

## Australia: One more rate hike or is the RBA done?

The discussion about Reserve Bank of Australia (RBA) policy is very similar to that of the Fed's: have rates peaked? If not, when will that happen, and by how much? And almost as importantly, when will they start to cut? Here are our thoughts on these questions



New RBA Governor,  
Michele Bullock

### The Great Rate Debate

The debate about monetary policy for most central banks is usually set in the context of a trade-off between squeezing out inflation and the ensuing rise in unemployment that this creates. We can look at historical reaction functions during previous business cycles and try to apply these with tweaks to the current situation.

However, the current situation is like nothing we have ever seen before, and for this author, that covers a period of over three decades. In short, there is a lot of guessing going on these days, and probably as much guessing inside central banks as outside them. That makes high-conviction calls on central bank rate policy difficult.

The first part of this note will focus on those aspects of the macroeconomy that we do know before we try to pin down what this may mean for policy in this uncertain environment. So,

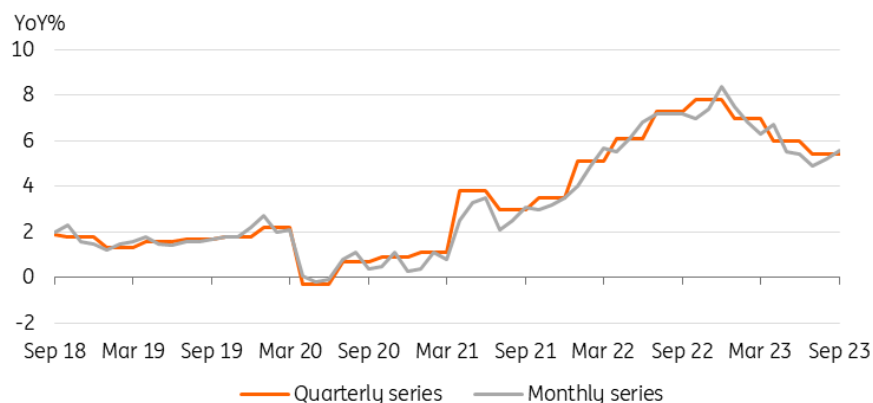
what do we know?

## Inflation: we do know this

Let's start with inflation because whatever else happens, if inflation fails to materially slow, then it presumably means more tightening ahead. And the news is, typically, quite mixed and hard to disentangle.

The good news is that inflation rates have moderated since peaking in December 2022 at 8.4% (monthly series). The inflation rate is now running at only 5.6% YoY (September latest) or 5.4% for the quarterly 3Q23 reading.

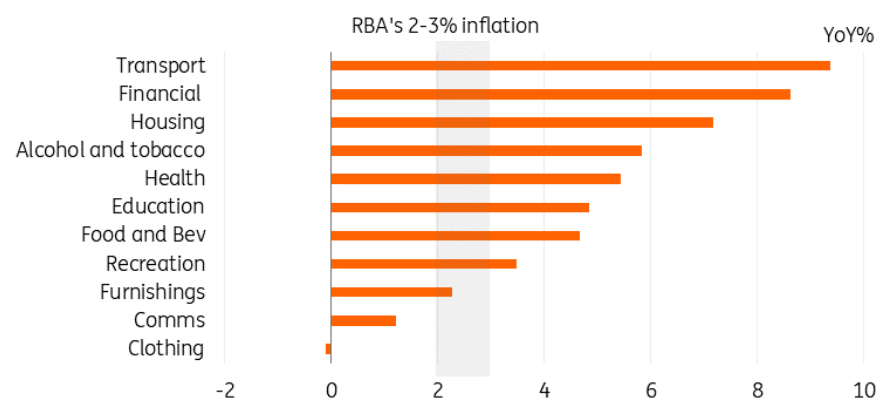
## Australian inflation (YoY%)



The bad news is that inflation is rising again. And though the RBA has a very unambitious date for hitting its inflation target (2025), its tolerance for outright increases in inflation is probably not particularly high. However, that may depend on what is driving them and how likely these are to persist.

