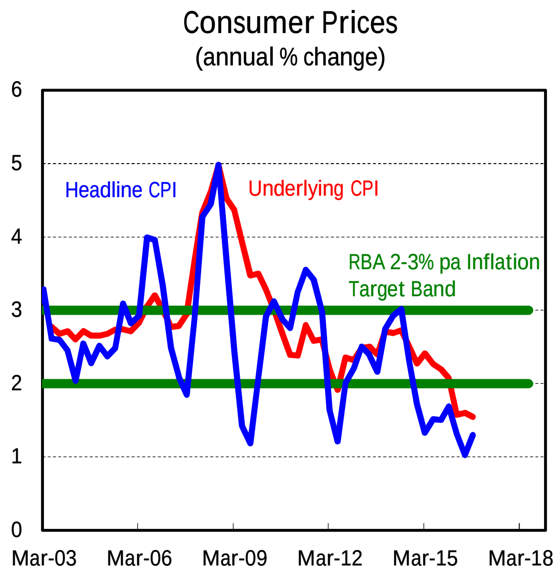
Data Snapshot

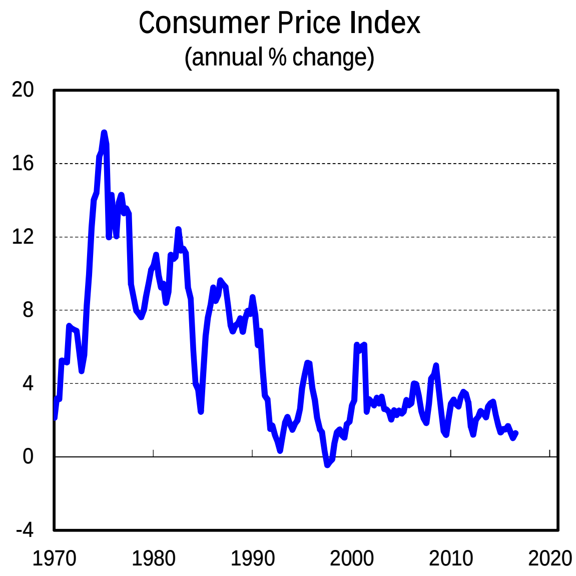
Wednesday, 26 October 2016

Bank of Melbourne

Consumer Price Index
Lineball Call for the RBA

- It was a mixed picture on inflation for the September quarter. Headline CPI rose 0.7% in September quarter, which was stronger-than-expected. The annual pace of inflation edged up from 1.0% in the June quarter to 1.3% in the September quarter. However, the factors pushing up inflation in the quarter, including fruit and vegetables, tend to be volatile and transitory.
- Underlying inflation, which strips out the effect of volatile items, remained very subdued. The average of the two key measures of underlying inflation came in at 0.3% in the September quarter, and 1.5% in the year. The outcome was in line with our forecasts and a little below market expectations. The data suggests that inflation remains persistently low.
- Both the headline and underlying rates of inflation remain well below the RBA's 2 to 3% per annum target band.
- Non-tradables inflation lifted slightly, but remains close to its weakest level in 17 years, providing evidence that domestic price pressures remain subdued.
- Persistently low inflation and further signs of slack in the labour market suggests a strong case exists for a further rate cut. That said, today's data may not be enough of a downside shock for the RBA. Indeed, we note that while very low, inflation is not inconsistent with the RBA's forecasts published in August. With some hesitation, we continue to expect that the RBA will lower official interest rates by 25 basis points when it meets next week on Tuesday, but admit that it will be a very close call.





It was a mixed picture on inflation for the September quarter.

Headline CPI rose 0.7% in September quarter, which was above market expectations for an increase of 0.5%. The stronger-than-expected result saw the annual pace of inflation edge up from 1.0% in the June quarter to 1.3% in the September quarter. However, the main contributors to the increase in prices for the quarter were fruit and vegetables, which tend to be volatile, and transitory. There were also some seasonal factors boosting prices for the quarter.

Underlying inflation, which strips out the effect of volatile items like petrol and food, remained very subdued. The average of the two key measures of underlying inflation came in at 0.3% in the September quarter, which was below consensus forecasts for a 0.4% increase but in line with our own forecast. The annual rate of underlying inflation hit a record low. For the year to the September quarter, underlying CPI rose by 1.5%, down from an upwardly revised increase of 1.6% in the year to the June quarter. Today's data suggests that inflation remains persistently low. Spare capacity within the global and local economies is keeping a lid on prices in Australia and around the world. Underlying inflation has averaged 0.3% per quarter, over the past six quarters.

