

Inflation Focus Q1

13 March 2025



Key Points

- Tectonic shifts are underway in the global economy, driven by the changing geopolitical and global trade backdrop
- Inflation should continue to grind lower near term, with goods deflation and slowing services inflation still in place
- Central banks are set to respond to any emerging price pressures, which should help to contain inflation medium term
- Inflation will remain volatile, however, amid more fractured global trade and defence spending pressures

Historical shifts underway in the global economy

Inflation remains above target in key regions, largely moving sideways over the past quarter. At a more granular level, there are some positive developments, with slowing wage growth in Europe, falling rent and services inflation in the US, and goods deflation still in place globally. Inflation is moreover weak in Asia, amplified by the deflationary environment in China, with producer prices under pressure across the region. In LatAm, a rebound in inflation has triggered a marked shift in the monetary policy stance, confirming that central banks remain focused on inflation and are willing to act should it be needed.

So far, developments have been largely as expected and would normally have strengthened our conviction that inflation targets are within reach. Looking forward, however, tectonic shifts are underway in the world economy, with implications for the outlook.

US tariffs on Mexico and Canada would derail the growth outlook if implemented

The US has moved forward with tariffs more aggressively than expected, given 25% tariffs announced (but currently paused) on Mexico and Canada. The two countries are the most important trading partners for the US, with highly integrated supply chains and large mutual dependencies. Should these tariffs eventually be rolled out, they would be highly disruptive, not only for Mexico and Canada but also for the US itself.

As a result, there is a high likelihood that tariffs are watered down over coming weeks, and this already seems to be happening. However, even if that is eventually the case, the sheer uncertainty that has been created is negative for sentiment, investment, and

economic activity. This has become visible in the latest data, which shows weakening global business confidence and US consumer sentiment, with the latter also reflecting a slowing job market and disruptive Federal job cuts. As the US consumer becomes more cautious, this will help to contain US services price pressures. The path for goods prices in the US is more uncertain and subject to the path for tariffs, but a strong dollar and weakening energy prices should provide some offset.

Europe changes tack, potentially ending stagnation as fiscal spending is unleashed

The geopolitical backdrop is also changing, and this has triggered a historic shift in European fiscal policy. Debt financed defence and infrastructure spending is set to rise materially over coming years, led by Germany. While the exact timing and form of spending is uncertain, it should spur sentiment, demand and growth in the region, providing a more robust domestic backdrop for inflation, particularly over the medium to long term. That said, with wage growth normalising, external demand remaining weak, and manufacturers under pressure, the near-term outlook for inflation for the region is still one of moderation.

US tariffs are disinflationary for the rest of the world, as long as broad-based retaliation is avoided

The US has also raised tariffs on China and is expected to target Europe next. This is creating pressures on exporters to the US to cut their prices, instead of passing tariffs on to the US consumer. Anecdotal evidence suggests that this is happening across supply chains to the US, leading to more broad-based downward pressure on costs and margins. China has also diversified its exports away from the US, adding to overcapacity and disinflationary pressures

elsewhere. As a result, the global pricing environment for goods should remain weak. This outlook hinges critically on other countries avoiding persistent and broad based retaliation, however.

Market pricing implies increased growth concerns in the US and transformational changes in Europe

Inflation was already expected to run at a higher pace for longer in the US, and recent changes have not markedly shifted this view. Indeed, investor focus has shifted from inflation to growth concerns, as implied by the sharp fall in US Treasury yields, with market implied inflation expectations also falling. For Europe, changes to market pricing imply a more fundamental shift, with a surge in German Bund yields, reflecting both the stronger growth outlook and a more robust inflation backdrop. While implied market inflation expectations have risen, they continue to track well below those of the US.

Critical that central banks stay vigilant

With historical shifts underway in the global economy, it becomes even more critical that central banks remain focused on inflation, and act should it be needed. So far, this appears to be the case, with the ECB toning down its rate cut guidance and the Fed reiterating the need for restrictive policy to remain in place for longer.

We expect central banks to remain vigilant. This should provide an anchor point for inflation expectations and market pricing and ensure that borrowing costs are at an appropriate level to avoid a persistent overshoot of inflation. Given escalating geopolitical pressures and potentially conflicting objectives, this will be a key factor to monitor.

