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## Inflation Jitters Give RBA Food for Thought

Persistent or transitory? The inflation debate has been raging throughout the pandemic, and it has intensified in recent weeks.

Investors are becoming increasingly concerned that inflationary pressures are more permanent than central banks are arguing. And bond and swap rates are responding.

Since 13 October, the Australian three-year swap rate has risen rapidly from around 0.65% to break through 1.00% during trade on 19 October. It has since moderated slightly, and this morning was trading at 0.96%. An increase in swap rates puts upwards pressure on fixed lending rates.

Meanwhile, markets are currently tipping the first Reserve Bank rate hike to be as early as the second half of 2022.

The dramatic rise in yields followed a surprising surge in New Zealand consumer prices. CPI jumped 2.2% in the September quarter – its strongest rise in more than ten years. Food and petrol prices contributed to the increase. Housing-related costs were also a driver.

Of course, market pricing stands in stark contrast to the RBA's guidance that the cash rate won't increase until at least 2024. In a speech on 14 September, Governor Lowe noted he found it "difficult to understand why rate rises are being priced in next year or early 2023". However, markets are clearly unconvinced, with rate hike expectations brought further forward since the Governor's comments.

We continue to expect the first rate hike will come in 2023 – not as early as markets expect but sooner than the RBA has indicated. This is consistent with the RBA's guidance that inflation will need to be around the middle of the 2–3 per cent target range, and that it won't be enough for inflation to "sneak across the 2 per cent line for a quarter or two". For this to occur, the central bank expects that wages growth will need to be around 3%.

Australia's September quarter inflation report, which will be released on Wednesday, will be the next important test.

We have forecast 0.5% quarterly growth in trimmed mean inflation – the Reserve Bank's preferred measure of inflation. This follows 0.5% growth in the June quarter. We expect the annual pace to lift to 1.9%, from 1.6%. We anticipate headline CPI will rise 0.8%, while the annual rate will pare back from 3.8% to 3.1% due to base effects. Our forecasts suggest transport and housing will be the largest contributors to the rise in prices.

The RBA has been at pains through the pandemic to underscore that the cash rate won't rise until 2024. The concern for the RBA, and central banks globally, is inflation expectations becoming unanchored to the upside. Former Federal Reserve Chair Ben Bernanke defines poorly anchored inflation expectations as when "the public reacts to a short-period of higher-than-expected inflation by marking up their long-run expectation considerably". This in turn could drive actual inflation to run too hot, and force a tightening in monetary policy that is earlier than currently anticipated. This scenario could play out, for example, if the supply chain disruptions which have

been pushing up prices take longer to resolve than expected.

The RBA will release updated forecasts on 5 November in the Statement on Monetary Policy. Markets will be forensically examining the numbers to see how, or if, the RBA will respond to recent market developments.

Elsewhere, retail sales data for September will also be released this week, which we expect were flat in the month. This follows a 1.7% decline in August, which left retail sales 6.0% lower since May. A flat result would be consistent with spending stabilising at locked down levels in NSW and Victoria. There was also a modest easing in restrictions in regional NSW and Victoria, and the 'Local Government Areas of concern' in Sydney.

In this release, retail sales volumes for the September quarter will also be published. We have forecast a 5.2% decline in sales volumes in the quarter, as lengthy lockdowns in two of our major cities pummelled the sector. We expect nominal sales fell around 4.8% in the quarter. We have projected a 0.4% increase in retail prices in the quarter, mostly reflecting increases in food prices. Volumes fell 0.5% in the first quarter of 2021 as mini circuit-breaker lockdowns hit retailing before recovering 0.8% in the second quarter.

Private sector credit data for September will also go to print this week. We have forecast a 0.4% increase in the month. Lockdowns have driven a temporary lift in credit growth over the last few months, as businesses shored up their cash flow buffers in response to lockdowns. Credit grew by 0.9%, 0.7% and 0.6% over June, July and August, respectively. Business credit spiked up to 1.6%, 1.1% and 0.6% over the same period. We expect that business credit growth will slow over the coming months. Looking ahead, once the recovery firmly takes hold, we expect the pick-up in activity will flow through to demand for credit.

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## Forecasts

End Period:	2021		2022			2023	
	Close (22 Oct)	Q4 (f)	Q1 (f)	Q2 (f)	Q3 (f)	Q4 (f)	Q1 (f)
<b>Aust. Interest Rates:</b>							
RBA Cash Rate, %	0.10	0.10	0.10	0.10	0.10	0.10	0.25
90 Day BBSW, %	0.04	0.07	0.10	0.15	0.20	0.40	0.65
3 Year Swap, %	0.96	0.60	0.70	0.80	0.95	1.10	1.20
10 Year Bond, %	1.80	1.70	1.75	1.80	1.90	2.00	2.05
<b>US Interest Rates:</b>							
Fed Funds Rate, %	0.125	0.125	0.125	0.125	0.125	0.375	0.625
US 10 Year Bond, %	1.63	1.60	1.70	1.80	1.90	2.00	2.05
<b>USD Exchange Rates:</b>							
AUD-USD	0.7466	0.75	0.76	0.77	0.78	0.78	0.79
USD-JPY	113.50	112	112	113	113	114	114
EUR-USD	1.1643	1.19	1.20	1.19	1.18	1.18	1.17
GBP-USD	1.3755	1.38	1.39	1.40	1.41	1.41	1.40
NZD-USD	0.7157	0.71	0.72	0.73	0.74	0.74	0.74
<b>AUD Exchange Rates:</b>							
AUD-USD	0.7466	0.75	0.76	0.77	0.78	0.78	0.79
AUD-EUR	0.6414	0.63	0.63	0.65	0.66	0.66	0.68
AUD-JPY	84.76	84.0	85.1	87.0	88.1	88.9	90.1
AUD-GBP	0.5427	0.54	0.55	0.55	0.55	0.55	0.56
AUD-NZD	1.0434	1.06	1.06	1.05	1.05	1.05	1.07

	2019	2020	2021 (f)	2022 (f)
GDP, %	2.1	-0.9	0.0	7.4
CPI (Headline), %	1.8	0.9	3.0	2.4
CPI (Trimmed mean), %	1.6	1.2	2.1	2.8
Unemployment Rate, %	5.2	6.8	5.1	3.8
Wages Growth, %	2.2	1.4	2.0	2.8

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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