18 October 2010

# Inflation Poised To Shift Higher

- Q3 CPI fractionally higher than market/RBNZ expected
- CPI to increase 2.6% in Q4 (4.3% y/y) as GST hits
- But inflation issues much broader and farther than that
- With signs of core inflation strengthening already
- Reinforcing upside to market's OCR projections

| Consumers Price Index - 2010 Q3 | | | | |
|---|---|---|---|---|
| | **Actual** | Mkt Pick | Sep MPS | Previous |
| CPI - qtly % chg | **1.1** | 1.0 | 0.9 | **0.2R** |
| CPI - ann % chg | **1.5** | 1.5 | 1.4 | **1.7R** |
| R - revised | | | | |

This morning's Q3 Consumers Price Index was firm enough to maintain our inflation story. Firstly, that inflation is bottoming out around the mid-point of the Reserve Bank's 1.0 to 3.0% target band. Secondly, that its undercurrents are northward inclined, which, combined with a number of increased government charges will send CPI inflation to 4.3% y/y this quarter and 5.0% by mid next year. With this, the RBNZ will want to be wary of running policy on the slack side in any way shape or form.

That NZ inflation is simply middling is enough of a story in itself. It implies that the degree of contraction GDP experienced since late-2007, as clear as it was, was mostly about cooling things down – a reminder, in turn, of just how overheated and inflationary the economy had become. And that the lagged impacts on inflation from the recession are probably through by now, given the GDP recovery we've been registering since early 2009 (albeit mildly so).

It's also a wonder CPI inflation isn't any lower given the relative strength of New Zealand's trade-weighted exchange rate – highly unusual during a battle to shake a recession. It's another sign that underlying inflation is sticky, and hardly slack.

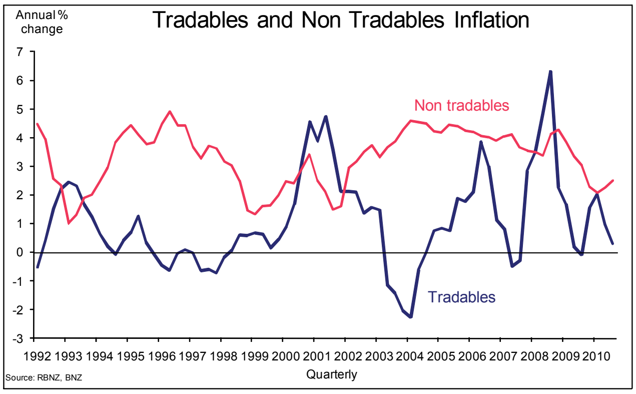
Indeed, there were even signs that core inflation was starting to nudge higher again already. To be sure, the 1.2% increase in the non-tradables component of the CPI included seasonal elements (such as local authority rates), a big one-off jump in ACC charges, as well as the impact of the Emissions Trading Scheme on electricity prices.

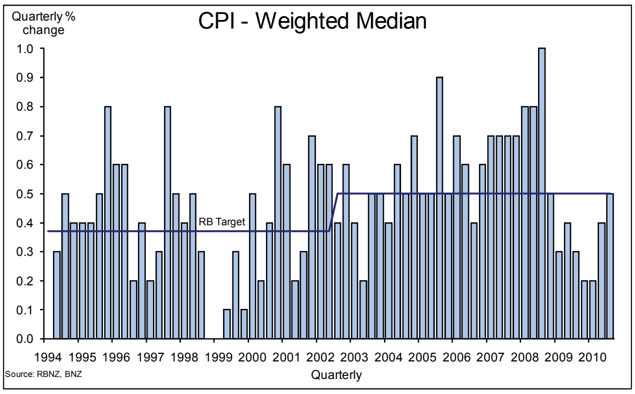
However, the trimmed mean (10%) measure should have excluded such extremes, and it increased 0.8% in the September quarter. And while weighted-median inflation, at 0.5%, looked tame enough, this quarterly measure has been picking up through the year, to the extent of turning the annual rate higher in Q3.

The other sign that core inflation was starting to turn was the still-increasing proportion of prices that were, on balance, rising.

As for the headline CPI, it increased 1.1% in the September quarter. This was just a notch above market expectations, of 1.0%. We wouldn't want to make a big deal of this, nor the 0.2% overshoot from the 0.9% the Reserve Bank had in its Monetary Policy Statement. Post-MPS food price out-turns probably explained much of the latter's difference.

