Business Weekly

Inflation benign now but not forever

This Week

Inflation for the December quarter of last year will look fairly benign compared to the rather surprising surge reported for the preceding quarter. We expect the CPI to register a quarter-on-quarter drop of 0.2%, which would lift the annual inflation rate from 1.7% to 1.9% – still just on the low side of the inflation target mid-point. That snapshot portrays inflation as pretty benign. A pullback in food prices after poor weather is accentuating the weakness of the quarterly figure, but ex-food inflation is still likely to be a moderate 0.2%.

But in a year's time inflation pressures will become more noticeable. One surprising thing about the recession was that it didn't dampen inflation pressures a great deal. The sustained economic boom had inflation pressures in the economy wound up tighter than a banjo string. Yet the deepest recession since the 1970s and widespread wage restraint has not done much more than cause inflation to dip slightly below the middle of the target band. The main area in which inflation pressures did ease dramatically was the building sector. But even then the main trend was for prices to stop going up rather than reverse some of the cost pressures that occurred during the heat of the housing construction boom when builders were so in demand they could virtually name their price. One other issue is that administered inflation (local authority rates, ACC levies, other government charges) has steamed on unscathed by mere market forces of demand and supply.

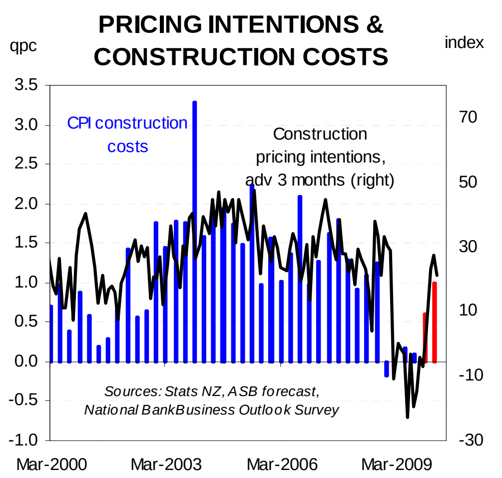
Last week's Quarterly Survey of Business Opinion from the NZIER did show early signs that disinflationary pressure will abate over the next year. The key capacity utilisation measure, a gauge of firms' ability to expand output without cost increases, has been heading up towards the level sustained during the boom. Businesses are showing greater desire to raise prices to shore up crushed margins, if conditions permit. Labour conditions are also turning: it is still relatively easy to find new employees, but noticeably less so than in the first half of 2009. Some of the wage restraint imposed by businesses will also ease over the next year, leading to some pick-up in labour costs. And the one sector hit by disinflation over the past couple of years – house building – is on the verge of recovery.

NZ is in a position of low inflation and a degree of spare capacity, a position that will steadily change over the next couple of years. The OCR is also at a very low level, holding down short-term market rates. At some point the RBNZ will have to take the punchbowl away (or at the least replace it with a smaller bowl). That will be the focus of the following couple of weeks as the January 28 OCR decision looms and passes.

Click here for:

Foreign Exchange	• NZD down slightly, as USD lifts. Euro dips on Greece concerns.
Interest Rates	• Interest rates ease, with the biggest movement coming at the long end.
Week Ahead	• Q4 CPI inflation, December food price index, and retail trade report due.
Week in Review	• NZIER's business survey, building consents and electronic card data.
Global Calendars	• UK CPI, Retail trade, unemployment rate, and BoE minutes. US housing data.

Chart of the week



- Non-tradable inflation has been surprisingly persistent through the recession. In particular, the decline in construction costs was muted given the extent of the contraction in the building sector.
- Business surveys in recent months point to an imminent rebound in building activity, with pricing intentions in the sector rising back to almost pre-recession levels in recent months. As such we expect a modest rebound in construction costs over the coming year.
- In addition, rental inflation is expected to lift in light of population growth which will underpin demand for housing.
- The rebound suggests the RBNZ can no longer rely on excess capacity in the building and housing sectors to contain core domestic inflation pressures.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7349	0.7404	0.7116	0.6474	0.5469	FLAT	0.7250	0.7450
NZD/AUD	0.7977	0.7945	0.8003	0.8024	0.8118	FLAT	0.7900	0.8050
NZD/JPY	66.79	68.24	63.74	61.26	49.36	FLAT	67.50	69.50
NZD/EUR	0.5119	0.5095	0.4944	0.4573	0.4131	FLAT	0.5050	0.5150
NZD/GBP	0.4515	0.4599	0.4391	0.3949	0.3700	FLAT	0.4500	0.4650
TWI	66.5	66.9	64.8	60.9	54.4	FLAT	66.00	68.00

