

Monday, 6 February 2023

RBA Feb Hike: Will They Or Won't They?

After a week of focusing on international central banks, all eyes will turn to the Reserve Bank (RBA) this week. The RBA Board meet on Tuesday for their first meeting of 2023, after not meeting in January, as is standard practice.

In its first meeting of the year, the RBA Board will be faced with a challenging inflationary environment. Annual inflation in the December quarter surged to 7.8% – its highest level in over 32 years. This was higher than expected by consensus but was slightly lower than the 8.0% outcome forecast by the RBA in its latest set of projections from the November Statement on Monetary Policy.

However, importantly, inflation continues to remain very elevated and broadened across a range of categories in the December quarter. Trimmed mean inflation, a better measure of underlying inflationary pressures, spiked to 6.9% in annual terms in the quarter. This was the highest pace on record, going back to 2002, and was critically much higher than the RBA's own forecast of 6.5% from the November statement.

While the annual outcome accelerated, in part due to the price shocks we saw last year when Russia invaded Ukraine, the quarterly outcome decelerated to 1.7% from the 1.9% recorded in the previous quarter. Additionally, the unwinding of government subsidies, in particular the fuel excise cut and housing construction subsidies, also impacted the numbers.

As noted, the inflationary pulse is broadening. In the December quarter, almost 90% of all categories and sub-categories measured by the Australian Bureau of Statistics (ABS) grew at an annual pace of more than 3% – the top of the RBA's 2-3% inflation band. This is the largest share of categories and subcategories growing at such a rapid rate since 1990.

While inflation is expected to slow over 2023, the pace going into the end of 2022 will likely raise a few eyebrows at the RBA. The expected decline over 2023 reflects a combination of unwinding supply chain disruptions and high commodity prices, in addition to weaker domestic demand as the economy slows under the weight of higher interest rates.

Beyond the rapid inflationary pulse, the RBA will also have a range of economic data to consider. Since the last meeting, key economic data has shown a mixed picture and demonstrates that a slowing of the economy is underway.

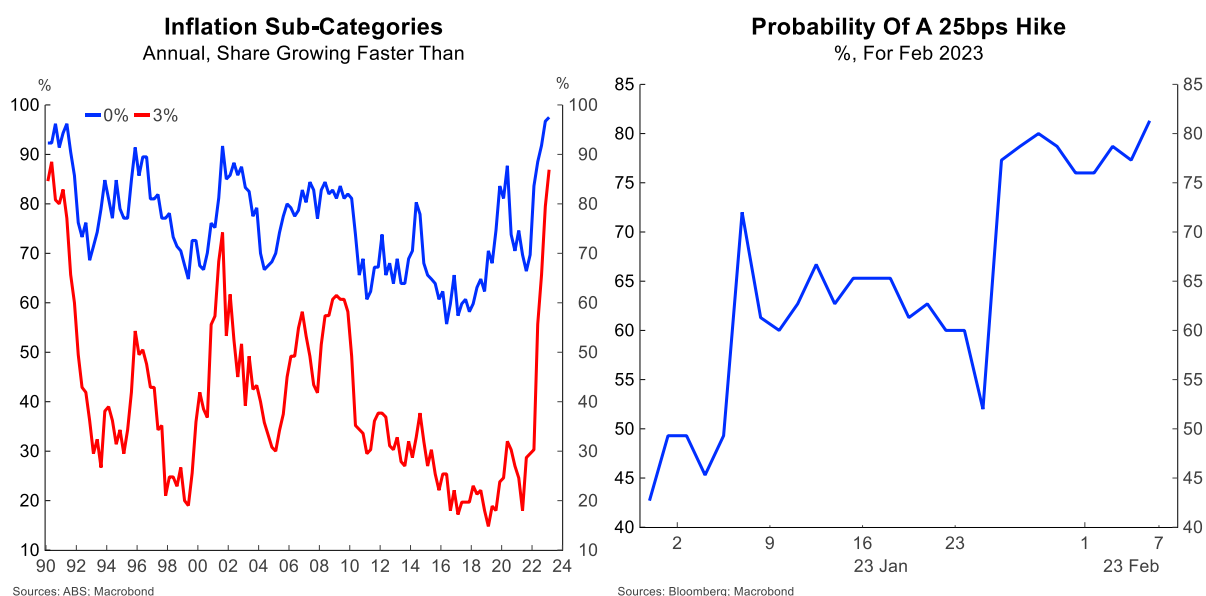
The labour market has begun to show signs of slowing. Employment fell in December and job ads are pulling back from elevated levels. However, measures of the jobs market and labour demand remain incredibly hot, despite signs of them beginning to cool. Additionally, the impact of the tight labour market on wages growth will be another key consideration for the RBA in 2023. More information on this will be available on 22 February with the release of the December quarter Wage Price Index.

Looking at other measures, businesses are becoming less confident about the economic outlook. On the other hand, sentiment among consumers increased slightly. However, consumer confidence remains deeply entrenched in pessimistic territory and it is likely to be some time before this improves materially.

Households are also starting to feel the pinch from rapid interest rate hikes. Nominal retail spending slowed sharply in December, following a large increase in November. Seasonal patterns make the data around the end of the year difficult to interpret. This reflects the increasing popularity of Black Friday and Cyber Monday sales in November, which are impacting seasonal factors applied by the ABS. However, looking at the data over the entire quarter shows that retail spending has slowed materially.

Nominal retail spending rose by 0.9% in the December quarter – the weakest quarterly outcome in over a year. But high prices have been eating into the bang that consumers are getting for their buck. After accounting for price increases, real retail spending fell 0.2% over the December quarter. Excluding periods impacted by lockdowns, this was the first quarterly decline in retail spending volumes since the December quarter 2018.