Moreover, both measures of inflation continue to sit below the RBA's 2-3% per annum target band.

CPI Groups Analysis

The largest increase was in food and non-alcoholic beverages in the September quarter. Within this group, there were strong gains in fruit (19.5%) and vegetable (5.9%) prices. Also contributing significantly to the increase in CPI for the quarter, were higher prices for electricity (5.4%), tobacco (2.3%) and property rates and charges (4.0%). The increase in electricity prices follows declines in four out of the last five quarters and reflects increased wholesale electricity costs in the eastern and southern States. The increase in tobacco prices was mainly due to the federal excise tax increase from 1st September.

In keeping with recent quarters, volatility in the oil price was a swing factor for inflation. In the September quarter CPI data, automotive fuel prices declined 2.9%, after a 5.9% increase in the June quarter. If the recent upward trend in oil prices (in October) were to continue, automotive fuels would unlikely provide a similar detraction from inflation in the December quarter. Other significant price declines included telecommunication equipment and services (-2.5%), which declined for the eleventh consecutive quarter.

There was also seasonal impact from a fall in the price of pharmaceutical products (-0.9%), reflecting the annual pattern where subsidies kick in for the Pharmaceutical Benefits Scheme (PBS) safety net as a greater proportion of consumers reach the threshold.

Consumer Prices	September quarter 2016, % Quarterly change	Annual change
Food and non-alcoholic beverages	1.7	1.5
Alcohol and tobacco	1.1	5.7
Clothing and footwear	0.3	1.2
Housing	1.0	1.8
Furnishings, household equipment and services	1.1	1.9
Health	-0.2	3.9
Transport	-0.5	-3.4
Communication	-2.3	-7.5
Recreation and culture	0.6	0.6
Education	0.2	3.3
Insurance and Financial Services	0.9	2.9
Total CPI	0.7	1.3

Over the last twelve months, softness in inflation was driven by ongoing price declines in communication (-7.5%), reflecting lower prices for audio, visual & computing equipment and transport (-3.4%), driven by an 12.6% fall in fuel prices.

Annual price growth was strongest for alcohol & tobacco (5.7%), which was driven by a lift in the excise on tobacco. Prices also increased for health (3.9%, reflecting higher prices for medical & hospital services) and education (3.3%) in the year to the September quarter.

Tradables and Non-Tradables Inflation

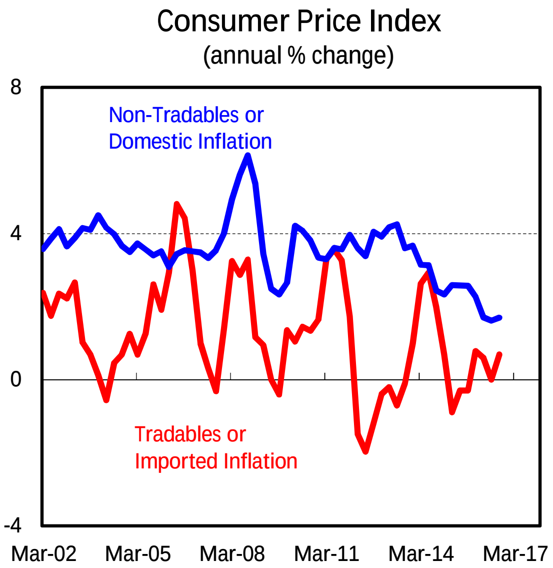
A strong rise in the prices of fruit and vegetables in the quarter (11.9%) helped drive a 1.0% increase in the tradables component of inflation. This was the strongest result since June 2015 and could have been higher except for a 2.9% decline in automotive fuel prices. Tradables inflation includes the prices of goods and services that are imported or compete with imported goods and services. Their prices are mostly determined by the global markets. Over the year, tradables inflation was just 0.7%, assisted by a 12.6% decline in automotive fuels and a 0.6% decline in clothing prices.

