Summit Nears But Will RBA Unfurl Flag?

It has been a long journey for the Reserve Bank (RBA) and the Australian economy. After climbing up the steep mountain of interest rates hikes since May last year to slay the dragon of surging inflation, the clouds appear to be clearing and the summit is now distinctly in view. The RBA may even be starting to unfurl its flag as it approaches this interest-rate peak and prepares to nail a flagpole into the peak.

Some economists think that we have already reached the peak and that no further hikes will be forthcoming. However, let's not celebrate too soon as we may still need those crampons and pickaxes to climb a little further.

We need to stay vigilant as inflation risks remain prevalent. A still robust economy, a tight labour market that shows few signs of material easing, and inflation still being well outside of the RBA's 2-3% band suggest there may be a final push ahead before we reach that elusive summit.

Indeed, our group view is that an additional 25 basis point hike will be forthcoming at the August Board meeting – taking the cash rate to 4.35%, which we now expect to be the peak in this cycle. Nevertheless, we concede it will be another close call and finely balanced decision. Ultimately, the Board's interpretation of the balance of risks will determine which way the pendulum swings.

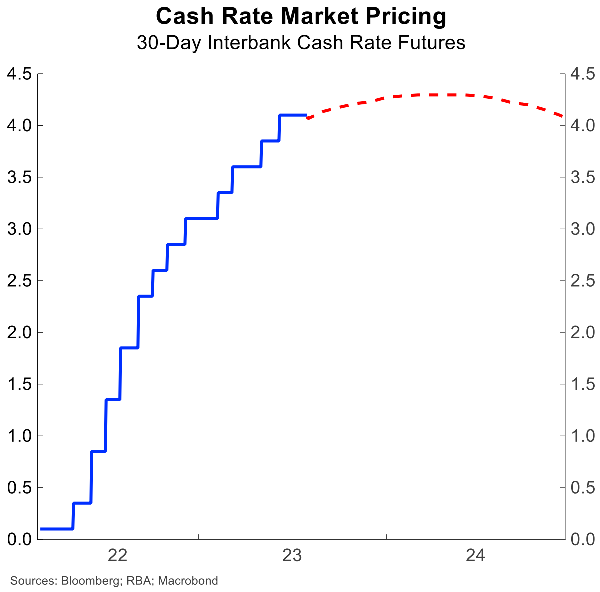
These are the questions that economists and financial markets are grappling with. Not just here, but also overseas as we near the end of central bank tightening cycles around the world.

Last week, we saw a spate of decisions from key central banks, including the US Federal Reserve and the European Central Bank (ECB). Both raised rates by 25 basis points, as expected. However, financial markets focussed on any hints to how much more tightening may be expected. While maintaining a tightening bias, both central banks emphasised they are data-dependent regarding the need for future hikes. This has been reflected in financial market pricing. Currently, financial markets expect the Fed to be on hold from here, with a risk of one more hike. In Europe, markets expect one more hike from the ECB, but it's quite not a done deal. Interest-rate markets are currently pricing around a 90% chance of another hike by the end of the year.

But what about Australia? The RBA Board meets tomorrow to decide whether to increase the cash rate by 25 basis points, to 4.35%, or extend its July pause, leaving the rate at 4.10%.

Interest-rate markets expect the RBA to be on pause in August, attaching only a 14% chance, but remain open to the potential for one more hike in the cycle. Looking beyond August, markets are currently pricing in around 21 basis points of hikes by early next year. This suggests an almost 85% probability of one more hike.

Economists have a slightly different view for tomorrow. A Bloomberg survey of 30 economists shows that most expect a hike at tomorrow's meeting, but it's also a close call. Specifically, 18 of 30 surveyed expect a 25-basis-point hike, with the remainder expecting the RBA to pause.



As is often the case when nearing the end of a cycle, there are solid reasons for either option.

The June quarter inflation data released last week showed that inflation came in weaker-than-expected. Prices rose 6.0% over the year to the June quarter, a big step down from the 7.0% rate in the March quarter. The trimmed mean measure, which removes the impact of volatile items, was 5.9% in the quarter – down from 6.6% in the March quarter.

