Oil Surge - A New Inflation Threat?

Oil prices have been on the move up, sharply so. Last week oil prices breached US$90 a barrel for the first time since November last year, reaching a ten-month high of almost US$94 a barrel last Tuesday according to West Texas Intermediate pricing. The rally has been underway since June. Indeed, prices have spiked almost 40% from late June when the oil price had been around the US$67 a barrel mark. The price of Brent crude, another international benchmark, has also spiked, piercing US$95 a barrel last week for the first time this year. A break above US$100 a barrel in the near term can't be ruled out.

The oil price surge is due to stronger than anticipated seasonal demand and a drawdown in oil inventories. Saudi Arabia and Russia also recently announced their intentions to extend voluntary oil production cuts until the end of December 2023. They were originally due to expire in the Northern Hemisphere summer. Supply and inventories are both tight. The decision by Saudi Arabia, as well as Russia, to cut production amid rising prices led the International Energy Agency to recently warn OPEC+ was "locking world oil markets into substantial deficit".

Major central banks around the world have made progress in bringing down inflation, but with inflation rates above target in the major economies, the war on inflation is not yet won. The re-acceleration in oil prices poses a challenge to the ability of central banks to bring inflation under control. Rising oil prices means rising fuel costs, which add to inflationary pressures and weigh on economic activity. Fuel costs are also an important driver of inflation expectations which are another important avenue through which elevated oil prices pose a threat to inflation.

There's a risk that oil prices hover around the current elevated levels for the remainder of this year, but the slowdown in economic activity, including concerns around China's recovery, should see a weakening trajectory next year. Considerable discipline is also needed from OPEC+ to ensure the strategy around keeping prices higher works.

Nevertheless, it means central bank heads are posed with new challenges around inflation. The higher for longer theme is likely to continue to dominate amid this backdrop. Further tightening can also not be completely ruled out. The Chair of the US Federal Reserve, Jay Powell, certainly stressed this last week in the press conference that followed the on-hold rates decision. His message was clear – there will be no near term relief from elevated borrowing costs. The Fed also published fresh projections, including the "dot plot" of Fed member interest rate estimates. It showed that members expect one more rate increase this year, which would take the federal funds rate to between 5.5% and 5.75%. After that, most members see a slower path of rate cuts in 2024 and 2025, which shows a hardening of the Fed's commitment to the higher for longer theme and approach to monetary policy.

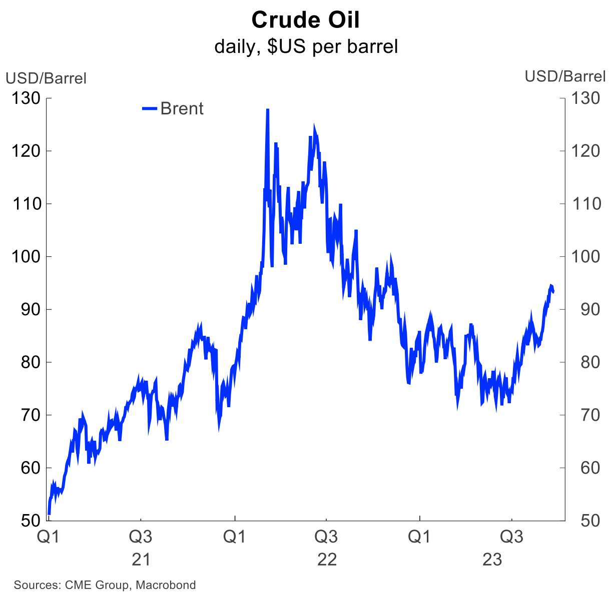
The median estimate of the Fed's nineteen policymakers is for the bank's benchmark rate to fall to just 5% to 5.25% next year, which is significantly higher than the 4.5% to 4.75% range signalled when the dot plot was last updated in June.

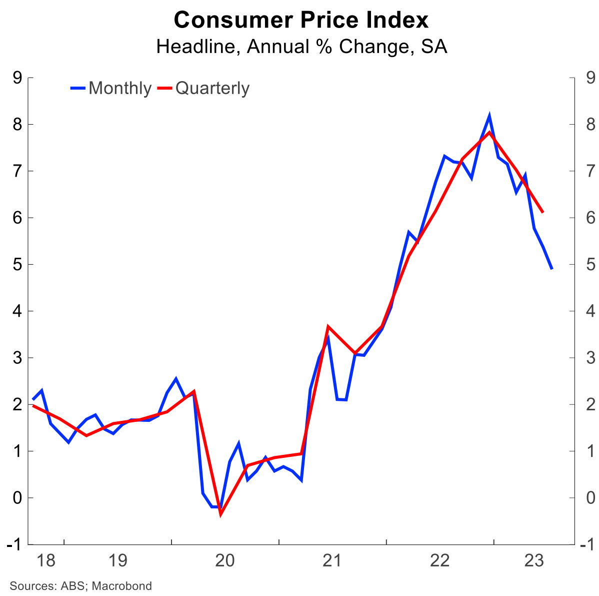
Part of the hardening of the commitment around higher for longer also reflects the growing confidence policymakers appear to have in being able to cool inflation whilst avoiding a hard landing. Fed policymakers now expect economic growth to slow next year to 1.5%, from 2.1% this year, and for the unemployment rate to go no higher than 4.1%. That's just a tad higher than the current rate of 3.8%.