Here, a breakdown of inflation into its components is both instructive and also not particularly encouraging. Because, with a few exceptions, most of the major sub-groups of inflation are running higher, and often considerably higher, than consistent with a 2-3% inflation target.

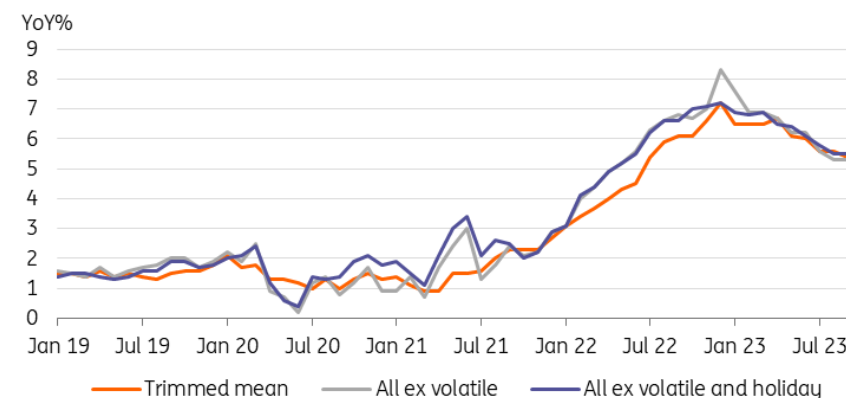
## Inflation by major component



It may be of some comfort to know that the various core measures, which strip out volatile items, including seasonal spending such as holidays, are still edging lower, or at worst, have not started to increase again. However, persistently higher volatile items will eventually be factored into price and wage-setting behaviour, so we can't write off the headline increases in inflation completely.

## Core inflation

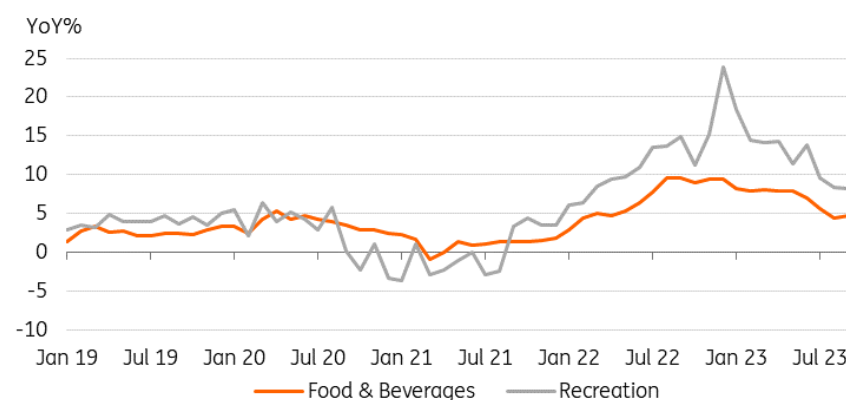
Monthly series (YoY%)



Source: CEIC, ING

Optimistically, some of the most significant contributors which fall into the volatile items group - food & beverage and recreation (holiday prices are highly volatile) - both peaked last year and have been easing back since then. That said, in the September release, food and beverage inflation began to nose up again, and recreation inflation is not falling as rapidly as it was.

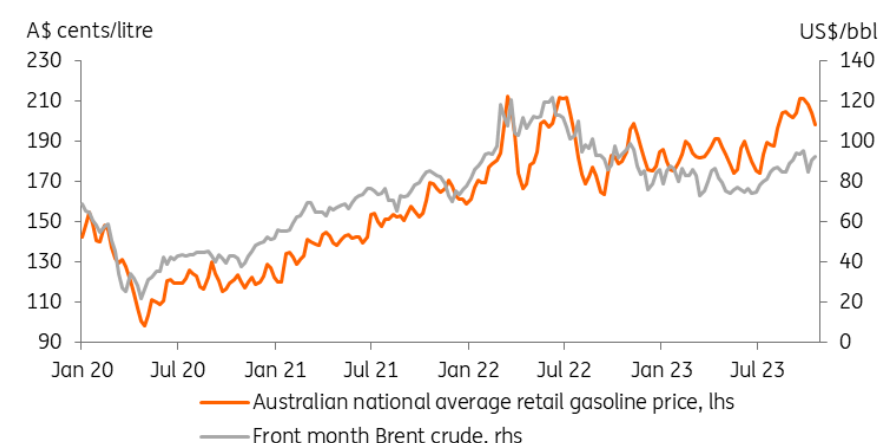
## Volatile items inflation (YoY%)



