

Australian inflation outlook

31 October 2026 · Arculus Funds Management

Unlike the market, we were not at all surprised by last week's CPI data, having forecast, just after the commencement of the Iran conflict, that the real impact on final prices would only begin to arrive 6–9 months later. This would be the same lag that occurred with the Russian invasion of the Ukraine. In context it also needs to be appreciated that unlike the Federal Reserve, ECB and BOE, the central bank interest setting board had failed to achieve a period of negative monetary growth after the pandemic spending enabled the inflation genie to break out of the bottle.

At this week's central bank interest setting board meeting, the market is convinced an interest rate increase will occur, but we are on the fence, balanced between rising inflation, wages growth and government spending and our two trick economy dependent on housing/data centre construction and the sale of iron ore through exports. This will be the most difficult decision the 'interest setting board' has faced in many decades. While the banks and other market participants are reading the recent speeches by RBA employees to guide their forecasts, we base our forecasts on the economics – and we naively hope that our central bank interest setting board is also using economics without political influence. Obtusely, we would point out that the bank economists that predicted and justified interest rate cuts in 2025 were wrong then and they are wrong again now.

September quarter inflation

Firstly, the September Quarter inflation data. It is now clear that inflation has become embedded at a rate above the RBA 2–3% target range. Quarterly trimmed mean inflation (the RBA preferred inflation measure) printed at the expected 1% for an annualised rate of 3.6% (previously 3.5%). The biggest contributor was transport and it is now feeding into final goods prices.

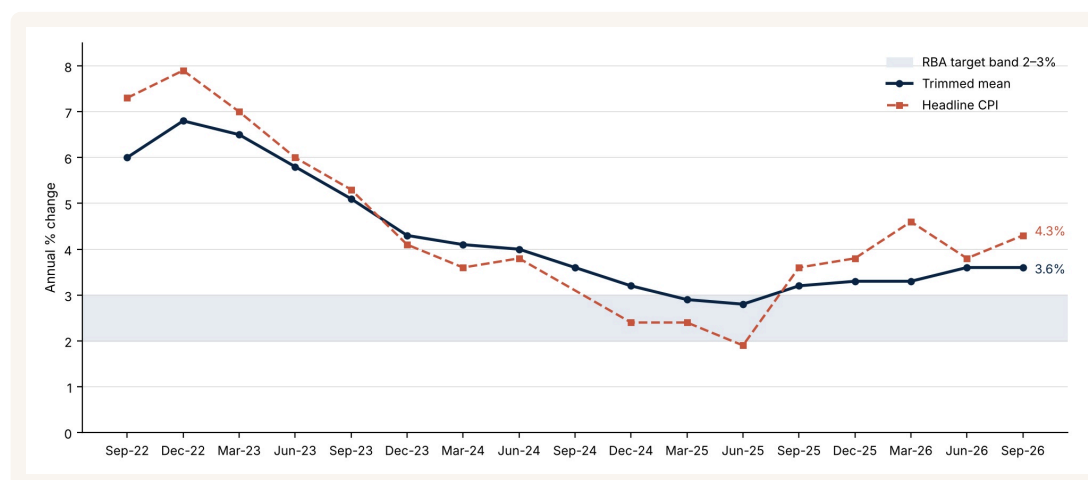


Figure 1 · Trimmed mean and headline CPI, annual % change

Source · ABS, Consumer Price Index Australia, September 2026. Quarter-end readings.

It is automotive fuel prices with the expiry of the subsidies driving the increase in the transport costs.

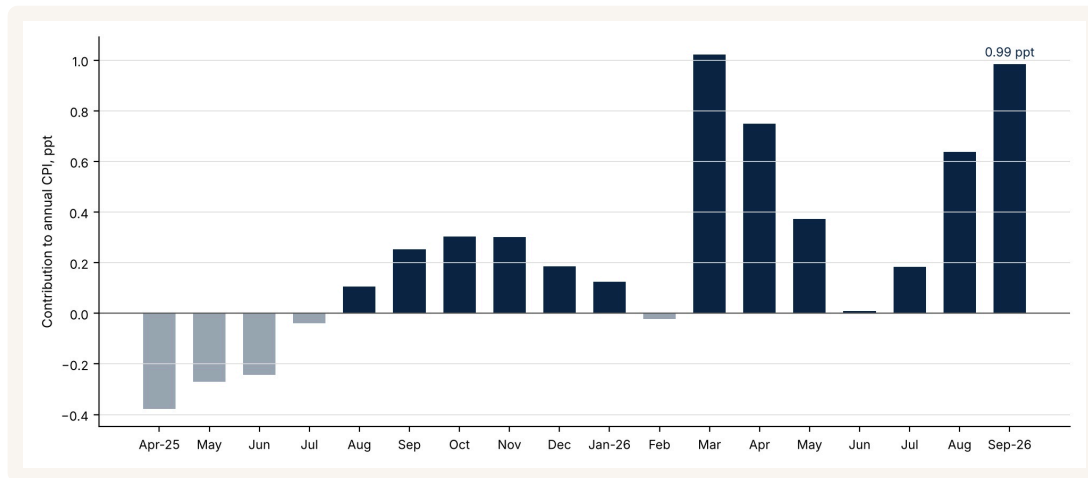


Figure 2 · Transport contribution to annual CPI, percentage points

Source · ABS, Consumer Price Index Australia, September 2026. Automotive fuel rose 9.4% in September and 23.6% over the year.

