7 July 2022

ECONOMY WATCH

Q2 CPI seen +1.5% q/q on trimmed mean and 1.9% on headline

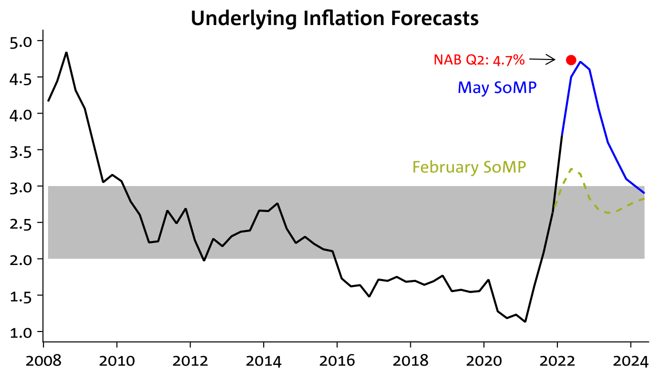
- Q2 CPI is on Wednesday 27 July and we forecast Headline of 1.9% q/q and 6.3% y/y. For the more closely watched core trimmed mean measure, we look for an increase of 1.5% q/q and 4.7% y/y, with the risks tilted to the upside. Such a quarterly rise for trimmed mean would be the highest quarterly increase since Q4 1990, and importantly on a six-month annualized would be at 5.9%.
- The RBA is already braced for a punchy number with Governor Lowe expecting headline inflation to peak at close to 7% y/y in Q4 2022 (this revealed in a recent speech and revised higher from the 5.9% in the May SoMP). As for core inflation, the RBA's May SoMP forecasts implied a 1.3% q/q for Q2. If CPI prints line with our forecasts, that will keep the pressure on the RBA to continue to normalise quickly.
- In terms of the CPI drivers, these are outlined in detail below. The lift in inflation to date has been concentrated in goods, fuel, and construction costs. In Q1, these factors were joined by a higher food prices and a lift in CPI rents. In Q2, the NAB Business Survey suggests the cost-push inflation impulse has broadened across industries and is being readily passed on into end prices.
- As for the largest contributions, we expect a still very-high construction cost increase and another large contribution from fuel which will together add around 0.6ppt to the quarterly headline number. Add to that an expected large q/q rise in fruit and veg prices on flood impacts and we get to a headline estimate of 1.9% q/q.
- For monetary policy, the RBA will be looking closely at both how high inflation prints, as well as how broad inflation is across the economy. A print in line with our forecasts would be consistent with the RBA needing to normalise policy quickly with another 50bp hike in August. We currently see the RBA cash rate getting to 2.10% by the end of 2022 and peaking at 2.6% in 2023, with the risk the RBA wants to get to its self-assessed neutral rate of 2.5% by the end of the year.
- Important for the RBA is whether they can continue to chart a credible path back to at-target inflation. The RBA's July post-Meeting Statement suggests they can, seeing "*Inflation is forecast to peak later this year and then decline back towards the 2-3 per cent range next year*". Much of that profile depends on an easing of global inflation pressures and inflation expectations remaining "*well anchored*", as well as the response of wages growth at low levels of unemployment.
- A trimmed mean inflation print that surprises higher driven by broad domestic items could make the case for more aggressive action. A core number near 1¾% q/q would in our view make it very difficult for the RBA to end its hike cycle at neutral, with the need to move policy into restrictive territory given inflation would be seen more persistent than previously thought. Such an upside surprise would also likely lead to an active debate at the August meeting of hiking by 50bp, or a more aggressive 65-75bp move, though monthly meetings mean more 50bp increases would still deliver a rapid tightening.

