

# Inflation Focus Q1

21 March 2023



## Key Points

- Further falls in inflation are expected as the economic outlook deteriorates on policy tightening and banking turmoil
- Headline inflation is coming down but services inflation is still a problem, showing little signs of conforming
- Central banks are expected to maintain their focus on inflation, but peak rates are approaching
- Policy risk is elevated given an aggressive tightening cycle and its uncertain and delayed effects

### **Growth set to slow as tightening and financial turbulence weigh on the economy**

Growth and inflation were resilient in early 2023, forcing further policy tightening and hawkish guidance from central banks. This amplified pressures in parts of the financial system and contributed to stresses and turmoil in the banking sector. Even before the latest events, however, it was clear that economic growth was becoming increasingly divergent, with weak activity in large part of the economy, offset by strong services. As the effects of past tightening are yet to fully impact broader economic activity, we continue to expect growth to slow going forward, with the US heading for recession and weak and fragile growth in Europe. While banking sector turmoil highlight vulnerabilities and complicate the policy outlook, a systemic crisis is not expected. That said, recent events will trigger a further tightening in credit conditions and add to the slowdown that we had been anticipating.

### **Goods price inflation is not a problem**

Headline inflation is coming down but at a slow pace. In the US, which led the way on the upside, annual CPI inflation has fallen from 9% in June 2022 to 6% in February. This decline is entirely accounted for by falling goods price inflation, having collapsed from over 12% YoY in early 2022 to 1% currently (ex energy and food). This disinflationary impulse was led by easing supply chain and shipping conditions, falling commodity prices, and a shift in spending towards services, along with lockdowns in China that weighed on demand. This played out as we had expected, but many of the drivers were one-offs and are unlikely to be repeated this year. While commodity prices should remain

benign amid weak global growth and financial volatility, we suspect further sharp falls in goods price inflation are less likely.

### **Services inflation rises further, boosted by strong demand and sticky rents**

By contrast, services inflation has risen further, partly reflecting strong housing related price pressures. This component should ease over the coming year as rents and house prices are now weakening. Other drivers of services inflation, most notably leisure, travel and transportation, have also been strong, however, as demand for consumer services has surged while capacity is limited given a tight labour market. Going forward, the broader economic slowdown that we expect should ease price pressures in the services sector. But this is not yet visible in the data, and still brisk services inflation means that central banks will likely maintain a hawkish stance for the time being.

### **Labour markets are still not in balance**

Policymakers are also preoccupied with labour markets, which remain surprisingly robust despite layoffs and slowing job growth in pockets of the economy. The gap between the number of open positions and unemployed workers is elevated in almost all regions, with little improvements over the past months. One positive development though is that wage growth has fallen back materially in the US, easing concerns around a wage-price spiral developing in the world's largest economy. In large parts of Europe and in Japan, by contrast, wage growth has picked up with a lag, helping to drive stickiness in core measures of inflation. While labour market pressures should ease

as the economic cycle deteriorates, this is not yet happening.

### **Less policy tightening will be needed to contain inflation**

Central banks now face a difficult tradeoff as large scale support measures may be warranted to reduce the risk of a financial crisis at the potential cost of amplifying near-term price pressures in the economy. Given sticky core inflation, tight labour markets and lingering concerns around a deanchoring of inflation expectations, we suspect that central banks will maintain a hawkish stance near term. That said, the end of the tightening cycle is likely to be brought forward. We had expected a peaking of rates in 2023 H2 and some rate cuts before year end. The need for additional rate hikes will now be reduced as issues in the banking sector will likely lead to a further tightening in credit conditions, while increased uncertainty around the economic and financial market outlook weigh on demand and commodity prices. Indeed, financial markets have already repriced the policy outlook, and safe haven demand has led longer-term government bond yields down.

### **Policy risk is elevated**

While a severe banking and financial crisis is not expected, sticky inflation means that central banks are likely to hike rates further. Given the uncertain and delayed effects of tightening measures, policy risk remains elevated. Indeed, recent events have exposed some of the vulnerabilities and tradeoffs that are inherently involved in an aggressive tightening cycle.

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## US

Upside risk to near-term price pressure

Annual inflation rates keep trending down, but the pace slowed at the beginning of this year. Headline CPI inflation decelerated to 6.0% YoY in February from 6.4% the month before while the Core CPI rate slowed to 5.5% YoY from 5.6%. Although the monthly pickup in prices was mostly in line with expectations, the stickiness in core inflation underlines that inflation risks are still very present. This will keep the Fed at its toes to fight against a broad-based re-acceleration in price growth and rising inflation expectations that would make it much harder to achieve its long-term inflation target. Supported by rising energy prices headline CPI rose

0.4% MoM, but more important from a longer-term perspective is the continued strength in core services while trimmed-mean inflation measures remain elevated.

