ECONOMIC UPDATE

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WEEK ENDING 29TH OCTOBER 2021

BOQ GROUP

Key points

- **Inflation has risen quicker than RBA forecasts;**
- **The global trends of strong demand and limitations on supply are also playing out in Australia;**
- **But for the RBA convinced that inflation is going to be sustainably within 2-3% they will need to see evidence of higher wages growth;**
- **The CPI numbers have not changed my view of the first cash rate move in H2 2023;**
- **But the RBA stop its QE program by the end of Q3 next year.**

Summary

The Q3 CPI numbers showed inflation is on the rise. The surprise was that 'underlying' inflation (the movement of prices excluding large one-offs) was up a stronger than expected 0.7%. But the quarterly 'headline' inflation (or how much prices rose for all items) was pretty much in line with expectations.

Australia has joined the global trend of not enough supply to meet strong demand. One result is weaker economic activity. Too much demand and a lack of supply is also leading to higher prices. In an environment of strong demand and a lack of supply firms have felt more comfortable about passing on some of these prices to customers. Australian consumer inflation expectations have risen.

Many analysts (including the RBA) believe this rise of inflation will prove to be temporary and disappear as economies fully re-open. There are good reasons to think this might occur. But the re-opening process from the pandemic has taken longer than many people had envisaged just a few months ago.

The RBA (and other central banks) believe that sustainable inflation won't occur until wages growth picks up. The RBA has nominated a wages growth 'target' of over 3% as being consistent with achieving its inflation objectives. We will get an update on wages growth from a range of indicators in November/December. The last reading of the best measure (wages price index) was up just 1.7% in the year to June 2021. This was surprisingly low given the strength of the economy at that time and employer feedback about the extent of worker shortages. But wages growth can take time to change regardless of the state of the economy.

I don't think there will any imminent cash rate hike. After having an extended period of inflation under their target the RBA is determined to make sure inflation is within band in coming years. The key for a rate move is whether the RBA thinks that inflation is sustainably within 2-3%. And for that the RBA will need to see evidence that wages growth is above 3%. As noted we get our next set of wages readings in November/December. But at best a number of close to 3% is unlikely to take place until the end of next year (and more likely 2023). So it appears to me that financial markets have priced in too many interest rate increases too early.

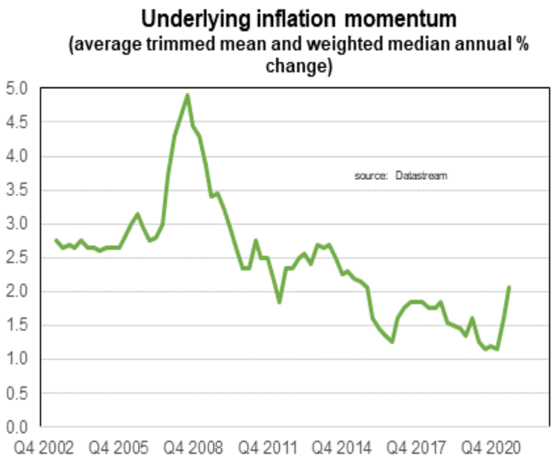
That is not to say that the RBA will be doing nothing in coming months. The RBA may not change the timing of their review of their quantitative easing program (QE, or buying federal and state government bonds) from February of next year. But the change in economic conditions means that they might stop their QE program by end September next year. I am open to the possibility that the RBA may abandon its YCC policy in coming months. To abandon their YCC they will need to be comfortable that inflation will stay within its target band. And for that they will need to see some substantive movement on the wages front.

September quarter inflation outcomes

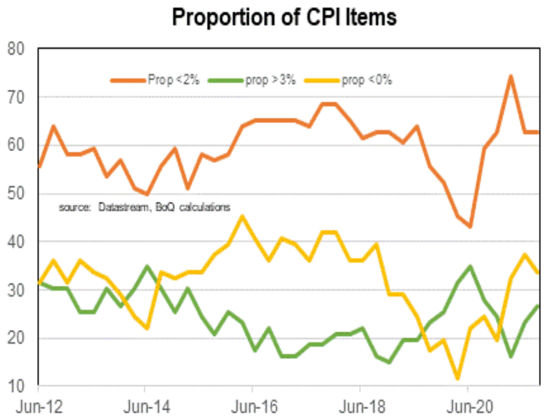
The Q3 CPI numbers showed inflation is on the rise. The surprise was that 'underlying' inflation (the movement of prices excluding large one-offs) was up a stronger than expected 0.7%. That inflation measure is now above 2% for the first time since 2015 (and the highest quarterly reading since 2013). But the quarterly 'headline' inflation (or how much prices rose for all items) was pretty much in line with expectations (+0.8%), and there was some moderation in the year-to rate (3%).

Until the September quarter figure Australia had been an outlier. Many countries globally had experienced inflation comfortably above forecasts. This had not been the case in Australia, and was probably the reason why Australians had not been heading much about inflation in the news. The Q3 underlying figure was higher than expected. But the movement in the headline figure was less dramatic than what has happened overseas. And price rises for most items in the CPI basket remains modest.

