2 May 2023

ECONOMIC UPDATE

Another step higher

Key Points

- **The RBA surprisingly increased the cash rate by a quarter percentage point following its May meeting, taking the cash rate to 3.85%;**
- **The RBA said further rate hikes are possible;**
- **While inflation is above 3% the only cash rate movement can be up;**
- **Household spending and the global economy were the two main risks nominated by the RBA.**

What the RBA decided

The RBA surprisingly increased the cash rate following its May meeting. While economists did expect another quarter percentage point rate rise, they did not think it would take place until the following quarter. Clearly what is playing on the RBA's mind is that the inflation rate is currently around 7%, well above its stated target. The monthly CPI figures indicate that inflation is declining but at only a moderate pace.

While noting that goods inflation is falling, the RBA noted the strength of service prices as well as the sticky pace of underlying inflation in other economies. The $A has traded 'soggy' in recent weeks, partly a result of expectations that the peak of the RBA cash rate would be at or below that of peer countries. And a lower $A makes it harder for the RBA to keep inflation low.

The RBA nominated as its key uncertainty, consumer spending. Disposable incomes are being hit by the higher cost of living, rising interest rates as well as the previous decline in house prices. Some households are already making tough financial decisions, others have the benefit from significant saving.

The RBA noted that the world economy is a source of uncertainty. That is true given the uncertainty of how the recent banking sector problems may impact the global economy. More generally, the economic data has been surprisingly strong in many economies for much of this year. The aggressive rise of interest rates in a number of economies is likely to (in time) result in weaker economic outcomes.

The RBA did not reference the recent rise in house prices. Maybe that is because the April rise in house prices occurred too late to form a basis of analysis at this meeting. It is also possible that the RBA hasn't formed a strong view as to why house prices have gone up and so therefore think it is too early to call the bottom of the market.

The inflation outlook

The good news from the Q1 CPI data was that the peak of inflation is clearly in the rear-view mirror. There are good reasons to expect inflation to decline further over the next year. Goods inflation will decline further as household spending on goods continues to fall, supply-chain snarls get fully resolved and the benefits from the reduction of shipping costs are realised in consumer prices.

The decline of producer prices has been larger to date than that for consumer prices. History would suggest that is a signal that there is more slowing in the CPI to come. Slowing growth in materials prices is slowing the growth of costs for building a house (but we are a long way from talking about falling costs). Better weather means food prices are unlikely to rise as fast as they have over the past year. A fall in oil prices means fuel prices are not rising and may well fall in coming months (providing the $A does not decline significantly).

Spending on services continues to be strong and service prices are influenced by wages growth which is on the rise. Low vacancy rates mean rents will be rising strongly for some months to come. We know that electricity and gas bills will be increasing in the second half of this year. Not only does higher utility bills directly impact the CPI but also has an indirect impact as it leads to higher costs for businesses.

The big picture is that the pandemic and the Russia-Ukraine War has led to a rise in costs for Australian firms that has been largely passed onto the consumer. Some (but not all) sectors have also been able to widen margins. The feedback from firms is that while cost growth is slowing it remains elevated. Slowing consumer demand (particularly for goods) means some of the rise in costs in coming quarters will need to be absorbed within margins. It is probable that a fair proportion of the rise in costs will be passed onto consumers, particularly for services. So how much consumer spending slows, and costs rise will be the key short-term drivers of the inflation outlook.

This means that while inflation is likely to continue to decline it is also likely to remain elevated for at least the next year. While inflation remains north of 3% the RBA can't think about cutting rates. Indeed, as we found out following the May meeting the only rate change that can occur when inflation is above 3% is a rate rise.

House prices

Recently I put out my March quarter house price update. The bottom line from that note was that despite the rise of prices across Australia in March I did not change my view that the peak-to-trough decline in standalone house prices in this cycle would be 15% (it had fallen by around 10% to February), but following the second successive decent monthly rise in house prices in April I have had to fall on my sword on that view.

It is still possible that house prices may fall again. As we found out in May there is uncertainty about what will be the peak of the cash rate. A weaker global and domestic economy may mean there is less financing available in the economy, including for housing. And a weaker jobs market might have negative implications for both potentially new and existing borrowers.

