Monday, 24 July 2023

Inflation D-Day and Central Bank Blitz

As we approach the top of central bank rate hiking cycles, the job of policymakers becomes increasingly difficult as the fine trade-off between inflation and growth narrows and the consequence of striking the wrong balance rises. This is a key reason more and more central banks have been pausing to gather more information. During times like this data becomes paramount, not just the observed outcomes, but also forecasts for future outcomes.

Monetary policy acts with a lag and impacts different macroeconomic variables asymmetrically. For example, higher interest rates will slow growth before they slow inflation, as inflation is the byproduct of activity in the economy. Additionally, household spending will initially be more sensitive to rate hikes than businesses investment. This feature of rate hikes increases the difficulty of making policy decisions because policy needs to be set for what is going to happen not what has already happened. This means that economic forecasts become just as important as the economic data as we near the top of the cycle. In fact, the key insight from the observed data quickly becomes what it means for the forecasts.

This week, there are several key data releases which will not only provide an update on how the economy is evolving, but they will also form a key part of the Reserve Bank's (RBA) updated forecasts to be released next week in the August Statement of Monetary Policy.

The first cab off the rank, and arguably the most important, will be the June quarter inflation report due on Wednesday. The consumer price index (CPI) rose 7.0% over the year to the March quarter and we have since received two monthly inflation reads pointing to solid progress on disinflation. However, the stickiness of inflation remains a key question. Sticky services inflation has been observed overseas and the jury is not yet out on whether our experience will be the same.

We expect the CPI rose 1.1% over the June quarter, which would represent the softest quarterly jump since the September quarter 2021. This is expected to result in annual inflation slowing to 6.3%. Trimmed mean inflation, which strips out the largest and smallest price increases and is the measure of most interest to the RBA, is also expected to gain 1.1% in the quarter to be 6.0% higher in annual terms. This compares to an annual reading of 6.6% in the March quarter but would be only slightly weaker in quarterly terms – pointing to some stickiness in the core measure.

The CPI will be followed up by some other significant inflation data. On Thursday the June quarter trade price indices will be released. The trade price indices measure price changes for our imports and exports which flow into the terms of trade. The prices we pay for our imported goods are an important leading indicator for CPI inflation as many of these items are inputs into the goods and services purchased by consumers.

Friday will feature the release of the producer price index (PPI), which measures the inflation faced by businesses for their inputs. This is another important leading indicator for CPI inflation and provides a key insight into the drivers of the inflationary pulse. In annual terms, the PPI declined for a second straight quarter in the March quarter, reaching 5.2% - it's lowest since the first quarter of 2022. Further slowing in the PPI is expected for the June quarter and will provide a gauge on the breadth of disinflation underway in goods prices as supply pressures unwind.

The final piece of domestic data for the week will give us a read on the other side of the inflation and growth dynamic. Retail sales growth was hotter-than-expected in May, jumping 0.7%, the fastest increase since January. We don't expect this strength to be repeated in June as households increasingly hold back spending in the face of higher prices and rising interest rates. However, strong population growth and resilience in the labour market remain tailwinds for consumption, especially for non-discretionary items. We anticipate retail spending eased 0.2% in June, giving back some of strength from May. This result is likely to be even weaker once adjusting for higher prices, though the level of spending remains elevated.

Central Bank Blitz

Offshore, there are a string of central bank meetings scheduled for this week. The US Fed will take the limelight with its decision due in the early hours of Thursday morning (AEST).

After "skipping" a hike in June to allow more time to digest the lagged impacts of its policy tightening to date, the Fed is widely expected to resume hiking with a 25-basis-point increase in the federal funds rate, to 5.25% - 5.50%. There has been solid progress on inflation in the US, with headline annual inflation falling from a peak of 9.1% in June last year to 3.0% in June this year. However, much of this has been driven by the disinflation underway in goods prices, underpinned by normalisation in the supply side of the economy.

Core inflation remains sticky having fallen from a peak of 6.6% in September 2022 to 4.8% in June. This reflects very strong wages growth which remains inconsistent with the Fed's 2% inflation target. Indeed, we are yet to see any meaningful loosening in conditions in the labour market which remains incredibly tight with an unemployment rate of just 3.6%. This could suggest that the Fed may still have more to do yet.

The guidance will again be key. Markets are only pricing around a 30% chance of another rate hike beyond July. This is at odds with committee members "dot-plot" projections, where the median expectation included two additional rate increases post the June meeting. We expect the guidance will keep optionality and give the Fed room to go again if necessary or pause to digest more information.

The European Central Bank (ECB) policy meeting will follow on Thursday night. They too are widely expected to hike their policy rates by 25 basis points. If realised, this will take the main refinancing rate to 4.25%, it's highest level since 2008. The ECB is yet to pause in its rate hiking cycle.

Finally, the Bank of Japan (BoJ) is expected to leave its policy settings unchanged at its July meeting on Thursday. The BoJ has persisted with its expansionary policy settings to help stimulate the economy, despite signs that inflation is lifting and broadening. There are still no concrete signs of a potential change in tack from the BoJ.

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Group Forecasts

		2023		2024			
End Period:	**Close (21 Jul)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.60	4.60	4.60	4.35	4.10	3.85
90 Day BBSW, %	4.36	4.80	4.80	4.63	4.38	4.13	3.88
3 Year Swap, %	4.28	4.30	4.15	4.00	3.80	3.60	3.50
10 Year Bond, %	4.01	3.90	3.70	3.50	3.30	3.20	3.10
US Interest Rates:							
Fed Funds Rate, %	5.125	5.375	5.375	5.125	4.625	4.125	3.625
US 10 Year Bond, %	3.83	3.70	3.50	3.30	3.10	3.00	2.90
USD Exchange Rates:							
AUD-USD	0.6729	0.69	0.69	0.71	0.72	0.73	0.74
USD-JPY	141.73	138	136	134	132	130	128
EUR-USD	1.1124	1.11	1.12	1.12	1.13	1.14	1.15
GBP-USD	1.2854	1.28	1.28	1.29	1.29	1.30	1.30
NZD-USD	0.6169	0.62	0.62	0.63	0.64	0.65	0.66
AUD Exchange Rates:							
AUD-USD	0.6729	0.69	0.69	0.71	0.72	0.73	0.74
AUD-EUR	0.6049	0.62	0.62	0.63	0.64	0.64	0.64
AUD-JPY	95.4	95.2	93.8	95.1	95.0	94.9	94.7
AUD-GBP	0.52	0.54	0.54	0.55	0.56	0.56	0.57
AUD-NZD	1.09	1.11	1.11	1.13	1.13	1.12	1.12

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.6	0.6	1.0
CPI (Headline), %	3.5	7.8	4.3	3.2
CPI (Trimmed mean), %	2.7	6.9	4.1	3.3
Unemployment Rate, %	4.7	3.5	4.0	5.3
Wages Growth, %	2.3	3.4	4.1	3.3

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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