Source: CEIC, ING

Less optimistically, tight global oil supply and the recent outbreak of violence in Israel and Gaza have raised concern about future oil supply, pushing up oil prices further, and this will keep Australian retail gasoline prices elevated.

## Retail gasoline and crude oil prices



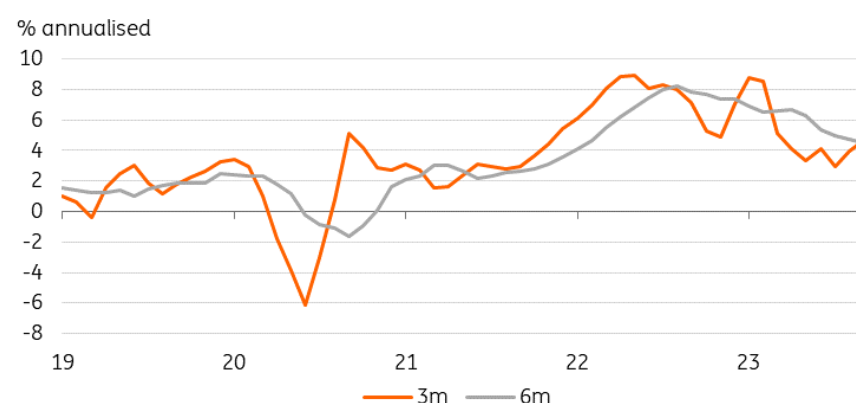
Source: CEIC, ING

Even without these volatile contributions, for the next month or so, it will be far easier for inflation to go up than to go down.

Last year, the month-on-month increases between August and October were all quite low, making it harder for the inflation rate to decline in these months this year (a basic requirement for the year-on-year inflation rate to decline). This is one reason why the monthly inflation rate has risen in the last two months.

That would be less of a problem if the monthly “run rate”, which we proxy with the 3m and 6m annualised growth rates, were running at a level consistent with the longer-run inflation target. Not only have these measures started to rise again (the 3m rate anyway), but they are still running too high to bring inflation down to 2-3%, for which we need to see month-on-month growth rates consistently averaging no more than 0.2%, not 0.6% MoM as in August and September.

## Annualised inflation rates (run-rate)



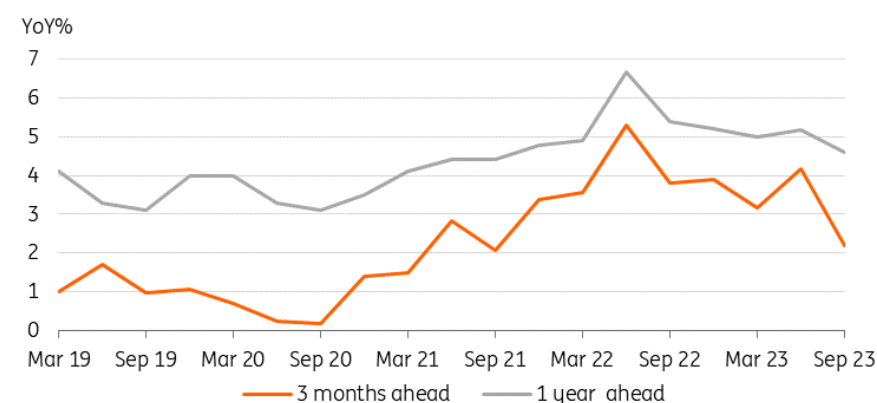
Source: CEIC, ING

The story with inflation expectations is more confusing. Central banks tend to take these expectations very seriously, perhaps a bit more seriously than they should, given that most

people, when asked to estimate the current inflation rate, would probably answer, "What's that?".

