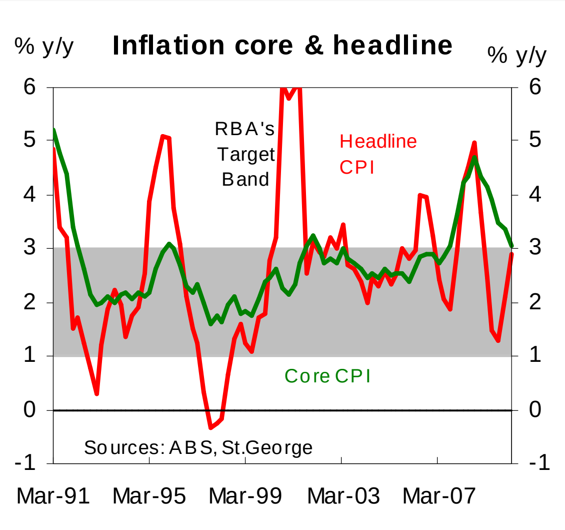
RESEARCH REPORT

CPI preview - rate rise delayed by a whisker

Thursday 22 July 2010

- **St.George is forecasting a 0.7% q/q rise in the average of the RBA's core CPI measures in the June quarter. So we agree with the RBA's statement that the June quarter CPI will *'show the underlying rate of inflation continuing to moderate in year-ended terms, to be below 3 per cent for the first time in three years.'* We expect the headline rate to rise by 0.9% taking the year-on-year rise to 3.3%.**
- **On this basis we have to hold to our view that with core inflation decelerating, increased uncertainty surrounding the global growth outlook, and questions being raised about the transition from public to private domestic demand in Australia, the RBA can remain on the sidelines. Even if we get a higher than expected core CPI, say 0.8% q/q (or even 0.9% q/q) it is not clear that the Bank would raise rates.**
- **While a 0.9% q/q would clearly place them in difficult situation in regards to their inflation target, when asked this week if a 0.9% q/q rise would be a signal for RBA to lift rates, Mr Stevens answer was somewhat circumspect. *'The thing that's most transparent and clear is the objective – 2 percent to 3 percent on average over time. I don't want to pinpoint any particular CPI result.'***
- **He went on to elaborate that inflation was just one of many factors the Board considers at each meeting and the final decision would also depend upon what else is happening, what caused the high inflation, and that it was not sufficient to just look back at the inflation outcome. He also noted that during his time as Governor, most decisions were difficult implying that such circumstances would be equally difficult.**
- **Next week, if the core CPI prints higher than our forecast we too will also be taking into account a wider range of factors, including the market's response to this week's bank stress test reports in Europe, before making a decision on our forecast for the RBA at the August meeting.**



Contribution to June Qtr CPI

	% contrib.
Recreation	-0.06
Ed	0.00
Clothing	0.00
Communications	0.01
Food	0.02
Households	0.07
Health	0.11
Transport	0.12
Housing	0.14
Finance	0.17
Alcohol/Tob	0.33
	0.89

A closer look at the numbers

We are forecasting a 0.9% increase in the June quarter CPI due on the 28 July, pushing the year-on-year rate to 3.3%. The core rate should rise by a slightly lower 0.7%, resulting in a year-on-year rate of 2.9%, falling just within the RBA's target band.

Our view is roughly in line with the RBA. In an unusual move RBA Governor Stevens revealed the central bank's forecast for the quarter – typically only financial and calendar year forecasts are released – saying it expected the core rate to moderate in year ended terms, 'to be below 3% for the first time in three years'. This would suggest they are also figuring on an 0.7% increase – possibly less.

This dangerously downplays the risk of a higher inflation outcome - and an August tightening. There are a number of key items, which are providing upward momentum in the general cost of living, which will eventually see growth breach the RBA's target. We think this is more likely to occur September, prompting a rate rise in November. Price pressures are particularly evident amongst non-tradeable goods and services, including utilities, education, childcare and health services.