These were encouraging results and were also lower that the RBA's own forecasts from May, which centred on 6.3% and 6.0% for the headline and trimmed mean measures, respectively.

The result confirms the disinflationary process that has been underway for some time overseas is now working its way through the Australian economy too. This is particularly evident regarding goods inflation, which fell to its lowest level in 1½ years – at 5.8%. Services inflation accelerated, with the annual pace rising to its fastest since 2001. But encouragingly, the quarterly pace slowed and was not far above the average quarterly pace in the 10 years leading up to the pandemic.

But it's not all good news, when we remove the impact of volatile items, inflation for market goods and services remained strong and the quarterly pace accelerated. Rents continued to rise at a rapid rate and we expect electricity prices to spike over coming quarters – although government subsidies will offset a lot of this impact in the near term.

The global disinflationary process from an easing in supply-chain disruptions and commodity prices will continue to place downward pressure on inflation for some time yet. However, this reflects the relatively easier part of the race. Once this disinflationary process runs its course, it will arguably become more difficult for the RBA to continue to see inflation coming down. This means that the 'last mile' in the inflation fight may prove particularly challenging.

Taking a step back, it is also important to note that inflation is still running at twice the top of the RBA's 2-3% band and that the RBA doesn't expect it to return to the band until the middle of 2025 – although the Board will receive an important update on the RBA's forecasts for this meeting.

History teaches us that inflation expectations are very difficult to get back down if they become unanchored. For the RBA, it is important that households continue to have confidence in the Board's commitment to get inflation back down. As a result, the RBA would be wary of declaring victory too soon.

The labour market remains incredibly tight. At 3.5%, the unemployment rate is still around the lowest level in almost 50 years and is only marginally above the low point in this cycle. Importantly, it is well below the RBA's estimates of the natural rate of unemployment, which is around 'the low 4s'. This suggests that the labour market needs to ease, and the unemployment rate needs to rise for inflation to sustainably return to target. Some easing has been evident in recent data – for example, though job vacancies pulling back from their peaks and the underemployment rate ticking up. But overall, the picture remains one of a very tight labour market with only a gradual easing expected over coming months. This places upward pressure on inflation and is a key upside risk the RBA will be wary of.

Inflation has proven to be somewhat sticky overseas. The US has arguably led this cycle and has provided a guide for what may happen in other countries. For around six months, services inflation proved sticky and difficult to get down. The most recent readings have been positive and show that perhaps the long-awaited slowdown in these stickier inflation components has arrived. However, the Fed is careful in not getting complacent and wants to wait for more data to confirm this process is firmly underway. It has been a hard-fought battle for the Fed to get to where they are today, but the road ahead looks less rocky.

These are important comparisons for the RBA. While there are many unique domestic aspects to every cycle, the international landscape has important implications for a small open economy such as Australia. In various ways, we have lagged the US in this cycle. As a result, it is important not to ignore the risk that getting the stickier components of the inflation basket back down may also prove to be challenging here and require more tightening.

Domestic Data Releases

In addition to the RBA Board meeting tomorrow, there are a spate of economic data releases this week. Firstly, June private sector credit numbers were released this morning. These showed that credit growth slowed to 0.2% in June – the slowest pace since November 2020. In annual terms, credit expanded 5.5% higher over the year. Business credit grew 0.3% while housing credit expanded by 0.2% in the month.

Tomorrow, a raft of housing releases will be delivered. Housing market strength has continued as dwelling prices are expected to have increased by 0.9% in July. This follows growth of 1.2% in June. This result would see the year-to-date gains for national dwelling prices increasing to 3.1%, from 2.2% in June. Prices continue to rise as growth is supported by still robust demand hitting up against constrained supply. Despite higher rates, demand has been supported by record population growth. This contributes to people looking to escape the tough competition in the rental market and purchase a dwelling of their own. Additionally, migrants who are in a position to do so are likely skipping the rental queue, contributing to demand. On the other side of the ledger, supply is still constrained as listings are well below average.

