

Business confidence and CPI figures released next week are expected to maintain the Reserve Bank's inflation wariness, but provide insufficient justification to pull the trigger and hike in the January OCR Review.

Quarterly Survey of Business Opinion – 2006 December Quarter (due Tuesday 16 January 10:00am)

	ANZ National	Previous
Business Confidence	-10	-19
Capacity Utilisation	91.5	92.3
Pricing Intentions	22.6	28.0

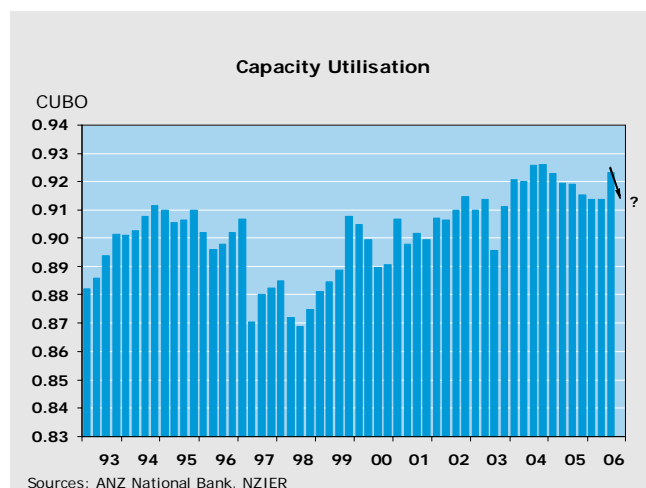
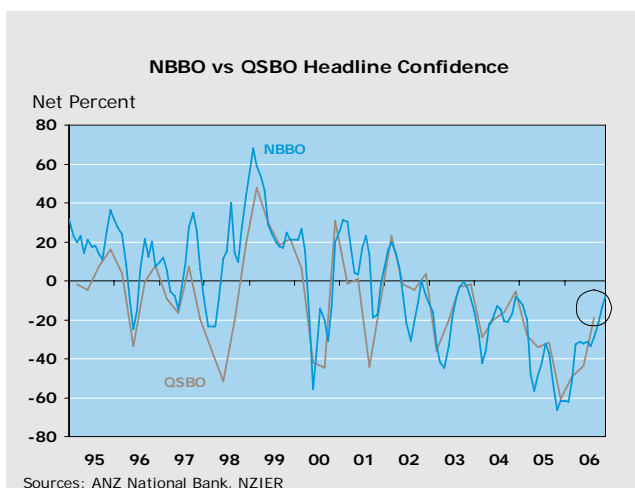
Key points

- **Headline business confidence to continue improving.**
- **We expect a pullback from the previous quarter's surprising surge in capacity utilisation.**
- **Cost pressures and pricing intentions to ease on the back of lower petrol prices.**

Headline business confidence and own activity are both expected to increase, in line with the recent improvement in the *National Bank Business Outlook* survey. Firms are growing increasingly optimistic as a result of falls in petrol prices, high commodity prices, and gathering momentum in consumer spending, despite extremely tight financial conditions. The survey would not have incorporated the late year rally in the NZD.

Capacity utilisation is expected to pull back from September's reading. This, together with weaker than expected Q3 GDP and downward historical GDP revisions, imply the Reserve Bank's estimate of their output gap could well be in negative territory. Based on their inflation forecasting framework, this implies non-tradable inflation easing over the second half of this year, which will be a welcome relief for the Reserve Bank.

Pricing intentions and cost expectations to ease slightly due to lower petrol prices. However, firms will continue to report pressures on their margins due to non-oil related cost increases and the difficulty in passing these costs onto consumers in a competitive environment. Still, the easing in pricing intentions will give the Reserve Bank some comfort.



Market Implications

While the market will react to a strong headline business confidence reading, for us the capacity utilisation figure is the key. A pullback will mean the Q3 reading was a statistical blip, and indicate that resource pressures – while tight – are nonetheless not as tight as what is perhaps feared. Employment growth – another key capacity indicator – partly reversed its Q2 strength in Q3 and we suspect capacity utilisation could do the same. The Reserve Bank is forecasting Q4 2006 and 2007 Q1 GDP growth of 0.7 and 0.6 percent respectively, which implies activity gauges will need to jump materially from Q3 for this growth rate to be achieved.

