

AUSTRALIAN MARKETS WEEKLY



The impact of the housing downturn on inflation

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Analysis – The impact of the housing downturn on inflation

- Headline inflation picked up in Q2, increasing by 0.6% in the quarter and 1.6% over the year, where half the quarterly increase was due to a spike in petrol prices. At the other end of the spectrum, housing costs - which have the biggest weight in the CPI at 23% of the basket - continued to restrain inflation, falling for the first time since 1998. The weakness in housing costs reflects new home prices and rents, which also have largest single weights in the CPI at 8% and 7%, respectively. New home prices are barely growing, partly due to tighter access to credit, while rents are rising at the slowest rate in decades.
- The weakness in new home prices and rents has weighed slightly on core inflation as together they account for 22% of the trimmed mean CPI, which is the measure preferred by the Reserve Bank. Excluding these series, we estimate that trimmed mean inflation is closer to 2%, although it is not clear to us why housing services should be left out of the measurement of underlying inflation, especially when they account for a large share of overall spending, and when trend inflation should ideally average the same as headline inflation over time. Low interest rates should eventually produce a turnaround in housing costs, but we expect it to take time.

The week ahead – RBA testifies on policy; US/China trade tensions escalate

- Governor Lowe is testifying on policy on Friday, where he should expand on the decision to keep rates unchanged at 1% and retain an easing bias, elaborating on his view that rates are likely to stay low for an extended period. He will also offer an initial assessment on the intensification of the trade conflict between the US and China (the Deputy Governor should offer a more detailed assessment when he speaks on “Risks to the outlook” on 15 August). Note also that Governor Lowe is meeting with other central bankers at the Fed’s annual conference at Jackson Hole, where he is slated to speak on 25 August. As for the Statement on Monetary Policy, today’s policy press release indicates that there are material changes to the bank’s optimistic outlook for growth, although it will now take another year for inflation to return to the 2-3% target band. Unemployment should still fall, but from a higher starting point. On Wednesday, the RBNZ is widely expected to cut by 25bp to 1.25% and maintain an easing bias given the weaker world outlook.
- Internationally, the trade conflict between the US and China will dominate the economic data, with the latest intensification being the devaluation of the Chinese currency and the US Treasury accusing China of manipulating its currency.

To contact NAB’s market experts, please click on one of the following links:

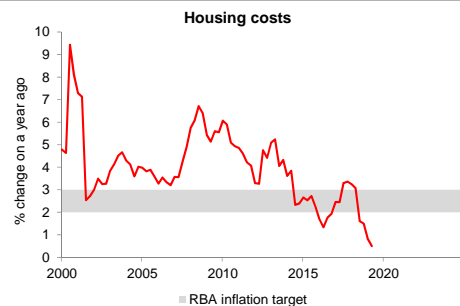
- [Ask the Economists](#)
- [Ask the FX Strategists](#)
- [Ask the Interest Rate Strategists](#)

Key markets over the past week

	Last	% chg week		Last	bp/% chg week
AUD	0.6785	-1.3	RBA cash	1.00	0
AUD/CNY	4.79	1.2	3y swap	0.74	-11
AUD/JPY	72.1	-3.4	ASX 200	6,498	-5.1
AUD/EUR	0.605	-1.9	Iron ore	95	-14.7
AUD/NZD	1.037	-0.3	WTI oil	55.1	-5.1

Source: Bloomberg

Chart of the week: Housing cost inflation is negligible



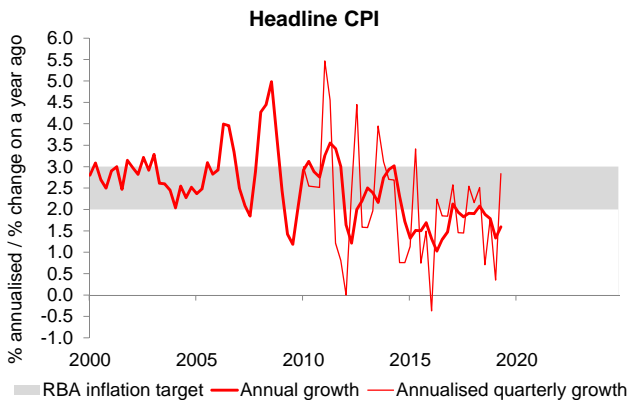
The impact of the housing downturn on inflation

