The View From The Outer

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EVANS & PARTNERS

The September Q CPI: Implications for Interest Rates & the AUD

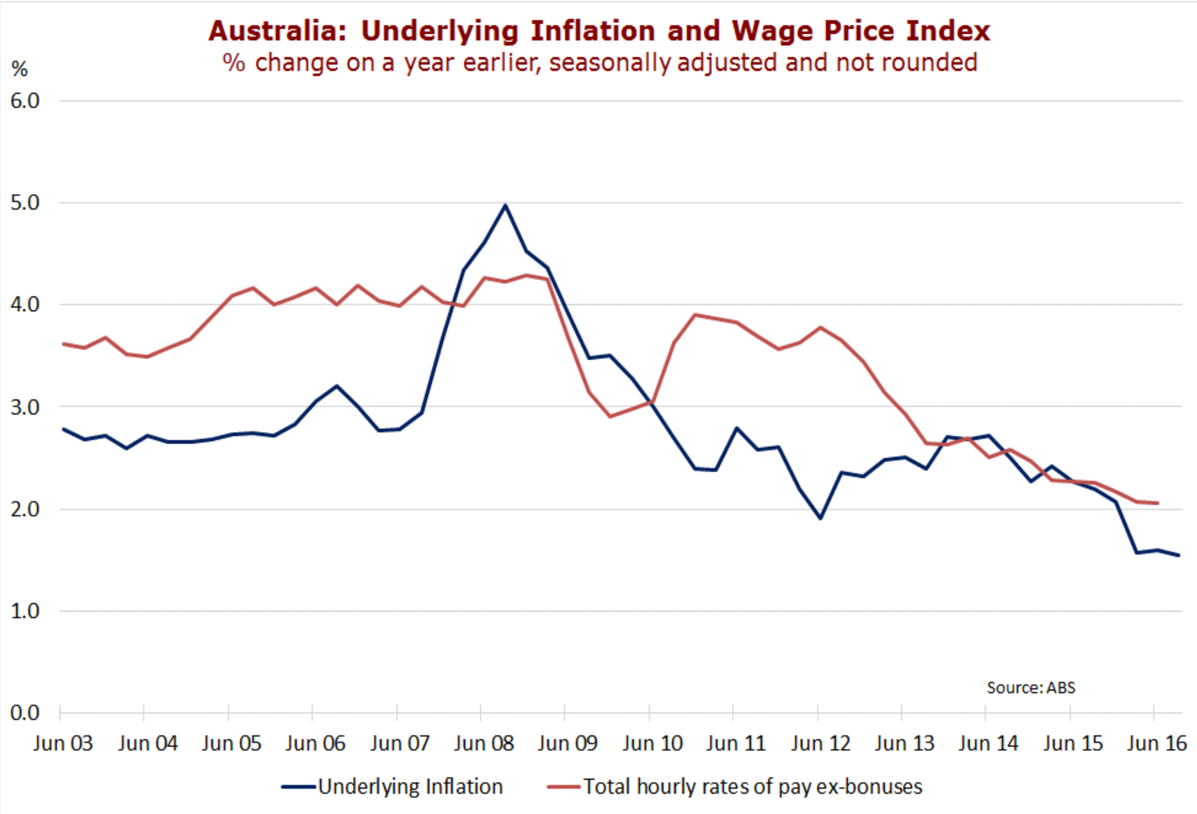
September quarter Consumer Price Index (CPI) – Monetary policy implications: From a monetary policy perspective, the critical judgement to make was whether the September quarter CPI result provides the RBA with a catalyst to revise their inflation forecasts. Underlying inflation remains unquestionably low at 1.5% through the year to the September quarter, but we view this as consistent with the RBA's current outlook. The RBA's August forecast was 1.5% through the year to the December quarter 2016, before a mid-point forecast of 2% from June 2017 to December 2018.

Any revision to these forecasts will not be published until the quarterly Statement on Monetary Policy (SOMP) on 4 November, but their inflation outlook will inform decision making at the RBA Board meeting on Cup Day (1 November). This was apparent with the rate cuts in May and August this year. We do not expect a meaningful change (if any) to the RBA's inflation view on the back of this result. In our view Australian monetary policy is likely on hold for an extended period (we presume until at least the end of 2017).