Consumers Price Index – 2006 December Quarter (due Wednesday 17 January 10:45am)

	ANZ National	RBNZ	Market
Headline CPI	0.0% qoq 2.9% yoy	-0.1% qoq 2.7% yoy	0.0% qoq 2.9% yoy

Key points

- **Headline inflation to fall below 3 percent on the back of a large fall in petrol prices.**
- **CPI to contain a persistent inflation theme despite soft headline number.**
- **Further drop in petrol prices to ease Q1 CPI, buying the Reserve Bank more time.**
- **Collectively the Reserve Bank will remain on edge but we find it hard to go beyond the headline rate being below 3 percent when it comes to prospects for a hike in the January *OCR Review*.**

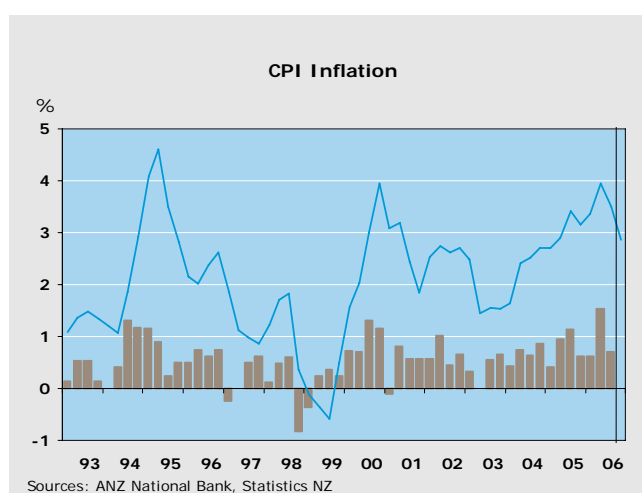
We expect headline CPI to be flat for the quarter, taking annual inflation to 2.9 percent, the first time it has been below 3 percent since June 2005. However, the near 15 percent fall in petrol prices (which alone would have shaved 0.8 percentage points off the CPI) mask a still sustained underlying inflation pressure. Non-tradable inflation is expected to remain stubbornly sticky, rising 1.0 percent in the quarter and taking the annual rate to 4.1 percent. Once again, the housing group will account for the bulk of the increase, with home ownership costs remaining strong thanks to a resurgence in housing activity. A key area to watch will be for signs of a build-up in cost-push (wage-inflation) pressure in the services arena.

An accelerating reading on non-tradable inflation will concern the Reserve Bank, even if headline inflation comes in line with their expectations. The Reserve Bank looked through the first round impact of rising petrol prices in the middle of last year, and similarly will look through the sharp falls seen in Q4. Their focus will firmly be on non-tradable inflation, specifically the housing group – and we suspect they will get little comfort from it. The Reserve Bank is forecasting non-tradable inflation to rise by 1.0 percent in the quarter.

Core inflation measures are still expected to stay elevated. CPI ex-energy and fuel will increase by 0.6 percent in the quarter, taking the annual rate to 2.7 percent. The Reserve Bank's new core inflation measures (factor model and exponentially smoothed) will show the annual rate still close to 3.0 percent.

Against this backdrop, it will be difficult to go beyond inflation falling below 3 percent and we see the risk profile for the quarter pointing towards the downside, courtesy of weaker tradable inflation. Looking ahead to Q1 CPI, there appears to be further relief in sight. The Reserve Bank's 0.6 percent forecast for Q1 CPI is looking high given further reductions in petrol prices and aggressive discounting on airfares and travel deals to the pacific islands. Together with the higher NZD, this will keep tradable inflation low and take some pressure off the Reserve Bank, despite their wariness towards non-tradable inflation.

The collective message looks similar to the October *OCR Review* where additional time has been bought, even against a backdrop of strong housing related activity.



CPI Components	Quarterly % change	%-point contrib.	Annual % change
Food	0.6	0.11	4.0
Alcohol and Tobacco	0.5	0.04	3.3
Clothing and Footwear	0.5	0.02	-0.2
Housing and Household Utilities	1.8	0.36	6.0
Household Contents and Services	-0.1	0.00	0.5
Health	1.4	0.07	2.7
Transport	-3.8	-0.66	0.2
Communication	-0.1	0.00	2.2
Recreation and Culture	0.3	0.03	0.8
Education	0.2	0.00	5.0
Miscellaneous Goods and Services	0.6	0.04	3.2
All Groups	0.0	0.00	2.9
Tradables	-1.2	-0.56	1.2
Non-tradables	1.0	0.54	4.1

Market Implications

Inflation will need to surprise materially on the upside for the Reserve Bank to contemplate hiking in January given softness seen in last year's Q3 GDP figures (0.3 percent versus the Reserve Bank's forecast of 0.7 percent). While compositional aspects are expected to maintain the Reserve Bank's inflation concern, the market needs a show-stopper to ratify current pricing. We suspect an outturn in line with expectations will see the market pare back the 60 percent probability priced in for a January rate hike.

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