

The only way is down (or up) for Australia

Australia's central bank is still signalling that further rate hikes may be needed, while the market is only pricing in cuts. Where do we stand?



The Reserve Bank of Australia, Sydney

The inflation news has been helpful, but could be about to turn up again

At its last meeting in February, the Reserve Bank of Australia (RBA) statement noted that "a further increase in interest rates cannot be ruled out". This is a position we have taken for some months while favouring a base case that rates have peaked. However, many in the market have put the RBA's comments down to "bluster" – an attempt by the central bank to try to dampen markets' expectations for easing in 2024.

In support of the "bluster" camp, the news on Australian inflation has been extremely helpful. Monthly data on inflation dropped to just 3.4% in December 2023, only 0.4pp higher than the top of the RBA's inflation target range of 2-3%. Moreover, the latest release for January, which we and others expected to start rising again, remained unchanged at 3.4%. The RBA has been telling us that inflation is not likely to drop into its target range until 2025. Does this seem like another episode of misleading forward guidance like others in recent RBA history?

The answer is, probably not. Inflation has been helped lower over recent months due to some

really big supply-side-driven price spikes in 2022. These have not been repeated to nearly the same extent in 2023, and the net result is that the year-on-year comparison of the price level has dropped sharply. Despite the surprisingly low January numbers, that comparison is likely to reverse again, and we are expecting inflation to start pushing higher – at least for a few months.

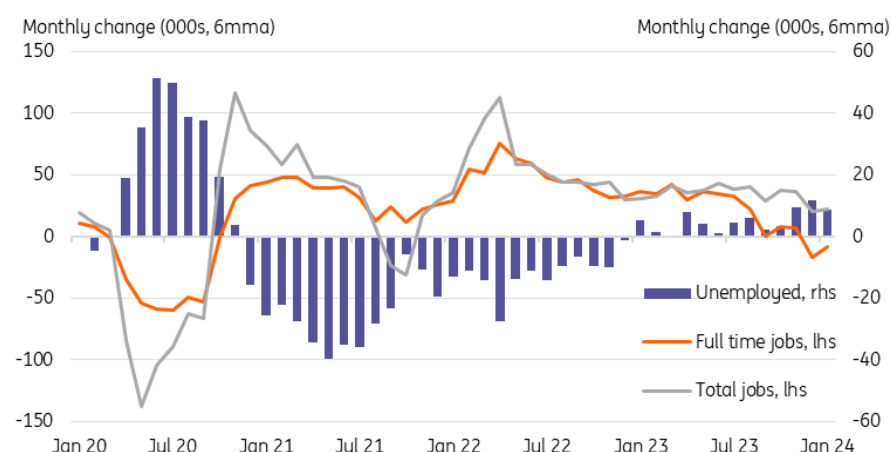
That will keep inflation from dropping into the RBA's target range in the near term. For this to happen further out, it will need month-on-month inflation to average 0.25% each month or lower, considerably below the average achieved in the last six months.

The macro story is beginning to slowly soften

Optimistically, factors that could get the run rate of inflation down do seem to be emerging. For one thing, the labour market now appears to be cooling. Australian labour data is horribly volatile, but the trend in both full-time jobs and total employment has slowed, with full-time job creation now trending negatively. The number of those unemployed has been rising since early 2023, and the only reason the unemployment rate hasn't risen more is that the labour force has been lifted by rising rates of inward migration. We expect these post-re-opening migration flows to slow. However, until they do, they are also keeping property prices and rents supported. This flips the argument back away from the “bluster” camp as household balance sheet gains have supported consumer confidence and spending.

Even here though, signs of cracks may be beginning to emerge. Monthly retail sales are also very volatile, but looking at smoothed trends, there also seems to be some softening underway.

Trends in Australia's labour market



Source: CEIC

There is a window for one more hike, but this will close by mid-year

When you put it all together, we think the RBA has a valid point. The inflation story has far from being put to bed yet and could still deteriorate, though the macro story does look as if it is slowly going to start to weigh on inflation and will hopefully bring some more downward pressure to bear by the middle of the year.

As a result, we believe that there is still a window for one further rate hike from the RBA. But if this

does not happen before June when the May inflation data could have risen to a short-term peak of around 4-4.5%, then the market's view that rates have already peaked will probably be vindicated. What happens will crucially depend on the run of inflation and other data between now and then – but it is a much closer call than market pricing suggests.

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