Bulletin

16 July 2015

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Australia Q2 CPI preview: 1.0%qtr/1.9%yr

Strong rise in fuel & fruit is supported by steady gains in housing, health & household contents

- **Westpac is forecasting a robust 1.0%qtr rise (1.9%yr) in the headline CPI in the March quarter.**
- **The ABS analysis suggests that June is historically a softer quarter for the CPI, in part due to the Pharmaceutical Benefit Scheme resetting, the discounting of domestic holiday travel and falling fruit & vegetable prices. Using the ABS seasonal factors we estimate a 1.2%qtr rise in the seasonally adjusted CPI.**
- **The core measures, which are seasonally adjusted, are forecast to rise 0.5%qtr/2.2%yr (on average) and the 6mth annualised pulse moderates to 2.3%yr from 2.6%yr. These key policy sensitive rates are not presenting a threat to the RBA's inflation target.**
- **Behind the stronger headline CPI print are: the rebound in petrol from late Q1 through Q2 and into early Q3, a solid bounce in fruit & vegetable prices (4.5%qtr), and solid gains in medical & hospital services. Housing costs continue to rise (0.5%qtr) and this quarter household contents & services also gained (1.1%qtr).**
- **The offsets this quarter were relatively modest outside of pharmaceuticals and domestic holiday travel, with audio visual & computers continuing to fall as did communication costs.**
- **Last quarter we made special note of the divergence between Australian automotive fuel prices and the AUD price of crude oil and how this was due to a widening of the refining spread, or crack, for Singapore gasoline. This spread continued to widen in Q2 to a historical high keeping Australian petrol prices elevated.**

A quick recap on the March quarter CPI

The headline CPI rose 0.2% in Q1 and the annual rate eased back to 1.3%yr from 1.7% in Q4, 2.3%yr in Q3 and 3.0%yr in Q2.

For the core measures, the trimmed mean rose 0.64% and weighted median lifted 0.62%. The annual pace of the average of the core inflation measures lifted a touch to 2.4%yr from 2.3%yr in Q4 but that is still less than the 2.6%yr in Q3. Core inflation is now hugging the bottom half of the RBA's target band.

In the March quarter, the collapse in petrol prices (–12.2%) and falling fresh fruit & vegetables (–2.0%) more than offset the rise in health (2.5%) and education (5.3%). Food surprised on the strong side (+0.2%) adding to motor vehicles (0.4%) and recreation (0.7%). These groups would, to varying degrees, have an exposure to the AUD suggesting we may be seeing some pass through of AUD depreciation limiting the fall in traded goods (which includes petrol) to –1.2%qtr.

Non-traded prices, which are dominated by housing, health and education were close to expectations rising 1.0%qtr.

June quarter 2015 CPI forecast

	Q2 2015 forecast		Q1 2015 actual	
Item	**% qtr**	**contrib**	**% qtr**	**contrib**
Food	1.0	0.18	0.2	0.03
of which, fruit & vegetables	4.5	0.13	–2.0	–0.06
Alcohol & tobacco	1.0	0.07	0.8	0.05
of which, Tobacco	1.7	0.04	0.9	0.02
Clothing & footwear	1.4	0.06	–1.3	–0.05
Housing	**0.5**	**0.10**	**0.8**	**0.18**
of which, Rents	0.4	0.03	0.4	0.02
of which, House purchases	0.9	0.08	0.9	0.08
of which, Utilities	–0.1	0.00	1.6	0.06
H/hold contents & services	1.1	0.10	–0.5	–0.04
Health	1.8	0.10	2.5	0.13
of which, Pharmaceuticals	–1.8	–0.02	5.7	0.07
Transportation	4.2	0.49	–3.4	–0.39
of which , car prices	0.5	0.02	0.4	0.01
of which, auto fuel	13.0	0.46	–12.2	–0.43
Communication	–0.5	–0.02	–1.4	–0.04
Recreation	–0.3	–0.04	0.7	0.09
of which, audio vis & comp	–1.6	–0.04	–1.0	–0.02
of which, holiday travel	0.1	0.01	0.5	0.02
Education	0.0	0.00	5.3	0.17
Financial & insurance services	0.3	0.01	0.2	0.01
CPI: All groups	1.05	–	0.19	–
CPI: All groups % year	1.91	–	1.33	–
Core inflation	**%qtr**	**%qtr**	**%yr**	**%yr**
	Jun–15	**Mar–15**	**Jun–15**	**Mar–15**
CPI	**1.0**	**0.2**	**1.9**	**1.3**
CPI seasonally adjusted	**1.2**	**0.3**	**1.9**	**1.3**
CPI ex housing	1.0	0.0	1.5	0.8
Weighted median	0.46	0.62	2.3	2.4
Trimmed mean	0.59	0.64	2.2	2.3
Average RBA core	0.52	0.63	2.2	2.4
Average RBA core* ex CPM	0.54	0.68	2.4	2.5
Traded good & services	2.2	–1.2	0.7	–0.9
Non-traded goods & services	0.5	1.0	2.6	2.6

Sources: ABS, RBA, Westpac Banking Corporation.

