ECONOMIC UPDATE

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WEEK ENDING 29TH APRIL 2022

Key points

- **Inflation was a lot higher than expected in Q1;**
- **It is possible that Q1 was the peak quarter for inflation;**
- **But the risks are that inflation will remain above the RBA's 2-3% inflation target into next year;**
- **Strong economic growth and too high inflation means interest rate hikes are imminent;**
- **I expect the cash rate to be at least 1.25% by year-end.**

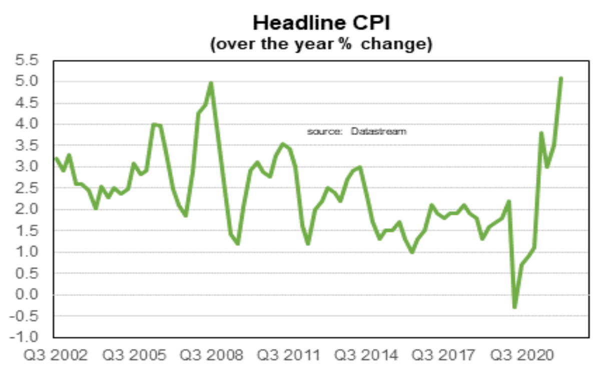
Inflation in the March quarter

Back in 1990 there was a hit song, "Things that make you go 'hmmm" by C+C Music Factory. Personally it wasn't one of my favourites. But the song came to mind when the Q1 inflation numbers were released. Analysts expected a big number, but not that big. According to the ABS the CPI increased by 2.1% in the March quarter. You have to go back to the GST to see a bigger quarterly rise. And before that it was September 1989 when Richard Marx was topping the charts.

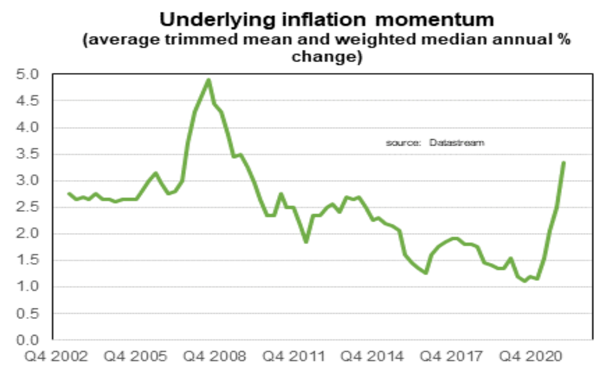
The price rises were broad. The so-called 'trimmed mean' (a mathematical approach to eliminating the most volatile movements) used as a measure of 'underlying' inflation rose by a big 1.4% in the quarter. Over half the items in the CPI basket have risen by over 3% over the past year. Goods inflation has been stronger than services reflecting stronger demand. Goods prices have also been more heavily impacted by supply-chain problems and rising input costs. The end of government incentives meant rising housing costs. Government incentives (such as restaurant vouchers) helped hold down the price of a meal out.

Strongly rising prices is no surprise for households and firms. In April consumer inflation expectations are at their highest level in over ten years. Business price expectations (in the retail sector) were at their highest ever level in the March quarter.

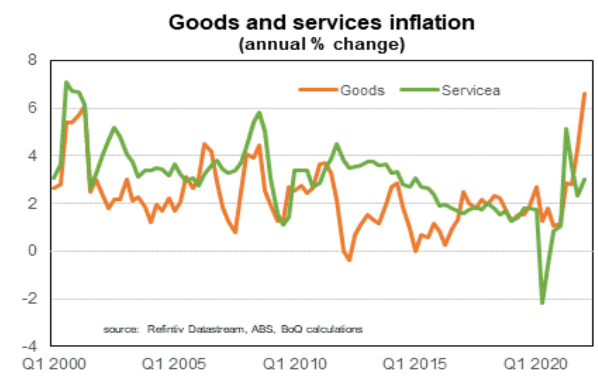
Headline inflation is at its highest level in over two decades.



