WILSONS

Australia Joins the High Inflation Club

Our weekly view on asset allocation.

02 May 2022

Fastest Consumer Price Rise in More Than 20 Years

Australia's headline consumer price index (CPI) in the first quarter jumped by 2.1% on the previous quarter, well in excess of the consensus expectation of 1.7%.

This marks the largest quarterly rise since the GST-driven spike in mid 2000.

Year-on-year (y/y) inflation also accelerated sharply to 5.1%, the highest since 2001. This was well above the consensus estimate of 4.6% and way above the RBA's Feb-22 forecast of 3.9%.

Inflationary pressures were relatively broad, with 7 of the 11 categories growing at 3% or greater year on year. Also, the components that represent the largest part of the CPI saw some of the most significant increases.

A key upward driver was housing construction (i.e., new dwelling purchases of owner-occupiers), jumping 5.7% quarter on quarter (q/q) and 13.7% y/y. The jump largely stems from continued shortages of supplies such as timber, labour shortages and increased freight costs.

The surge in global oil prices unsurprisingly lifted automotive fuel costs sharply again (11.0% and 35.1% y/y), contributing 1.1% points to the CPI y/y; albeit a large decline should occur in Q2 given the government's cut to fuel excise.

Food prices also experienced a relatively strong jump, growing 2.8% q/q and 4.3% y/y with beef (7.6%), vegetables (6.6%), non-alcoholic beverages (5.8%), and fruit (4.9%), the main drivers of the rise.

In recent months, the spike in food prices has been largely led by higher input costs, combined with COVID-related disruptions. We expect the impact of the recent floods to feed into significant second-quarter food price inflation.

Figure 1: Australian inflation (headline CPI) spikes to a 22 year high

Source: Refinitiv, Wilsons.

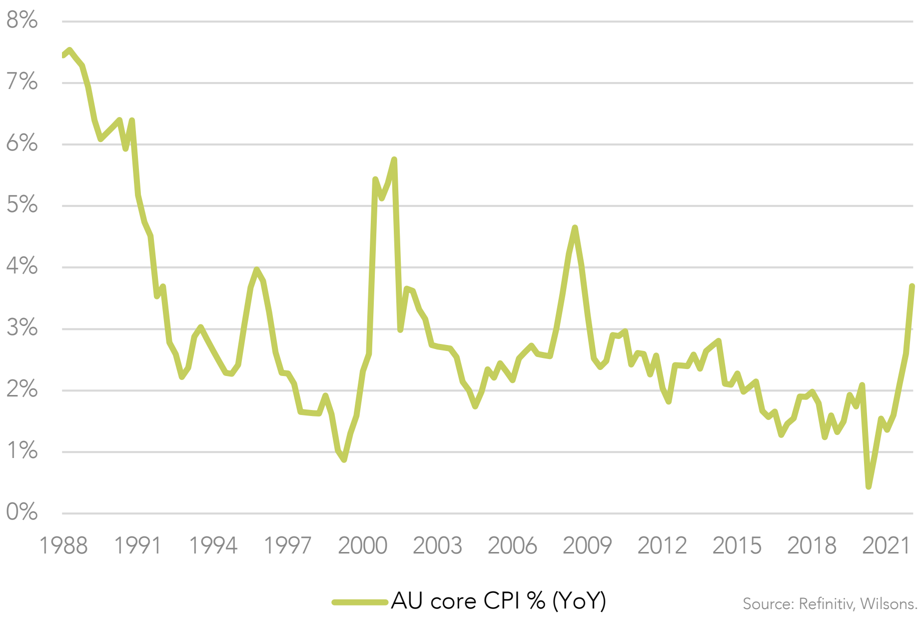
Figure 2: A broad based rise with large categories leading the way

	Qrt on Qrt	Year on Year	Pts contrib. Y on Y
Transport	4.2	13.7	1.4
Housing	2.7	6.7	1.5
Furnishings, household equipment and services	1.1	4.9	0.4
Education	4.5	4.7	0.2
Food and non-alcoholic beverages	2.8	4.3	0.7
Health	2.3	3.5	0.2
Recreation and culture	0.6	3	0.3
Insurance and financial services	0.5	2.7	0.2
Alcohol and tobacco	1.1	1.8	0.2
Communication	0.3	-0.8	0
Clothing and footwear	-0.6	-1.5	0
All groups CPI ; Australia ;	**2.1**	**5.1**	**5.1**

Source: ABS.

