

Inflation risks rebuild in Australia, supporting RBA tightening

While easing services inflation offers some relief, the March CPI underscores intensifying energy driven price pressures. Second round effects from higher oil prices keep inflation risks skewed upward, supporting a hawkish 25bp RBA hike at the 5 May meeting. We expect that to underpin AUD strength in a generally favourable external environment



Australian CPI rose 4.6% year-on-year in March, and we expect a hawkish hike on 5 May

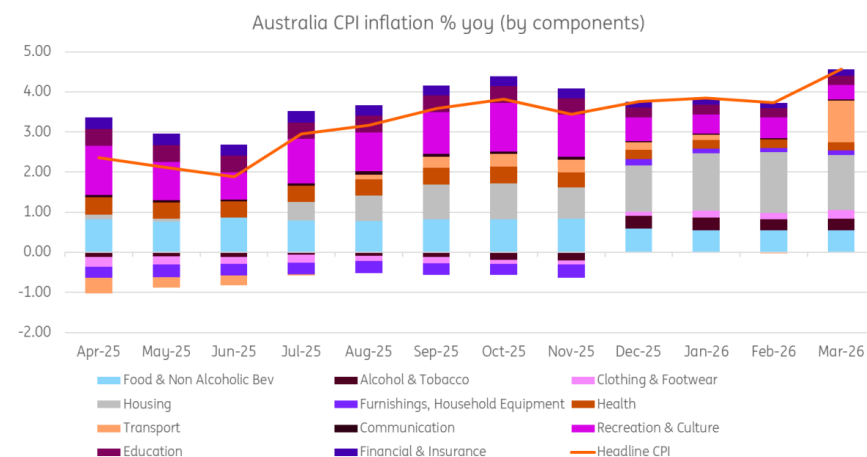
Energy costs drive headline inflation higher

CPI inflation in March rose to 4.6% year-on-year from 3.7% in February, in line with our expectations. The entire 0.9 percentage point increase was driven by higher transport inflation, which surged to 9.0% YoY, reflecting higher fuel prices. This pushed 1Q CPI inflation to 4.1%, about 50 bp higher than the 4Q25 average.

Underlying inflation also remained firm. March trimmed-mean CPI was also elevated, increasing to 3.5% YoY, slightly above the 3.4% recorded in 4Q. This was largely driven by persistent price pressures in housing, where inflation accelerated to 6.8% YoY, even as contributions from other persistent components, such as recreation and culture, eased. The quarter also marked a reversal

of last year's trend, where services inflation remained elevated and persistently outpaced goods inflation. The surge in fuel prices and transport inflation saw goods inflation surging to 5.5% YoY in March compared to 3.6% in services, while also lifting YoY inflation in tradables almost four-fold to 4.5%.

Australian CPI contribution by components



Source: CEIC

Inflation dynamics strengthen case for a May hike

We expect the Reserve Bank of Australia to take some comfort from the easing in services inflation. However, the broader risk backdrop has shifted to the upside, as higher oil prices are likely to generate second-round effects that could place renewed pressure on services inflation. With further pass-through of higher oil prices into transportation, electricity, and utility costs, we now expect CPI inflation to increase to 5% YoY in 2Q, much higher than the RBA's June 2026 target of 4.2%.

At the March monetary policy meeting, despite a split vote, the discussion was focused on the timing of further tightening rather than whether additional rate hikes would be required. Since then, risks around that assessment have continued to tilt higher amid both domestic and global developments. In particular, the RBA highlighted three key sources of uncertainty that could shape the future path of policy.

First, uncertainty around the evolution of the Middle East conflict remains elevated. There are still no signs of de-escalation, prompting us to revise our oil price outlook higher. Under our updated base case, ICE Brent is now expected to average \$104/bbl in 2Q26, up from \$96 previously. Ongoing inventory drawdowns and a slower recovery toward pre-war supply levels also lift our 4Q26 forecast to \$92/bbl, from \$88 earlier. These dynamics continue to pose an upside risk to headline inflation.

Second, there is uncertainty around the growth outlook. While aggregate demand prospects remain uncertain, Australia's position as a net energy exporter and generally healthy household balance sheets suggest the economy retains a degree of resilience to higher energy prices.

Third, while members who voted to hold rates steady previously placed greater weight on weaker-than-expected consumption, easing unit labour cost growth in the December quarter, and

uncertainty around further labour market tightening, more recent data has challenged this view. Labour market outcomes in 1Q were firmer than anticipated, with employment growth rebounding strongly and the unemployment rate edging down to 4.2% from 4.3% in 4Q25. This points to persistent domestic capacity pressures and reinforces the RBA's tightening bias.