US
Consumers' inflation expectations rise to the highest since 1995

Headline CPI inflation slowed notably from 0.5% MoM in January to 0.2% MoM in February, with core inflation also registering a better than expected 0.2% rise, leading to annual rates easing back to 2.8% and 3.1% respectively. While this is encouraging, with key components such as owners' equivalent rent and services weakening, inflation is still not fully vanquished. Consequently, the Fed will need to proceed with caution, particularly if inflation expectations show signs of becoming unanchored. Consumers' long-run inflation expectations rose to the highest since 1995 in the University of Michigan's latest survey, emphasising the need to bring inflation rates closer to target. Input cost

pressures continue to rise, particularly in manufacturing, as suppliers pass on tariff-related price hikes. Raw material prices have shown the largest monthly gain since October 2022 according to the latest PMI survey, while wage pressure remains elevated. At the same time, however, recent business surveys show signs of intensifying competition, which is driving down services price inflation. Policy uncertainty, reduced hiring and the aggressive federal layoffs driven by the Department of Government Efficiency are expected to keep a lid on wage growth, helping to reduce service inflation in the quarters ahead.

UK
Inflation remains high despite lackluster growth

Price pressures remain stubbornly high in the UK. Although headline CPI inflation ticked down by 0.1% MoM in January the decline was less than consensus expected, leading to an acceleration in the annual rate from 2.5% YoY in December to 3.0%. Core inflation also picked up markedly from 3.2% YoY to 3.7%. The latest PMI surveys show that input cost inflation accelerated for the fourth month in a row in February. Major factors for high cost pressures are linked to higher salary payments and the impact of suppliers trying to pass on forthcoming increases in employers' National Insurance contributions. Greater raw material costs and higher energy bills are pushing input prices up further. At the

same time, wage pressure remains elevated despite private sector firms signalling an increasingly reluctant stance to hire new staff given weaker demand and an uncertain outlook.

The potentially stagflationary environment is a significant challenge for the Bank of England which recently raised their own inflation forecast for the current year. A softening labour market and modest growth will help to keep price pressures in check, but the BoE will have to proceed with caution to make sure that longer-term inflation expectations remain well anchored.

Eurozone
The game has changed

Disinflationary pressures continue to filter through the Eurozone as core price pressures are fading despite volatility around energy and goods prices. This has allowed the ECB to cut rates further to 2.5% in March. But, a historic announcement by the incoming German government of fiscal expansion in excess of 20% of GDP, coupled with EU-broad plans for EUR 800bn in defence spending, has increased both the growth and inflation outlook. The ambition of these packages is likely to significantly impact Eurozone GDP growth in the coming years and in the best case scenario will increase potential growth persistently. This economic strength is likely to lead to further domestic inflationary pressure.

Offsetting this, the deteriorating relationship between Europe and the US increases the likelihood of punitive tariffs, which would weigh heavily on growth should they materialise. Inflation most recently printed at 2.4% YoY for February, with core inflation at 2.6%. Closely watched services inflation finally dipped below 4%, to 3.7% YoY. We expect this rate to continue to decrease, and it is crucial that it does. The ECB is now close to our initial estimates of neutral policy, but we continue to see further cuts towards a 2% deposit rate in our base case. As above, uncertainty regarding fiscal policy and the impact of tariffs significantly complicate the picture, and in opposing directions.

Switzerland
Inflation to remain low, but deflationary pressures have eased

Inflation continues to fall, with CPI at 0.3% YoY in February, down from 0.6% at the end of Q4. The details were a bit stronger than headline suggested though. After falling for five consecutive months prices rose MoM, and core CPI ticked up to 0.9%. Deflationary pressures on producer and import prices have also eased, with import prices now falling at -0.8% YoY, up from -4.4% in early Q4. This follows last year's front-loaded SNB policy easing, which helped to stabilise the currency. While this is encouraging, CPI excluding rents remains in deflationary territory at -0.3% YoY. Additionally, the regulated rent reference rate was cut by 25bps in March, which will weigh on rents in H2.

Economic growth headwinds are also set to persist, given a highly fractured and uncertain external environment, which should help to contain wage and price pressures more broadly.

Given this, we expect inflation to move sideways at around the current rate in 2025. In contrast to last year, inflation is tracking in line with the SNB's latest forecast, and we see the policy stance as broadly neutral. While the SNB is set to maintain its dovish stance, prospects for further easing are limited unless global conditions deteriorate materially.

