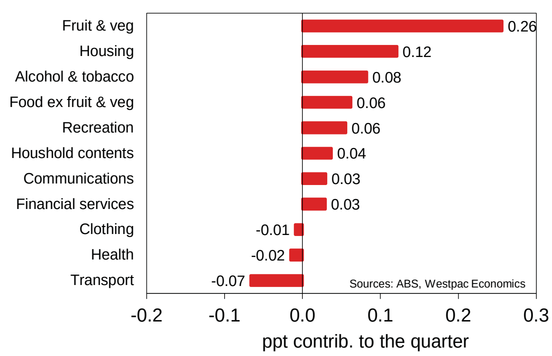
16 January 2014

Aust. Q4 CPI forecast 0.6%qtr, core 0.7%qtr.
Fruit & vegi prices explain almost 1/2 of the rise.

- **Our Q4 headline CPI forecast is 0.6%qtr/2.6%yr. Core inflation, as measured by the average of the trimmed mean and weighted median, is forecast to rise by 0.7%qtr/2.4%yr in Q4. Note that the Q3 headline CPI printed1.2%qtr, 2.2%yr, versus our top of the market 1.0%qtr forecast. Further, the ABS estimates that seasonality in Q4 is a 0.1ppt drag on the CPI i.e. the headline should come in lower than the seasonally adjusted estimate.**
- **We estimate that the 6 month annualised pace of core inflation will lift from 2.4%yr to 2.7%yr. That is still comfortably within the RBA band and thus inflation is not high on the list of concerns for monetary policy.**
- **The main upside surprises a quarter ago were on housing and recreation, with only a partial offset from a downside surprise on food. In Q4, we anticipate a larger than usual seasonal rise in fruit and a normal seasonal rise in domestic holidays. Vegetables are forecast to have an unseasonal rise - they normally decline in Q4. When they occur, such instances tend to have an out-sized impact on inflation. Together, fruit and veg explain almost half of the projected increase in the headline CPI. Offsetting these upward forces are the usual Q4 declines in pharma, medical services, childrens' footwear, accessories, tableware and international holidays. The average petrol price for Q4 was 2% lower than the Q3 average. This will contribute –0.07ppts to the CPI.**
- **Housing remains key to both the core and non-tradable measures of inflation. Housing inflation is forecast to ease back to 0.5%qtr from 2.0%qtr in Q3, which was boosted by the usual seasonal bump in utilities and rates & taxes.**
- **To date, the only area where we are seeing any meaningful inflationary impact from the weaker AUD is via higher petrol prices. The inflation outlook remains quite benign.**
- **Inflationary expectations remain contained and aggregate slack is rising, suggesting downside risks to our fundamentals based medium term inflation profile.**

Contributions to 0.6%qtr 2013Q4 CPI forecast



December quarter 2013 CPI forecast

	Q4 2013 forecast		Q3 2013 actual	
Item	**% qtr**	**contrib**	**% qtr**	**contrib**
Food	1.9	0.32	0.2	0.03
of which, fruit & vegetables	8.7	0.26	-1.2	-0.03
Alcohol & tobacco	1.2	0.08	0.9	0.06
of which, Tobacco	3.2	0.07	1.3	0.03
Clothing & footwear	-0.2	-0.01	1.1	0.04
Housing	**0.5**	**0.12**	**2.0**	**0.44**
of which, Rents	0.6	0.04	0.6	0.04
of which, House purchases	0.8	0.07	0.5	0.04
of which, Utilities	0.0	0.00	5.7	0.20
H/hold contents & services	0.4	0.04	1.0	0.09
Health	-0.3	-0.02	0.0	0.00
of which, Pharmaceuticals	-1.5	-0.02	-1.1	-0.01
Transportation	-0.6	-0.07	2.4	0.28
of which , car prices	-0.5	-0.02	-0.8	-0.03
of which, auto fuel	-2.0	-0.07	7.6	0.27
Communication	1.0	0.03	0.1	0.00
Recreation	0.4	0.06	1.9	0.24
of which, audio vis & comp	-1.8	-0.04	-0.4	-0.01
of which, holiday travel	1.9	0.09	4.7	0.22
Education	0.0	0.00	0.0	0.00
Financial & insurance services	0.6	0.03	0.4	0.02
CPI: All groups	0.58	–	1.17	–
CPI: All groups % year	2.56	–	2.16	–
Core inflation	**%qtr**	**%qtr**	**%yr**	**%yr**
	Dec-13	**Sep-13**	**Dec-13**	**Sep-13**
CPI seasonally adjusted	**0.73**	**0.97**	**2.5**	**2.3**
CPI ex housing	0.48	0.78	1.7	1.4
Weighted median	0.73	0.58	2.4	2.3
Trimmed mean	0.69	0.68	2.4	2.3
Average RBA core	0.71	0.63	2.4	2.3
Average RBA core* ex CPM	0.7	0.6	2.2	1.9
Traded good & services	0.3	1.2	0.6	-0.1
Non-traded goods & services	0.7	1.1	3.6	3.6

Sources: ABS, RBA, Westpac Banking Corporation.

