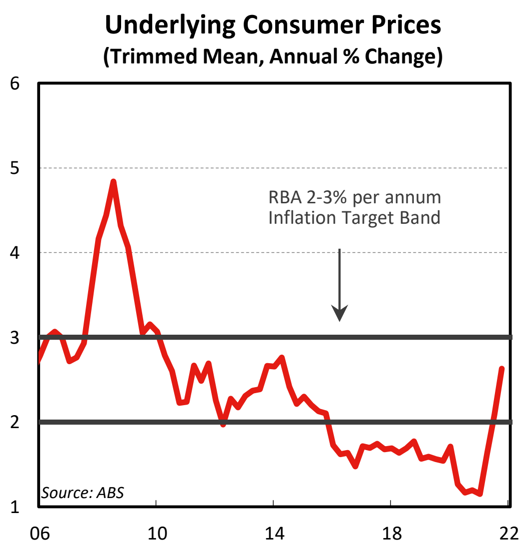
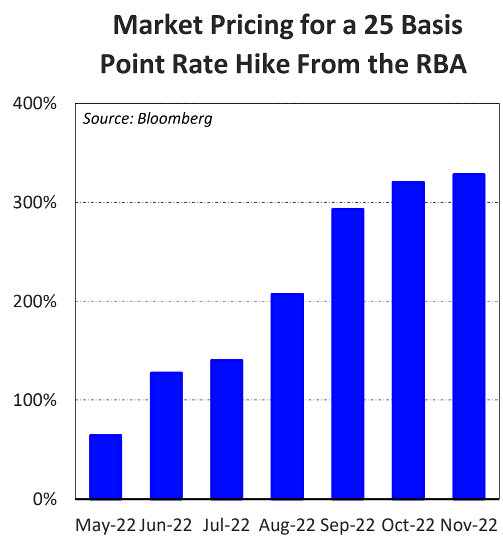
Tuesday, 25 January 2022

Consumer Price Index

RBA Forecasts Blown Out the Water

- **The pressure on the Reserve Bank (RBA) to pullback support and start a rate hike cycle is building following another hot inflation print.**
- **Underlying inflation increased 1.0% in the December quarter to be 2.6% higher over the year. This is the highest annual rate in more than 7 years and the second consecutive print within the RBA's target band. Headline inflation rose 1.4% in the quarter and 3.5% over the year.**
- **Today's numbers blow the RBA's forecasts out of the water. The RBA expected annual underlying inflation to print at 2.25% and annual headline inflation to be at 3.25%.**
- **Rising fuel costs, global supply-chain disruptions and the housing boom remained key drivers of inflation in the quarter. The increase in prices was broad-based across capital cities.**
- **Several other measures of inflation were at elevated levels. Tradables inflation grew by 4.9% over the year – its fastest pace in 20 years. And annual non-discretionary inflation hit 4.5%, the highest in 10 years and more than double the pace of discretionary inflation.**
- **Today's print reinforces our expectation that the RBA will drop quantitative easing at next week's meeting. It also further shifts the dial in favour of a rate hike in 2022. Our forecasts remain for a rate-hike cycle to start in August with an initial 15 basis points.**
- **Interest-rate markets have shortened their odds of an earlier move. The characterisation of inflationary pressures as 'transitory' by the RBA must surely now be in the rear-view mirror. Given the strength of the data, we cannot rule out lift-off even sooner than August.**





Headline and Underlying Inflation

The pressure on the Reserve Bank (RBA) to pullback support and start a rate hike cycle is building following another hot inflation print.

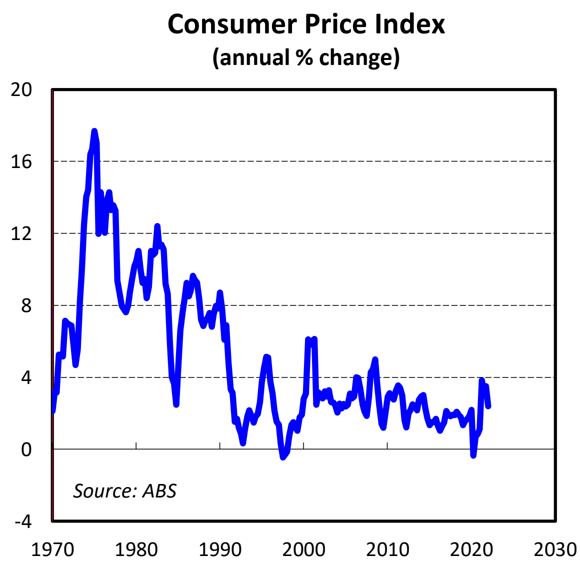
The number that will be making the RBA nervous is trimmed mean inflation. The RBA pays close attention to the trimmed mean measure when setting policy.

