

# Business Weekly

## Inflation causes a jolt

### This Week

Local events of the past week made us increasingly wary about the chances the RBNZ will wait until 'the latter part of 2010' before starting to lift the OCR back towards a more normal level. Australian markets were also rocked by utterances from the RBA Governor. The impact of the string of events has pushed local interest rates up further.

First cab off the rank was NZ house prices. Strengthening buyer interest but low listing levels have turned the housing market into a sellers' market once more. Consequently, the REINZ's new stratified median price measure has risen nearly 8% off its low, reversing losses made since roughly mid-2008. The RBNZ's September *Monetary Policy Statement* and other recent comments from the RBNZ indicate a rising degree of concern about the imbalanced nature of the economic recovery (i.e. a household-based one built on housing). The RBNZ sees a return to a debt-fuelled household-led economy as undesirable given the already-considerable external liability position of NZ. That gives another dimension to the importance of housing, over and above direct inflation pressures.

Next, Q3 CPI inflation increased 1.3% qoq, with the market median expectation centred on 0.8%, and the RBNZ expecting 0.9% (as were we). This result was considerably stronger than expected, underlying inflation pressures have not weakened to the extent expected.

Later in the day after the CPI release, the RBA Governor stepped up to the plate with a speech. Just over a week beforehand he talked about 'gradual' removal of stimulus. Less than two weeks (and a large jump in employment) later and the message had changed to "prompt", with the view that central banks can't be "too timid" in removing rate cuts made in response to a threat when that threat has passed. Asian central banks are starting to make the same sort of noises. Australian market expectations of a 50bp move in November have intensified as a consequence of the speech.

We see the NZ inflation outcome and recent acceleration in house prices as making the RBNZ more reluctant to leave the OCR unchanged until "the latter part of 2010". The risk has grown of the RBNZ unwinding the stimulus earlier than it implies. We now see April as the more likely timing (previously June), which still leaves the RBNZ lagging behind the RBA. But we expect the RBNZ to move the OCR in 50bp moves in the initial stages. The RBNZ will want to be sure the economy will continue to recover – but once it has that certainty we expect the RBNZ Governor will be using words like 'prompt' from the start rather than 'gradual'.

### Click here for:

#### [Foreign Exchange](#)

- NZD extends gains as local data outperforms and USD weakens

#### [Interest Rates](#)

- Stronger CPI brings rate expectations forward

#### [Week Ahead](#)

- Annual net migration flow to continue rising

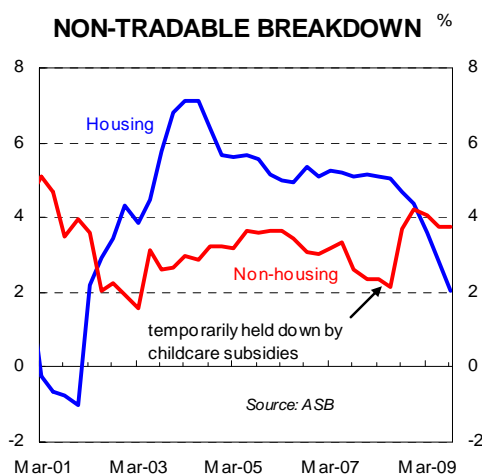
#### [Week in Review](#)

- Inflation and retail spending stronger than expected, house prices rise.

#### [Global Calendars](#)

- BoC rate window; RBA and BoE meeting minutes; US Beige Book, housing.

### Chart of the week



- The component of inflation classed as non-tradable inflation is primarily driven by domestic influences (such as wages, construction costs) as opposed to tradable inflation, which is influenced heavily by global price movements and the NZD.
- Housing makes up a significant component of non-tradable inflation via rents, the cost of constructing a new home, and local authority charges. The demand-influenced parts such as rents and construction costs are registering very muted increases, a sign the recession is biting.
- In contrast, non-tradable inflation outside the housing components is surprisingly high still. Administered inflation (i.e. government fees and duties) remains high, compounded by still-strong local authority rates. These components are making inflation sticky, restricting the extent to which inflation will weaken despite the deep recession.

