18 April 2017

CPI Inflation to Persist Around 2%

- Annual CPI inflation to hit 2.1% in Q1
- And will keep middling the 1-3% target band thereafter
- Pay-equity ruling to ripple into macro wage data
- Prices likely higher at dairy auction overnight
- Impacts of this wet autumn bear thinking about
- Can the PSI hold above the now-racy PMI (57.8)?

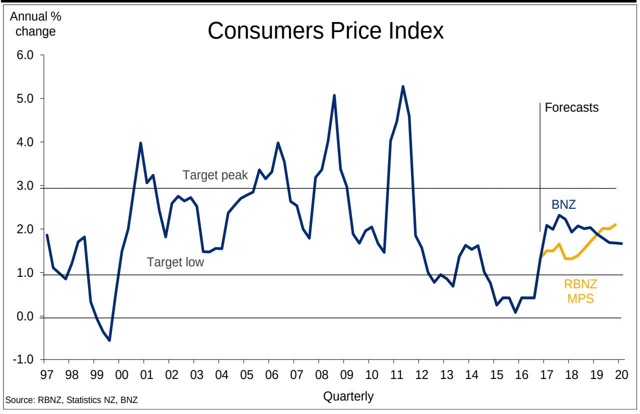
New Zealand's annual CPI inflation is likely to persist around the mid-point of the Reserve Bank's 1.0 to 3.0% target band this year, and beyond. This run will begin with Thursday's Q1 CPI result. Our expectation of a strong gain in this – which we've harboured for a while – can be confirmed at 0.9% (now that we know the March Food Price Index eased about as much as we thought it would…no curve balls there). This would boost annual CPI inflation to 2.1% in Q1, from 1.3% (and 0.4% back in Q3 2016).

The market is looking for a 0.8% lift in the March quarter CPI, for an annual result of 2.0%.

These are miles above what the RBNZ expected as per its February Monetary Policy Statement, namely 0.3% for the quarter and 1.5% for the year. To be fair, the Bank has since intimated that its expectation is now higher. But also that it doesn't see annual CPI inflation holding up near 2% beyond the short term. In contrast, we believe it will stay up. The Quarterly Survey of Business Opinion pointed to this as well.

Yes, the lift in the Q1 CPI is partly predicated on food and fuel prices. But this is not to lose sight of the firm to firming undercurrent of pricing trends, and strongly so in respect of domestic (non-tradables) inflation.

That's More Like It



So there remains potential for the core CPI measures to edge up closer to 2.0% y/y. The trimmed mean and weighted median measures will, of course, be published as part of the CPI report itself. However, the factor-model measures, which the Reserve Bank compiles and puts emphasis on, are typically not posted on the Bank's website until 3pm or soon thereafter.

In any case, there are also some headline CPI consequences to think through. Presuming annual inflation does get up to about 2% in Q1, and stays up there for a while, we will surely see further rebound in the near-term inflation expectations survey measures. The softening of these measures, a while ago, was instrumental in the Bank's last phase of OCR easing. So we would have thought their rebound would be important too.

And don't underestimate the impact that CPI indexation still has on wage and salary negotiations in New Zealand these days. Indeed, it might help explain the lack of strong nominal wage and salary inflation over recent times, when there has been plentiful sign of the labour market tightening. Real wage growth has been strong. And with headline CPI inflation coming back onto the radar, wage adjustments based on cost-of-living clauses promise to as well.

Then there are today's media reports that the government will announce it will be boosting pay rates in areas of social services that it funds (principally aged residential care, home support and disability services). This is the outcome of the landmark pay-equity case brought by Kristine Bartlett. The pay increases are thought to cover about 55,000 workers, involve substantive increases (of about 43% in some cases), and cost the government $500m per annum when fully moved to by 2022. While there is to be no back-dating, the pay increases would come into effect 1 July this year (something to factor into May's Budget).

