Services Inflation Key For RBA

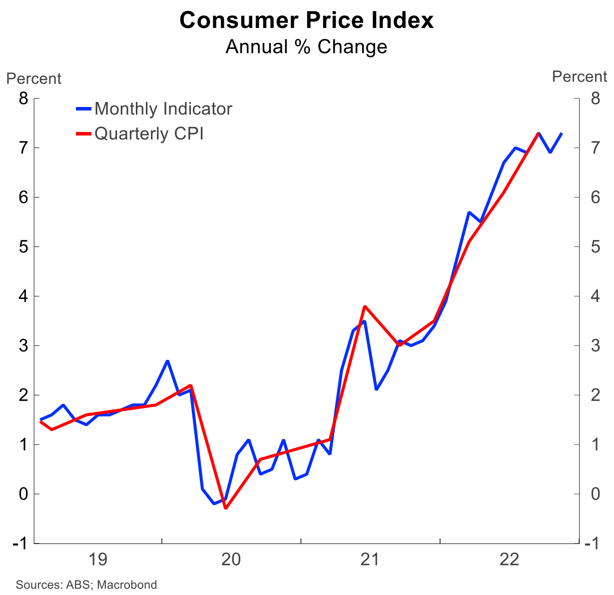
This week will see the release of the **Consumer Price Index (CPI)** for the December quarter of 2022. If the outcome is higher or in line with what the Reserve Bank (RBA) is expecting, it will firm up the likelihood of a rate hike in February. A soft read may see markets entertain a February pause. Markets have priced a 60% likelihood that the RBA will hike by 25 basis points in February.

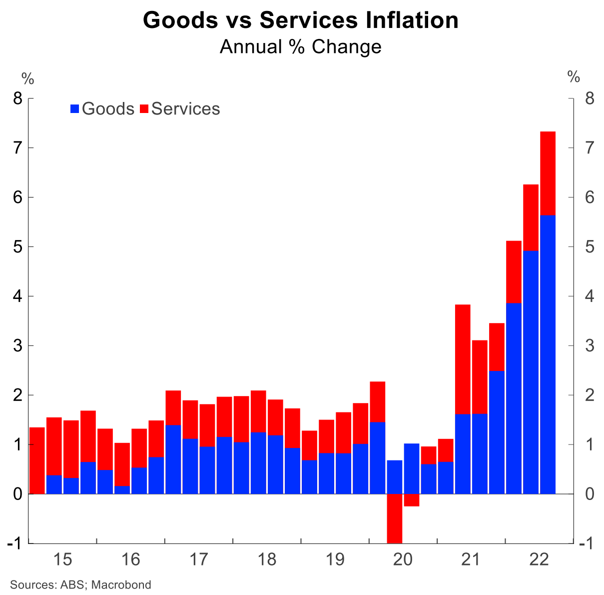
The monthly inflation indicator, which provides a partial read of inflationary pressures, has been a little softer than expected. The RBA is expecting the annual headline inflation rate to be 8.0% in the December quarter. The monthly indicator showed that inflation was running at 6.9% over the year to October 2022, before accelerating to 7.3% in November. These monthly reads only provide a partial indicator and do not account for some of the important components of inflation, including electricity prices, which may surprise on the upside.

Our view is that annual headline inflation will peak at 7.4% in the December quarter. We expect annual headline inflation to ease to 3.7% in 2023 and 3.0% in 2024.

While markets will be closely monitoring the headline outcomes, the make up of inflationary pressures is just as important. Goods (i.e. electronics and clothing) inflation has been the main driver of the recent inflationary spike. This has been driven in part by global supply-chain disruptions and elevated shipping and freight costs. As these disruptions dissipate, we expect the prices of goods to also ease, a process that has already started in the US.

Services (i.e. haircuts and education) inflation is much "stickier". It is driven by the cost of labour or wages. Where wages growth remains elevated it will become harder to get inflation down without causing higher unemployment. In Australia, services inflation and wages growth have, at this stage, remained consistent with inflation easing to the RBA's 2-3% inflation over time.





