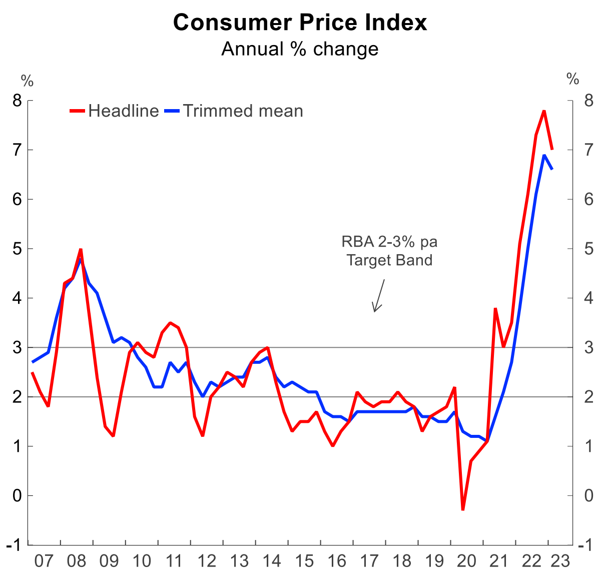
Data Snapshot

Wednesday, 26 April 2023

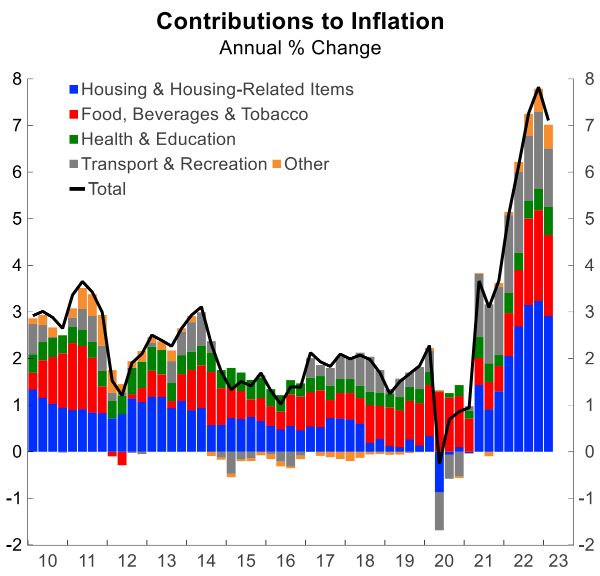
Consumer Price Index

Past the Peak But Far From the Finish

- **The March quarter inflation report confirmed that inflation passed a peak in the December quarter of 2022. The consumer price index (CPI) rose 7.0% over the year to the March quarter, slowing from a near 33-year high of 7.8% in the December quarter.**
- **The outcome represents welcomed progress. However, it also demonstrates just how much work is left to do. If the CPI rose at March's quarterly pace of 1.4% for a full year, it would result in an annual inflation rate of 5.3%, still well above the RBA's mandated target of 2-3%.**
- **Over the quarter, services prices rose 1.7%, to be 6.1% higher in annual terms. This is the fastest annual pace of services inflation in almost 22 years! This is an important area to watch as services tend to be much 'sticker' and more difficult to get down.**
- **Housing remained the biggest driver of inflation in the March quarter. However, a rotation between the housing sub-categories accelerated as cost pressures subside for new dwelling purchases, while rents are storming higher at an accelerating pace.**
- **Recent RBA communication has emphasised their implied path of getting inflation down to the top of the 2-3% band by mid-2025. Today's data suggests that they are on this path. Our house view is for another hike in May, but there is a risk that the RBA continues to pause and wait for more data. Importantly, the meeting remains live and it will be a very close call.**



Sources: ABS; Macrobond



Sources: ABS, Macrobond

Headline and Underlying Inflation

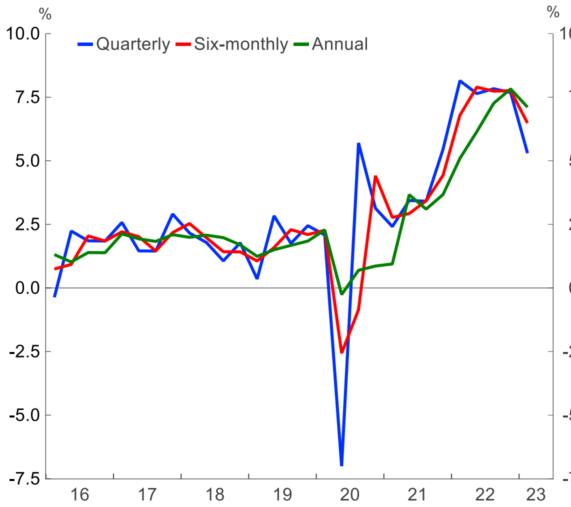
The March quarter inflation report corroborated the recent monthly readings in confirming that inflation did in fact peak in the December quarter of 2022. The Reserve Bank (RBA) Board likely let out a reserved sigh of relief on the result, though it is only a little win in what is and will be a long and bumpy battle against inflation.