### General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

## Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7384	0.7263	0.7103	0.5675	0.6173	UP	0.7300	0.7500
NZD/AUD	0.8074	0.8050	0.8154	0.7886	0.8902	DOWN	0.8000	0.8150
NZD/JPY	67.21	65.47	64.80	56.17	62.72	UP	66.50	68.00
NZD/EUR	0.4958	0.4942	0.4825	0.4361	0.4587	FLAT	0.4950	0.5050
NZD/GBP	0.4527	0.4589	0.4333	0.3849	0.3562	DOWN	0.4450	0.4600
TWI	66.3	65.7	64.7	56.6	61.1	UP	65.00	67.00

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

- NZD steadily pushed higher over the week, spurred by ongoing USD weakness and stronger than expected local data (including retail sales, REINZ house prices and inflation). However, the NZD lost much of its gains over the weekend (on the back of US dollar recovery) ending up just over a cent on last Monday's levels. We see the USD remaining at low levels this week, so see further upside risks to NZD this week.
- The NZD lost ground against the AUD, underscored by the difference in interest rate outlooks between the RBA and the RBNZ. The NZD made a number of attempts to gain ground against the AUD as NZ data outperformed, although these gains were ultimately trumped by the ramp up in market expectations for the RBA to deliver 50bp in November. There are no market moving New Zealand economic data scheduled for release this week. Australian and US economic data are likely to be the major influences on NZD/AUD this week, and we think the balance of risks lie with a lower NZD/AUD this week.
- The NZD also lost footing against the pound, although this is coming off some recent highs. Officials from the Bank of England (BoE) have finally started to sound more confident their policies are aiding the UK's economic recovery. The release this week of the minutes from the BoE's previous policy meeting will be closely watched for clues to an early end to the BoE's "quantitative easing" program. We see downside risks to NZD/GBP this week.

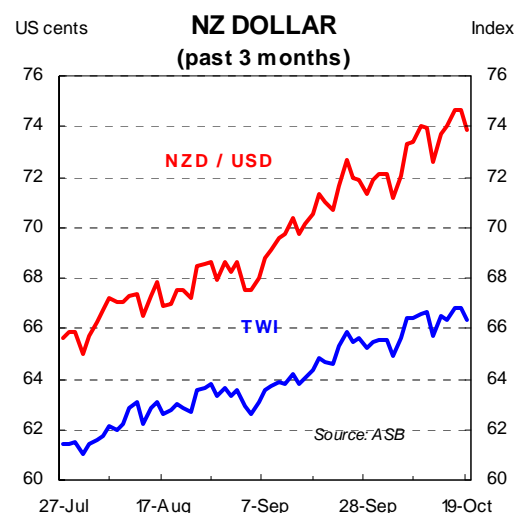
### Short-term outlook:

Key data	Date	Time (NZST)	Market expects
September Net Migration	21/10	10.45	-

**Potential currency movers from this week:** UK house prices (19th), US housing starts, building permits (20th); minutes from the Bank of England's previous policy meeting (21st) Federal Reserve's Beige book of business liaison (21st); UK retail (22nd) US jobless claims, house prices (22nd); UK GDP (23<sup>rd</sup>), US existing house sales (23rd). Speakers: Bernanke (19th, 23rd), Plosser (20th), Rosengren (22nd)

### Medium-term outlook: [Last Quarterly Economic Forecasts](#)

- We continue to expect the NZD to appreciate further against the USD over the next 6-9 months. However, we have revised up our expected peak to USD 0.82. The story remains primarily one of USD weakness, also overlaid by some Downunder strength.
- The reasons for the expected USD weakness remain similar to the drivers in place since mid-March, namely:
  - 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.
  - Diversification out of USD is expected to occur due to concerns about US government debt.
  - And, related, concern about the USD's future role as a reserve currency.
- 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 British 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. The NZD will be caught somewhere in the middle: weakening slightly against the AUD but dragged up against other currencies.
- For more on the relative fundamentals driving the NZD see our Economic Note ["NZD: The Flighty Bird"](#).
- The September MPS made it pretty clear the RBNZ is unlikely to cut the OCR to try dampening the NZD. Direct FX intervention also appears unlikely (at the least, very risky) with the dominant driver of the high NZD being the weak USD.



