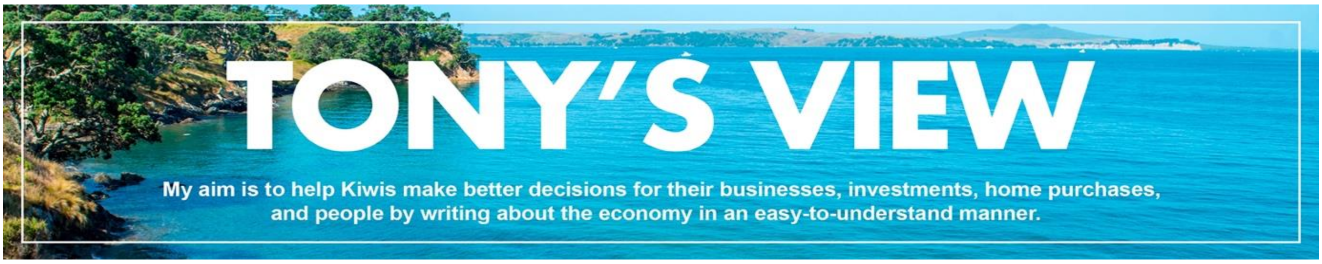

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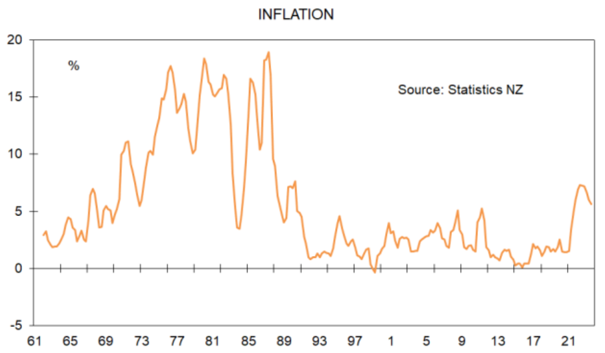
Inflation still too high

There was finally some good news on the inflation front this week – but it wasn't good enough to start any serious thinking about monetary policy easing in the next few months. So, curb your enthusiasm.

The annual inflation rate peaked at 7.3% last year and was 6% in the year to June. Now it has fallen to 5.6% whereas the common forecast had been 6% and a bit higher. This is good. But 5.6% is still a long way away from the target range of 1% - 3%. And as yet we do not have in hand solid evidence showing us that the surge in migrant labour is causing restraint on the pace of wages growth.

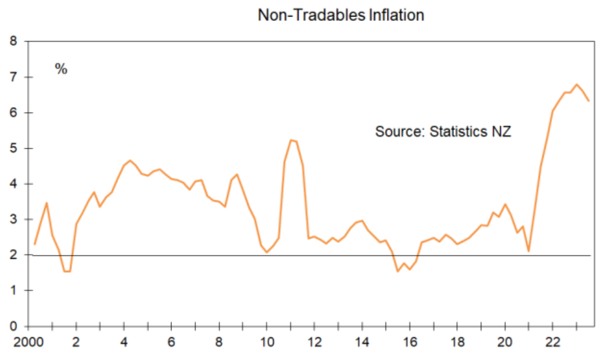


Hopefully that will arrive in a couple of weeks time because weakness in wage rises is a key thing which the Reserve Bank needs to see before it can think about expressing some ease about the inflation outlook.

It is not just that the 5.6% rate is still too high. When we try to get a feel for what inflation is doing without special factors we still see an excessive rate of price increase in place.

One measure we economists look at and which gets a strong focus in the United States is inflation excluding food and energy. These things can bounce around in price quite a bit. Excluding them we see that whereas during the September quarter the headline inflation rate (for just three months) was 1.8%, this underlying rate was 1.3%. That is still 5.2% annualised from 3.6% annualised in the June quarter. This is still too high. The annual ex-food & energy rate of inflation is exactly 5.2% in fact from 6% three months ago. Too high.

We also like to look at what we call the non-tradables rate of inflation. This is derived by excluding items traded across the border. This rate was much too high at 1.7% in the quarter from 1.3% in the June quarter. The annual non-tradables inflation rate is 6.3% from 6.6% three months ago. Too high and not falling quickly.



We can also strip away the top 10% of things rising in price out of the 649 measured, and the top 10% falling in price to get something called trimmed inflation. This measure rose by 1.5% in the September quarter after rising 1.3% in the June quarter. That is 6% annualised and the annual rate is 5.7% from 5.8% three months ago. This also is too high.

