ECONOMICS

18 Oct. 10

Business **Weekly**

Inflation as low as it gets

This Week

This morning's CPI was on the high side of most expectations, particularly the RBNZ's. Even so, at 1.5% yoy it has hit its lowest annual rate since early 2004. But this is as good as it will get for inflation, as the string of government influences of the past 4 months will push inflation above 5% by mid-2011. A number of the influences behind the outsized 1.1% quarterly figure were well anticipated. Fruit and vegetable prices were pushed up as a result of bad weather, and these prices will normalise as growing conditions improve. Around 0.2-0.3 percentage points of the increase were directly due to government related charges: ACC levies, the dregs of the tobacco excise, and the Emissions Trading Scheme.

Notwithstanding these impacts, the domestic (non-tradable) component of inflation was on the high side of our and RBNZ expectations. Other ways of slicing and dicing the inflation figures also suggest the underlying picture isn't as weak as the headline annual rate suggests.

It is unlikely that the RBNZ will react much to this inflation figure, high though it was relative to its forecast. There is enough uncertainty about the pace of local and global economic recovery, the effect of the Canterbury earthquake, and the price impacts of GST to easily warrant the RBNZ remaining on hold for the rest of the year.

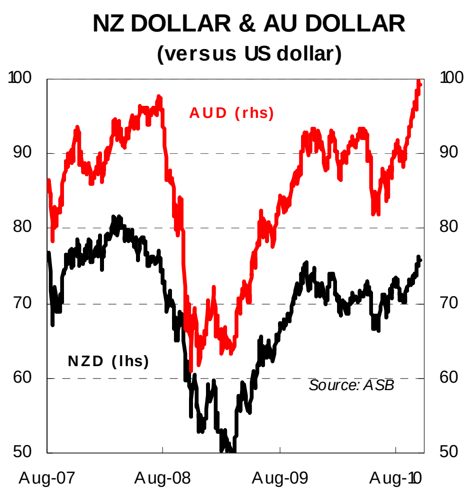
But the RBNZ has made a few (optimistic in our view) assumptions about the mildness of future inflation. For one it forecast very muted inflation for the second half of 2010 (if not longer), and has now found that Q3 wasn't quite as low as anticipated. The Q4 figures, out in mid-January, also risk being on the high side of the RBNZ's current forecast. If so, that would make for two readings undermining the RBNZ's inflation outlook, which hugs the mid-point of the target band even well after the economy has ground out of recession. Furthermore, the RBNZ assumes that medium-term inflation expectations will fall slightly during the run of government-induced price increases, something we see as mildly heroic. A run of less benign inflation and inflation expectations outcomes between now and March are likely to set the scene for a March OCR increase.

One factor that will assist in keeping inflation contained is the high NZ dollar. Any further appreciation of the broader NZD would be over and above the RBNZ's assumption and in isolation could result in the RBNZ remaining on hold for even longer. And further appreciation is indeed a risk, with the rampant AUD briefly hitting parity with the USD. But the dubious benefit of having some lacklustre domestic data is that the NZD has underperformed most major currencies over the last month.

Click here for:

Foreign Exchange	• USD weakness; AUD hits parity with USD. NZD little changed over week.
Interest Rates	• Domestic interest rates little changed over the week. No impact from strong CPI
Week Ahead	• Tourism and Migration (September) Roy Morgan Consumer Confidence
Week in Review	• REINZ House Sales and Retail Sales.
Global Calendars	• US housing data, Fed's Beige book, BoE minutes, Chinese monthly data release.

Chart of the week



- The Australian dollar hit parity with the greenback, rising to US$1.0003 at 1.17am on Saturday before easing back towards 0.99 by this morning.
- The backdrop of firm Asian and global growth, combined with rising Australian interest rates, is supportive of an appreciation for the AUD.
- The high level of the Australian dollar is good news for Aussie consumers and importers but bad news for exporters, rural producers and the tourism sector.
- AUD strength has seen the NZD/AUD cross rate drop from 0.82 in mid-July to 0.76 today. The cross rate is very competitive for New Zealand firms who export into Australia, and helpful for encouraging Australian visitors. Likewise, NZ firms exporting into other markets have a competitive edge over Australian counterparts

