20 April 2017

Core Inflation More Than Apples

- Inflation highest since 2011
- Significantly higher than RBNZ forecasts
- Higher inflation doesn't look like an aberration to us
- Core measures push above 2%
- Questions how long OCR can stay at 1.75%

Consumers Price Index - 2017 Q1

	Actual	Mkt Pick	Feb MPS	Q4
CPI - qtly % chg	**+1.0**	+0.8	+0.3	**+0.4**
CPI - ann % chg	**+2.2**	+2.0	+1.5	**+1.3**

The key message from today's consumer price inflation figures is that core inflation is rising and has poked above 2% on some measures. That is more important than the headline annual inflation rate jumping up to 2.2% in Q1, or the specifics around which prices rose this particular quarter. That said, higher headline inflation is relevant to the extent that it is likely to influence inflation expectations. Keep watch for indicators on the latter over coming months and quarters.

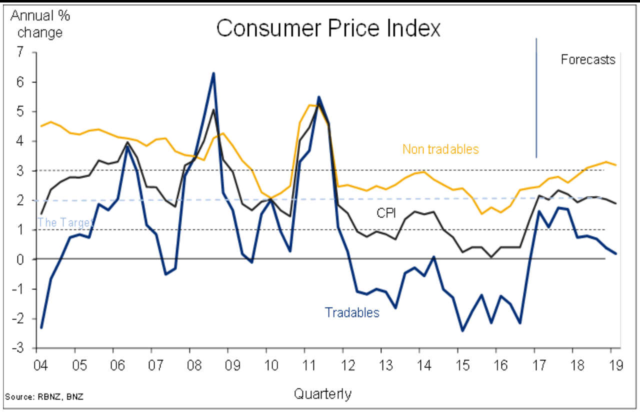
Today's inflation figures were higher than market expectations; expectations that had already been shunted higher over recent months. It was only a couple of short months ago that we felt alone picking materially higher annual inflation for this quarter. In the end, Q1's result surpassed the market's 2.0% expectation and our 2.1% estimate. Annual inflation has lifted to its highest level since 2011.

It is a similar story for the RBNZ. While the RBNZ acknowledged a likely higher CPI in its March OCR review, the degree of lift was probably still a surprise on the day. In any case, the Bank will have to build today's higher starting rate of inflation into its full set of forecasts for its May MPS, compared to the 1.5% it expected for this quarter when it published its February MPS.

At its March OCR Review, the RBNZ said 'Headline CPI will be variable over the next 12 months due to one-off effects from recent food and import price movements, but is expected to return to the midpoint of the target band over the medium term'. That is the Bank effectively saying that it will look through near term results driven by 'one-offs', seeing them as an aberration.

We are not convinced the higher inflation is an aberration. Indeed we expect annual inflation to be about 2% or above over the coming year or two. This outlook is

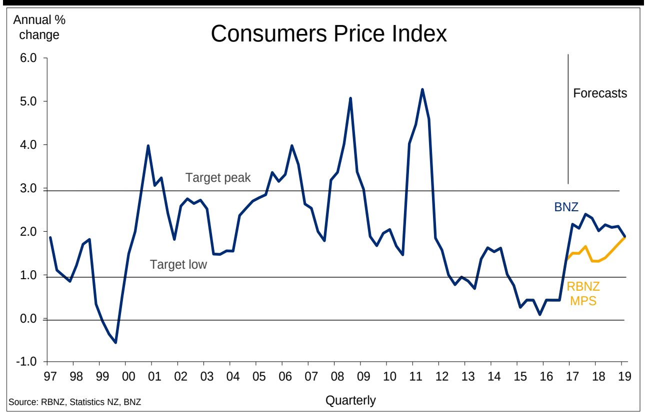
Watch Rising Non-Tradable (and Core) Inflation



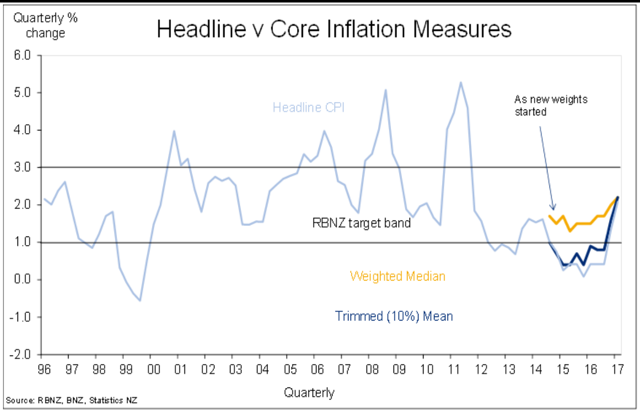
materially higher than the RBNZ had forecast back in February.

The bank will also have to factor in a materially lower NZD than was included in its previous projections. Even after this morning's pop higher, at 76.7, the NZ TWI sits nearly 3% below where the RBNZ projected it to average through Q2. It is important to note that this has occurred without weakness in key primary export product prices indicating a genuine easing in monetary conditions from the external channel. This mix adds upside to the Bank's previous tradable inflation forecasts. So too will the indirect effects of global inflation pushing higher including the likes of higher producer price inflation in China (even after adjusting oil and currency movements). All this as tradable annual inflation has just printed its first meaningfully positive result in five years.