Interest-rate markets subsequently have shortened the odds of another rate hike from the Fed. At the next meeting, markets are attaching a probability of 21% of another hike whilst another rate hike by January 2024 is seen as a 50/50 call.

Markets now see more chance of another hike in Australia, with an 80% chance of a rate hike by March 2024.

The data will be more important than ever and remain the key to any possible future rate hikes.





Consumer price index monthly measure

In this coming week, it will be all eyes on the monthly inflation measure due Wednesday. The monthly consumer price index (CPI) measure lifted 0.3% in July to be up 4.9% in the year, a moderation from the 5.4% annual pace in June and the recent peak of 8.4% per annum in December. In August, the march higher in oil prices, and subsequent lift in the price of petrol at the bowser, is likely to contribute to the annual rate ticking up from 4.9% in the year to July to 5.2% in the year to August. Petrol prices rose close to 8% in August while diesel is up more than 12%. The range of forecasts of economists surveyed is 4.7% to 5.6% per annum.

The other data out this week includes job vacancies (Thursday), nominal retail sales (Thursday) and private-sector credit (Friday).

Job vacancies

Job vacancies are declining but remain elevated. Over the three months to May, the fall in job vacancies slowed to only 2.0% taking vacancies 10% below the peak registered in May 2022. May 2023's results are nearly double the level prior to covid, underscoring the incredibly tight nature of the labour market. We expect job vacancies in the August quarter to ease again but not enough to alter our view that the unemployment rate is likely to tick up only gradually in coming months. It is currently near a 50-year low at 3.7%.

Nominal retail sales

Nominal retail sales for August should rise 1.0%, after a lift of 0.5% in July. The spend on hospitality and recreation is likely to have boosted the outcome with spending at cinemas (Barbie, Oppenheimer) and the Women's World Cup important factors. These, however, are temporary boosts and the underlying trend remains of households tightening their belts, especially on discretionary spending. There is also a question of substitution, that is, did households pull back on spending elsewhere to fund greater spending in cinemas and at the football. Or was the spending on top of their normal spending patterns. The strong pace of population growth, running at 2.3% per annum, is bolstering nominal retailing.

Private-sector credit

Credit growth extended to the private sector remains modest as higher interest rates cause demand to moderate. In monthly terms, credit grew 0.3% in July, unchanged from June. Monthly growth ranged between 0.2% and 0.6% over the past 10 months, after a noticeable step down late last year. In annual terms, credit grew 5.3%, down from 5.6% in June and well below the 8.9% September 2022 cycle peak. For August, we forecast another reading of 0.3% growth. That will see annual growth slow to 5.0%.

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Group Forecasts

		2023	2024				2025
End Period:	**Close (22 Sep)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	4.10	4.10	4.10	4.10	3.85	3.60	3.35
90 Day BBSW, %	4.13	4.30	4.30	4.22	3.97	3.72	3.47
3 Year Swap, %	4.09	3.95	3.90	3.80	3.70	3.60	3.50
10 Year Bond, %	4.10	4.00	3.80	3.60	3.40	3.30	3.22
US Interest Rates:							
Fed Funds Rate, %	5.375	5.375	5.125	4.875	4.625	4.375	4.125
US 10 Year Bond, %	4.29	4.10	3.90	3.70	3.50	3.40	3.30
USD Exchange Rates:							
AUD-USD	0.6432	0.66	0.67	0.68	0.69	0.70	0.71
USD-JPY	147.85	144	142	140	138	136	133
EUR-USD	1.0657	1.10	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.2383	1.27	1.28	1.29	1.30	1.30	1.30
NZD-USD	0.5899	0.61	0.61	0.62	0.62	0.62	0.63
AUD Exchange Rates:							
AUD-USD	0.6432	0.66	0.67	0.68	0.69	0.70	0.71
AUD-EUR	0.6032	0.60	0.60	0.61	0.61	0.61	0.62
AUD-JPY	95.08	95.0	95.1	95.2	95.2	95.2	94.4
AUD-GBP	0.5195	0.52	0.52	0.53	0.53	0.54	0.55
AUD-NZD	1.0904	1.08	1.10	1.10	1.11	1.13	1.13

	2021	**2022**	**2023 (f)**	**2024 (f)**
GDP, %	4.6	2.7	1.2	1.6
CPI (Headline), %	3.5	7.8	3.9	3.2
CPI (Trimmed mean), %	2.6	6.9	3.8	3.1
Unemployment Rate, %	4.7	3.5	3.8	4.7
Wages Growth, %	2.3	3.4	3.8	3.2

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

For more information

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