ZURICH

Inflation Focus Q4

16 December 2021

Key Points

- Headline inflation is expected to have peaked by the middle of 2022, partly reflecting more favourable base effects
- Supply chain improvements should help to contain rapidly rising goods prices, though strong demand persists
- A shift towards tighter policy is required to drive a moderation in demand and anchor inflation expectations
- Given stretched supply chains and persistently strong goods demand the risk to inflation is to the upside

Inflation rises further on excess demand and Covid and energy related effects

Consumer price inflation has risen further in most regions, but on diverse factors and with varying policy responses. Annual inflation rates are at multi-decade highs in the US and have risen strongly in the UK and the Eurozone, partly reflecting energy and Covid related effects, but also due to sharply increasing durable goods prices, particularly for new and used cars, electronics, and furnishing. In the US and some other regions, recent strong inflation prints were also boosted by rising shelter costs, given a buoyant housing market. In LatAm, global price pressures have been amplified by fiscal excesses and currency effects, triggering accelerated rate hikes. These are now weighing on demand, with Brazil slipping into a technical recession. In Asia, inflation remains contained and in line with central bank targets due to large output gaps and modest domestic demand.

Headline inflation should peak in H1 in many regions as special effects wane

Inflation will stay elevated into 2022 but upward pressure on prices is expected to moderate in H1 as energy and one-off Covid effects diminish. While oil prices have fallen back from their October peak, the recent surge in European gas prices is a wild card, and is yet to be fully reflected in household bills. This could add further upward pressure on Eurozone and UK inflation over coming quarters.

Supply chain pressures should ease, and key input prices appear to have peaked

Rapidly rising prices on durable consumer goods and supply chain price pressures are uncomfortable, but there are signs that we may be close to peak inflation here as well. On the supply side, production has ramped up in ASEAN supply chain hubs following lockdowns and disruptions in Q2 and Q3, and excess delivery times and order backlogs have fallen back further down in the supply chain. Transportation costs and prices on key inputs, including semiconductors, iron ore and lumber have stabilised and, in some cases, ticked lower after a peak in Q2.

Goods demand is too strong, and a rebalancing towards services is required

While supply chain pressures may be beginning to ease, demand is very strong. US consumer demand for durable goods is up over 20% compared to pre-Covid levels (in real terms). This pace of growth is not sustainable and should moderate as spending shifts towards services and pent-up demand wanes. This normalisation underpins our relatively benign inflation outlook, in which elevated price pressures are expected to moderate in H1 2022.

While the outlook remains relatively benign, near-term risk is to the upside

Even if demand and supply conditions improve, businesses have run down their stocks and unfilled orders are elevated. This reduces supply-chain resilience and creates vulnerability to new disruptions. We cannot rule out another round of more severe lockdowns that could ripple through global supply chains and labour markets at a difficult point in time, amplifying upward pressure on goods prices and potentially also wages. In addition, there is a risk that goods demand stays excessively strong, as households are cash rich and as new Covid restrictions could delay a rebalancing towards services.

While the basecase around inflation remains fairly benign and anchored by central bank actions, near-term risk is to the upside. Rolling restrictions and persistently strong goods demand are key vulnerabilities.

Central banks are focused on inflation, but this is no time for complacency

We are encouraged by the shift towards tighter monetary policy that is now underway in most regions, but most notably in LatAm and Eastern Europe.This confirms that central banks remain focused on inflation and are prepared to take action to contain demand and price pressures. Major central banks have so far lagged behind, maintaining a dovish stance. This has arguably been the correct strategy, having persistently undershot inflation targets in the past, and with lingering Covid risk.

Given significant upside surprises to inflation and continued strong demand, alongside deeply negative real interest rates and highly favourable financial conditions, we now need to see a shift towards stimulus removal. We anticipate this will be delivered, as inflation targeting central banks have the intention and the means to tighten policy from current favourable levels. This is likely to be a dominant theme for 2022, leaving policy expectations and rates highly sensitive to news on inflation, wages and Covid developments. Importantly, it will help to anchor inflation expectations and wage pressures, and over time drive a moderation in demand from current elevated levels.