- Headline inflation picked up in Q2, increasing by 0.6% in the quarter and 1.6% over the year, where half the quarterly increase was due to a spike in petrol prices. At the other end of the spectrum, housing costs - which have the biggest weight in the CPI at 23% of the basket - continued to restrain inflation, falling for the first time since 1998. The weakness in housing costs reflects new home prices and rents, which also have largest single weights in the CPI at 8% and 7%, respectively. New home prices are barely growing, partly due to tighter access to credit, while rents are rising at the slowest rate in decades.
- The weakness in new home prices and rents has weighed slightly on core inflation as together they account for 22% of the trimmed mean CPI, which is the measure preferred by the Reserve Bank. Excluding these series, we estimate that trimmed mean inflation is closer to 2%, although it is not clear to us why housing services should be left out of the measurement of underlying inflation, especially when they account for a large share of overall spending, and when trend inflation should ideally average the same as headline inflation over time. Low interest rates should eventually produce a turnaround in housing costs, but we expect it to take time.

Headline inflation picked up in Q2, mainly on higher petrol prices

The Q2 CPI showed headline inflation picked up in the quarter, with the CPI rising by 0.6% after holding steady in Q1. After seasonal adjustment, the CPI rose by 0.7% in Q2, which was the largest quarterly increase since 2015, with annual inflation picking up from 1.3% to 1.6%.

Chart 1: The CPI picked up sharply in Q2 ...

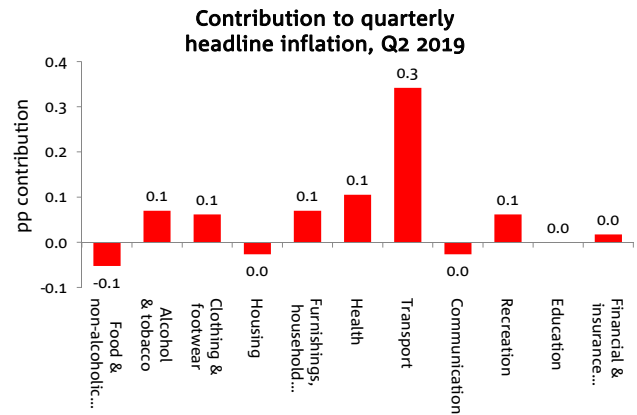


Note: The CPI excludes the impact of the GST. Annualised quarterly growth is seasonally adjusted.
Source: Australian Bureau of Statistics, Reserve Bank of Australia, National Australia Bank

The pick-up in inflation in the quarter was mainly due to higher petrol prices, which are included in the transport category. Prices rose by 10% in the quarter, adding 0.3pp to the CPI.

At the other end of the spectrum, the food, communication and housing categories were marginal drags on the CPI. Food prices fell as fruit and vegetable prices unwound an earlier flood-driven increase, while communication prices continued their trend decline.

Chart 2: ... mainly reflecting a spike in petrol prices



Source: Australian Bureau of Statistics, National Australia Bank

Housing costs, which have the largest weight in the CPI, were weak in the quarter

More interesting was the decline in housing costs, which fell by 0.2% in the quarter, where the Bureau of Statistics cited, "lower electricity and gas prices, weak housing market conditions and increasing rental vacancy rates in some capital cities".

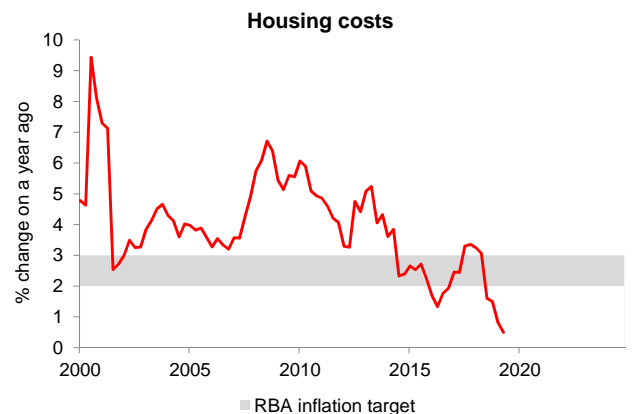
This was the first fall in original terms since 1998, although after seasonal adjustment costs were slightly higher, rising by 0.2%. Annual growth in housing costs has slowed to 0.5%, which is the smallest increase since costs declined in 1998.