The consumer price index (CPI) rose 7.0% over the year to the March quarter, slowing from a near 33-year high of 7.8% in the December quarter. The outcome represents welcome progress, but 7.0% is still an eye wateringly large number. To put it into perspective, annual inflation at 7.0% would see prices double in a touch over 10 years. Before the recent inflation spike, the last time the CPI doubled, it took almost 30 years.

On a quarterly basis, the CPI rose 1.4% in the March quarter, slowing from a 1.9% gain in the December quarter. This was the slowest quarterly increase since the December quarter of 2021, suggesting that near-term inflation momentum is trending in the right direction. However, it also demonstrates just how much work is left to do. If the CPI rose at a quarterly pace of 1.4% for a full year, it would result in an annual inflation rate of 5.3%, well above the RBA's mandated target of 2-3%.

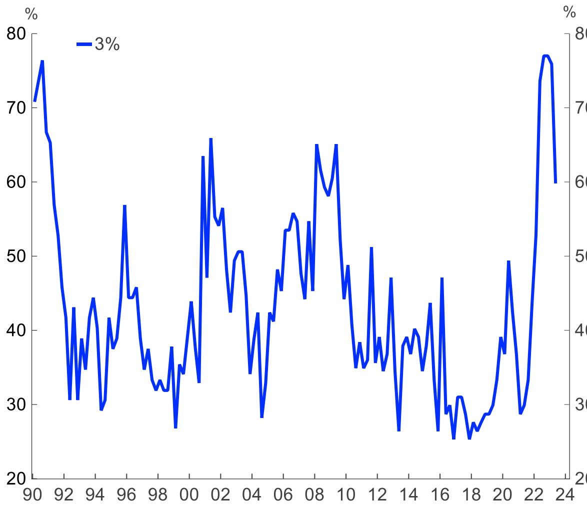
The RBA's preferred measure of inflation, the trimmed mean or 'core' inflation, which trims out the largest and smallest price increases at both ends of the distribution, struck a similar tone – that is, a welcomed moderation in inflationary pressures from a very elevated starting point. The trimmed mean rose 1.2% in the March quarter to be 6.6% higher in annual terms. This will be a positive development for the RBA, as the overseas experience has shown core inflation to be very sticky. The US for example currently has headline inflation running below its core measure of inflation which has only receded marginally from its peak.

Consumer Price Index
Annualised % Change, Seasonally Adjusted



Sources: ABS; Macrobond

Inflation Sub-Categories
Quarterly Annualised Growth, Share Growing Faster Than



Sources: ABS; Macrobond

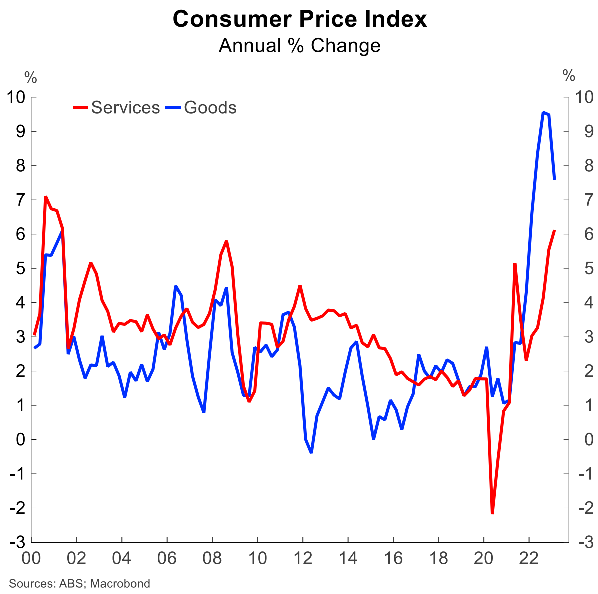
Given the trimmed mean measure strips out 'extreme' price movements, it is more reflective of the broader inflationary pulse and is less sensitive to large price movements in a few spending categories. The moderation in the core measure of inflation is therefore of critical importance and points to an unwinding of pressures across the broader inflation basket. In a similar fashion, the share of categories growing at an annualised pace that's above the RBA's target pulled back in the March quarter. On a seasonally adjusted annualised basis, the share of the 87 CPI categories growing above 3% was 59.8% in the March quarter, down from 75.9% in the December quarter.