Higher transport costs are feeding into travel and recreation costs. It is worth noting that households appear to be cutting discretionary expenditure in other areas such as clothing and furniture and these prices showed a monthly fall.

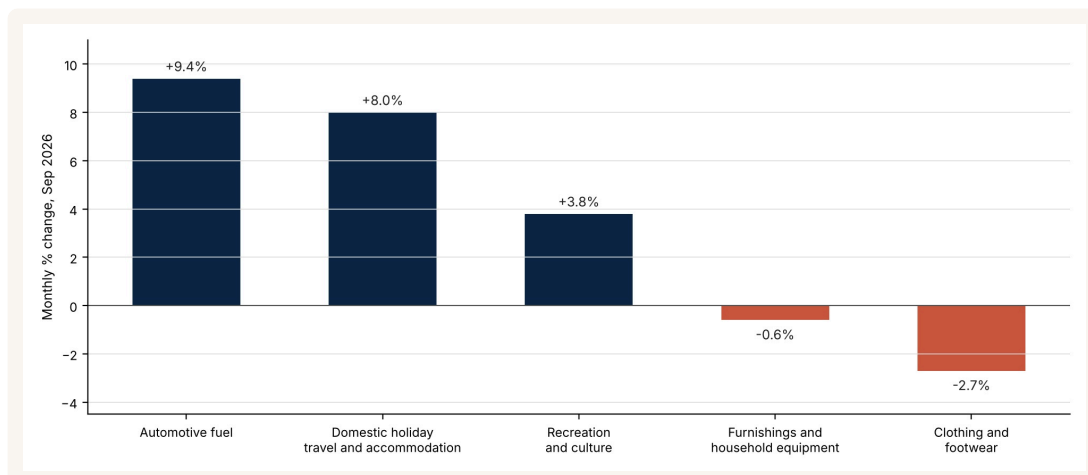


Figure 3 · Selected price changes, September 2026 month

Source · ABS, Consumer Price Index Australia, September 2026.

The problem here for the central bank interest setting board is that a stabilisation or fall in the oil price may mean that inflation subsides over the next few months.

Oil, food and fertiliser

Given that the Brent oil price has remained elevated in October and the prospects of it remaining higher for longer, it is difficult to forecast a fall in the oil price feeding into lower automotive fuels and then lower transport costs. However, we may see costs plateau over the next few months if the current level of shipments through the Strait of Hormuz is maintained. If the Strait is fully opened then the oil price may fall and this would alleviate much of the current inflationary pressure.

Globally we have not seen higher food prices despite the impact on the fertiliser supply from the trade disruption in the Strait of Hormuz. In fact, agricultural prices have fallen over the September quarter and this will flow into final good prices in the December quarter.