Anyway, there was a bit of counter-relief on the annual CPI results, albeit on technical grounds. Specifically, annual inflation eased to 1.5% in Q3 (versus the market's 1.5% and the Reserve Bank's 1.4%). This was aided by the Q2 CPI being revised down by 0.1%, on account of a revised drop in second-hand car prices in the quarter. The fall in annual inflation in Q3 was also reliant on the hefty 1.3% inflation of Q3 2009 falling out of the annual calculation.



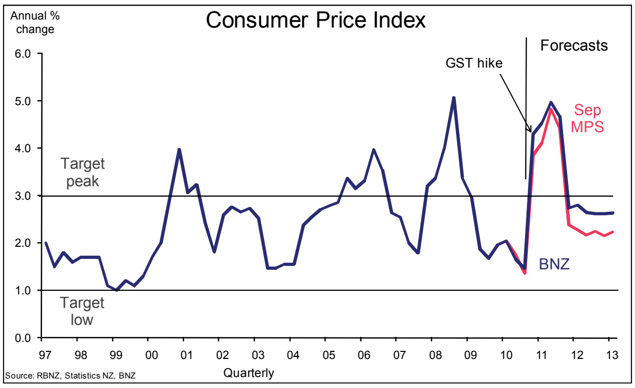
While the Q3 CPI increase was a fraction below the 1.2% we had judged, it felt firm enough, overall. Its details were certainly in keeping with our nitty gritty estimations, meaning there's little reason to change our computations for Q4 CPI inflation. Having said this, we have taken the opportunity to "round down" our view on this to 2.6%, from 2.7% - mainly to better reflect the "strong for longer" view we've recently taken on the currency, which should help keep a lid on imported product prices.

Of course, the Q4 CPI will capture the guts of the GST increase, which, if every CPI component subject to GST was to rise by exactly the extra impost, would increase 2.0%. Sure, some businesses might not adjust by this much, if at all. But for others it might be a trigger point for changing sticker prices by the GST increase and more (which is their prerogative, of course, providing they don't blame it all on GST). Then there are the underlying price increases that were likely to occur anyway.

How this all washes out is very difficult to know. But it will certainly have us turning up at the lock-up for the Q4 CPI release.

The real story, in any case, is how inflation pans out next year and beyond. We believe it is looking like a headache, which will, or at least should, discomfort the Reserve Bank. This is fundamentally driven by upside pressure on core inflation, as the economic recovery picks up, amid less supply-side potential than generally appreciated. The likes of GST and other public sector charges will simply add to the potential for a general inflation psychology around prices and wages to take hold.

With this in mind, the Reserve Bank will not want to risk running slack policy. This is why we believe the Bank will probably budge up its OCR again as soon as next March, as the start of series of 25bp rate hikes, taking the cash




rate to a 5.00% peak by early 2012. A slacker policy path than this runs the risk of letting inflation run too high for too long.

As for the rest of this week's local economic news, we've already seen the pleasing increase in Septembers' Performance of Services Index. It strengthened to a seasonally adjusted 54.8, from 51.9. Go the recovery.

Next up is Fonterra's latest fortnightly auction, which is conducted in the wee hours of Wednesday morning (NZT). After signs of a slight correction in the last auction we'll be interested to see what this week's one delivers.

As for Thursday's tourist arrival numbers for September, they will probably fail to beat year-ago levels, for a change, while we expect net immigration to be modestly positive for the month. Thursday afternoon's ANZ-RM consumer confidence index could arguably go either way, from its solid 116.4 of September, while we are looking for September's credit card billings to at least hold their gains of August, in order to be consistent with the 2.1% increase we expect for September's retail sales.

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# Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates had a very quiet week with relatively low deal flow and a market generally happy with pricing largely sat on its hands. There was a small amount of movement at the front end of the curve with pricing for the first hike reduced to around 50% for the March meeting, followed by around a 40% chance of hikes for each further meeting through 2011. While it does seem unlikely that the RBNZ will need to hike sooner than that, there does seem to be a significant risk that the hiking cycle next year will need to be more aggressive than currently priced.