Japan
Price pressures pick up

National CPI surged to 4% YoY in January, marking the second-highest reading in four decades, driven by a spike in rice prices. Core CPI, excluding fresh food and energy, also edged higher to 2.5% YoY. Although Tokyo CPI for February offered some relief, the overall trend indicates a potential reacceleration of inflation. Wage growth remained robust in December, with a notable increase in bonuses. The proposed wage hike from the trade union (Rengo) is set at 6% this year, up from 5.8% last year, marking the largest wage demand in 30 years. This significant wage pressure is a clear response to ongoing labour shortages.

Inflation pressure and notably higher food prices continue to weigh on consumer confidence, creating uncertainty about whether consumption will gain momentum.

Underlying inflation pressures are, however, largely driven by the tight labour market, rather than strong consumption. Hence, the BoJ remains on track to raise rates this year, potentially bringing its policy rate to 1% by the end of the year.

China

Deflation continues to hamper the economy

Deflation continues to pose a significant challenge, with both consumer and producer prices remaining persistently weak. In February, PPI was still deeply negative at -2.2% YoY, while annual CPI inflation fell into negative territory for the first time since Covid-19, dropping from 0.5% to -0.7%. The timing of Chinese New Year complicates data interpretation, but even the average CPI for January and February is slightly negative, indicating intensifying deflation.

The GDP deflator further declined in Q4, falling from -0.5% YoY in Q3 to nearly -0.8%. There is a risk that prolonged deflation could become entrenched.

Overcapacity is a major issue, with production significantly exceeding domestic demand in various industries. With the focus remaining on exports as a growth driver, this is leading to China exporting its overcapacity and deflation overseas.

The National People's Congress meeting indicates no intentions for major stimulus measures to reflate the economy, though policymakers are starting to be aware of 'excessive price competition' driving down producer prices. Overall, it looks like China will not escape deflationary pressures in the near future.

Australia

The easing inflation trend continues

Both headline and core CPI have decreased more rapidly than anticipated in the last quarter, with headline CPI falling from 2.8% YoY to 2.4% and core CPI from 3.5% YoY to 3.2%. The disinflation trend in goods persists, while services inflation is nearing the upper limit of the RBA's target range. Rent components remain stubbornly high due to a lack of housing supply, but the overall trend is downward. Wage growth is also slowing despite a robust labour market with strong job creation. These conditions enabled the RBA to implement its first rate cut in February, reducing its policy rate from 4.35% to 4.1%. However, this is considered a cautious cut as

the RBA remains wary of the still-strong labour market, indicating tight capacity.

Despite the RBA's cautious stance, we anticipate that the central bank will deliver an additional two rate cuts this year, lowering the cash rate to 3.6% by year end. With the terminal rate remaining elevated for an extended period, inflation is expected to fall within the 2-3% target range this year, aligning with RBA forecasts.

EM Asia

Falling inflation trajectory

India's headline CPI fell from 5.2% YoY to 4.3% in January, driven by softer food prices. Core CPI remains steady around the lower end of the RBI's target range at 4%. With slowing growth momentum, inflation should not become a major concern, allowing the central bank to cut rates further.

In ASEAN, inflation is decelerating, with the average CPI across ASEAN-6 (Singapore, Malaysia, Indonesia, Thailand, the Philippines, and Vietnam) falling to around 2% in February. In Malaysia, low inflation, at 1.7% YoY, is partly due to fuel subsidies, with a modest increase likely going forward. Indonesia's headline CPI fell into

negative territory at -0.1% YoY for the first time in more than two decades, driven by a 50% discount on electricity tariffs, while core CPI was stable around 2.4%.

Overall, inflation is weak across the region, but central banks have refrained from cutting rates aggressively due to FX concerns. The spill-over effects of China's industrial overcapacity is also evident in several industries, where cheap Chinese exports have flooded markets, putting pressure on local producers. This has led Vietnam, Malaysia, and Indonesia to impose tariffs on Chinese products, with Indonesia also banning Temu, a Chinese e-commerce platform.

Brazil

Tighter Monetary Stance Ahead Amid Unruly Inflation Dynamics

Inflation escalated in Q4 2024 amid a booming economy and solid labor market, ending the year at 4.8% YoY, up from below the threshold level of 4% in Q2 2024. Although January's CPI brought some relief by decelerating to 4.6%, this was primarily due to a one-off discount in residential electricity tariffs, which is expected to reverse as soon as February. Consensus expectations also imply inflation will rise to above 5% YoY. Meanwhile, core services inflation accelerated in January to 6% YoY. Despite recent signs of economic slowdown, the pass-through of slowing growth to inflation could take time given strong underlying pricing dynamics.

