Core Inflation Converging Up Close To 2%

- Core inflation firming up around 2% y/y
- Still, CPI likely to slow to 1.5% by end-2019
- After today’s 1.7% y/y result for Q2, as expected
- RBNZ still biased to cut again in August
- As markets (unmoved by CPI) keep pricing
- But interim data could provide crunch points

The news in morning’s June quarter CPI was that core inflation was converging up close to 2% per annum, if it wasn’t there already. This is important given annual headline CPI inflation itself is likely to dip to 1.4% in Q3, and 1.5% in Q4 this year. This, after the 1.7% it printed at today, based on a quarterly result of 0.6%.

As such, the Q2 CPI was in line with market expectations and those of the Reserve Bank's May Monetary Policy Statement (MPS). For the record, we anticipated 0.5% inflation for the quarter, and 1.6% for the year, but not on any story that inflation is, in any serious respect, unacceptably slow. It was more a rounding issue, as it turned out.

The RBNZ rightly anticipated the annual rate of inflation in the non-tradables part of the CPI also, namely 2.8% (unchanged from Q1). Note: while it printed quarterly inflation of “only” 0.3%, compared to 1.1% in Q1, this reflected seasonality. The seasonally adjusted non-tradables CPI rose 0.7% in Q2, the same as it did in Q1.

While this gave a sense of underlying inflation being exactly in line with RBNZ expectations, other measures of core inflation took a definite step upwards in Q2. This was significant, as some of them did look a bit wobbly in Q1, at face value.

For instance, trimmed-mean inflation in Q2 was 0.7%, after 0.1% in Q1. Its annual pace nudged up to 2.0%, from 1.8%. This was at a 10% cut-off. But it was a similar story at increased rates of trim. And the 30% trimmed-mean measure the RBNZ frequently references printed annual inflation of 2.1% in Q2, after 1.9% in Q1.

The (less-volatile) weighted-median CPI increased 0.5% in Q2, following 0.4% in Q1. This nudged its yearly pace up to 2.3%, from 2.2%.

In addition, the CPI ex food on energy rose to 1.7% y/y, - from 1.5% - bearing in mind the RBNZ puts some store in it, and that it was running at 0.9% early last year.

There was also a clear increase in the proportion of prices that increased during the June quarter – whether compared to the March quarter, or the June quarter of last year.

With all of this, including the robustness in non-tradables inflation, there seems a good chance that the sectoral factor model measure of inflation increases a touch in Q2, from the 1.7% y/y it remained at in Q1. Also bear in mind the potential for recent history to be revised. Having said this, it’s a difficult measure to guess. The RBNZ will publish its findings at 3pm.

To the extent that core CPI measures are converging up close to 2% per annum – as many of them are already – it gels with the middling inflation we’re seeing in the labour market. The Labour Cost Index – which is more like a unit wage cost – is running close to 2%, for example. The nominal measures – like the unadjusted LCI and average hourly earnings measure from the Quarterly Employment Survey – are more in the realm of 3.5% y/y.
We Take The High Road

In terms of the details of the headline Q2 CPI, there were some surprises for us to note. The price of clothing was stronger than we expected, along with furniture and furnishings. There was also another noticeable increase in the price of appliances that we hadn’t figured on.

On the other hand, there was softness in vehicle prices, and transport costs (in spite of fuel prices rebounding in Q2, much as we thought). There was also a slightly slower tone in construction inflation, as it pertains to the residential/household side of things, albeit hardly weak.

As for rents, these increased 1.0% in the June quarter, as we expected. This was as Statistics NZ introduced its new measure – one which has been exhibiting higher inflation than the incumbent index Statistics NZ has just moved from. So it was no wonder its Q2 outturn posted the strongest inflation in many years. This momentum will carry on for the meantime, given ongoing pressure on the housing stock. This will feed underlying inflation measures.

In spite of some unders and overs in the detail, there was nothing in today’s CPI to have us changing our inflation forecasts. All that has really happened is that we have been rounded up an index point as a starting point, such that we now see annual CPI inflation of 1.4% in Q3, 1.5% in Q4 and 1.9% in Q1 2020.

As mentioned, this won’t be a great look for the RBNZ over the near term, and those who try to anticipate its OCR moves. And a weak-looking headline CPI could well conspire with slow GDP, and patchy employment, in Q2, along with a global backdrop struggling to rebound, to nourish the idea of another 25 basis points cut to the Official Cash Rate at the August MPS. This certainly remains our bias.

Still, looking through to next year, CPI inflation stands a good chance of trundling along around the mid-point of the Bank’s 1.0 to 3.0% target band is looking. In support of this, core inflation rates of inflation are converging around 2.0% already (including in wages and salaries).

As for market reaction to this morning’s CPI report it was muted (to say the least). NB: there were some Dow Jones headline results initially scrolling (on Bloomberg) which looked to have muddled the Q1 and Q2 results. But with all confirmed, the market is left well over the line for a rate cut in August along with a half-chance of a further cut, to 1.00%, by November. That’s a reasonable way of playing it for now. But appreciate the potential for interim data points to shunt things around – this way or that.
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