16 October 2018

CPI Target Achieved

- **Annual headline inflation 1.9%**
- **Q4 will burst through 2.0%**
- **Underlying inflation contained**
- **But non-tradables inflation headed for rate hike territory**
- **Hurdle for rate cuts gets higher by the day**

Mark September quarter 2018 in your diaries as the last quarter, for at least a year, when you will witness annual headline CPI inflation beneath 2.0%. Today's 0.9% quarterly reading (1.9% annual) for the September quarter provided further support for our view that not only will inflation push past the RBNZ's target band mid-point this year but that it will stay there for all of 2019.

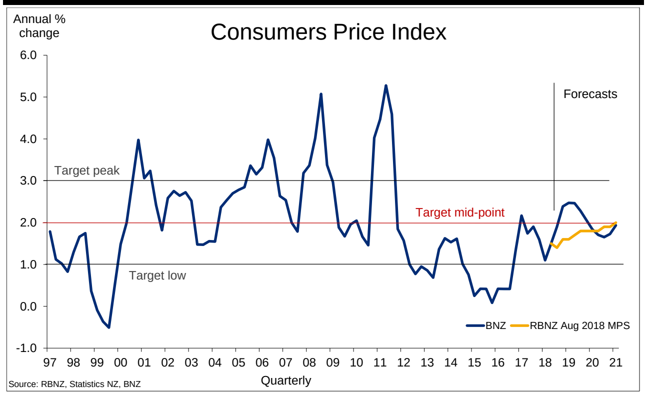
This means inflation will hit target more than two years ahead of when the RBNZ had postulated when it put together its August Monetary Policy Statement. All and sundry have jumped on the bandwagon and suggested that the "miss" should be ignored because it was just a matter of surprise petrol price increases. To an extent, we concur. Petrol prices rose 5.5% in the quarter and are up 18.6% for the year. This means, if you exclude petrol, annual inflation is just 1.1%. But to do this is only looking at one small piece of a much bigger picture.

To start with, the hike in the headline inflation rate is likely to feed through into higher inflation expectations. The Reserve Bank itself has acknowledged that inflation expectations have become more adaptive in their nature over time. Higher inflation expectations, in turn, tend to feed through into heightened actual inflation as they impact price and wage setting behaviour.

The potential impact on these behaviours is exacerbated in the current environment as businesses suffer from margin pressure (in part because of the very same rising fuel costs) and employees bid for inflation compensation at a time when the labour market is already very tight and encourages heightened wage claims. One of the lessons of the 1970s oil price shock was that central banks were slow to react to second round impacts of the shock which built upon the broader increase in inflation that was underway.

But this is probably the lesser of our concerns. Our bigger issue is that non-tradables inflation is not only headed higher but at a greater pace than anticipated by the RBNZ.