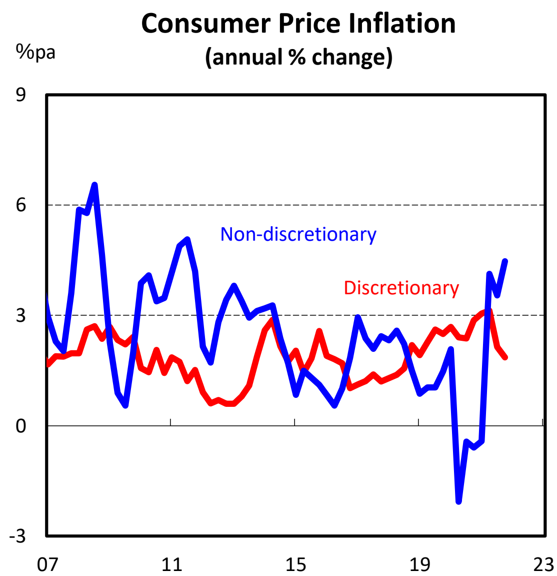
It increased 1.0% in the December quarter to be 2.6% higher over the year. This is the highest rate in more than 7 years and the second consecutive print within the RBA's 2–3% target band. In their most recent forecasts, published in November, the RBA expected underlying inflation to print at 2.25% annual growth.

The headline consumer price index (CPI) rose 1.4% in the December quarter, taking the annual rate to 3.5%. The RBA expected headline inflation to print at 3.25%.

Rising fuel costs, global supply-chain disruptions and the housing boom remained key drivers of inflation in the December quarter. Some of the strength also reflected higher clothing & footwear prices, with less aggressive discounting in the quarter, while the reopening of borders supported accomodation and travel inflation.

Today's numbers blow the RBA's forecasts out of the water, ahead of an important meeting next week, where the central bank will consider the future of its bond-buying program and its cash-rate settings. Today's data reinforces our view that the RBA will scrap quantitative easing altogether at next week's meeting and further shifts the dial in favour of a rate hike in 2022. And indeed, market pricing for the first RBA rate hike has shortened.





Groups Analysis

Prices increased in ten out of the eleven CPI groups and were unchanged in one group.

The key drivers of the increase were the transport group and clothing & footwear.

The transport group was up 2.8%, underpinned by a 6.6% increase in automotive fuel prices, reflecting increased global demand for oil and constrained supply. In fact, fuel prices reached record levels in December. Meanwhile, motor vehicle prices continued to rise sharply alongside supply bottlenecks and solid domestic demand.

The clothing & footwear group was up 2.6% in the December quarter, driven primarily by garments for women. This follows the arrival of new season summer stock and lower discounting than in the previous quarter. This series tends to be volatile quarter to quarter.

Housing remained a key driver of inflation, with the housing group up 1.8% in the December quarter. The main contributor was new dwelling purchases by owner occupiers, which rose 4.2% in the quarter. This marks the largest increase in this category since 2000 when the GST was introduced. Robust demand for housing constructions has allowed builders to pass on increases in the cost of materials and labour to households. The unwinding of HomeBuilder has continued to push up prices, although less than in the September quarter. Recall, the Australian Bureau of Statistics (ABS) adjusts consumer prices by the value of government grants, meaning that the HomeBuilder program depressed readings of new housing inflation. But as the impact of the program unwinds, this effect is reversing, pushing up new housing inflation. Supply shortages underpinned by global-supply disruptions also pushed up the prices of timber, hardware and paint.

The recreation and culture group rose 1.5% in the quarter, following the reopening of interstate borders and the commencement of quarantine-free international travel to select destinations. This saw both domestic and international holiday travel & accomodation prices increase. The lifting of lockdowns in NSW and Victoria also likely contributed.