The New Zealand government bond market was also quiet, largely following on from offshore moves as yields in the US and Australia pushed higher. We will likely continue to follow offshore trends, but there still seems to be solid demand for NZGBs and we expect NZ to outperform in the event of an offshore sell off.

| | 90 day bills | 04/13 NZGS | 05/21 NZGS | 2yr swaps s/a | 10yr swaps s/a | 2yr/10yr swaps(bps) |
|---|---|---|---|---|---|---|
| 8-Oct-10 | 3.18% | 3.92% | 5.11% | 3.76% | 4.91% | 115 |
| 15-Oct-10 | 3.20% | 3.87% | 5.05% | 3.75% | 4.95% | 120 |
| **Change (bps)** | **2** | **-5** | **-6** | **-1** | **4** | **5** |

The swaps market continued to trade a very tight range in the short end, with the 2-yr swap seemingly anchored within a couple of basis points of 3.75%. The backend of the curve underperformed somewhat as long end yields were higher offshore. With the CPI print today coming in largely on expectation it seems unlikely that the swaps market will awaken from its slumber anytime soon.
We expect the tight ranges at the front of the curve to continue to hold, with the backend somewhat more prone to action from offshore moves.

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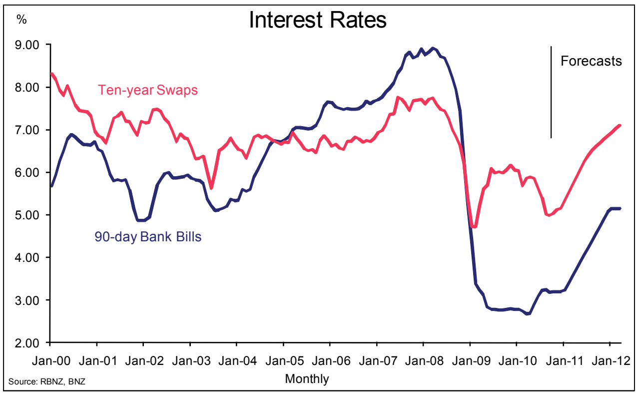


## Interest Rate Technicals

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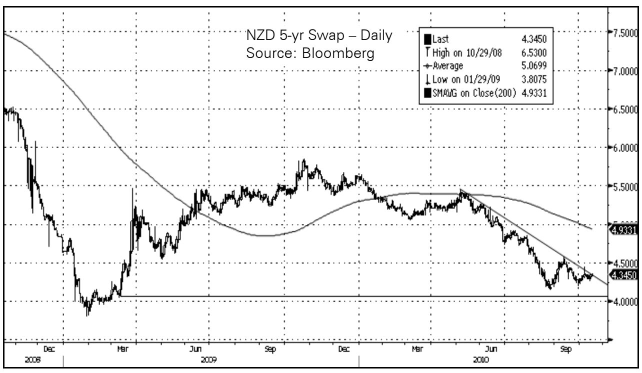
### NZD 5yr Swap Rate

Outlook: Neutral
MT Resistance: 4.36%
MT Support: 4.06%

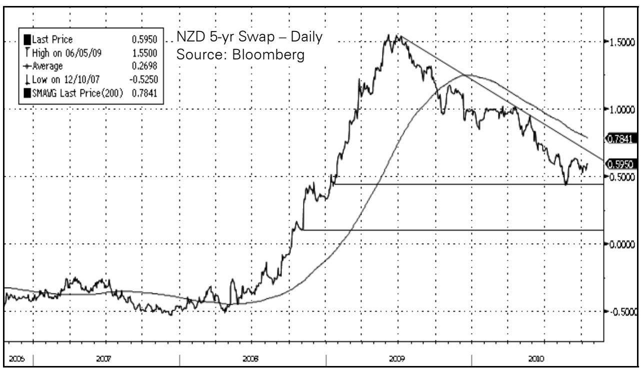
Market is staying below downward sloping resistance, which is now coming in at 4.36%. A close above this level will initiate a borrowed position.




### NZ 2yr-5yr Swap Spread (yield curve)

Outlook: Rangebound
MT Resistance: +70
MT Support: +10

Market rejected near term support at +42. Look for a range trade between +42 and downward sloping resistance, now coming in at +70. A break of either of these lines will give us the next move.



# Foreign Exchange Market

Reuters pg BNZWFWDS

The NZD/USD climbed to 27-month highs of nearly 0.7650 last week. Despite this, the NZD still managed to take out the title of weakest performing currency.

A sliding USD bolstered demand for most of the major currencies last week. Not only did solid global data and strong corporate earnings sap demand for “safe-haven” currencies, but last week’s FOMC minutes essentially confirmed the markets’ supposition the US Federal Reserve is mulling a return to quantitative easing (QE). The associated brightening in the global outlook saw global equity markets push up to 5-month highs and the CRB commodity price index surged to the highest level since October 2008. All in all, it was the perfect recipe for continued USD weakness and, accordingly, the USD index slumped to the lowest level since December 2009.