Underlying Inflation Spikes to Well Above the RBA's Target Band

Figure 3: "Underlying" inflation is well above the RBA's (2-3%) target zone



Source: Refinitiv, Wilsons.

The RBA's preferred "core" or "underlying measure" (the trimmed mean) lifted sharply to 3.7% on the year, the highest since March 2009. Indeed the 1.4% q/q jump was the largest core rise since 1990.

The year-on-year underlying outcome was well above the consensus expectation of 3.4% and the RBA's 3% estimate. Core inflation is already well above the RBA's forecast peak of 3¼% y/y in Q2-22.

This latest lift in the underlying CPI marks four quarters at or above the RBA's 2 - 3% target band. This follows ~7 years below the mid-point (averaging 1½%); however, the RBA 10-basis-point "emergency" cash rate does now look increasingly out of step with Australia's current inflation backdrop.

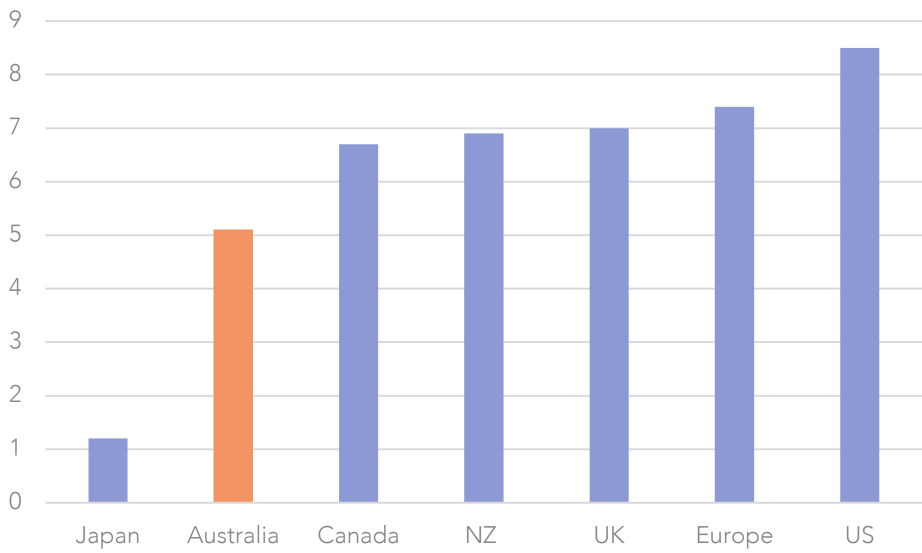
It's a Global Problem

Inflation is still well below most other major economies, where inflation is running at multi-decade highs of 6 - 8% y/y. That said, the impact of global inflation pressure was evident in tradables CPI, lifting 2.8% q/q and 6.8% y/y; albeit domestic trends drove up non-tradables to 1.8% q/q and 4.2% y/y.

Global inflation prints have surprised to the upside for the best part of a year now. Previously, Australia has been a laggard. However, now the magnitude of the inflation pickup is hitting home, especially compared to the RBA's estimates, with the q/q increase in headline inflation more than double their February statement of monetary policy forecast.

So, Australia clearly has an inflation problem of sorts, though not as bad as many other parts of the world, where it is in some cases at a 40-year high. As we have been discussing at length, inflation pressure in the US has been particularly acute, with prices climbing at their highest rate since the early 1980s, jumping 8.5% over the past year to March.