Table 1: Consumer Price Index Forecasts

	Actual				
	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22
Headline CPI					
CPI - NSA					
%q/q	0.8	0.8	1.3	2.1	1.9
%y/y	3.8	3.0	3.5	5.1	6.3
Core Measures					
Trimmed Mean					
%q/q	0.5	0.7	1.0	1.4	1.5
%y/y	1.6	2.1	2.6	3.7	4.7
Weighted median					
%q/q	0.4	0.8	0.9	1.0	1.3
%y/y	1.5	2.1	2.5	3.2	4.2

Source: National Australia Bank, ABS

Chart 1: Inflation seen higher than RBA forecast in Q2



Source: National Australia Bank, ABS, RBA

Taylor Nugent, Economist, Markets

Q2 CPI: Key points

We look for a broad-based acceleration in inflationary pressures in Q2 that would further pressure the RBA as it seeks to chart a credible path back to 2-3% inflation.

An overlapping storm of inflationary pressures is seen driving price increases across the basket.

- High goods spending facing into a still-constrained supply side that had earlier positioned for an extended slowdown
- Increased demand for residential space
- Frictional reopening pressure across services and travel as pent-up demand outpaced capacity rebuild
- Energy and food price shocks emanating from Russia's invasion of Ukraine
- Flooding in NSW and south-east Queensland
- Tight labour markets and strong domestic demand

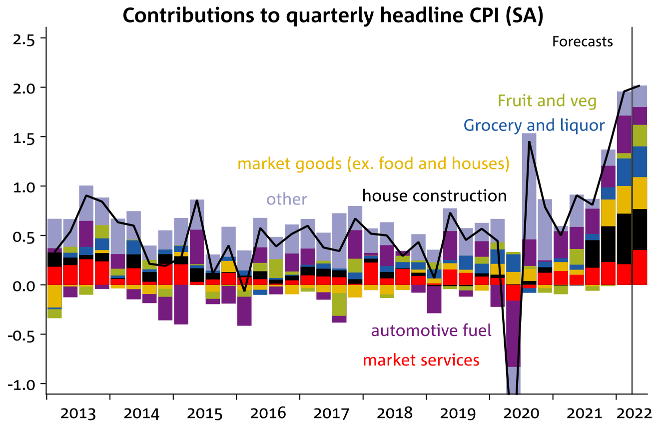
Apart from the domestic labour market and demand backdrop, most of these thematic drivers are unlikely drivers of persistent inflation pressures. That is small consolation, though, to a Central Bank attuned to the risk of elevated inflation resulting in a shift to 'inflation psychology' or a self-sustaining momentum on the back of a too-fast acceleration in wages growth. In that context, we see a high and broad Q2 CPI print keeping the pressure on the RBA to move quickly towards more neutral settings. Risks of an even stronger underlying inflation print are meaningful.

The NAB Survey continues to indicate firms are willing and able to pass upstream cost pressures on to end consumers. The initial lift in cost pressures was concentrated in wholesale, construction and manufacturing, reflecting the concentration in goods and house construction demand and prices. The recent surge in energy and fuel costs, alongside an uptick in domestic labour cost growth, has seen cost pressures broaden. In what follows, we step through some of the key drivers of our component level forecasts.

Food

Food price inflation was subdued through most of 2021 even as other parts of the basket were moving higher. We pencil in **2.0% q/q sa increase in Q2 for grocery and liquor prices (excluding fruit and veg)**. In Q1, grocery inflation moved higher by 1.9% q/q and was a key contributor to the further acceleration in price rises in the quarter. In Q2, that story is expected to continue given survey data, company reporting and anecdotal evidence, as well as more timely data and our internal price tracking.