This is an important input into understanding household consumption, as retail spending accounts for around a third of household spending.



Internationally, the environment remains incredibly challenging and many developed economies are at risk of recession in 2023. However, optimists have something to cheer as some of the storm clouds that were brewing in late 2022 appear to be less threatening. China's economy is rebounding rapidly following the lifting of its stringent COVID-zero policies. The outlook for Europe has become brighter following a milder-than-expected winter and lower energy prices. The US labour market has also demonstrated continued strength even as the US Fed has hiked rates aggressively.

The RBA Board will be considering these domestic and international factors as it meets tomorrow. The Board is likely to consider hiking by 25 basis points or pausing to assess the impact that the 300 basis points of hikes to date have had on the economy. In recent meetings, these have been the two main options on the table. The Board has also recently discussed the possibility of

returning to 50 basis point hikes. While this may be discussed again, it is a less likely possibility.

We continue to expect the Board to lift rates by another 25 basis points given the elevated inflationary pressures and the risks that inflation expectations become further entrenched across the economy. A 25-basis-point hike is widely, but not universally, expected by economists. In fact, three of the 30 economists surveyed by Bloomberg expect a different result, with two expecting the RBA to go on hold and one expecting a 15-basis-point move.

Financial markets are also confident that a hike will be delivered. Interest-rate markets are currently pricing a slightly more than 80% chance of a 25-basis-point hike. This probability has been increasing steadily in recent weeks, particularly following the stronger-than-expected December quarter inflation result on 25 January.

Data Calendar

In addition to the interest rate decision, the RBA will also be publishing its latest set of forecasts in the February Statement on Monetary Policy on Friday. This will provide key insights into the RBA's thinking around the current state of the domestic and global economy, and its expectations over the next few years. The RBA's inflation outlook and forecasts are a key output and will be watched closely.

Shifting our attention away from the RBA, we also received updated data for the volume of retail sales over the December quarter this morning. Price rises and interest rate hikes are beginning to weigh on consumer spending, as the volume of retail sales fell by 0.2% in the December quarter.

On Tuesday, we will receive data for the December trade balance, which has benefited strongly from elevated commodity prices. The trade surplus is likely to remain elevated in December, as exports are expected to rise by 0.7%, while imports are expected to advance by a smaller 0.2%. This would result in the trade surplus lifting to \$13.5 billion, up from \$13.2 billion in November.

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Forecasts

| End Period: | 2023 | | | | 2024 | | |
|------------------------------|---------------|--------|--------|--------|--------|--------|--------|
| | Close (3 Feb) | Q1 (f) | Q2 (f) | Q3 (f) | Q4 (f) | Q1 (f) | Q2 (f) |
| Aust. Interest Rates: | | | | | | | |
| RBA Cash Rate, % | 3.10 | 3.60 | 3.85 | 3.85 | 3.85 | 3.60 | 3.35 |
| 90 Day BBSW, % | 3.34 | 3.97 | 4.05 | 4.05 | 3.97 | 3.72 | 3.47 |
| 3 Year Swap, % | 3.54 | 3.80 | 3.75 | 3.70 | 3.60 | 3.55 | 3.50 |
| 10 Year Bond, % | 3.38 | 3.45 | 3.30 | 3.10 | 2.90 | 2.70 | 2.55 |
| US Interest Rates: | | | | | | | |
| Fed Funds Rate, % | 4.625 | 4.875 | 4.875 | 4.875 | 4.875 | 4.375 | 3.875 |
| US 10 Year Bond, % | 3.52 | 3.40 | 3.30 | 3.20 | 3.10 | 2.90 | 2.70 |
| USD Exchange Rates: | | | | | | | |
| AUD-USD | 0.6923 | 0.69 | 0.70 | 0.72 | 0.74 | 0.75 | 0.76 |
| USD-JPY | 131.19 | 136 | 135 | 134 | 132 | 130 | 128 |
| EUR-USD | 1.0795 | 1.06 | 1.07 | 1.09 | 1.11 | 1.12 | 1.13 |
| GBP-USD | 1.2056 | 1.22 | 1.22 | 1.23 | 1.24 | 1.25 | 1.26 |
| NZD-USD | 0.6331 | 0.64 | 0.65 | 0.66 | 0.67 | 0.68 | 0.68 |
| AUD Exchange Rates: | | | | | | | |
| AUD-USD | 0.6923 | 0.69 | 0.70 | 0.72 | 0.74 | 0.75 | 0.76 |
| AUD-EUR | 0.6413 | 0.65 | 0.65 | 0.66 | 0.67 | 0.67 | 0.68 |
| AUD-JPY | 90.828 | 93.8 | 94.5 | 96.5 | 97.7 | 97.5 | 97.3 |
| AUD-GBP | 0.5743 | 0.57 | 0.57 | 0.59 | 0.60 | 0.60 | 0.60 |
| AUD-NZD | 1.0941 | 1.08 | 1.08 | 1.09 | 1.10 | 1.11 | 1.13 |

| | 2021 | 2022 (f) | 2023 (f) | 2024 (f) |
|-----------------------|------|----------|----------|----------|
| GDP, % | 4.6 | 2.6 | 1.0 | 2.0 |
| CPI (Headline), % | 3.5 | 7.8 | 3.9 | 3.1 |
| CPI (Trimmed mean), % | 2.6 | 6.9 | 3.6 | 3.1 |
| Unemployment Rate, % | 4.7 | 3.5 | 4.6 | 5.1 |
| Wages Growth, % | 2.3 | 3.6 | 4.5 | 3.5 |

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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