*Westpac's estimte. The ABS is not providing an estimate of impact of the carbon tax.

The Q4 CPI seasonal drag is less than it has been.

You do normally see a seasonal drag in Q4 following on from the seasonally stronger Q3. The ABS seasonal factors suggest that seasonality in Q4 is worth –0.1ppt compared to +0.2ppt in Q3. Key to this historically observed seasonality is falling vegetable prices, electricity (particularly in Victoria), pharmaceuticals (as more households becoming eligible for the PBS subsidies), medical services and international holidays. Only partially offsetting this are the season rises in fruit and domestic holidays.

However, the ABS conducts concurrent seasonal adjustment so we will have new seasonal factors following release of the December quarter CPI and they could differ from the current estimates. Note that the seasonal factor for 2012Q3 was worth –0.3ppts.

Fruit & vegetable prices to rise 1.8%qtr contributing 0.3ppts.

Wholesale fruit prices rose 13% in Q4 following on from a 12% rise in Q3 and a 5.3% in Q2. Given that retail fruit prices have been broadly flat over the last two quarter, –3.4% in Q2 and +3.2% in Q3, we are looking for an 11% catch-up bounce in Q4.

Vegetables are trickier to estimate as the volatility at the wholesale level is about double that at the retail level. In Q1, despite a 7%qtr rise in wholesale vegetable prices, retail prices fell. We were therefore not surprised by the ‘carryover’ 3.3% rise reported in the Q2 CPI. In Q3 though, we were surprised with a 4.5% fall in retail prices which was larger than the 3.7% fall at the wholesale level. For Q4, we expect the observed 23% bounce in wholesale vege prices to translate into a 6% rise at the retail level.

Seasonality is neutral for clothing & footwear.

Following the usual positive re–pricing of clothing & footwear in Q3, price rises are expected to be more muted in Q4. While there should be some impact from a weaker AUD, the retail market remains very competitive as prices continue to adjust to the lower global prices. And we also note a recent pattern of discounting in components of clothing that the ABS is yet to pick up in its seasonal factors. This is behind our forecast for a 0.2% fall in clothing & footwear prices in Q4, which should contribute –0.01ppts to the CPI.

Housing is a foundation for modest inflationary pressure.

Housing, with a large weight of 22.3%, is forecast to rise by 0.5%qtr, contributing 0.12ppts to the CPI.

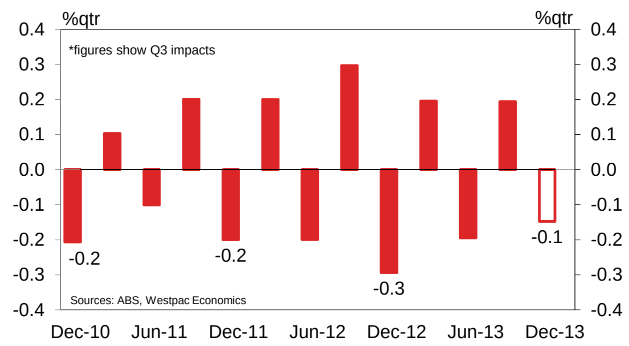
In the Q3 CPI, housing costs rose 2.0%qtr as the normal seasonal re-pricing of utilities and rates & taxes kicked in. Utilities prices rose 5.7% in the quarter. More importantly, rents (6.7% of the CPI) recorded a modest 0.6% rise while dwelling purchases (8.7% of the CPI) rose just 0.5%qtr.

New dwelling purchase prices are forecast to rise around the average pace of 0.8%qtr in Q4, contributing 0.07ppts. We don’t believe that underlying demand for new dwellings is robust enough to support ongoing widespread acceleration in dwelling price inflation, but equally we would be surprised to see the pace ease back further from the modest Q3 print.

