RETAIL SALES – MARCH QUARTER 2007

Key points

- **Today's retail sales data was significantly stronger than market expectations.**
- **Retail volumes growth implies considerable upside risk to Q1 GDP, while the monthly nominal figure was the third consecutive monthly result to surpass market expectations.**
- **While no-change remains the order of the day, the market is under-pricing the risk of a move in June in our view.**

	Actual	ANZ National	Market
Real Retail Sales	**3.8% qoq**	1.7% qoq	1.8% qoq
Nominal Retail Sales	**1.3% mom 7.4% yoy**	-0.4% mom	-0.2% mom
Nominal Core Retail Sales	**0.8% mom 8.6% yoy**	-0.6% mom	-0.7% mom

Assessment and implications

Retail sales growth was significantly stronger than market expectations in March. Nominal monthly retail sales rose by 1.3 percent in March compared with expectations of a small fall and comes after increases of 0.5 percent and 2.1 percent (revised upwards) in January and February respectively. Core sales, which exclude motor vehicle related industries, rose by 0.8 percent in the month. The monthly trend measure was also revised upwards, and although it has been stable around 0.8 percent for the past three months, this is up considerably from the 0.3 percent trend growth from March 2006. Volumes in the quarter were equivalently strong, rising by 3.8 percent.

Strength was reasonably broad based across the quarter, with strong growth across durable, non-durable and services areas. There was notably aggressive discounting within key durables sub-groups, with the retail price deflator falling 0.4 percent in the quarter (but more than 1 percent across durable groups), and flat on a year-ago.

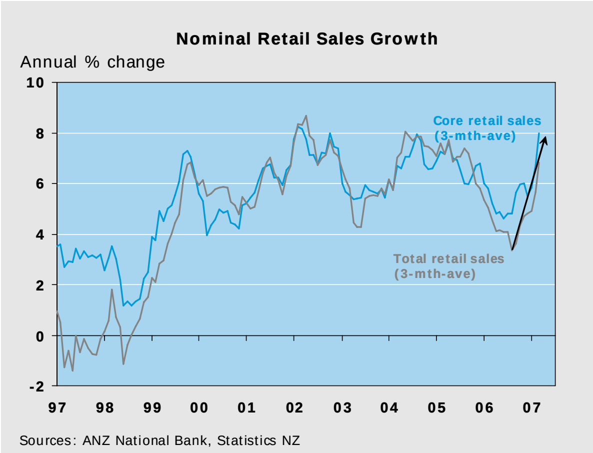
Quarterly volume growth implies considerable upside risk to Q1 GDP. The 3.8 percent increase in retail sales volumes in the March quarter is the largest quarterly increase since the series began in September 1995. This provides considerable upside risk to Q1 GDP, and the Reserve Bank's March *Monetary Policy Statement* estimate of 0.8 percent.

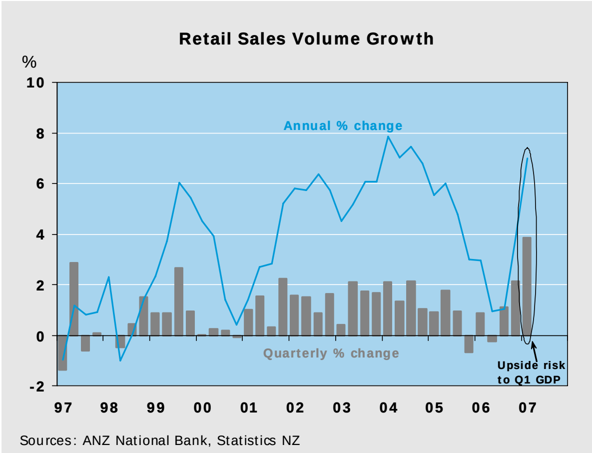
It is looking increasingly likely the Reserve Bank has more work to do. While there is no doubting the full impact of tighter financial conditions has yet to be truly felt, and urge caution on behalf of the Reserve Bank, two areas concern us.

- **The inflation nuances.** Our travels around the country are notable for the strength of the inflation theme, with businesses in particular looking for an opportunity to recover lost margins. The economy has far stronger momentum than envisaged in Q1, and will be putting pressure on medium-term inflation trends via the output gap. Today's retail figures showed outright deflation in key areas, and yet core CPI inflation in the same quarter was running hot. It points to some disconcerting inflation trends if retail deflation ceases.

- **The Reserve Bank is facing an asymmetric risk profile at present.** They cannot afford to let momentum within the economy continue given the prevalence of inflation pressure. While forward indicators and anecdote may point towards a softening in activity in Q2 courtesy of post successive hikes and the squeeze up in the currency (and we have seen consumer confidence ease), the Reserve Bank cannot afford to run the risk of letting the pattern of consolidation and then rebound continue. This time around, the consolidation for the economy and housing needs to be definitive. The bias will be to do more than is necessary on the rates front to engineer this.

For now we'll remain calling no change. But the more we travel around the country and hear the inflation nuances, and see data prints like today, the greater we see the risk of a move in June. Waiting until July doesn't wash either. If the Reserve Bank is serious about breaking the back of a rampant consumer and housing market, then we see little point in waiting. At present we put the odds on a June hike at 40 percent.





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