Chart 2: Goods, Homebuilding and Fuel driving CPI



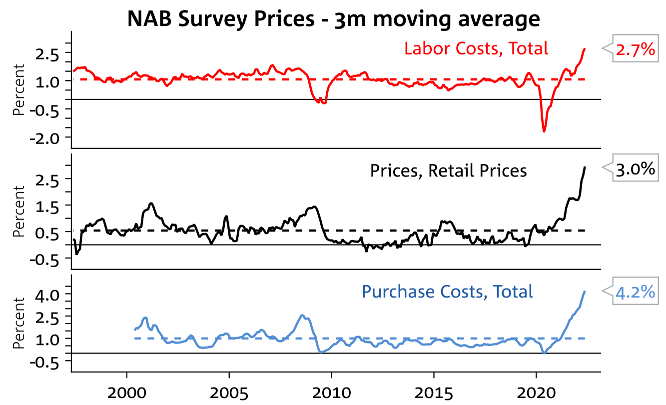
Source: National Australia Bank, ABS

Table 2: Component Forecasts

Consumer Price Index - Component Expectations	Mar-22	NAB Jun-22	NAB Qtr cont.	in CPI Basket
Food and non-alcoholic beverages	2.8	2.4	0.4	16.8
Fruits and vegetables	*5.8*	*7.8*	*0.2*	*2.3*
Restaurants and takeaway	*0.7*	*1.4*	*0.1*	*6.4*
Alcohol and tobacco	1.1	1.3	0.1	9.0
Clothing and footwear	-0.6	2.2	0.1	3.3
Housing	2.7	2.3	0.5	23.2
Rents	*0.6*	*1.0*	*0.1*	*6.2*
New dwellings	*5.7*	*4.5*	*0.4*	*8.7*
Utilities	*1.1*	*1.0*	*0.0*	*4.4*
Household equip and services	1.1	2.2	*0.2*	9.2
Health	2.3	2.2	0.1	6.5
Transport	4.2	2.0	0.2	10.6
Automotive fuel	*11.0*	*4.5*	*0.1*	*3.3*
Communication	0.3	0.2	0.0	2.4
Recreation and culture	0.6	1.4	0.1	8.6
Domestic travel and accom.	*0.3*	*2.0*	*0.0*	*2.0*
Education	4.5	-0.2	0.0	4.6
Insurance and financial services	0.5	0.9	0.1	5.8
Headline CPI	**2.1**	**1.9**	**1.9**	--
Trimmed Mean, sa	1.4	1.5	--	70
Weighted Median, sa	1.0	1.3	--	--

Source: National Australia Bank, ABS

Chart 3: Input prices to find their way to goods inflation



Source: National Australia Bank (NAB Business Survey)

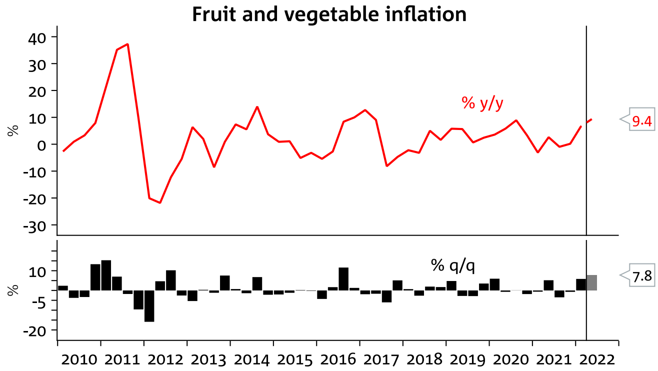
As for the volatile **fruit and veg components, we pencil in an increase of 8% q/q.** Flood disruptions have added to extant input cost pressures to drive a surge in wholesale prices for a range of fruit and veg items, especially for vegetables. Sizing up the move in measured retail prices is difficult for this volatile component. One key measurement point to note here is that the CPI since Q4 2017 takes advantage of scanner data and multilateral index methods that allow for more timely information on substitution between product-level categories within certain expenditure classes. That means that within the 'vegetable' component the measured price will account for some of the substitution away from expensive products such as iceberg lettuce towards relatively cheaper products. As a result of capturing consumers actual spending patterns in a timelier way, the impact of large price swings in some products will be smaller than in previous shocks, such as the large price rise for bananas in 2011 from cyclone Yasi.

