### WINTER HIBERNATION

- We expect headline CPI rose 0.1% q/q in Q2, which would see annual inflation tick up from 1.1% in Q1 to 1.2%.
- The risk that domestic inflation remains sluggish for longer is increasing. The RBNZ will remain cautious until there’s a little more certainty that inflation is increasing in a broad based, sustainable way.

### KEY POINTS

- **We expect headline CPI rose 0.1% q/q in Q2** (released 17 July). This would bring annual inflation to 1.2% – a 0.1%pt lift from Q1, but well below the RBNZ’s May MPS forecast of 1.5% y/y.

- **The small quarterly rise reflects a mix of higher fuel prices plus some of the usual ups and downs in other categories.** A 3.5% q/q rise in petrol prices is expected to make the largest class-level contribution to quarterly headline inflation followed by a seasonal rebound in international airfares, with the latter exacerbated by higher fuel costs. A seasonal rise in fruit and vegetable prices will also contribute. On the other hand, a seasonal decline in domestic airfares is expected to provide a drag, but this should be limited by higher-fuel-cost-induced price rises. Accommodation services prices are also expected to make their usual Q2 journey south reflecting the seasonal lull in tourism.

- **As has been the case for some time, the housing group is expected to remain at the fore** (rising 0.4% q/q), with both rents and the purchase of housing expected to rise. Quarterly rents inflation is likely to decelerate slightly following the student-induced bustle in Q1. Stepping back, however, we’re starting to question how long housing-related inflation will last. After running hot for so long, anecdotes are beginning to suggest that building cost inflation may be starting to decelerate. And given inflation outside of housing has been generally subdued, we wonder how much softer the overall picture will become if inflationary pressures fail to broaden. That said, we believe there is some upside around rents.

- **We have pencilled in a flat quarter for non-tradables inflation.** However, our Monthly Inflation Gauge suggests there could be some downside to this after contracting 0.2% (3m/3m) in the June quarter\(^1\). That said, the Gauge did increase 0.3% m/m in June and has been tracking broadly sideways in annual terms in the past couple of months suggesting momentum hasn’t slipped further, after moderating in early 2018. **On the tradables side, we’re expecting a 0.3% q/q rise**, although past NZD depreciation and higher-than-anticipated fuel cost pass-through suggest there’s a bit of upside to this.

- **We’ll be watching closely for any deterioration in core inflation measures.** Core and underlying inflation measures were mixed in Q1. The Reserve Bank’s sectoral factor model estimate was unchanged at 1.5% y/y from Q4’s upwardly revised level, the weighted median measure rose 0.2%pts to 2.2% y/y, while the trimmed mean measures were down across all levels of trim in annual terms.

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\(^1\) On a q/q basis, the Gauge has ranged within ±0.4%pts of non-tradables CPI since late-2010 with an average ‘error’ of zero.
We retain the view that domestic inflation will rise and broaden in time, particularly since firm margins are currently being squeezed. But the risk that inflation remains sluggish for longer is increasing, particularly given activity growth seems to have lost a bit of momentum recently. And while the labour market is close to full employment, recent labour market indicators suggest further tightening may be limited. Just how much wage growth accelerates beyond the impact of higher minimum wages and government wage negotiations is a key uncertainty. On the other hand, a lift in inflation expectations, perhaps related to minimum wage increases and higher tradables inflation, could lead to more sustained inflationary pressures than currently expected.

A crucial consideration for the RBNZ is the degree of underlying inflationary pressure and the extent that this is expected to increase. In addition to the risks described above, a number of other factors are muddying this assessment, including global trade risks (and possible impacts on world prices), and policy changes such as fees-free tertiary education, tobacco excise duty and regional fuel charges (though the effects of these are temporary).

We expect the RBNZ will stay cautious, given the inflation pulse remains subdued, the growth outlook has softened, and downside risks have increased. In fact, if downside risks were to materialise, an OCR cut could eventuate quite rapidly, although we are not there yet. The RBNZ is likely to maintain a neutral stance until there’s more certainty that inflation is increasing in a broad based, sustainable way.

Table 1. ANZ Q2 CPI component-level forecast

<table>
<thead>
<tr>
<th>Groups</th>
<th>q/q%</th>
<th>%pt cont.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>0.8</td>
<td>0.1</td>
</tr>
<tr>
<td>Alcoholic beverages and tobacco</td>
<td>0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Clothing and footwear</td>
<td>0.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Housing and household utilities</td>
<td>0.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Household contents and services</td>
<td>-0.5</td>
<td>0.0</td>
</tr>
<tr>
<td>Health</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Transport</td>
<td>0.5</td>
<td>0.1</td>
</tr>
<tr>
<td>Communication</td>
<td>-1.8</td>
<td>-0.1</td>
</tr>
<tr>
<td>Recreation and culture</td>
<td>-1.5</td>
<td>-0.1</td>
</tr>
<tr>
<td>Education</td>
<td>0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Miscellaneous goods and services</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>0.1</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Source: ANZ, Statistics NZ, RBNZ
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