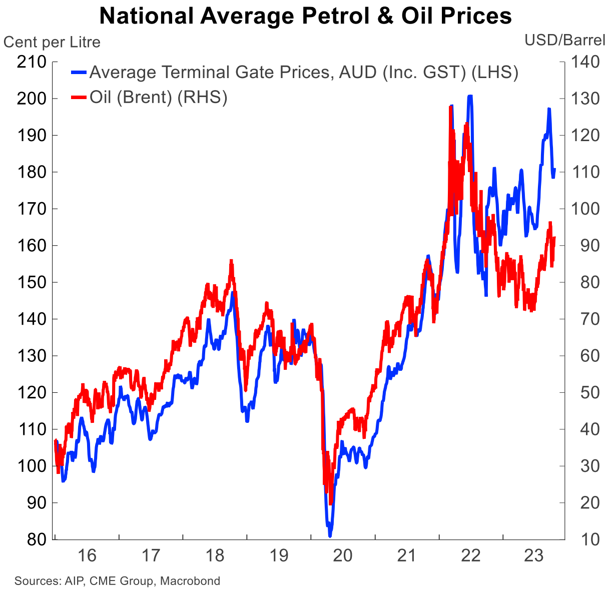
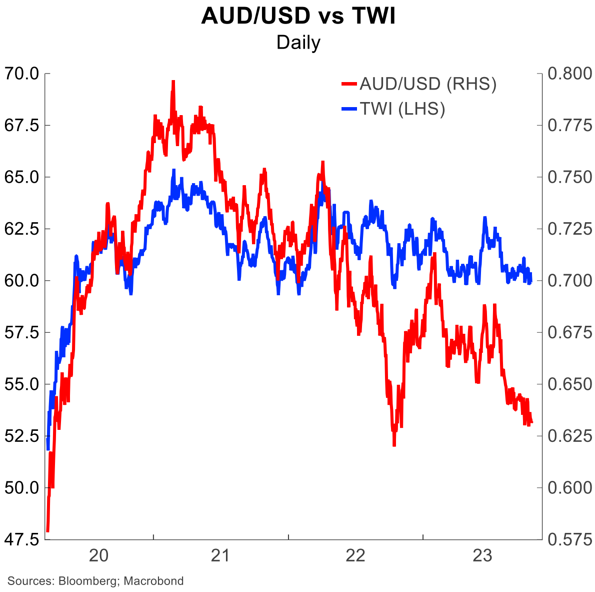
RBA Sensitive to Inflation Surprise

The main act on the domestic calendar this week is the September quarter consumer price index (CPI), which the Australian Bureau of Statistics (ABS) will publish on Wednesday. This will provide a key update on the pace of disinflation and how inflation dynamics are evolving in the Australian economy.

Headline inflation has fallen from a more than three-decade high of 7.8% in the December quarter of 2022 to 6.0% in the June quarter of 2023. Underlying inflation, as measured by the trimmed mean, is also down from a peak of 6.9% in the December quarter to 5.9% in the June quarter. For the September quarter, we expect both headline and underlying inflation to print at a quarterly pace of 1.1%. This would see the annual pace slow further to 5.3% and 5.0%, respectively.

We continue to see progress on goods disinflation, reflecting the unwinding of supply-chain disruptions and weaker demand from households. Household budgets are squeezed by inflation, higher interest rates, and larger tax payments alongside bracket creep from nominal wage increases. However, upside risks to inflation remain. For example, the quarterly pace of inflation is expected to have accelerated from the June quarter – where headline and underlying inflation were 0.8% and 0.9%, respectively.





There are a range of factors impacting inflation dynamics. One recent development has been the sticker shock of higher petrol prices driven by the price of oil. The Brent oil futures price jumped to 10-month high of US$97.69 per barrel at the end of September. Price rises were spurred by extended supply cuts from Saudi Arabia and Russia, in addition to stronger-than-expected demand.

