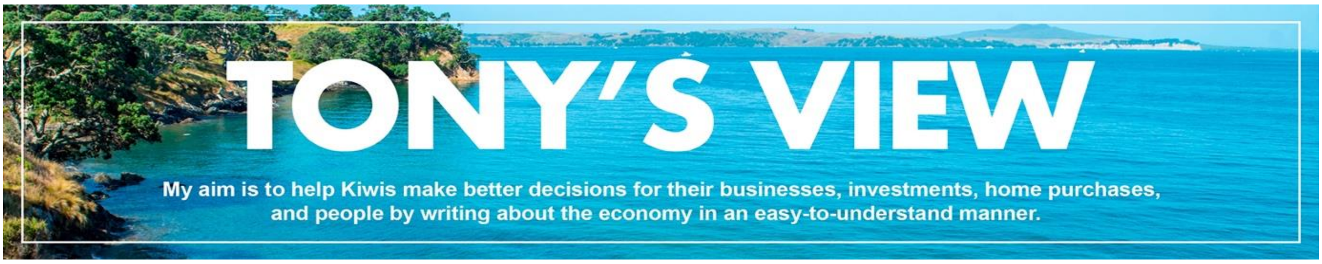

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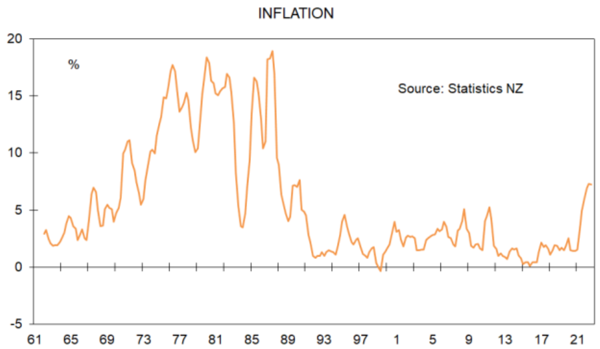
Inflation higher than expected

Oh well, you can't win them all. I'm very happy with my call to fix 5 years at 2.99% last year. But this year things have not worked out so well with regard to upside potential for interest rates and how quickly inflation will react to tightening monetary policy and depressed levels of consumer and business confidence.

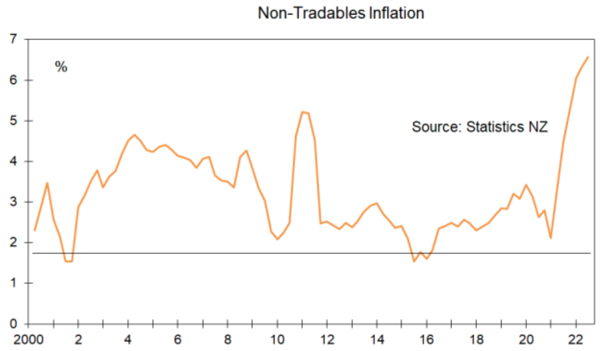
Everyone in the markets on Tuesday morning was primed for the annual inflation rate in the September quarter falling from the June quarter 7.3% down to something near 6.3% - 6.6%. In the event the rate reported was a much higher than expected 7.2%. The fall from 7.3% was within the range of statistical variation and on that basis, one cannot yet say that inflation is on its way down.



On the face of it the result implies a lot further upside for interest rates with monetary policy potentially staying tight for a lot longer than the next 12 months. But we economists look through the headline number (which admittedly is the one which influences wages growth which will now bear watching even more intensely) and concentrate on underlying inflation.

There are various ways of gaining insight into underlying inflation and one of them is to remove items which are imported or have their prices greatly affected by exchange rate moves. These are called tradables. The rate of tradables inflation eased to a horrible 8.1% from a terrible 8.7%. It is too high. But what really matters is non-tradables inflation.

That latter rate did not fall slightly or stay steady as was expected. It lifted from 6.3% to 6.6%. The lift is bad, but the magnitude of the outcome was only 0.3% generally above expectations and not the 0.7% or so error for the headline number.



Therefore, the monetary policy implications are not as dire as one would immediately think from looking at the 7.2% headline outcome.

