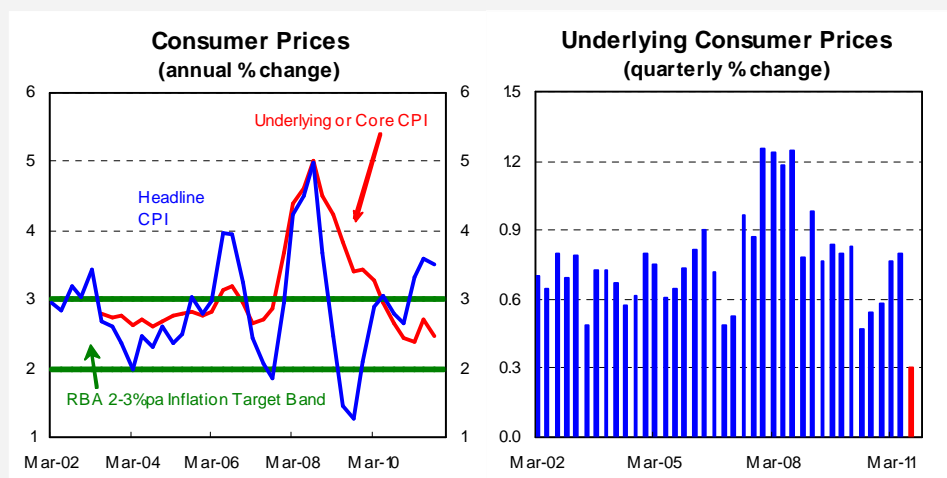


DATA SNAPSHOT

CPI - Tips The RBA Over the Rate Cut Line

Wednesday, 26 October 2011

- Underlying inflation shocked on the downside – rising by only 0.3% in the September quarter - well outside of consensus expectations and even the range of forecasts, including our own. Some of the shock has to do with the changes to the data brought about by the introduction of new weights and seasonal adjustment mechanisms.
- Nevertheless, it is clear that inflation is now contained. The RBA's existing forecasts for inflation to breach its target band by the end of the year are now unlikely to come to fruition. Indeed, the 0.3% rise in underlying inflation is the lowest quarterly rise in fourteen years and only the second lowest quarterly increase since 1982.
- The annual rate of underlying inflation has stepped down from 2.7% to 2.5% - the mid point of the RBA's target band, significantly shortening the odds of a rate cut from the RBA as soon as November 1, the day of the Melbourne Cup.
- We think the low inflation outcome is now enough to tip the RBA over the rate cut line, although it will remain a close decision. While we are now expecting the RBA to tap on the accelerator by 25bp, we do not think it will be the start of a deep rate-cutting cycle.



Underlying Inflation

Underlying inflation, which is the average of the trimmed mean and weighted median measures, rose just 0.3% in the September quarter. The small size of the rise came as a shock – consensus expectations were centred on growth of 0.6% (as were we) – and the outcome also fell well outside of the range of forecasts in the market of 0.5% to 0.8%.

Indeed, the 0.3% rise in underlying inflation is the lowest quarterly rise in fourteen years and only the second lowest quarterly increase since the June quarter of 1982.

The small size of the rise takes annual inflation down from 2.7% to 2.5% - the mid point of the Reserve Bank's medium-term 2-3% per annum target band.

Much of the surprise has to do with the 16th series of the CPI, which has introduced a new weighting to the categories in the CPI basket and new seasonal adjustment mechanisms. It meant there were revisions to the June quarter; when the June quarter data was first published under the 15th series, it reportedly rose by 0.9%, in the interim it was revised down to 0.6% growth and today has been revised back up to 0.8%.

Underlying inflation gives a truer picture of inflation by stripping out the volatility in the data compared with headline inflation. The greater focus is now on underlying inflation.

Headline Inflation

Headline inflation in original terms rose by 0.6% in the September quarter, in line with market expectations, taking the annual rate of growth down slightly to 3.5%. The headline inflation rate in seasonally adjusted terms rose by a smaller 0.4% in the quarter, but the annual rate fell to 3.5% (matching the original estimate).

Inflation for goods was low, printing at 0.2% growth in the quarter, while services inflation was stronger jumping 1.2% in the quarter. Annual growth in services inflation is also outpacing that of goods inflation – 3.9% compared with 3.2%.

Key contributors to the increase in the quarter were electricity (+7.8%), international holiday travel & accommodation (+5.1%), rents (+1.2%), water & sewerage (+8.6%) and property rates & charges (+5.2%). Capping the increase in inflation in the quarter were falls in pharmaceutical products (-5.0%), audio, visual & computing equipment (-3.3%), automotive fuel (-1.4%), vegetables (-2.5%), motor vehicles (-1.0%) and fruit (-1.2%).

Cash Rate Outlook

At the RBA's October Board meeting, it noted that an improved inflation outcome would increase the scope for monetary policy to provide some support to demand, should that prove necessary. Today's data then has shortened the odds for a rate cut significantly.

The RBA's existing inflation forecasts have underlying inflation breaching its target band at the end of the year and having a '3' in front over the forecast horizon period. But today's data means that when the RBA publishes its quarterly Statement on Monetary Policy report on November 4, its inflation forecasts will be downgraded. It is unlikely that underlying inflation will now breach the target over this horizon.

Recent domestic demand partial indicators have shown an improvement – including retail sales, housing finance, building approvals and employment growth. However, it is too early to assess if these improvements are the start of a lasting trend and they still remain on the soft side of the ledger. Together with the uncertainty about the European sovereign debt crisis, which is keeping intact the downside risks to the world economic outlook, the RBA is more likely to lean towards cutting rates.

There has been improved sentiment over the European sovereign debt crisis recently, but considerable uncertainty remains and we think that history has shown there is unlikely to be a quick resolution.

One could also argue for the RBA keeping its powder dry. For example, because of the recent improvement in domestic demand, the still low rate of unemployment, the weak productivity outcomes that mean unit labour costs are rising and the recent easing in financial conditions, for example through lower fixed mortgage rates.

However, the risks have been growing for a rate cut and the low inflation outcome now means that on balance, the RBA is more likely to cut rates by 25bp as soon as November 1, the day of the Melbourne Cup (when they next meet).

We do not think that this rate cut would precipitate a deep series of rate cuts. We think the November rate cut will be followed by another cut to rates in February 2012 and then we believe rates will be kept steady.

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