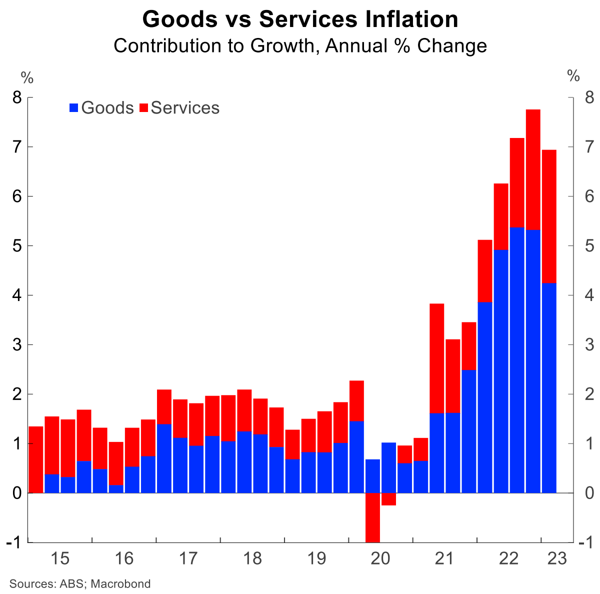
Goods and Services Inflation

A key development around inflationary pressures that has been playing out globally for some time is a shift from price pressures driven by supply-chain disruptions and elevated commodity prices following the war in Ukraine, to pressures increasingly being driven by the balance of domestic supply-demand factors across respective economies. There are several ways we can split the inflation data to get a handle on how these developments are evolving. One approach is by comparing goods versus services inflation. Other approaches include tradables versus non-tradables inflation, in addition to inflation for non-discretionary versus discretionary items.

Over much of 2022 and now into 2023, the contribution to inflationary pressures from services has been steadily rising. In the March quarter, services inflation accelerated further. Over the quarter, services prices rose 1.7%, to be 6.1% higher in annual terms. This is the fastest annual pace of services inflation in almost 22 years!

This is an important area to watch as services are more impacted by domestic factors, such as domestic demand/supply, and wages pressures. They also tend to be much 'sticker' and more difficult to get down once price increases take hold, risking potentially higher interest rates and greater impacts on the economy down the track. The stickiness of services inflation also reflects that it is harder to trade services across borders and it can be more difficult to substitute them for cheaper alternatives than for goods.





Looking at some of the key services components, health and education services were significant contributors to services inflation. Health services rose 3.8% in the quarter, to be 5.3% higher in annual terms. Medical & hospital services (up 4.2% in quarterly terms) were a significant driver, as healthcare services providers increased their prices in the March quarter, as typically occurs each year. Additionally, other heath costs, such as private health care, also increased in the quarter.

Education fees also often rise in the March quarter, in line with the beginning of the new year. Education costs rose 5.4% in annual terms, the strongest annual gain in over seven years. Tertiary education recorded a gain of 9.6% over the year – the fastest pace of growth in the history of the sub-category (back to 2001). The price gain was impacted by changes introduced in 2021 as part of the Jobs-ready Graduates Package.

On the other hand, pressures on holiday travel and accommodation eased following surging in the December quarter. Prices for international holiday travel & accommodation declined 8.2% in the quarter as the peak season passed. This followed a 7.6% surge in the December quarter. However, domestic travel was still in vogue during the school holiday period, although price pressures eased. Prices for domestic holiday travel & accommodation grew 4.7% in the March quarter, down significantly from the 13.3% leap in the December quarter.

Rents also continued to rise strongly. Pressures on rents have been extremely elevated as population growth surges following a record inflow of migrants into the country. This has combined with lower average household sizes during the pandemic and a lack of new supply to drive down vacancy rates to record lows across the country and impact rental growth.

This is expected to remain a sticky category as elevated market rents, which reflect new rents being agreed (i.e. the flow), gradually flow through into the entire pool of rents, which is what is measured in the CPI (i.e. the stock). Additionally, market rents are expected to continue to rise further as demand outstrips supply. In the March quarter, rents rose 1.6%, to be 4.9% higher in annual terms. This is the fastest pace of annual rent inflation since the December quarter of 2009.

