

# Market Musings

Global Rates, FX &amp; Commodities Strategy

27 October 2021

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## RBA: Change of View - Hike Cycle Starts Q4'22

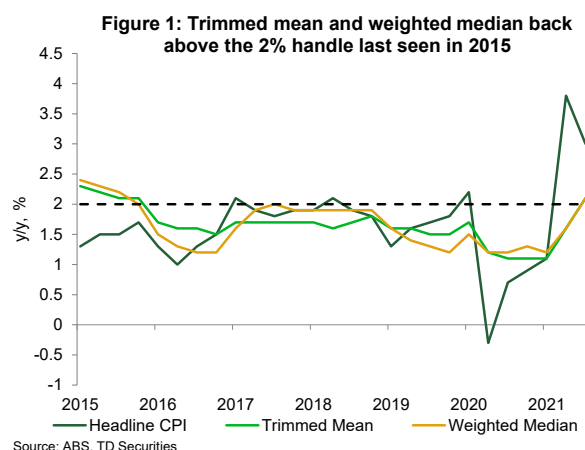
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- Q3 CPI handily beats RBA and market expectations.
- Price pressures are likely to persist in our view.
- We bring forward our first RBA hike to Q4'22.
- At next week's meeting, it's more likely the RBA pre-announces QE to end in Feb'22 over announcing a shift in the target bond to the Apr'23s.

### Inflation Within RBA's Target Band

Since last week, the market has been challenging the RBA's message that it is unlikely to hike before 2024. Today's Q3 inflation print bolstered market confidence in this view further as the annual Q3 CPI trimmed mean (RBA's preferred inflation measure) at 2.1% y/y exceeded market expectations (cons: 1.8%). CPI trimmed mean at 2.1% y/y is the strongest since 2015 and is now within the RBA's inflation target band of 2-3% (Figure 1).



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The breakdown for headline CPI appears below.

Figure 2: Percentage Point Contribution (pp) To Annual Inflation				
	Q4-20	Q1-21	Q2-21	Q3-21
<b>Headline CPI (NSA)</b>	<b>0.9%</b>	<b>1.1%</b>	<b>3.8%</b>	<b>3.0%</b>
Food	1.54	1.29	1.32	0.24
Alcohol and Tobacco	1.37	1.27	1.21	0.39
Clothing and Footwear	0.09	0.14	0.16	-0.13
Housing	1.12	1.05	1.33	0.36
Household Furnishings, Supplies & Services	0.57	0.49	1.57	0.52
Health	0.56	0.59	0.72	0.31
Transportation	-0.46	0.06	1.09	1.07
Communication	0.11	0.14	0.16	-0.03
Recreation	-3.96	-3.75	-3.69	0.20
Education	0.35	0.27	0.44	0.08
Financial & Insurance Services	-0.45	-0.47	-0.49	0.05

Source: ABS, TD Securities

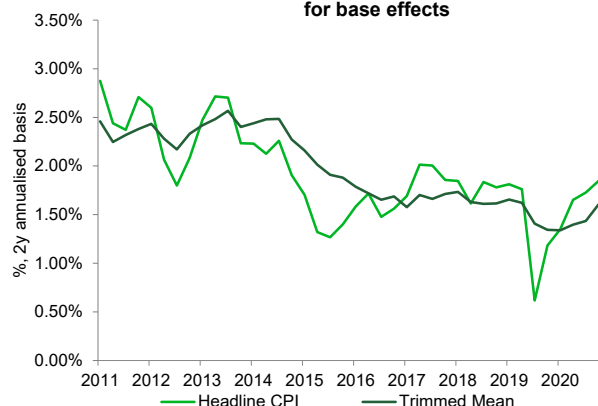
Surprisingly annual headline CPI came in slightly below market expectations at 3.0% y/y (cons: 3.1%). This could be due to the impact of food prices. Remember that the CPI trimmed mean series is seasonally adjusted while the reported headline CPI is not. After seasonal adjustment, food prices rose 0.5% q/q (NSA: 0.3% q/q) and coupled with its sizeable weight in the CPI basket (~17%) likely drove trimmed mean higher. In contrast, the smaller rise in food prices in the headline CPI series likely dampened the Q3 annual headline print (Table 1) as food contributed 0.24%-pt in Q3, much lower than 1.32%-pt in Q2.