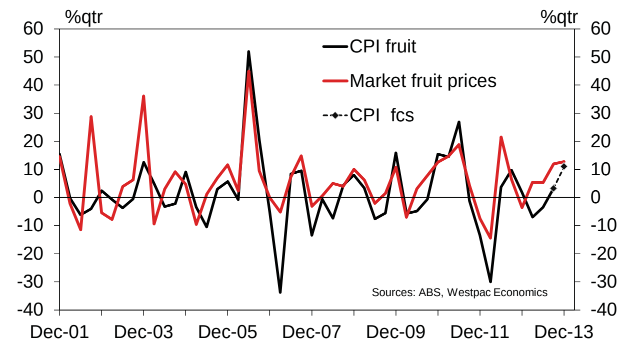
Rent inflation did tick up to 1.0%qtr in Q2 following on from a run of 0.8%’s in 2013Q1, 2012Q4 and 2012Q3. It moderated back to 0.6%qtr in Q3 and we expect it to hold around this pace in Q4.

We are forecasting a 0.5%qtr gain for the non-housing components of the CPI. Non-housing price inflation has been running a touch slower than housing inflation.

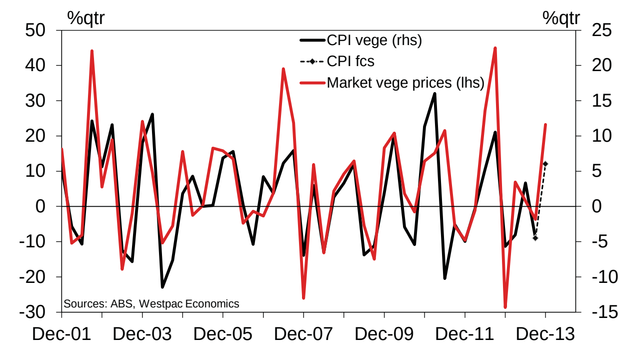
Seasonal impact on headline CPI (ABS estimate)



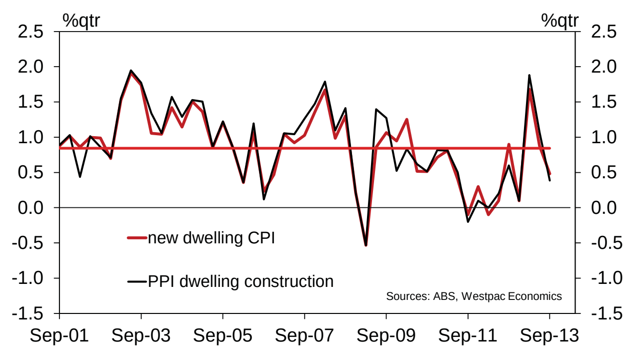
Wholesale fruit prices still rising in Q4



Unseasonal Q4 bounce in vegetable prices



Dwelling PPI vs CPI dwellings



Pharmaceuticals seasonal drag continues.

Pharmaceutical prices rise in Q1 then fall in Q2, Q3 and Q4. The Q1 rise is associated with the start of a new year for the PBS and few families' total spending on health breaches the threshold for government assistance. In the June quarter some families breach the threshold and hence the subsidies start to kick in. This process continues in the Sep and Dec quarters.

In terms of our Q4 assumption, we have been noting a moderating trend in the reported declines post the Q1 jump. We suspect this is due to changes in operation of the Pharmaceutical Benefits Scheme (PBS) as the Federal government attempts to compress the growth of its obligations in this area (smaller price rises result in smaller subsidies). This is why we are forecasting a modest 1.5% fall in pharmaceutical prices compared to the 3.9%qtr fall in the ABS seasonal factor for this item.

Transport price prices set to be a drag in Q4.

The bowser price of petrol started Q4 at close to $1.50 per litre. Through the quarter it fell to a low of $1.42 but rose strongly on the back of a weaker AUD to hit a high of $1.53 in late December. We estimate that on average, auto fuel fell 2% in Q4 compared to the average prevailing in Q3.

While the ABS reports no discernable seasonality in motor vehicle prices, we can observe that in recent history Q3 and Q4 have tended to have the largest fall in car prices; Jun has tended to have the smallest fall or even a modest rise. We also suspect there would be a lag between changes in the value of the AUD and retail car prices. Given the competitive nature of the global car market, the effect of ABS hedonic pricing (that is prices are adjusted for any change in the quality of the product) and the weakness in the Japanese yen, car prices are forecast to fall again in Q4; –0.5% following on from –0.8% in Q3.

The deflation pulse from audio, visual & computing equipment continues but rising airfares boost holiday travel costs.