Rounding out the food component is takeaway and restaurant prices. We pencil in 1.4% q/q, reflective of broadening inflation pressure. Some of the same pressures as grocery and the input cost pressures across agricultural commodities and food more broadly exist alongside strong demand and emerging labour cost pressure. Retail sales data showed very strong nominal spending in April and May, with the ABS specifically noting higher prices were most evident in cafes, restaurants and takeaway food and food retailing. Stimulus measures, namely Dine and Discover in NSW and Midweek Melbourne Money, continue to have an effect and add some uncertainty. The use of these vouchers subtracts from prices and took 0.5ppt off growth in Q1. These programs continued in Q2, and we assume a broadly similar uptake and no impact on growth, before the end of the programs supports growth in Q3, but much will depend on their relative uptake in Q2 vs Q1.

Goods

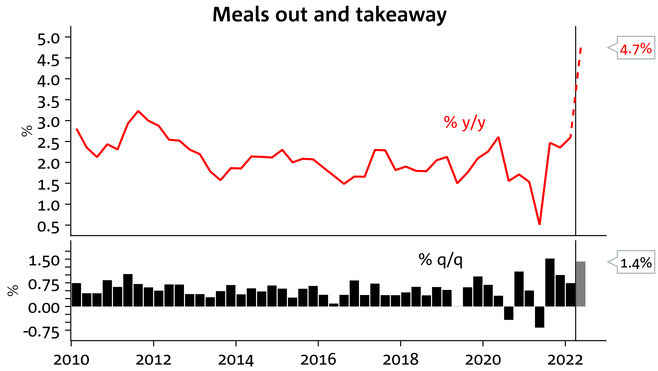
We expect elevated goods price inflation to sustain in Q2 as cost pressures remain. The pick up on goods price inflation has been a key driver of the lift in inflation from pre-pandemic levels. Market goods excluding tobacco, which was seeing large increases in prices from regular excise increases prior to the pandemic, and food and new dwellings, which are subject to largely separate drivers to other consumer goods, saw outright deflation for most of the post-GFC period. **This subset of market goods is seen 1.8% q/q higher** (seasonally adjusted) and accounts for around 16% of the CPI. That would be a modest further acceleration from already elevated Q1 levels after a marked shift higher in recent quarters as price pressures recently alongside the well told story of goods supply chain

Chart 4: Large price increase for vegetables expected



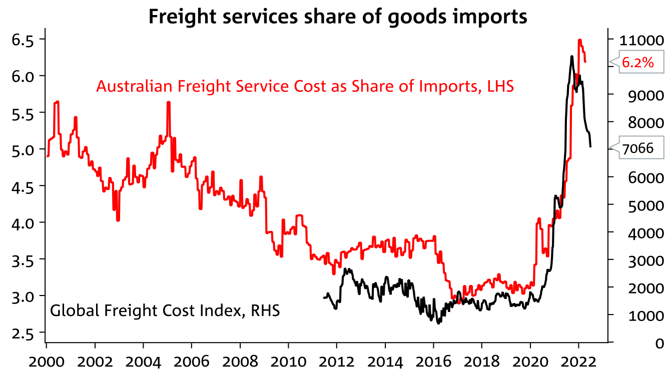
Source: National Australia Bank, ABS

Chart 5: Vouchers weighed on growth in Q1



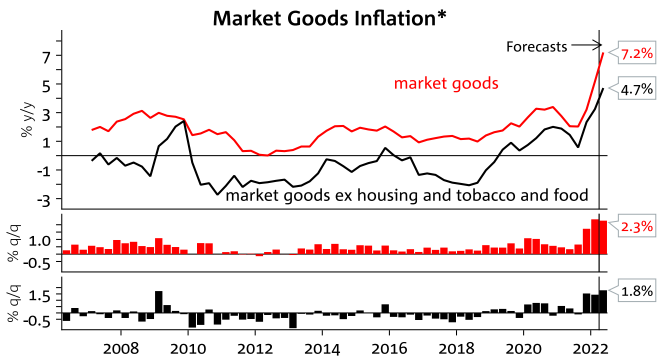
Source: National Australia Bank, ABS

Chart 6: Input prices to find their way to goods inflation



Source: National Australia Bank, ABS

Chart 7: Goods inflation to lift further



Seasonally adjusted; calculated by NAB from ABS data and NAB forecasts
Source: National Australia Bank, ABS