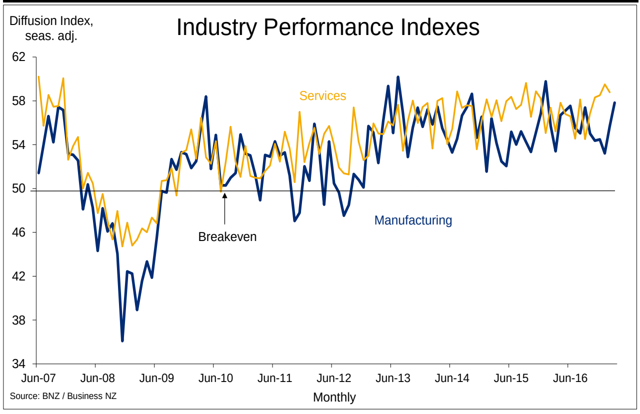
We believe they will have a non-negligible impact on the various wage and salary measures, starting Q3 2017. Ripple effects into the wider labour market will also need consideration. There is also the potential for similar pay-equity claims to be brought by other government-related sectors, where pay rates are argued to be low simply because they are dominated by females. It's an issue worth keeping tabs on.

The remainder of this week's local news, in chronological order, begins with the Global Dairy Trade auction, overnight. Based on the various indicators at hand, we anticipate a moderate increase in the overall price index, underpinned by whole-milk. This would keep alive the potential for Fonterra to nudge up its 2016/17 milk price by the time it is finalised over the latter part of 2017.

Of course, we were sitting there late last week wondering what impact the impending Cyclone Cook might have on the economy, the rural economy in particular. While the storm proved not nearly as bad as feared, it clearly hit some places very hard. And this is just the latest in a run of extreme downpours this autumn, which we're still assessing the economic impact of. It seems nothing to change our macro-economic forecasts at this stage, but there may be some sector/regional stories to tease out in the fullness of time.

The March Performance of Services Index is due for publication tomorrow (10:30am). Even if it moderates, it has some room to do so from its 58.8 level of February without disturbing our views, especially with the news that the PMI bounced back further in March, to 57.8.

A Strong Convergence



The NZ data run finishes Friday (1:00pm) with the release of the ANZ Roy Morgan consumer confidence index. For the month of April, anything still in the 120s would be fine by us.

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Global Watch

- Very quiet data week ahead
- Watching North Korean tensions
- PMIs due for US, EU, Japan
- EU CPI out on Wednesday
- A trio of Fed speakers, post weak CPI

Australia

A very quiet week ahead. The only scheduled data for release are the RBA Minutes today and the Quarterly NAB Business Survey Thursday.

The RBA Minutes is the only piece of data of note though it is not expected to yield much in the way of new information given recent RBA speeches and the release of the RBA's Financial Stability Review. It is also worth noting the Minutes pre-date the latest employment data which was vastly more positive than what would have been discussed at the April board meeting (Chart 1).

Also likely to gain attention will be the NZ CPI which can sometimes provide a lead on Australia's CPI which is released the following week (Chart 2). We see a punchy 0.9% q/q outcome which would take the y/y rate to 2.1%.

Chart 1: RBA Minutes Pre-Date Bumper Jobs

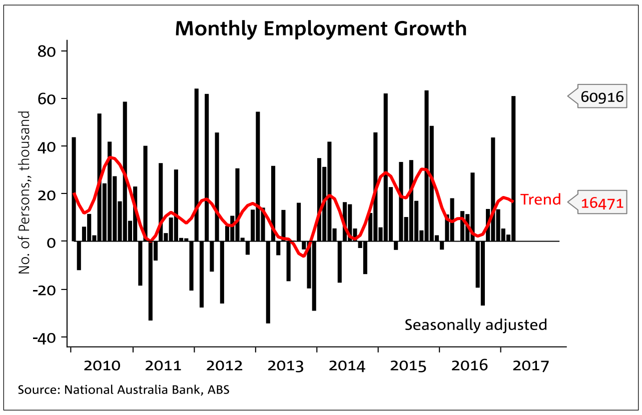
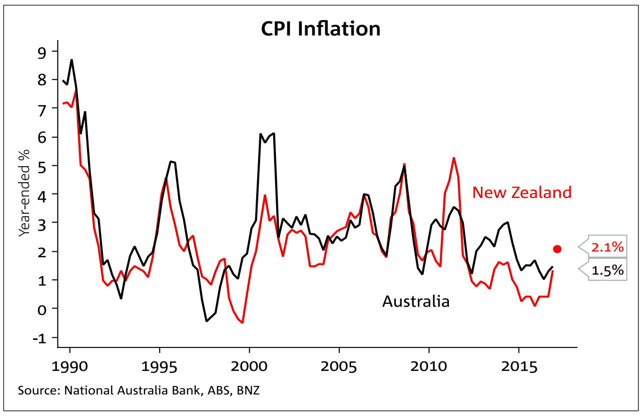
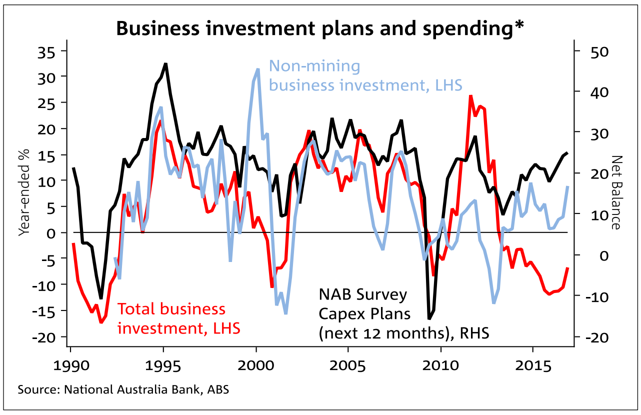