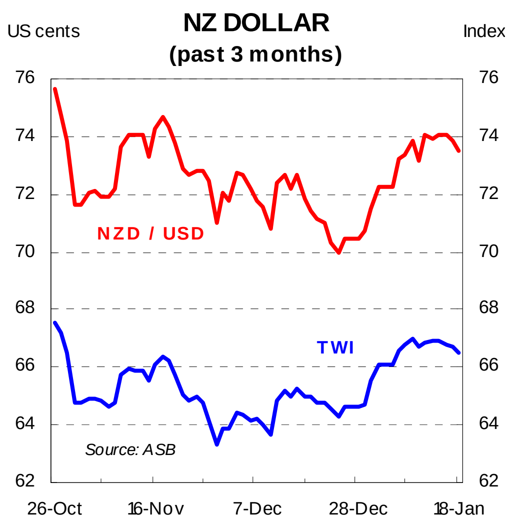
^Weekly support and resistance levels * Current is as at 11am Monday; week ago as at Monday 5pm

- NZD was mixed last week, easing against the USD, JPY and GBP but gaining slightly on the AUD and EUR.
- Markets are looking for clues as to when the RBNZ might begin to raise rates. This week's economic data are important, with NZ CPI due. This should produce NZD volatility, as will pressure from the US reporting season and any negative sentiment from developments in the Eurozone.
- The USD should rise as participants' concerns over the Euro-zone member states (i.e. Greece) escalate. The AUD and NZD may have difficulty rising over the early part of the week as concerns over the Euro lead to a USD rise.
- The US CPI and industrial production results last Friday were mixed, suggesting the Fed could leave its policy guidance unchanged next week (28th January). The US equities reporting season is underway this week. Further mixed results on incoming US economic data could feed into some additional USD support this week.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
Q4 CPI qoq	20/1	10.45 am	0.0%
Nov Retail Trade Survey mom	21/1	10.45 am	0.5%

Potential currency movers from overseas this week: US net long-term TIC flows UK CPI (19th), Bank of England Minutes, US Housing starts, building permits, Producer Prices (20th), Philly Fed Survey (21st), UK retail sales (22nd)



Medium-term outlook: [Last Quarterly Economic Forecasts]

- We continue to expect the NZD to appreciate further against the USD over the first half of 2010. The story remains primarily one of USD weakness, also overlaid by some Downunder strength.
- We expect the USD to remain under pressure until the Federal Reserve starts to unwind its policy stimulus: the earlier that starts the sooner the NZD's rise is likely to be capped.
- The reasons for the expected USD weakness remain similar to the drivers in place since mid-March 2009, namely:
  I. US residents increase their offshore investment, encouraged by improvement in the global economy, with USD liquidity demand and safe-haven buying also no longer boosting the USD.
  II. Diversification out of USD is expected to occur due to concerns about US government debt.
  III. And, related, concern about the USD's future role as a reserve currency.
- In late 2009 the USD has responded positively to strong US data - a change from the pattern of the past 8 months. There is a risk that the USD troughs a lower level than our current forecasts imply.
- The NZD is also likely to mildly outperform other major currencies in the ongoing environment of improving global growth prospects and rising commodity prices. Outright weakness in the Pound will continue to hold the NZD/GBP rate at very elevated levels. The Pound, like the USD, is being weighed down by debt concerns and the state of its financial sector – both of which have ramifications for the future growth rate of the economy.
- The buoyant Australian dollar is also likely to contribute to an overall strengthening of the NZD. The RBA is likely to continue lifting its cash rate back to a less stimulatory level. Rising interest rates there will lift the AUD.

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	2.50	2.50	2.50	2.50	2.50	FLAT
90-day bank bill	2.78	2.76	2.76	2.79	2.78	FLAT
2-year swap	4.58	4.62	4.54	3.92	4.58	FLAT
5-year swap	5.45	5.57	5.53	5.40	5.45	FLAT
5-year benchmark gov't stock	5.41	5.48	5.43	4.77	5.41	FLAT
NZSX 50	3249	3304	3154	2818	3249	DOWN

