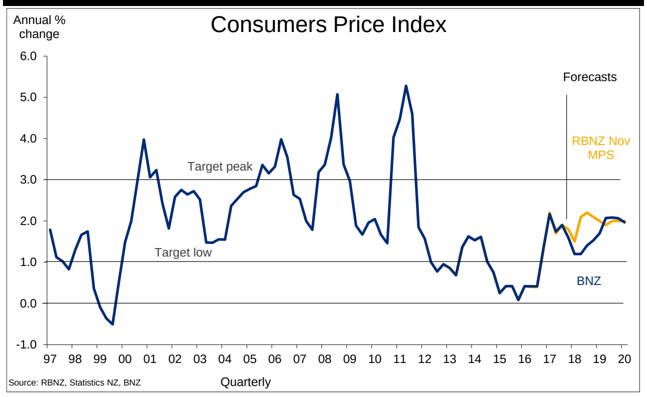
So tradables, inflation slowed to 0.5% y/y in Q4, from 1.0% in Q3. The RBNZ anticipated it to stay at 1.0% (and that was before the general increase in fuel prices that occurred since the November MPS was finalised).

Non-tradables inflation, on the other hand, printed at 2.5% y/y in Q4. This was a fraction above Reserve Bank expectations, of 2.4%. But any thought that this might please the Bank on the core inflation front was undermined by the weighted-median, and trimmed-mean, versions. These, while noisy in Q4 (as they traversed to the new CPI weights), weren't as wholly robust as they were in Q3. The weighted-median, for example, stayed at 2.0% on an annual basis but posted a quarterly gain of just 0.1%. And the trimmed-mean broadly eased into the range of 1.7 to 1.9%, y/y, and 0.2 to 0.3% q/q – depending on what sized tails you prefer.

As for the RBNZ sectoral factor model version of (underlying) inflation, it remained steady at 1.4% y/y.

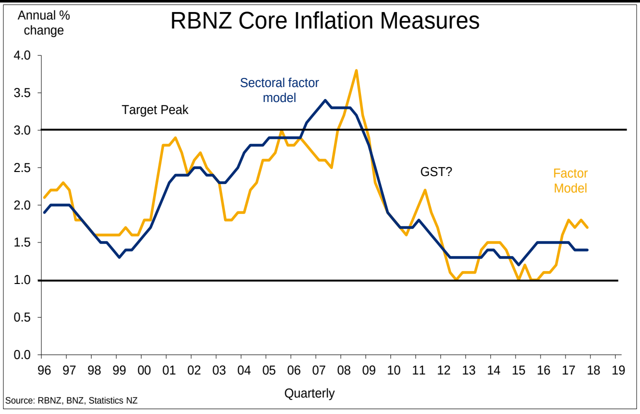
To its credit, the Reserve Bank has been talking up the flexibility it has in achieving its CPI inflation mandate

Mind The Gap



National Australia Bank

Lagging



(similar to the rhetoric from the RBA of late). Still, a sustained period of low-balling headline CPI inflation can only reinforce the refrain (for lifting its cash rate) that the Bank outlined in November.

With this, we will also need to keep an eye on inflation expectations variables, all over again. As it happens, the RBNZ quarterly survey of (inflation) expectations is due early next month.

To be sure, we haven't resiled, one bit, from our broader argument that central banks are likely over-reacting to the subdued CPI inflation we are seeing, and the factors behind it. Today's CPI result doesn't tell us of any "problem" in or for the economy, and certainly nothing the Bank could directly counter with its short-term interest rate management.

It does make you wonder if there will come a point when interest rate decisions won't be so heavily influenced by CPI inflation itself?

Nonetheless, we again find ourselves demarcating what we think the Bank should do, from what we think it will do over the nearer term. And the latter is leaning to further delay. We were already highlighting the increasing risk that the Bank was unlikely to start hiking as soon as August. This was partly on the belief that GDP growth in Q4 and Q1 is likely to undershoot November MPS expectations, along with the view CPI inflation would "disappoint" the Bank too. The boisterous NZ currency this year (so far) - in spite of central banks globally becoming variously less dovish - won't help the cause.

Today's CPI result simply adds more straw to the camel's back. So we formally delay our rate hike call on the RBNZ, now starting February next year (previously August 2018), while maintaining the +25bps per quarter profile after that, meaning the peak of 3.00% also now occurs six months later, in February 2020.

We had thought about delaying the start point simply to November this year. This was mindful of the likes of 1) the intensifying capacity constraint signals from the real economy, 2) the fiscal stimulus gathering steam this year, 3) wage inflation that will radiate from the new government's policies, 4) a housing market that might not be as chilled as the RBNZ expects and 4) the broadening global pulse around economic growth and inflation. But in the end we decided to "get in front" of how the RBNZ is likely to play and see things, and monitor the risks accordingly.

This, of course, is the way the markets have recently been playing the RBNZ as well. So today they have backed off the November OCR hike they were entertaining, as pricing for a first full hike drifts into early 2019. Accordingly, the NZD has struggled today too, coming off the best part of cent against USD (and AUD) on the Q4 CPI result. Still, the currency has been generally on the up through January – threatening to keep a cap on headline CPI inflation and thus perceived central bank response.

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