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7564	0.7538	0.7302	0.7086	0.7462	FLAT	0.7450	0.7650
NZD/AUD	0.7617	0.7646	0.7729	0.7704	0.8078	FLAT	0.7550	0.7700
NZD/JPY	61.55	61.83	62.56	65.23	67.69	FLAT	61.00	63.00
NZD/EUR	0.5410	0.5393	0.5559	0.5261	0.4996	FLAT	0.5350	0.5450
NZD/GBP	0.4737	0.4728	0.4655	0.4641	0.4558	FLAT	0.4650	0.4800
TWI	66.9	66.9	67.0	65.8	66.8	FLAT	66.00	68.00

^Weekly support and resistance levels * Current is as at 10.20 am Monday; week ago as at Monday 5pm

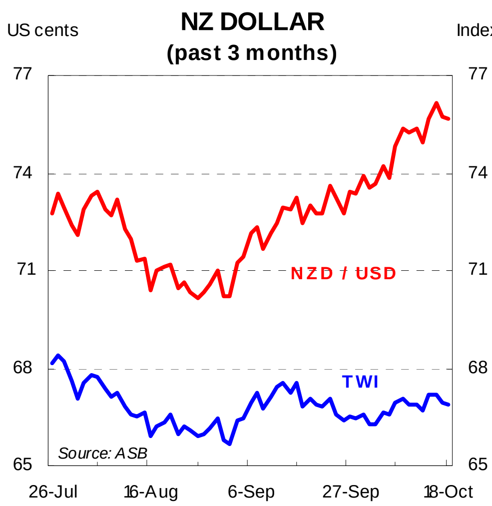
- The NZD ended the week little changed against the USD last week. The NZD has failed to press far beyond the 0.76 mark, peaking around 0.763 last week. We see the risks for the NZD this week as relatively balanced.
- The AUD tried to crack through USD parity (one Australian dollar equalling one US dollar) all last week, and eventually made it through at 1.17am on Saturday morning. The parity party didn't last long though – by the end of New York trade last week the AUD was back down at 0.99 against the greenback. We expect the AUD will re-test the parity figure this week and over the coming months, and peak around 1.02 in early 2011.
- USD weakness continues, as the prospect of further quantitative easing weighs on the USD. The FOMC minutes, and several Fed speakers last week revealed some opposing views on further quantitative easing. However Ben Bernanke's speech on Friday showed the Chairman is of the view that there is a case for further Fed action. Major currencies spiked higher against the greenback as Ben Bernanke commenced his speech only to ease over the remainder of the New York Session. We expect the USD will remain weak with downside risks against the major currencies this week.

.**Short-term outlook:**

Key data	Date	Time (NZST)	Market expects
Tourism and Migration - September	21/10	10.45am	-
Roy Morgan Consumer Confidence	21/10	3.00pm	-

Potential currency movers from the offshore this week: US Net long-term TIC flows, industrial production, capacity utilization, NAHB housing market index (18th); ECB euro zone current account, construction output, and Zew survey (econ. sentiment), US housing starts & building permits, Bank of Canada rate decision (19th); German producer prices, Bank of England minutes, Bank of Canada monetary policy report, US Fed's Beige Book (20th); German, euro zone PMIs, UK retail sales, US weekly initial jobless and continuing claims, Philadelphia Fed survey, euro zone consumer confidence (21st); German IFO - business climate, Canadian CPI and retail sales (22nd).

Fed speakers: Bernanke, Lockhart, Evans, Dudley, Duke, Kocherlakota (20th); Plosser, Lacker (21st); Bullard, Hoenig(22nd); Plosser (23rd).



Medium-term outlook: [Last Quarterly Economic Forecasts]

- We updated our currency forecasts in late September: the NZD forecasts have been lifted slightly. The near-term lift is driven by rising New Zealand Terms of Trade and USD weakness, rather than the New Zealand economy's domestic strength.
- Currency volatility remains low. Reflecting this low volatility, episodes of risk aversion are likely to be smaller and less frequent in the future. When volatility is low, relative economic health becomes a major driver of exchange rates. With this in mind, we have revised up our forecasts for the AUD and CAD as well as the NZD forecasts. These economies continue to benefit from strong Terms of Trade and upward pressure on local interest rate settings. AUD in particular is likely to out-perform over the coming months.
- We anticipate that the USD will decline further over the next six months, as the Fed continues with its commitment to keep rates at extremely low levels for an extended period of time. If the Fed implements more quantitative easing before year-end, the USD will further decline.
- GBP is forecast to out-perform EUR, reflecting a more rapidly improving UK economy and a healthier banking system. We are holding to our medium-term view that the EUR is likely to exhibit a mild bias to depreciate as selected euro zone sovereign states continue to experience funding pressures and the European Central Bank (ECB) extends "unlimited liquidity" to euro zone banks.
- JPY, CHF and SGD are likely to continue to appreciate in the coming months as market participants gravitate toward the "safety" of current account surplus country's currencies.