We still believe that inflation will continue to fall substantially over the course of the year as the US economy is slowing down. A cooldown in shelter costs and healthcare inflation will help to bring down core inflation, but there are risks to the upside in the near term that could trigger a more aggressive response from the Fed, particularly given that lower healthcare inflation has less of an impact on PCE Core, the FOMC's preferred inflation measure.

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## UK

Broad-based falls in inflation ease the pressure on the BoE

Although still elevated, inflation has receded more than consensus expected at the beginning of the year. Headline CPI inflation slowed to an annual rate of 10.1% in January, down from 10.5% the month before while Core CPI fell substantially to 5.8% YoY from 6.3%. On a monthly basis, headline CPI inflation stood at -0.6%, the largest drop in four years. Weight changes related to the CPI basket helped to lower the inflation measure, but easing core goods prices, cheaper fuel and weaker non-core service costs all contributed to the slowdown in price pressure. We expect inflation rates to fall substantially this year, but there elevated uncertainty in the near term, not least given the very tight labour

market. Wage growth continually accelerated over the course of 2022 and stood at 6.7% YoY in December, the highest level since July 2021 when reopening the economy boosted spending and wages.

While the overall trend in inflation looks promising, the BoE will keep its focus on the labour market where rising wages could spill over more broadly into service inflation and consumers' inflation expectations, not least since the better outlook for the Eurozone economy will mitigate potential headwinds to growth in the UK.

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## Eurozone

Sticky core inflation will worry the ECB and lead to higher policy rates

In Q1, headline inflation continued its series of monthly declines that began late last year. The main impetus continues to be falling energy inflation. Further falls in headline inflation are likely over the coming months as favourable base effects in terms of energy inflation continue. However, one complication is that food prices and food inflation have spiked higher and are likely to remain volatile over coming months, possibly slowing down the overall fall in headline inflation expected over coming months.

Perhaps even more worrying for the ECB is that core inflation continues to rise, ticking up further to 5.6% in

February for example. There may have been some statistical distortions that led to the jump in core inflation recently and more favourable base effects could see core inflation falling back somewhat in coming months. Nevertheless, the underlying message is that core inflation is sticky, as we have been arguing for some time. The upshot is that we expect the ECB will continue hiking interest rates despite recent volatility in financial markets and stresses in the banking system. However, the risk is that in the course of trying to deal with inflation, the ECB chokes off the modest economic recover.

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## Switzerland

Inflation surprisingly strong in early 2023

Inflation reaccelerated in early 2023, with CPI up from 2.8% in December to 3.4% in February. We had expected inflation to rebound on higher electricity prices, but strength was broadbased, with solid price gains on services and food. Core inflation, which had been stable at around 2%, jumped to 2.4%, marking a multi-decade high. Businesses were also affected by higher electricity prices, with the producer and import price index up by 0.7% MoM in January, before falling back by 0.2% in the latest data. We suspect that some of the strength in Jan/Feb data reflects a calendar year effect, as companies reviewed their prices in the new year. Looking forward, the economic outlook has

deteriorated markedly, with financial and banking sector turbulence set to weigh on credit conditions and activity. This should lead to a less favourable pricing environment, limiting businesses ability to mark up prices. We maintain our view that annual inflation rates will fall sharply in H2.

That said, the labour market remains very tight and inflation is tracking slightly above the SNB's latest forecast. Given its preference for low inflation, and despite fragilities in the banking system, we expect the SNB will hike rates further, possibly in this week's policy meeting.

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## Japan

Attempting to forge a path through the inflation jungle

Interpretations about where Japan is in the inflation cycle are difficult due to the various definitions of core CPI measures. Tokyo headline inflation, a leading indicator for nationwide inflation, as well as the Tokyo core CPI fell a percentage point to 3.3% YoY in February. However, the 'new core CPI' (excluding fresh food and energy), at 3.2% YoY, as well as the 'core core CPI' (excluding food, but not alcohol, and energy) at 1.8%, both rose versus the prior month. The latter even reached a 42-year high. Special factors, such as the recent prefectural travel discounts, are excluded from the calculation, while public subsidies for gas and

electricity, are included, reducing the energy bill component in the inflation measure. Meanwhile, prices for processed food, dining out, and durable household goods contributed to higher inflation. Consumer surveys are showing that higher inflation is having a negative impact on consumer confidence, but less so on real spending, which is also confirmed by the latest brisk consumption data. Inflation risks may come from a surge in administered electricity bills from June onwards, which may even keep consumer prices above 2% until later 2024.