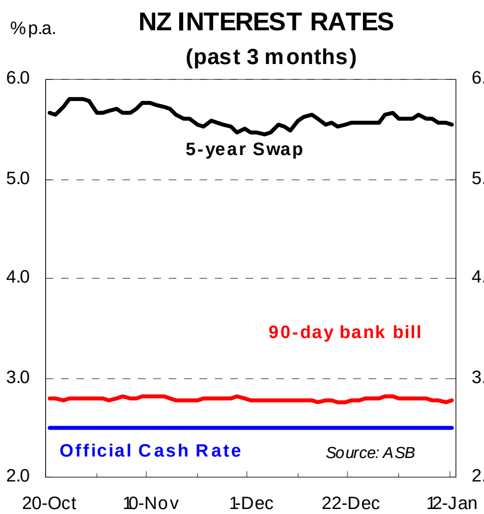
* Current is as at 11.00 am Monday; week ago as at Monday 5pm. Please note that we have recently changed the NZ govt 5-year benchmark bond to April 2015 maturity (from April 2013). This does cause some distortion in the comparison against the previous levels (i.e. month ago).

- NZ yield curve flattened, with the longer end easing 12 basis points over the week. Weakness in offshore interest rates pushed longer-term NZ rates lower.
- US 10-year Treasury yields experienced a roller-coaster weak, with rates lifting strongly mid-week before easing back by Friday. Strong demand from indirect bidders (typically foreign buyers) in an auction for US 30-year notes, disappointing US retail trade figures, and concerns about the Greek Government debt situation weighed on global sentiment and yields.
- Australian interest rates lifted on Thursday, following the stronger than expected employment report: market pricing moved from pricing a 56% chance of a February hike, to a 73% chance. However, interest rates unwound the lift over Friday, following weakness in global markets.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
Q4 CPI qoq	20/1	10.45 am	0.0%
Nov Retail Trade Survey mom	21/1	10.45 am	0.5%

Comment: NZ CPI is the last piece of key data prior to the RBNZ next OCR announcement (28th January). Last week's NZIER business survey confirmed continued tightening in capacity measures despite the low growth outlook, highlighting the risks to medium-term inflation outlook. Following the surprisingly strong inflation result in the previous quarter, the RBNZ are likely to be wary of another stronger than expected result.



Medium term outlook: [Last Quarterly Economic Forecasts]

- The RBNZ continues to hold the cash rate at 2.5%. The RBNZ adopted a more hawkish tone at the December Monetary Policy Statement. The RBNZ now recognises the stronger economic outlook and the risks to inflation moving toward the upside. The RBNZ has moved forward its expected tightening to the middle of 2010, with the 90-day interest rate track now increasing from Q3 2010.
- The RBNZ has revised up its view on the economic outlook, with the composition of growth now more household led. The move acknowledges the recent strength in house prices as well as the improvement in consumer and business confidence. The RBNZ notes there is upside risk to spending growth given the strength of house prices, although points the weakness in household credit growth as indicating cautious consumer behaviour.
- The RBNZ has become more concerned on future inflation pressures, noting it has been surprised by the extent non-tradable prices have help up. The recession has not triggered a period of muted inflation; it merely appeared to wipe out the excess inflation pressure from the economy. There is no longer much scope for the RBNZ to absorb upside surprises to the inflation outlook other than to lift rates earlier than currently intended.
- Historical revisions to GDP over 2006 also have some serious implications for monetary policy. The official estimates now suggest growth was very weak over 2006, and yet inflation pressures remained firm through this period. This suggests NZ has a lower non-inflationary growth rate than previous assumed. The RBNZ needs to remain vigilant with capacity measures already have started to firm very early during the recovery phase.
- The next move in the OCR is up, it's just a matter of when. We continue to expect the RBNZ will hike by April next year, as the strength in the housing market continues to test the RBNZ's patience. The RBNZ has a substantial amount of policy stimulus to unwind, the first steps are likely to be bigger (i.e. 50 basis point moves).

NZ Data Preview: a look at the week ahead

Data	Date	Time (NZST)	Previous	Market expects	ASB expects
Q4 Consumer Price Index qoq	20/1	10.45 am	+1.3%	0.0%	-0.2%
November Retail Trade Survey mom	21/1	10.45am	0.0%	0.5%	0.1%