Chart 2: NZ CPI Will Be Watched for Aussie CPI Forecasts



Finally, NAB releases the quarterly version of the NAB Business Survey. While not market moving, the survey does contain details about expected expenditure and expected employment. The NAB Capex expectations series has been more positive of late which led the pick-up in non-mining business investment.

Chart 3: NAB Survey Positive on Investment Intentions



China

Little data this week. Most focus on North Korean tensions. Only March property prices today.

Japan

Trade balance Thursday and the Nikkei PMI Friday are the highlights.

US

A quiet week with the highlights being Industrial Production Tuesday, the Fed's Beige Book Wednesday, Jobless Claims Thursday and the flash Markit PMIs Friday. There are also a couple of Fed speakers including George (non-voter) Monday, Rosengren (non-voter) Wednesday and Kashkari (voter) Friday.

UK

Also a very quiet week with only Retail Sales Friday. The market expects this to be weak with the core measure expected to be -0.3% m/m after a stellar February read.

Euro

Some key data this week with the Trade Balance and CPI Wednesday, and the flash Markit PMIs Friday.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

Global rates are tracking near lows for the year, driven by two key dynamics – lower global risk appetite on rising geopolitical tensions and reduced conviction on prospects for the Fed tightening in the quarters ahead.

BNZ's risk appetite index has fallen from 81% to as low as 65% last week, as the market becomes concerned about escalating US-Russia relations after the US bombing of a Syrian airfield and the US agitating North Korea, with Vice President Pence recently commenting that "all options" are on the table.

Against that backdrop, Citigroup's US economic surprise index has taken a dive, following a string of weaker-than-expected economic releases, which sees Q1 GDP likely coming in sub-1% at an annualised rate and a question mark hanging over the path of inflation. CPI inflation for March was 0.3% below market expectations at both the headline and core level, suggesting that the Fed can take a more relaxed attitude to normalising monetary policy. Policy tightening expectations have been priced out of the curve, with the Fed Funds market now indicating a less than 50% chance of a hike as soon as June and just 29bps of hikes now priced in for the rest of the year.

In yesterday's Asian trading session we saw the US 10-year rate trade as low as 2.20%, with the bottom of the pre-existing 2.30-2.60% range no longer a supporting factor. A continuation of geo-political risk and more soft data could see the market testing the 2% mark over coming weeks. The market is still slightly net short US Treasuries.

Lower US rates have been the key driver behind lower NZ rates. Longer term rates all reached fresh lows last week. In a fast moving market, previous support levels no longer apply. That said, borrowers can now hedge at much more attractive levels compared to a month ago.

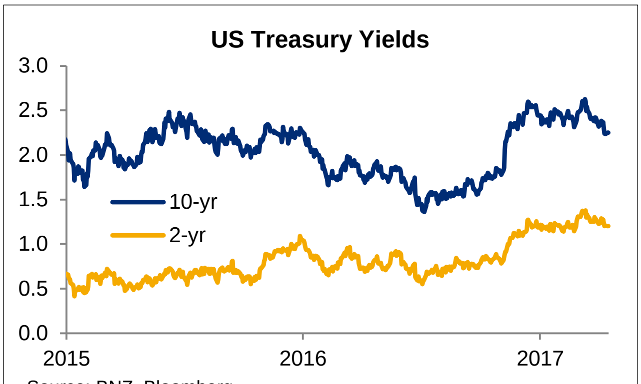
The short end of the NZ yield curve remains well anchored by expectations of steady monetary policy. While US CPI data surprised to the downside, NZ Q1 CPI data due this Thursday is expected to show rising inflationary pressure. Annual CPI is expected to be 2.0% by the market and 2.1% by BNZ economists. This is well up from 1.3% y/y in Q4 and 0.4% just six months ago. Core inflation measures are also expected to continue their rising trend.

