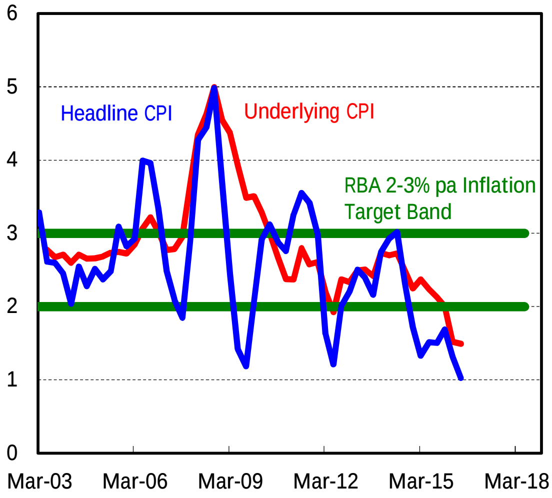
Wednesday, 27 July 2016

Consumer Price Index
Rate Cut on the Back Burner?

- The average of the two key measures of underlying inflation was higher than expected lifting 0.5% in the June quarter. The annual rate held steady at 1.5% in the year to the June quarter.
- While underlying inflation was higher than expected, inflation is still very low and likely to stay below the RBA's 2-3% annual inflation target until 2017 at the earliest.
- Headline CPI rose by 0.4% in the June quarter. The fall in prices in the previous quarter was reversed in the June quarter. These swings were partially due to movements in oil prices.
- The annual rate of headline inflation fell to 1.0% in the year to the June quarter, which was in line with our forecasts and the slowest rate of annual headline inflation since June 1999.
- Non-tradables inflation was the weakest in 17 years, providing evidence that domestic price pressures remain subdued.
- The RBA has much to consider and it will be a close call next week. The weak inflation outlook keeps the door open for another rate cut, which remains a possibility this year. However, today's data is consistent with the RBA's inflation forecasts published in May. Today's data, taken with economic growth at close to trend and further signs of non-mining activity improving, we think that the RBA will leave interest rates unchanged when it meets next week.

Consumer Prices
(annual % change)



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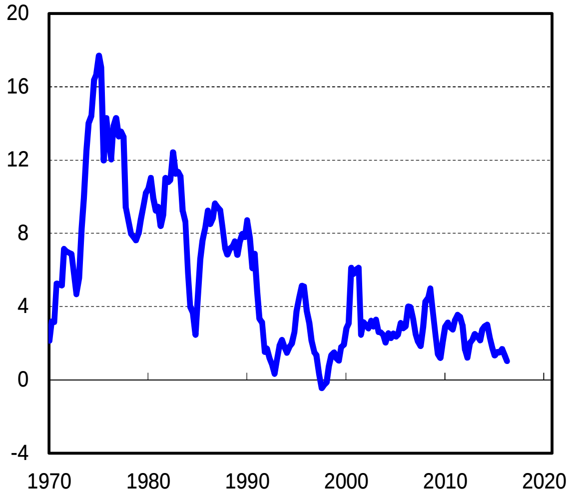


Inflation was less weak than expected in the June quarter. Headline CPI rose by 0.4% in the June quarter. The annual rate of headline inflation fell to 1.0% in the year to the June quarter, which was in line with our forecasts and down from 1.3% in the year to the March quarter. It was the slowest rate of annual headline inflation since June 1999.

Unlike the headline rate, underlying inflation abstracts volatile items such as petrol and food prices. The underlying rate of inflation is the major focus for the RBA. The average of the two underlying inflation measures rose 0.5% in the June quarter. This was stronger than our forecast (and the consensus forecast) for a 0.4% increase in the quarter and follows an increase of 0.2% in the March quarter.

The annual rate of underlying inflation held at 1.5% in the June quarter, an unchanged pace from the 1.5% increase in the year to the March quarter. The annual rate of underlying inflation remains well below the bottom of the RBA's 2-3% annual inflation target band. Underlying inflation remains very low and confirms that there is currently little upward pressure on inflation.

CPI Groups Analysis

Rising private health insurance premiums were a key factor behind the lift in inflation, with medical and hospital services rising 4.2% in the June quarter. This is seasonal, with private health insurance premiums rising on 1 April each year. Automotive fuel prices (5.9%), tobacco prices (2.1%) and new dwelling purchase by owner-occupiers (0.9%) also added to the increase in inflation in the quarter. The increase in automotive fuel prices follows three consecutive quarterly declines previously. Although fuel prices rose in the June quarter, so far in the September quarter the oil price has retreated. If the recent trend in the oil price were to continue, automotive fuels would be unlikely to provide a similar boost to inflation in the September quarter.

These price increases were partially offset by declines in prices for domestic holiday travel and accommodation (-3.7%), motor vehicles (-1.3%) and telecommunication equipment and services (-1.5%).

	June quarter 2016, %	
Consumer Prices	Quarterly change	Annual change
Food and non-alcoholic beverages	-0.3	-0.1
Alcohol and tobacco	1.0	5.9
Clothing and footwear	2.0	-0.2
Housing	0.4	1.3
Furnishings, household equipment and services	0.6	1.6
Health	2.6	4.5
Transport	1.0	-2.8
Communication	-1.5	-7.2
Recreation and culture	-0.7	0.8
Education	0.0	3.3
Insurance and Financial Services	0.5	2.4
Total CPI	0.4	1.0

Over the last twelve months, softness in inflation was driven by ongoing price declines in communication (-7.2%), reflecting lower prices for audio, visual & computing equipment, transport (-2.8%), driven by an 11.6% fall in fuel prices, and clothing & footwear (-0.2%).