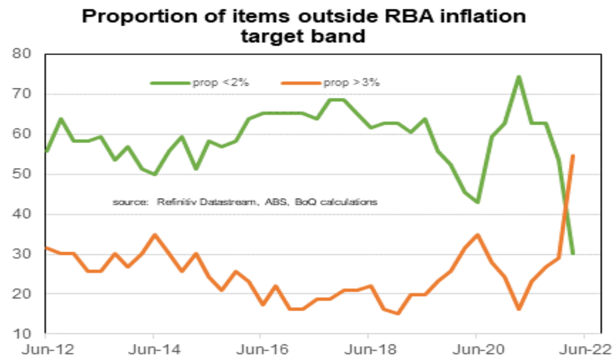
And 'underlying' inflation is above the RBA's 2-3 target band.



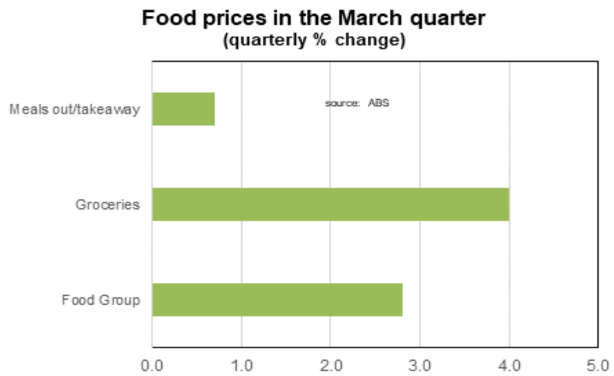
Goods inflation has been substantially stronger than services.



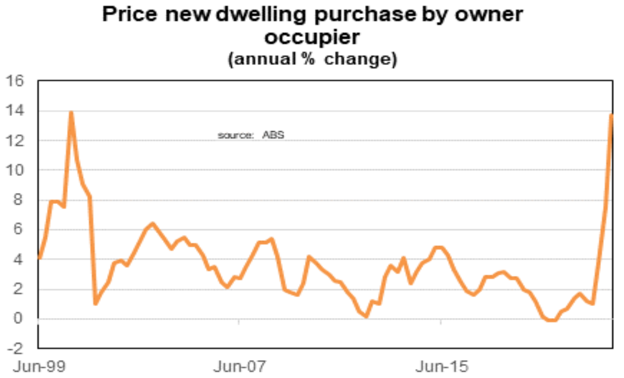
The prices for more than half the items in the CPI basket have risen by more than 3%.



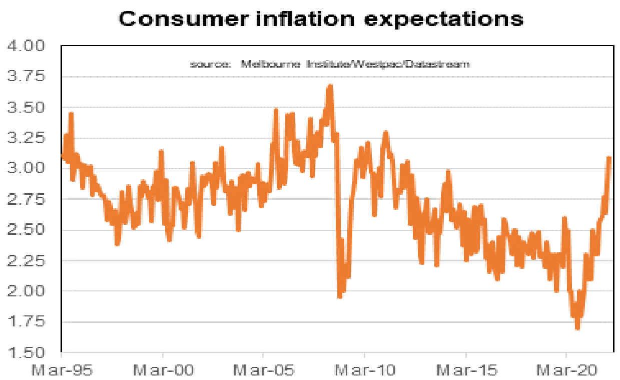
Government incentives have held down the price of restaurant meals.



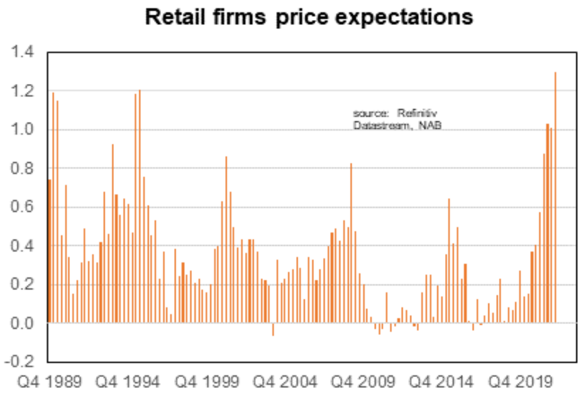
But housing costs have risen substantially.