## 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	3.00	7.50	FLAT
90-day bank bill	2.82	2.81	2.78	3.04	7.14	FLAT
2-year swap	4.71	4.40	4.08	3.70	6.33	FLAT
5-year swap	5.68	5.48	5.38	4.83	6.47	FLAT
11/11 gov't stock	5.15	4.94	4.86	4.20	5.74	FLAT
NZSX 50	3205	3174	3158	2695	2809	UP

\* Current is as at 11am Monday; week ago as at Monday 5pm

- Last week's CPI report delivered a shocking surprise, with inflation rising 1.3% qoq compared to market expectations of 0.8%. A surprise larger than a 0.2 percentage points is considered significant, so a difference of 0.5 percentage points is very rare, causing a strong market reaction. The headline rate of inflation is not moderating as much as expected and, although underlying inflation pressures remain weak, the downside risks to inflation are rapidly disintegrating.
- Combined with a strong housing market report the previous day (days to sell suggest an incredibly tight housing market with house prices likely to rise further), interest rates made strong gains as the market brought forward expectations of OCR hikes. The yield curve flattened.
- We have moved our rate call forward, now expecting the first OCR hike in April (with an aggressive 50 basis point start). The market is getting ahead of slightly itself, pondering the possibility of a hike in December, with 25bp fully priced in for January and 50bp priced in for March.
- Tough talk from RBA Governor Stevens also added to the momentum last week. At a speech on Thursday the Governor switched his tone from a "gradual" to "prompt" withdrawal of stimulus being needed. The market is now moving to expect a 50bp hike in November.

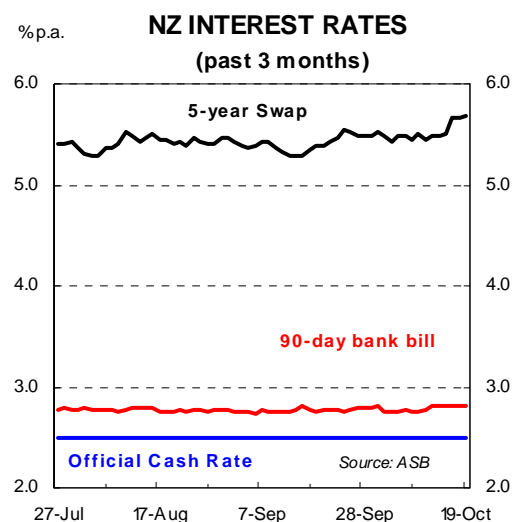
### Short-term outlook:

Key data	Date	Time (NZST)	Market expects
September Net Migration	21/10	10.45	-

**Comment:** The RBA board minutes Tuesday (1.30 pm NZT) is the largest wild card of the week, with market rate expectations currently evolving rapidly. Recovering net migration in NZ is another reminder of buoyant demand in the housing market, and another strong result will provide support to the market's optimistic expectation of early rate hikes from the RBNZ. Offshore, a deluge of Chinese data will be on the radar, including the first estimate of Q3 GDP. An array of US housing data and the Fed's beige book are the highlights from the States.

### Medium term outlook: [\[Last Quarterly Economic Forecasts\]](#)

- The RBNZ continues to hold the cash rate at 2.5%, although has now backed off its easing bias. The market did not see a strong easing bias as credible given the number of stronger than expected indicators of late. In September, the RBNZ continued to state it expected to hold the cash rate at or below current levels until the latter part of 2010. That stance is becoming increasingly untenable.
- The RBNZ's overall growth and inflation forecasts were unchanged at the September MPS, despite incorporating significantly stronger monetary conditions. The RBNZ sees more inflation pressure in the economy stemming from a less weak global outlook, a pick up in net migration supporting the housing market, and improved business confidence.
- Over the past few months, the continual flow of better than expected data will be hard for the RBNZ to ignore. World demand has stabilised and the outlook for 2010 continues to improve. Dairy prices have lifted off lows and have led Fonterra to revise up its forecast payout. While the agricultural sector remains under extreme pressure, the downside risk to growth stemming from this sector is lessening. Net migration continues at a robust pace, and continues to provide support to housing demand in a tight market. Housing supply has been slow to respond, resulting in a surprisingly strong lift in house prices over the past 6 months which is likely to make the RBNZ uncomfortable. Business and consumer confidence has surged pointing to an earlier recovery in growth than previously thought. Meanwhile, the downside risks to inflation have also abated.
- The next move in the OCR is up, it's just a matter of when. We expect the RBNZ will hike by April next year (previously June). 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

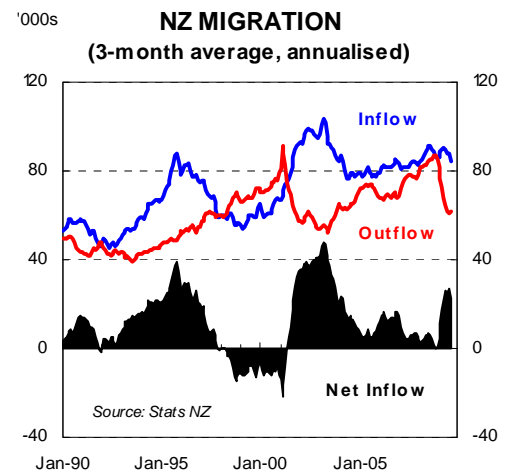
Data	Date	Time (NZST)	Previous	Market expects	ASB expects
Sep International Travel and Migration	21/10	10.45 am	15,640	-	-