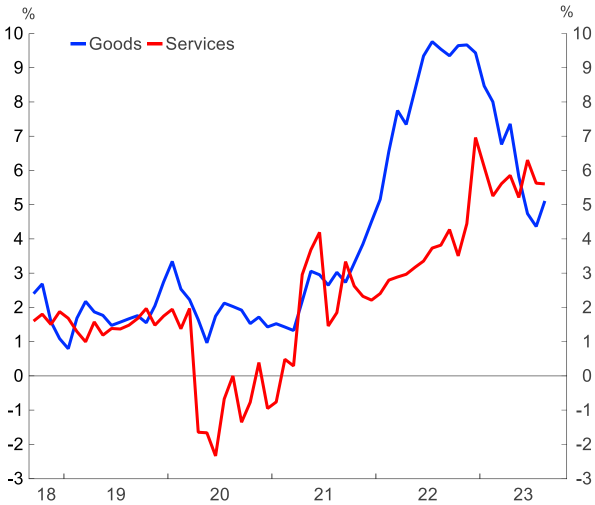
Oil prices pulled back from these highs through the start of October, however, oil prices have rallied again following the growing conflict in the Middle East. Developments here will remain an important area to watch and have important ramifications for the supply and price of oil. The continued weakness of the Aussie dollar is another factor which has exacerbated the risks from elevated oil prices. This is again most evident in petrol prices, which adjust quickly to changes in the oil price and the exchange rate.

This is particularly important for headline inflation and inflation expectations. The longer petrol prices remain elevated, the further they can feed through the supply chain, increasing the probability of being passed down to final prices. Near-term inflation expectations typically closely track petrol prices and other frequently purchased items, such as food. While near-term inflation expectations are elevated, medium-term expectations remain within the 2-3% target band. Reserve Bank (RBA) Governor, Michele Bullock, last week spoke of the importance of keeping medium-term inflation expectations anchored in the RBA's fight to get inflation back to the 2-3% band.

While changes in the AUD/USD exchange rate are quickly reflected in petrol prices, they take more time to emerge in other goods and services. Additionally, the trade weighted index (TWI), which hasn't fallen as much as the AUD/USD, is more important for overall imported inflation, meaning that the risk is not as significant as it may appear if looking at the AUD/USD rate.

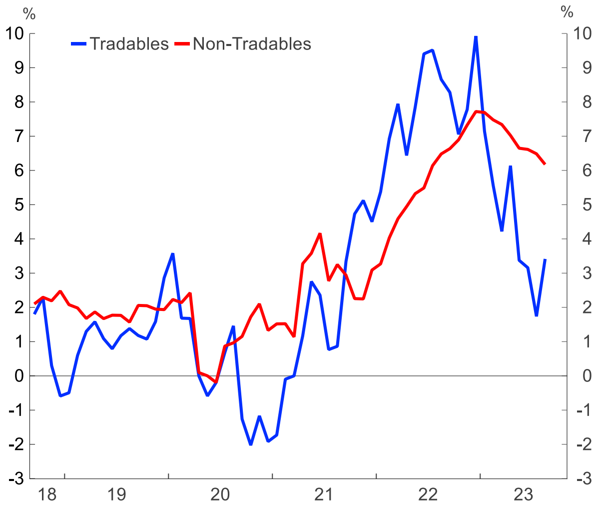
The other component of inflation which the RBA is monitoring with particular interest is services inflation. Services inflation has shown some early signs of being somewhat sticky, as has been the case overseas. The monthly inflation indicator has shown that services inflation and inflation for non-tradables, both of which are impacted more by domestic supply and demand factors, has been coming down slowly. This compares with a more rapid fall in goods and tradables inflation, which are more impacted by international factors, such as supply-chain disruptions. We have seen the greatest progress in these areas.

Monthly Consumer Price Index
Annual % Change



Sources: ABS; Macrobond

Monthly Consumer Price Index
Annual % Change



Sources: ABS; Macrobond

The RBA will be combing through the details of the release to better understand how inflation dynamics are evolving and what it means for their forecast trajectory out to 2025. The October minutes showed that the RBA has a "low tolerance for a slower return of inflation to target than currently expected". This creates a risk that a material upside surprise may prompt the RBA to shift from its current approach. However, that is not our base case scenario, and we expect the

RBA to remain on hold in November.