Against the broadly softer USD, EUR/USD scaled 9-month highs above 1.4150 and the AUD briefly outstripped the USD in value, climbing above 1.000 for the first time since the AUD was floated in 1983. The NZD/USD was happy to head higher on the coattails of the EUR and AUD, eventually reaching 27-month highs around 0.7645.

However, more disappointing local economic news took some of the shine off the NZD. Last week’s retail and REINZ housing reports were genuinely soft, supporting our view RBNZ rate hikes are off the agenda for the rest of 2010, and tempering demand for the NZD.

Looking ahead, following this morning’s CPI release, there is precious little occupying the NZ data calendar this week. In any case, sentiment towards the USD is what really matters for the NZD at present.

Global markets remain firmly on QE watch. How this week’s long line-up of Fed speakers influences market expectations of additional Fed QE will be the key influence on USD sentiment this week. Current market pricing appears to reflect an expectation of roughly US$1tn in additional asset purchases in November. Given the potential for markets to be disappointed, and already heavily short USD positioning, we suspect the pace of USD selling will, in the least, slow in coming weeks. Equally though, a sustained USD rally is unlikely ahead of the 3 November FOMC meeting.

All up, we suspect pull-backs in the NZD/USD will be limited to around 0.7450 this week. Sure, the USD is starting to look oversold and the risk of markets being disappointed on the size of Fed quantitative easing is growing. But lofty NZ commodity prices (watch for Fonterra’s milk price auction on Wednesday) and buoyant risk appetite should ensure buyers will be found on dips. According to our short-term valuation model, “fair-value” in the NZD/USD is seen between 0.7350 and 0.7550.

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## Foreign Exchange Technicals

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**NZD/USD**

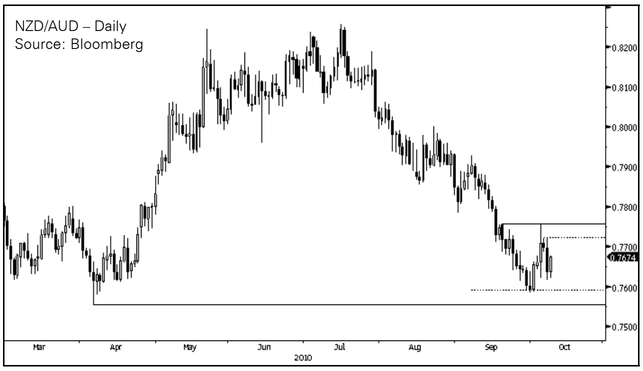
Outlook: Buy a dip
ST Resistance: 0.7640 (ahead of 0.7765)
ST Support: 0.7340 (ahead of 0.7255)

Momentum is positive. A daily close above 0.7640 would strengthen the uptrend.


**NZD/AUD**

Outlook: Sell a rally
ST Resistance: 0.7680 (ahead of 0.7720)
ST Support: 0.7590 (ahead of 0.7555)

The currency has been rangy of late, but momentum is still negative and a test of 0.7590 support remains the bigger risk facing the pair.



# Key Upcoming Events

| | Forecast | Median | Last |
|---|---|---|---|
| **Monday 18 October** | | | |
| NZ, CPI, Q3 | +1.2% | +1.0% | +0.3% |
| NZ, BNZ PSI (Services), September s.a. | | | 51.4 |
| Jpn, Tertiary Industry Index, August | | -0.5% | +1.6% |
| US, NAHB Housing Index, October | | 14 | 13 |
| US, Industrial Production, September | | +0.2% | +0.2% |
| **Tuesday 19 October** | | | |
| Aus, RBA Minutes, 5 Oct Meeting | | | |
| Germ, ZEW Sentiment, October | | -7.0 | -4.3 |
| UK, CBI Industrial Trends, October | | -19 | -17 |
| US, Housing Starts, September | | 580k | 598k |
| Can, BOC Policy Announcement | | | 1.00% |
| **Wednesday 20 October** | | | |
| NZ, Fonterra Auction | | | -1.3% |
| Aus, Westpac Leading Index, August | | | +0.4% |
| Germ, PPI, September y/y | | +3.8% | +3.2% |
| UK, BOE Minutes, 6/7 Oct Meeting | | | |
| US, Beige Book | | | |