Still, with the notion of the "wisdom of crowds" as a motivator not to entirely ignore such views, the published consumer inflation expectations survey has also fallen, and quite sharply recently for the near-term outlook. This is not enough to conclude that financial conditions are sufficiently tight to bring inflation down in an acceptable timeframe. But it may suggest that the household sector is finally beginning to register some pain in response to the rate hikes that have already been undertaken.

## Consumer inflation expectations (YoY%)



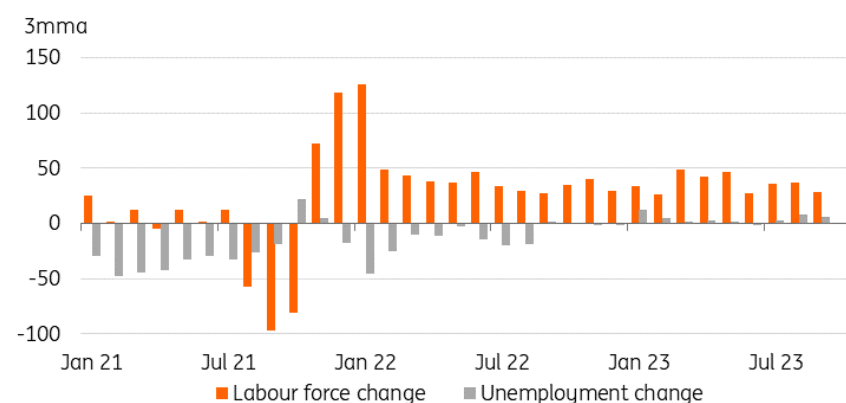
## Other relevant considerations

We will turn now to other parts of the economy since if inflation is a lagging indicator of the broader macro trend, then the rest of the economy could shed some light on whether, even if current inflation run rates are too high, conditions are conducive to them falling later on.

Here, the news is not particularly reassuring.

We will focus on the labour market because that is the part of the economy that the RBA pays most attention to. And the first thing to note is that the number of unemployed, though marginally increasing on a 3-month trend basis, is increasing at a far slower rate than the increase in the labour force. The net result of this is that the unemployment rate is still very low, and there is more of a tendency for it to decline than to rise.

## Labour force trends



That backdrop doesn't suggest that wage growth will moderate any time soon, though the good news here is that, unlike some other developed economies, the rate of wage growth remains very subdued. That may be the flip side of the labour supply story and helped by rapid inward migration post-pandemic.

Employment growth has slowed but remains positive and is highly volatile. Looking at recent surges in part-time working, that may be a prelude to a bigger increase in full-time jobs, and those are jobs that are more secure, better paid, have longer hours and better perks, so they have a much greater impact on domestic demand than the equivalent part-time employment. This is not guaranteed to keep growing, but equally, there aren't many particularly worrying signals flashing about the labour market, at least not yet.

Another aspect of the strength of the labour force, which reflects strong population growth, is that despite the rise in interest rates since their pandemic trough of 10bp (cash rate target), to 4.10% currently, housing rentals are actually still rising. Household debt service costs have risen for many, but the overwhelming driver for the market currently is still an excess of housing demand over supply. Consequently, absent a solid and sustained construction surge, this is likely to remain the case. Industry reports, which are a lot more timely than the official data, suggest that rentals continued rising through the third quarter and into the fourth.