However, the comparison with housing costs in the 1990s is not on a like-for-like basis. This is because in 1998 the Bureau of Statistics overhauled the measurement of housing costs by replacing mortgage-interest charges with new home prices (from a monetary policy perspective, interest charges created an undesirable *positive* correlation between interest rates and inflation).

As a result, since the late 1990s housing costs have comprised: (1) new owner-occupier home prices, which exclude land; (2) rents; (3) utilities, covering electricity, water, sewerage, and gas; (4) local council rates; and (5) maintenance/repair costs on existing homes.

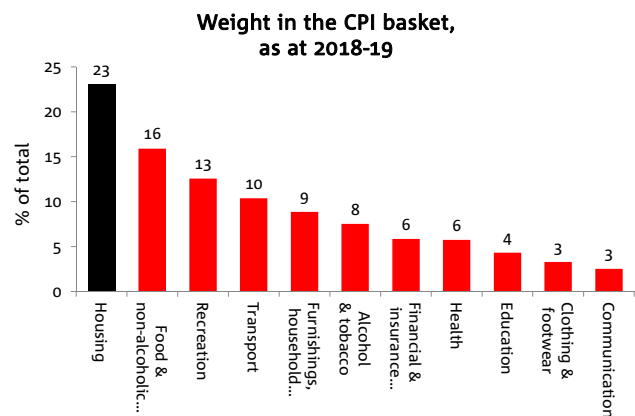
The weakness in housing costs is important given its influence on the overall CPI, as housing has the largest weight in the CPI, accounting for 23% of the total basket in 2018-19.

Chart 3: There is almost negligible pressure on inflation from housing costs



Source: Australian Bureau of Statistics, Reserve Bank of Australia, National Australia Bank

Chart 4: Housing costs have the largest weight in the CPI

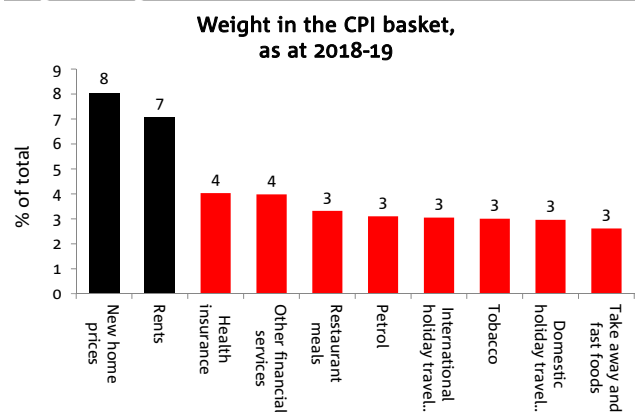


Source: Australian Bureau of Statistics, National Australia Bank

New home prices and rents have the largest single weights in the CPI and are barely growing

The two most important components of housing costs are new home prices and rents, which have the largest individual weights in the CPI at 8% and 7% of the basket in 2018-19, respectively.

Chart 5: New home prices and rents have the single largest weights in the CPI



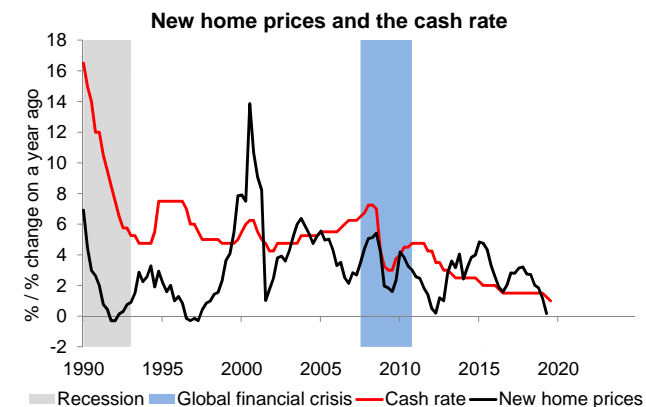
Source: Australian Bureau of Statistics, National Australia Bank

New home prices fell by 0.4% over the first half of 2019, which is the first decline in prices since 2012. This means that prices are little changed over the past year, increasing by only 0.2%.

While growth has been similarly weak a number of times over recent decades, past weakness has been triggered by high interest rates, whereas current weakness reflects tighter access to credit.