US

Core CPI inflation to remain elevated as shelter costs rise, but headline CPI is expected to peak soon

Inflation rates have accelerated further in the fourth quarter with headline CPI inflation rising at an annual rate of 6.8% in November, the highest in decades. Core inflation measures have also picked up markedly with core CPI rising to 4.9% YoY while core PCE inflation was 4.1% YoY in October. Price pressure caused by ongoing supply chain disruptions is proving to be stickier than initially expected, exacerbated by strong goods demand and an aggressive restocking of business inventories. Meanwhile, shelter costs have now started to pick up as expected given the significant rise in house prices observed over the course of the year. Higher shelter costs will keep core inflation measures elevated in the coming months. On the other hand, there are early signs that input price pressure is starting to ease and the recent fall in energy prices should further help to bring headline inflation measures down, likely in the first half of 2022. The Fed has turned more hawkish and is accelerating its tapering process, signalling its commitment to reach its average inflation target. It is reassuring that longer-term inflation expectations remain well anchored, reflecting investors' belief that the Fed has the intention and the ability to keep inflation under control over the course of the business cycle.

UK

CPI inflation to stay high in the near term as energy prices feed through, but should fall later in 2022

Headline CPI inflation accelerated to 5.1% YoY in November while core inflation rose to 4.0% YoY. Surging energy prices were a significant driver of the rapid rise in headline inflation as the Office of Gas and Electricity Markets (Ofgem) significantly increased its default tariff price cap by 12.2% and petrol prices jumped in October. The recent fall in energy prices is expected to have a mitigating impact on inflation going forward, not least given fading base effects kicking in in Q1 2022. However, as Ofgem is likely to substantially raise its default tariff price cap in April again, the peak in headline inflation is probably still ahead of us. Core inflation was boosted by ongoing supply chain distortions and strong pent-up demand, impacting a range of products and services like used cars and accommodation. While these effects on core inflation are likely to linger on for longer than expected, prices will eventually normalise, leading to falling core inflation later in 2022. With inflation rates significantly above target, an improving employment situation and a strong economic outlook the Bank of England has started to tighten its monetary policy by raising the Bank Rate to 0.25% from 0.1% at its meeting in December.

Eurozone

The inflation surge continues, but a peak is close

Inflation has moved even higher than expected in the final quarter of 2021, hitting a record high since the euro was created of 4.9% in November. Higher energy inflation, due to oil and gas prices, was a large contributor. Base effects from high oil prices should diminish substantially next year. Some statistical distortions that have boosted inflation will also soon fade. In January, the German VAT cut in the last six months of 2020 will fall out of the annual price comparison, subtracting around three tenths of a percentage point from Eurozone inflation. In addition, because the Covid crisis in 2020 affected the consumption of some items more than others, different weightings were applied to the consumption basket for 2021, distorting the impact of leisure travel price inflation. This effect should also reverse soon. Although the numbers are alarming, we may be close to a peak in Eurozone headline inflation. However, one wild card is the extent to which high natural gas prices have yet to feed through to household energy bills. Overall, the current inflation prints are making the ECB's communication job challenging, but we still expect it will continue with asset purchases next year, albeit at a reduced pace compared to 2021.

Switzerland

Headline CPI should peak in early 2022 before tracking lower through the year

Annual CPI inflation has risen further, with the headline and core measures at 1.5% and 0.7% in November. Monthly price gains have decelerated though, down from an average of 2.4% in H1 to 1.2% over the past three months (both annualised). As underlying price pressures are benign and unless oil prices rise further, we expect headline CPI inflation to peak at around 1.7% in early 2022, before falling back towards 1% through the year. This leaves the forecast for average annual CPI inflation slightly above 1% in 2022, up from an estimated 0.6% in 2021. The upswing in inflation is to a large degree a reflection of energy prices while domestic price pressures are benign. Nominal wages rose by only 0.1% YoY in Q3. While wage growth will strengthen in a tight labour market, this is unlikely to become a factor that drives inflation markedly higher in 2022. Domestic goods prices are rising at a modest 0.7% YoY, despite higher input prices, while services inflation is a bit higher, partly reflecting a rebound in restaurant and hotel prices, following the reopening of these sectors.

As anticipated, while the SNB revised up its inflation forecast in the December meeting the dovish stance was maintained. We expect monetary policy to remain unchanged in 2022.