## What does this mean for the RBA?

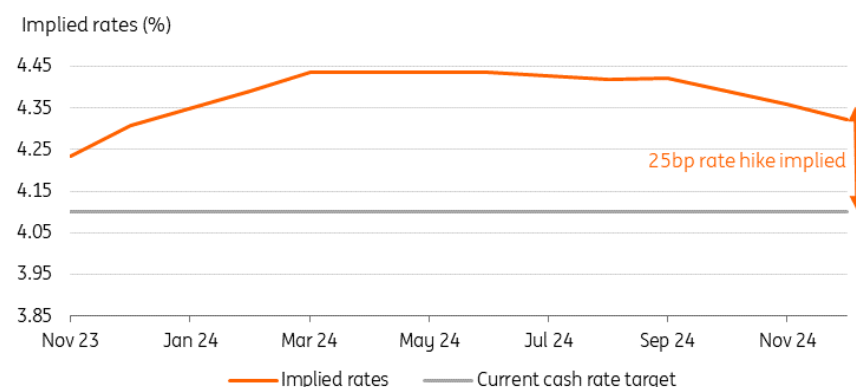
When we put all this together and consider the recent pauses in the RBA's hiking cycle, notably to "gather more information on the state of the economy", and add in the fact that new Governor Michele Bullock will be well advised to stamp her authority on inflation fighting early on in her tenure, we struggle to come up with any other answer than that RBA rates have not yet peaked. Inflation is no longer falling; even when adjusted for volatile items, it is not falling very fast. The labour market is not only not slowing enough to bring inflation run rates down, but it is still showing a lot of strength. And parts of the economy, such as housing, are showing much more resilience to rate increases than has usually been the case.

We think there is enough information right now to justify a further hike to 4.35% at the 7 November meeting. And if not then, by the December meeting, there should be an even stronger case to be made, as there is a good chance that the October monthly inflation rate will move even

higher.

The market has belatedly swung around to our way of thinking, though not exactly. They have recently accepted that there is a chance of a further rate hike before the end of this year, even pricing in a small chance of two hikes (we concur, though a second hike would not be our base case). However, they then don't expect any easing until the very end of 2024, while we see a more rapid pace of inflation decline in 2024, making room for earlier cuts. Admittedly, the situation is highly fluid and changes almost by the day.

## Market rate expectations



## And bond markets?

As well as RBA rate policy, where Australian government bond yields go next is going to be heavily determined by what happens to the US economy, Fed funds and US Treasury yields, which Australian government bond yields track closely.

## Australian and US bond yields



The near term looks very volatile. A very similar inflation dynamic to that driving Australian markets is at play in the US, which has briefly taken US 10Y Treasury yields above 5%. But there is also likely to be strong downward pressure if the Middle East conflict escalates. The US macro economy also shows a few more cracks than the Australian economy. If any of these start to look

more threatening, they could also put pressure on the higher-for-longer mantra that has recently been pushing global bond yields higher.

Ultimately, and probably by early next year, we do expect the US macro story to show more evidence that it is turning weaker and for more easing to return to implied rates in 2024 and 2025, dragging down Treasury yields with it. And this should also weigh on Australian yields. With the Australian inflation backdrop a little higher and the macro backdrop a little hotter than that in the US, we'd probably expect this turn in sentiment to see US Treasury spreads over Australian bond yields shrink, but for yields on balance to decline, though not perhaps before they have gone up a bit further in the short term.

## Summary forecast table

Economic indicator	2Q23	3Q23F	4Q23F	1Q24F	2023	2024	2025
GDP Growth (YoY%)	2.1	1.7	1.2	1.1	1.9	1.6	2.9
Inflation (YoY%)	6.0	5.3	4.9	4.4	5.8	3.6	2.7
House prices (YoY%)	-0.9	3.5	4.0	3.9	0.4	1.5	3.4
Unemployment rate (%) eop	3.5	3.7	3.9	4.2	3.9	4.4	3.8
(end of period)	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	4Q25
Cash rate target (%)	4.10	4.35	4.35	4.10	3.85	3.60	3.35
10Y bond yields (%)	4.48	4.50	4.00	3.80	3.60	3.50	4.00
AUD/USD	0.64	0.64	0.66	0.69	0.71	0.73	0.75

Source: ING

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