Other domestic economic developments

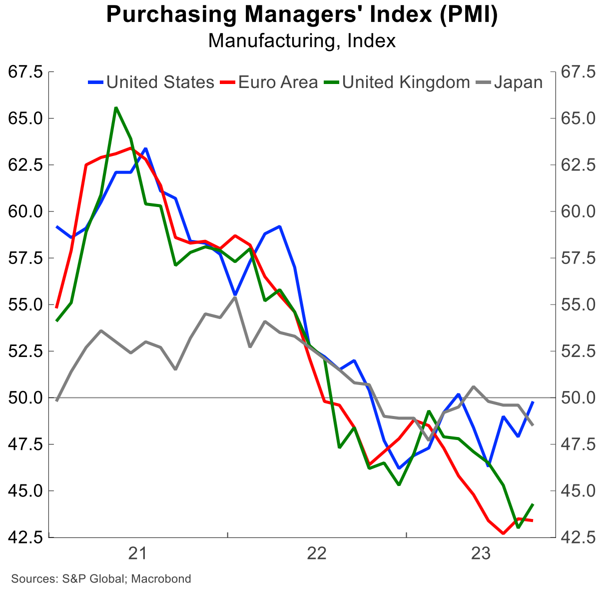
While inflation data will steal the show, there are a range of other domestic developments to watch this week. Firstly, staying with the RBA, Governor Michele Bullock will be delivering a speech on Tuesday night, titled: "Monetary Policy in Australia: Complementarities and Trade-offs". Additionally, the Governor and Assistant Governor Chris Kent, will appear in front of the Senate Economics Legislation Committee for the Supplementary Budget Estimates in Canberra on Thursday. Both appearances will be closely watched for any clues as to the RBA's thinking on the inflation challenge.

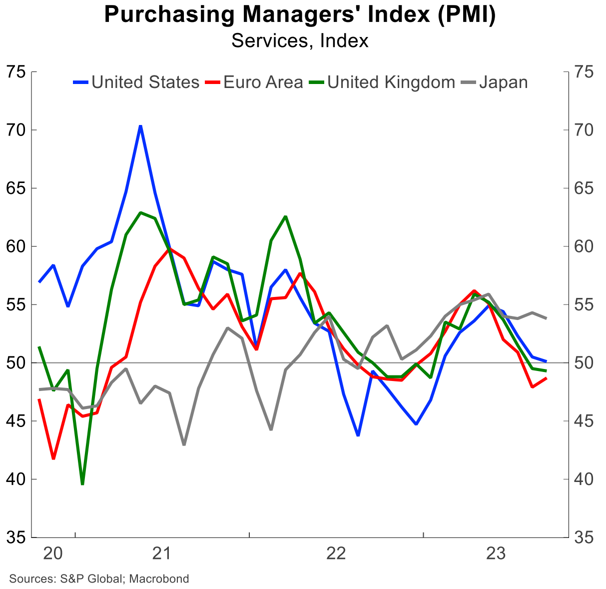
Import and export price indices for the September quarter will be published on Thursday, adding to a range of inflation-related data releases this week. International import and export prices are important inputs into goods and tradables inflation, where we have seen the most progress, as noted above. In the quarter, the AUD/USD exchange rate depreciated by 3.4%, while the TWI depreciated by a smaller 1.0%. Prices of commodities exported by Australia fell by 0.9%, while oil prices spiked by almost 30%. These factors will all impact import and export prices.

The September quarter producer price index (PPI) will be released on Friday. This provides important evidence of how price pressures are developing at the producer, rather than the consumer, level. Like consumer prices, we have seen a welcome slowdown for producer prices from a peak of 6.4% in the September quarter of 2022, to 3.9% in the June quarter of 2023. Improvements in supply chains and the availability of goods, in addition to reductions in commodity prices have been important factors driving the slowdown.