Japan

Headline CPI inflation likely to creep higher from a low level, but some downward pressure will persist

While inflation has become a major topic globally, it is interesting to note that one of Japan's core inflation measures, the core CPI ex fresh food and energy, stands in deflationary territory at -0.7% YoY. However, there are some distortions that need to be considered, including the administered cut of mobile phone fees (-54% YoY in October) that became effective under previous PM Suga. Excluding all special factors, Japan's core CPI measures stand at around ½%, in line with the 0.5% YoY November CPI for Tokyo. Looking forward, another special factor will be a drag on inflation in 2022, as the 'Go To' campaign is likely to be relaunched from February to July 2022 unless the plan needs to be cancelled due to the potential spreading of the new Covid variant, Omicron. The 'Go To' travel campaign offers 30% discounts on accommodation of up to JPY 10,000 and vouchers worth JPY 1,000-3,000, subsidised by the government, and will weigh on inflation. Rising energy and raw material producer import prices (+90% YoY in October) are likely to lead to a short-term spike in Japan's CPI inflation rate. However, overall, it is fair to say that inflationary pressures are not a major issue for Japan, despite some signs that energy, services, and food prices are creeping higher.

China

The big PPI-CPI gap should narrow in 2022, as PPI inflation moderates while CPI inflation rises from negative territory

China's producer prise inflation inched back to 12.9% YoY in November from the 26-year high of 13.5% in October, predominantly driven by surging energy and material prices due to power shortages and supply bottlenecks, but also due to political pressure to reach environmental targets. Indeed, the PPI mining component surged from negative territory in 2020 to close to 70% YoY. However, the impact on consumer prices remains negligent, as the consumer goods component of the PPI is barely positive. Meanwhile, consumer price inflation moved from -0.5% a year ago to 2.3% YoY in November, mainly held back by pork price deflation. Pork prices surged in 2020 and were up 135% YoY early in the year due to the swine flu. In 2021, increased pork supply saw prices tumble by a record -46.9% YoY in September, dragging down consumer price inflation. We expect the PPI-CPI gap to at least narrow significantly in 2022, if not even reverse, not only due to base effects. While material price inflation will remain a topic, it should peak soon. In addition, fuel and utility prices are administered, less volatile price components. Meanwhile, the drag from pork prices on consumer prices is likely to wane. Consumer price inflation would also rise in sync with our expected gradual consumption recovery.

Australia

Inflation will rise but should not overshoot the RBA's target

Core inflation rose from 1.6% to 2.1% YoY in Q3, meeting the RBA's 2-3% target for the first time since 2017. Q3 headline inflation, by contrast, fell from 3.8% to 3.0% YoY. Increases in fuel and homebuilding prices were the main drivers of headline inflation, reflecting the pass-through effects of elevated global energy and material prices on domestic input prices. Strong demand for goods amid lockdowns also lifted household goods prices while house prices advanced further although at a slower pace than in H1 2021.

We suspect upward inflation pressure will persist as global supply remains tight. By contrast, on the demand side a shift from goods to services consumption as the economy reopens helps ease goods demand and reduce the supply-demand mismatch. Wage growth has returned to the pre-Covid rate of 2.2% YoY and is set to rise on the back of the tight job market. Nevertheless, it should not be substantial enough to lift core inflation above 3%, the upper bound of the RBA's target. A potential increase in the participation rate should also help alleviate labour supply pressure. With that, we expect the RBA's first-rate hike in H1 2023.

ASEAN

Inflation will rise as the economic recovery continues, but remains well contained

Elevated energy prices have translated into higher headline CPI inflation across ASEAN. However, core CPIs are benign except in Singapore. Thanks to high vaccination rates and limited social restrictions, Singapore's recovery was ahead of the pack. As a small open economy, it also experienced a more direct impact from global prices on domestic inflation. As a result, the Monetary Authority of Singapore (MAS) was the first to tighten monetary policy in the region.

Elsewhere, economic scars of the Delta outbreak are still evident, leaving Malaysia, Thailand, and the Philippines with sizable output gaps. As economies reopen, producers should be able to pass high input costs to consumers, implying higher CPI inflation ahead. Large output gaps mean inflation should stay contained though. In Indonesia, output is likely to return to its pre-pandemic levels by end 2021, but consumer spending is still weak, with the near-term inflation outlook remaining benign. The Philippines is one of the few countries in ASEAN with high inflation, mainly due to local supply issues. We expect these to alleviate over time.

We think most ASEAN central banks, except the MAS, will wait for growth to rebound sustainably before hiking interest rates in H2 2022.

