Australia Q2 2010 CPI
One Soft Reading or the Goldilocks Economy?

The CPI Result

The Consumer Price Index for the second quarter of 2010 came in at 0.6% growth over the quarter, with the annual rate at 3.1%. This was a considerable slowing from the previous 0.9% quarterly pace in Q1.

The outcome surprised most market participants, who had been looking for underlying strength in consumer prices given relatively good performance in most other areas of the economy. An additional top-up to consumer prices was also expected due to administered price increases in tobacco. In the event, much slower increases in food prices, retail and recreation–linked to anecdotal reports of ongoing discounting by retailers–contributed to the softer than expected result. A much lower reading in the volatile financial services component also reduced the headline outcome. A similar slowdown was also apparent in the core measures used to gauge underlying inflation.

Implications for Inflation Linked Bonds

One quarter's soft inflation reading has only a marginal impact on inflation linked bonds. First and foremost, a material impact on inflation linked bonds requires not just a fall in inflation in one quarter, but a decline in inflation expectations over the remaining life of the bond, which could be over 10 years or greater. This has clearly not been the case today. Looking beyond the current quarter, we continue to expect elevated inflation over longer time periods in Australia.

Second, with most inflation linked bond portfolios having a longer duration than nominal bond portfolios, the bond market rally seen today will actually provide a greater performance benefit to inflation linked bonds than to nominal bonds. For these reasons, the market response to today's softer inflation numbers do not on their own send a negative signal for inflation linked bonds. This would only be the case if the longer term view on inflation shifted more markedly towards disinflation in Australia.

Is Australia the Goldilocks Economy?

Taking a step back from today's inflation reading, Australia's broader economic direction remains an open question. Most economic indicators are consistent with a modest economic recovery, and some indicators, such as employment, are consistent with very favourable outcomes. Against this backdrop, it is difficult to view Australia as being susceptible to the same types of economic risks currently faced by some of the world's major economies. For that reason we are firmly of the view that deflation remains a very remote risk for Australia. Even if Australia were threatened with such circumstances, the extreme falls in the Australian dollar in such a scenario would act as a very strong buffer against deflation.

So how should we reconcile today's outcome with the broader economic outlook? As a general principle we believe that Australia cannot sustain Goldilocks-type conditions for any sustained period of time. Either inflation must continue to rise, in line with the significant pressures seen in labour markets and infrastructure capacity, or the rest of the economy must slow. Given the outlook for investment associated with ongoing structural strength in Australia's terms of trade, we believe the latter is less likely.

Furthermore, with much of today's soft CPI reading driven by discounting by retailers, whose input costs such as rent and labour are very much still increasing rather than decreasing, we do not view this as a sustainable source of downward pressure on inflation. Accordingly we look for underlying inflation to resume its upward trend over the medium term in Australia. Investors remain well placed to benefit from the protection provided by inflation linked bonds in these circumstances.