NAB Monetary Policy Update 7 Nov 2023

NAB expects follow up hike in February

NAB Economics

Key points

- The RBA delivered on expectations for a rate rise at its November meeting – taking the cash rate to 4.35%. Reflecting recent data, the staff's inflation outlook has been revised up and we now see one further rise as likely to balance the risks, pencilling in a 4.6% rate peak in February, though December is live.
- As expected, the re-acceleration in underlying inflation in Q3 as well as ongoing resilience in consumer spending and the labour market has forced a material upwards revision to the RBA's forecasts – not just in the near term but through the profile. Unemployment now peaks lower and inflation returns to the top of the target range only at the end of 2025. The full staff forecasts will be released Friday.
- Recent communication from Governor Bullock has made clear the Board was already at the limit of its tolerance for inflation remaining above target. Given the revisions to the outlook, we expect the Board to form the view that a single 25bp adjustment to rates is not enough to mitigate the risks on inflation – seeing a further rise, most likely in February after the Q4 CPI.
- Looking further ahead, given the resilience of the economy and labour market thus far we now see rate cuts as unlikely to begin until November (previously August) with gradual cuts through 2025 and early 2026 to 3.1%, around the long-run neutral level.

Strong Q3 CPI and resilient activity data trigger November rate rise.

As expected, the Q3 CPI saw some re-acceleration of underlying inflation and while petrol prices contributed to the result, the breadth of pressures was evident in the trimmed mean which printed at 1.2% q/q (5.2% y/y). Domestically sensitive services components remain strong with market services (excluding volatile travel and telecommunications) running at 1.6% q/q and non-tradables inflation at 1.3% q/q.

The persistent strength of these domestic inflation measures aligns with the resilience seen in indicators of activity. NAB's business surveys show business conditions and capacity utilisation still above average, and consumer demand also appears to have remained robust through Q3 with retail sales volumes increasing 0.2% q/q – ending a run of three quarters of decline and pointing to a reasonable pickup in wider consumption in the quarter.

The labour market also remains fundamentally very tight with the unemployment rate ticking back down to 3.6% in September (albeit the pace of employment growth appears to have eased). A strong Q3 wage growth figure is also likely, partly reflecting minimum and award wage increases as well as wider wages resetting in July. Employment and wage growth have supported incomes while also continuing to create labour cost pressures for businesses, contributing to inflation on the services side alongside energy and rents.

Our view for some time has been that the Q3 CPI would trigger a material upward revision to the RBA's inflation forecasts, prompting the Board to further tighten monetary policy settings as 'insurance' against inflation remaining above target for too long. The November meeting delivered on this expectation with the Board statement conceding that inflation "is proving more persistent than expected a few months ago" and "the risk of inflation remaining higher for longer has increased".

Revised inflation outlook enough to warrant some further tightening.

The resilience in recent activity data suggests the economy is weathering the period of elevated inflation and the adjustment to higher rates better than had been expected. While households are under pressure, incomes have been supported by employment and wage growth, savings rates have adjusted, and stronger-than-expected population growth has supported aggregate demand.

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The recent data flow has been reflected in revisions to the RBA staff's forecasts, which now see inflation at 3½% by end-2024 (previously 3¼%) and only returning to the top of the 2-3% target band by end-2025 (previously mid-2025 for trimmed-mean inflation). Unemployment is also forecast to peak lower, at 4¼% (previously 4½%). The full RBA forecasts will be released in the *Statement on Monetary Policy* on Friday.

The post-meeting statement added that "whether" any further tightening of monetary policy is needed "will depend upon the data and the evolving assessment of risks", somewhat softening the hiking bias of prior statements. In our view however, the revisions to the outlook mean a single 25bp adjustment is unlikely to be seen as enough to offset the upside risks. As such, we pencil in a further hike to a 4.6% peak – most likely in February, when the Board will have the benefit of the full Q4 CPI to assess the evolution of inflation pressures (though December is a live possibility).

Rates cuts now unlikely until late 2024, with a gradual easing profile.

Similar to the RBA, NAB's own activity and labour market forecasts will be upgraded when released later in the month. We still see below-trend GDP growth in both 2023 and 2024 but quarterly consumption growth is set to remain positive, and, in our assessment, unemployment should peak closer to 4.5% than 5%.

A more limited deterioration in the labour market will mean less pressure on the RBA to ease policy settings, and with year-ended inflation remaining clearly above target through 2024, we now see the cash rate as likely to remain on hold (at the revised peak of 4.6%) until November 2024. From there, we see a gradual profile of normalisation, and pencil in 25bp rate cuts per quarter back to 3.1% by early 2026. That is a level that we see as around the long-run neutral rate.

On balance, we see a 4.6% peak as sufficiently restrictive to offset domestic inflation pressures while remaining below the levels of rates seen elsewhere, in line with the Board's stated preference to tolerate a slower path of disinflation in order to try to maintain post-pandemic employment gains. Still, the flow of data will remain critical as the Board assesses the trajectory of inflation in a highly dynamic and uncertain environment.

Table 1: Updated cash rate profile

	2023		2024				2025				2026
	Nov	Dec	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Cash Rate	4.35	4.35	4.60	4.60	4.60	4.35	4.10	3.85	3.60	3.35	3.10

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