pressures and elevated goods demand. There are tentative signs of some easing in these pressures globally, with shipping rates off their highs, large increases in inventories of very low levels in 2021 and new orders softening in PMIs. But that is more likely to be a story for later this year at the earliest with indicators of upstream cost pressure in Australia very elevated as the more recent leg higher in fuel costs bites.

Housing

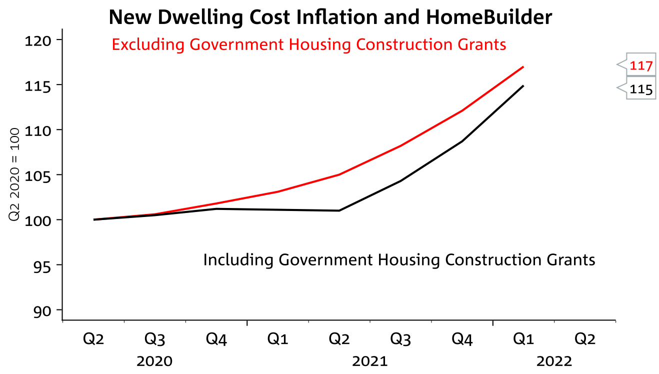
New dwelling construction will continue to dominate the headline number and we pencil in a 4.5% q/q rise, contributing 0.4ppt of headline growth. The magnitude of measured increases in this high-weighted component is a key source of uncertainty. Newly constructed dwellings accounts for 8.7% of the CPI and alone accounted for over 0.5ppt of the Q1 2.1% q/q CPI. With full pipelines and still-elevated cost pressure being reported in construction, we see price increases continuing. There is an additional tailwind from the ongoing unwind of HomeBuilder, with the measured price level still 1.8% lower due to subsidy payments. That gap will close by Q4. Further out, as pipelines are worked through and some of the upstream cost pressures abate or reverse, the risk some of the extraordinary run up in new dwelling prices unwinds over time, especially in an environment of cooling housing demand. Prices were already 19% above pre-pandemic Q1 2020 levels in Q1. (Note the New Dwelling component does not include the cost of land)

Rents inflation is seen picking up further and we look for a 1.0% q/q rise. Vacancy rates are low across capitals and have decline sharply in Melbourne and Sydney recently. The two largest capitals together account for two thirds of the CPI rents component and had been a key drag on CPI rents. Advertised rents have continued to move higher, and importantly, advertised unit rents in Sydney and Melbourne are now above pre-pandemic levels.

The CPI measures the stock of rents paid, rather than the flow of newly agreed rental prices, and so reflects changes in advertise rents with a lag. Our models of tend to find that the relationship between advertised rents and CPI rents is strongest at a lag of around 3 quarters. With Sydney and Melbourne rents looking to have accelerated further in Q2 after returning to growth in Q1, rents are likely to grow more strongly over 2022.

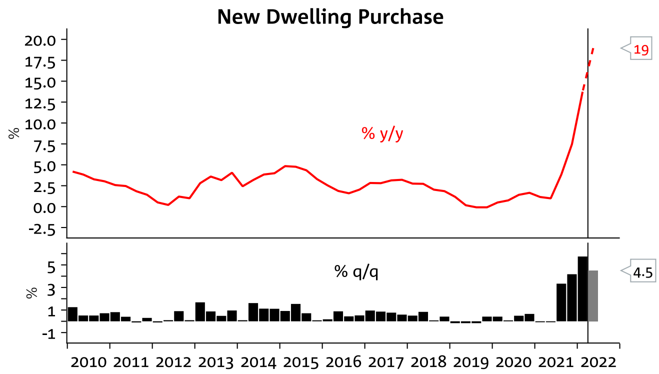
A shock to household formation and demand for space during the pandemic are two factors helping to explain low vacancy rates even with slower population growth over the pandemic. The persistence of that shock is one uncertainty for

