National Australia Bank

22 April 2013

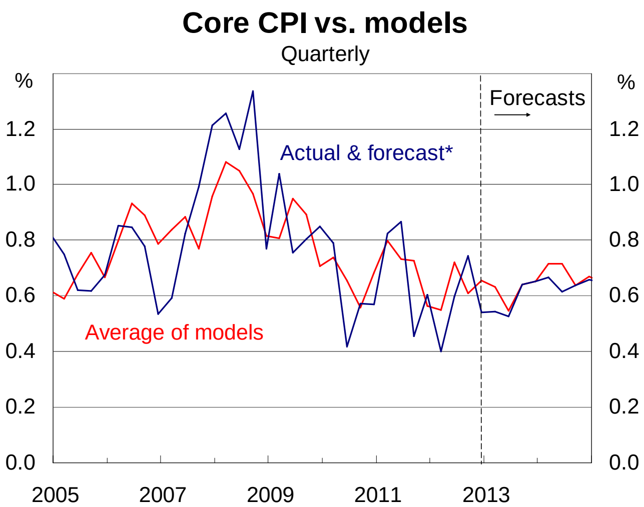
CPI preview – March quarter 2013

- With little indication of inflation pressures emerging in the early months of 2013, we expect the CPI release (due 24 April) to confirm that underlying inflation remained subdued in March quarter 2013.
- We see underlying inflation remaining within the RBA's target over the medium to longer term, with soft consumer spending, below-average labour cost pressures, a still high AUD and a shift in business focus towards increased efficiency expected to keep price pressures well contained.
- Core inflation in the March quarter is expected be 0.5% (2.5% through the year; including the impact of carbon), unchanged from the December quarter outcome and well within the RBA's comfortable range. Headline CPI inflation is expected to be a little stronger, at 0.7% (2.8% through the year), largely reflecting seasonal strength in a number of the CPI components, including pharmaceuticals, utilities, fruit & vegetable prices and automotive fuel.
- While 'green shoots' are emerging in official data for employment and retail trade, with equity and house prices strengthening as well, forward indicators of demand remain subdued and point to the prospect of continued sluggish growth over at least the first half of 2013.
- The appreciation of the Australian dollar together with soft consumer demand is expected to have kept underlying inflation well contained in the March quarter. The NAB Quarterly Business Survey suggests retail inflation was almost non-existent in the March quarter.
- Like us, the RBA seems very comfortable with the outlook for underlying inflation, stating in the minutes of its April meeting that "the inflation outlook, as assessed at present, would afford scope to ease policy further, should that be necessary to support demand". This raises the question, "what is the tipping point for further policy easing?". No doubt the RBA will remain focused on the performance of the non-mining sector, and in particular, the impact that previous stimuli are providing to this sector. But we remain unconvinced at this point that the non-resource sector will be able to fill the hole caused by the imminent passing of the resource investment peak next financial year,
- Combined with the expected rise in the unemployment rate to near 5¾% by mid year, these inferences imply the need for a further two 25 bps cuts, which we have tentatively pencilled in for June and November. However, timing is still very fluid, with higher house prices a possible delaying factor.

	Quarterly % change			*Year-ended % change*		
	Sep-12	Dec-12	Mar-13 (f)	Sep-12	Dec-12	Mar-13 (f)
Headline CPI	1.4	0.2	0.7	2.0	2.2	2.8
Core CPI (inc carbon tax)*	0.7	0.5	0.5	2.4	2.3	2.5

** Core CPI is the average of trimmed mean and weighted median CPI*

Underlying/core inflation[1]



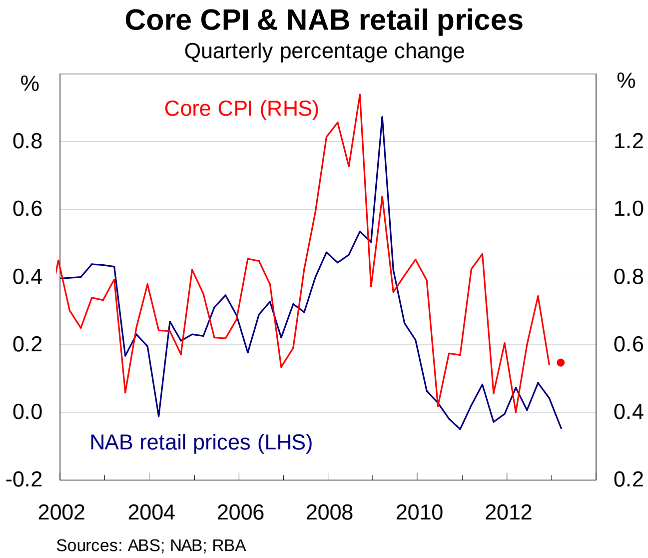
* Includes impact of carbon pricing
Sources: ABS; NAB; RBA

[1] The RBA targets an underlying rate of inflation, which is measured using the 'trimmed mean' and the 'weighted median' inflation rates. Both of these series are used by the RBA to assess the underlying rate of inflation in the economy. They do not represent an unchanging sub-group of goods and services. Trimmed mean inflation is defined as the average rate of inflation after 'trimming' away 15% of price changes at both ends of the distribution, while weighted median inflation is the rate of change in the item in the middle of the distribution.