Figure 4: Australian inflation is still on the low side in a global context



Source: Refinitiv, Wilsons.

This surge has been led by rising energy costs fuelled by the war in Ukraine, prolonged supply-chain disruptions and rebounding consumer demand. Across the normally tepid European Union, consumer prices have soared 7.4% (a 43-year high) through the year to March.

We expect that inflation in the US is at, or very close to a peak. Indeed, we think it is fairly likely that the April inflation data, released May 11th, will show some easing in US inflation pressure. To the extent that Australia is an inflation laggard, we think the Q2 reading will show a further pickup (albeit it will be muted by the fuel excise cut). We then expect some easing over the second half of the year. This will likely take some pressure off the RBA to tighten as rapidly as the futures market currently suggests.

However, the RBA cash-rate outlook has almost certainly been expedited in the near term by the sharp acceleration in inflation. The strongest reason to expect the RBA to wait to raise rates is the RBA commenting in their April meeting that they would require "additional evidence over coming months", including wages (due mid-May). However, the magnitude of the upside surprise in Q1 suggests the RBA will probably begin lifting rates at the meeting this week (May 3rd).
We expect the first move to be +15bp (to 0.25%),

While there has been some talk recently of a super-sized, 40-basis-point start to the rate hike cycle, we believe the RBA remains inherently cautious. We note there have been no hikes since 2010, and no move greater than 25bp since 2000. A cautious start seems more likely, we feel. While May's meeting is during the Federal election campaign, we note that the RBA previously hiked in the 2007 election campaign.

Figure 5: The RBA has flagged wages growth as a key signpost for the cash rate. Next reading is mid May

Source: Refinitiv, Wilsons.

Interest Rates - How Fast and How High?

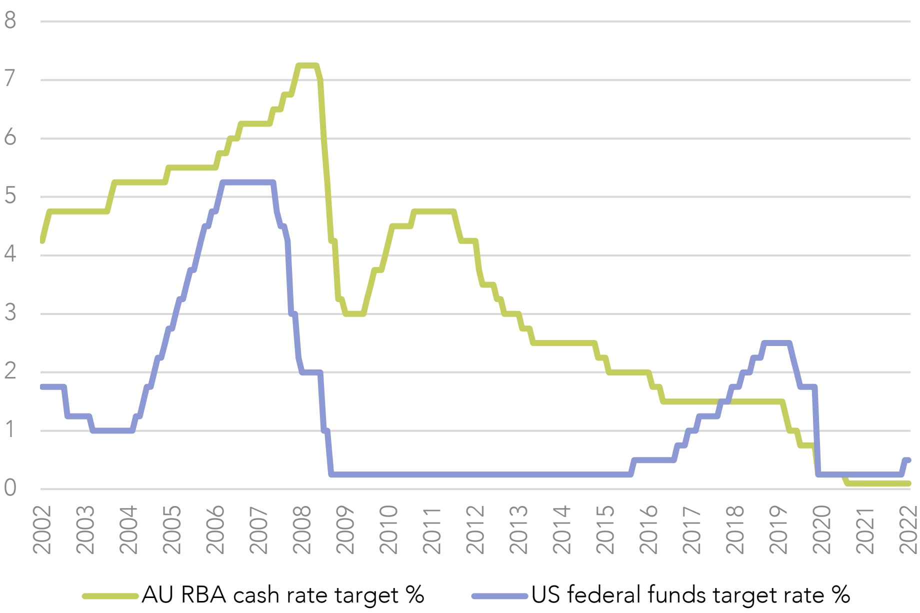
We then expect to see follow-up hikes of 25bp in June, and after each CPI point thereafter in August and November. This would take the cash rate to 100bp by year end, in contrast to current pricing of 250 basis points.

