27 January 2023

ECONOMIC UPDATE

Inflation has likely hit the peak, but how fast is the descent?

Key Points

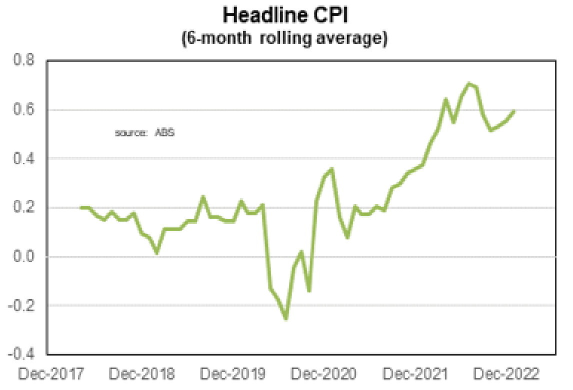
- The December quarter inflation number came in higher than expected;
- A quarter percentage point rate hike is likely in February given the 7.8% inflation rate, rising global cash rates and a very low unemployment rate;
- The good news is that the CPI is likely to have peaked in Q4 2022;
- But a further quarter percentage point rate hike is likely to ensure that inflation returns back towards 2-3%.

Inflation Outcome

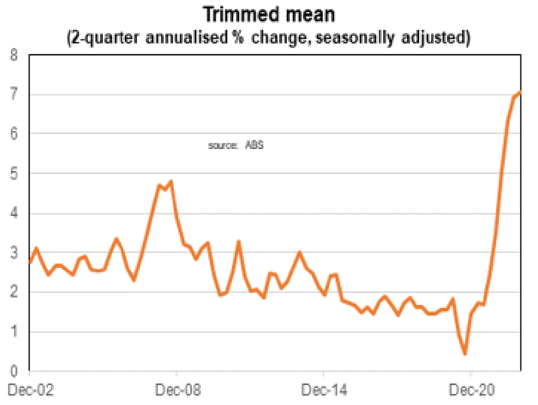
The December quarter CPI came in comfortably higher than expected (1.9% in the quarter versus consensus of 1.6%). Sometimes quarterly movements can be heavily influenced by 1 or 2 components. But the mathematical measures that aims to gauge the 'underlying' movements was also higher than expected (trimmed mean 1.7% v 1.5%). While inflation was higher than financial market expectations it still printed a little under RBA forecast (RBA 8% for annual % change to December 2022 v actual of 7.8%).

The headline number was at its fastest pace since March 1990. The headline number looks to have peaked, in line with what has happened in other OECD economies. The likelihood of a peak in prices is more obvious for goods than for services.

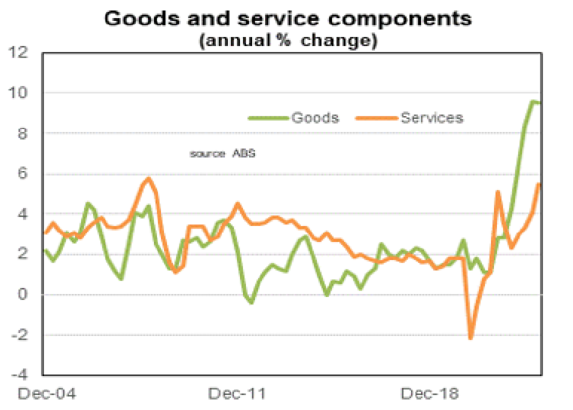
The headline CPI looks to have peaked but there is no clear sign yet of a decline.



The underlying measures were also high.



The peak in goods inflation is more obvious than that for services.



Travel and accommodation inflation was particularly strong.

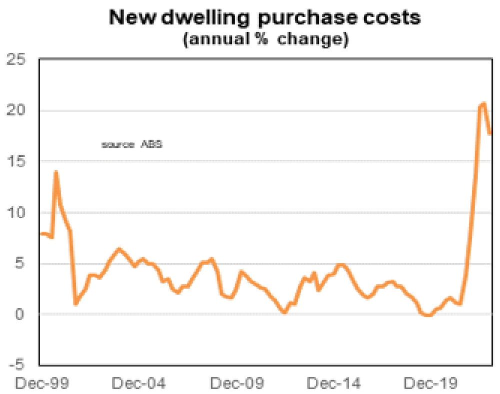
Inflation has likely peaked

There is a strong consensus that the Q4 CPI will be the peak of inflation in this cycle. Inflation was always going to rise in 2022 reflecting the interruptions caused by COVID. Demand was boosted by aggressive fiscal and monetary policy economic support. Supply struggled to keep up reflecting supply chain problems and a cap on the labour force caused by international borders being shut. Then the Russia-Ukraine War caused energy and food prices to rise sharply. Flooding in various parts of Australia boosted fruit and veggie prices.