The deflation of audio visual & computing equipment is there as usual and while the ABS does not report any seasonality in the component, we have noticed that Q4 and Q1 have tended to have the largest falls in prices. That is why we are forecasting a 1.8% fall in Q4 compared to the 0.4% fall in Q3.

Domestic holiday travel costs tend to bounce in Q4 and the best price airfares data does not give us any reason to suspect this will not happen again. But the appreciation of the AUD in Q4, in quarterly average terms, should help add to the normal seasonal discounting we see in international holidays. All up, we forecast holiday travel costs to rise 1.9% in Q4 adding 0.09ppts to the CPI.

Culture & recreation is forecast to rise 0.4%, contributing 0.06ppts.

Core inflation remains within the target band.

Our forecast for a 0.7%qtr rise in the average of the RBA's measures of core inflation will see the annual pace lift a bit to 2.4%yr from 2.3%yr. The six month annualised pace of core inflation lifts to 2.7%yr from the 2.5%yr reported in Q2. *However, it is noteworthy that this is the peak six month annualised pace in our core inflation forecasts.* That suggests that inflation does not (and will not) pose a threat to Australian policy makers in the medium term. In fact, given that inflationary expectations are continuing to moderate, and the rising degree of aggregate slack in labour markets and domestic demand, the risks to our forecasts lie to the downside.

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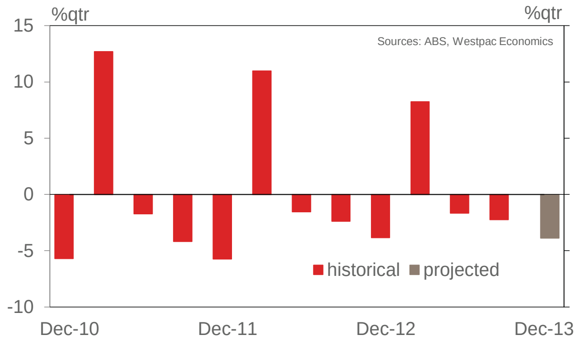
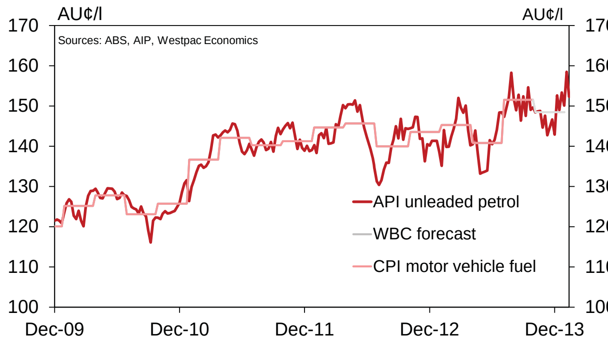
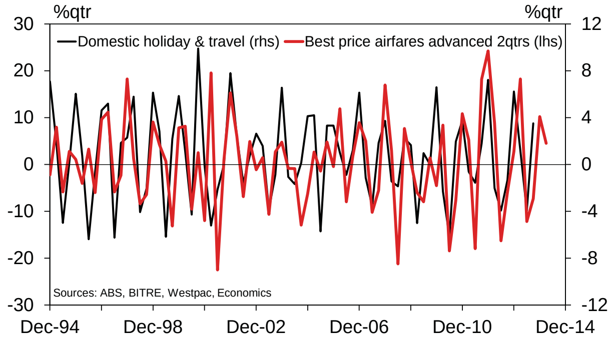
ABS seasonal factors - pharmaceuticals



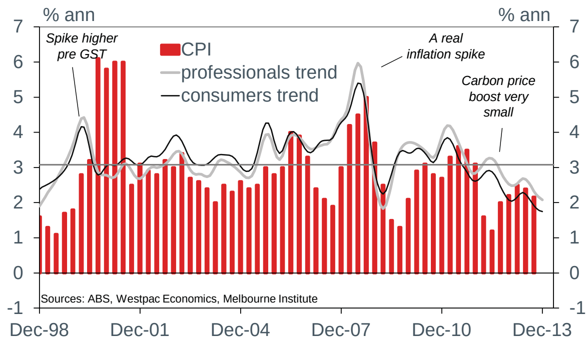
Weekly bowser price & CPI auto fuel index