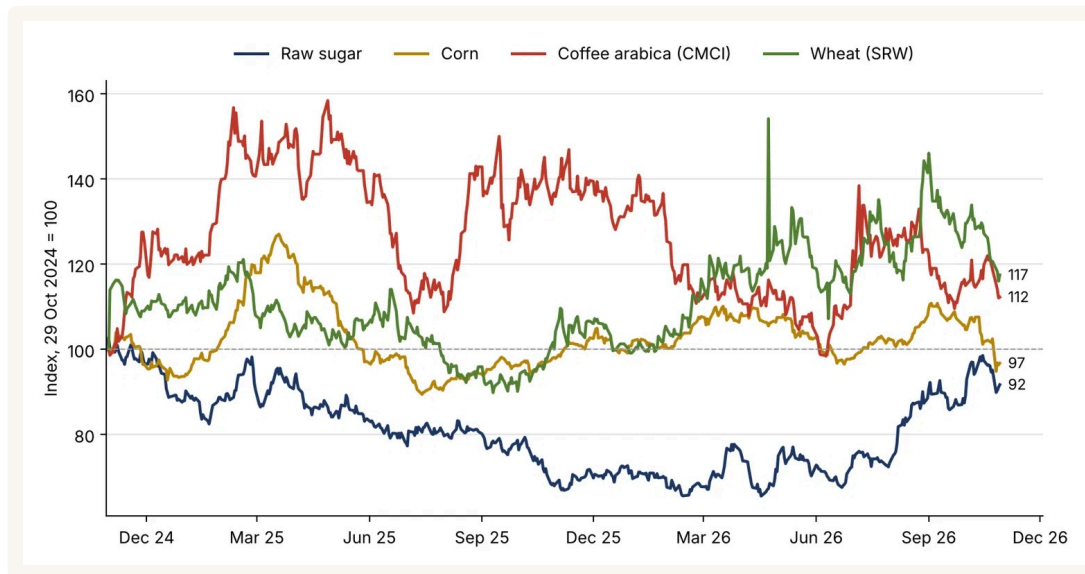


Figure 4 · Agricultural prices, index 29 October 2024 = 100

It is possible that we are yet to see the impact of the closure of the Strait of Hormuz on fertiliser prices because of an inventory reduction, but at this stage we cannot forecast it.

Urea is the most exposed nutrient to Hormuz because Gulf producers supply a large share of seaborne granular urea. It is also the only fertiliser here with an exchange-referenced forward market, which is why it moved fastest on the way up and on the way down.

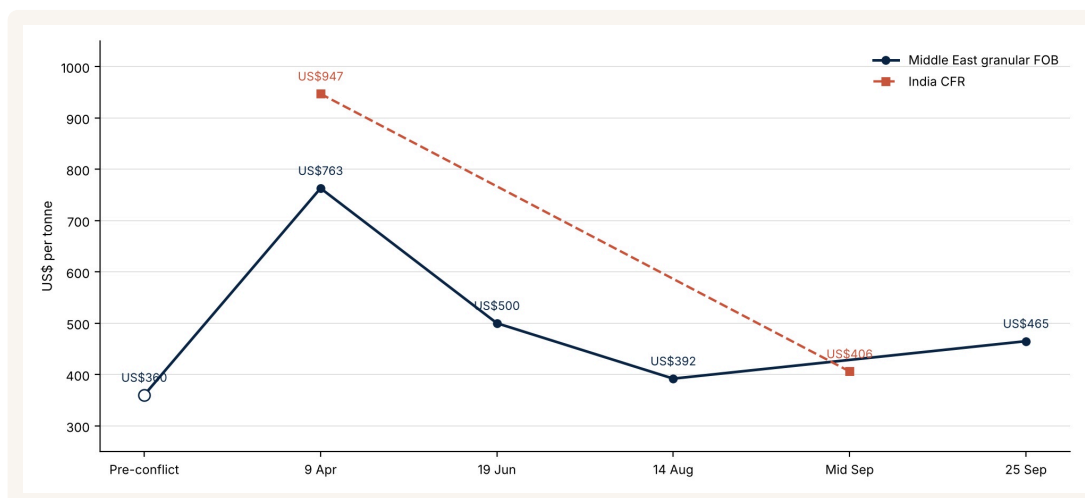


Figure 5 · Granular urea prices, Middle East FOB and India CFR

Source · Arculus Funds Management. The pre-conflict Middle East figure (open marker) is approximate. India CFR points are April and mid-September 2026.

Middle East granular FOB prices rose from roughly US\$360 before the conflict to US\$763 on 9 April. They then fell to US\$500 by 19 June as the memorandum restored shipping and reached US\$392 by 14 August even after conflict resumed. India CFR followed the same path at a lower level, with the April print of US\$947 taken as the midpoint of the lowest offers of US\$935 to US\$959 and a mid-September print of US\$406. The pre-war US\$360 figure is not verified to a primary source.

The last verified Middle East print is 25 September at US\$465, up US\$73 from the August low. The most plausible reading is that the market sold off on demand weakness and Indian tender supply after the June accord, and has begun to reprice supply risk. We have no late-October Middle East print and the outcome of the Indian Potash Limited tender of 7 October has not been verified.

We may only begin to see the impact on Urea prices in the months ahead and this will not impact the Northern or Southern hemispheres production for 12 months. This is very good news for the inflation forecast.

Full employment and aggregate demand

Secondly, we have to visit the other side of the RBA mandate where there is a commitment to full employment. Really, what we are talking about here is Aggregate Demand (C+G+I+X-M). Here the RBA behaviour was most disappointing with an earnest attempt to claim that NAIRU is 4.90%. NAIRU is the lowest rate of unemployment before inflation will begin to accelerate. The RBA has shifted its position on NAIRU several times over the past 2 years and this has some economists questioning the quality of their economic modelling (we would blame politics before the model outputs). Under Governor Phillip NAIRU was estimated at 4.75% but when it fell well below this level there was a raft of left wing academics claiming that NAIRU was somewhere below 4%. The RBA under Bullock was cutting rates when the unemployment was near 4.1% so, at the time, its economic modelling must have estimated NAIRU under this level or it was cutting rates just ahead of a Federal Election, when inflation had fallen only due to both Federal and State energy subsidies, for political reasons?