Monetary policy is sufficiently accommodative, but would a stronger AUD put this at risk? The RBA Governor's interest rate decision statement post the 4 October RBA Board meeting implies monetary policy is sufficiently accommodative at present: *"Funding costs for high-quality borrowers remain low and, globally, monetary policy remains remarkably accommodative."* Domestically, the RBA Governor's Statement noted: *"Low interest rates have been supporting domestic demand and the lower exchange rate since 2013 has been helping the traded sector. Financial institutions are in a position to lend for worthwhile purposes. These factors are all assisting the economy to make the necessary economic adjustments, though an appreciating exchange rate could complicate this."* Without a further notable downward revision in the inflation outlook we would question how much the economy (as opposed to asset prices) would benefit from any further easing. Any marginal lift to nominal GDP growth (real growth plus inflation) may come at the expense of increased risks to financial stability.

We do, however, acknowledge that a continuation of the recent appreciation of the Australian dollar in trade-weighted terms is the major risk to our on hold interest rate view. The Australian TWI as of 27 October at 65.1 is up ~4% since 30 June 2016, but still ~13% below the average level in 2013. We do not expect to see sufficient additional strength in the AUD to force the RBA to ease. See page 3 for a discussion of the exchange rate outlook.

Abundant evidence of disinflation and increased competitive pressure. The headline CPI in the September quarter may have been a little above expectations, increasing to +0.7% q/q and +1.3% on year ago (oya), but disinflation is widespread. Competitive pressure in the supermarket industry is evident in the Food and Non-alcoholic Beverages component, where prices were flat in the quarter once Fruit (+19.5%) Vegetables (+5.9%) and the Restaurant & take-away food components were excluded. From a retail perspective, the prices of Footwear, Garments (clothing), Major household appliances and the Telecommunications components all declined in the September quarter.

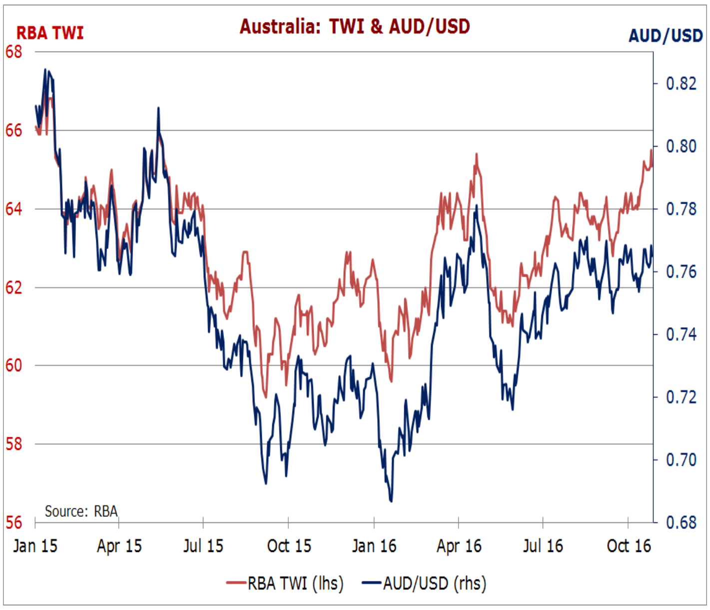


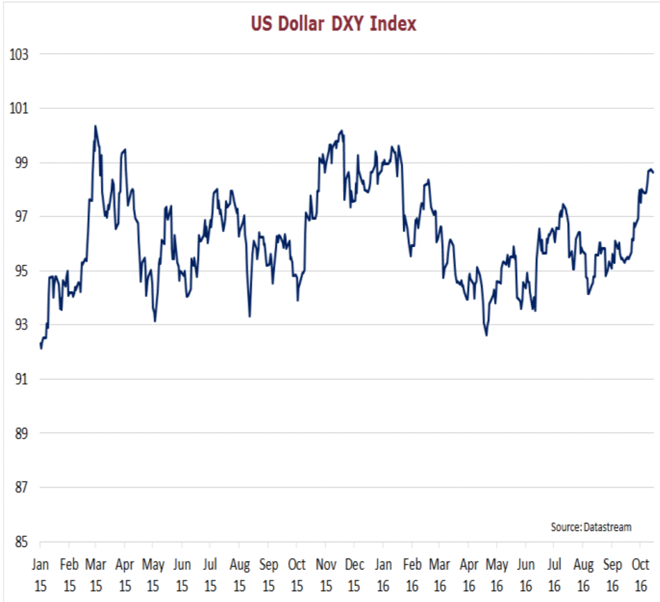
Annual growth in Underlying inflation (+1.5%) and the Wage Price Index (2.1% to June) are both the lowest in the series history. The unwinding of the resources investment boom and the dramatic Terms of Trade decline (pressuring National Income and Nominal GDP growth) are amongst the contributory factors to slower wages growth.