In a nutshell we can say this. The direction of change is good, though not in a straight line as every measure for the September quarter showed an increase greater than what happened in the June quarter. But we believe the trends in all are down. Good. But annual rates of 5% and more are still much too high.

What then does this mean for interest rates? The initial reaction in local financial markets was falls of around 0.08% for fixed wholesale borrowing costs facing banks. Unfortunately for borrowers, on Tuesday night data on retail spending released in the United States were much stronger than expected.

This caused fresh rises to multi-year highs in US medium to long term interest rates which have fed through to our rates. This has been the story for the world since about April or so. Stronger than expected data in the United States applying upward pressure to interest rates around the world, even in countries like New Zealand where since the same time some of the factors which influence how fast our economy grows have gone down.

These factors include deteriorating tax receipts which have long told us that no matter what Saturday's election outcome turned out to be there will be a tightening of fiscal policy over the next couple of years.

International commodity prices for the things we sell have gone down, though it is good to see some recovery in dairy prices at the past four auctions. China's economic outlook has got worse (they provide 1/3 of our export receipts) and could deteriorate further depending upon what happens in the property sector offset against additional stimulatory policies.

Oil prices have risen from low levels and the risk is further increases accrue if the situation in the Middle East spreads to wider policy actions by some countries – oil exporters.

An El Nino weather pattern has now become established for this season and that means eventually much drier conditions on the east coast which will hit farm incomes. Farmers have already closed their wallets and it is very unlikely that any policy changes by the new government will cause any improvement in spending ability and willingness in the coming year.

Add in mortgage interest rates rising because of the US rate rises and we get a worsened outlook for our economy, but not a recession. That is because we now are into the fifth month of the upward leg of the house price cycle (something I expected but the important thing for economic sentiment is when others see it – which is now).

Also, we have a 2.1% population boost from net migration inflows as departing Kiwis are more than replaced by Chinese, Indians, Filipinos, South Africans and others. The export education sector is recovering but with a lot further to go for the Chinese market.

For retailers the outlook is bad until perhaps late next year because of falling house construction, high cost of living increases, high mortgage interest rates, and overall consumer pessimism.

For house builders the challenge is to stay in reasonable shape through to the recovery in orders for new builds which I expect to happen through 2025 in lagged response to the population boom and by then falling interest rates.

For farmers and farm communities, conditions will be tough because of lowish export prices, poor growing conditions, and still rising costs. At least the Kiwi dollar is generally low.

For the real estate and related sectors apart from construction and its running mates, the outlook is good as the two and a half year queue of delayed buyers is now getting motivated to move. Media will highlight stories of investors going back into the market even though I believe for most the high interest rates will still act as a deterrent for now. First home buyers are likely to accelerate their purchases as their window of opportunity now closes more rapidly.

In case you missed it

This week I released results of my monthly survey of mortgage brokers with mortgages.co.nz. The main themes to come through from the statistical and anecdotal responses include these.

- First home buyers remain strongly interested in purchasing a property.
- Investor enquiries are at their highest levels since late-2020.
- Borrowers strongly prefer the 18 and 24 months terms for fixing their interest rate.
- Seasonal patterns of activity for now have been disturbed by the general election.

mortgages.co.nz & Tony Alexander Mortgage Advisers Survey - October 2023 - mortgages.co.nz

If I were a borrower, what would I do?

The general election outcome so far (final votes are not in yet) has had no meaningful impact in the financial markets. The Kiwi dollar continues to trade on the lowish side against a firm greenback supported by firm monetary policy expectations. The NZD is also being depressed by worries about the Chinese economy which accounts for one-third of our goods export receipts.

Wholesale interest rates remain vulnerable to the ups and downs coming out of the US markets, but at least this week we did have one strong local factor to consider. The September quarter inflation numbers were released on Tuesday and they showed inflation lower than expected at 5.6%. But all measures are still too far away from the 1% - 3% for comfort and while no further increase in the official cash rate from the 5.5% set in May is likely, cuts may not start until well into 2024.

This week wholesale interest rates initially fell then medium to long rates went back up again after stronger than expected economic data in the United States. The US ten year government bond yield has been pushed up to 4.9% from 4.74% last week and 4.23% a month ago.

The one year swap rate which banks borrow at to lend fixed for one year has ended today near 5.8% from 5.9% last week. But the three year rate is near 5.45% from 5.5% and the five year rate is 5.27% from 5.3%.

If I were borrowing at the moment, I'd probably fix 12-18 months.

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.