In contrast, Trimmed mean inflation came in higher than expectations. We suspect **rising new dwelling prices could be a key driver of underlying price pressures going forward**. Interestingly, ABS did not mention the Homebuilder grant in their media release (see quote below) for CPI trimmed mean and perhaps this was not deemed as a temporary factor like free childcare which was "trimmed" off. This suggests that new dwelling prices could be a factor that drove trimmed mean higher in Q3 and may also be perceived more as a structural issue in the coming quarters. Builders are likely to pass through increases in both materials and labour costs to new dwelling prices given robust construction demand.

*"Underlying inflation measures reduce the impact of irregular or temporary price changes in the CPI, such as the significant fuel price increases this quarter or the impact of free childcare in 2020." - [ABS Q3 CPI Media Release](#)*

Broadly, inflation is running ahead of RBA forecasts, the Bank expecting the annual trimmed mean to cross the 2% handle after Q2 2023 based on its August SoMP. Using a 2-year annualised basis to account for base effects/COVID period, inflation is still trending higher with headline and trimmed mean at 1.85% and 1.60% in Q3 (Figure 3). It is not above 2% on this broader measure, but the trend is higher.

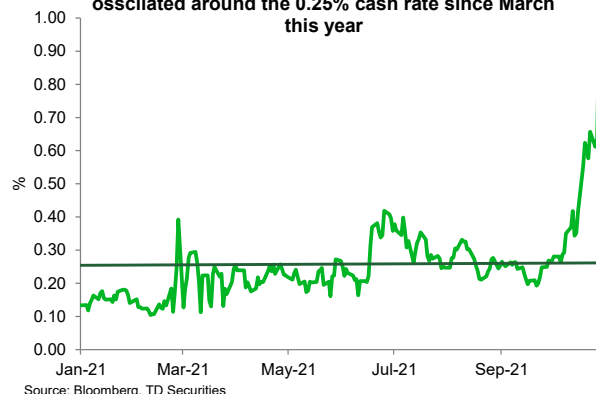
**Figure 3: Inflation picking up even after accounting for base effects**



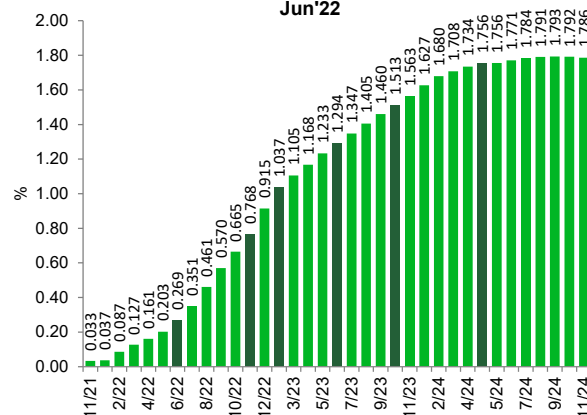
## The Market is Not Waiting for the RBA's Confirmation

The market has been pricing in the potential for the RBA to lift the cash rate in 2022 for sometime now. For example, the Dec'22 RBA OIS meeting date has essentially priced in a 0.25% cash rate since March 2021 (Figure 4), nearly 8 months ago. This pricing has run contrary to the RBA's message indicating it is unlikely to hike the cash rate before 2024. The market is now pricing in the first hike in Jun'22.

**Figure 4: The implied RBA Dec'22 meeting date has oscillated around the 0.25% cash rate since March this year**



**Figure 5: OIS Priced for RBA hikes beginning from Jun'22**



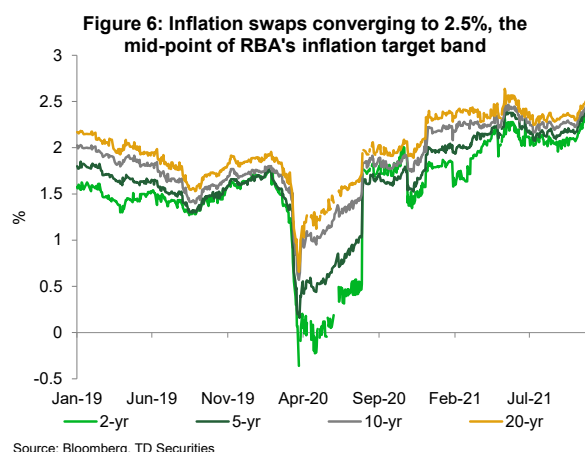
Today's strong underlying inflation print, exceeding the RBA's and the market's estimate by a handy margin, provides the market with the confirmation that its pricing has been right all along and that the RBA is likely to be behind the curve. This suggests rallies in Aus rates are likely to be shallow as participants are disposed to sell strength.