NAB's models of underlying or core inflation are based on the size of the output gap, labour costs growth, productivity growth, currency movements, fuel prices and error correction mechanisms. In addition to our own models, we also monitor a model based on published RBA research, based principally on unemployment and import prices. The chart shows the fit of the average of NAB and RBA models is reasonably close. At least they seem to explain the core drivers of underlying inflation. A large part of the reason for our March quarter forecast remaining slightly less elevated than the level of inflation suggested by the models reflects our judgement from our survey that retailers have remained under intense pressure.

The NAB Quarterly Business Survey provides further evidence that retail inflation remains very subdued, pointing to underlying inflation of just 0.4% in the March quarter. Retail margins have also remained very tight, reflecting the stronger pace of purchase and labour costs inflation compared to prices. The annual growth rate of the wage price index (including bonuses) of 3.4% in the December quarter was the slowest pace since mid-2010. With labour market conditions seemingly still soft, it is likely that the softness in wages growth at the end of last year has persisted into early 2013, and it is unlikely to place upwards pressure on prices any time soon.

While ABS data show a sharp pick up in employment growth in February, which was partly unwound in March, we are reluctant to accept the extent of the overall improvement in labour market conditions implied by official data. Perhaps a more realistic measure of labour market conditions is the unemployment rate, which lifted to 5.6% in March. The softness implied by the unemployment rate, as well as other market measures of the labour market which have weakened appreciably in recent months, is likely to remain a concern for the RBA, and a potential trigger for further rate cuts.



Like us, the RBA seems very comfortable with the outlook for underlying inflation, expecting it to remain well within its 2-3% target band over the medium to longer term. With tight fiscal policy and some sectors of the economy experiencing depressed conditions (eg. consumer and trade dependent sectors), we believe there is still a need for further policy easing to set the economy back on a sustainable growth path. We see the need for two more rate cuts before the end of 2013; we have pencilled in two 25 bps cuts for June and November, taking the official rate to 2.50%. Timing will, however, be very data dependent. Further strength in house prices could cause the RBA to stay its hand, but unemployment is likely to be the key variable. While we expect a soft inflation outcome for the March quarter, within reason, a stronger pace of inflation is unlikely to change our view that further rate cuts are necessary.

Headline inflation

Headline CPI inflation is expected to have been a little stronger than the underlying rate in the March quarter. This largely reflects largely reflecting seasonal strength in a number of the CPI components. We anticipate headline inflation to rise to 0.7% (2.8% through the year).

Other specific factors impacting the March quarter headline CPI outcome

- **Housing costs** growth is likely to have risen modestly in early 2013, albeit from a very subdued 0.2% rise in the December quarter. Electricity and utilities price growth probably increased due to seasonal pricing, while there may still be residual impacts flowing through as a result of carbon pricing. Results from the NAB Residential Property Survey suggest that national housing rents rose by 1% in the March quarter – slightly stronger than 0.8% growth in housing rents reported in the December quarter CPI release. Nonetheless, the NAB Quarterly Business Survey showed a fairly benign pace of growth in construction costs and transport & utilities prices. Taken together, it appears that housing cost inflation may have lifted modestly in the March quarter.

- **Fruit & vegetable** prices (3.0% of spending) are estimated to have risen strongly over the March quarter, up by around 10% (not seasonally adjusted), more than offsetting a 2½% fall in the December quarter.
- **Transportation costs** appear to have risen over the March quarter, excluding seasonality. Automotive fuel prices at the pump (3.6% of household spending) are estimated to have increased by between 1½-2% in the quarter, consolidating a 2.6% rise in petrol prices in the December quarter.
- **Education** (3.2% of spending) and **health** (including pharmaceutical products and medical & hospital services; 5.3% of spending) prices tend to exhibit strong seasonal growth in the March quarter, and are likely to have contributed to solid inflation in overall prices.
- The **Australian dollar** strengthened notably in the first quarter of 2013 in trade weighted terms, to a high level relative to history. This is likely to have kept import price pressures fairly subdued. While the full impacts of currency adjustments take several quarters to fully filter through to domestic prices, it is likely that we are still seeing the deflationary impacts of currency appreciation over the past year or so, which is likely to have kept import price inflation soft in the March quarter, offsetting some of the strength in some of the key CPI components.

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