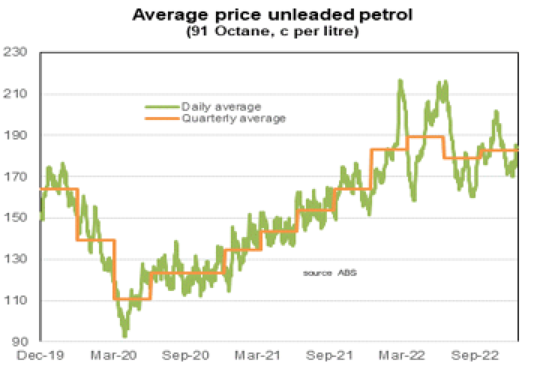
Some of these factors have become less of an issue. There are only so many more couches or gym equipment that a household needs. Production of many goods has picked up sharply as supply-chain snarls get unwound. Already the growth of housing building costs has declined as materials become more widely available at a cheaper cost. Despite the reimposition of excise levy petrol prices were below their first half of 2022 peak. Fruit and veggie prices declined (although most food prices were still up).

Inflation in many countries has started to moderate and is now surprising on the low side of expectations. The higher $A will help reduce the price of imports.

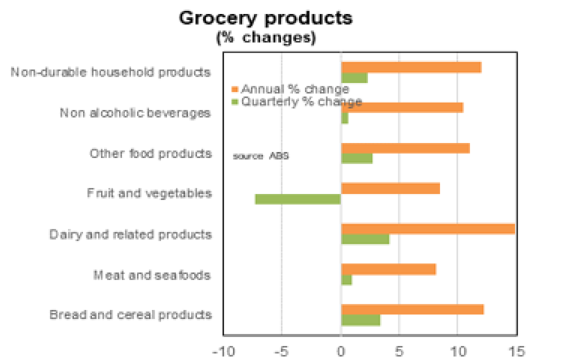
The growth in dwelling costs has begun to decline.



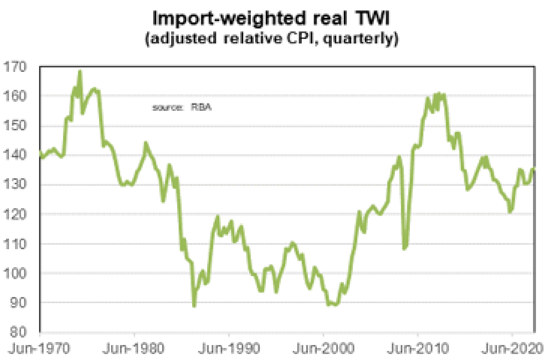
Petrol prices remain below their peak in the first half of last year.



Food prices remains high although there was a decline for fruit and veggies.



A stronger exchange rate will help keep a lid on imported inflation.



The important question is how quick inflation declines

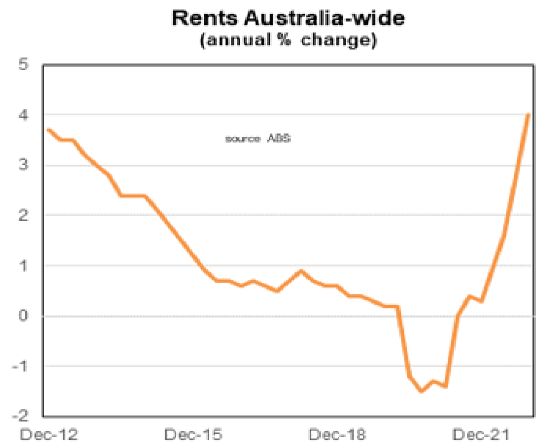
How quickly inflation moderates over the next couple of years will play an important part in determining the interest rate outlook. While a number of factors will lower inflation there are also factors that will drive inflation higher. Electricity and gas prices are set to increase further this year although probably not as much as had been feared.

The demand for labour has started to decline (falling job vacancies) and the supply of labour is rising (increasing immigration). Demand for workers in some sectors of the economy has fallen, whether because of slowing consumer demand for goods or rising interest rates (impacting areas of finance and IT). In time the combination of lower demand for labour and higher supply of workers will reduce concerns about worker shortages. But such is the current demand for workers labour shortages will remain a significant issue for much of this year. And a tight labour market will likely lead to a further rise in wages growth. Firms in industries where labour is a significant cost will likely pass some of this increased cost onto customers.