### International Travel and Migration - September

#### Net Migration: previous 15,640 per annum (year to August)

Net migration inflows have picked up strongly over the past six months, mostly owing to a dramatic fall in the number of departures, particularly to Australia. The deterioration in the world economy is likely to be behind the decline in departures as a weakening labour market in Australia has deterred New Zealanders from heading across the Tasman. We expect these trends to continue, with net migration peaking early in 2010 at around 22,000 net new migrants per annum. A boost to net migration has provided some underlying support to NZ's flagging housing construction sector.

Overseas short-term visitor arrivals are also expected to slow over the next year as weakening world growth reduces demand for international travel.

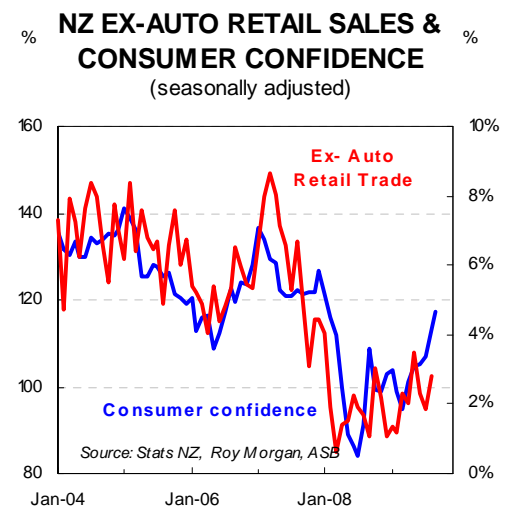


## NZ Data Review: weekly recap

### August Retail Trade Survey

Retail sales picked up strongly over August, with retail sales up 1.1% compared to market median expectations of a 0.5%. Core retail spending increased 1.2% following two consecutive months of decline, suggesting some technical bounce back was likely in the volatile monthly survey. Clothing sales led the surge, up 6.5% with the unseasonably warm weather in August potentially helping early spring clothing sales. Housing-related sectors (such as hardware and furniture stores) also enjoyed strong growth in spending over the past month, with the turn around in housing demand likely to be stimulating spending on housing related goods.

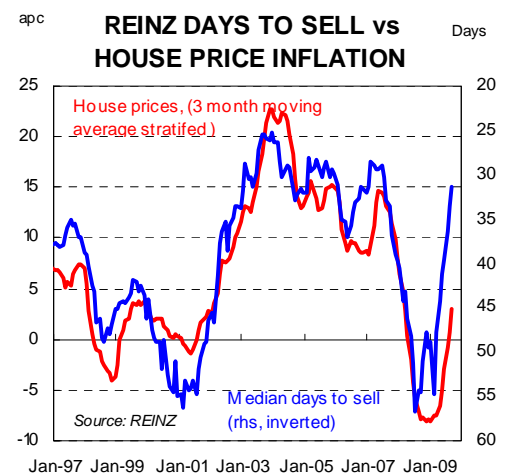
The pick up over August does highlight the improved optimism on the consumer spending outlook. Consumer confidence has lifted firmly over recent months. In addition, retail spending volumes should also be supported by the current surge in net migration. We do expect a slow recovery in consumer demand to continue over the next year.



### September REINZ housing data

House sales increased 2.9% (seasonally adjusted) over September, largely as expected given the steady pace of mortgage approvals and agent listing data. Housing demand continues to be underpinned by the lift in net migration and low interest rates.

REINZ stratified median house prices increased 1.9% over September, and are up 2.5% over the past 3 months. The lift in house prices over the quarter was slightly stronger than we had expected, with house prices maintaining momentum from the June quarter. The lift in house prices comes from an imbalance between supply and demand. Median days to sell have dropped sharply over the past few months, and are now at 31.4 days – well below average. The low number of days to sell is indicative of a competitive housing market, and suggests further increases in house prices are likely over the next few months.



### Q3 CPI Inflation

Inflation was significantly stronger than anticipated, increasing 1.3% compared to median market expectations of 0.8%.

