Westpac

Institutional Bank

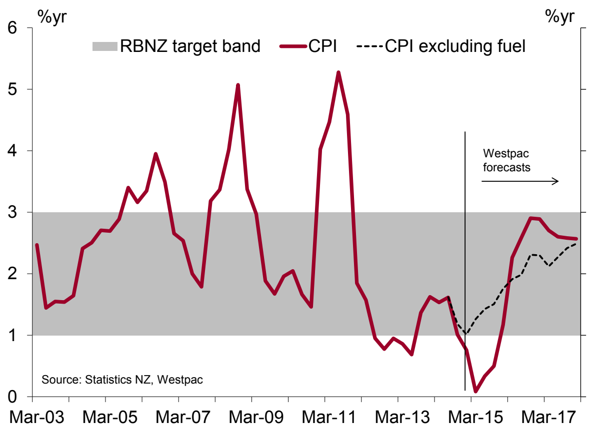
21 January 2015

The tables have turned

Dec quarter consumer prices fell 0.2%, annual inflation 0.8%

- Consumer price inflation was even softer than expected in the December quarter, with widespread softness in prices of internationally-traded goods.
- The plunge in fuel prices means that annual inflation will turn sharply lower again in coming quarters.
- Underlying inflation is still expected to rise gradually as the economy continues to grow, but further interest rates hikes could be delayed for some time.
- In the meantime, there will be little to stop the market from entertaining the idea of interest rate cuts.

CPI inflation forecasts



The Consumer Price Index (CPI) was softer than expected in the December 2014 quarter, falling 0.2% compared to market forecasts (including our own) of a flat outturn. The quarterly decline is not in itself cause for alarm – seasonal price patterns, particularly for food, mean that the CPI falls more often than not in December quarters. However, the downside surprises relative to our forecast were fairly widespread, and the overall picture was that firms' pricing power remained very subdued.

Annual inflation has fallen below the bottom edge of the Reserve Bank's 1-3% target band for the second time in recent years (it fell to 0.7% in the year to June 2013). That picture will soon take another dramatic turn: the recent plunge in fuel prices means that annual inflation will fall very close to zero in the early part of this year, and may just barely scrape back within the target band by year-end.

The (presumably) one-off nature of the oil price shock means that the Reserve Bank can look through it to some degree. But even the underlying picture of inflation doesn't look all that strong right now; the case for further interest rate hikes is likely to take even longer to build than we previously thought. We've pushed out our forecast for the next OCR hike another three months to June 2016.

CPI details

The 0.2% fall in the CPI consisted of a sharp -0.8% drop in internationally-traded goods and services, and a subdued 0.3% increase in non-tradables prices. Lower fuel prices and a seasonal fall in food prices were the known factors; excluding these two items, the index would have risen by 0.2%.

The downside surprise relative to our forecasts was largely on the tradables side and was fairly widespread, encompassing household items, electronics, clothing and vehicles. The persistent strength of the New Zealand dollar has been a major factor behind the weakness in tradable goods prices in recent years. By early last year there was some evidence that the strong currency was having a diminishing impact on prices, suggesting that firms were starting to regain some pricing power. But that evidence has since evaporated; tradable goods prices were surprisingly weak given that the NZ dollar actually fell over the second half of last year.

There are a few pockets of price strength that are worth noting. The first is housing construction. The price of new homes rose 1.7% in the December quarter and was up 5.4% on a year ago, the biggest annual increase since March 2008. The massive post-quake rebuild job in Canterbury, combined with a push to make up for years of under-building in Auckland, was always expected to strain the capacity of the construction industry, and the consequences are now plain to see. The cost of building a new home in Auckland (up 7.0%yr) is now rising at a faster pace than in Canterbury (up 6.3%yr), although the cumulative increase in Canterbury since the earthquakes has been far greater. Other housing-related prices were subdued in the December quarter, with rents up 0.3% and property maintenance costs rising just 0.2%.

The other notable price hike was in domestic airfares, up 8.3% for the quarter and 6.5% on a year ago. It's difficult to pin down the reasons for such a sharp increase, though it may have to do with the removal of some routes to smaller centres. In any case, it's difficult to see rising airfares being sustained over the next year given what's happened to fuel prices.

Outlook for 2015 and beyond

Inflation is likely to be extremely low over 2015, with the recent plunge in fuel prices set to weigh on the annual inflation rate over the next year. We're in the midst of producing a fuller set of economic forecasts at the moment, but we've included a mechanical update of our inflation forecasts taking account of the fall in fuel prices, the stronger trade-weighted New Zealand dollar (as other currencies such as the euro have fallen) and lower than expected inflation from today's release.

On that basis, we see annual inflation falling to just 0.1% in the March quarter of this year, and remaining below 1% for the next two quarters. Lower fuel prices knock about 1 percentage point off the CPI directly, and there are likely to be some second-round effects in terms of lower transport costs.

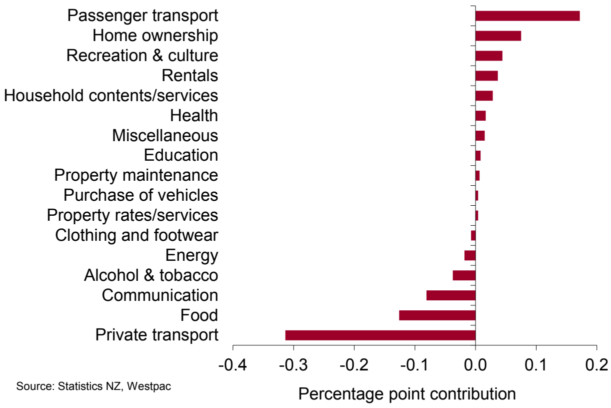
Given the one-off nature of the oil price shock, there's likely to be an increased focus on 'ex-fuel' or other purported 'core' measures of inflation over the next year. However, even these sorts of inflation measures are coming from a soft starting point, and will take some time to return to the 2% midpoint of the RBNZ's inflation target. For this reason, we've pushed out our expected timing for the next OCR hike from March 2016 to June 2016.

