Rate cut all but certain after weak inflation data

Consumer price index

- **Low inflation: The Consumer Price Index – the main measure of inflation in Australia – rose by 0.1 per cent in the March quarter, well below expectations centred on a 0.6 per cent rise in prices. In seasonally adjusted terms the CPI fell by 0.2 per cent. The CPI stands just 1.6 per cent higher than a year ago – the lowest rate in 2½ years.**
- **Fruit prices plunge. The price of fruit fell 30 per cent in the quarter with international holiday travel down 4.8 per cent, domestic travel down 2.0 per cent, furniture prices down 6 per cent and TV, audio equipment and computers down 6.3 per cent. On the other side of the equation, there were seasonal rises in tertiary education fees (+4.7 per cent), secondary education fees (+7.7 per cent) and prices of medicines (+14.1%). Also rents rose 1.0 per cent with petrol prices up 2.5 per cent.**
- **A raft of items have recorded the biggest annual price declines on record, including food, personal care, newspapers, books, stationery and snacks and confectionary. Car prices have fallen to the cheapest levels in 24 years.**
- **Underlying measures restrained: Underlying inflation rose 0.4 per cent over the quarter to be up 2.1 per cent on the year. The Reserve Bank monitors three measures to derive the underlying inflation rate. The trimmed mean rose by 0.3 per cent in the March quarter; the weighted median rose by 0.4 per cent and the CPI less volatile items rose by 0.4 per cent.**
- **Reserve Bank tipped to cut rates: The low inflation reading paves the way for the Reserve Bank to cut rates by 25 basis points on May 1.**

What does it all mean?

- Inflation is well and truly contained and the Reserve Bank is all but certain to cut interest rates on May 1. The low inflation data removes the last hurdle for the Reserve Bank to cut interest rates next month. The sluggishness in the domestic economy has ensured that businesses continue to absorb any increases in costs, while the strength of the Australian dollar continues to keep imported prices low. In addition the uncertainty and downside risks to the global economy have resulted in subdued commodity price in recent months.
- Inflation rose by just 0.1 per cent in the March quarter and when seasonal factors are taken into account, inflation actually fell by 0.2 per cent. The producer price data yesterday highlighted that businesses have been absorbing costs while also passing on the savings thank to the high Aussie dollar in order to get consumers to spend. And

The Eight RBA Inflation Measures

	Quarterly		*Year-ended*	
	Dec Qtr 11	Mar Qtr 12	Dec Qtr 11	Mar Qtr 12
CPI - seasonally adjusted	0.2	-0.2	3.0	1.5
CPI - unadjusted	0.0	0.1	3.1	1.6
– Tradables	-1.2	-1.4	1.8	-1.5
– Tradables (ex food, fuel & tobacco)	-0.6	na	-1.1	na
– Non-tradables	0.7	1.0	3.7	3.6
Selected underlying measures				
Trimmed mean	0.6	0.3	2.6	2.2
Weighted median	0.5	0.4	2.5	2.1
CPI ex volatile items(a) and deposit & loan facilities(b)	0.3	0.4	2.5	2.0

(a) Volatile items are fruit, vegetables and automotive fuel (r) revised
Source: ABS, CommSec

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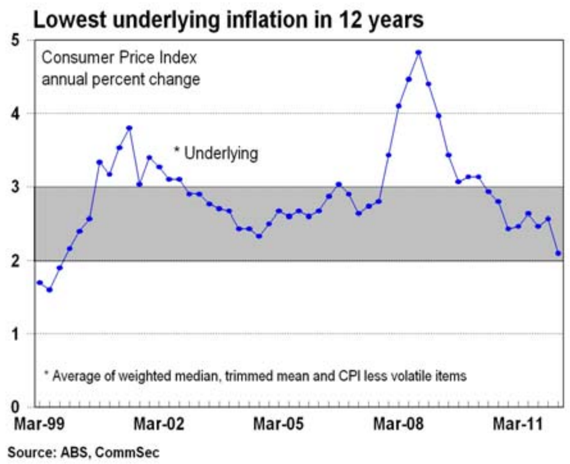
given the ongoing strength of the dollar it is difficult to believe that inflation will be a problem over the coming year.

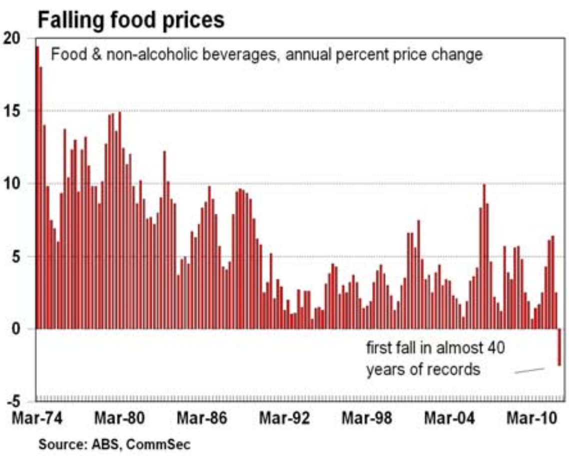
- Not only was the headline inflation rate virtually flat, but the closely-watched underlying measures also recorded decidedly subdued readings. In addition annualised underlying inflation has fallen to the bottom of the Reserve Bank's 2-3 per cent target band. The average of the three key underlying inflation measures stands at 2.1 per cent. It's clear that domestic inflation is unlikely to stand in the way of a rate cut next month.
- The minutes from the last Reserve Bank Board meeting acknowledged the slowdown in the domestic economy and the key focus is how much stimulus should now be provided – particularly given that domestic banks may not be able to pass on the entire rate cut. Interestingly after the inflation data financial markets pricing on the size of the expected rate cut in May rose from 23 basis points to 32 basis points – effectively 1¼ rate cuts.
- CommSec expects the Reserve Bank to cut rates by at least a quarter of a per cent in May. There is the risk that the Reserve Bank cuts rates by half a per cent, but we expect the Bank to remain conservative. The RBA is still wary about the huge income flowing in from resources. But certainly we can't rule out future rate cuts if the domestic and global economies remain subdued.

