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Weekly economics podcast: Cash rate glued on hold

By Perpetual Corporate Trust

17 November 2025

The RBA's cash rate is glued on hold at 3.60% over the next few months. Beyond that, the next move is shaping up as a hike, rather than a cut. Sticky inflation above 3% y-o-y and a still tight labour market keeping annual wage growth above 3% y-o-y are the reasons why the RBA cannot cut the cash rate further, but needs instead to consider whether the cash rate is high enough to bring inflation down inside the 2-3% target over the next two years. The underlying cause of why the labour market is staying too tight and inflation is caught above 3% through the remainder of this year and through 2026 is that household spending is starting to rise too fast in an economy where government spending has been and still is growing rapidly and growth in supply is limited by a long and continuing period of poor productivity.

Australian data and survey releases over recent weeks highlight the risk of a protracted period ahead of high inflation above 3.0% y-o-y. The first of these data releases was the Q3 CPI report showing that annual CPI inflation had risen more sharply than expected to 3.2% y-o-y from 2.1% in Q2. Underlying (trimmed mean) inflation also showed a bigger than expected increase to 3.0% y-o-y from 2.7% in Q2. While higher electricity prices after removal of state government electricity rebates were the main reason for the lift in inflation there were also signs of higher inflation in several other areas of the CPI, including grocery prices, education and health costs.

Looking ahead, the next CPI report is the new comprehensive monthly report for October out later this month. The old and less comprehensive monthly CPI was up at 3.5% y-o-y in September, about where the October CPI is likely to come in. Beyond October is the issue of when the Federal Government electricity rebate ends. There is talk that the scheduled ending of the $75 per quarter rebate on 31st December may be extended through to the end of June 2026. Whatever is decided, the additional upward blip to annual inflation will start to show either in January or July 2026. When it does come through, annual CPI inflation will lift close to 4% y-o-y.

The RBA's latest economic forecasts released in the November Monetary Policy Statement show substantial upward revision to inflation forecasts compared with the previous August inflation forecasts. The latest RBA inflation forecasts for 2026 show CPI inflation at 3.7% in June and 3.2% in December (previously 3.1% and 2.9% in the RBA's August forecasts). Trimmed mean (underlying) inflation is forecast to be 3.2% in June and 2.7% in December 2026 (previously 2.6% forecast for both June and December 2026). These changes to the RBA's inflation forecasts showing inflation above 3% through to mid-2026 mean no possibility of cutting the cash rate over the next few months, but growing risk that the next rate change is a hike if the RBA needs to adjust its inflation forecasts higher in February and/or May next year.

The first signs that the RBA may need to adjust its inflation forecasts higher next year are showing in the tightness of the labour market combined with indications of overly-strong growth in household spending.

A still very tight labour market was evident in the October labour force report. Employment rose by 42,200 (full-time employment by 55,300) stronger than the 20,000-lift expected and consistent with the RBA's latest employment growth forecasts. The unemployment rate fell to 4.3% from 4.5% in September.

Relating to household spending, Q3 home loans rose by 4.7% q-o-q and by 17.6% y-o-y corroborating the strength of demand for housing evident in rising house prices over recent months. The November Westpac consumer sentiment survey showed a remarkably strong increase, up 12.8% m-o-m, taking the index reading above 100 for the first time in 4 years. The sharp lift in consumer sentiment came even with the RBA leaving the cash rate unchanged at its November interest rate setting meeting – the time when the sentiment survey was conducted.

Household spending has been rising above 5% y-o-y according to recent monthly reports and looks set to rise at even faster pace over the next few months.

These recent reports and surveys relating to the tightness of the labour market and the rising strength of household spending are sowing the seeds for potential upward revision again of the RBA's inflation forecasts when the next Monetary Policy Statement is released in February.

In the near term more reports that will be important driving upward revision to the RBA's inflation forecasts include the Q3 wage price index report out this Wednesday, the October CPI report later this month and the Q3 GDP report out in December, especially the productivity measures in that report.

At this stage, we see the Q3 wage price index coming in around 0.8% q-o-q, 3.4% y-o-y - to take any pressure off the RBA it would need to come in below 3.2% y-o-y. The October CPI we see at 3.5% y-o-y with underlying inflation at 3.1% y-o-y. To take pressure off the RBA outcomes of 3.3% for the CPI and 2.9% or less for underlying inflation would be needed. The Q3 GDP report needs to show that GDP per hour worked lifted by at least 0.3% q-o-q.

The review of recent reports relating to inflation, the labour market and household spending and a realistic look ahead at inflation and wage growth reports as well as productivity provide no wriggle room for the RBA to cut the cash rate in the near term. Instead we see the RBA becoming increasingly uneasy with the cash rate on hold at 3.60% over the next two or three interest rate setting meetings ahead of outright warning towards mid-2026 that next rate change could be a rate hike.

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