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## China

Reflation should be manageable

China's core CPI inflation rate remained roughly stable at 0.8% YoY in January/February versus December (the two-month basis avoids Lunar New Year distortions), while producer price deflation stabilised in February on a MoM basis, but intensified to -1.4% YoY due to the base effect. Reopening is likely to drive inflation somewhat higher through its impact on demand, as is already visible in tourism spending related prices, while potentially higher commodity prices should alleviate current producer price deflation over the course of the year. We assume inflationary pressures will be rather modest going forward. Lockdown related bottlenecks

are likely to be scaled back, while the pork cycle, which had been a dominant force in determining inflation in the past, should help to keep food price inflation low, as it did in February. Reopening related price pressures will be met by the softer supply-chain related price impact, as normalisation takes hold. Shelter costs may increase somewhat, but not significantly as the government will be cautious not to stimulate the property sector too much.

Overall, we do not assume CPI inflation will come close to or even exceed, the government's 'around 3%' inflation target.

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## Australia

Inflation shows signs of peaking, allowing the RBA to soften its hawkish tone

In Q4, quarterly headline and trimmed mean inflation accelerated from 7.3% to 7.8% and from 6.1% to 6.9% YoY, respectively. However, the newly published monthly CPI series suggests that inflation has now peaked, declining from 8.4% to 7.4% YoY in January. The wage price index, which increased slightly from 3.2% to 3.3% YoY in Q4, remained consistent with the central bank's 2% inflation target, alleviating wage-price spiral concerns raised by the Reserve Bank of Australia (RBA) in recent policy statements.

While the unemployment rate remains historic low with seasonality distortions making labour data relatively

volatile, the easing in job vacancy and subdued employment growth in the last three months hint at tentative signs of a cooling labour market.

Importantly, long-term inflation expectations remain well anchored, indicating that inflation is expected to be rather short term, and markets remain confident in the RBA's ability to bring down inflation eventually. We maintain our forecast of 3.85% for the RBA's terminal rate in this cycle, with one further 25bp hike to go.

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## ASEAN

Inflation is likely to have peaked in the region, with central banks signalling the end of the hiking cycle

In most countries in the region, inflation is falling, supported by a substantial drop in energy prices. Core inflation in *Malaysia* and *Indonesia* declined from 4.1% to 3.9% YoY in January and from 3.3% to 3.1% YoY in February, respectively. As underlying inflation is now moderating, policy rates are likely to have peaked in both countries. In *Thailand*, inflation dropped considerably in February and is now closer to the central bank's target range, partly due to favourable base effects. However, the recovery of the tourism sector, thanks to an expected return of Chinese tourists, poses upside risks to inflation. Hence, we expect the

Bank of Thailand to deliver another 25bp rate hike in March. *The Philippines*, an exception in the region, is still grappling with acute inflation, with headline CPI hovering above 8% YoY since December last year. This prompted the central bank to hike its policy rate at a rapid pace, and the extent and size of further hikes will depend on whether inflation shows meaningful signs of peaking.

On the currency front, ASEAN central banks have room to tap into their FX reserves to stabilise their currencies if need be, but risk of renewed rate hikes in the region remains if the Fed continues to raise rates.

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## Brazil

Disinflation continues but at a slower speed

Despite the last monthly CPI inflation rate being above market expectations, annual CPI inflation is gradually falling, down from 5.8% in December to 5.6% in February, and down from the peak of over 12% in Q2 2022. While this is encouraging, services inflation remains at levels incompatible with convergence to the inflation target, with prices for 82% of the services components still rising. Core inflation also remains high despite decelerating for the eight consecutive months, now at 8.4%.

Electricity prices increased 1.4% in February due to tax hikes, while gasoline prices rose by 1.2% MoM. Despite

these increases, gasoline and electricity are still down vs a year ago, helping annual inflation to move lower.

We expect inflation to continue to fall in Q2, benefiting from favourable base effect, though there are upside risks to this view. The recent increase in payrolls will likely affect the disinflation process, and potential tax hikes could also impact inflation, particularly gasoline prices. The near-term improvement in the global outlook and the resilience of the service sector should also affect price dynamics. Therefore, and considering the fiscal uncertainty, we do not expect the central bank to start the easing cycle before Q4 2023.

