

From the desk

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Inflation eases, but for how long?

Introduction

The Australian Bureau of Statistics released the June quarter 2010 Consumer Price Index today. This is key to policy deliberations by the Reserve Bank of Australia (RBA) to keep inflation between 2% and 3% over the business cycle.

Data summary

- Headline inflation rose 0.6% in the June quarter (0.9% in March), with the annual rate now at 3.1% (2.9%).
- Underlying inflation rose 0.5% in the June quarter (the equal lowest quarterly result since December 2000 and lower than the 0.8% result in March), with the annual rate now at 2.7% (3.0%).
- Both results were notably better than market expectations (1.0% and 0.8%, respectively) as higher tobacco (+15.4% over the quarter), health (+2.2%), fuel (+2.1%) and rent (+1.1%) were offset by lower audiovisual/technology (-2.7%) and food (-0.3%).

What does this mean for interest rates?

- Homebuyers and the Federal Government will be happy as this inflation result is likely to see the RBA hold fire on interest rates for at least three months.
- The result was not only better than the market expected, but also the RBA forecast. In its May Statement on Monetary Policy the RBA expected underlying inflation to be 2.75% by Q210, which implies expectations of a 0.6% Q2 increase.
- The June quarter result is around what would be expected at this stage of the economic cycle (with growth slightly below trend, recent tariff reductions and lower producer price pressures).
- Accordingly, the market has lowered the probabilities of an interest rate rise in August to around zero and discounted rates rises for the remainder of 2010.

However, before we start popping the champagne corks, the risks to inflation, and therefore interest rates, at this stage remain to the upside.

- In the medium term, inflationary pressures should persist and it might be the case that the June quarter 2010 represents the low point in the cycle. If economic growth continues to rise (which appears likely considering jobs growth is strong, unemployment is likely to be in the '4%'s soon, the investment outlook is better than robust and the terms of trade aren't far off record highs) then inflation could well strengthen in Q3.
- The terms of trade are the ultimate wild card in the medium-term inflation outlook. Although the recent iron ore and coal price rises will take time to impact the domestic economy, it will add significantly to income growth, demand and price pressures through time.
- Monday's Producer Price Index confirmed that upstream price pressures troughed in 2009 and higher utility prices are likely to further lift producer prices going forward. This suggests price pressures may be rising by end-2010 and unless growth is at or below trend, then the current 'average' interest rate settings won't keep inflation within the RBA's target band over the medium term. Fasten your seatbelts after September.

What does this mean for investment markets?

- Today's data prompted a decline in bond yields and the Australian Dollar and a rise in sectors traditionally sensitive to interest rates, such as financials. The impact of interest rate settings on share prices varies as to whether it signals inflation or stronger economic growth. The fact that inflation is lower than expected, but the global climate remains fragile and China is slowing, suggests that market sentiment is likely to remain bumpy in the period ahead. Stock price valuations will be a very important input into any investment decision from here on.

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