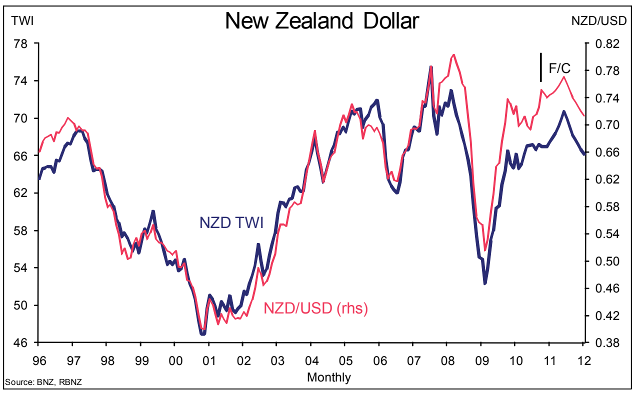
| | Forecast | Median | Last |
|---|---|---|---|
| **Thursday 21 October** | | | |
| NZ, Credit Card Billings, September | | | +0.5% |
| NZ, External Migration, September s.a. | | | +840 |
| NZ, ANZ-RM Consumer Confidence, October | | | 116.4 |
| China, Industrial Production, September y/y | | +14.0% | +13.9% |
| China, GDP, Q3 y/y | | +9.5% | +10.3% |
| China, CPI, September y/y | | +3.6% | +3.5% |
| Euro, PMI Services, October 1st est | 53.7 | 54.1 | |
| Euro, PMI Manufacturing, October 1st est | 53.2 | 53.7 | |
| UK, Retail Sales vol., September | +0.3% | -0.5% | |
| US, Philly Fed Index, October | +1.8 | -0.7 | |
| US, Leading Indicator, September | +0.3% | +0.3% | |
| Can, BOC Qtly Policy Report | | | |
| **Friday 22 October** | | | |
| Aus, Terms of Trade, Q3 | +4.0% | +14.2% | |
| Germ, IFO Index, October | 106.5 | 106.8 | |
| **Monday 25 October** | | | |
| NZ, Holiday, Labour Day | | | |

# Historical Data

| | Today | Week Ago | Month Ago | Year Ago |
|---|---|---|---|---|
| **CASH & BANK BILLS** | | | | |
| Call | 3.00 | 3.00 | 3.00 | 3.00 |
| 1 mth | 3.15 | 3.14 | 3.12 | 3.14 |
| 2 mth | 3.16 | 3.15 | 3.20 | 3.23 |
| 3 mth | 3.20 | 3.19 | 3.15 | 3.28 |
| 6 mth | 3.23 | 3.23 | 3.24 | 3.34 |
| **GOVERNMENT STOCK** | | | | |
| 11/11 | 3.49 | 3.53 | 3.63 | 3.90 |
| 04/13 | 3.88 | 3.92 | 4.05 | 4.90 |
| 04/15 | 4.35 | 4.39 | 4.56 | 5.54 |
| 12/17 | 4.79 | 4.83 | 5.01 | 6.06 |
| 05/21 | 5.06 | 5.11 | 6.53 | - |
| **CORPORATE BONDS** | | | | |
| BNZ 05/13 | 5.08 | 5.08 | 5.10 | - |
| BNZ 09/16 | 6.26 | 6.11 | 6.18 | - |
| FON 04/14 | 5.59 | 6.86 | 5.65 | - |
| FON 03/16 | 6.02 | 6.83 | 6.18 | - |
| GEN 03/14 | 5.56 | 5.61 | 5.63 | 7.19 |
| GEN 03/16 | 6.16 | 6.19 | 6.23 | 7.98 |
| TRP 06/20 | 6.32 | 6.32 | 6.39 | 7.93 |
| **SWAP RATES** | | | - | |
| 2 years | 3.76 | 3.76 | 3.80 | 3.92 |
| 3 years | 3.99 | 3.99 | 4.04 | 4.67 |
| 5 years | 4.35 | 4.33 | 4.42 | 5.42 |
| 10 years | 4.96 | 4.91 | 5.00 | 6.20 |

| | Today | Week Ago | Month Ago | Year Ago |
|---|---|---|---|---|
| **FOREIGN EXCHANGE** | | | | |
| NZD/USD | 0.7561 | 0.7567 | 0.7266 | 0.6426 |
| NZD/AUD | 0.7613 | 0.7635 | 0.7739 | 0.7983 |
| NZD/JPY | 61.52 | 61.94 | 62.29 | 61.82 |
| NZD/EUR | 0.5404 | 0.5400 | 0.5567 | 0.4605 |
| NZD/GBP | 0.4735 | 0.4738 | 0.4640 | 0.3893 |
| NZD/CAD | 0.7649 | 0.7634 | 0.7496 | 0.7294 |
| TWI | 66.87 | 66.99 | 66.93 | 60.78 |

### NZD Outlook



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