The Reserve Bank had expected the headline rate to be 6.4% rather than 7.2%. The non-tradables rate they expected to be 6.3% rather than 6.6%.

Another way of measuring underlying inflation is to do what the Americans do and strip out food and household energy. Doing that we see that annual rate lifted from 6.1% to 6.3% with a 2.2% rise in the September quarter from 1.3% in the June quarter. No good news there but not a devastating outcome as suggested by the headline 7.2%.

We can also trim away the top 10% of items rising in price and the top 10% falling in order to get a better grasp of what is happening underlying the fluctuations. Doing that we get annual trimmed inflation rising from 6.6% to 6.9%. Again, not good but again not devastating.

The shock inflation result says that there is more work for the Reserve Bank to do and that means the official cash rate looks set to go higher than thought previously. We can probably lock in a 0.75% rise come the review on November 23 plus some more warning words from the Reserve Bank. A 1% rise is also being talked about.

It is tempting to lock in a series of further rises come the cash rate review after that on February 22. But there is a three month gap between the November and February reviews and a lot can happen in that time to improve the inflation outlook or make it worse.

The gap buys the Reserve Bank extra time before necessarily having to lift their projected peak for the cash rate all the way from 4.25% to the 5.5% which is now priced in the financial markets.

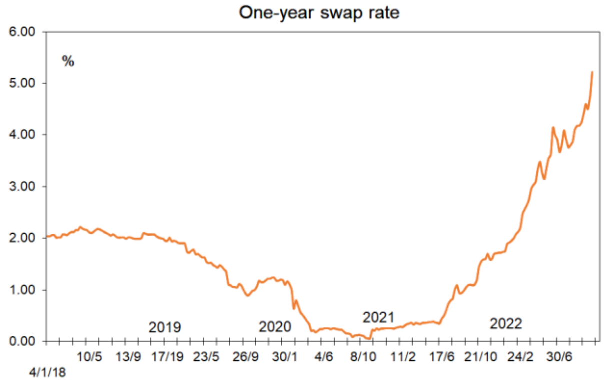
That rate seems excessive, and it pays to remember that it takes about 18 months for interest rate changes to affect the inflation rate. The impact of rises starting in October last year are running through the system and they will begin to manifest themselves soon in business pricing decisions. So, the Reserve Bank will be wary of tightening too much even though they have explicitly stated that they have decided to take the risk they do exactly that rather than tightening too slowly and having to play catch-up.

They are in fact expressing some pride in the earlier start to their tightening cycle than almost all other central banks. Fair enough and well done.

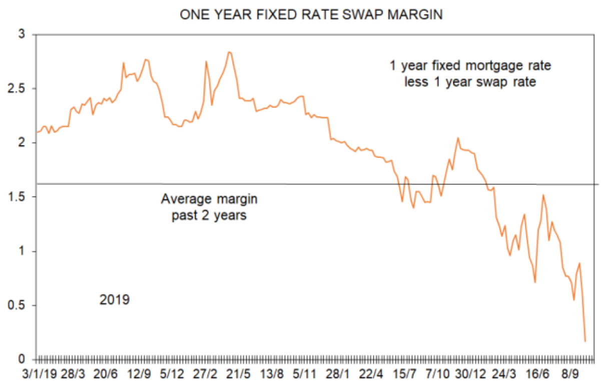
It pays to keep in mind that the world looks headed for a recession and that is guaranteed to bring down inflation offshore and then here. Our economic growth rate is set to slowdown with levels of house construction soon falling away to a mild degree.

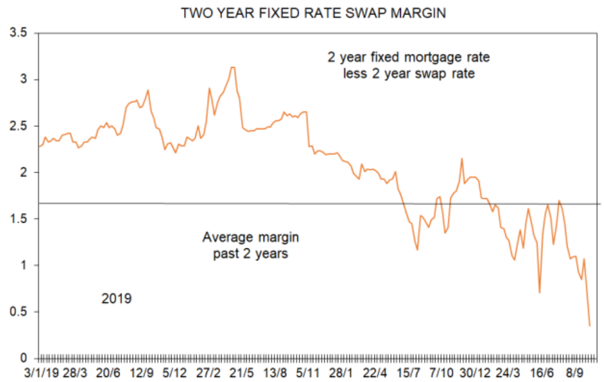
Because the higher than expected inflation number implies wholesale borrowing costs for banks sitting higher than expected, we should anticipate a round of fixed mortgage interest rate rises soon from the major lenders. They have kept rates little changed in recent weeks despite hikes in their funding costs probably because they did not want to take the risk of raising rates only to have to cut them again.