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

The June quarter has some very significant ‘knowns’ but, as always, many ‘unknowns’ remain.

The June quarter saw two large known forces push the CPI in one direction with few known significant offsets. But, as always, a large number of unknowns remain. Also we don’t have access to the data the ABS does and/or, in many cases, the survey process the ABS uses potentially causing many small errors along the way.

One of the most obvious events in the last few quarters has been the extreme volatility in the pump price of automotive fuels. The national weekly average price for unleaded fuel hit a low of 104¢/litre in the week ended February 1 before surging to 143.3¢/l by the week ended June 7. The has resulted in 12.2% fall in the average fuel price in Q1 which was followed by a 13% surge in Q2 to take petrol prices back to almost the average in Q4.

Westpac uses a crude oil indictor to forecast the outlook for Australian petrol prices based on a 4 week moving average of the A$ price of Brent and TAPIS plus an estimate for refining, taxes, transport and retail margins. This indicator has had a close relationship with Australian (and Singapore) petrol prices but in July the error from the indictor widened out to 18.9¢/l, the widest spread we have seen in the history we have back to 2003. But as the relationship of this indicator and Singapore gasoline prices has also broken down the error is not due to a widening of Australian margins but rather the refining spread (or crack) in Singapore. So just looking at crude oil prices can give you a misguided perception of where Australian petrol prices are headed. Singapore refining margins should return to more normal levels as refiners respond to the higher margins and lift supply of these grades of gasoline. But at least for the near term we have to assume that the margins will remain around current levels.

The other large known is the surge in wholesale fruit prices. Fruit wholesales price surged 25%qtr in the June quarter with particularly large rises for peaches, strawberries, watermelons and grapes. We have pencilled in a 10% rise in the CPI fruit prices but again we can’t be certain just how the wholesale prices will translate through to the retail prices. Retailers, especially the large supermarkets, have a tendency to smooth out the impact of wholesale price volatility. By contrast, the ABS seasonal factors suggest fruit prices normally fall around –2.0% in Q2 following a large –4.8% seasonal effect in Q1.

Wholesale vegetable prices rose 1.8% in Q2 but, as always, we can’t be sure just how this was passed on to the retail level nor if there was any residual catch-up from the 16%qtr surge in Q1. However, we have pencilled in a 2% fall in vegetables in the Q2 CPI as potatoes saw a significant seasonal fall in the quarter, and from time to time they have had a significant impact on CPI vegetable prices driving the average retail prices in the opposite direction to wholesale prices. But clearly there are upside risks to this forecast.

Westpac is forecasting fruit & vegetable prices to rise 4½% in Q2.

Fruit & petrol driving the 2.2%qtr surge in tradable inflation …

A 13% surge automotive fuels would contribute a 0.46ppt rise in the CPI. Add in the rise in motor vehicles, spare parts, other services and urban transport fares and total transport costs will make a 0.49ppt contribution to the CPI.

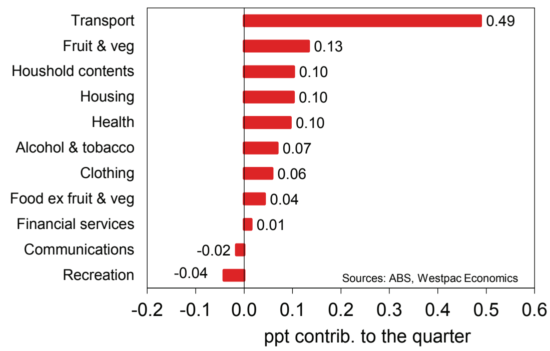
When you combine this with the 0.13ppt contribution to the CPI from fruit & vegetables prices (from a forecast 4½% rise) these two groups alone make a 0.62ppt contribution to the forecast 1.0% Q2 rise in the CPI. So you should be able to see why we are arguing that while a 1.0% rise is a very robust print for the CPI this should not be considered one that is threatening the RBA’s inflation target. It is also significant that these two components alone contribute