There are sound reasons to believe, however, that the main impact of these on wages growth is now largely behind us. The Terms of Trade rose in the June quarter and presumably did again in the September quarter. Even though we expect iron ore and coal prices will retrace lower, the outlook for the Terms of Trade is much more benign from current levels given the Terms of Trade has already declined by 36% over the period from September quarter 2011 to the March quarter 2016.

Whilst the underlying inflation series may remain below 2% for a little while yet, it appears to be in the process of bottoming out and we expect inflation to gradually return to within the target range. Absent an unexpected substantial rise in the Australian dollar from here, we do not expect another rate cut domestically given the current demand outlook.

A footnote on flexibility: The RBA's 2-3% inflation target is defined as a medium term average. It is not a hard limit. As a postscript to the above discussion, the following extract from the RBA Governor Philip Lowe's speech of 18 October should leave us in no doubt that the RBA will, as in the past, adopt a flexible approach to implementing monetary policy: *"I hope that it is well understood that our framework allows for temporary deviations of inflation from the medium-term target. We have never thought of our job as keeping the year-ended rate of inflation between 2 and 3 per cent at all times. Indeed, since June 1993, CPI inflation has been below 2 per cent for 24 per cent of the time, and coincidentally above 3 per cent for 23 per cent of the time. What is important is that we deliver an average rate of inflation consistent with the medium-term target."*

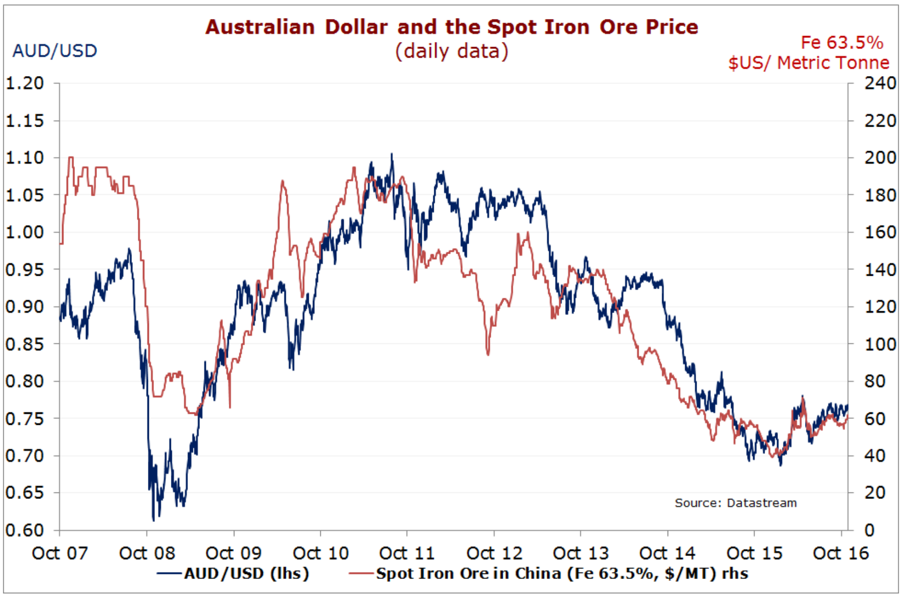




The outlook for the Australian dollar – has it been driven by the US Dollar, interest rates or the iron ore price? The trade-weighted value of the US Dollar is now back around end 2015 levels, having rallied over the last month as expectations of the Fed tightening at the December FOMC meeting have increased. While the AUD/USD has traded in a relatively narrow range over this period, like the US Dollar, the Australian dollar has also been tracking higher in TWI terms. (See chart above left).

The Australian TWI, (65.1) is currently around levels seen briefly in late April 2016, as the iron ore price spiked to above $US65/t. Prior to that, the TWI was last at these levels in April/May 2015.

The US Dollar is currently strengthening ahead of an expected December tightening, as was the case last year. A December Fed Funds Rate increase of 0.25% accompanied by cautious forward guidance and a further downward revision to the Fed participants rate forecasts (the SEP or “Dot Plot” forecasts) may well see the US Dollar run out of steam thereafter. (See second chart above right). Certainly, we doubt the Fed, or EM economies would welcome renewed strength in the US Dollar in 2017.



As is so often the case, it is the trend in commodity prices which has been seemingly driving the AUD over the last 12 months; in particular that of our largest export iron ore (see chart left).

We expect prices to decline through 2017 on low cost additional supply (and consequently the Australian Dollar with it). However the longer China fiscal stimulus underpins the AUD by supporting iron ore (and coal) prices, the more this will challenge EPS expectations across relevant sections of the industrial market.

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