Part of the surprise was on the non-tradable front, the portion most related to the state of domestic inflation pressures. However, the key housing components – housing construction, maintenance, rents – were very weak (part of the decline in maintenance costs was the insulation subsidy). During the housing boom these components were the bugbear of the RBNZ, but they are likely to contain inflation a while longer given subdued construction levels. But with house prices creeping up, so are real estate agent fees, one area in which the housing market is starting to lift inflation.

Many of the strong contributors to non-tradable inflation were administered inflation. The increase in local authority rates of 5.6% qoq was slightly more than anticipated. Vehicle licencing fees rose 16.2%, impacted by higher Accident Compensation Corporation levies, which should also have impacted non-tradables. Medical costs were lifted by hospital services charges.

Tradables inflation was affected by sharp seasonal rebounds in international airfares (up 11%), and lagged effects of the past NZD depreciation on imported goods. One example is car prices, up 3.1% despite low sales volumes. We expect the NZD rebound will start to dampen imported inflation going forward.

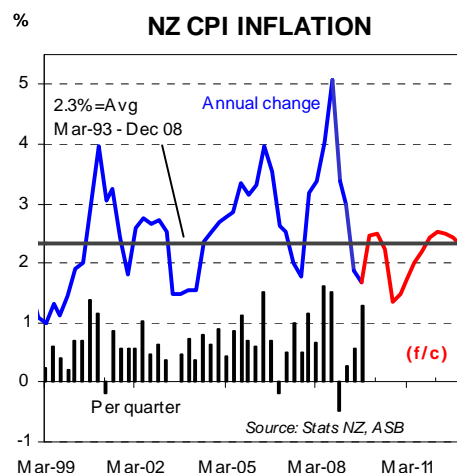
### 2009 Fiscal Accounts

Core Crown Tax revenues for the 2009 June year were \$54.681 billion, against May's Budget forecast of \$54.053 billion. The full-year deficit was larger than we expected given that in the 11 months to May the deficit was tracking slightly smaller than the expectation for the 11 months to May. The main change has been in the expense line, which went from being approximately \$550mn below what was forecast for the 11 months to May to being around \$1,650 million higher for the full 12 months.

Relative to the 2008 June year, the Treasury notes a few key expense increases:

- An estimated cost to the Crown of \$800mn for the deposit guarantee schemes. The cost is based on an assessment of the risk of default, which in the retail guarantee scheme's case covers 73 institutions and \$124 billion of guaranteed deposits (note though that the sum of deposits at risk through 2 finance company failures to date amounts to less than revenue the Crown has received from guarantee fees). The May Budget did not include an expense for the schemes.
- Reduced expected value of collections from tax receivable and student loans on assumption of reduced recovery rates (with both combining to a \$1.3bn expense increase).
- Increased unemployment benefits paid relative to 2008.
- The value of KiwiRail has been written down \$300mn

Some washouts at the end of the year contributed to a larger OBEGAL deficit than the Budget forecast. However, given the near certainty that the Treasury will revise up its economic outlook, the forecast deficits in December's Half Year Update will be smaller than the Budget forecasts. We continue to expect the Government to run substantial deficits and raise huge amounts of debt, but the average annual deficit over 2010 – 2013 is likely to be closer to \$5.5bn than the \$8.7bn average forecast in May's Budget.