Today's low oil prices will have a restraining effect on global oil supply, and by this time next year we expect prices to be rising strongly again. Indeed, our forecasts would see headline inflation approaching 3% again during 2016 – though again, given the isolated nature of this price movement, the RBNZ would have some scope to look through it. We expect a more gradual but consistent rise in underlying inflation over the next couple of years, driven by population growth, a tightening labour market, above-trend economic growth and a booming construction sector.

For now, we suspect that markets won't spend much time debating the distant date of any future rate hikes. More likely, given very low headline inflation (and a sustained breach of the RBNZ's inflation target band), there will be growing speculation about the possibility of OCR cuts this year. In fact, interest rate markets have already shifted towards pricing in a small probability of a rate cut.

We don't think the RBNZ will cut rates, or even entertain the idea, on the basis of low inflation alone. However, we wouldn't dismiss this possibility altogether. There is a plausible set of circumstances under which the RBNZ could cut rates this year – perhaps involving some combination of financial turmoil offshore, falling commodity prices and a local drought. So we don't see a significant barrier to market interest rates pushing even lower from here. Of course, lower interest rates will provide further fuel for the already-hot housing market. We expect the Reserve Bank to tighten macroprudential policy at some point in the second half of this year.

Contributions to quarterly inflation



Source: Statistics NZ, Westpac

CPI and OCR forecasts

		CPI		OCR
		Qtr %	Yr %	
2014	Dec (Actual)	-0.2	0.8	3.50
2015	Mar	-0.3	0.1	3.50
	Jun	0.5	0.3	3.50
	Sep	0.5	0.5	3.50
	Dec	0.5	1.2	3.50
2016	Mar	0.7	2.3	3.50
	Jun	0.8	2.6	3.75
	Sep	0.8	2.9	4.00
	Dec	0.5	2.9	4.25
2017	Mar	0.6	2.7	4.50
	Jun	0.7	2.6	4.50
	Sep	0.8	2.6	4.50
	Dec	0.5	2.6	4.50

Michael Gordon
Senior Economist

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Satish Ranchhod, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

Disclaimer

Things you should know: Each time someone visits our site, data is captured so that we can accurately evaluate the quality of our content and make improvements for you. We may at times use technology to capture data about you to help us to better understand you and your needs, including potentially for the purposes of assessing your individual reading habits and interests to allow us to provide suggestions regarding other reading material which may be suitable for you.

If you are located in Australia, this material and access to this website is provided to you solely for your own use and in your own capacity as a wholesale client of Westpac Institutional Bank being a division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ('Westpac'). If you are located outside of Australia, this material and access to this website is provided to you as outlined below.

This material and this website contain general commentary only and does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material and this website may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material and this website does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. The forecasts given in this material and this website are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Transactions involving carbon give rise to substantial risk (including regulatory risk) and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. Statements setting out a concise description of the characteristics of carbon units, Australian carbon credit units and eligible international emissions units (respectively) are available at www.cleanenergyregulator.gov.au as mentioned in section 202 of the Clean Energy Act 2011, section 162 of the Carbon Credits (Carbon Farming Initiative) Act 2011 and section 61 of the Australian National Registry of Emissions Units Act 2011. You should consider each such statement in deciding whether to acquire, or to continue to hold, any carbon unit, Australian carbon credit unit or eligible international emissions unit.

Additional information if you are located outside of Australia

New Zealand: The current disclosure statement for the New Zealand division of Westpac Banking Corporation ABN 33 007 457 141 or Westpac New Zealand Limited can be obtained at the internet address www.westpac.co.nz. Westpac Institutional Bank products and services are provided by either Westpac Banking Corporation ABN 33 007 457 141 incorporated in Australia (New Zealand division) or Westpac New Zealand Limited. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activity.

Disclaimer continued overleaf.

Disclaimer continued

Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

U.K.: Westpac Banking Corporation is registered in England as a branch (branch number BR000106), and is authorised and regulated by the Australian Prudential Regulatory Authority in Australia. WBC is authorised in the United Kingdom by the Prudential Regulation Authority. WBC is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority in the United Kingdom. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. This material and this website and any information contained therein is directed at a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services Act 2000 (Financial Promotion) Order 2005 or (b) high net worth entities, and other persons to whom it may otherwise be lawfully communicated, falling within Article 49(1) of the Order (all such persons together being referred to as “relevant persons”). The investments to which this material and this website relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this material and this website or any of its contents. In the same way, the information contained in this material and this website is intended for “eligible counterparties” and “professional clients” as defined by the rules of the Financial Services Authority and is not intended for “retail clients”. With this in mind, Westpac expressly prohibits you from passing on the information in this material and this website to any third party. In particular this material and this website, website content and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission (“CFTC”) as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC (‘WCM’), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 (‘the Exchange Act’) and member of the Financial Industry Regulatory Authority (‘FINRA’). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

For the purposes of Regulation AC only: Each analyst whose name appears in this report certifies that (1) the views expressed in this report accurately reflect the personal views of the analyst about any and all of the subject companies and their securities and (2) no part of the compensation of the analyst was, is, or will be, directly or indirectly related to the specific views or recommendations in this report.