Monday, 22 April 2024

Domestic Market to Eye Inflation Data

This week, domestic markets and investors are focussed on the update of the quarterly inflation report, released this Wednesday. A lot has changed since the Bureau of Statistics published the last update at the end of January. Concerns about inflation returning slower to targets have dominated major economies, particularly the US and including Australia. This has been mirrored in interest-rate pricing expectations.

Back in late January, interest-rate markets were fully priced for rate cuts to start in Australia in August and a June cut was priced with a 96% probability. Two 25-basis-point cuts were fully priced before year's end. In the US, the market expectation was that rate cuts would start in May, with almost six rate cuts priced for the full year.

Move forward one quarter and markets have pushed out the timing of rate cuts this year, reduced the number of cuts, and lifted the terminal policy rates.

In Australia, interest-rate markets are not fully pricing a cut until 2025. December is almost fully priced, at 96%. In the US, expectations have been dialled all the way back to just one cut and starting in November! The significant change in the rate cut timing and lift in bond rates for the US has spurred selling in the AUD/USD and pushed it towards the bottom of its year-long trading range.

But do homegrown factors warrant an RBA rate-cutting cycle not starting until December? Some of the push back in market pricing for rate cuts locally is a result of what is happening in US markets. US economic activity is being supported by fiscal policy support, fixed rate mortgages – which limit the impact of the higher Fed funds rate - as well as strong investment around AI and the Inflation Reduction Act (IRA). Inflation in the US has surprised to the upside for three straight months and jobs data in the US continues to stay firm. US Federal Reserve officials have been out in force in recent weeks warning of a delay in rate cuts.

Domestic employment data certainly shocked the market with its remarkable resilience last week, suggesting the Reserve Bank may not need to be in any urgency to cut in the near term. Jobs data has been incredibly volatile over the past few months, but if we try to look through the swings, it's clear that the labour market remains tight. Indeed, the net increase in full-time employment over the past three months was the strongest in a year and the average net jobs added each month over the past three months was around 40,000 – that is, solid!

The quarterly update on the consumer price index (CPI) this Wednesday will be important in shaping expectations for the Reserve Bank and better understanding the progress made on Australia's inflation path back to the 2-3% target.

Consensus forecasts expect the headline inflation rate to rise by 0.8% in the March quarter, a step up from the 0.6% quarterly pace in the December quarter of last year. Such an outcome would cause the annual growth rate to decline to a more than two-year low of 3.5%. But the tail risks from the range of market economist estimates certainly lie to a stronger outcome, with the range between a rise of 0.7% and 1.0% in the quarter. Our Group forecast matches that of consensus.

The RBA prefers the underlying measures of inflation, in particular, the trimmed mean. Again, the Group is looking for a rise of 0.8% in the March quarter. Such a forecast would see the annual growth rate of trimmed mean inflation slow from 4.2% to 3.8%, the slowest rate in two years.

Services inflation will deserve close scrutiny, as the progress made on inflation to date has been primarily driven by goods disinflation. Services disinflation needs to come to the party also in a more meaningful way. We expect services inflation to rise by 1.1% and the annual rate to be elevated at 4.7%, which means the risk of rate cuts taking longer to arrive remains.

Amidst the economic factors, central banks around the world must also contend with the uncertainty evolving from the Middle East conflict, which has escalated over the past week. It is difficult to ascertain the path from here, but the economic risk from a deepening of this conflict includes upward pressure on oil prices and inflation being higher for longer. Will stagflation risks rear its head? The upside risk to inflation from a prolonged or escalation in the conflict could flatten the bond yield curves with longer-dated bond yields likely to be higher than otherwise would be the case and shorter-dated yields reflecting higher terminal policy rates. The latter reflecting the fact central banks may have less cutting to do in this sort of backdrop even if activity softens. But such geopolitical uncertainty and conflict could fuel demand for safe-haven assets such as government bonds. So there’s a tension that exists in bond markets.

One thing remains certain this week – volatility in financial markets is set to continue.

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So long, Winston

Group Forecasts

	2024				2025		
End Period:	**Close (19 Apr)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.35	4.35	4.10	3.85	3.60	3.35	3.10
90 Day BBSW, %	4.36	4.37	4.12	3.92	3.67	3.47	3.30
3 Year Swap, %	4.08	3.95	3.85	3.75	3.65	3.60	3.55
10 Year Bond, %	4.26	4.05	3.95	3.85	3.90	3.90	3.95
USD Exchange Rates:							
AUD-USD	0.6418	0.68	0.69	0.70	0.71	0.72	0.72
USD-JPY	154.64	148	145	141	137	133	130
EUR-USD	1.0656	1.11	1.13	1.14	1.15	1.16	1.17
GBP-USD	1.2370	1.27	1.28	1.29	1.30	1.30	1.31
NZD-USD	0.5888	0.63	0.64	0.64	0.64	0.65	0.65
AUD Exchange Rates:							
AUD-USD	0.6418	0.68	0.69	0.70	0.71	0.72	0.72
AUD-EUR	0.6022	0.61	0.61	0.61	0.62	0.62	0.62
AUD-JPY	99.25	99.9	100.1	98.7	97.3	95.5	93.6
AUD-GBP	0.5188	0.53	0.54	0.54	0.55	0.55	0.55
AUD-NZD	1.0900	1.07	1.09	1.09	1.11	1.11	1.11

	2022	**2023**	**2024 (f)**	**2025 (f)**
GDP, %	2.4	1.5	1.6	2.5
CPI (Headline), %	7.8	4.1	3.0	2.7
CPI (Trimmed mean), %	6.8	4.2	3.1	2.8
Unemployment Rate, %	3.5	3.8	4.5	4.6
Wages Growth, %	3.3	4.2	3.2	3.1

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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