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	3.00	3.00	3.00	2.50	2.50	FLAT
90-day bank bill	3.20	3.19	3.17	2.69	2.82	FLAT
2-year swap	3.79	3.80	3.84	4.25	4.68	FLAT
5-year swap	4.38	4.37	4.46	5.23	5.66	FLAT
5-year benchmark gov't stock	4.35	4.41	4.59	5.16	5.18	FLAT
NZSX 50	3266	3235	3212	3282	3207	UP

* 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.6 months ago).

- The NZ curve was little changed over the week, with rates up to 5 years trading in a narrow range. Longer term rates drifted higher, following the US move up. The NZ 10-year swap rose from 4.94 to 5% over the week. The market did not react to the Q3 CPI inflation figures this week, despite quarterly inflation printing a touch stronger than the market expectation (a summary of the outturn is in the review section of this document).
- There is limited Australian data scheduled this week. The highlight will likely be the RBA's October meeting minutes on 19 October. After the surprise on-hold decision on 5 October, it will be interesting to see the more detailed rationale for leaving rates unchanged.
- US Federal Reserve chairman Ben Bernanke has signalled more quantitative easing, saying, "there would appear - all else being equal - to be a case for further action." However, long-term US Treasury yields actually rose on Friday despite the speech. Market participants perhaps expected something more specific from Bernanke. A dip in demand in recent auctions also been blamed for week's bond sell-off, which pushed the US 10-year yield back up to 2.50% for the first time in two weeks. Over the week US 10 year yields rose by 16.5pts.

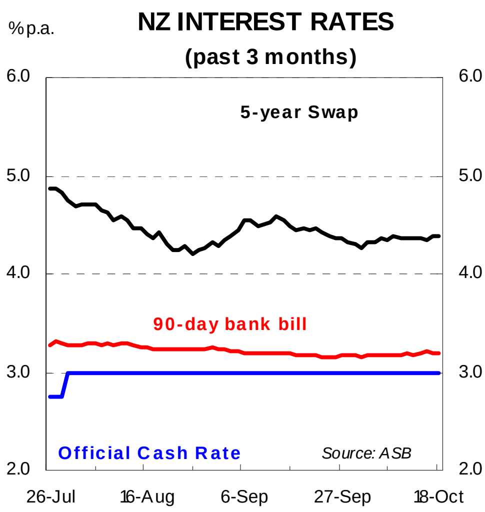
Short-term outlook:

Key data	Date	Time (NZST)	Market expects
Tourism and Migration - September	21/10	10.45am	-
Roy Morgan Consumer Confidence - Oct	21/10	3.00pm	-

Comment: Although the Q3 CPI result was stronger than the RBNZ's forecast in the September MPS, the RBNZ is unlikely to be troubled by the outcome. The 1.5% annual increase is the smallest annual increase since March 2004. However, the detail within the Q3 CPI release suggests inflation pressures are picking up.

The RBNZ meet next week on 28th October. We do not expect this week's data, or the NBNZ's Business Outlook Survey next week to change the view that the RBNZ remaining on hold is appropriate at present.

We expect the next 25bp rate hike from the RBNZ will occur at the March 2011 MPS review.



Medium term outlook: [Last Quarterly Economic Forecasts]