But given the increases over the past couple of months it might be difficult to achieve the 15% decline target. The combination of strong population growth and a lack of supply has put upward pressure on prices. The relative lack of affordability I think will limit the upside to house prices this year. Across Australia I now expect that prices will be around flat for the year (within a band of plus or minus 3%). I will provide a more detailed outlook on my house price views in a few weeks.

Interest rate outlook

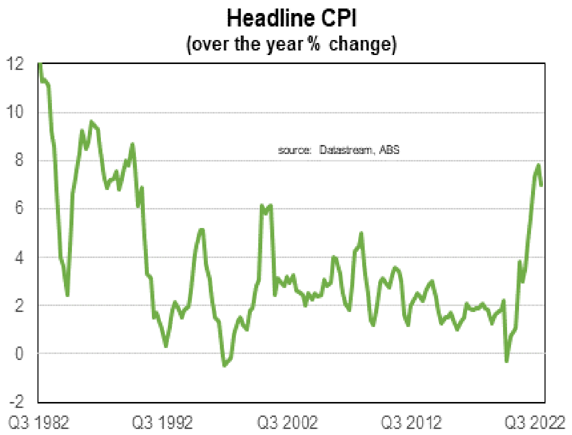
The bounce in house prices has interest rate implications. Peak-to-trough house price declines of 15-25% were widely forecast, with the bottom in prices not expected to be hit until sometime later this year. As the RBA noted, declining wealth from falling house prices was one of the factors that was expected to be a negative for consumer spending. That the fall in house prices is looking likely to be less and the bottom potentially reached earlier than had been projected suggests that there is upside risk to consumer spending forecasts.

This is against a backdrop of inflation being well above the target band and the unemployment rate still hovering near fifty-year lows. The peak in the cash rate in many peer countries is also expected to be above that of Australia.

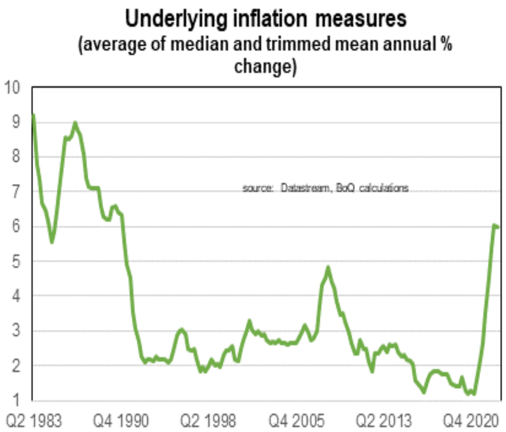
At the time of writing, financial markets were a bit over two-thirds priced about the possibility of another quarter percentage point rate hike in this cycle (which would take the cash rate to 4.1%). Financial market pricing suggests that the most probable time for the next move is in August following the publication of the Q2 quarterly CPI data. If there is to be another rate hike that timing appears reasonable.

The current high inflation rate and the stickiness of inflation in other economies argues for another cash rate rise, but the cash rate has risen aggressively over the past year, and we are months away from observing the full impact. I think the RBA has done enough rate hikes already in this cycle. But the RBA's evident concern about inflation means another quarter percentage point rate rise remains a distinct possibility. Whether that risk turns into outcome will depend upon how quickly inflation declines this year.

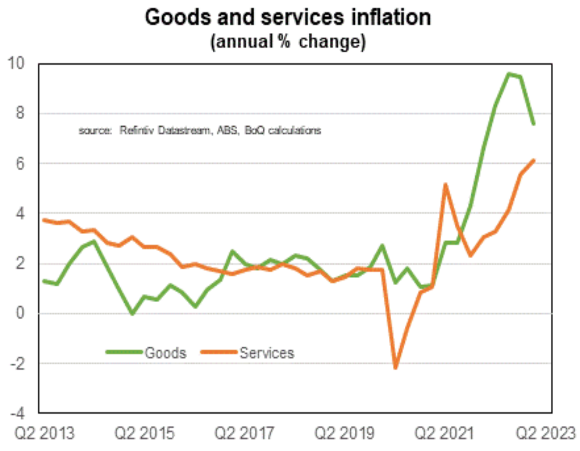
Inflation has started to decline.