Key forecasting indicators of the CPI

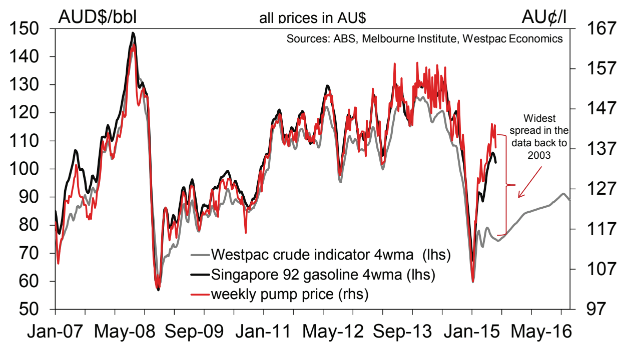
	Sep–14	Dec–14	Mar–15	Jun–15
CPI %qtr	**0.5**	**0.2**	**0.2**	**1.0 (f)**
CPI %yr	2.3	1.7	1.3	1.9 (f)
RBA core %yr	2.5	2.3	2.4	2.2 (f)
AUD/USD	0.93	0.86	0.79	0.78
AUD/USD %yr	1.0	–7.8	–12.2	–16.6
TWI	71.3	67.8	64.4	63.6
TWI %yr	1.1	–4.5	–6.8	–11.1
Crude oil, Brent US$bbl	104	77	56	64
Crude oil, Brent %yr	–4.5	–29.3	–47.8	–41.3
Output gap, adv. 3qtrs	–0.4	–0.4	–0.4	–0.2

Sources: ABS, RBA, Bloomberg, Westpac Economics. *Actual from 3 quarters prior.

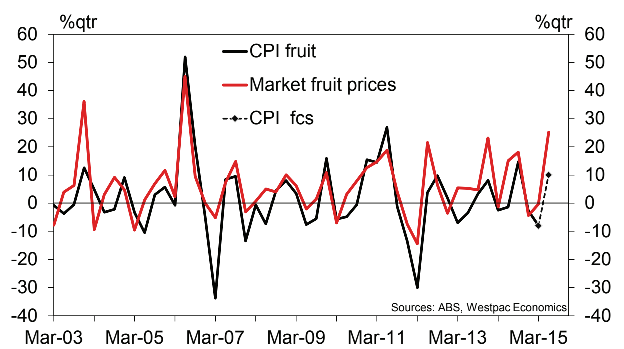
Contributions to 1.0%qtr 2015Q2 forecast



Petrol prices, the spread to crude has widened



Fruit prices, wholesale & CPI



1.8ppts to the 2.2% rise in tradable goods & services prices in the quarter so it is more likely to be a one off effect rather than a significant upwards shift to inflations risks from the tradable sector.

... as AUD depreciation boosts usual seasonal lift in clothing.

In Q2 clothing & footwear prices tend to rise due to price resetting following discounting in the Q1 post-Christmas sales. We have allowed for a slighly larger increase than the average of the previous three years to take into account the fall in the AUD. Our forecast 1.5% rise will contribute 0.06ppt to the CPI.

Discounting in holiday travel costs isn the norm in Q2 with the ABS seasonal factors suggesting a seasonal impact around -6¾%. Airfare pricing data suggest that the average domestic discount air fare did fall in the quarter. But we are uncertain as to how the falling Australian dollar has impacted international holiday travel costs. We suspect that while low oil prices are helping we do expect to see some fare adjustments associated with the lower AUD over time. In addition, as Australians spend AUD overseas, we should be seeing the impact of the lower AUD in these estimates. Westpac is forecasting a modest 0.5%qtr rise in holiday travel & accommodation contributing 0.02ppts.

All up Westpac is forecasting traded prices to rise 2.2%qtr/0.7%yr compared to –1.2%qtr/–0.9%yr in Q1.

For non-tradable prices health costs rising despite PBS ...

Pharmaceuticals fall in Q2, Q3 and Q4 as more families progressively gain access to the Prescribed Benefits Scheme (PBS); they then rise in Q1 as the threshold of assistance is reset. But the June quarter also saw increases in health insurance premiums (industry weighted average of 6.2% which is the same as the 2014 increase) as well as the usual rise in hospital services. Westpac is forecasting a 1.8%qtr rise contributing 0.10ppts to the CPI.

... dwelling prices mixed by city but robust overall.