There is considerable debate at present as to how far the RBA will lift the cash rate over the medium term. Currently, the futures market has the cash rate peaking in late 2023 at around 3.5% before easing back to 3% in 2024. A number of economists think the neutral cash rate for Australia is much lower due to the high level of household gearing. Some put it at 1.5% or possibly even 1.25%.

We note the pre-Covid cash rate was relatively stable at 1.5% for several years and the economy (and inflation) remained relatively subdued through this period. We expect that given this cycle's much more aggressive fiscal stimulus, driving large household cash balances and less focus on fiscal repair, the cash rate will need to push up to at least 2% by late next year. However, we agree that futures market pricing of 3.5% looks way too hawkish given household debt levels.

The RBA will also be mindful of the underlying causes of this inflationary surge, which has to a large extent been imported – basically driven by COVID supply-chain dislocation and, more recently, the war in Ukraine.

Figure 6: The RBA's emergency cash rate looks increasingly at odds with the inflation backdrop



Source: Refinitiv, Wilsons.

Unless wages really take off and threaten a wage-price spiral, the RBA is likely to proceed at a measured pace and will be wary of overtightening in the face of what is largely a supply-side problem.

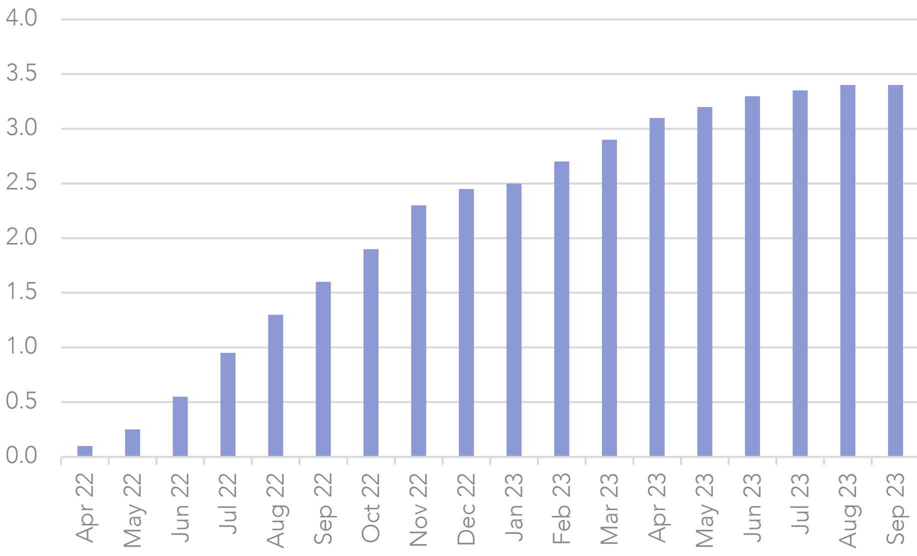
High rates will likely slow the pace of growth next year, but recession risks remain low in our view. We think the ability of the economy to ease back from its current well-above-trend pace of 4.5% to a more trend-like 2.5% over the next 12 to 18 months is relatively good, absent any significant negative external shock.

Asset Market Implications From Rising Cash Rates

House prices have likely peaked in our view, and we expect them to edge lower over the next 12 to 18 months, but serviceability is currently at record affordable levels. We think mortgage holders can cope with a gradual 200bp rise in mortgage rates over the next 12 to 18 months though there will be impacts on both consumer spending and house prices.

We do not see a gradual shift to a 2% cash rate as a big headwind for the share market with dividends well in excess of expected cash rates and eps growth prospects still decent. We remain overweight Australian equities. The 10-year bond yield at just over 3% currently looks reasonably good value in the context of our assumed 2% cash rate peak. However, the path of the US ten-year bond yields (2.8%) will also impact the direction of our long-term interest rates. We have begun to edge up domestic fixed-interest exposure recently from an under-weight position.

Figure 7: Futures market implied cash rate pricing (a very aggressive profile)



Source: ASX.

Figure 8: Australia's high household debt burden likely means a relatively low "neutral" cash rate

Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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