Consumer inflation expectations are at their highest level in a decade.



Business price expectations are at record highs.



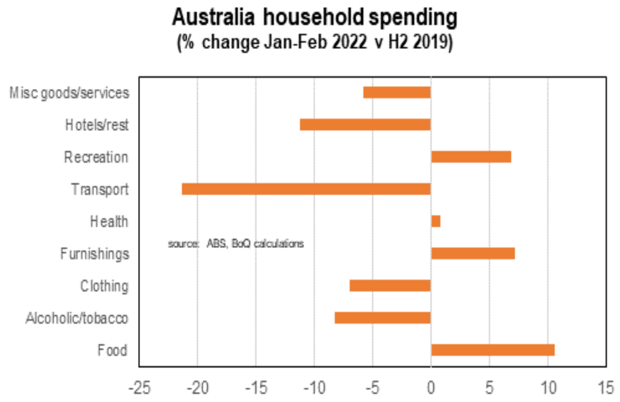
Strong demand, problems with supply get you higher prices

It has been a combination of very strong demand and problems with supply that has led to such big price rises. The strength of demand is underlined by an unemployment rate that is near five decade lows and capacity utilisation near record highs. Over COVID demand was particularly strong for goods as consumers trapped at home had both the means and the desire to spend. COVID-related absences meant factories didn't have the workers to produce those goods. Spending more time at home meant less spending on services (going to restaurants, the football and cinemas)

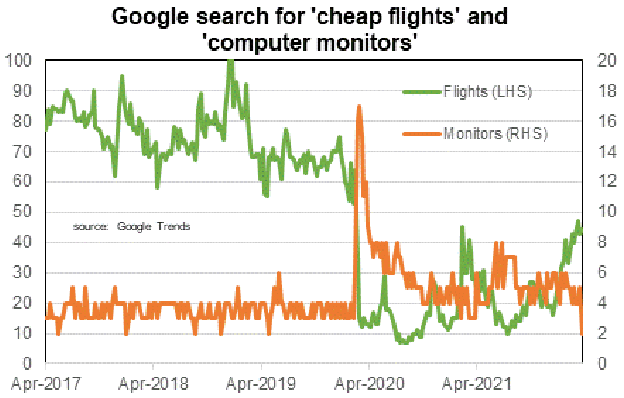
There are signs that spending is slowing on goods and rising on services. Anyone who has recently been to an airport can tell you there are lot more people getting on a plane. Spending on goods is slowing, partly because those dollars are being spent on services and partly because households have bought all the durable goods (such as TV's and washing machines) that they need. Whirlpool (for example) recently indicated that consumer demand for products has started to level out (which may also reflect the impact of higher prices).

The strong demand for goods has meant that firms have substantially run down their stocks and led to a big strong demand from firms to boost inventory. Low stock levels has meant delays in delivering goods. For example, website pricemycar.com.au indicated that in March the average time for a delivery of a new car was a bit over 4 months (a lot of people I ask believe the delivery time is up to one up to one year).

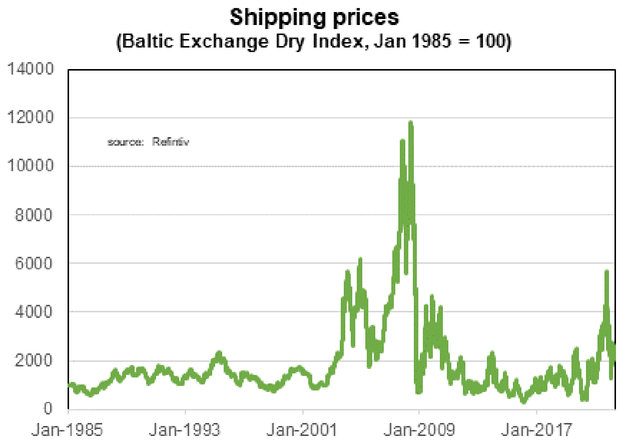
Spending on goods has been stronger than services. But that is starting to change.