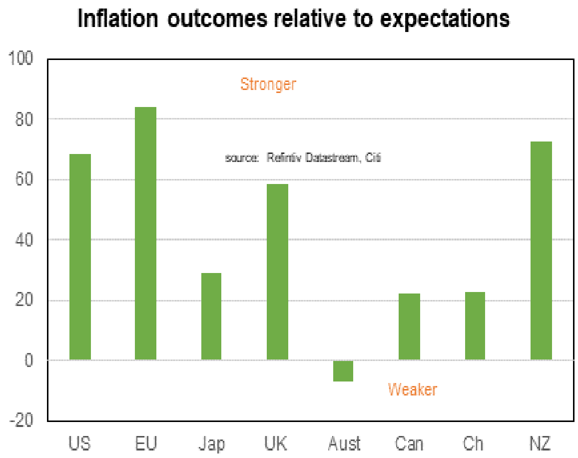
Underlying inflation has returned to the RBA's 2-3% target.



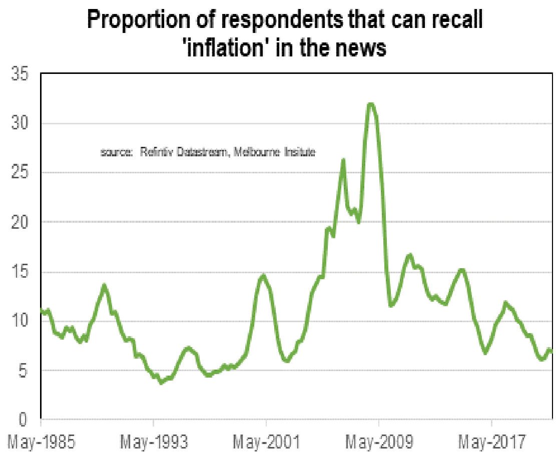
Over 60% of households goods and services are rising by under 2%.



To date inflation movements have been less surprising in Australia than elsewhere.



And this is probably the reason it has not made the news.



Inflation is picking up in Australia.....and that is good news

For much of the past fifty years rising inflation was seen as a bad thing. That is because it was too high, leading to a negative economic impact. But in recent years inflation has been too low (at least partly because economic growth has not been strong enough). So some rise of inflation is 'good' news as it is confirmation that the economy is improving.

The world economy is still in the process of opening up. Governments' in developed countries have largely been able to protect household and business incomes. This has enabled spending to bounce back quickly. But government restrictions and some consumer caution has meant that firms' have been unable to get the workers or materials they need to meet that higher demand. Australia has joined the global trend.

One result of not having the workers or materials is that production is lower and economic activity weaker. The Q2 GDP rise of 0.7% would have been higher if it was not for these supply problems. Too much demand and a lack of supply is leading to higher prices even in places such as Japan and Europe that have been fighting deflation for much of the past decade. In an environment of strong demand and a lack of supply firms have felt more comfortable about passing on some of these prices to customers. Australian consumer inflation expectations have risen.

Many analysts (including the RBA) believe this rise of inflation will prove to be temporary and disappear as economies fully re-open. There are good reasons to think this might occur. One example is that construction costs are on the rise reflecting the current big building boom. But approvals to build new homes have been slowing over the past few months reflecting the end of government incentive programs (HomeBuilder). This suggests that these costs will moderate. Petrol prices will also fall in time when the global supply of energy rises. But the re-opening process from the pandemic has taken longer than many people had envisaged just a few months ago.

What to do about supply chains

A growing number of firms have realised the supply-chain vulnerabilities created by COVID (and other recent catastrophes such as earthquakes, floods, cyclones and bushfires). It has been reported that many global firms may either look to increase the amount of inventory they hold or increase production closer to customers to reduce these vulnerabilities. A Mckinsey survey conducted in 2020 found 93% of supply-chain executives were looking to improve the resilience of their supply chains, including by nearshoring/regionalizing suppliers and reducing the proportion of unique parts.

Where possible firms' will look to diversify where they source their goods (and services). But supply chains have been set up to maximise efficiency. It will be very hard for (say) manufacturer's to quickly break those chains and source goods elsewhere. That is not to say that supply chains will never change. Rising cost structures has meant there has been some movement of production away from China. But that is more a geographical move of supply chains than a wholesale change in their structure. In time technological developments (such as 3D printing) could allow more production to be done cost effectively within Australia (or countries close by).