A good starting point to assess the need for another rate rise is the application of The Taylor Rule. Our previous work on this subject can be found in our paper, Taylor Rule Sensitivity Analysis: United States and Australia Prepared: 13 July 2026

Risks to the outlook for aggregate demand

Our house view is that Aggregate Demand is on the edge of a major and prolonged contraction. Make no mistake it is still too early to be adding duration because of offshore factors and we expect that higher inflation over the next 12 months will keep the RBA on hold into 2028 when miraculously they will cut rates ahead of the next Federal election but there are now significant risks to the outlook that need to be acknowledged and are hopefully part of the RBA modelling or ad-hoc analysis. These are set out below.

- The likely change of government in Victoria, where the situation is so dire it is jeopardising the entire Australian economy. No matter who is elected there will be a prolonged period of depressed economic activity until the debt is paid down.
- While not as advanced as in the US economy, the data centre build out is at risk of collapse under a debt burden that is drowning the sector as interest rates rise. Even without a collapse in data centre investment it is hard to see where an investment will be commercial in a private capacity.
- Bathla may well prove to be the biggest corporate collapse in Australia's history but it would be foolish to believe that there will not be more to follow. The risk here is that bad lenders drag good lenders into the same very, very deep hole. Even without a collapse of the private credit business model in the short term, we cannot see how bank system lending growth will not decline over the next 12 months and bring about a fall in land values – particularly in outer metro areas. This has negative implications for household spending, particularly on discretionary good and services.
- Australia is highly reliant on the export of iron ore to fund its magic pudding and the fall in the iron ore price is a prescient reminder of how vulnerable the economy has become on China. There are forecasts of it falling from the current US\$91 a tonne to US\$74 a tonne over the next few months.

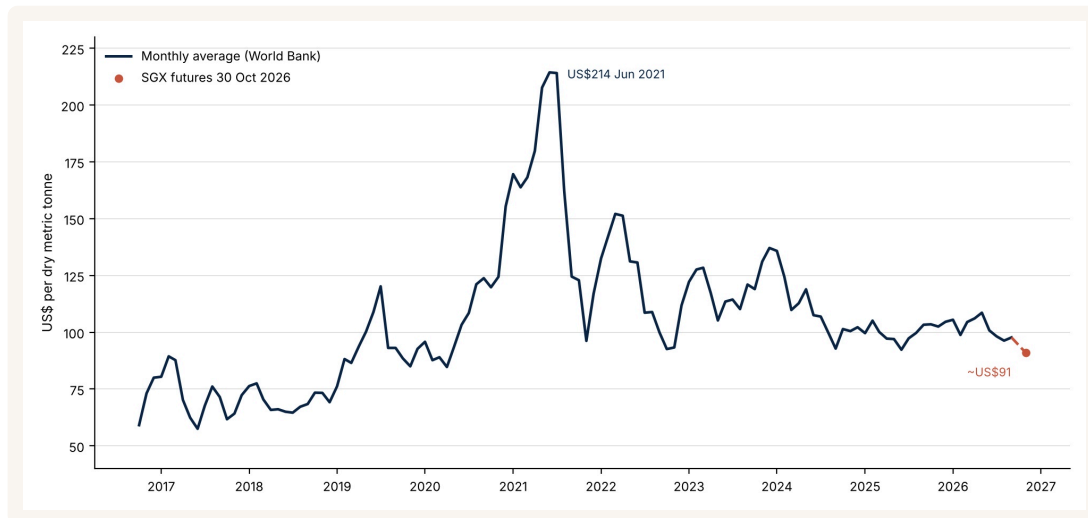


Figure 6 · Iron ore 62% Fe CFR China, US\$ per dry metric tonne

Source · World Bank Commodity Price Data (Pink Sheet), monthly averages to September 2026. October 2026 point is the SGX front-month futures price on 30 October 2026.

- Then there is the fact that one of the main reasons that inflation was moving higher in Australia, before the Iran conflict, was the expiry of the energy subsidies and that the rising household energy bill is a direct consequence of the cost of building out the renewable transmission network. As energy is judged an essential good by nearly all households we may see them cutting consumption as an offset.

Summary

In summary then, we believe that the central bank interest setting board can hold off a rate increase until February when it will be in a better position to judge the impact of the data centre building outlook and the actions taken by the next Victorian government. We see inflation having peaked in the September quarter, at least in the short term, and until the prospect of big jumps in public sector wages drives it higher (we are already seeing claims of 9% by some public sector unions but they may prove to be redundant post the Victorian election). Aggregate demand will be weaker over the next 12 months and we are at risk of entering a prolonged period of economic contraction.

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