What do the figures show?

Consumer Price Index

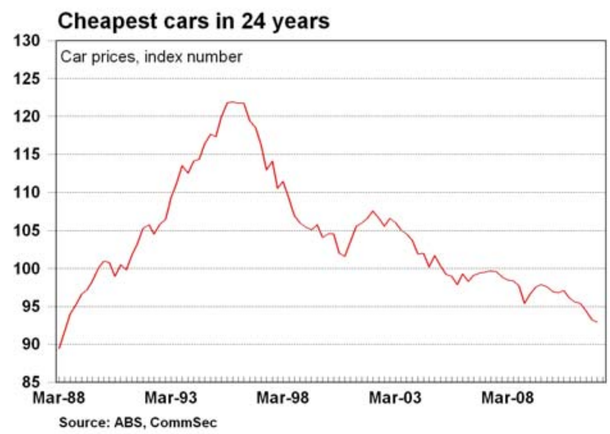
- The All Groups Consumer Price Index (CPI) fell by 0.2 per cent in seasonally adjusted terms in the March quarter after rising by 0.5 per cent in the December quarter. In original terms the CPI index rose by 0.1 per cent in the March quarter.
- In the March quarter the ABS notes that "*The most significant price rises this quarter were for pharmaceutical products (+14.1 per cent), secondary education (+7.7 per cent), automotive fuel (+2.5 per cent), medical and hospital services (+2.1 per cent), tertiary education (+4.7 per cent) and rents (+1.0 per cent). The most significant price falls this quarter were for fruit (–30.0 per cent), international holiday travel and accommodation (–4.8 per cent), furniture (–6.0 per cent), audio, visual and computing equipment (–6.3 per cent) and domestic holiday travel and accommodation (–2.0 per cent*).
- The annual rate of inflation fell from 3.1 per cent in the December quarter to 1.6 per cent in the March quarter.
- **Underlying measures** of inflation were mostly weaker in the March quarter. The **weighted median** measure rose by 0.4 per cent in the quarter, with the annual rate falling from 2.5 per cent to 2.1 per cent. The **trimmed mean** measure rose by 0.3 per cent in the quarter with the annual rate falling from 2.6 per cent to 2.2 per cent. And CommSec estimates that the **CPI excluding fruit, vegetables, petrol and deposit and loan facilities (CPIX)** rose by 0.4 per cent in the quarter with the annual rate rising from 2.5 per cent to 2.0 per cent.
- **A raft of items have recorded the biggest annual price decline on record;** Fruit and vegetables (fell by 20.1 per cent over the year), Personal care (down 3.2 per cent over the year), Food (down 2.5 per cent over the year) and Newspaper, books and stationery (down 0.5 per cent over the year – biggest fall in 22 years).
- **Prices of tradables** fell by 1.4 per cent in the March quarter, with lower fruit prices, furniture, audio, visual and





computing equipment, garments for men, garments for women, and household textiles, partially offset by pharmaceutical products, automotive fuel, and tobacco. The annual growth rate of tradables fell from 1.8 per cent to 1.5 per cent.

- **Prices of non-tradables** rose by 1.0 per cent in the March quarter. Price increases for electricity, beer, and waters, soft drinks and juices drove the higher result. The annual rate of non-tradables inflation fell from 3.9 per cent to 3.6 per cent in the March quarter.
- Tradable goods are those items whose prices are largely determined on the world market. Non-tradable prices are more affected by domestic economic conditions.



What is the importance of the economic data?

- The **Consumer Price Index (CPI)** is regarded as Australia's premier measure of inflation. The CPI is published quarterly and measures price changes for a 'basket' of goods and services that dominate expenditure of metropolitan households. The "All Groups" index is the main focus, but other inflation measures are also published such as so-called 'underlying' measures. These include measures that abstract from price changes in volatile price items such as fresh food and petrol.
- The Reserve Bank aims to keep the headline inflation rate between 2-3 per cent over an economic cycle. If inflation is high and expected to rise, the Reserve Bank may elect to raise interest rates in order to constrain price pressures. Conversely, if inflation is low and expected to remain low, the Reserve Bank may elect to cut interest rates if it believes the growth pace of the economy is in need of strengthening.

What are the implications for interest rates and investors?

- The data over the past couple of weeks have shown no clear signs of substantial or sustainable improvement in economic conditions. And today's data will ensure that the Reserve Bank is more comfortable when it comes to easing rates.
- The Reserve Bank has plenty of scope to cut interest rates, and we anticipate policy makers will look to do just that at the May meeting – that is, reduce interest rates by a quarter of one per cent
- It's great news for homeowners and great news for potential homebuyers. The likelihood of further rate cuts should help to alleviate pressures on household budgets and stimulate activity in the housing sector.
- Retailers have reason to cheer the latest inflation result. If the Reserve Bank cuts rates as expected, this should serve to boost consumer confidence as well as the purchasing power of Aussie consumers. On the sharemarket, retailers, housing-dependent stocks and industrials have the most to gain from lower interest rates and thus lower borrowing costs.

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