Brazil

Inflation risk remains biased to the upside

The announcement of changes in the methodology for calculating the government spending cap to allow additional fiscal spending in 2022 increased fiscal uncertainty, putting upward pressure on inflation expectations and negatively impacting investor confidence since the credibility of the fiscal anchor is at stake. Inflation remains high and widespread, mainly driven by energy, food, and industrial goods prices, and with upward pressure on services prices. Headline and core inflation reached 10.7% and 7.2% respectively in November. Inflation is expected to remain around current levels in the coming months. However, the anticipated slowdown in economic activity and the impact on tightened financial conditions is likely to reduce inflation in 2022. The central bank continued with its aggressive tightening, raising the Selic rate by 150bps to 9.25% in December. The statement was hawkish, mentioning that it is appropriate to continue tightening until inflation decelerates and inflation expectations converge around target. The monetary authority also noted that price increases were higher than expected, both in the more volatile components and core inflation. As a result, the BCB signaled another adjustment of the same magnitude for the next meeting.

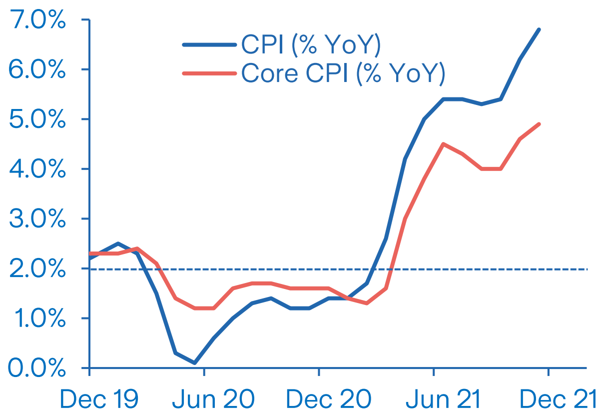
LatAm

Inflation pressures are expected to remain, keeping inflation above central bank targets

Headline and core inflation have accelerated in Chile and Mexico, and we expect inflation in these countries to remain well above their respective targets of 3% during 2022. In Chile, headline and core inflation reached 6.7% and 5.8% respectively in November, consistent with an overheated economy, with solid domestic demand pressuring goods prices to jump 7.4% YoY. Even though an economic deceleration is expected for 2022, the FX depreciation, the increase in goods prices, and the risk of higher energy prices continue to put upward pressure on inflation. The Central Bank is accelerating tightening, and we expect the policy rate to reach 5% in Q1 2022. In Mexico, headline inflation reached 7.4% YoY in November, driven by the removal of electricity subsidies and an increase in food prices, but core prices also maintained an upward trend. Inflation is expected to remain elevated at current levels in both countries in 2022. In Argentina, inflation reached 52% YoY in October, despite policies to control prices. Low net FX reserves will make it difficult for the government to continue with FX interventions, forcing them to allow significant currency depreciation, which, together with the end of price controls on goods and the freezing of regulated prices, will create additional inflation pressures during