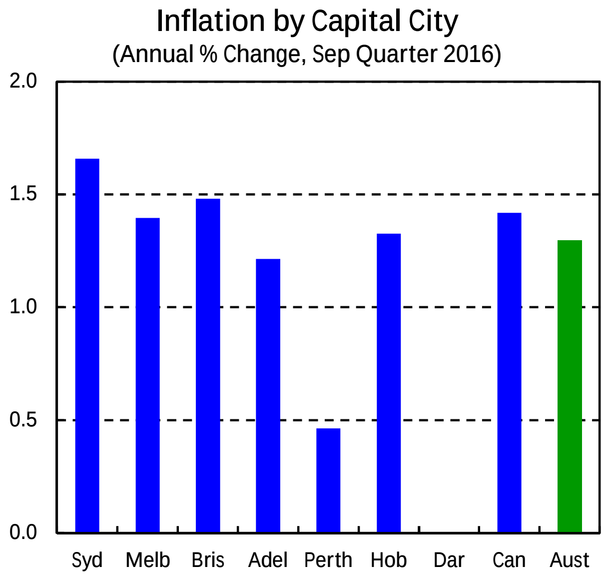
Non-tradables inflation remains subdued. The non-tradables component of inflation reflects domestic prices which are not subject to international or import competition. These include items such as rents, childcare, postal services, insurance and restaurant meals. This measure is important to the RBA, as it provides a better indication of price pressures in the domestic economy.

In the September quarter, non-tradables CPI rose 0.5% and follows four consecutive increases of 0.4%. The modest increase came despite significant increases in childcare (3.6%), postal services (1.0%), insurance (2.5%) and housing related costs (1.0%). On an annual basis, non-tradables inflation stood at 1.7%, close to its weakest level in 17 years.

The soft pace of non-tradables inflation coincides with a slow pace of wage growth in the economy and relatively soft demand outside of housing related sectors. It is difficult to see what could trigger a significant pickup in domestic inflation in the near-term.

The Australian economy is growing at a pace close to trend, but domestic demand has been weak for the past three years. We do not expect domestic demand to expand rapidly over the next 12 months hence non-tradables inflation is expected to remain subdued.





Inflation By State

Prices increased in all capital cities in the September quarter. The strongest gains in CPI were in Sydney (1.0%), followed by Adelaide and Canberra (both 0.8%), Hobart (0.7%) and Brisbane (0.6%). Price increases were more subdued in Melbourne (0.5%) and Darwin (0.4%).

In annual terms, inflation in all capital cities increased, or stabilised in the September quarter. Price increases were strongest again in Sydney (1.7%), followed by Brisbane (1.5%), Melbourne and Canberra (both 1.4%). Inflation was slower in Hobart (1.3%) and Adelaide (1.2%) and prices in Darwin were unchanged over the year to September.

Outlook

Headline inflation has been temporarily boosted by a jump in food prices. However, the underlying picture of inflation remains weak coming in below market expectations. The RBA's preferred measures of core inflation suggests that broader price pressures remain very subdued. Moreover, there does not seem to be much prospect that inflation will pick up any time soon. The low pace of inflation reflects strong competition and excess capacity within the global and local economies.

We are doubtful that these conditions are likely to turnaround anytime soon. The Australian economy is growing at a reasonable pace, but not sufficient to result in a substantial reduction in spare capacity or any notable decline in slack in the labour market. That would suggest that inflation is unlikely to pick up to the RBA's 2 to 3 percent target band over the medium term as the RBA is expecting. It is our view that the RBA will need to lower rates eventually to as low as 1.0%.

A case can be made for the RBA to lower the cash rate again when it meets next week. The minutes of the October board meeting indicated that today's CPI release was important in guiding the rate outlook. Inflation is very low and likely to remain low for some time. There remain signs of slack within the labour market despite a falling unemployment rate, as confirmed by labour market data last week. Full-time jobs have contracted over the year, wage growth remains very low and labour market underutilisation is high. Moreover, the RBA's concern around the housing market seems to have eased of late and lowers the hurdle for a cut.

That being said, RBA Governor Lowe has recently stressed that there is flexibility around the RBA's 2 to 3% inflation target. These comments would suggest today's data may not be enough of a downside shock for the RBA. Indeed, we note that while very low, inflation is not inconsistent with the RBA's forecasts published in August.

In summary, and with some hesitation, we continue to expect that the RBA will lower official interest rates by 25 basis points when it meets next week on Tuesday, but admit that it will be a very close call.

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