- The RBNZ kept the OCR unchanged at 3% at the September Monetary Policy Statement. The RBNZ had lifted the OCR in June and July. However, with recent data proving weaker than expected, fears the global economy may be losing some momentum and added uncertainty created by the Canterbury Earthquake, we expect the RBNZ to remain on hold until early next year.
- The RBNZ slashed its growth forecasts in its September Monetary Policy Statement. The RBNZ undertook a major rethink on the household sector outlook. Noting the weakening fundamentals for the housing market and weak appetite for credit, the RBNZ substantially scaled back forecasts for household spending and investment.
- The RBNZ also slashed its projection for the 90-day interest rate, reflecting its weaker outlook for the domestic economy as well as placing more emphasis on higher bank funding costs. The RBNZ now has an implicit assessment of neutral closer to our own, although we expect that the RBNZ will get there more quickly than the 2.5 years implied by its MPS forecasts.
- The RBNZ has also revised its inflation forecast lower. However, we believe the RBNZ is being optimistic in assuming medium-term inflation expectations will remain subdued in face of a spike in headline CPI over the coming year.
- We now expect the RBNZ will wait until March to resume lifting the OCR. That gives another 6 months to allow the economy to strengthen and better assess the earthquake disruption. Between now and then one CPI and two inflation expectations results will be released. On both fronts we expect the RBNZ to become less sanguine about its low medium-term inflation outlook (building on the implications of the Q3 CPI). Market pricing of a 3.8% OCR peak by mid-2012 still looks light, but in the immediate future there appears no catalyst to change that expectation.

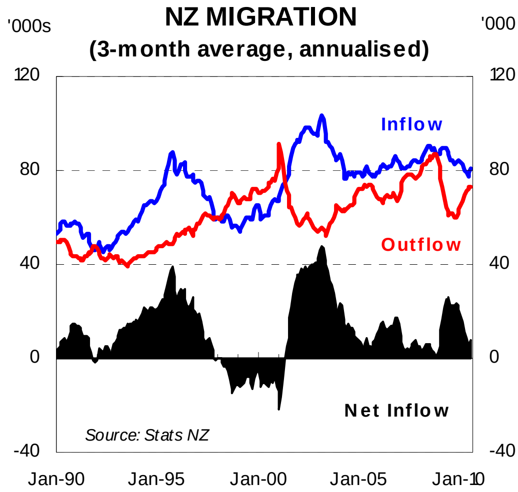
NZ Data Preview: a look at the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
September Tourism and Migration – permanent inflows	21/10	10.45am	+840	-	-
Roy Morgan Consumer Confidence - October	21/10	3.00pm	116.4	-	-

Thursday 21 October

Tourism and Migration - September

Previous permanent net inflows:
+840 (Aug month, s.a.), +14,507 (year to Aug).



Monthly net migration has shown some recovery in the last two months from the weak levels seen earlier in the year. Departures to Australia and UK show some signs of stabilising following some robust growth in recent months. Nonetheless, total departures look to remain on an upward trend and departures to Australia will be one to keep an eye on given the continued strength in the Australian labour market.

A decline in PLT arrivals in August was broad-based. This largely reflected a smaller number of people arriving here on work permits, given continued weakness in the NZ labour market. Overall, we expect annual PLT inflows to decrease over the next year.

Short-term visitor arrivals edged up slightly in August, reflecting a recovery in tourists from the US and Asia. We expected this recovery to continue, although the Canterbury earthquake will most likely have impacted travel plans for short-term arrivals and departure figures in September.

NZ Data Review: weekly recap

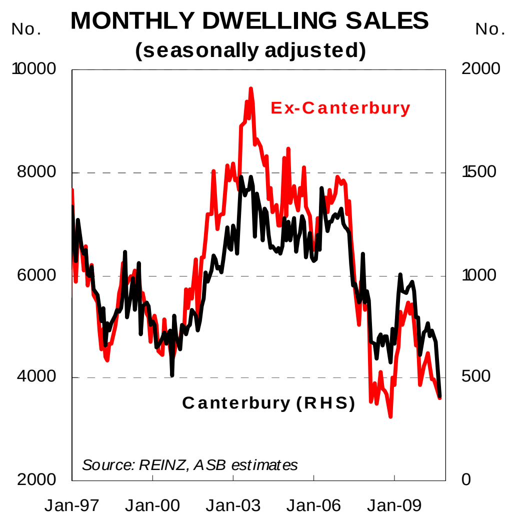
September REINZ house sales

The data were affected by the Canterbury earthquake, with house sales in the Canterbury/Westland region falling 38% from the previous month on a seasonally-adjusted basis. Excluding this region, house sales fell 6.5%.

Nationwide days to sell extended to 45 days, from 44 in August. We estimate that excluding Canterbury, days to sell held steady. This suggests the housing market remains tipped in favour of buyers, with days to sell comfortably above the long-run average of 38 days.

The REINZ Stratified Median House Price Index (which takes into account the composition of houses sold) eased 0.3% over the month, to be down 1.3% on year-ago levels.