Dwelling prices are on a stronger rising trend in Sydney with a 3.4% gain through the last half of 2014. Gains also quite robust in Melbourne (2.3%) but muter in Brisbane (0.7%), Perth (1.6%) and Adelaide (1.8%). We are looking for an average gain of 0.9% in Q2, matching Q1, and contributing 0.08ppts.

Westpac is forecasting a 0.5% rise in non-tradable prices leaving the annual rate flat at 2.6%yr.

Overall seasonality is a small negative in Q1

Using the ABS seasonal factors, the seasonally adjusted CPI rise of 1.2%qtr compared to our headline forecast of 1.0%. There is an important caveat however; the ABS conducts concurrent seasonal re-analysis and the revisions to the seasonal factors can sometimes be quite significant. As such, we caution that we can't be sure what the ABS will estimate as the seasonal impact in Q2. This matters as the core measures are seasonally adjusted and revisions to the seasonal factors do impact the core estimates.

Conclusion

A robust Q2 headline print is due to petrol and fresh fruit driving a bounce in tradable prices. This is supported by a ongoing steady gains in non-traded goods & services due to housing and health. As for the core, policy sensitive measures, the 6mth pulse will ease a touch to 2.3%yr from 2.6% in Q1 and 2.1%yr in Q4. If you exclude the two 2.1%yr prints in the last half of 2014, you have to go back to Q2 2013 to find a print of 2.2% or lower.

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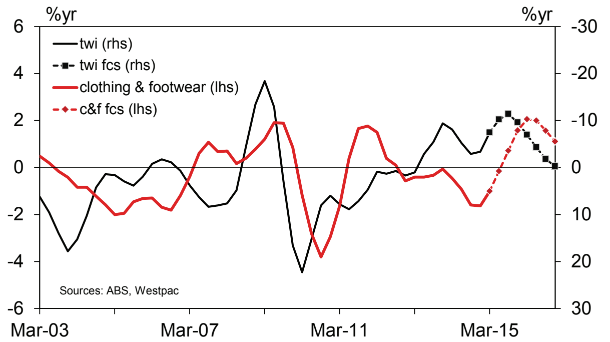
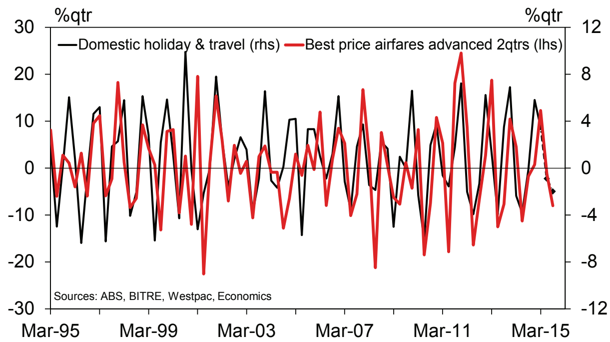
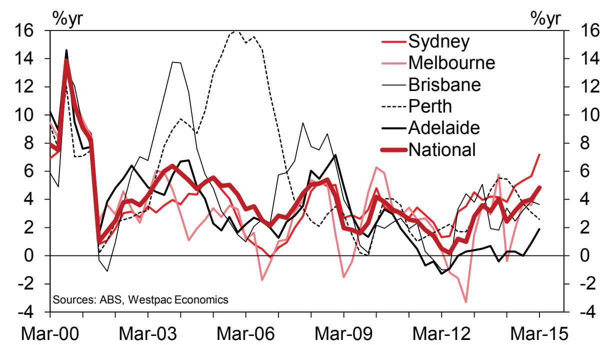
Clothing & footwear vs. the currency



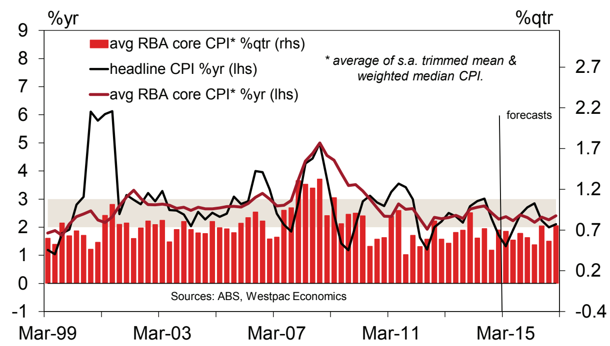
Domestic holiday & travel



Dwelling inflation accelerating in Sydney



We are seeing the quick bounce in petrol prices



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