The prospect of inflation reaching the mid-point of the target band and ongoing healthy economic growth would normally see the NZ rates market wanting to take the curve higher. But the RBNZ's messaging has been crystal clear recently. The Bank sees inflation at 2+% unlikely to be sustained and it won't be moved into signalling tighter monetary policy ahead. This limits the likely market reaction to higher inflation. A 2-year swap rate of 2.30% is consistent with BNZ's view of the first tightening not occurring until May next year, followed by a series of modest rate hikes beyond then.

The OIS market has recently lost interest in pricing in rate hikes over the next 12 months. Market pricing is now consistent with BNZ's view of a May 2018 hike, after previously entertaining strong potential for an earlier tightening than that.

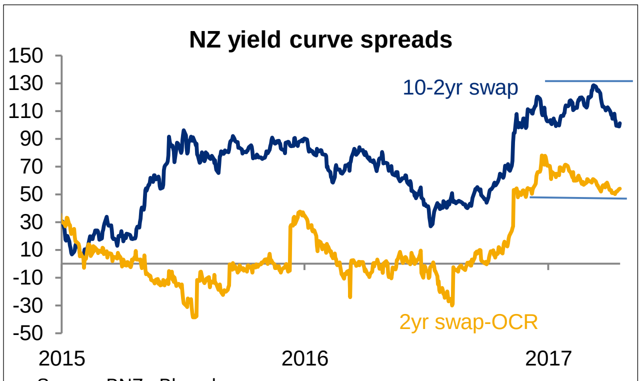
There is a lack of key global economic releases this week, so geopolitical risks are likely to remain centre-stage and a key force on global rates this coming week.

US 10-Yr Rate Reaches Fresh 2017 Low



Source: BNZ, Bloomberg

NZ Yield Curve Flattening on Global Forces



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.96	1.96 - 2.00
NZ 2yr swap (%)	2.29	2.25 - 2.34
NZ 5yr swap (%)	2.82	2.78 - 2.94
NZ 10yr swap (%)	3.31	3.27 - 3.46
2s10s swap curve (bps)	102	100 - 113
NZ 10yr swap-govt (bps)	35	24 - 35
NZ 10yr govt (%)	2.95	2.93 - 3.24
US 10yr govt (%)	2.25	2.20 - 2.43
NZ-US 10yr (bps)	70	69 - 81
NZ-AU 2yr swap (bps)	47	38 - 49
NZ-AU 10yr govt (bps)	48	46 - 54

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD continues to show signs of consolidation. The TWI has traded in a tight range over the past five weeks and NZD/USD has been contained within a tight two-cents range between 0.69-0.71 since early March. To a casual observer the tight ranges might appear to suggest not too much going on, but there is plenty of news to digest and think about.

BNZ's risk appetite index peaked at 81% in early March and closed last week at 65%, a reflection of the higher VIX index and wider credit spreads. Geopolitical tensions have increased significantly, with the US bombing of Syrian and Afghanistan targets and sabre-rattling with North Korea. Undoubtedly, this dynamic is NZD-negative and geopolitical tensions are now expected to linger for some time. Trump will be delighted to see his approval ratings increase since he authorised the military action and began to agitate North Korea.

An offsetting dynamic is the unwinding of the Trump reflation trade. Political gridlock means that the risk of a substantial fiscal easing has diminished. Furthermore, hard data in the US continue to point to a weak Q1 GDP outcome, likely sub-1% at an annualised rate, while Friday's CPI was a significant shock to the downside. While some one-off factors might explain some of the CPI miss, it is no longer obvious that US inflation is on a rising trend. Fed tightening risk is being priced out of the curve and this is USD-negative.

It seems that the NZD is being torn by two significant offsetting forces – lower risk appetite pulling it lower, and a soft USD working in the opposite direction. For the year-to-date, the USD is the weakest major currency.