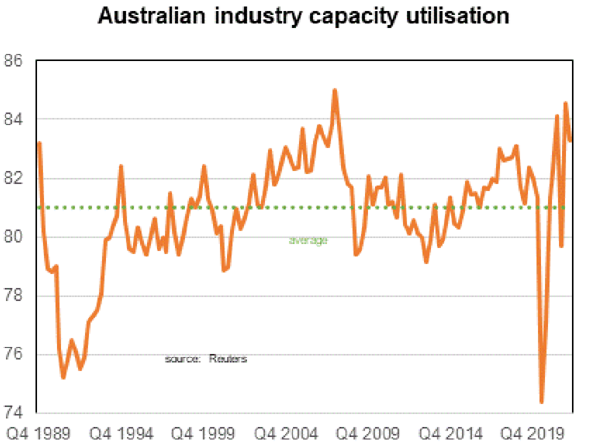
More people are catching a plane. Less are buying computers.



Shipping prices costs have declined from their highs although remain elevated by historical standards.



Capacity utilisation is near record highs.

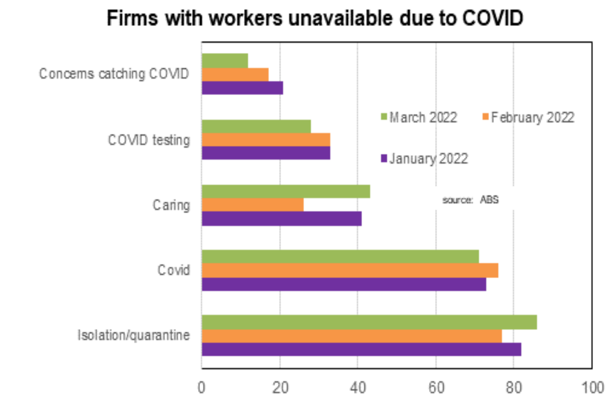


The supply-chain problems have started to ease. The backlog of orders has begun to be run down as the number of new orders slows and more workers return to work. The backlog of orders is still big though and with capacity utilisation already high will take some time to be reduced back towards more normal levels. The possibility of rolling lockdowns in China as they battle COVID and a lengthy Russia-Ukraine War could mean that global supply chain problems could last at least through for much of this year.

The most significant ongoing issue will be a lack of workers. The relaxation of regulations should mean that COVID will have a gradually diminishing impact upon worker availability. But indicators such as job ads and vacancies point to ongoing very strong demand for labour. Slow population growth has meant that the supply of workers has been unable to keep up. Already larger firms in particular are reporting concerns about higher wages. Hopefully rising immigration numbers will help. But increasing labour costs are likely to intensify in coming months.

Finally, while commodity prices may have hit their high from the Russia-Ukraine crisis substantial declines are unlikely for some time reflecting strong demand and years of under investment in many areas of energy.

Less workers are worried about COVID.



Companies are starting to work down their backlog of orders.