Chart 8: New Dwelling prices still weighed by HomeBuilder



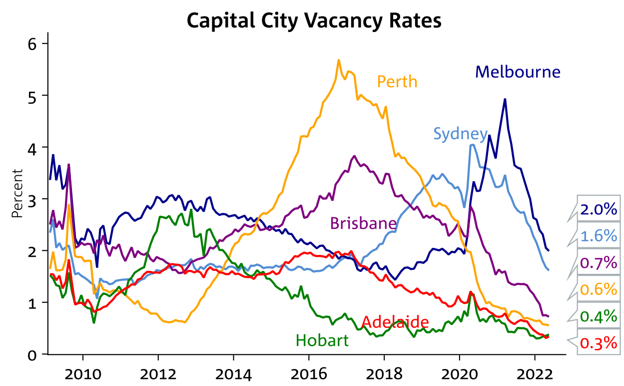
Source: National Australia Bank, ABS

Chart 9: New Dwelling inflation adds uncertainty to headline



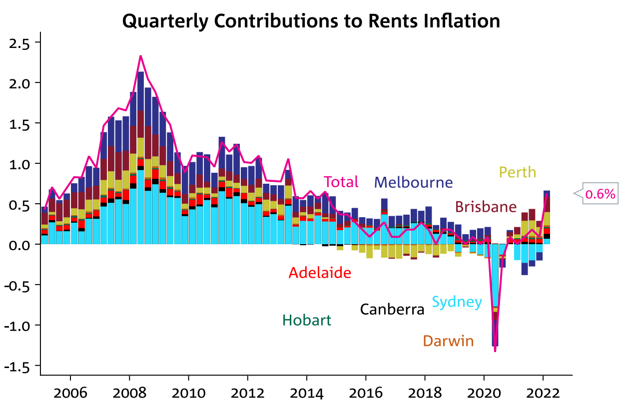
Source: National Australia Bank, ABS

Chart 10: Vacancy rates are very low



Source: National Australia Bank, SQM

Chart 11: Sydney and Melbourne had been weighing



Source: National Australia Bank, ABS

rents inflation further out, but rents growth tends to be highly sensitive to domestic labour market conditions and highly persistent, so an acceleration in rents will be closely watch by the RBA as it seeks to 'chart a path' back to 2-3% inflation.

Market Services

Rents and restaurants, discussed above, are key parts of market services inflation. But we also look for broadening of inflationary pressures across other components of market services. **In aggregate, we look for further acceleration in market services inflation** as demand for services has returned strongly and input cost pressures have become more evident.

One key driver of the expected uptick this quarter is travel costs. **Domestic travel costs are expected to rise an unseasonal 2.0% rise q/q, or 5.1% seasonally adjusted.** That on the back of higher domestic airfare costs as well as price increases across accommodation services.

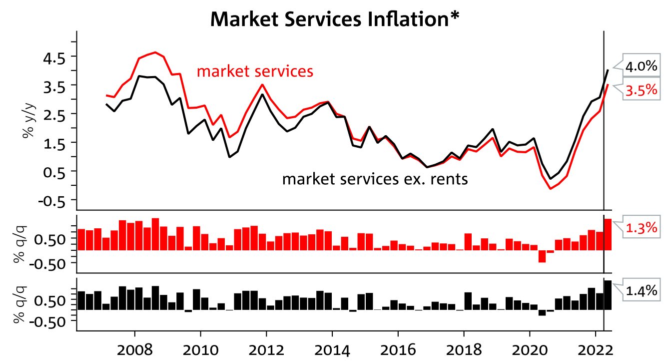
International travel prices have been volatile and recent quarters and price rises are likely to be evident here as well. **International travel will continue to have little impact on the CPI**, however, until the CPI reweight effective in Q4. International travel currently has only a 0.1% weight in the consumption basket, which reflects pandemic patterns of spending.

