BofA SECURITIES

Australia Economic Watch

CPI preview: Cooling slowly

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Economics
Australasia

Micaela Fuchila
Economist
Merrill Lynch (Australia)
+61 2 9226 5337
micaela.fuchila@bofa.com

Oliver Levingston
Rates Strategist
Merrill Lynch (Australia)
oliver.levingston@bofa.com

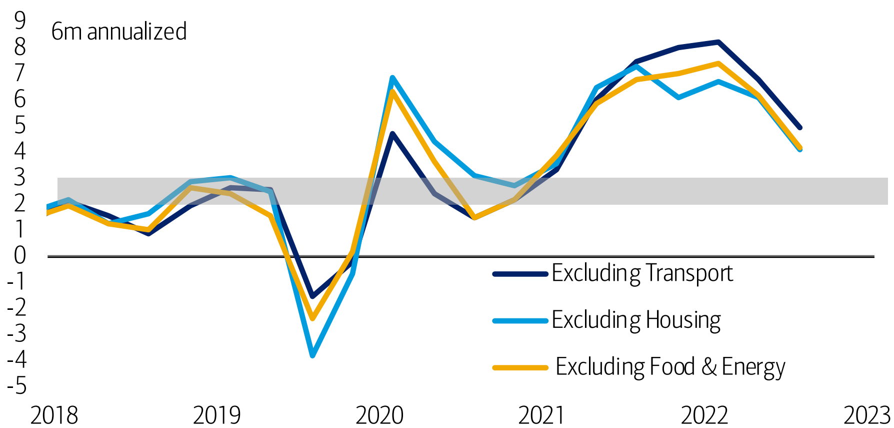
We see a 1.1% qoq rise in 3Q, but annual CPI will fall

The official quarterly CPI report for the September quarter will be released on October 25th and we look for a strong 1.1% qoq rise that will push annual inflation down to 5.3% yoy from 6% on the back of base effects. Monthly inflation was mixed with softer-than-expected outcomes in July due to subsidies and a rise in August reflecting higher petrol prices.

Data for the September quarter is often seasonally strong, but the focus will be on the core measures as well as traction from rates in the sticky services sector. In addition to petrol prices, we expect positive contributions from the housing component as well as utilities. We see a 1% rise in core inflation, which will see the annual core down to 5%.

The Reserve Bank of Australia (RBA) will be closely watching this release. Recent communication suggests less tolerance for overshooting the target. Weakness in the household sector will contribute to softer inflation, in our view. We do not expect further hikes from the RBA this year and next, but an upside surprise in CPI along with strong labour market outcomes could trigger further tightening.

Exhibit 1: Inflation momentum is slowing
But energy prices place upside pressure



Source: ABS, Macorbond

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Market implications

Front-end swaps have cheapened aggressively as markets position for higher policy rates from the RBA in 2024. The shape of the curve looks wrong and higher yields (lower swap prices) are likely being driven by offshore moves, similar to the dynamic when the OIS curve steepened in September. The timing of terminal pricing (September) looks particularly anomalous given weakness in the consumer sector is likely to continue weighing on inflation and we recommend scaling into 2024 flatteners. We are monitoring February-September 2024 flatteners. Event-driven risk associated with CPI and unemployment prints means investors should add risk gradually.

The composition matters

Monthly inflation data (updated until August) suggests the annual rate of inflation will ease for a third consecutive quarter in 3Q (Exhibit 2). That said, 3Q will reflect increases in both tradables and non-tradables.

Petrol prices increased 9.1% in August, following a fall of 0.2% in July. We assume a 5% rise in petrol in 3Q. The housing component will continue to rise, with rents driving the increase. Rent prices increased 7.8% in the 12 months to August 2023, up from 7.6% in July, reflecting strong demand for rental properties and tight rental markets. However, new dwelling prices have eased of late due to improvements in the supply of materials.

Exhibit 2: Monthly CPI suggests lower inflation
For a third consecutive quarter

Source: ABS

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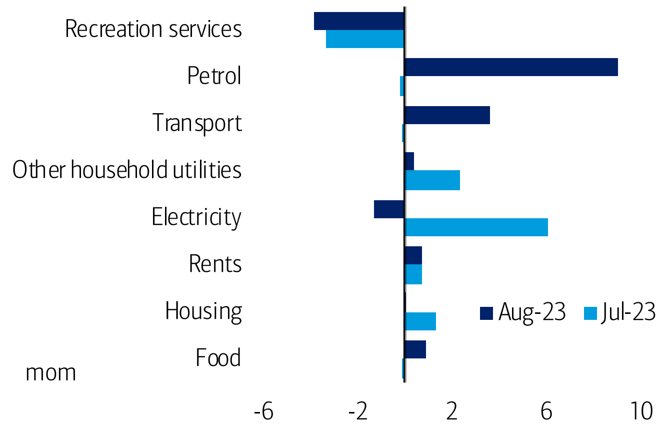
Exhibit 3: Monthly CPI suggests a narrow-based rise
Petrol will be the main driver



Source: ABS, Macrobond

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The data will include two major policy measures to reduce cost of living for households: utility rebates and childcare support. The Australian Government is partnering with state and territory governments to provide up to A$3bn in electricity bill relief for eligible households and small businesses through the Energy Bill Relief Fund from 1 July 2023 through to 30 June 2024. Notably, electricity accounts for 2.2% of the CPI basket. The government estimates energy bill relief is expected to reduce inflation by 0.75 percentage points (ppts) in 2023-24.