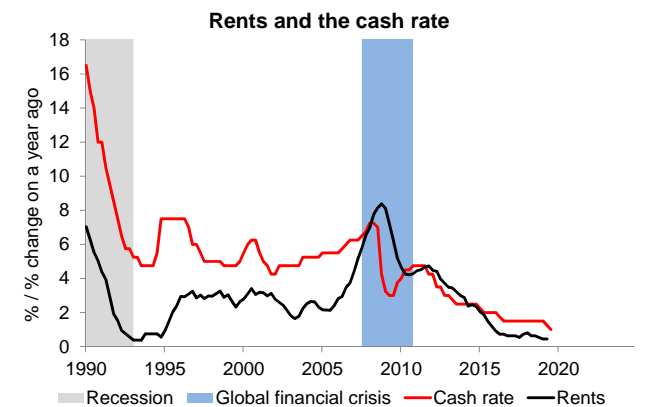
Rents are also very weak, up only 0.4% over the past year, equalling the low reached during the early 1990s recession, which itself marked the slowest growth since the late 1950s.

Chart 6: Weak new home prices reflect access to credit rather than higher interest rates



Note: The Q3 2019 observation for the cash rate is as at August.
Source: Australian Bureau of Statistics, Melbourne Institute, National Australia Bank

Chart 7: Weakness in growth in rents matches the multi-decade low reached in the early 1990s recession



Note: The Q3 2019 observation for the cash rate is as at August.
Source: Australian Bureau of Statistics, Melbourne Institute, National Australia Bank

The weakness in housing costs has fed into lower core inflation

The weakness in housing costs has also been reflected in the trimmed mean CPI, which is the Reserve Bank’s preferred measure of underlying inflation.

The trimmed mean CPI is based on weighted distribution of prices, where extreme price movements are excluded – or “trimmed” – from the calculation (the trimmed mean CPI used by the Bureau of Statistics and the Reserve Bank trims 30% of the distribution). Unlike traditional exclusion measures of underlying inflation, this means that the mix of goods and services included in the trimmed mean CPI varies over time.

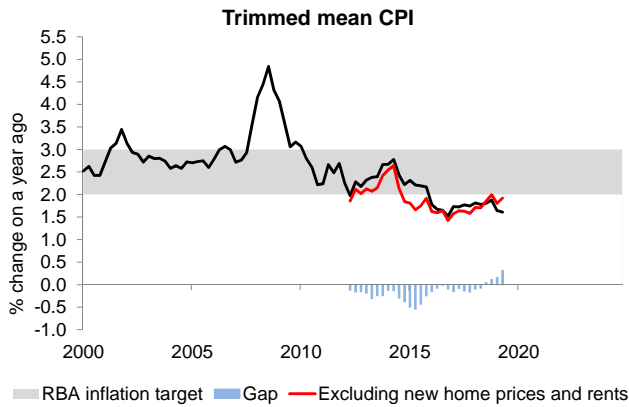
However, new homes and rents are generally included in the trimmed mean CPI because their price movements tend to be smooth. For example, in Q2 2019, new home prices accounted for 12% of the trimmed mean CPI, while the share of rents was 10%.

To gauge the impact of housing costs on core inflation, we calculated the trimmed mean CPI excluding new home prices and rents. This narrower measure of inflation has been below the 2-3% target band almost continuously since 2014, tracking about 0.1-0.5pp below published trimmed mean inflation over most of this decade.

Recently, this modified measure of inflation has picked up from about 1.5% to 1.7-1.9%, briefly reaching the bottom of the target band at the end of last year. As a result, this series has been about 0.1-0.3pp *above* published trimmed mean inflation since Q3 2018.

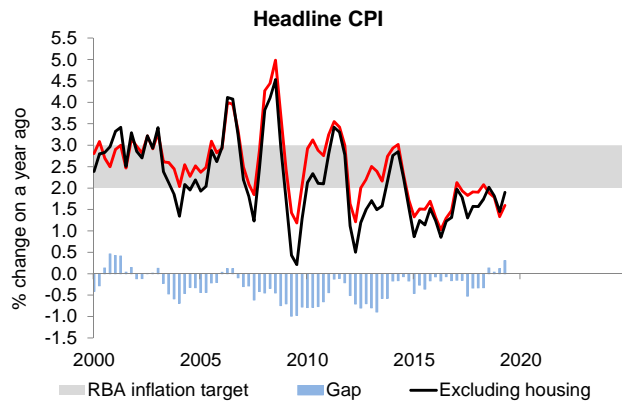
This mimics the gap between the headline CPI and the CPI excluding all housing costs, where the CPI ex-housing costs has also exceeded headline inflation over recent quarters.