Labour market the key to services inflation:

Labour market data released last week showed the market ended 2022 in a very strong position. The unemployment rate remained at 3.5%, around the lowest level in almost 50 years. The participation rate remained close to its historic high and other indicators, including youth unemployment and underemployment, all confirmed that the labour market is extremely tight.

A tight labour market increases the risk of unsustainable wages growth and elevated services inflation. Unlike other comparable nations, the current pace of wages growth remains sustainable. This could reflect several factors such as Australia's wage fixing system creating inertia, a slowdown in labour demand and high overseas migration numbers.

While still incredibly tight, there were some signs that the labour market was cooling. The first monthly employment decline in five months was recorded in December of almost 15k. Employment gains also slowed in 2022. Over the first half of 2022 there was 327k jobs added, while only 125k jobs were added over the second half of the year.

Last week the Federal Treasurer stated that there is significant upside to population growth. Reports suggests that net overseas migration could be around 300k in 2022-23 – that would be the highest on record. The upside risk identified by the Treasurer was provided further support with the release of the overseas arrival and departure data. The data showed that 180k temporary workers came into Australia over the 5 months to November 2022 – the highest on record. More workers will help fill skill shortages and put downward pressure on wages growth.

There are positive early signs that labour demand is easing while labour supply continues to accelerate. This could help ease wage pressures over time. *However, an elevated services inflation read may make the RBA uncomfortable, even where the headline inflation number comes in softer than expected.* Services inflation will be particularly important this time around, given the Wage Price Index (WPI) for the December quarter will be released following the RBA's February meeting.

Other data to be released:

This week will also see the release of **business confidence data for December**. There had been a growing disconnect between consumer and business confidence until late last year. While consumer confidence was deeply entrenched in negative territory for most of 2022, business confidence remained resilient on the back of strong business conditions. In November (latest read), business confidence declined to -4 index points – the first negative print since December 2021. As we reported last week, consumer confidence improved slightly in January by 5%, although deep pessimism remains.

On the **international front** we have several second-tier data releases including the purchasing managers' indexes for the US and the UK. More significantly, on Friday, **US Personal Consumption Expenditures (PCE) inflation data** will be released. This is the Fed's preferred measures of inflationary pressures. Economists are expecting annual core PCE inflation to have eased to 3.9% in the December quarter 2022, down from the 4.7% recorded in the September quarter.

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Forecasts

		2023				2024	
End Period:	**Close (23 Jan)**	**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, %	3.27	3.97	4.05	4.05	3.97	3.72	3.47
3 Year Swap, %	3.51	3.80	3.75	3.70	3.60	3.55	3.50
10 Year Bond, %	3.40	3.20	3.10	3.00	2.90	2.80	2.70
US Interest Rates:							
Fed Funds Rate, %	4.375	4.875	4.875	4.875	4.875	4.375	3.875
US 10 Year Bond, %	3.48	3.40	3.30	3.20	3.10	2.90	2.70
USD Exchange Rates:							
AUD-USD	0.6963	0.69	0.70	0.72	0.74	0.75	0.76
USD-JPY	129.60	136	135	134	132	130	128
EUR-USD	1.0856	1.06	1.07	1.09	1.11	1.12	1.13
GBP-USD	1.2397	1.22	1.22	1.23	1.24	1.25	1.26
NZD-USD	0.6449	0.64	0.65	0.66	0.67	0.68	0.68
AUD Exchange Rates:							
AUD-USD	0.6963	0.69	0.70	0.72	0.74	0.75	0.76
AUD-EUR	0.6419	0.65	0.65	0.66	0.67	0.67	0.68
AUD-JPY	90.283	93.8	94.5	96.5	97.7	97.5	97.3
AUD-GBP	0.5621	0.57	0.57	0.59	0.60	0.60	0.60
AUD-NZD	1.0804	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	7.4	3.7	3.0
CPI (Trimmed mean), %	2.6	6.6	3.4	3.0
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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