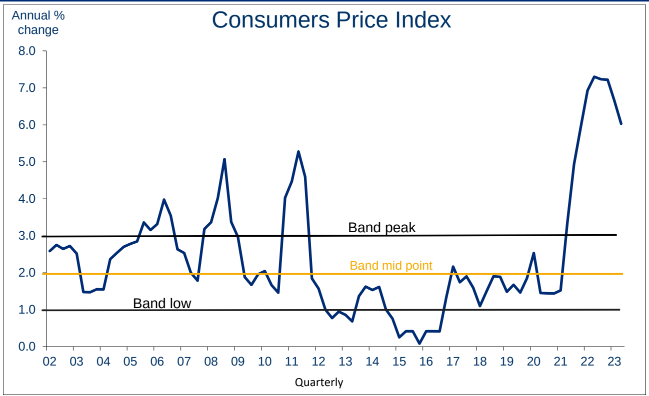
24 January 2024

Inflation plummeting

- **CPI inflation in freefall**
- **As tradables prices fall**
- **Core measures also declining rapidly**
- **But will RBNZ defer to elevated non-tradables**
- **We still think cuts will be a 2024 phenomenon**

Today's CPI outturn was bang on market, and our, expectations. The CPI increased 0.5% for the quarter, 4.7% for the year. This being so we see no need to change our view that the RBNZ will start lowering interest rates in the second half of this year. The economy is, for all intents and purposes in recession, inflation is falling rapidly and the labour market is easing very quickly. It all says ease.

Inflation tumbles



Be that as it may, we feel no better able to judge how the Reserve Bank will respond to this in the near term (i.e. at the February Monetary Policy Statement).

At face value, it would be reasonable to assume the Bank should print an interest rate track which shows rates lower and sooner than it had believed previously. Note that the Bank had assumed a 0.8% increase in the headline CPI for this quarter. Based on this, the Bank pencilled in, at its November Monetary Policy Statement, more than a 50% chance of a rate hike this year and almost no chance of the cash rate being below its current level of 5.5% until the second half of 2025.

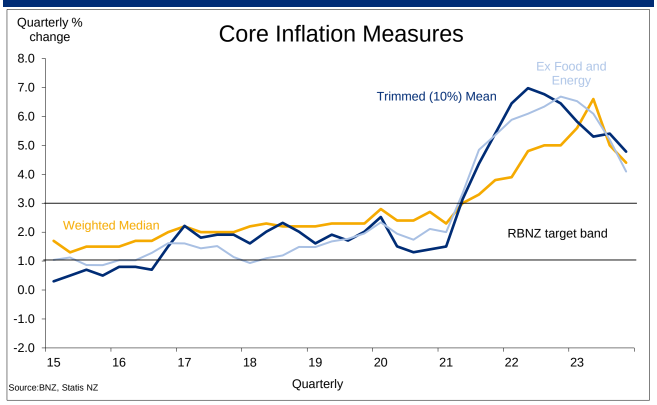
Importantly, not only is the headline lower than expected but the drop in published inflation should help bring down inflation expectations, something which is a necessary precursor to the RBNZ lowering rates.

Consumers Price Index - 2023 Q4				
	Actual	Mkt Pick	Nov MPS	Q3
CPI - qtly % chg	**+0.5**	+0.5	+0.8	**+1.8**
CPI - ann % chg	**+4.7**	+4.7	+5.0	**+5.6**
Non-tradables qtly % chg	**+1.1**	+0.8	+0.9	**+1.7**
Non-tradables ann % chg	**+5.9**	+5.6	+5.7	**+1.7**
Tradables qtly % chg	**-0.2**	+0.1	+0.7	**+1.8**
Tradables ann % chg	**+3.0**	+3.3	+4.0	**+4.7**

The pace of decline in inflation should not be overlooked. A year earlier, annual inflation was 7.2% which it had averaged across calendar 2022. The worm has most definitely turned, and we think inflation will keep falling relatively quickly for the next few quarters. Our flash estimate for the Q1 2024 CPI is 0.6% which will drop annual inflation to 4.0%. We see it inside the target range by September 2024 and close enough to being on target a year later. This track is entirely consistent with our view of a H2 cut.