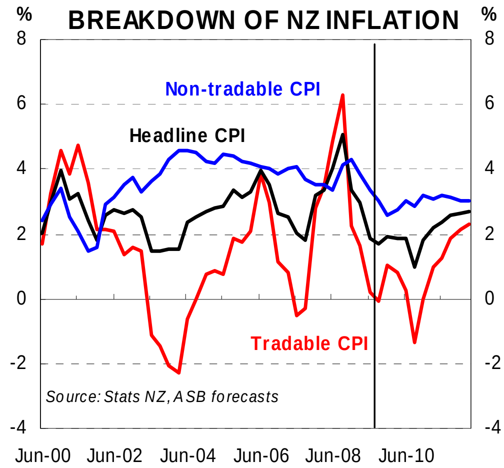
Thursday 20 January

Q4 Consumer Price Index

Previous: +1.3% qoq ASB f/c: -0.2%

Falling food prices are expected to drive a 0.2% decline in CPI for the December quarter, thus bringing annual inflation to 1.9%. In the near-term, lagged effects from the strength in the NZ dollar over the second half of 2009 should weigh on tradable inflation, while spare capacity in the economy should mean non-tradable inflation will also ease.

However, there are signs inflation pressures will build up later this year, as a recovery in demand encourages firms to expand output. Given the extent to which firms have pared back on investment, a rebound in activity is likely to place pressure on resources. Thus we expect headline inflation to be in the top half of the target band from 2011.



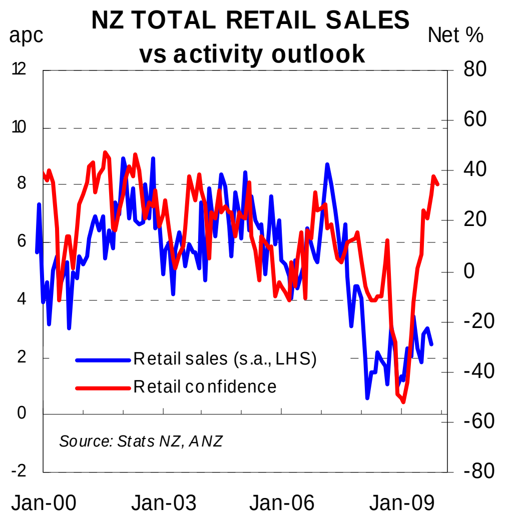
Thursday 21 January

November Retail Trade Survey

Previous: 0.0% mom ASB f/c: 0.1%

We expect November retail sales to show very weak growth for the month, given earlier data on electronic card transactions. Recent consumer credit data continue to point to near-term weakness in consumer spending given the constrained nature of household balance sheets generally.

However, consumer confidence data in recent months show consumers' confidence regarding big-ticket item purchases has lifted, albeit from very low levels. This is possibly driven by the improvement amongst households regarding job security. Furthermore, recent business surveys indicate retailers are feeling more confident about activity in their industry over the coming year. Overall, this suggests retail spending will recover later this year.



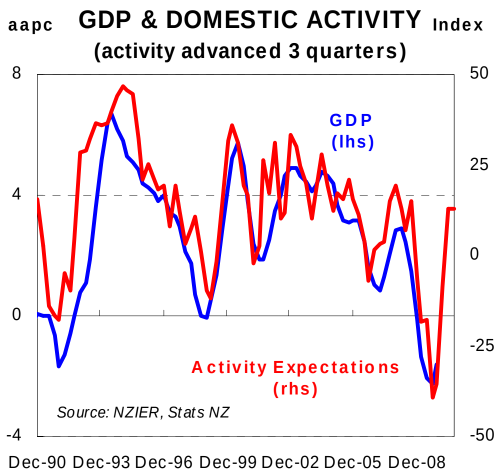
NZ Data Review: weekly recap

Q4 NZIER Quarterly Survey of Business Opinion

While forward-looking business confidence dipped slightly (in seasonally adjusted terms), there was an improvement in experienced activity. Improved demand in the manufacturing and building sectors underpinned the improved activity, with capacity utilisation for these sectors lifting to the highest level since June 2008.

This improved demand has meant increased scope for businesses to pass on rising costs, with margins widening as a result. Despite the resultant increase in experienced profitability, profitability expectations remain low.

Overall, the survey suggests the economic recovery gained some momentum towards the end of 2009 after very weak growth in 2009Q2 and Q3. Nevertheless, the indications are that activity is still pretty weak, in line with our expectations that the recovery has entered into a gradual acceleration of growth rates rather than an explosive rebound.