We expect that housing turnover in Canterbury will be very subdued over the rest of the year. Insurance issues disrupted the settlement of sales in September, and added caution over potential hidden damage is likely to slow sales down.

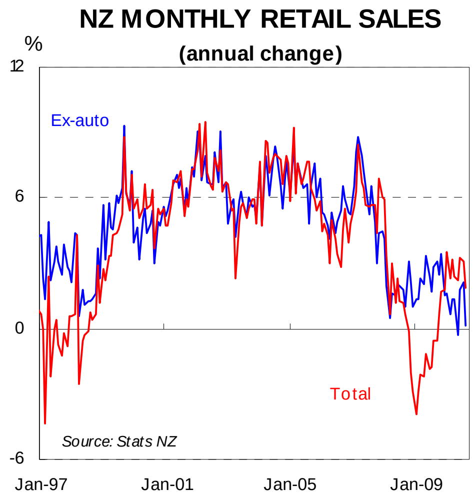


August Retail Sales

Total retail sales were flat over the August month, while excluding the auto sector sales declined 0.6%. This weaker than expected result reflected continued caution amongst households in regards to spending. Declines in hardware and appliance spending suggested little sign of a pre-GST spend-up. The weakness in these areas is also likely a reflection of continued subdued activity in the housing market. However, more recent electronic card transactions data showed a robust increase in spending on durables in September, suggesting these declines will largely reverse over in the following month.

Spending in other areas was also subdued, particularly in regards to discretionary spending. In particular, spending in department stores and bars and clubs continued to decline.

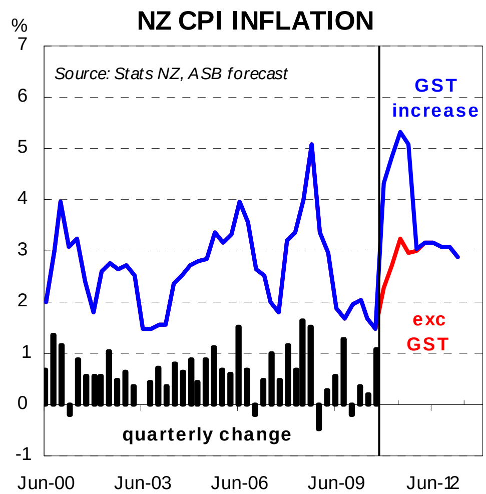
Overall, the August result points to continued caution amongst households in regards to spending.



Q3 CPI Review.

At 1.1% qoq and 1.5% yoy the Q3 CPI was a touch below our expectations, but stronger than what the RBNZ forecast at the September MPS. Non-tradable inflation, at 1.2% qoq showed signs of picking up from some weak results in previous quarters, even leaving aside the boost from various Government charges for the quarter.

As we expected, the 2.4% increase in food prices was the key driver of the increase in tradable inflation in Q3. There was an increase in the proportion of items in the CPI basket which increased in price, suggesting that inflation was becoming more broad-based. In addition, the annual rate of increase in the weighted median CPI ticked up to 1.6% in Q3 (from 1.3% in the previous quarter), while the annual rate of trimmed mean was 1.7%. Given the weighted median and trimmed mean measures are used to gauge underlying inflation in the NZ economy, these results suggest inflation pressures are picking up.



Global Data Calendars

Note: Calendar 2 is in UK times. Add 12 hours for NZ times.