Inflation and interest rate outlook

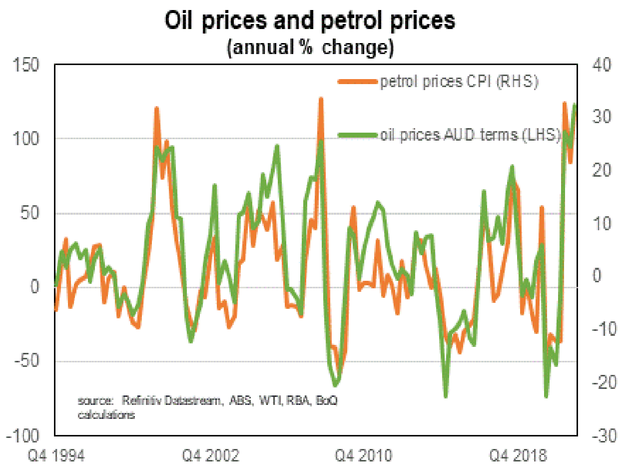
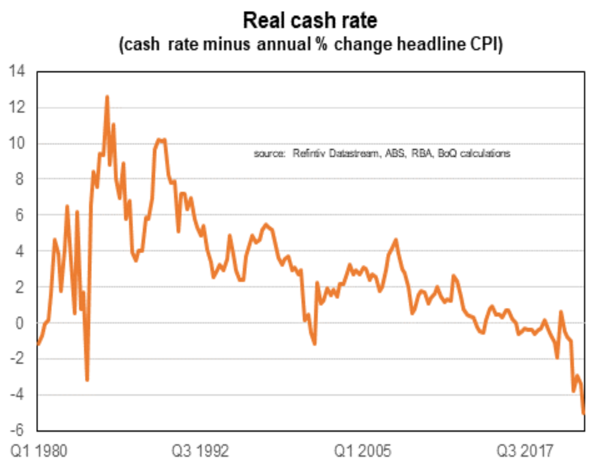
There is a good chance that the March quarter was the peak in quarterly inflation. Oil prices have fallen from their peak post the Russia-Ukraine crisis and the Federal Government has (temporarily) reduced taxes on fuel. The result is likely to be lower petrol prices in the June quarter.

But as noted supply constraints are likely to be around for much of this year and a significant decline in commodity prices is unlikely. This means that there will still be delays in getting goods for some time and input costs are unlikely to decline substantially. Firms' are also likely to be confronted with rising labour costs (particularly in the services sector). In a recent ABS survey over 20% of firms indicated they experienced costs rising to a great extent. With demand still strong more firms are likely to pass on more of these costs onto customers. That means inflation forecasts for 2023 might be too low.

All of this means that interest rates will need to go up and go up soon. Post the Q1 CPI number financial markets had priced in a very high chance of a move 0.15 percentage point move in May. There is a strong economic case that the RBA should have already moved. But it not yet clear whether the RBA has seen enough evidence that wages growth has got to a level that ensures that inflation will stay sustainably within the 2-3% target. The RBA may also feel nervous about raising interest rates during an election campaign. There has been discussion as to whether the first rate hike will be 0.15 or 0.4 percentage points. Given that there has been no rate rise since 2011 a cautious first move is likely to be more appropriate.

The more important issue is that the first move is unlikely to be the last. There will almost certainly be a number of rate hikes over the second half of the year. I think the cash rate will end the year at 1.25%. At the time of writing financial markets had far more aggressive thoughts at 2.50%.

Who is right will depend upon how the economic growth and inflation picture evolves over the remainder of the year. Already some in financial markets think there is a chance of an economic slowdown in 2024 reflecting COVID developments in China, slowing growth in new orders and the impact of higher interest rates and less supportive fiscal policy. I believe that concerns about economic growth will mean the RBA will not be as aggressive as financial market forecasts. But if inflation expectations or wages growth head too high over the next 12-18 months the RBA may not have much choice but to follow the more aggressive rate hike path suggested by current financial market pricing.

Petrol prices may have peaked.	Interest rates (after inflation) are at their lowest level in over forty years.
	

We have had a couple of years now we there has been a run of things that make you go ‘hmmm’, whether that be the pandemic, the Russia-Ukraine war, a rock-bottom unemployment rate or the sudden spike of inflation. Hopefully the strong probability of higher interest rates is not one of them as it has been increasingly well flagged over recent weeks. But I have the feeling that the Q1 CPI number will not be the last time we will be going ‘Hmmm’ in coming years.

We live in interesting times.

Regards

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