But if only it was this simple. Last quarter, the CPI surprised the RBNZ to the downside but, rather than moving to a more dovish stance, it actually raised its interest rate track. Even though all the measures of core inflation were falling the Bank suggested that they were still too high for comfort hence necessitating its more aggressive stance. In addition, the RBNZ made a big point of highlighting the fact that the decline in inflation was being driven exclusively by tradables inflation. Indeed, it noted that non-tradables had surprised to the upside justifying its more hawkish positioning.

Core in decline

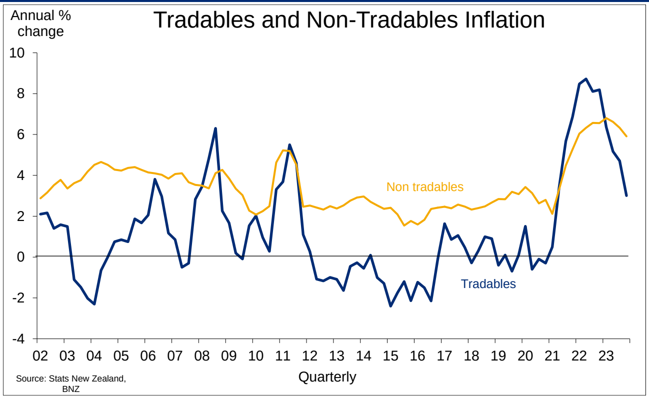


So, what will the Bank do this time around? After all, exactly the same commentary could be repeated. Core measures of inflation have continued to fall sharply but they are still higher than what the RBNZ would like to see. One should, of course, note that it will take time for all measures to get back to target, when they have been so distant from it, so the level, in and of itself, shouldn't be a big deal.

We await the RBNZ's release of its factor model and sector factor model estimates of the CPI at 3.00pm this afternoon. It's almost certain they too will display a declining trend helped by likely downward revisions to past quarters.

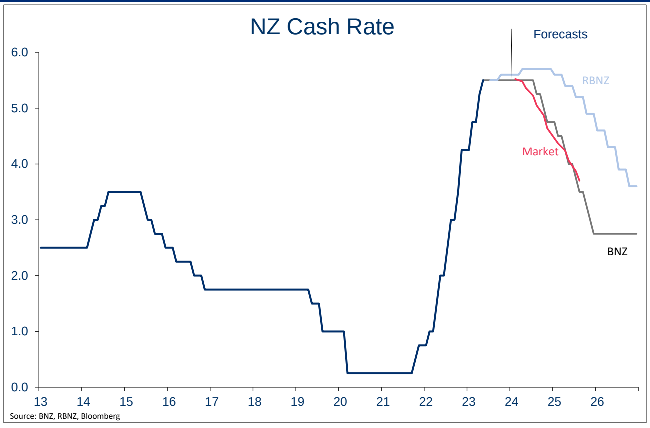
But potentially the biggest sticking point is what happened to non-tradables inflation. Yet again this surprised to the upside coming in at 1.1% for the quarter compared to the 0.9% the RBNZ forecast. Compare this with tradables that came in at -0.2% against the RBNZ's +0.7% assumption. Will the RBNZ again pay most attention to non-tradables or will it finally acquiesce and moderate its stance.

Non tradables the problem



An additional problem facing the Bank is market pricing. Despite the RBNZ's best efforts to dissuade it, the market is currently pricing in three rate cuts by the end of this year. While we think this is entirely appropriate, we're not convinced the RBNZ would wish to condone this at this juncture. Were it to do so then there is a very real risk that the market would rally further into territory that would very much unnerve the Bank. Don't forget that market pricing for year end is already around 100 basis points below the Bank's most recent track.

A big gap



Putting all this together we feel even more comfortable with our view that ultimately the RBNZ will be easing this year. However, we are not convinced that today's data will be sufficient to shift the Bank's stance just yet given its recent past rhetoric. We now await RBNZ's Chief Economist Paul Conway's January 30 speech with even greater interest in the RBNZ's update on recent data outcomes.

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