Underlying this uncertainty, three or four key categories, have the potential to surprise on the upside. These include changes in the price of financial services, overseas and domestic travel, rentals and house purchases.

Offsetting these trends has been heavy discounting of consumer goods – mostly imports - such as clothing, footwear and furniture. In the December quarter clothing and footwear prices fell by a record amount. Usually this discounting is more than reversed in June. This time, retailers seem to have sacrificed margins again to maintain sales via the bringing forward of end-of-financial-year sales. This was a point made in the RBA board's June minutes which stated that many retailers had reported 'significant discounting' to drive sales. To what extent retail discounting has been used will be key as to whether the CPI prints outside of expectations.

Food

Food is forecast to grow by a marginal 0.1% over the quarter (contributing 0.02 points to the headline rate). Milk, cheese and ice cream should show a gradual lift in line with previous trends. Likewise for bread and cereal products, meat and seafood and "other food" which includes eggs, jams, tea and coffee. We think lamb prices have picked up a little more than usual. Food and vegetables have a seasonal tendency to decline in June – we predict this will be in the order of around 1.5%. Restaurant and take-away meals should rise in line with recent trends.

Alcohol and Tobacco

This category is expected to grow by 4.6%, contributing 0.33 points. The government's 25% increase in the excise on cigarettes will cause tobacco prices to rise by around 10%, resulting in the largest point contribution to the headline measure (0.25ppts). This is a one off and will not be counted in the more important core inflation rate. Alcohol prices are likely to rise by a more modest 0.3%.

Clothing and footwear

Overall we expect prices to rise by 0.1%q/q (contribution negligible). This is a minor increase when compared to previous growth. Generally, the sales cycle sees prices cut in December, which are then more than offset in June, resulting in an upward trend over the year. Retail prices were indeed cut by a record amount during December, while we suspect the June the pick-up has been remarkably subdued. This is a testament that many retailers are struggling, while being assisted by a higher $A, and sizeable discounts from overseas suppliers due to the GFC. Retailers have bought forward end-of-financial year sales, and for some items at least, reportedly have cut prices again. We think these items will most likely include discretionary goods such as men and women's outerwear.

Housing

This category is estimated to rise by 0.6% (contributing 0.14pts). This is a difficult category to forecast and encompasses some weighty items. We think rents have increased by around 0.5% based on the existing trend. Real estate reports suggesting rents have softened should

be treated with caution, as this is unlikely to have fed into existing agreements. Electricity prices should contract for seasonal reasons (-0.7%) and then resume their upward trend in September due to increased charges. Likewise, water and sewerage will probably be flat this time, and then rise next quarter due to new charges. "Other housing" is expected to grow by around 1% largely due to a 1.2% increase in house purchases. Greater clarification on this category will be found in the release on producer prices on the 26 July.

Household contents and services

This is expected to grow by 0.8% (contributing 0.07pts). Seasonal trends would suggest growth would have been greater except for retailers bringing forward end-of-financial year sales. Price increases have been limited with households turning increasingly cautious when buying discretionary goods such as furniture and big-ticket electrical items. Less discretionary items such as household supplies should follow trend rising on average around 0.7%. Childcare should be flat, with most fee increases set at the beginning of the year.

Health

Overall we expect health to grow 2.1% (contributing 0.11 pts). Health costs have been growing reasonably quickly over the last few years, in particular hospital and medical services. We estimate this item alone to have risen by 3%, bumped up by the annual increase in private health insurance premiums. This has been partially offset by a decline in pharmaceuticals, after the usual March jump due to the reduction in consumers who qualify for subsidised medications under the Pharmaceutical Benefits Scheme (PBS).

Transportation and Communication

Transport is forecast to rise 0.9% (contribution 0.12 pts). The main driver here is automotive fuel. Global prices for crude oil are recovering and should continue to do so – albeit remaining a long way from the record peak in mid-2008. Car prices will probably rise marginally following March heavy discounting. In contrast transport fares should contract a touch due to NSW's new urban schedule, MyZone. Communication should rise 0.2% (contributing 0.01pts).