Since the Aug SoMP, the AUD and TWI are a touch stronger but these factors are unlikely to overshadow the positive bigger picture story. Trimmed mean beat expectations, Brent is more than 20% above the Aug assumptions, Australia's borders are likely to open 6 months before the RBA expected and population growth assumptions are likely to be lifted. This suggests the Aug SoMP upside scenario becomes the Bank's Central scenario next week.

For markets there will be some confusion in interpreting the RBA's Nov forecasts. The long-standing assumption has been for the Bank to embrace OIS market pricing. However, with the OIS strip diverging significantly from the Bank's dovish stance, what impact will this have on the forecasts? For this reason we will focus on the Bank's language.

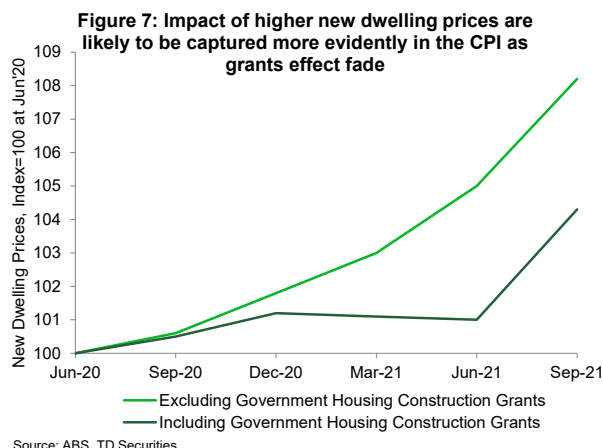
There is a possibility the Bank pushes back on today's strong CPI outcome next week, that it needs more data to assess how persistent price pressures are and for now views the increases as transitory. This may drive a FI rally, but this commentary would run counter to the more hawkish language from a number of offshore Central Banks.

Zero-coupon inflation swaps across multiple tenors are all converging towards the midpoint of the RBA's 2-3% target band as shown in Figure 6. If the inflation impetus was temporary, then longer dated inflation swaps should not be backing up like they are. Our interpretation is that the market is stating it's not just about energy, the anticipated increase in prices is a broader story.



In the near term we see further upside inflation pressures. Construction played a role in driving today's stronger outcome, perhaps not as strong as we had expected. Nonetheless, the expected rebound in housing activity and the declining influence of the Government's Homebuilder program should see construction feature prominently to the upside in upcoming CPI releases (see Figure 7, expect that gap to close with a move higher). Also, higher energy prices mean transport should provide a strong positive contribution to CPI as well.

The next piece of the puzzle is the labour market. Commentary the RBA has provided from its liaison program suggests there should be a meaningful rebound in labour market activity as the recovery takes hold. An unemployment rate with a 3 handle cannot be ruled out as we show in Figure 8. This potentially could get the RBA close to achieving annual wages growth of 3%.



The risks that underlying inflation could be stronger and the labour market firmer than we thought means the risks are skewed towards the RBA hiking earlier than our May'23 call. Below is a grid of the major data releases for the RBA to assess late this year and over 2022. Working off this grid, a hike in May'22 is the earliest the Bank could move and would require trimmed mean prints of 2.5%+ in Jan'22 and Apr'22. A hike in Aug'22 is possible following Q2'22 CPI in July, but a hike in Q4'22 is lining up as most likely with additional wages and GDP data at hand. We now change our call for the RBA to commence its hike cycle in Q4'22.

**Figure 9: Schedule of Data Releases**

Month	CPI	Wages	GDP
Nov-21		Q3'21	
Dec-21			Q3'21
Jan-22	Q4'21		
Feb-22		Q4'21	
Mar-22			Q4'21
Apr-22	Q1'22		
May-22		Q1'22	
<b>Jun-22</b>			<b>Q1'22</b>
Jul-22	Q2'22		
Aug-22		Q2'22	
Sep-22			Q2'22
Oct-22	Q3'22		
Nov-22		Q3'22	
Dec-22			Q3'22

Source: Bloomberg, TD Securities

Our official forecast is for the RBA to shift the target bond from the Apr'24s to the Apr'23s at next week's meeting but we do admit it's more likely next year. What's more likely is the RBA announcing an end to QE in Feb at next week's meeting.

With the yield on the Apr'24s yet again testing levels seen last week when the RBA stepped in as a buyer, the expectation is for the RBA to step in as a buyer again either tomorrow or Friday. However not doing so will stoke speculation the Bank could announce a target bond shift to the Apr'23s next week.