The Brazilian central bank has kept its hiking cycle uninterrupted, raising the Selic rate by 275bps since Q3 2024 to 13.25%. Monetary tightening is key to addressing persistently unanchored inflation expectations, as well as to moderating FX depreciation pressures, though uncertainty around the fiscal policy outlook remains the weak link for macroeconomic stabilisation. We anticipate a terminal Selic rate of 15%, with inflation ending 2025 at 5.25%.

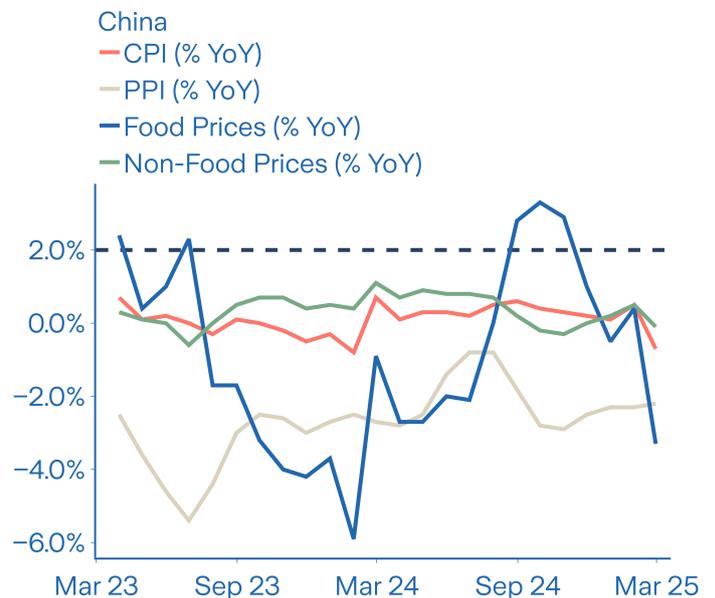
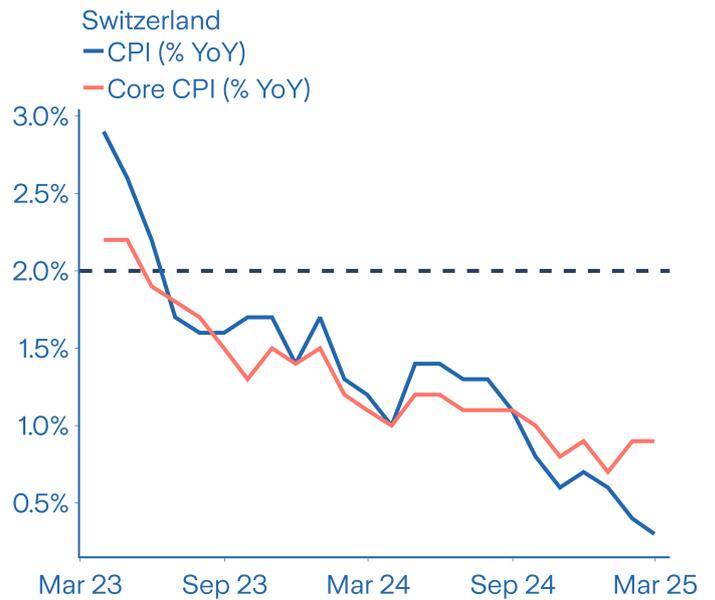
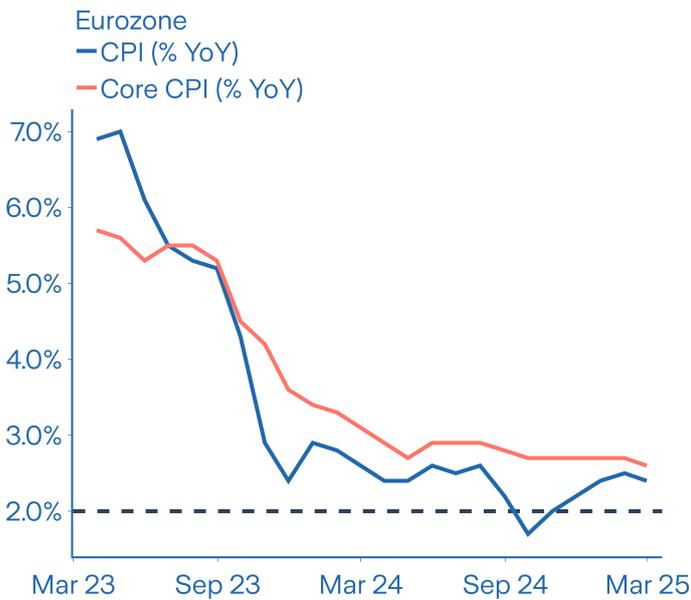
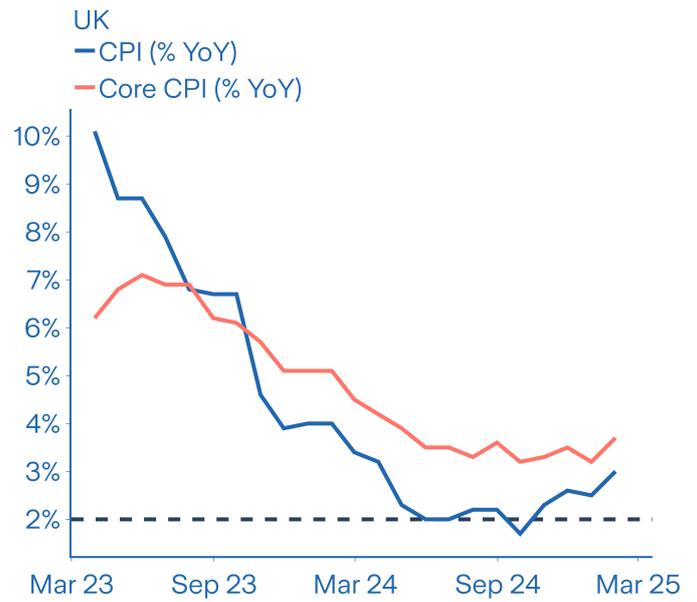
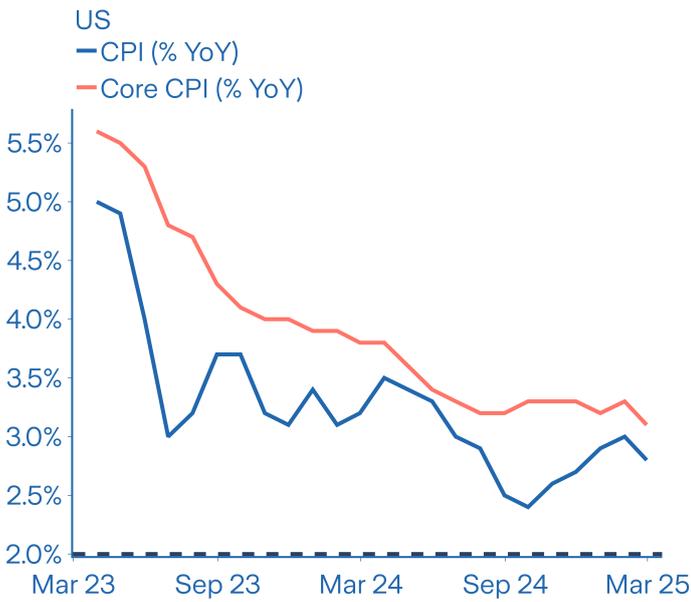
LatAm