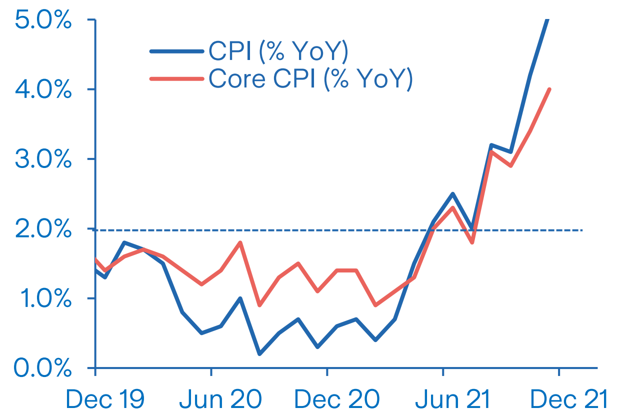
Current and historic inflation

US: Headline CPI should peak soon



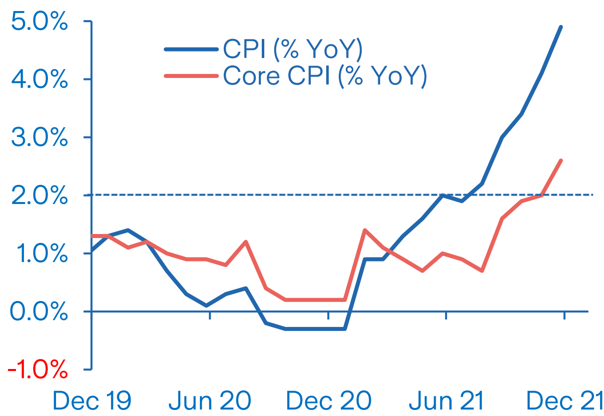
Source: BLS

UK: Energy price impact has got further to go



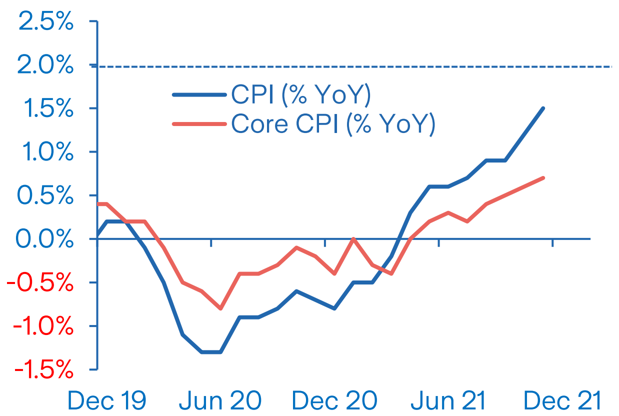
Source: ONS

EZ: Peak is close, but rising gas prices are a risk



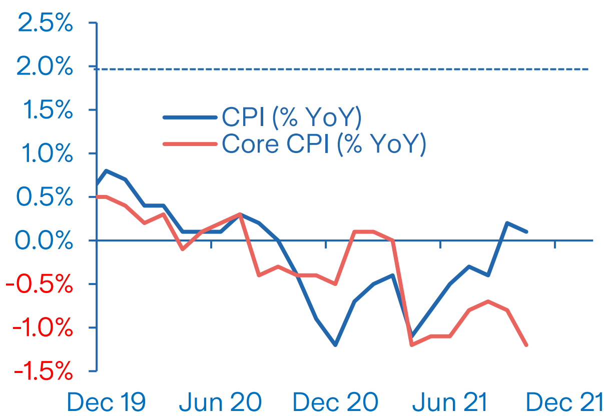
Source: Eurostat

CH: Headline CPI should peak in early 2022



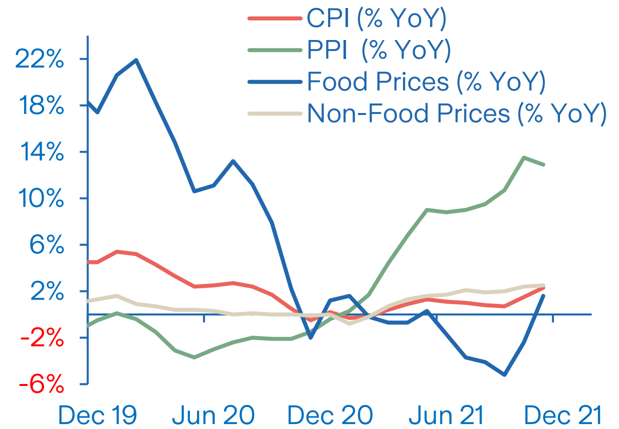
Source: Federal Statistics Office

Japan: CPI should creep higher



Source: Ministry of Interal Affairs & Communication

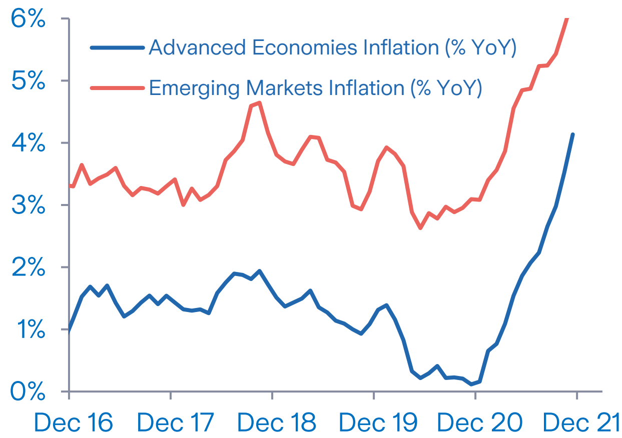
China: PPI-CPI gap expected to narrow