Housing finance is expected to have expanded 1.5% in June, following a 4.8% jump in May. A recovery in new loan commitments reflects the stronger housing market activity and the uptick in prices. This is expected to have continued in June after prices rose in the month.

Building approvals have been weak but incredibly volatile for some time, driven by large swings in approvals for multi-density dwellings (e.g. apartments and townhouses). In fact, double digit gains or falls were recorded in five of the past 12 months. The challenges facing households and the construction sector have contributed to underlying weakness. Looking behind the curtain, this weakness is still present, but some signs of a stabilisation may be nearing. In June, we expect approvals to have pulled back by 7.0%, partly unwinding the 20.6% surge in May.

On Thursday, the June trade balance will be released. The trade surplus is expected to have narrowed slightly to $10.4 billion in June, from $11.8 billion in May. This reflects a decline in exports earnings as commodity prices have eased from elevated levels, partly offset by falling imports, as higher rates impact household spending.

Retail sales volumes for the June quarter will also be released on Thursday. We received the nominal retail spending figures for June on Friday last week. Based on these figures, nominal spending rose 0.4% over the three months to June. Nonetheless, while inflation surprised to the downside in the quarter, it remained elevated. Still robust increases in prices are expected to lead to a 0.6% fall in retail sales volumes over the June quarter. If realised, this would match the result in the March quarter and mean that real retail sales (adjusted for prices) would have contracted for three consecutive quarters.

Finally, on Friday, the RBA will release the latest iteration of its quarterly Statement on Monetary Policy (SoMP). The SoMP will provide key insights into the RBA's thinking on the domestic and global economy. Importantly, we will receive an updated set of economic forecasts out to the end of 2025. These forecasts will provide an updated view on how the RBA is tracking on its goal of getting inflation down to the top of the 2-3% band by the middle of 2025 and where the RBA thinks inflation will sit at the end of 2025. These forecasts will be key for the future path of monetary policy and will be closely examined by the RBA Board at their meeting on Tuesday.

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Group Forecasts

		2023		2024			
End Period:	**Close (28 Jul)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.35	4.35	4.35	4.10	3.85	3.60
90 Day BBSW, %	4.28	4.55	4.55	4.47	4.22	3.97	3.72
3 Year Swap, %	4.17	4.30	4.15	4.00	3.80	3.60	3.50
10 Year Bond, %	4.07	3.80	3.70	3.50	3.30	3.20	3.10
US Interest Rates:							
Fed Funds Rate, %	5.375	5.375	5.375	5.125	4.625	4.125	3.625
US 10 Year Bond, %	3.95	3.70	3.50	3.30	3.10	3.00	2.90
USD Exchange Rates:							
AUD-USD	0.6650	0.69	0.69	0.71	0.72	0.73	0.74
USD-JPY	141.16	138	136	134	132	130	128
EUR-USD	1.1016	1.11	1.12	1.12	1.13	1.14	1.15
GBP-USD	1.2851	1.28	1.28	1.29	1.29	1.30	1.30
NZD-USD	0.6160	0.62	0.62	0.63	0.64	0.65	0.66
AUD Exchange Rates:							
AUD-USD	0.6650	0.69	0.69	0.71	0.72	0.73	0.74
AUD-EUR	0.6034	0.62	0.62	0.63	0.64	0.64	0.64
AUD-JPY	93.9	95.2	93.8	95.1	95.0	94.9	94.7
AUD-GBP	0.52	0.54	0.54	0.55	0.56	0.56	0.57
AUD-NZD	1.08	1.11	1.11	1.13	1.13	1.12	1.12

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.6	0.6	1.0
CPI (Headline), %	3.5	7.8	4.0	3.2
CPI (Trimmed mean), %	2.6	6.9	3.8	3.3
Unemployment Rate, %	4.7	3.5	4.0	5.3
Wages Growth, %	2.3	3.4	4.1	3.3

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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