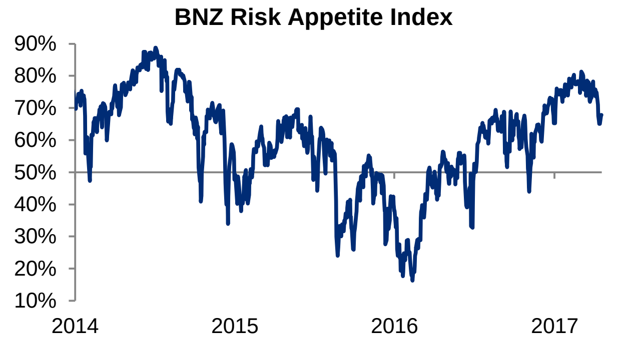
The other factor in our short term fair value model, an NZ commodity price index, has been flat year-to-date. That said, whole milk dairy futures have shown a strong rebound over the last few weeks, but the market seems to have largely ignored this dynamic. Tonight's GDT dairy auction is expected to show the third consecutive fortnightly increase in average pricing.

Weaker risk appetite has driven down our fair value estimate to around 0.7240. The current 3% gap between spot and fair value is lower than the 5% gap seen a couple of weeks ago, but with geopolitical risk lingering in the background we can't see the gap being closed completely. We think that USD 0.70-0.71 seems a fair range for the NZD in the absence of any further deterioration in risk appetite.

The global economic calendar is fairly sparse this week. Our attention will be focused on NZ's Q1 CPI released on Thursday, which is expected to show headline inflation reaching the 2% mid-point of the target band for the first time under the current Governor's tenure. However, the RBNZ has already indicated that it will look-through what it suspects to be a temporary rise in inflation. This has reduced the prospect for a market reaction to the likely high inflation outturn.

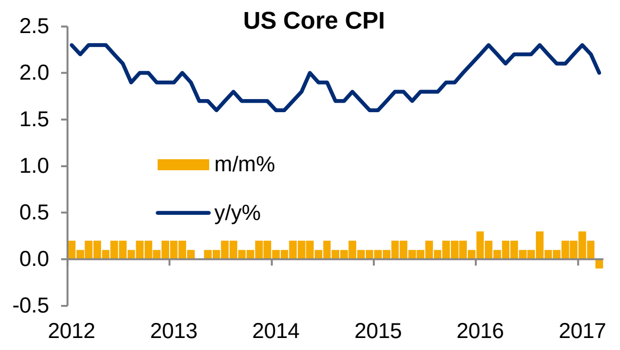
NZD/EUR has shown a modest upward drift after being hammered in early March. Focus turns to Sunday's first round of the French Presidential election. If current poll leaders Macron and Le Pen take out the top two spots, then that is likely to be seen as EUR-positive, with Macron expected to decisively beat Le Pen in the second round vote in May.

Risk Appetite on Its Way Down



Source: BNZ, Bloomberg

US Inflation Heading Lower?



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7010	0.6910 - 0.7050
NZD/AUD	0.9234	0.9120 - 0.9320
NZD/GBP	0.5579	0.5530 - 0.5670
NZD/EUR	0.6585	0.6470 - 0.6620
NZD/JPY	76.36	75.70 - 78.40

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7240	-3%
NZD/AUD	0.9070	2%

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Technicals

NZD/USD

Outlook:	Downward channel
ST Resistance:	0.7090 (ahead of 0.7250)
ST Support:	0.6890 (ahead of 0.6860)

Another week has passed with support and resistance levels not really threatened, as the currency trades in a tight range. Strong support kicks in between 0.6860-0.6890. A break of this would open up significant downside risk. Mild short-term resistance comes into play from around 0.7090.

NZD/AUD

Outlook:	Trading range
ST Resistance:	0.9350 (ahead of 0.9400)
ST Support:	0.9150 (ahead of 0.9100)

After a significant fall, support kicked in around the 0.91 mark. This would need to hold for a few weeks to be be sure. The first area of resistance kicks in around 0.9350-0.9400.

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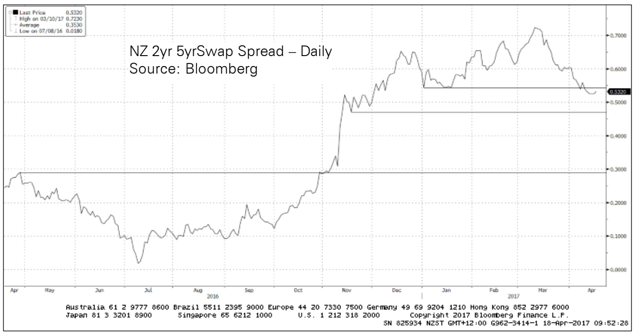
NZ 5-year Swap Rate

Outlook:	Neutral
MT Resistance:	2.92
MT Support:	2.62

Support at 2.80 is holding but will not turn positive until timeline is broken. Support at 200 day mov avg 2.62 and resistance horizontal line 2.92.