Source: National Bureau of Statistics China

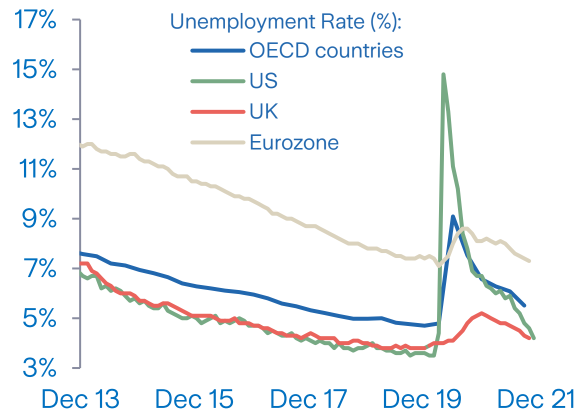
Key indicators

Inflation surges, with energy a common driver



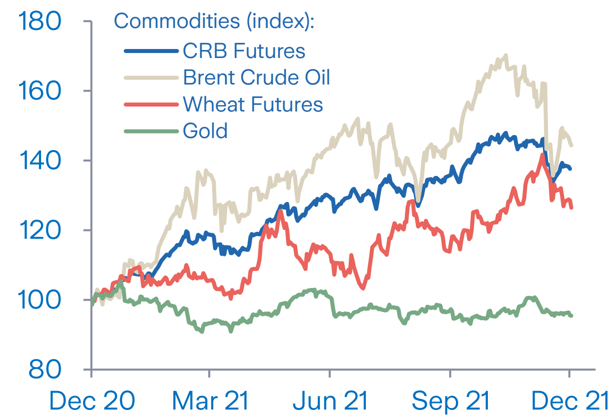
Source: ZIG, Bloomberg

Labour markets tightening further



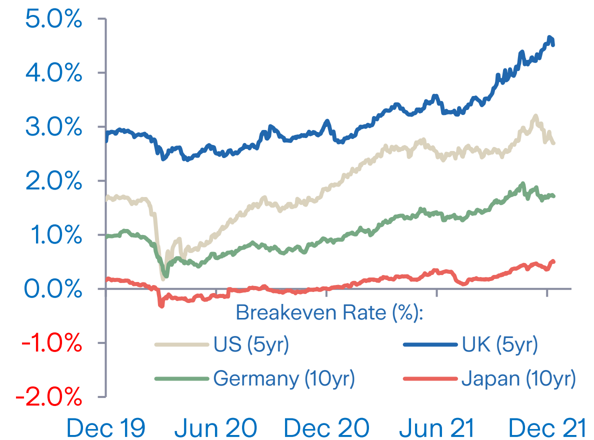
Source: Bloomberg

Base effects will become more favourable



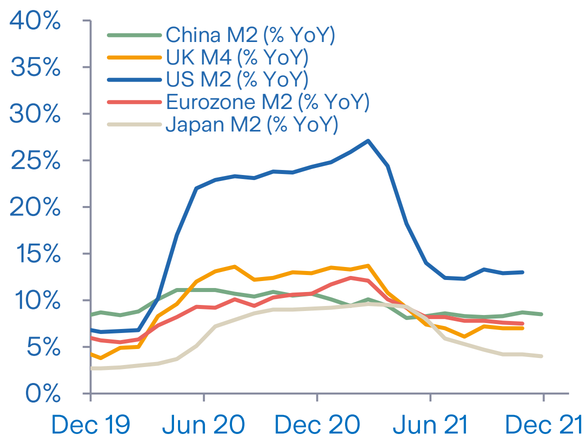
Source: Bloomberg

Not a time for complacency for central banks



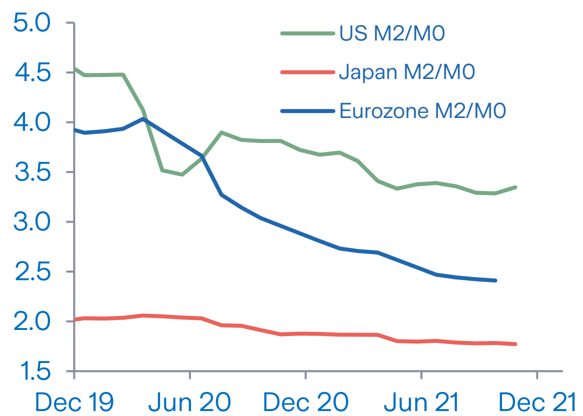
Source: Bloomberg

US money growth still running at a high rate



Source: Bloomberg

Money multipliers fall as money base expands



Source: Bloomberg

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