

NAB now expect hikes in March and May

Key points

- We now expect the RBA to raise rates in both March and May to a peak of 4.35% (previously one hike in May and 4.1% peak)
- The starting point of robust growth, a too-tight labour market and too-high inflation already supported further tightening.
- New upside pressure on inflation tips the balance in favour of an additional increase.
- Much will depend on the trajectory of oil prices and the domestic data flow, and we see two-sided risks around our new central case for a 4.35% peak.
- We continue to expect gradual easing back towards more neutral levels from H2 2027.

Detail

We now expect the RBA to deliver a 25bp increase to the cash rate at the March meeting, followed by another increase in May, taking the cash rate to a peak of 4.35%. We previously expected the RBA to hike to 4.1% on May, with the risk skewed to an additional increase. We see the risks as more balanced around our new baseline forecast for policy rates at 4.35% in May.

There are four key reasons for our change in view.

First, in our view, the combination of hawkish commentary from both the Governor (see here) and Deputy Governor (see here) over the past week contains more signal than noise. It is clear from their commentary that senior RBA officials are inclined to view the Iranian conflict as an inflationary shock.

Second, the starting point for the RBA prior to the Iran conflict was: 1) inflation that is too high and a forecast that saw inflation return to target over an extended period of time; 2) GDP growth that is above the RBA's estimate of trend; and 3) a tight labour market. Against this backdrop, we can infer that the RBA will have very limited tolerance for upside pressure on inflation and likely, somewhat more tolerance for softer growth outcomes. This means that the policy of least regret is to hike in March.

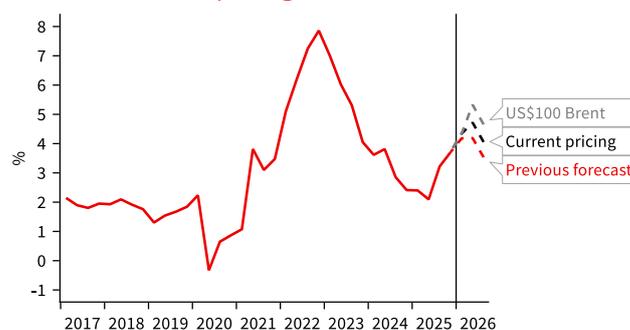
Third, the RBA's February forecasts implied that should the economy progress as forecast, the RBA would need to deliver ~65bps of hikes in order to ensure that inflation returns to a

more sustainable trajectory consistent with the Bank's inflation targeting framework.

Since February, we know the following:

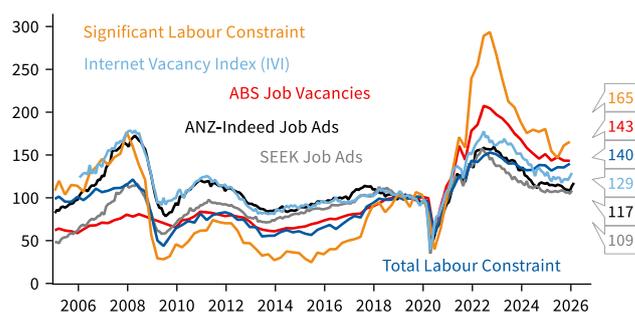
- 1) The peak in headline inflation will be higher than forecast one month ago (for example, NAB was forecasting a peak of 4.2% yoy for headline CPI in Q2; that forecast is now 4.75%, assuming Brent settles ~\$85/bbl – see Chart);
- 2) There is now upside risk to the core CPI projections, the magnitude of which will be mostly determined by the extent and distribution of second round price increases;
- 3) Recent GDP data confirm that the economy's growth rate as of end-2025 was ~0.5ppts above the RBA's estimate of trend GDP growth; and
- 4) Labour market data are suggesting that the unemployment rate is tracking a little lower than the RBA expected in Q1 *and* that labour demand may be picking up (see Chart).