Chart 8: Truncated mean inflation excluding new home prices and rents is now slightly higher than published trimmed mean inflation



Note: The gap is the trimmed mean inflation rate excluding new home prices and rents minus the published trimmed mean inflation rate.
Source: Australian Bureau of Statistics, Reserve Bank of Australia, National Australia Bank

Chart 9: This mimics the gap between the CPI ex-housing and the headline CPI



Note: The gap is the headline inflation rate ex-housing costs minus published headline inflation.
Source: Australian Bureau of Statistics, Reserve Bank of Australia, National Australia Bank

It's not clear why housing costs should be excluded from core inflation

While this analysis shows that earlier strength in new home prices and rents boosted underlying inflation and that current weakness is now restraining inflation, it is not clear to us why new home prices and rents should be excluded from core inflation. After all, consumer prices should capture the cost of consuming the flow of services from housing.

Also, from a practical perspective, a key reason for estimating core inflation is that it should approximate the trend in inflation, such that it needs to average the same rate as headline inflation over time. This is difficult to achieve if housing costs are left out of the calculation.

Nonetheless, it seems likely that housing costs will weigh on core inflation for some time yet, particularly when low rental yields reflect low interest rates and given there will be downward pressure on rents as more apartments come on to the market. Lower interest rates should eventually produce a turnaround in housing costs, especially when the population continues to grow at a strong rate, but it may take time.

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CALENDAR OF ECONOMIC RELEASES

Country	Economic Indicator	Period	Forecast	Consensus	Actual	Previous	GMT	AEST
Tuesday, 06 August 2019								
US	ISM Non-Manufacturing Index	Jul		55.5		55.1	14.00	0.00
GE	Factory Orders MoM	Jun		0.8		-2.2	6.00	16.00
Wednesday, 07 August 2019								
NZ	QV House Prices YoY	Jul		--		2	17.00	3.00
AU	AiG Perf of Construction Index	Jul		--		43	22.30	8.30
AU	Home Loans MoM	Jun	1.0	0.2		-0.1	1.30	11.30
NZ	RBNZ Official Cash Rate	Aug 7	1.25	1.25		1.5	2.00	12.00
GE	Industrial Production SA MoM	Jun		-0.9		0.3	6.00	16.00
GE	Industrial Production WDA YoY	Jun		--		-3.7	6.00	16.00
Thursday, 08 August 2019								
CH	Trade Balance	Jul		37		50.98	14.00	0.00
CH	Exports YoY	Jul		-2.6		-1.3	14.00	0.00
CH	Imports YoY	Jul		-7		-7.3	14.00	0.00
JN	BoP Current Account Balance	Jun		1200		1594.8	23.50	9.50
Friday, 09 August 2019								
US	Wholesale Inventories MoM	Jun F		0.2		0.2	14.00	0.00
NZ	ANZ Truckometer Heavy MoM	Jul		--		-4.5	22.00	8.00
NZ	Net Migration SA	Jun		--		4240	22.45	8.45
AU	RBA Governor's Parliamentary testimony on monetary policy							9:30
JN	GDP SA QoQ	2Q P		0.2		0.6	23.50	9.50
JN	GDP Annualized SA QoQ	2Q P		0.6		2.2	23.50	9.50
JN	GDP Deflator YoY	2Q P		0.4		0.1	23.50	9.50
AU	RBA Statement on Monetary Policy	Aug						11.30
CH	CPI YoY	Jul		2.7		2.7	1.30	11.30
CH	PPI YoY	Jul		-0.1		0	1.30	11.30
UK	Monthly GDP (MoM)	Jun		0.1		0.3	8.30	18.30
UK	GDP QoQ	2Q P		0		0.5	8.30	18.30
UK	GDP YoY	2Q P		1.4		1.8	8.30	18.30
UK	Industrial Production MoM	Jun		0		1.4	8.30	18.30
UK	Industrial Production YoY	Jun		-0.1		0.9	8.30	18.30
CH	New Yuan Loans CNY	Jul		--		1660		
CH	Money Supply M2 YoY	Jul		--		8.5		
CA	Housing Starts	Jul		--		245.657	12.15	22.15
CA	Net Change in Employment	Jul		--		-2.2	12.30	22.30
US	PPI Final Demand MoM	Jul		0.2		0.1	12.30	22.30
CA	Unemployment Rate	Jul		--		5.5	12.30	22.30
CA	Hourly Wage Rate Permanent Employees YoY	Jul		--		3.6	12.30	22.30
US	PPI Final Demand YoY	Jul		1.7		1.7	12.30	22.30
Upcoming Central Bank Interest Rate Announcements								
Australia, RBA		Sep 3	1.00	1.00		1.00		
New Zealand, RBNZ		Aug 7	1.25	1.25		1.50		
Europe, ECB		Sep 12	-0.50	-0.50		-0.40		
Japan, BoJ		Sep 19	-0.10	-0.10		-0.10		
US, Federal Reserve		Sep 18	2/1.75	2/1.75		2.25/2		
UK, BOE		Aug 1	0.75	0.75		0.75		