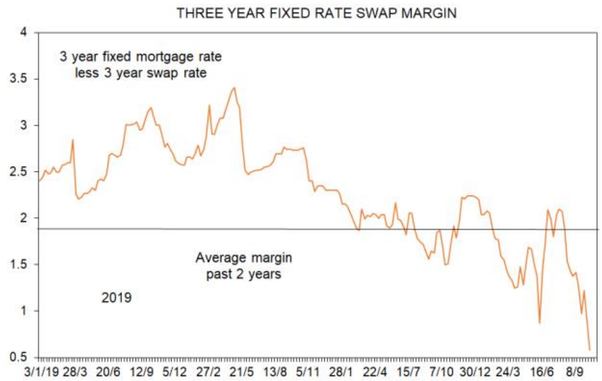
Most of the rise in their borrowing costs recently has reflected offshore changes related to volatile events. But with a New Zealand event in the mix, they are likely to seek to rebuild crunched margins.

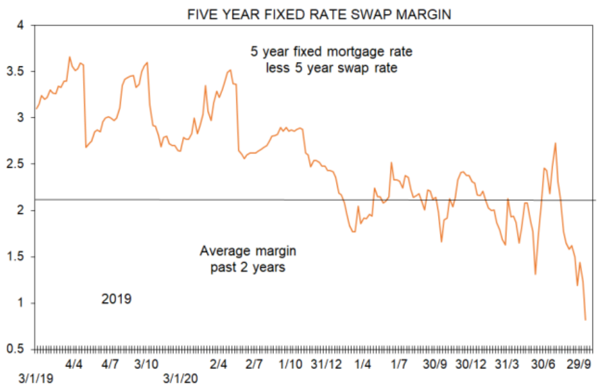


For instance, here are the four graphs which I include in Tview Premium each week showing the difference between bank wholesale borrowing costs (the swap rates) and the best fixed rate available in the market for each term from the top five lenders. Note how crunched margins have become recently and compared with averages for the past two years shown as the inserted horizontal lines.









There is a round of fixed rate rises happening now and the banks will be watching each other closely looking for where they might extract some pricing/marketing advantage. We don't know where rates are going to settle because my graphs above by definition show we cannot predict fixed mortgage rates on the basis even of getting one's wholesale borrowing cost forecasts 100% correct.

But if I were borrowing currently, I'd do it sooner rather than later. Would I personally feel inclined to move further out along the yield curve and fix for three years or longer? No.

This is because the message from Tuesday's CPI release was that interest rates need to be higher now than earlier hoped. That means the outlook for the economy has to be worse, and the speed with which inflation and interest rates therefore fall when those higher rates achieve their true grip will be greater.

I would be sticking with 1-2 year rates if I were back borrowing again.

For the record, some of the items which contributed most to 7.2% headline inflation in the past year are these.

Housing	16.8%
Private transport (petrol, airfares)	15.6%
Fruit and veges	13.8%
Furniture	10.3%
Accommodation	10.1%
Hospital services	8.6%
Meat, poultry, fish	7.2%
Rates	7.2%

And here some things that have fallen in price this past year.

Telecommunication equipment	-1.1%
Household textiles	-1.2%
Audio-visual and computing equipment	-5.8%
Credit services	-6.7%

If I were a borrower, what would I do?

I'd fix one year in all probability, but maybe put a tad at two years. And I'd be snappy about doing it as the true significance of the inflation number is that banks will no longer treat the recent surge in wholesale funding costs as potentially unsustainable. They will now act to rebuild their margins. There is no way of knowing how much by unfortunately.

To see the interest rates currently charged by major lenders go to www.mortgages.co.nz

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.