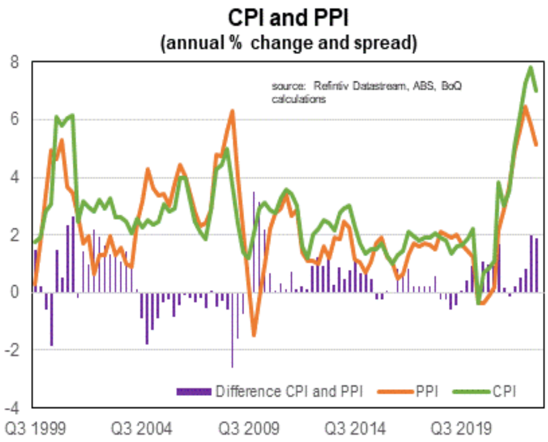
But the underlying measures have only just peaked.



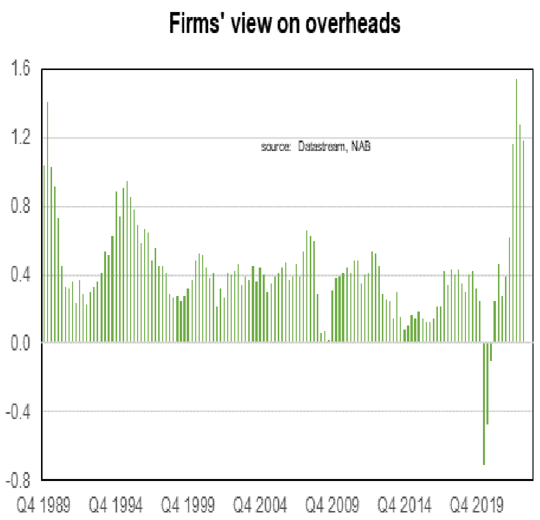
Goods inflation is falling but service prices are still on the rise.



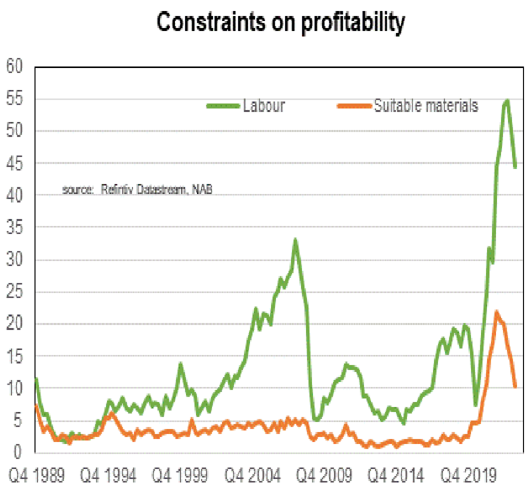
Movements in producer prices suggest that there are more falls in CPI inflation to come.



One concern is that firms report that overhears remain high.

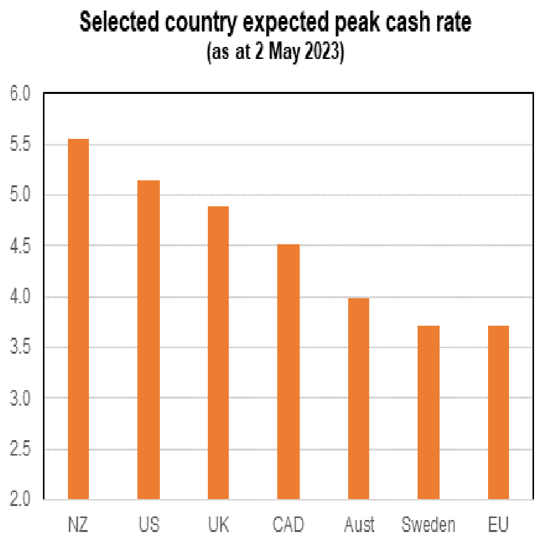


A lack of materials and labor were still major constraints in the March quarter.



Monthly headline CPI numbers are declining but only slowly.

The cash rate in Australia is expected to peak below many other peer economies.



We really do live in interesting times.

Regards

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