Bank of Melbourne

Monday, 27 February 2023

The RBA to Ratchet Up It's Inflation Fight

Updated Reserve Bank View

Earlier this month, the Reserve Bank (RBA) hiked the cash rate again but also strengthened its resolve around fighting inflation. Indeed, it explicitly suggested that at least two more rate hikes were likely. The February Board Meeting Minutes reaffirmed this strong indication. The minutes noted that "members agreed that further increases in interest rates are likely to be needed over the months ahead".

For some time, since October last year, our view has been that the cash rate would peak at 3.85% in May. However, the stronger resolve of the RBA and the upside surprise to underlying inflation for the final quarter of last year suggests to us that there are upside risks to inflation.

Interestingly, in December, the Board considered a pause in its discussion along with a hike of 25 basis points and a hike of 50 basis points. At the February Board meeting, the discussion around a pause was dropped. Again, it highlights the RBA's elevated worry about the inflation outlook.

The RBA now expects inflation to be higher in the near term as it upgraded its inflation forecasts for 2023 and 2024 in the February Statement on Monetary Policy (SoMP). However, it still expects inflation to subside, slowing to 3%, the top of the 2-3% band, by mid-2025.

However, forecasts further out have greater variability attached to them or rather are less precise. The fact that the nearer term forecasts for inflation are higher suggests the risks to inflation are to the upside. And if that materialises, it makes bringing down inflation more challenging, requiring further rate hikes.

The next inflation report is due on April 26. We expect the underlying inflation rate will ease to around 6.6% from the 6.9% pace recorded for the December quarter. This should be close to the RBA's expectations, unlike the 6.9% result that exceeded the RBA's forecast of 6.5%. However, it is likely to still be too high for comfort.

Therefore, our Group view on the cash rate outlook has shifted. We now anticipate the RBA will need to hike three more times rather than two more times, taking the cash rate to a peak of 4.10% in May. We are anticipating rate hikes at each of the next three meetings. Around the middle of the year, the evidence of a slowing in economic activity should be deep enough to warrant the RBA pausing. Already there are signs of slowing, but these signs so far are modest and emerging.

Interest-rate markets are fully priced for four more rate hikes from the RBA, with the peak in the cash rate at around 4.36% towards the end of 2023 (according to 30-day cash-rate futures).

The consensus among economists is more divided with the peak ranging from 3.60% to 4.85%. There are risks to both sides and we certainly can see reasons why the RBA could stop at 3.85% or go even higher to 4.35% - but our core view is a peak of 4.10%. Much will depend on the data, especially on household spending, jobs, inflation and wages.

Domestic Data

It's a huge week for data this week as the Australian Bureau of Statistics (ABS) drops the December quarter National Accounts and several partial indicators in the lead-up. While the start of a new month brings with it fresh data on private sector credit, retail trade and the housing market. We will also get an update on the trajectory of inflation as the monthly indicator will be released for January.

This morning, business indicators data for the December quarter was released which includes key information on the revenue, profit and inventories of businesses. Business profits surged 10.6% in the December quarter, almost fully unwinding an 11.5% slide in the September quarter. All but one of fifteen industries reported an increase in profits in the quarter. Notably, profits in the non-mining industries climbed 9.6% in the quarter, while mining profits were up 11.6%. In annual terms, profits rose 16.0%, led by a 33.2% increase in mining profits. When looking at the profit margins, eight of the 15 industries have lower margins than a year ago – this means that their costs have gone up by a larger magnitude than revenue.

Inventories contracted in the December quarter following a sizeable build-up over the remainder of 2022. Total inventories declined 0.2% in the quarter but remain 5.9% higher in annual terms. The wear-down of inventories in the quarter was concentrated in the retail and accommodation & food industries.