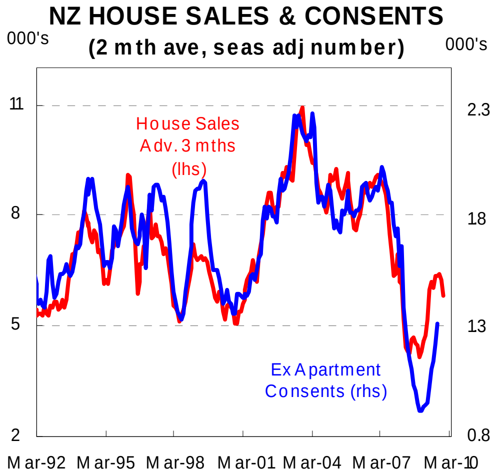


November Building Consent Issuance

Dwelling consent issuance continues to improve, with total consent issuance posting a small gain in November of 1.1%. Our forecast was for a 0.5% gain, and we expect an ongoing lift from the very low level of consent issuance in early 2009.

Core consent issuance averaged around 1900 per month over 2006-2007, but dropped to as low as 745 at the start of 2009. A recovery in the housing market since then has seen core consents lift. The recovery in residential construction continues to lag behind the recovery in housing demand, but the recent increase in house prices should also help stimulate new construction. We expect core consent issuance to continue recovering into 2010.

In contrast to the decline in residential consents during the recession, non-residential consents have remained comparatively steady over the past 18 months. We expect this recent pattern for non-residential work may continue over early 2010 as business confidence recovers.



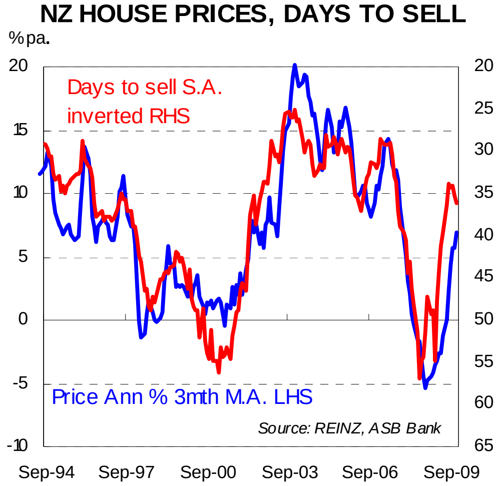
REINZ House Sales - December 2009.

The REINZ Monthly Housing Price Index fell 0.9% in December. Over the past 3 months the index has increased by 2.8%, and is up 6.4% on year-ago levels. Housing prices are 3.8% below the peak reached two years ago in November 2007. The Auckland House Price Index is showing prices are up 9.7% on year-ago levels (was 11.9% in November). Wellington prices are up 9.5% yoy and Christchurch prices are up 5.8% yoy.

The nationwide median house price (not stratified) lifted to $360,000, eclipsing the high set last month of $355,000.

Seasonally-adjusted sales turnover fell 3.5% over the month, with turnover up 15.2% yoy. Turnover is well below average levels (7,200 monthly sales is the average for the period between 1993-2009). Seasonally-adjusted turnover for 2009 peaked at 6659 sales in April 2009. The year ended on a slightly quiet note: seasonally-adjusted turnover of over 6,000 was recorded in 6 out of 12 months last year, but was 5,622 and 5423 in November and December respectively.

December is a holiday affected month. However, at this stage a lift in days to sell, the run-off in turnover, and dip in the stratified house price index suggests that demand pressure may be ebbing after a period of recovering demand outstripping modest supply.



Global Data Calendars

Note: Calendar 2 is in UK times. Add 13 hours for NZ times.