Fuel

Timely pump prices data implies an increase of 4.5% q/q for automotive fuel and a 0.2ppt contribution to quarterly growth. Automotive fuel will add to inflation for an 8th consecutive quarter, the longest run of price increases in the series that dates back to the 1970s, surpassing the previous record of 7 quarters to Q4 2000. The continued moves higher in fuel prices have been a key support for headline inflation in Australia, as in other countries. More recently, widening refining margins have supported a continued move higher in pump prices above the oil price.

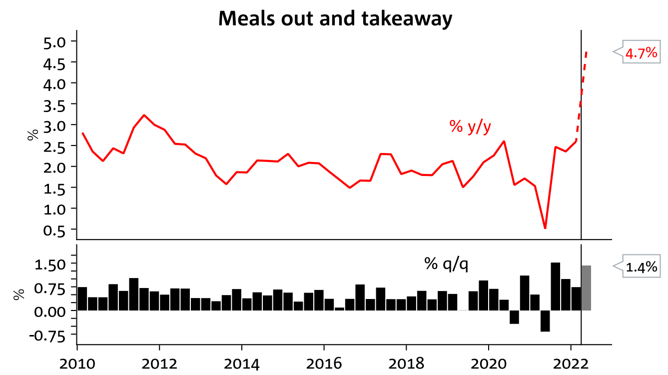
Looking further out, there is a clear risk to some pull back in current elevated pump prices, though if current levels are sustained it would point to another positive contribution in Q3, and the scheduled unwind of the fuel excise tax in Q4 would contribute around 0.4ppt to growth in the December quarter.

Chart 12: Prices rises seen broadening to Market Services



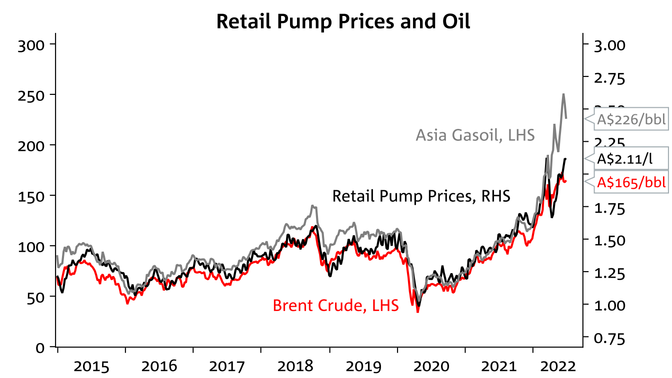
Seasonally adjusted; calculated by NAB from ABS data
Source: National Australia Bank, ABS

Chart 13: Prices higher for meals out, vouchers a factor



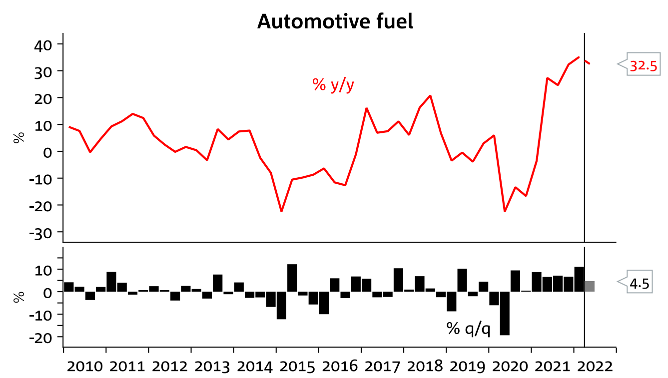
Source: National Australia Bank, ABS

Chart 14: Fuel prices higher again in Q2



Source: National Australia Bank, Bloomberg

Chart 15: Record 8th consecutive rise in automotive fuel



Source: National Australia Bank, ABS

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