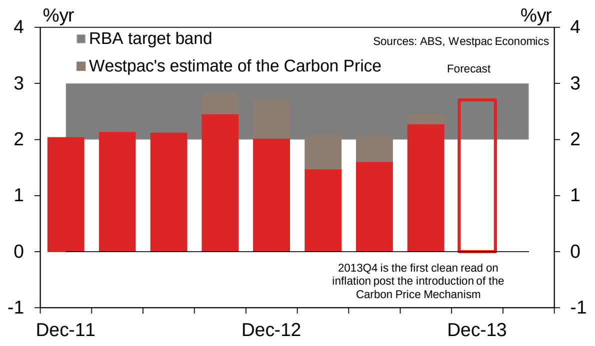
Domestic holiday & travel



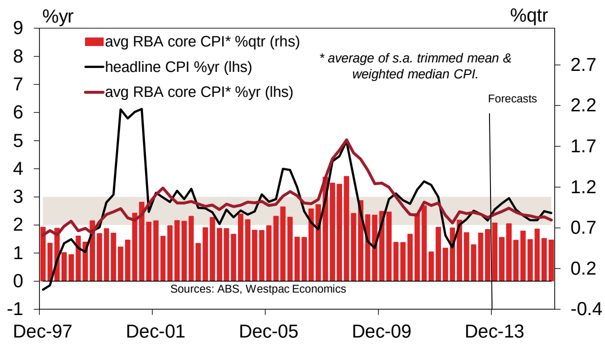
Inflationary expectations continue to decline



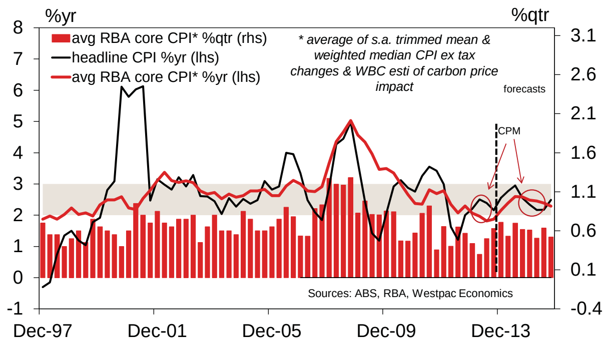
Six month annualised pace of core inflation



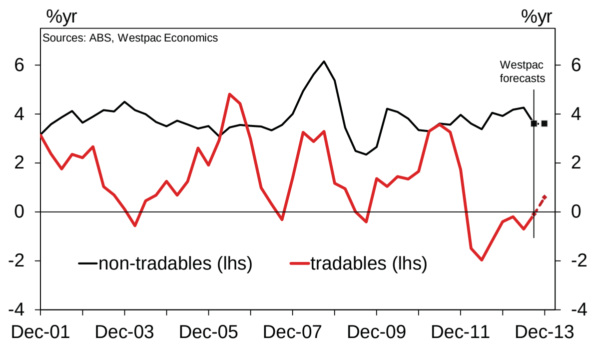
Headline & core inflation



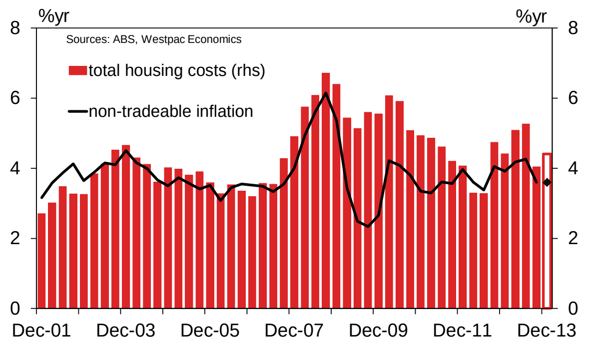
Carbon price boosts, then drags, on the headline



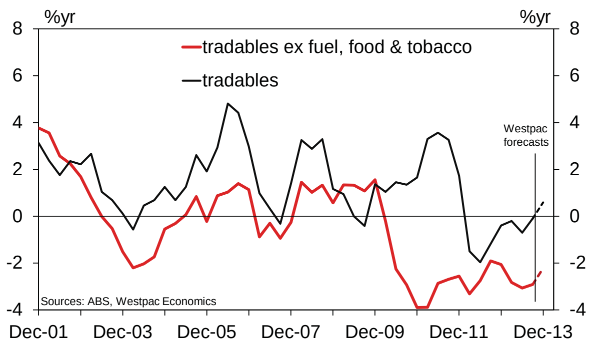
Tradable vs non-tradable inflation



Housing key to non-tradable inflation



Tradable inflation boosted by fuel & fruit/veg



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