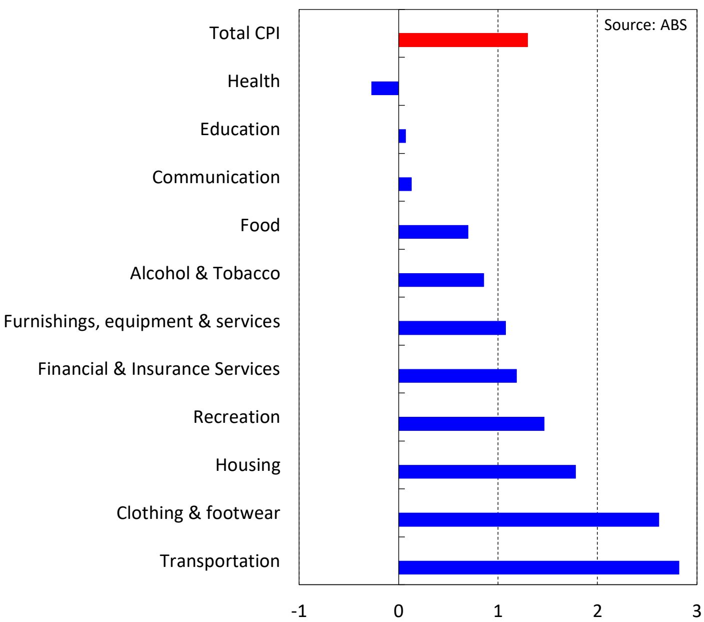
The insurance and financial services group rose 1.2% in the December quarter, primarily driven by a rise in real estate agent fees.

There was also a 1.1% increase in the furnishings, household equipment and services group. This was underpinned by an increase in toilet paper prices, as well as hairdressing & gardening services and childcare.

The alcohol and tobacco group rose 0.9%, partly reflecting an increase in the tax applied to tobacco which came into effect in September.

Price Changes of Selected CPI Categories

(Dec 2021, quarterly % Change)



The food and non-alcoholic beverages group, which is tends to be volatile, rose 0.7%. Easing restrictions saw an increase in the price of dining out and takeaway. The NSW Government's 'Dine and Discover' voucher scheme partly offset the increase.

The communication (0.1%) and education (0.1%) groups rose slightly.

Health was the only group which declined, falling 0.3%. The fall reflected an increase in the portion of consumers who qualified for the Pharmaceutical Benefits Scheme and Medicare Benefits Scheme.

Discretionary and Non-Discretionary Inflation

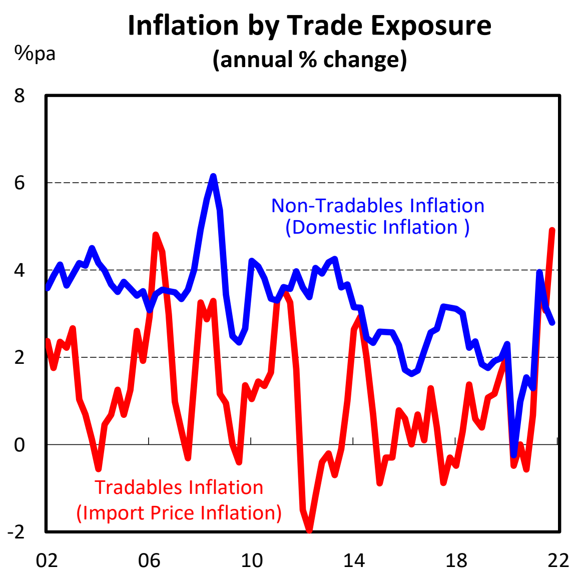
For the first time, the Australian Bureau of Statistics (ABS) published time series data on discretionary and non-discretionary inflation. Non-discretionary inflation captures goods and services that households are less likely to reduce their consumption of, such as food, fuel, housing and health costs. It showed that in the December quarter, annual non-discretionary inflation was running at 4.5% the highest since 2011 and more than double the pace of discretionary inflation at 1.9%. This is consistent with households reducing discretionary consumption alongside lockdowns.