Banxico to continue easing while Chile's central bank is on hold in H1 2025

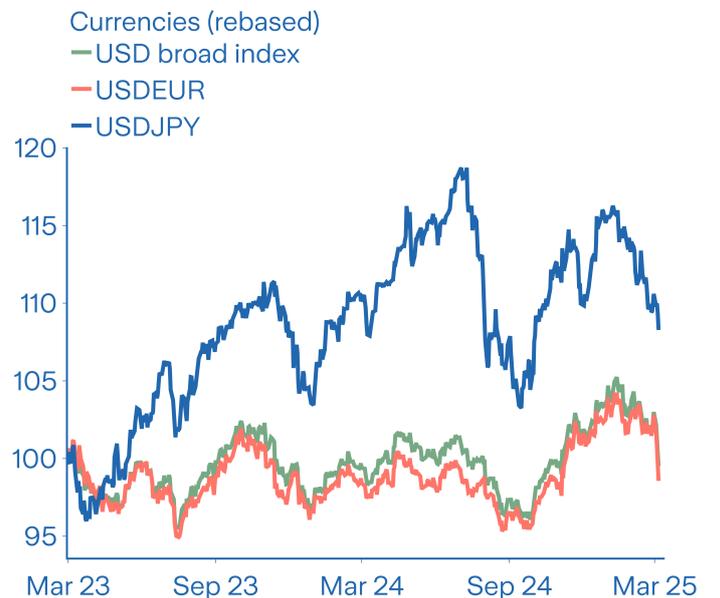
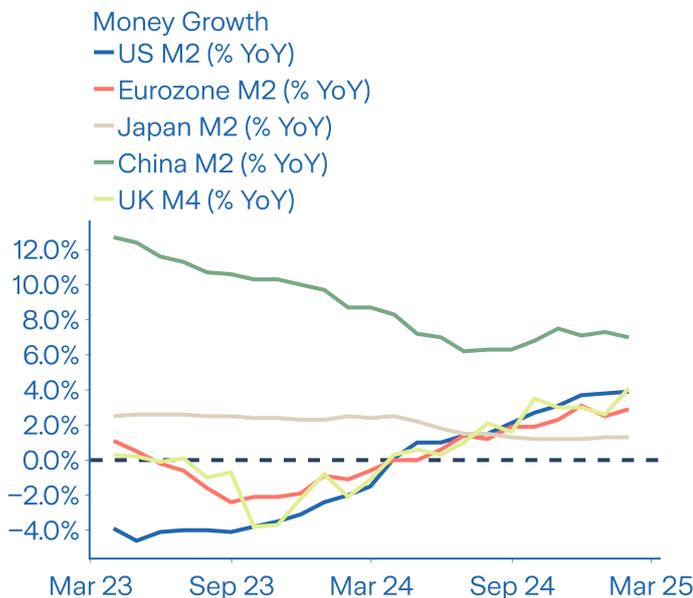
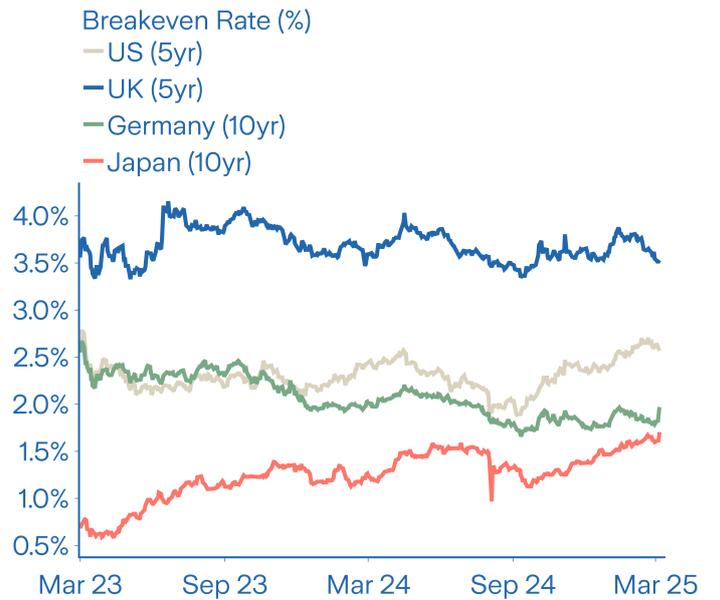
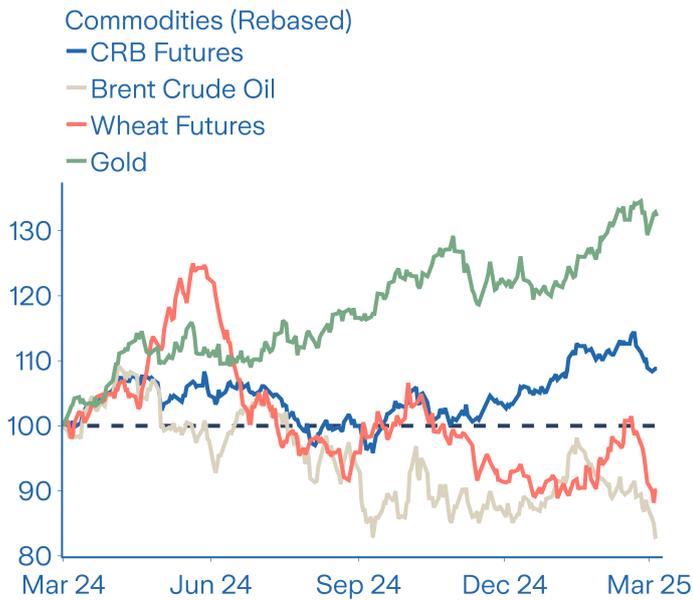
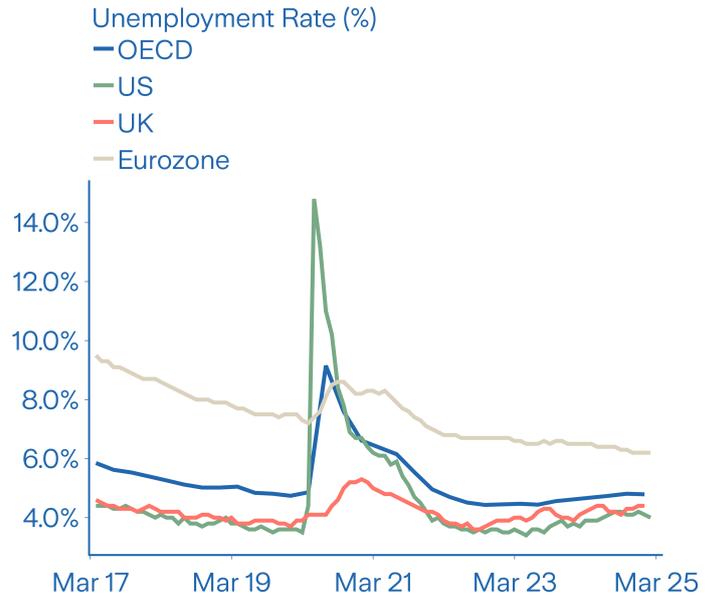
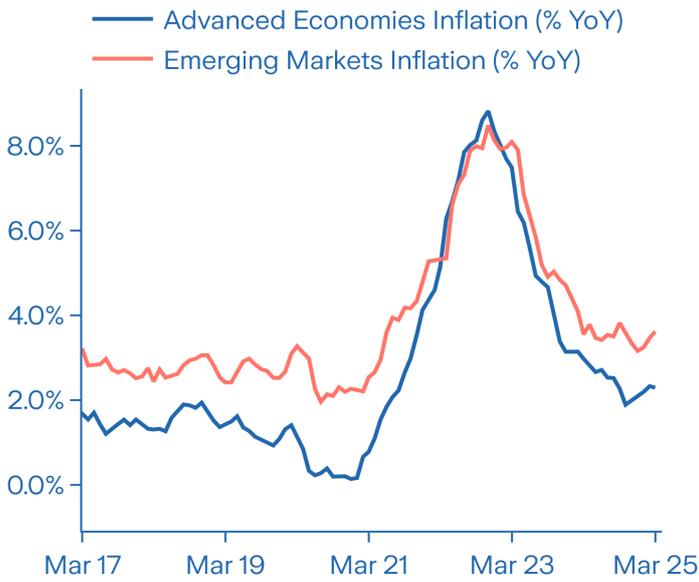
In Mexico, February's headline CPI accelerated to 3.8% YoY, up from 3.6% in January, but still below the 4.2% recorded at the end of 2024. Core inflation remained stable at 3.7% YoY, with both inflation measures staying within the central bank's tolerance range. Given the weakening economic backdrop, anchored inflation expectations, and a still highly restrictive monetary stance, we continue to expect that Banxico will keep cutting its reference rate to reach 8.25% by the end of 2025, implying 175bps in cuts YoY. A full-scale trade war with the US poses a major risk that could derail this view, although it is not our base case scenario.

In Chile, the February CPI print decelerated to 4.7% YoY, down from 4.9% in January, but still trailing above the official 3% target. Notably, inflation dynamics have been influenced by the one-off electricity tariff increase that took place mostly through H2 2024 and ended in January '25. We anticipate inflation to continue trailing above 4% YoY during H1 2025, in part reflecting base effects, and to end at 3.9% YoY by the end of 2025. We believe the central bank will keep the monetary policy rate unchanged at least during the first half of the year.

Current and historic inflation



Key Indicators



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