Tomorrow is jam packed with data releases including the December quarter balance of payments, and private sector credit and retail sales figures for January. After an end to the record run of current account surpluses in the September quarter, we expect the current account to swing back into a surplus of $2 billion in the December quarter. This will largely be driven by an improved trade position. Meanwhile, the progressive slowdown in credit growth is likely to have continued in January. There was a clear loss in momentum for credit growth in December so all eyes will be focused on whether this was a blip on the radar or the beginnings of a new trend. We expect private sector credit to have expanded by 0.4% in January, slightly up on the 0.3% gain in December. Retail trade also took a meaningful slide in December, falling 3.9% in the month. Note however, that this was falling off a very high base as seasonal sales sparked a surge in spending in November. In January, we expect retailing will return to growth of about 1.0% following December's sharp fall. However, this would not be enough to offset the weakness in December and would indicate that the underlying slowdown in spending is continuing.

GDP data out Wednesday will be the biggest focus of the week. We expect the economy expanded 0.7% in the December quarter, to be 2.7% higher through the year. This reflects that spending growth lost some momentum in the later part of the year, but likely remained robust. We will also be keeping an eye on alternative measures of inflation and wages growth that are included in the National Accounts which will be a key input in the Reserve Bank's (RBA) policy action.

On that note, the monthly consumer price index (CPI) indicator is also due out on Wednesday. We expect to see annual growth slow to 7.9% from 8.3% in December providing a signal that quarterly inflation has, in fact, moved past a peak. An increase in petrol prices in the month will likely be more than offset by a sharp fall in domestic holiday and travel costs as airfares pulled back in the month.

Finally, there will be three data releases on the housing market trickled throughout the week. The February iteration of CoreLogic's home value index will be released Wednesday morning and is expected to show a 0.1% fall in dwelling prices in the month. This is a considerably milder fall compared to recent months, we expect partly caused by the replacement of stamp duty with a land tax for first home buyers in NSW. Additionally, stock levels and volumes remain low, while foreign buyers are likely to have also contributed to stronger demand given the rental squeeze, particularly in Sydney.

On the supply side, we expect to see the pronounced fall in new building approvals to have resumed in January. This follows a surprise spike in approvals in December driven by high rise developments in NSW and Victoria. We foresee a 10% fall in approvals, partly unwinding the 18.5% jump in December. On the demand side, we do not expect to see any let up in the pace of declines in new housing finance as interest rates erode borrowing capacity and crimp demand for credit. We anticipate new housing finance fell 4.0% in January, led by a 4.2% fall for investors, while owner-occupier finance is expected to have fallen by 4.0%.

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Forecasts

		2023				2024	
End Period:	**Close (24 Feb)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	3.35	3.60	4.10	4.10	4.10	3.85	3.60
90 Day BBSW, %	3.51	4.22	4.30	4.30	4.22	3.97	3.72
3 Year Swap, %	4.12	4.00	3.95	3.90	3.80	3.65	3.50
10 Year Bond, %	3.82	3.85	3.75	3.45	3.25	3.00	2.80
US Interest Rates:							
Fed Funds Rate, %	4.625	4.875	5.375	5.375	5.375	4.875	4.375
US 10 Year Bond, %	3.94	3.90	3.80	3.50	3.30	3.10	2.90
USD Exchange Rates:							
AUD-USD	0.6726	0.70	0.71	0.72	0.74	0.75	0.76
USD-JPY	136.48	132	131	130	129	128	127
EUR-USD	1.0548	1.08	1.09	1.10	1.11	1.12	1.13
GBP-USD	1.1944	1.21	1.22	1.23	1.24	1.25	1.26
NZD-USD	0.6165	0.64	0.65	0.66	0.67	0.68	0.68
AUD Exchange Rates:							
AUD-USD	0.6726	0.70	0.71	0.72	0.74	0.75	0.76
AUD-EUR	0.6378	0.65	0.65	0.65	0.67	0.67	0.68
AUD-JPY	91.798	92.4	93.0	93.6	95.5	96.0	96.5
AUD-GBP	0.5632	0.58	0.58	0.59	0.60	0.60	0.60
AUD-NZD	1.0918	1.09	1.09	1.09	1.10	1.11	1.13

	2021	**2022 (f)**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.6	1.0	2.0
CPI (Headline), %	3.5	7.8	4.0	3.0
CPI (Trimmed mean), %	2.6	6.9	3.6	3.1
Unemployment Rate, %	4.7	3.5	4.6	5.1
Wages Growth, %	2.3	3.4	4.0	3.2

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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