NZ 2-year - 5-year Swap Spread (yield curve)

Outlook:	Neutral
MT Resistance:	+72
MT Support:	+29



Support at 53.5 has been broken but remain neutral until +47 has been broken.

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Key Upcoming Events

	Forecast	Median	Last
Tuesday 18 April			
Aus, RBA Minutes, 4 Apr Meeting			
China, Property Prices, March			
US, Fed's George Speaks			
US, Housing Starts, March		1,250k	1,288k
US, Industrial Production, March		+0.4%	flat
Wednesday 19 April			
NZ, BNZ PSI (Services), March			58.8
NZ, Dairy Auction, GDT Price Index			+1.6%
Aus, Westpac Leading Index, March			-0.07%
Euro, Trade Balance, February s.a.		+€18.5b	+€R15.7b
Euro, CPI, Mar y/y 2nd est		+1.5%	+1.5%P
US, Fed's Rosengren Speaks			
US, Beige Book			
Thursday 20 April			
NZ, CPI, Q1 y/y	+2.1%	+2.0%	+1.3%
Aus, NAB Business Survey, Q1			+5
Jpn, Merchandise Trade Balance, March		+Y606b	+Y813b
Euro, Consumer Confidence, April 1st est		-4.8	-5.0
US, Leading Indicator, March		+0.2%	+0.6%
US, Philly Fed Index, April		+26.0	+32.8

	Forecast	Median	Last
Friday 21 April			
NZ, ANZ-RM Consumer Confidence, April			125.2
Jpn, Tertiary Industry Index, February		+0.3%	flat
Euro, PMI Manufacturing, April 1st est		56.0	56.2
Euro, PMI Services, April 1st est		56.0	56.0
UK, Retail Sales vol., March		-0.3%	+1.4%
US, Markit PMI, April 1st est		53.5	53.3
US, Existing Home Sales, March		5.60m	5.48m
US, Markit PSI, April 1st est		53.4	52.8
Monday 24 April			
China, Leading Index (Conference Bd), March			+1.1%
Euro, Govt Debt/GDP, 2016			90.4%
Germ, IFO Index, April			112.3
UK, CBI Industrial Trends, April			+8
US, Chicago Fed Nat Activity Index, March			+0.34
Tuesday 25 April			
NZ, Holiday, ANZAC Day			
US, New Home Sales, March		565k	555k
US, Consumer Confidence, April			125.6
US, Shiller Home Price Index, February y/y			+5.9%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.84	1.75	1.84	2.26
2mth	1.91	1.75	1.90	2.30
3mth	1.97	1.75	1.96	2.32
6mth	2.02	1.75	2.02	2.34
GOVERNMENT STOCK				
12/17	1.84	1.85	1.88	2.03
03/19	2.10	2.10	2.19	2.08
04/20	2.25	2.29	2.44	2.15
05/21	2.36	2.43	2.62	2.21
04/23	2.65	2.75	2.93	2.40
04/25	2.90	3.03	3.24	2.66
04/27	2.96	3.13	3.38	2.80
04/33	3.27	3.48	3.75	3.13
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	89.33	84.35	84.85	134.50
N. AMERICA 5Y	67.89	65.43	64.60	80.28
EUROPE 5Y	76.68	74.32	71.82	73.50

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.29	2.29	2.34	2.23
3 years	2.49	2.50	2.62	2.29
5 years	2.82	2.85	3.06	2.49
10 years	3.31	3.37	3.62	2.93
FOREIGN EXCHANGE				
NZD/USD	0.70	0.6934	0.6931	0.6910
NZD/AUD	0.9242	0.9244	0.9188	0.9007
NZD/JPY	76.4660	77.260	79.520	74.894
NZD/EUR	0.66	0.6556	0.6485	0.6118
NZD/GBP	0.5585	0.5605	0.5696	0.4872
NZD/CAD	0.9346	0.9301	0.9329	0.8966
TWI	76.34	75.77	75.96	73.04

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