Recreation

Recreation prices are set to go backwards in June falling 0.6% (detracting 0.06pts). Over the last three to four years prices for audio, visual and computing equipment have shown a remarkable propensity to deflate. This quarter is unlikely to be an exception with the bringing forward of end of financial year sales. In addition there is likely to be a fall in domestic holiday travel and accommodation – mainly for seasonal reasons. Overseas travel cost should rise because of seasonal demand and because airfares are recovering from their GFC lows. Sport and other recreation should also grow (0.5%, contributing 0.02pts) in line with recent trends.

Education

Education will probably be flat – most fee increases are announced in the March quarter.

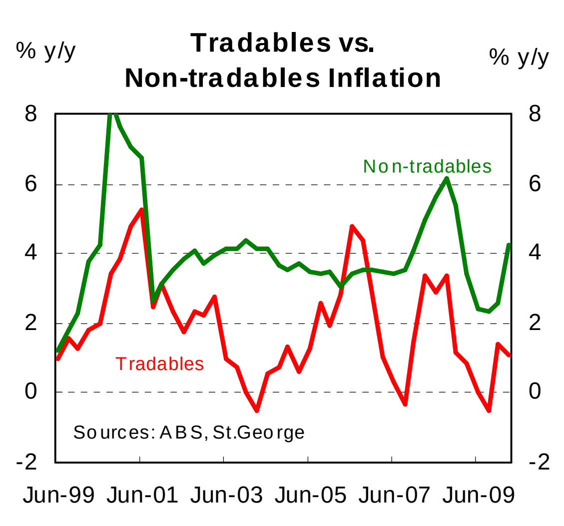
Financial and insurance services

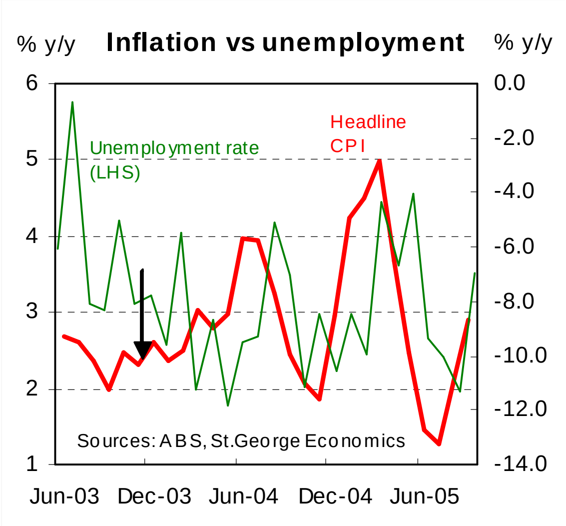
We expect prices to rise 1.9%, contributing 0.17pts. This is a more difficult category to calculate and has the potential to surprise.

The headline CPI measure versus the RBA's core rate

It is worth pointing out the reasons behind our forecasts for the core rate (0.7%), versus for the headline read (0.9%). On counting up the different contributions that make up the headline we came to a total 0.89% gain. This is a raw measure of price movements, which does not take into account seasonality, undue volatility or one-off price increases – such as the government's lift in the tobacco excise. In contrast the RBA's core measures attempt to capture the underlying momentum in household costs by paring away what is distracting noise when it comes to setting monetary policy.

This is done by removing the top and bottom 15% of the distribution (i.e. the largest positives and largest negatives are removed) to create a trimmed down index, which is then adjusted for seasonality. We would expect tobacco, hospital and medical services, overseas travel, and financial services to be removed from the core rate. In the end what is separating our headline and core rate are retail prices and to what degree retailers have cut prices for clothing, footwear and furniture etc in the June quarter. These items fall within the tradeable part of the index and are largely discretionary. Proportionally they also make up a large part of the overall index. During December, prices were cut in line with the seasonal trends, although reductions were deeper than usual. A further un-seasonal decline in June would depress the RBA's adjusted trimmed rate versus the headline.





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