GMT: Greenwich Mean Time; AEST: Australian Eastern Standard Time

FORECASTS

Economic Forecasts																				
	Annual % change				Quarterly % change															
	2018	2019	2020	2021	2018				2019				2020				2021			
Australia Forecasts	2018	2019	2020	2021	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Household Consumption	2.6	1.5	2.2	2.3	0.4	0.8	0.3	0.4	0.3	0.3	0.4	0.7	0.6	0.5	0.5	0.5	0.6	0.6	0.5	0.6
Underlying Business Investment	0.9	0.9	4.3	3.6	0.6	-1.0	-2.1	0.0	0.6	1.0	0.8	1.8	0.3	1.8	0.4	1.4	0.4	1.0	0.8	1.4
Residential Construction	4.7	-8.2	-8.3	-1.6	4.1	1.7	0.7	-2.9	-2.5	-3.3	-3.0	-2.2	-2.0	-1.8	-1.9	-0.8	-0.2	0.5	0.2	0.8
Underlying Public Spending	5.0	5.4	4.5	4.1	1.4	0.4	2.5	1.6	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0
Net Exports (a)	0.7	0.6	-0.3	-0.4	0.5	0.2	0.3	-0.2	0.2	0.3	0.1	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Inventories (a)	0.1	-0.2	-0.1	0.0	-0.1	0.2	-0.3	0.2	-0.1	-0.1	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic Demand (q/q %)	-	-	-	-	0.9	0.6	0.5	0.4	0.1	0.3	0.4	0.7	0.6	0.7	0.5	0.7	0.6	0.7	0.7	0.8
Dom Demand (y/y %)	2.9	1.4	2.3	2.7	3.4	3.2	2.8	2.4	1.6	1.3	1.2	1.6	2.0	2.4	2.5	2.5	2.5	2.6	2.7	2.8
Real GDP (q/q %)	-	-	-	-	1.0	0.9	0.3	0.2	0.4	0.4	0.4	0.8	0.5	0.6	0.5	0.6	0.5	0.6	0.5	0.7
Real GDP (y/y %)	2.8	1.7	2.3	2.3	3.1	3.1	2.8	2.4	1.8	1.3	1.5	2.1	2.2	2.3	2.4	2.2	2.2	2.3	2.3	2.4
CPI headline (q/q %)	-	-	-	-	0.4	0.4	0.4	0.5	0.1	0.6	0.4	0.6	0.4	0.4	0.5	0.7	0.5	0.5	0.6	0.7
CPI headline (y/y %)	1.9	1.6	1.8	2.2	1.9	2.1	1.9	1.8	1.4	1.7	1.6	1.6	1.9	1.7	1.8	1.9	2.0	2.2	2.3	2.3
CPI underlying (q/q %)	-	-	-	-	0.5	0.5	0.3	0.4	0.2	0.4	0.3	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5
CPI underlying (y/y %)	1.8	1.4	1.5	1.9	1.9	1.7	1.7	1.7	1.4	1.4	1.4	1.3	1.5	1.4	1.5	1.6	1.8	1.9	2.0	2.0
Private wages (q/q %)	-	-	-	-	0.5	0.6	0.6	0.5	0.5	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Private wages (y/y %)	2.1	2.3	2.5	2.8	1.9	2.1	2.2	2.3	2.4	2.3	2.3	2.4	2.5	2.5	2.6	2.6	2.7	2.7	2.8	2.8
Unemployment Rate (%)	5.3	5.2	5.3	5.4	5.5	5.5	5.1	5.0	5.1	5.2	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.4	5.5	5.5
Terms of trade	1.8	2.9	-3.8	-1.5	3.2	-1.2	1.1	2.9	3.1	-1.1	-2.6	-1.4	-0.6	-1.0	0.4	-0.2	-0.2	-0.8	-0.8	-0.5
Current Account (% GDP)	-2.0	-0.9	-1.8	-2.4	-2.2	-2.5	-2.1	-1.3	-0.6	-0.5	-1.1	-1.4	-1.5	-1.8	-1.8	-1.9	-2.0	-2.3	-2.6	-2.8