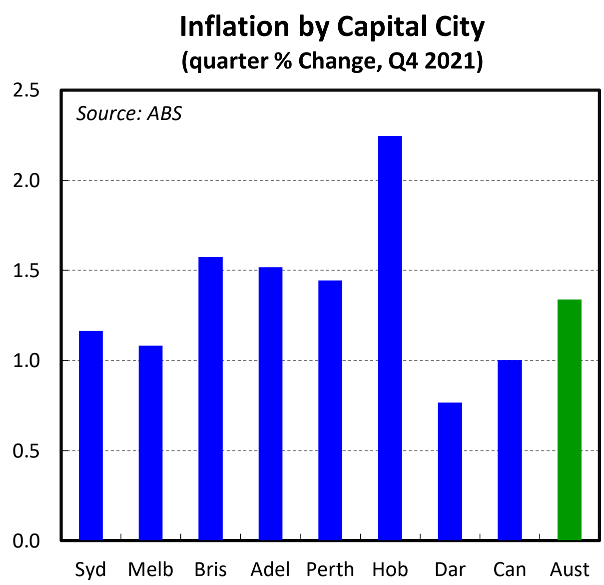
Tradables and Non-tradables Inflation

Tradables inflation rose 1.4% in the December quarter, while non-tradables rose 1.2% in the same period. Tradables inflation measures the prices of imported goods and services and is influenced by global factors, including movements in the currency and oil. Non-tradables inflation is a measure of the prices of domestically produced goods and services.

In annual terms, tradables inflation is now running at 4.9%, its highest level since 2001. This reflects the strength of global demand for goods and higher fuel prices. A weaker Australian dollar also pushes up tradables inflation.

Non-tradables inflation is running softer, at 2.8% over the year. In the quarter, both goods and services non-tradables inflation rose, driven by the price of new dwellings purchased by owner-occupiers and domestic holiday travel and accomodation respectively.





Inflation by capital cities

Inflation increased across all capital cities in the December quarter. Hobart (2.2%) led the charge followed by Brisbane (1.6%), Adelaide (1.5%) and Perth (1.4%). Our most populous cities of Sydney (1.2%) and Melbourne (1.1%) also recorded solid increases. Bringing up the rear were Canberra (1.0%) and Darwin (0.8%).

The increase in automotive fuel prices was a key driver of inflation across all cities. The particularly large increase in Hobart reflected higher dwelling prices as well as jump in electricity prices after a one-off winter energy bill supplement. The increase in Darwin was dampened by a fall in domestic airfares for the wet season, while the inflation in Canberra was weighed down by a fall in electricity prices due to a one-off rebate.

In annual terms, inflation ranged from 6.0% in Perth to 2.5% in Melbourne.

Outlook

Today's data put further pressure on the RBA to withdraw policy support sooner rather than later. The characterisation of inflationary pressures as 'transitory' is firmly in the rear-view mirror.

This print reinforces our expectation that the RBA will drop quantitative easing at the meeting next week, reflecting the considerable progress made towards its employment and inflation goals. Notably, Omicron will temporarily pause the recovery and could be seen as a reason to hold onto the bond-buying program a bit longer. But the RBA will consider this setback against the strong underlying momentum in the economy heading into Omicron and the likely resumption of growth once the worst of the Omicron wave passes. On balance, we expect the latter will given more weight, and hence expect the program will be dropped.

Turning to the cash rate, today's data further shifts the dial in favour of a 2022 rate hike. Governor Lowe has laid out, that to lift the cash rate "it won't be enough for inflation to just sneak across the 2% line for a quarter or two. We want to see inflation around the middle of the target range and have reasonable confidence that inflation will not fall below the 2–3% band again."

Our view remains that a rate-hike cycle will start in August. According to our inflation forecasts, we will have observed four inflation prints over 2% and three inflation prints over the mid-point of the target band. This is consistent with a hike, according to the criteria laid out by Governor Lowe. Lowe will also consider employment and wages. The unemployment has fallen faster than expected. Staff shortages and a tightening of the labour market should produce faster wage pressures, but Lowe might want concrete evidence.

Lift-off sooner than August cannot be ruled out. Indeed, interest-rate markets have shortened their odds of an earlier move.

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