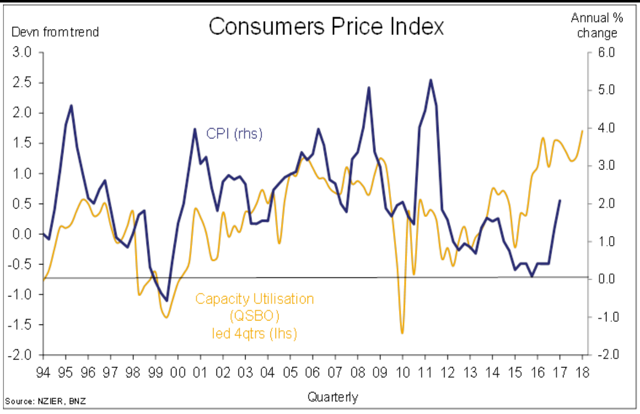
Inflation Outlook Higher Than RBNZ Projections



Core Inflation Jumps



Capacity Pressures Evident



Tradable annual inflation increased to 1.6% in Q1, its highest result since 2011. It was only six months ago that the RBNZ was projecting another negative result for this quarter. If nothing else, this illustrates the speed of potential change in this component and in itself cautions against over reacting to it in a knee-jerk fashion. This seems to be the RBNZ logic, especially as it sees heightening uncertainty overseas. But equally, we need to be aware of the positive undercurrents stemming from offshore especially as it has been the (deflating) tradable component that has been generally holding the CPI low over much of the past five years. Of course, the RBNZ has little direct and sustainable influence on tradable inflation. But it still matters. Higher current inflation is important in its own right, whatever the cause, as it can influence the likes of inflation expectations and wage negotiations.

Inflation can beget inflation, in other words. It is this dynamic that we think needs careful monitoring. It is easy to imagine inflation expectations continuing to edge higher given today's result.

Importantly, inflation seems to be becoming more broad-based over and above the particular moves this quarter such as strong, and expected, gains in petrol, food and cigarettes and tobacco (the latter on the back of an increase in excise duty). Indeed, some of these may not be all 'one-off' in nature.

Take food for example, no doubt some of the gains might be undone in time like the big jump in apple prices in January that has already unwound. Incidentally, there is potential for some other near term sharp food price increases as the impact of recent storms are felt, but, in our view, there is some genuine upward food price pressure stemming from the combination of offshore pricing and currency movements that is still to show up at the grocery store this year.

The more salient point is that core inflation is rising and even edging above 2% on some measures. For example, annual inflation at the 10% trimmed mean level was 2.2%, up from 1.6%, while the weighted median also rose to 2.2% from 2.0%. The exception to higher core inflation measures was annual CPI excluding food and energy that remained at 1.6% in Q1. We await the factor models that the RBNZ publishes around 3pm this afternoon for further guidance on core inflation.

Housing related annual inflation remained steady at 3.3%, with accelerating rents offsetting some deceleration elsewhere. More generally, non-tradable inflation rose to 2.5%, up from 2.4% in the previous quarter and higher than the RBNZ's 2.3% forecast. The RBNZ is less likely to look through higher core inflation and the non-tradable surprise.

In the first instance, the RBNZ may well feel relieved that inflation has lifted back to around the mid-point of the target band after being below it for so long. And the Bank will also be wary that recent GDP growth undershot expectations and retail interest rates have been pushing higher independent of the OCR. In other words, not all recent data have been pointing to more inflationary pressure ahead. But today's figures do ask serious questions of the RBNZ's view that it will hold the OCR steady until late 2019. Indeed, on today's inflation figures, and clear and increasing pressure on existing capacity evident from the likes of the latest Quarterly Survey of Business Opinion, our own view of a May 2018 OCR lift off from very low levels could even be a tad late but we will stay there for now. The RBNZ may still see uncertainty overseas, but the domestic inflation picture is starting to press.

Understandably, higher inflation (including core) has seen the market build in an earlier tightening by the RBNZ than it had yesterday. Not a major change, given the market has already been pricing interest rate hikes significantly before the RBNZ has indicated. For example, the 2-year swap rate lifted around 4bps shortly after the data. Meanwhile, the NZD/USD rose around 40 pts to around 0.7040. Both moves seem a fair response to today's information.

Doug_Steel@bnz.co.nz

Contact Details

BNZ Research

Stephen Toplis	Craig Ebert	Doug Steel	Kymberly Martin	Jason Wong
Head of Research	Senior Economist	Senior Economist	Senior Market Strategist	Currency Strategist
+(64 4) 474 6905	+(64 4) 474 6799	+(64 4) 474 6923	+(64 4) 924 7654	+(64 4) 924 7652

Main Offices

Wellington	Auckland	Christchurch
60 Waterloo Quay	80 Queen Street	111 Cashel Street
Private Bag 39806	Private Bag 92208	Christchurch 8011
Wellington Mail Centre	Auckland 1142	New Zealand
Lower Hutt 5045	New Zealand	Phone: +(64 3) 353 2219
New Zealand	Phone: +(64 9) 976 5762	Toll Free: 0800 854 854
Phone: +(64 4) 473 3791	Toll Free: 0800 081 167	
FI: 0800 283 269		

National Australia Bank

Peter Jolly	Alan Oster	Ray Attrill	Skye Masters
Global Head of Research	Group Chief Economist	Global Co-Head of FX Strategy	Head of Interest Rate Strategy
+(61 2) 9237 1406	+(61 3) 8634 2927	+(61 2) 9237 1848	+(61 2) 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+(61 2) 9295 1100
Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+(44 20) 7796 3091
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(85 2) 2526 5891