Price growth was strongest for alcohol & tobacco (5.9%), health (4.5%, reflecting higher prices for medical & hospital services) and education (3.3%) in the year to the June quarter.

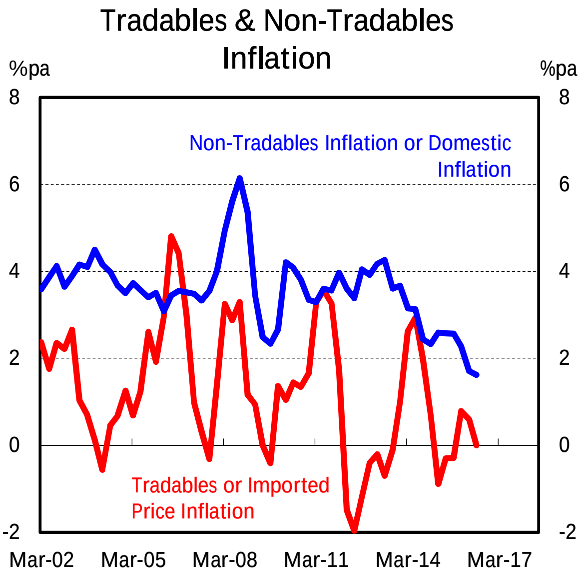
Tradables and Non-Tradables Inflation

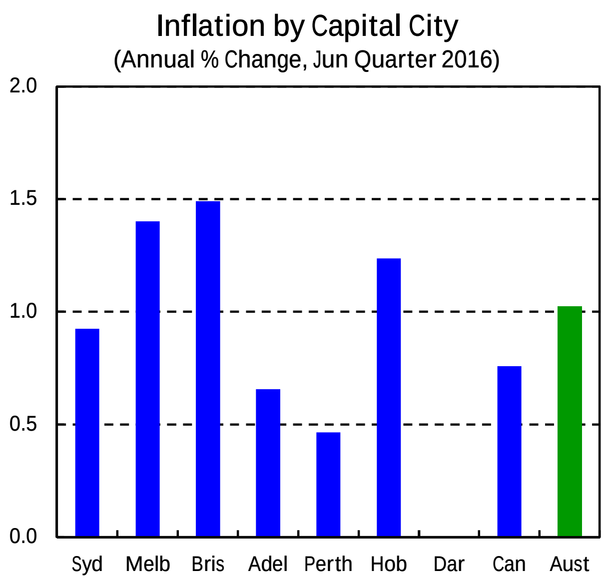
The rebound in petrol prices over the quarter helped drive a 0.6% increase in the tradables component of inflation. Tradables inflation includes prices of goods and services that are imported or compete with imported goods and services. Their prices are mostly determined by the world market. This suggests that global deflationary pressures may be abating given oil prices have recently stabilised. That being said, tradables inflation on an annual basis is non-existent. The tradables CPI component was flat from a year ago.

Non-tradables inflation was also subdued. The non-tradables component of inflation reflects domestic prices. This is also an important measure for the RBA, as it provides a better indication of price pressures in the domestic economy.

In the June quarter, non-tradables CPI rose 0.4%, and has increased at the same pace for four consecutive quarters. The modest pace of growth is despite another firm increase in the purchase cost of new dwellings. On an annual basis, non-tradables inflation stood at 1.6%, the weakest in 17 years.

The soft pace of non-tradables inflation coincides with a slow pace of wage growth in the economy. It is hard to see what could result in a 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 an extended period and we don't expect a substantial pick up until next year, at the earliest.





Inflation By State

In most capital cities, prices generally reversed their declines from the previous quarter. CPI in Sydney (0.6%), Brisbane (0.5%), Adelaide (0.5%) and Melbourne (0.4%) all increased moderately in the June quarter. There were more modest CPI increases in Darwin (0.3%), Perth (0.3%) and Canberra (0.2%), while prices in Hobart were flat for the quarter.

In annual terms, inflation in all capital cities has fallen further below the RBA's inflation target. Prices were flat in Darwin, and below 1.0% in in Sydney (0.9%), Adelaide (0.7%), Perth (0.5%) and Canberra. Annual inflation in Melbourne (1.4%), Brisbane (1.5%), and Hobart (1.2%) was relatively higher, but still at very low levels.

Outlook

Despite the slightly higher than expected outcome in today's underlying inflation data, inflation remains low. Indeed, there are factors which suggest that low inflation will persist. Most notably, underlying inflation and non-tradables inflation have been subdued over the last year. Global factors, as well as those closer to home, including weak wage growth are helping keep inflation low. On this basis, a rate cut from the RBA this year remains a possibility.

However, today's data is consistent with the RBA's inflation forecasts published in May. The RBA has left the door open for a rate cut in recent commentary, but it has stopped short of providing an explicit easing bias. In the minutes from its July meeting, the RBA indicated it would concentrate on further information on inflation pressures, the labour market and housing market activity in reaching a decision on interest rates. Employment growth at 1.9% annually and an unemployment rate of 5.8% suggest the labour market is in reasonable condition. The housing market has cooled somewhat in recent months, although activity is buoyant in some capital cities. While dwelling price growth has moderated in recent months, dwelling prices continue to climb.

We had expected a softer underlying inflation result would cement a rate cut in for August. The inflation release today failed to provide that assurance. Given that economic growth is close to trend and there are further signs of non-mining activity improving, we think that the RBA will not be in a hurry to cut interest rates in August.

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The Detail