Calendar - Australasia, Japan and China

Date	Time NZT	Econ	Event	Period	Unit	Last	Forecast Market	Forecast ASB/CBA
Mon 18 Oct	12.50	JP	Tertiary industry index	Aug	m%ch	1.6	~	~
	13.30	AU	New motor vehicle sales	Sep	m%ch	0.3	~	~
					y%ch	10.5	~	~
	18.30	JP	Nationwide dept. sales	Sep	y%ch	-3.2	~	~
	18.30	JP	Tokyo dept. store sales	Sep	y%ch	-3.4	~	~
Tue 19 Oct	04.00	JP	Cabinet office monthly economic report	~	~	~	~	~
	13.30	AU	Reserve Bank's Board October minutes	Oct	~	~	~	~
Wed 20 Oct	13.00	AU	DEWR skilled vacancies	Oct	m%ch	0.1	~	~
	13.30	AU	Westpac leading index	Aug	m%ch	0.4	~	~
	18.00	JP	Coincident index CI	Aug	Index	103.5	~	~
	18.00	JP	Leading index CI	Aug	Index	99.1	~	~
	20.00	JP	Convenience store sales	Sep	Sep	1.0	~	~
Thu 21 Oct	10.45	NZ	New Zealand net migration	Sep	Index	840.0	~	~
	13.00	AU	CBA-HIA housing affordability index	QIII	Index	108.3	~	~
	15.00	CH	Real GDP	QIII	y%ch	10.3	9.5	~
	15.00	CH	Producer price index	Sep	y%ch	4.3	4.1	~
	15.00	CH	GDP year-to-date	QIII	y%ch	11.1	10.5	~
	15.00	CH	Purchasing price index	Sep	y%ch	7.5	~	~
	15.00	CH	Consumer price index	Sep	y%ch	3.5	3.6	~
	15.00	CH	Retail sales	Sep	y%ch	18.4	18.5	~
					ytd y%ch	18.2	18.3	~
	15.00	CH	Industrial production	Sep	y%ch	13.9	14.0	~
					ytd y%ch	16.6	16.3	~
	15.00	CH	Fixed assets inv urban	Sep	ytd y%ch	24.8	24.6	~
	15.00	NZ	Credit card spending	Sep	m%ch	0.5	~	~
					y%ch	2.0	~	~
	15.00	NZ	ANZ consumer confidence index	Oct	Index	116.4	~	~
	17.30	JP	All industry activity index	Aug	m%ch	1.0	~	~
Fri 22 Oct	13.30	AU	International trade price indexes					
			Export prices	QIII	q%ch	16.1	~	1.0
			Import prices			1.9	~	0.0

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 Oct	13.30	CA	International securities transactions	Aug	C$bn	5.5	~	~
	14.00	US	Net long-term TIC flows	Aug	$bn	61.2	~	~
	14.15	US	Industrial production	Sep	m%ch	0.2	0.2	~
	14.15	US	Capacity utilization	Sep	%	74.7	74.8	~
	15.00	US	NAHB housing market index	Oct	Index	13.0	14.0	~
Tue 19 Oct	09.00	EZ	ECB Euro-Zone current account	Aug	€bn	-3.8	~	~
	10.00	EZ	Construction output	Aug	m%ch	-3.1	~	~
	10.00	EZ	Zew survey (econ. sentiment)	Oc	Index	4.4	~	~
	13.30	US	Housing starts	Sep	‘000	598.0	587.0	~
	13.30	US	Building permits	Sep	‘000	571.0	575.0	~
	14.00	CA	Bank of Canada rate	Oct	%	1.00	1.00	1.00
Wed 20 Oct	07.00	GE	Producer Prices	Sep	m%ch	0.0	~	~
	09.30	UK	Bank of England minutes	Oct	~	~	~	~
	13.30	CA	Wholesale sales	Aug	m%ch	-0.1	~	~
	15.30	CA	Bank of Canada monetary policy report	Oct	~	~	~	~
	19.00	US	Fed's Beige book	Oct	~	~	~	~
Thu 21 Oct	08.30	GE	PMI manufacturing	Oct	Index	~	~	~
	08.30	GE	PMI services	Oct	Index	~	~	~
	09.00	EZ	PMI composite	Oct	Index	~	~	~
	09.30	UK	Major banks mortgage approvals	Sep	‘000	45.0	~	~
	09.30	UK	Retail sales	Sep	m%ch	-0.5	~	~
					y%ch	0.4	~	~
	13.30	CA	Leading indicators	Sep	m%ch	0.5	~	~
	13.30	US	Initial jobless and continuing claims	Oct	~	~	~	~
	15.00	EZ	Consumer confidence	Oct	Index	-11.0	~	~
	15.00	US	Leading indicators	Sep	m%ch	0.3	0.2	~
	15.00	US	Philadelphia Fed.	Oct	Index	-0.7	~	~
Fri 22 Oct	09.00	GE	IFO - business climate	Oct	Index	106.8	~	~
	12.00	CA	CPI	Sep	m%ch	-0.1	~	~
					y%ch	1.7	~	~
	13.30	CA	Retail sales	Aug	m%ch	-0.1	~	~

ASB ECONOMICS & RESEARCH PHONE FAX

Economics

Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 374 8604	(649) 302 0992
Economist	Jane Turner	jane.turner@asb.co.nz	(649) 374 8185	
Economist	Christina Leung	christina.leung@asb.co.nz	(649) 369 4421	
CBA NZ Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 374 8819	