International economic data

Overseas, the European Central Bank (ECB) will meet on Thursday night (AEDT). The ECB is widely expected to keep its main policy rates on hold. That would leave the deposit rate at 4.00% and the main refinancing rate at 4.50%. The European economy faces a range of challenges. Growth has slowed materially and the outlook remains weak. Inflation, including in services, is coming down, which should allow the ECB room to pause and assess the flow of data. However, like other central banks, they will need to remain vigilant to potential upside risks.





The October iteration of the global purchasing managers' indices (PMIs) from S&P will be released throughout the week. These are a key leading indicator of economic growth and inflationary pressures around the world. The indicators have consistently shown that the manufacturing sector remains in contractionary territory and faces recessionary conditions across most major economies. While the services sector has demonstrated resilience, this appears to be waning of late as the full effects of aggressive monetary policy tightening around the world continue to transmit through the economy. The October update will provide important updates on these trends, including providing some guide on the relative tightness of monetary policy and the outlook for the future.

Turning to the US, the first estimate of Q3 GDP will be released, in addition to the September core personal consumption expenditures (PCE) deflator – the Fed's preferred measure of inflation. US growth has persistently surprised to the upside in 2023, led by strength in the consumer. Slowing inflation, in addition to a very strong labour market and robust nominal wages growth has resulted in positive real wages growth for US households. Additionally, given the prevalence of 30-year fixed rate mortgages, the cash-flow channel of monetary policy is slower to transmit through the US economy compared to Australia and most other major economies. These factors have supported household spending. Consensus forecasts are expecting annualised growth of 4.3% in Q3. A result of this magnitude would represent well above trend growth.

Inflationary pressures are expected to have continued to moderate in September, although signs of stickiness are likely to remain evident. Consensus expectations are for PCE inflation to slow to an annual pace of 3.4% in September, down from 3.5% in August. While core PCE (excluding the volatile food and energy components) is expected to slow to 3.7%, from 3.9% in August.

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Group Forecasts

		2023	2024				2025
End Period:	**Close (20 Oct)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.10	4.10	4.10	3.85	3.60	3.35
90 Day BBSW, %	4.22	4.30	4.30	4.22	3.97	3.72	3.47
3 Year Swap, %	4.38	4.10	4.00	3.90	3.80	3.70	3.50
10 Year Bond, %	4.75	4.45	4.50	4.40	4.30	4.20	4.00
US Interest Rates:							
Fed Funds Rate, %	5.375	5.375	5.125	4.875	4.625	4.375	4.125
US 10 Year Bond, %	4.91	4.60	4.65	4.60	4.50	4.40	4.20
USD Exchange Rates:							
AUD-USD	0.6314	0.66	0.67	0.68	0.69	0.70	0.71
USD-JPY	149.86	147	145	143	141	138	135
EUR-USD	1.0594	1.08	1.09	1.11	1.13	1.14	1.15
GBP-USD	1.2164	1.23	1.24	1.25	1.26	1.27	1.28
NZD-USD	0.5828	0.61	0.61	0.62	0.62	0.62	0.63
AUD Exchange Rates:							
AUD-USD	0.6314	0.66	0.67	0.68	0.69	0.70	0.71
AUD-EUR	0.5960	0.61	0.61	0.61	0.61	0.61	0.62
AUD-JPY	94.62	97.0	97.2	97.2	97.3	96.6	95.9
AUD-GBP	0.5191	0.54	0.54	0.54	0.55	0.55	0.55
AUD-NZD	1.0832	1.08	1.09	1.10	1.11	1.12	1.13

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.7	1.2	1.6
CPI (Headline), %	3.5	7.8	4.3	3.2
CPI (Trimmed mean), %	2.6	6.9	4.1	3.1
Unemployment Rate, %	4.7	3.5	3.8	4.7
Wages Growth, %	2.3	3.4	3.8	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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