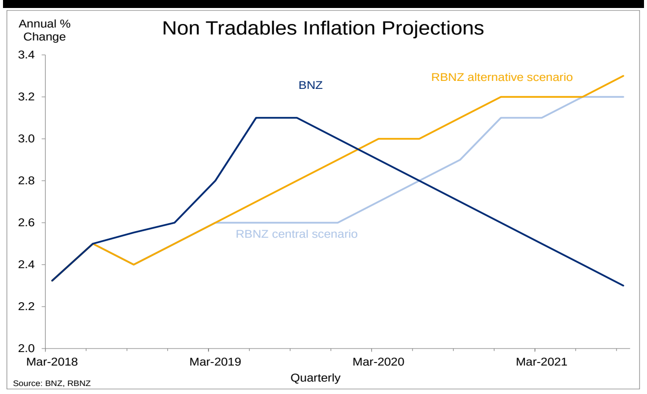
CPI Target Achieved



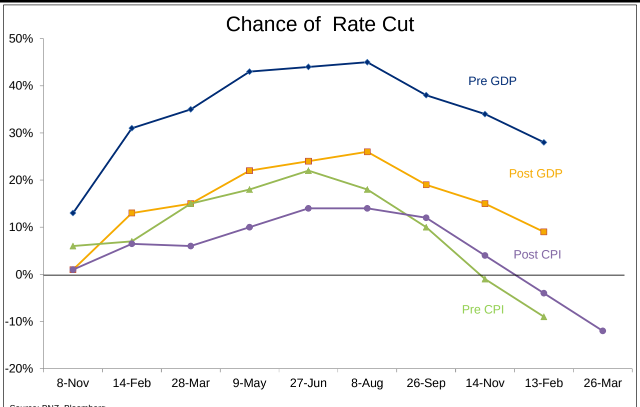
Non-tradables prices rose 0.8% in Q3 to be 2.6% up on a year earlier. This was 0.2% higher than RBNZ expectations and none of this could be blamed directly on fuel costs. You have to go back to Q2 2014 to find a reading higher than the current one. What's more, we think that this measure will be inflating at more than 3.0% by mid-2019.

We continue to be amazed by the fact that market participants only seem to have contemplated one of the alternative scenarios that the RBNZ produced in its August MPS – namely the one that said that if growth surprised on the downside that the Bank would be looking to cut rates. But the other scenario that was published, in the very same document, states that if non-tradables inflation surprises to the upside then the Bank would be forced to tighten. In terms of that scenario, a 0.3% surprise (starting from Q2 2019) results in a cash rate 50 basis points higher than the RBNZ's central scenario.

The Overlooked Scenario



Still Looking For Cuts



Source: BNZ, Bloomberg

As things stand, two-thirds of that surprise is already there and it has happened more than a year earlier than anticipated. Moreover, if our forecasts are correct, then the full extent of the surprise is likely to climb to over 0.5% at its peak. And by the way, while the upside surprise to inflation is already there, GDP growth also surprised the RBNZ significantly to the upside.

For the record, we are forecasting Q3 GDP growth of 0.8%, which will leave the level of economic activity still 0.5% above the RBNZ's track. For Q4, our early CPI pick is 0.6% compared with just 0.3% from the RBNZ. There may be some downside risk to our call but inflation would have to fall miles below our expectation to offset any of the pressure implied by today's outturn.

At least the market reaction was, in our opinion, in the "right" direction. The short end of the rates market sold off around 2.5 basis points and the NZD is up around 30 basis points against the USD. But this still leaves the market believing in a greater chance of an easing than a tightening next year and the currency remains a tad below the RBNZ's assumed level.

The big question, of course, is what is the RBNZ to do with this? We think the Bank will defend its decision to adopt a more dovish stance when it pushed its tightening out at the time of its August MPS. We said at the time that we thought that was an unwise decision because we feared that both growth and inflation would surprise the RBNZ to the upside. This is exactly what has happened.

Ironically, in this regard, it was the upside in growth that matters most as the Bank had pushed back its tightening cycle on the premise that the Q1 growth reading had surprised to the low side implying more spare capacity in the economy and, hence, lesser inflationary pressure. The Q2 GDP outturn would (all other things being equal) demand a complete reversal of this stance.

But all things never are equal and the Bank will not be keen to perform such an about face. Consequently, we believe the Bank's line will run something along the lines of:

- Happiness that 2.0% inflation has been achieved
- Inflationary expectations are still well anchored
- Core inflation measures remain subdued
- Most of the upside surprise in measured inflation is one off in nature so, provided there are no signs of significant pass through, it can be looked through
- Similarly, any impact from a weakening currency can be looked through
- International financial market volatility suggests heightened global risks
- Global growth looks like it may have peaked
- Dairy prices are under pressure
- Business confidence is weak

Accordingly, the Bank will likely see fit to maintain an unchanged interest rate track.

Be that as it may, the Bank's inflation and growth picture will have to be adjusted to cater for the published data. More importantly, we continue to believe the conditions for heightened inflation will build further and that, eventually, the RBNZ will have to acknowledge this.

Our central forecasts still have rate increases penciled in for the second half of next year. We won't thump the table on this as any number of things could upset the apple cart between now and then. Nonetheless, we will continue to push the message that the hurdle for a rate cut is much higher than many care to believe, and those who are quick to dismiss there being any chance of a rate hike do so at their peril.

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