Overall, today's inflation print strengthens our conviction that the RBA will deliver a 25bp rate hike at the forthcoming May monetary policy meeting. With disruptions stemming from the US–Iran conflict showing little sign of abating, we expect the RBA to adopt a hawkish hike, one that preserves flexibility and allows the Bank to remain firmly data dependent in subsequent policy meetings.

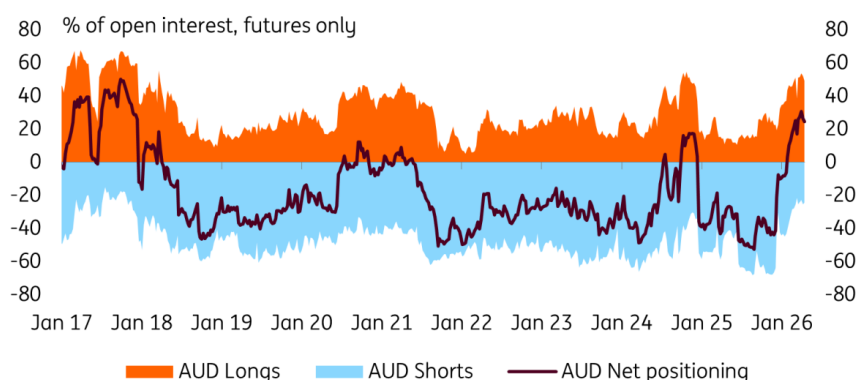
AUD momentum relying on hawkish RBA

Markets have trimmed pricing for the 5 May meeting from 21bp to 18bp after the slightly below consensus March CPI print. Even so, this still leaves enough pricing for the RBA to hike without unnerving the bond market. The cash rate future curve now embeds 60bp in total by year-end. While this is closely tied to swings in oil prices, it also suggests that a dovish hike – one that hints the cycle is nearing its end – would have a pronounced negative impact on front end AUD yields and the Australian dollar.

AUD was among the best performing currencies in April, and AUD/USD is around 0.7% above its pre-war levels. That reflects a mix of a resilient equity market, Australia's net-energy exporter status, and a hawkish RBA. Interestingly, six-month rolling betas show that short-term rate differentials are back to being the primary driver of AUD/USD.

This suggests that the Aussie dollar should have some elevated sensitivity to any forward-looking language by the RBA next week, and could take a sizeable hit in the event of a surprise hold. Speculative positioning is the most bullish since 2017, according to CFTC figures, suggesting corrections could be sharper than further rallies in AUD/USD.

Speculators are heavily long AUD



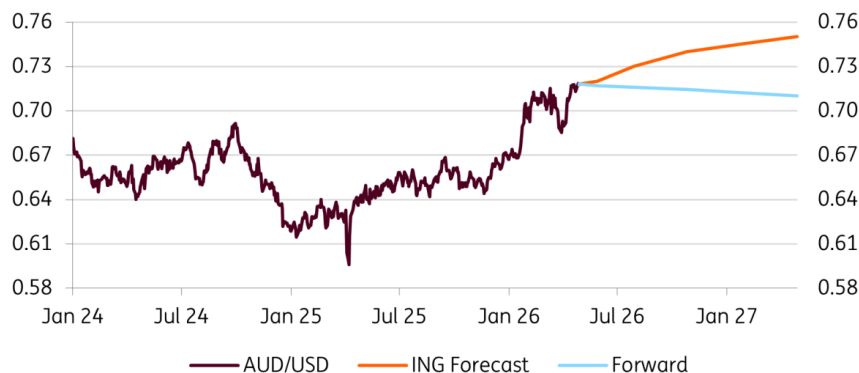
Source: ING, CFTC, Macrobond

We are bullish on AUD into year-end

Fundamentals ultimately matter more than positioning, and we think a hawkish RBA hike could continue to underpin broader support for AUD/USD. In our baseline scenario for the Iran war, we expect a partial reopening of the Strait of Hormuz in May.

That could result in a positive risk-sentiment response but only moderate negative impact on energy prices as some uncertainty lingers. That’s an ideal environment for AUD, and as we see the rate differential with the US dollar widening further in the second half of this year due to two Federal Reserve rate cuts, our call remains bullish on AUD/USD. We target 0.73 this summer, and 0.75 by year-end.

Our forecast for AUD/USD



Source: ING, Refinitiv

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