Automotive fuel repricing and headline inflation



Source: National Australia Bank, ABS

Measures of labour demand

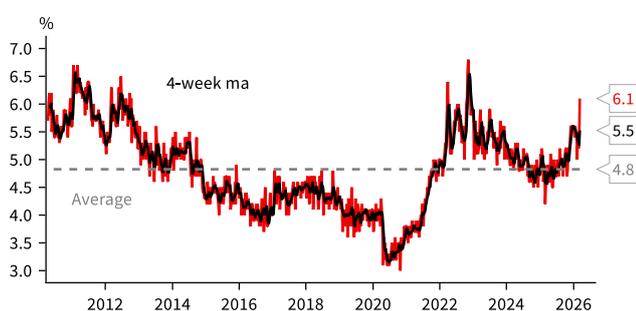


Source: National Australia Bank, Australian Bureau of Statistics, ANZ-Indeed, SEEK Australia, National Australia Bank, Jobs & Skills Australia, Macrobond

In summary, confirmation of limited or no spare capacity in the economy and the prospect of higher inflation for longer are hawkish and imply the RBA may be required to engineer a deeper slowing in growth in order to ensure inflation returns to the target band in a reasonable timeframe. Alternatively, it may be that a forecast return to the RBA's estimate of NAIRU (~4.5%) is no longer sufficient to deal with a higher inflation trajectory.

Fourth, short-term consumer inflation expectations are on the move. While the ANZ-Roy Morgan series is volatile, inflation expectations appear to have risen recently. This is likely to be causing some anxiety at the RBA, given the importance of central bank credibility and anchored inflation expectations to the success or otherwise of the inflation targeting framework.

Consumer Inflation Expectations*



Source: National Australia Bank, ANZ-Roy Morgan, Macrobond
Notes: * Two-years ahead.

Finally, the prospect of a higher peak in inflation and the possibility of a longer return to the target band for inflation means that real short rates will be lower for longer in an environment which demands lower growth and the creation of spare capacity in the labour market. Not hiking in March means that the RBA runs the risk of a longer period in which broader rate settings are not appropriate for economic fundamentals.

Ultimately, as we observed in our write up of the Deputy Governor's podcast last night, the debate is less about the direction of travel and more about the timing. Given the relatively unfavourable starting point for inflation in Australia and recent confirmation that the economy is running well above its trend rate of growth, the case for a near term rate hike is clear.

We have been flagging the risk of an additional rate hike to 4.35% this cycle, and now formally include this in our profile. We see two-sided risks to our terminal rate forecast; much will depend on the trajectory of oil prices and the domestic data flow. But for now, our starting assumption is that an additional inflationary shock will require a slightly higher cash rate than the RBA's projections assumed in February.

In summary, it is no surprise that the Deputy Governor said of next week's Monetary Policy Board meeting that "*I think there will be a very genuine debate.*" As we have noted before, monetary policy is all about risk management. Confirmation of limited or no spare capacity in the economy and one-sided

risks to already high inflation argue for action sooner rather than later. This allows the RBA the best chance of fulfilling both its inflation and full employment mandates.

Of course, there are offsetting reasons why the RBA may choose to hold next week. In short, these are:

- 1) The option value of waiting when uncertainty is elevated;
- 2) Evidence of softer household consumption and weaker unit labour cost growth in the national accounts for Q4;
- 3) Evidence of softer capacity utilisation outcomes in recent months;
- 4) The (small) risk of a full de-escalation of Middle East tensions, seeing oil prices return towards \$70/bbl;
- 5) The tightening in financial conditions in the past week (yields higher, AUD well supported, equities lower and credit spreads wider);
- 6) Some evidence of softer house price outcomes in recent months in the large capital cities, alongside tentative evidence of softer demand for credit; and
- 7) The RBA's oft-stated preference to wait for quarterly inflation outcomes, underpinning a cautious approach to policy changes in the past year or so.

Higher short-term inflation will dampen demand, and combined with a return to somewhat restrictive cash rate settings at 4.35%, is expected see the labour market weaken and activity growth slow. The RBA may need to tolerate a longer period of below trend growth or a softer labour market in order gain sufficient comfort inflation will sustain near target, but we do not expect policy rates above 4% are the new normal. We continue to expect gradual cuts from H2 2027 to take the cash rate to more neutral levels in the low to mid 3s – pencilling in 2 cuts in August 2027 and November 2027, for now.

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