Rising rents will also continue to pressure inflation. The supply of housing will be boosted by the increase in home completions this year. But there is also an increase in demand for housing reflecting the re-opening of borders (likely to be partially offset by a rise in the size of households as increasing rents pushes more people back into group housing or home with their parents). While there has been a decline in consumer and business inflation expectations those expectations enter 2023 at a high level.

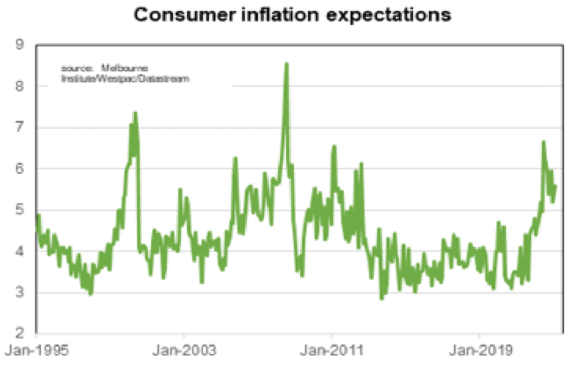
There is broad agreement amongst analysts about these conflicting factors. A bigger point of contention is the economic outlook. A number of analysts are looking for a sharp slowing of the economy beginning at the start of this year. Certainly economic growth did moderate over the second half of last year. But the economy still entered 2023 with decent momentum highlighted by the very low level of the unemployment rate and the still high level of vacancies. Growth of firms' order books has slowed but is still above long-term average levels.

Rents continue to rise across Australia



Wages growth has been picking up.

Consumer inflation expectations have declined but remain high.

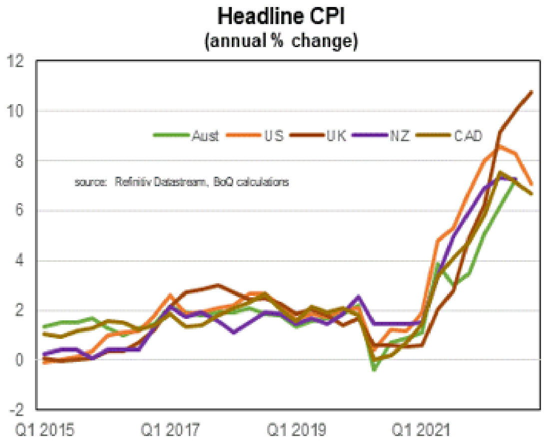


That is also the case with businesses.

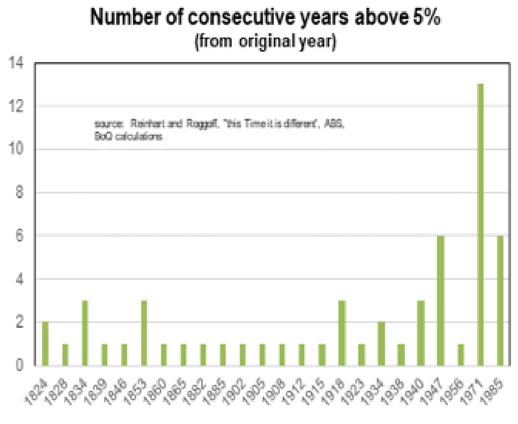
Outlook

It is widely agreed that inflation will slow in 2023. Before the release of the Q4 data, the consensus view (according to a Bloomberg survey) was that inflation will decline to around 4% by the end of 2023. There has only been one occasion since World War 2, where inflation rose higher than 5% and remained above that level for only one year.

Headline inflation looks to have peaked.



Since the Second World War it typically has taken at least two years for inflation to go back under 5%.



In my view an inflation rate of nearly 8% at a time of an extremely low unemployment rate and rising global cash rates is consistent with another quarter percentage point rate hike in February. Indeed, I think inflation in the second quarter will still be high enough at a time of rising wages growth and a still low unemployment rate for there to be a second quarter percentage point rate rise.

Central banks, financial markets and economists were all surprised about how high inflation reached last year. While there are good reasons to expect inflation to decline, the experience of 2022 was a reminder as to why inflation is a bad thing. For this reason central banks are likely to err on the side of caution in ensuring that inflation declines back to the 2-3% target. How cautious they are willing to be will depend upon what also happens with the unemployment rate.

We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland

BOQ | 255 George Street Sydney NSW 2000

Twitter: @petermunckton

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