Calendar – Australasia, Japan and China

Date	Time NZT	Econ	Event	Period	Unit	Last	Forecast Market	Forecast ASB/CBA
Mon 18 Jan	17.30	JP	Industrial production	Nov	m%ch	2.6	~	~
					y%ch	-3.9	~	~
	17.30	JP	Capacity utilisation	Nov	m%ch	0.2	~	~
Tue 19 Jan	18.00	JP	Consumer confidence	Dec	~	39.9	~	~
	18.00	JP	Consumer confidence households	Dec	~	39.5	~	~
Wed 20 Jan	10.45	NZ	Food prices	Dec	m%ch	-0.3	~	~
	10.45	NZ	CPI	QIV	q%ch	1.3	0.0	-0.2
					y%ch	1.7	2.1	1.9
	12.30	AU	WBC consumer confidence	Jan	%	-3.8	~	~
					index	113.8	~	~
	12.50	JP	Tertiary industry index	Nov	m%ch	0.5	~	~
	13.00	AU	DEWR skilled vacancies	Jan	m%ch	1.9	~	~
	19.00	JP	Machine tool orders	Dec	~	~	~	~
Thu 21 Jan	10.30	NZ	Business NZ PMI	Dec	~	51.8	~	~
	10.30	NZ	Retail sales	Nov	m%ch	0.3	0.5	0.1
	10.30	NZ	Retail sales ex-auto	Nov	m%ch	-0.1	0.2	0.3
	13.00	AU	MI unemployment expectation	Jan	Index	119.1	~	~
	13.00	AU	MI inflation expectation	Jan	%	3.6	~	~
	13.30	AU	New motor vehicle sales	Dec	m%ch	3.3	~	3.0
					y%ch	15.8	~	15.8
	15.00	CH	GDP	QIV	y%ch	8.9	10.5	~
	15.00	CH	Producer prices	Dec	y%ch	0.7	-2.1	~
	15.00	CH	Consumer prices	Dec	y%ch	1.4	0.6	~
	15.00	CH	Retail sales	Dec	y%ch	16.3	15.8	~
	15.00	CH	Industrial production	Dec	y%ch	19.6	19.2	~
	15.00	CH	Fixed asset investment	Dec	y%ch	32.1	31.5	~
	18.00	JP	Leading index CI	Nov	~	91.2	~	~
	18.00	JP	Coincident index CI	Nov	~	95.9	~	~
Fri 22 Jan	13.30	AU	Export price index	QIV	q%ch	-9.6	~	-2.0
	13.30	AU	Import price index	QIV	q%ch	-3.0	~	-3.9
	17.30	JP	All industry activity index	Nov	m%ch	1.2	~	~

Calendar – North America & Europe

Please note all days and times are UK time, not local release day/times

Date	UK time	Econ	Event	Period	Unit	Last	Forecast Market	Forecast CBA
Mon 18 Jan	00.01	UK	Rightmove house prices	Jan	m%ch	-2.2	~	~
					y%ch	1.7	~	~
Tue 19 Jan	09.30	UK	Consumer Price Index	Dec	m%ch	0.3	~	~
					y%ch	1.9	~	~
	10.00	EZ	Construction output	Nov	m%ch	-0.6	~	~
					y%ch	-7.7	~	~
	10.00	EZ	ZEW survey (eco. sentiment)	Jan	Index	48	~	~
	10.00	GE	ZEW survey (eco sentiment)	Jan	Index	50.4	~	~
	13.30	CA	Leading indicators	Dec	m%ch	1.3	~	~
	13.30	CA	Bank of Canada rate	Jan	%	0.25	0.25	0.25
	14.00	US	Net long-term TIC flows	Nov	$bn	20.7	~	~
	18.00	US	NAHB housing market index	Jan	Index	16.0	17.0	~
Wed 20 Jan	07.00	GE	Producer prices	Dec	m%ch	0.1	~	~
					y%ch	-5.9	~	~
	09.30	UK	Bank of England minutes	Jan	~	~	~	~
	09.30	UK	Jobless claims change	Dec	‘000	-6.3	~	~
	09.30	UK	ILO unemployment rate	Nov	%	7.9	~	~
	12.00	CA	Bank Canada CPI core	Dec	m%ch	0.4	~	~
					y%ch	1.5	~	~
	13.30	CA	Manufacturing sales	Nov	m%ch	2.0	~	~
	13.30	US	Producer price index	Dec	m%ch	1.8	0.0	~
					y%ch	2.4	~	~
	13.30	US	Housing starts	Dec	‘000	574	577	~
	13.30	US	Building permits	Dec	‘000	589	580	~
Thu 21 Jan	09.00	EZ	ECB monthly report	~	~	~	~	~
	13.30	CA	Wholesale sales	Nov	m%ch	0.3	~	~
	13.30	US	Initial jobless and continuing claims					
	15.00	US	Philadelphia Fed Survey	Jan	Index	20.4	18.0	~
	15.00	US	Leading indicators	Dec	m%ch	0.9	0.7	~
Fri 22 Jan	08.30	GE	PMI manufacturing	Jan	Index	52.7	~	~
	09.00	EZ	PMI services	Jan	Index	53.7	~	~
	09.00	EZ	PMI manufacturing	Jan	Index	51.6	~	~
	09.00	EZ	PMI composite	Jan	Index	54.2	~	~
	09.30	UK	Retail sales	Dec	m%ch	-0.3	~	~
					y%ch	3.1	~	~
	10.00	EZ	Industrial new orders	Nov	m%ch	-2.2	~	~
					y%ch	-14.5	~	~
	13.30	CA	Retail sales	Nov	m%ch	0.8	~	~

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