## Global Data Calendars

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

### Calendar – Australasia, Japan and China

Date	Time		Econ Event	Period	Unit	Last	Forecast	
	NZST						Market	ASB/CBA
Mon 19 Oct	15.00	AU	RBA Assistant Governor Lowe speaks in Sydney					
	18.30	JP	Tertiary industry index	Aug	m%ch	0.6	~	~
Tue 20 Oct	13.30	AU	Reserve Bank's Board October minutes					
	18.00	JP	Leading index CI	Aug	Index	83.3	~	~
	18.00	JP	Coincident index CI	Aug	Index	91.4	~	~
	19.00	JP	Machine tool orders	Sep	y%ch	-61.9	~	~
Wed 21 Oct	10.45	NZ	Visitor arrivals	Sep	m%ch	-0.8	~	~
	13.00	AU	Westpac leading index	Aug	m%ch	1.1	~	~
	13.30	AU	New motor vehicle sales	Sep	m%ch	0.3	~	2.5
					y%ch	-6.2	~	-3.7
Thu 22 Oct	15.00	NZ	Credit card spending	Sep	y%ch	0.1	~	~
	12.50	JP	Merchandise trade balance	Sep	¥bn	183.3	~	~
	12.50	JP	Adj merch trade balance	Sep	¥bn	235.4	~	~
	12.50	JP	Merchandise trade exports	Sep	y%ch	-36.0	~	~
	12.50	JP	Merchandise trade imports	Sep	y%ch	-41.3	~	~
	13.30	AU	CBA/HIA house affordability	QIII	Index	152.5	~	~
	15.00	CH	Real GDP	QIII	y%ch	7.9	8.9	~
	15.00	CH	Producer price index	Sep	y%ch	-7.9	-7.4	~
	15.00	CH	Purchasing price index	Sep	y%ch	-11.4	-10.7	~
	15.00	CH	CPI	Sep	y%ch	-1.2	-0.8	~
	15.00	CH	Retail sales	Sep	y%ch	15.4	15.5	~
					ytd y%ch	15.1	15.1	~
	15.00	CH	Industrial production	Sep	y%ch	12.3	13.1	~
					ytd y%ch	8.1	8.6	~
	15.00	CH	Fixed assets inv urban	Sep	ytd y%ch	33.0	33.0	~
	17.30	JP	All industry activity index	Aug	m%ch	0.5	~	~
	Fri 23 Oct	13.30	AU	Import price index	QIII	q%ch	-6.4	~
13.30		AU	Export price index	QIII	q%ch	-20.6	~	0.4

## Calendar – North America & Europe

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

Date	UK			Period	Unit	Last	Forecast	
	time	Econ	Event				Market	CBA
Mon 19 Oct	00.01	UK	Rightmove house prices	Oct	m%ch y%ch	0.6 -1.5	~ ~	~ ~
	10.00	EZ	Construction output	Aug	m%ch	-2.0	~	~
	18.00	US	NAHB housing market index	Oct	Index	19.0	20.0	~
Tue 20 Oct	09.30	UK	Public finances (PSNCR)	Sep	£bn	10.4	~	~
	09.30	UK	Public sector net borrowing	Sep	£bn	16.1	~	~
	13.30	CA	Wholesale sales	Aug	m%ch	2.8	~	~
	13.30	CA	Leading indicators	Sep	m%ch	1.1	~	~
	13.30	US	Producer price index	Sep	m%ch y%ch	1.7 -4.3	0.2 -4.5	~ ~
	13.30	US	Housing starts	Sep	'000	598	608	~
	13.30	US	Building permits	Sep	'000	579	590	~
	14.00	CA	Bank of Canada rate	Oct	%	0.25	0.25	0.25
	Wed 21 Oct	09.30	UK	Bank of England minutes	Oct	~	~	~
19.00		US	Fed's Beige book	Oct	~	~	~	~
Thu 22 Oct	09.00	EZ	ECB Current account	Aug	€bn	6.6	~	~
	09.30	UK	Retail sales	Sep	m%ch	0.0	~	~
	10.00	EZ	Government debt/GDP ratio	Dec	%	69.3	~	~
	13.30	US	Initial jobless claims	Oct	'000	~	515	~
	14.00	CA	Retail sales	Aug	m%ch	-0.6	~	~
Fri 23 Oct	15.30	CA	Bank of Canada monetary policy report					
	08.30	GE	PMI manufacturing	Oct	Index	49.6	~	~
	08.30	GE	PMI services	Oct	Index	52.1	~	~
	09.00	GE	IFO – business climate	Oct	Index	91.3	~	~
	09.00	GE	IFO – current assessment	Oct	Index	87.0	~	~
	09.00	GE	IFO – expectation	Oct	Index	95.7	~	~
	09.00	EZ	PMI manufacturing	Oct	Index	49.3	~	~
	09.00	EZ	PMI services	Oct	Index	50.9	~	~
	09.00	EZ	PMI composite	Oct	Index	51.1	~	~
	09.30	UK	GDP	QIII	q%ch y%ch	-0.6 -5.5	~ ~	~ ~
	09.30	UK	BBA housing finance	Sep	no.	38,095	~	~
	10.00	EZ	Industrial new orders	Oct	m%ch	2.6	~	~
	15.00	US	Existing home sales	Sep	\$mn m%ch	5.1 -2.7	5.4 5.9	~ ~

Views expressed in this report are those of the authors as at the date of this report and are based on information and sources believed but not warranted to be correct. Any views or information, while given in good faith, do not necessarily reflect the views of ASB and are subject to change without notice. Neither ASB Bank Limited nor any person involved in preparing this report accepts any liability for any loss or damage whatsoever that may directly or indirectly result from any views, information or omission contained in this report.