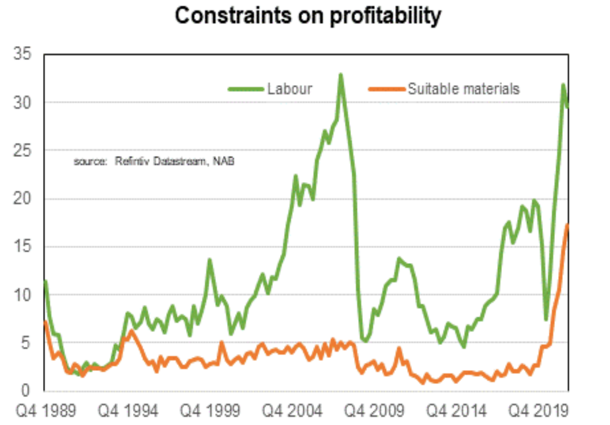
The key question is whether firms are able to sustainably pass on the higher costs of increasing inventory or making fundamental changes to their supply chains onto customers. That could happen in sectors where firms may receive government support (eg, areas of national importance such as defence and medical equipment). But as long as domestic producers face global competition it will be hard for many of them to sustainably pass on higher costs and remain competitive.

Sustainable inflation requires higher wages growth

The RBA (and other central banks) believe that sustainable inflation won't occur until wages growth picks up. The RBA has nominated a wages growth 'target' of over 3% as being consistent with achieving its inflation objectives. Technically it is not wages but labour costs adjusted for inflation (in the jargon, 'unit labour costs') that is the important variable for inflation. A more productive company can afford to pay higher wages. But economy-wide changes in productivity take time to engineer and so setting a wage-growth target is fine over a short time horizon (but needs to be regularly reviewed for any changes in productivity).

We will get an update on wages growth from a range of indicators in November/December. The last reading of the best measure (wages price index) was up just 1.7% in the year to June 2021. This was surprisingly low given the strength of the economy at that time and employer feedback about the extent of worker shortages. But wages growth can take time to change regardless of the state of the economy. In the 2000's wages growth was broadly flat at around 4% despite a rapidly declining unemployment rate. Nonetheless, all the indicators are that the jobs market is likely to be strong next year. And that firms are able to pass on at least some costs to customers. This suggests that wages growth will be picking up in coming quarters.

Many firms are facing material and worker shortages.



Does wages growth drive inflation, or does inflation drive wages growth?

Outlook for the RBA

At the time of writing financial markets have moved to pricing in the first full cash rate move (0.25%) by June next year, a cash rate of over 1% by end 2022, and a cash rate close to 1.75% by end 2023. That is a fairly substantive move from its current level of 0.1%.

Certainly, inflation is stronger than what the RBA (and most of the financial markets') had been forecasting. The RBA did not think that 'underlying' inflation would hit 2% until mid-2023. Headline inflation was expected to be 2.5% by the end of 2021. It is currently running at 3%.

I don't think there will any imminent cash rate hike. After having an extended period of inflation under their target the RBA is determined to make sure inflation is within band in coming years. That means they will need to see a number of quarters with inflation comfortably above 2%. And I am interpreting that as a couple of quarters of underlying inflation above 2.5%. If that is right then that rate could occur as early as the June quarter of next year. With the Q2 figures released in July that leaves open the possibility of an August 2022 rate move if inflation was the only driver of monetary policy.

But it is not. The key for a rate move is whether the RBA thinks that inflation is sustainably within 2-3%. And for that the RBA will need to see evidence that wages growth is above 3%. As noted we get our next set of wages readings in November/December. But at best a number of close to 3% is unlikely to take place until the end of next year (and more likely 2023). So it appears to me that financial markets have priced in too many interest rate increases too early.

That is not to say that the RBA will be doing nothing in coming months. Concerns about the virus have abated in recent weeks and the early signs are that the economy has bounced back well. Inflation is higher than anticipated. The RBA may not change the timing of their review of their quantitative easing program (QE, or buying federal and state government bonds) from February of next year. But the change in economic conditions means that they may finish their QE program by end September next year.

The other consideration for the RBA is their policy of yield curve control (or YCC, where the RBA holds down the 3-year government bond yields to around the cash rate of 0.1%). The current RBA view is that they won't be changing the cash rate to at least the first half of 2024. In line with that projection, the RBA is holding the government bond maturing in April 2024 to near 0.1% (it has risen a little in recent days). But the improved economic climate and higher inflation means financial markets are speculating on an earlier rate hike.

We have been here before. Back in June when the domestic economy was firing financial markets were actively speculating on a move in 2023 (and some even earlier). The RBA did not change their YCC policy but did appear open to a scenario where a move in the cash rate could be earlier than their H1 2024 projection.

I am open to the possibility that the RBA may abandon its YCC policy in coming months. They could reduce the amount of the curve they are controlling (say by only holding interest rates down for 1.5 years along the curve instead of the current 2.5 years) but it would be simpler to just remove all controls on interest rates (outside the cash rate). But to abandon their YCC they will need to be comfortable that inflation will stay within its target band. And for that they will need to see some substantive movement on the wages front.

COVID still means there must be some uncertainty about the economic outlook. And China is going through some challenging times. But the improved economic outlook, higher inflation outcomes, ongoing supply-chain problems and worker shortages means the chances of a cash rate move in 2023 have risen. Whether that is the case will depend upon what happens to wages. We will get a key reading of that on the 17th November (the release of the Wages Price Index).

We live in interesting times.

Regards

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