

Monday, 17 April 2023

Playing Waiting Game In Quiet Data Week

It's a quiet week for domestic data this week, providing a moment of calm before the March quarter inflation report is dropped next week. This release has the potential to cause some disruption in markets as the inflation print will likely be the deciding factor in the Reserve Bank's (RBA) May policy decision. Markets are currently pricing little chance of another hike in May, meaning an upside surprise to inflation could prompt some outsized moves in market pricing.

The minutes from the RBA's April meeting are due out tomorrow and will be the focus this week. Given Governor Lowe made a speech following April's decision detailing the Board's deliberations, the minutes are unlikely to break new ground. However, they will provide some crucial insight into how the RBA will interpret next week's consumer price index (CPI) report, as well as the other key data already released.

The RBA made it clear in the April statement and in Governor Lowe's speech that the Board is aiming to bring inflation back to target "within a reasonable timeframe" while "keeping the economy on an even keel". When queried on what constitutes "a reasonable timeframe", Governor Lowe explicitly stated that the Board was aiming to return inflation to the top of the 2-3% target band by mid-2025. In defending this objective, Lowe added that the Board was willing to accept slower progress on inflation relative to some other major central banks, to preserve the strength of the labour market.

One interpretation is that the RBA seems to want to do as little as possible (in terms of further rate hikes) to bring inflation back to target within the mid-2025 time horizon to give it the best chance of manufacturing a soft landing. The RBA's most recent forecasts, which have inflation returning to the top of the target band in mid-2025, are therefore a great yardstick for how the RBA is tracking towards these goals and how they will respond to the evolving data. The RBA will prepare updated forecasts for the economy ahead of the May meeting.

The March business survey and labour force data revealed that while the economy remains on robust footing, momentum is beginning to shift. Business conditions are trending south from very elevated levels, while confidence is lacklustre.

The March labour force release showed that the labour market is still very tight and that a substantial slowing is yet to materialise. The data showed that the labour market has absorbed an exceptional amount of new labour supply without any substantial loosening in conditions. But the influx of supply is likely to endure via record levels of migration, while the strength of worker demand has an expiration date as the economy slows. This suggests a pick-up in the unemployment rate is growing nearer. This snapshot of the economy suggests the impact of policy tightening to date is consistent with the RBA's goal of "keeping the economy on an even keel".

So, what about returning inflation to target "within a reasonable timeframe"? Well, the unemployment rate is tracking inside the RBA's forecasts. While the labour market remains tight

the data is not suggesting that conditions are getting significantly tighter. This means there is little sign of unsustainable upward pressure on wages growth, which will help the RBA sleep a little easier given wages growth remains consistent with returning inflation to target. Indeed, Governor Lowe noted that wages growth has not been a key driver of inflation to date.

The business survey also revealed a welcome slowing in price pressures for businesses, with some of this being passed through to slower growth in final product prices. Overall, this points to strong progress on goods disinflation contrasted by some stickiness on the services side given the resilience of the labour market. This narrative is consistent with the experience overseas. But it doesn't give us much new information on whether the inflation figures are tracking inside the trajectory implied by the RBA's forecasts and its mid-2025 deadline. That's where next week's inflation report comes in and why the RBA's decision will likely hinge on the result.

An upside surprise relative to the RBA's forecasts is likely to necessitate a policy response in the form of another 25-basis-point hike. However, any result inside this band is likely to see the Board stand pat with the cash rate at 3.60%. In either situation, we do not expect the Board to flag the end of the cycle and instead will reiterate that they are prepared to hike further if necessitated by the data.

Another crucial area to monitor over the coming months will be inflation expectations. The RBA's approach, if successful, will still see headline inflation remaining outside of the target band for three years. While this gradual approach increases the chances of avoiding recession, it also increases the risk of inflation expectations becoming unanchored. For now, inflation expectations remain well anchored but if this anchor were to drift higher it would prompt a renewed inflationary pulse and likely force the RBA to resume hiking later in the cycle, when the economy is expected to have slowed considerably and is more fragile to policy changes. The ultimate risk in such a scenario is stagflation, that is low growth and above-target inflation, a central bankers' kryptonite.

Jameson Coombs, Economist
+61 401 102 789

Group Forecasts

End Period:	2023				2024		
	Close (14 Apr)	Q2 (f)	Q3 (f)	Q4 (f)	Q1 (f)	Q2 (f)	Q3 (f)
Aust. Interest Rates:							
RBA Cash Rate, %	3.60	3.85	3.85	3.85	3.60	3.35	3.10
90 Day BBSW, %	3.65	3.95	3.95	3.97	3.72	3.47	3.22
3 Year Swap, %	3.46	3.65	3.60	3.50	3.40	3.20	3.00
10 Year Bond, %	3.32	3.40	3.30	3.20	3.00	2.80	2.70
US Interest Rates:							
Fed Funds Rate, %	4.875	4.875	4.875	4.875	4.375	3.875	3.375
US 10 Year Bond, %	3.51	3.50	3.40	3.30	3.10	2.90	2.80
USD Exchange Rates:							
AUD-USD	0.6707	0.69	0.72	0.74	0.75	0.76	0.76
USD-JPY	133.79	130	129	128	127	126	125
EUR-USD	1.0992	1.10	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.2413	1.23	1.24	1.25	1.26	1.27	1.28
NZD-USD	0.6205	0.64	0.66	0.67	0.68	0.68	0.68
AUD Exchange Rates:							
AUD-USD	0.6707	0.69	0.72	0.74	0.75	0.76	0.76
AUD-EUR	0.6103	0.63	0.65	0.66	0.67	0.67	0.66
AUD-JPY	89.757	89.7	92.9	94.7	95.3	95.8	95.0
AUD-GBP	0.5404	0.56	0.58	0.59	0.60	0.60	0.59
AUD-NZD	1.0804	1.08	1.09	1.10	1.11	1.13	1.13

	2021	2022	2023 (f)	2024 (f)
GDP, %	4.6	2.7	1.0	1.5
CPI (Headline), %	3.5	7.8	3.9	3.0
CPI (Trimmed mean), %	2.6	6.9	3.6	3.1
Unemployment Rate, %	4.7	3.5	4.5	5.0
Wages Growth, %	2.4	3.3	4.0	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

Contact Listing

Chief Economist

Besa Deda
dedab@banksa.com.au
+61 404 844 817

Senior Economist

Pat Bustamante
pat.bustamante@banksa.com.au
+61 468 571 786

Senior Economist

Jarek Kowcza
jarek.kowcza@banksa.com.au
+61 481 476 436

Economist

Jameson Coombs
jameson.coombs@banksa.com.au
+61 401 102 789

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