There was more positive news when it comes to inflation for goods, which pulled back further in the quarter. Goods prices rose 1.2% in the quarter, to be 7.6% higher over this year. This is down from a peak annual pace of 9.6% over the year to the September quarter. While still elevated, quarterly growth in goods prices has been slowing since peaking in the March quarter of 2022. This reflects a continued easing of supply chain disruptions, shipping prices returning to around pre-pandemic levels, and the pullback of commodity prices from their 2022 peaks.

The process of goods disinflation is something the RBA has been anticipating and has been well underway in other countries for some time. Following the release of the December quarter inflation report in early 2023, the RBA Governor noted his concern that this process hadn’t yet appeared to be in train in Australia. However, the March quarter inflation reading, in addition to recent monthly indicator readings, confirms that this process is now underway.

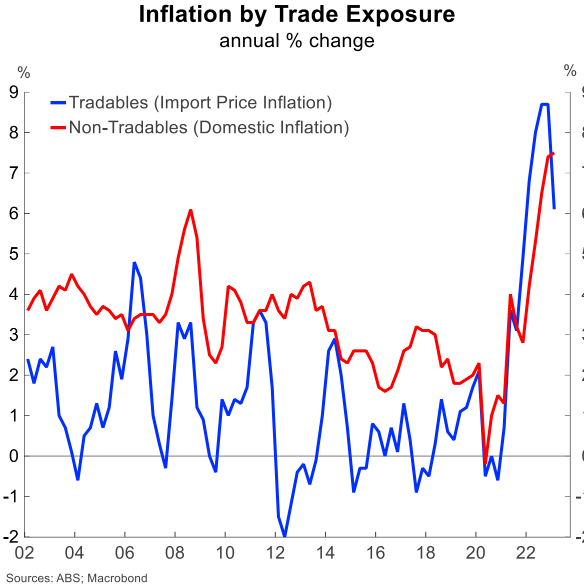
In fact, some goods categories experienced outright deflation in the March quarter, as prices declined due to increased discounting from retailers following the busy sales periods leading into the end of 2022 and reduced supply-chains disruptions. This included furniture (-4.6%), household appliances, utensils & tools (-2.9%), and clothing & footwear (-2.6%).

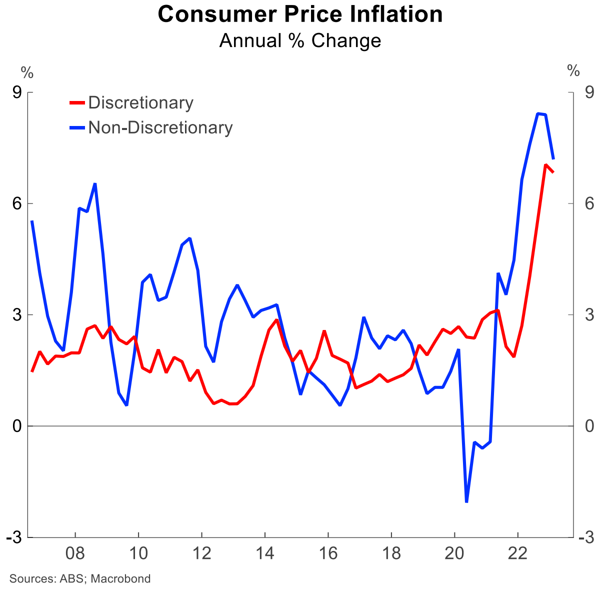
Tradables/Non-Tradables and Discretionary/Non-Discretionary Inflation

Another way to assess different types of inflationary pressures is to look at inflation by trade exposure and nature of consumption.

Tradables inflation is more impacted by international factors and global supply-chain disruptions, while non-tradables inflation is more reflective of domestic inflationary pressures. Similar to goods, tradables inflation continued to slow, reflecting improvements across the same underlying drivers. In fact, quarterly tradables inflation slowed to a crawl (0.3%) in the March quarter. In annual terms, tradables inflation has declined from a peak of 8.7% in recent quarters to 6.1% currently. On the other hand, pressures across non-tradable goods and services remained elevated (1.9% in quarterly terms and 7.5% in annual terms).