Source: NAB Group Economics; (a) Contributions to GDP growth

Exchange Rate Forecasts

	6-Aug	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
Majors						
AUD/USD	0.679	0.71	0.73	0.74	0.75	0.75
NZD/USD	0.65	0.67	0.68	0.69	0.70	0.70
USD/JPY	106.3	107	108	107	106	105
EUR/USD	1.12	1.12	1.13	1.13	1.13	1.14
GBP/USD	1.22	1.22	1.24	1.24	1.25	1.27
USD/CNY	7.05	6.96	6.95	6.92	6.90	6.85
USD/CAD	1.32	1.33	1.30	1.29	1.27	1.28
USD/CHF	0.97	0.98	0.98	1.02	1.02	1.00

Australian Cross Rates

AUD/NZD	1.04	1.06	1.07	1.07	1.07	1.07
AUD/JPY	72.1	76	79	79	80	79
AUD/EUR	0.60	0.63	0.65	0.65	0.66	0.66
AUD/GBP	0.56	0.58	0.59	0.60	0.60	0.59
AUD/CNY	4.79	4.94	5.07	5.12	5.18	5.14
AUD/CAD	0.90	0.94	0.95	0.95	0.95	0.96
AUD/CHF	0.66	0.70	0.72	0.75	0.77	0.75

Interest Rate Forecasts

	6-Aug	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
Australian Rates						
RBA cash rate	1.00	1.00	0.75	0.75	0.75	0.75
3 month bill rate	0.99	1.10	0.85	0.85	0.85	0.85
3 Year Swap Rate	0.75	0.80	0.80	1.10	1.25	1.40
10 Year Swap Rate	1.23	1.38	1.38	1.53	1.63	1.73
Offshore Policy Rates						
US Fed funds	2.25	2.00	2.00	2.00	2.00	2.00
ECB deposit rate	-0.40	-0.60	-0.60	-0.60	-0.60	-0.60
BoE repo rate	0.75	0.75	0.75	0.75	0.75	0.75
BoJ excess reserves rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
RBNZ OCR	1.50	1.25	1.25	1.25	1.25	1.25
China 1yr lending rate	4.35	4.10	4.10	4.10	4.10	4.10
China Reserve Ratio	13.5	13.00	12.50	12.00	12.00	12.00
10-year Bond Yields						
Australia	1.02	1.20	1.20	1.35	1.45	1.55
United States	1.73	1.90	1.90	2.00	2.10	2.20
New Zealand	1.28	1.60	1.65	1.85	2.00	2.20

Sources: NAB Global Markets Research; Bloomberg; ABS

Global GDP

	2018	2019	2020	2021
Australia	2.8	1.7	2.3	2.3
United States	2.9	2.4	1.7	1.7
Eurozone	1.8	1.2	1.3	1.4
United Kingdom	1.4	1.5	1.4	1.5
Japan	0.8	0.7	0.4	0.9
China	6.6	6.3	6.0	5.8
India	7.1	6.7	7.2	7.1
New Zealand	2.8	2.4	2.6	2.5
World	3.6	3.2	3.3	3.5

Commodity prices (\$US)

	6-Aug	Sep-19	Dec-19	Mar-20	Jun-20
Brent oil	60.2	68	70	70	75
Gold	1464	1334	1382	1393	1398
Iron ore	105	79	76	72	68
Hard coking coal*	156	178	170	165	160
Thermal coal	68	85	90	93	90
Copper	5660	6400	6300	6225	6150
Aus LNG**	9	12	12	12	12

* FOB quarterly contract prices (thermal coal is JFY contract)

** Implied Australian LNG export prices

CONTACT DETAILS

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