In addition, from 10 July 2023, changes to the Child Care subsidy scheme mean more families will be eligible for lower childcare fees. Families earning less than AUD 80,000 will have 90% of their childcare fees subsidized (up from 85%) and the income cap for eligibility has been increased from AUD 356,756 to AUD 530,000. Childcare accounts for 0.82% of the CPI basket. There are also seasonal increases in phone bills that could add upside pressure to the communications component and food prices should also add to CPI in the quarter, as supermarkets have increased milk prices. In New Zealand, food prices rose 0.9%. See: New Zealand Economic Watch: CPI review: A good downside surprise 17 October 2023.

While consumers are very constrained and have adjusted their spending for both discretionary and essential items, we would expect services to remain sticky. Retail spending data showed ongoing spending on cafes, restaurants and takeaway food services, but overall spending is soft reflecting traction from high rates. See: BofA Australia Household Consumption Tracker: Household spending: Decline, but no cliff 12 October 2023

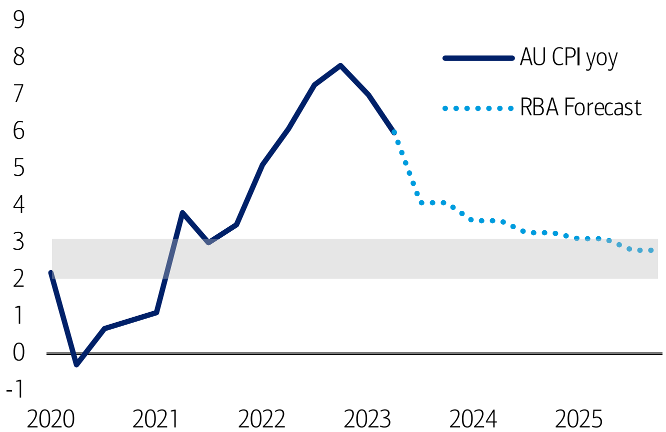
The national minimum wage increased by 8.6% from July, consisting of a 5.75% headline increase and an additional increase from a technical readjustment that realigned the minimum wage to a different wage classification. These increases impact around 30% of the labour force and will flow through to wages growth in the September quarter. There was also a 15% increase for direct care workers that will also impact wages growth in 3Q. The latter could provide a boost to demand-driven inflation in the near term.

The RBA's dilemma

The RBA will need to strike the right balance between upside risks to inflation in the near term as well as avoiding a further downturn in the household sector. See: BofA Australia Household Consumption Tracker: Household spending: Decline, but no cliff 12 October 2023. The Bank's implied assumption for 3Q is around 0.9% qoq. This means an upside surprise is likely. Uncertainty is associated with the traction from rates and the impact of weaker household spending and subsidies.

The Bank's forecast suggests the inflation target will be reached in 2H 2025 (Exhibit 4), and we think this is likely. However, at a speech this week, RBA's Governor Michele Bullock expressed concerns about inflation expectations. In her view, the RBA's main challenge is avoiding a de-anchoring of inflation expectations. The longer CPI remains above target, the harder it will be to contain inflation expectations (Exhibit 5).

Exhibit 4: RBA forecasts for headline CPI
Suggest an upside surprise is likely



Source: RBA, Macrobond

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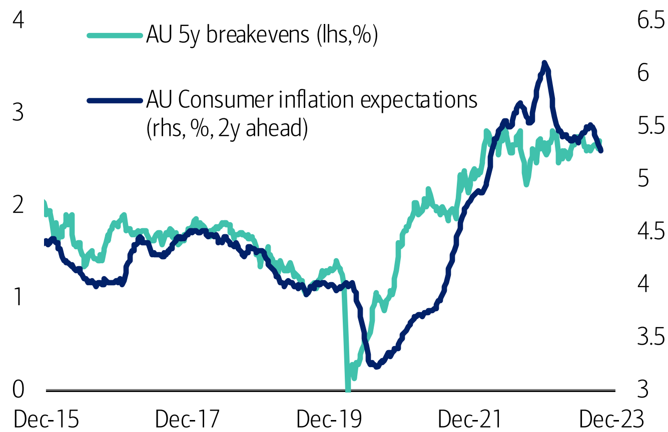
Exhibit 5: Inflation expectations move sideways
A key concern for the RBA



Source: Macrobond

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The RBA has placed ongoing focus on productivity growth. In their view, wages growth is still consistent with the inflation target, "provided that productivity growth picks up".

However, unit labour costs increased at their strongest pace in several decades (outside of the pandemic period) as productivity growth continued to be weak. Australia experienced a large decrease in labour productivity for the whole economy (-2.0%) and the market sector (-1.7%) in the June 2023 quarter. This is largely because hours worked increased more than output. Output was up 0.4%, while hours worked for the whole economy and the market sector increased by 2.4% and 2.2%, respectively – the largest quarterly increase on record, outside the COVID-19 pandemic.

The surge in hours worked during the June 2023 quarter was predominantly a result of employed workers working longer hours rather than an influx of new entrants. Specifically, 87.5% of the increase in total hours worked can be attributed to the rise in hours worked per employee.

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