As the economy slows, spending on discretionary goods and services is expected to reduce, as households look to conserve their weakened spending power and redirect their spending to non-discretionary categories. This reduced spending is likely to flow through into prices. This process appears to have been playing out in the March quarter. Prices of discretionary goods and services rose 0.6% in the quarter, down from 2.6% in the December quarter. However, price growth for non-discretionary goods and services accelerated from 1.3% in the December quarter, to 1.9% in the March quarter. This is likely to place further strains on household balance sheets, particularly lower income households, who spend a higher proportion of their income on non-discretionary consumption.





Inflation Categories

Reflecting the breadth of the moderation in prices pressures, only four of eleven major CPI groups accelerated in annual terms in the March quarter. This compares to 7 groups which accelerated in the December quarter and a peak of 9 groups which increased in the March quarter of 2022. In other words, most major CPI categories are now trending in the right direction for the first time since the September quarter of 2021.

Headline Consumer Prices	Quarterly Change (% December Qtr)	Quarterly Change (% March Qtr)	Annual Change (%)
Food & Non-alcoholic Beverages	0.9	1.6	8.0
Alcohol & Tobacco	1.2	1.1	4.4
Clothing & Footwear	2.6	-2.6	3.2
Housing	1.9	1.9	9.8
Furnishings, Household Equipment & Services	1.8	-0.5	6.7
Health	0.8	3.8	5.3
Transport	1.7	0.6	4.3
Communication	-0.5	0.1	1.2
Recreation & Culture	5.4	0.2	8.6
Education	0.1	5.3	5.4
Insurance & Financial Services	2.0	1.9	6.5
Total CPI (Original)	**1.9**	**1.4**	**7.0**
Total CPI (Seasonally Adjusted)	**1.9**	**1.3**	**7.1**
Trimmed Mean	**1.7**	**1.2**	**6.6**

Housing remained the biggest driver of inflation in the March quarter, rising 9.8% in annual terms and contributing 2.2 percentage points to the headline reading. However, a rotation between the housing sub-categories accelerated as cost pressures for new dwelling purchases continued to abate, while rents are storming higher at an alarming pace. This rotation is expected to continue as construction input costs come off the boil and the construction downswing deepens, while there is no near-term reprieve in sight for renters.

But while pressures from housing, food and transport continued to recede, we saw larger contributions to inflation from health and education, which are particularly 'sticky' by nature. Health was one of the fastest growing groups in annual terms, growing at 5.3%, its fastest pace since mid-2013. This was largely underpinned by a lift in in the cost of health insurance premiums and gap payments on GP consultations.

Similarly, the cost of education spiked 5.4% over the year to the March quarter, the largest annual increase since the December quarter of 2015. This was driven primarily by a surge in tertiary education, though increases in the cost of secondary education also played a role.

Inflation by Capital Cities

The annual pace of inflation decelerated across all capital cities. However, the quarterly picture is more mixed, as Brisbane, Darwin, and Canberra recorded an acceleration, which quarterly inflation slowed across the other capital cities.

Headline Consumer Prices	Quarterly Change (% December Qtr)	Quarterly Change (% March Qtr)	Annual Change (%)
Sydney	1.8	1.4	6.8
Melbourne	1.6	1.2	7.4
Brisbane	1.5	1.9	7.9
Adelaide	1.7	1.2	5.8
Perth	3.6	0.9	6.9
Hobart	1.5	1.2	6.2
Darwin	0.9	1.3	6.2
Canberra	1.2	1.4	7.0
Total CPI	**1.9**	**1.4**	**7.0**

Monthly CPI Indicator

The monthly CPI indicator showed a continued easing in the pace of monthly inflation. Over the year to March, inflation slowed to 6.3%. This contrasts with outcomes of 6.8% and 7.4% over the year to February and January, respectively.

Outlook

The March quarter inflation report is a key piece of data ahead of the RBA's May meeting. Today's result shows that inflationary pressures have peaked and are on their way down. An easing of global supply chain disruptions, lower commodity prices, and the impact from the string of cash rate increases are working their way through the economy. This is impacting supply and demand and flowing through to reduced price pressures.

However, the RBA's job is far from over and the Board will need to remain vigilant of inflationary pressures. While declining in the quarter, the annualised pace of inflation remains much too high and has some way to go before it falls into the RBA's 2-3% band.

Recent RBA communication has emphasised their implied path of getting inflation down to the top of the 2-3% band by mid-2025. Today's data suggests that inflation is on that path. However, the April minutes noted that those forecasts "were conditioned on monetary policy being tightened a little further."

Our house view is for another hike in May, but there is a risk that the RBA continues to pause and wait for more data. Importantly, the meeting remains live and it will be a very close call.

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