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## LatAm

Inflation remains high but is finally decelerating

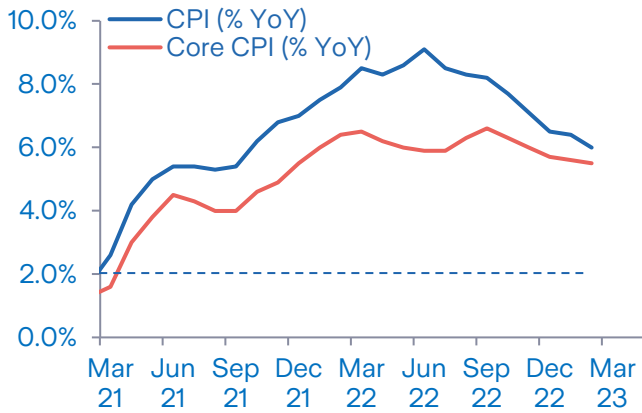
Except for Argentina, where annual inflation has accelerated and now exceeds 100%, headline inflation shows signs of deceleration in LatAm. Core inflation is sticky, however, and inflation expectations for year end increased during Q1. Convergence to target will likely take some time with a highly volatile inflation outlook, further challenging the monetary policy outlook.

After rising above market expectations in January, headline inflation in *Chile* surprisingly fell 0.1% MoM in February, reaching 11.9% YoY. Currency appreciation and falling transport prices are weighing on inflation, but core measures of inflation accelerated from 10.6% to

10.7%. The Central Bank will likely keep the policy rate unchanged in April and May. We expect a change in the forward guidance once we see three consecutive months of inflation deceleration, with the easing cycle set to start in Q3. In *Mexico*, upward inflation pressures are easing but core inflation is still concerning. Headline and core inflation fell in February, reaching 7.6% and 8.3%, respectively. We expect core inflation to decelerate further but remain above headline inflation in 2023, posing a risk to the outlook. Banxico is expected to hike further in March and May by 25bps each before starting the easing cycle in Q4.

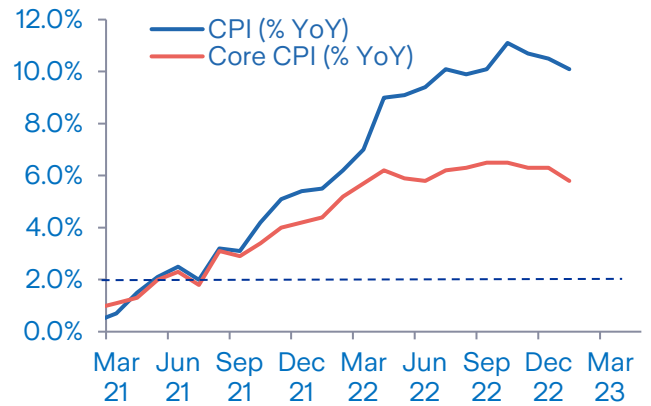
## Current and historic inflation

### US: Services inflation remains strong



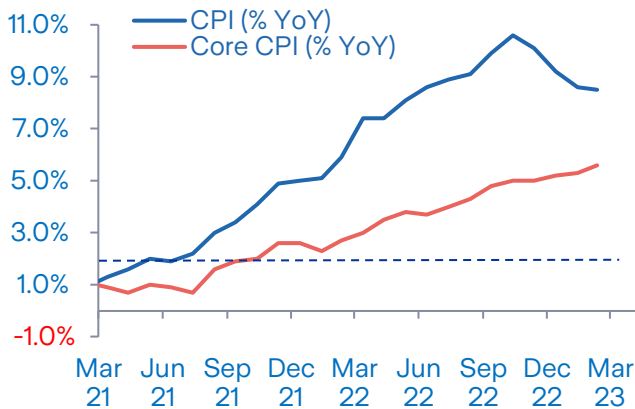
Source: BLS

### UK: Finally peaking



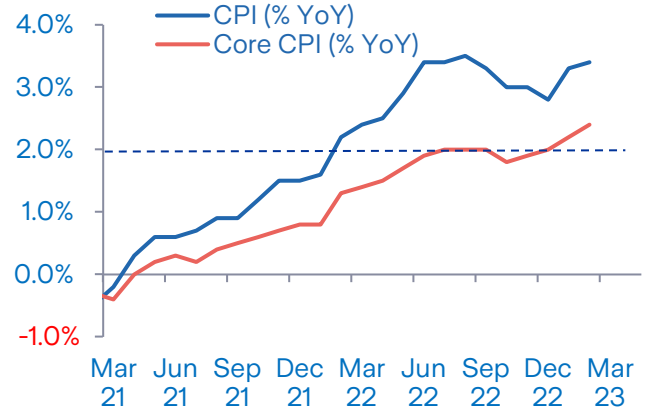
Source: ONS

### EZ: Sticky core inflation



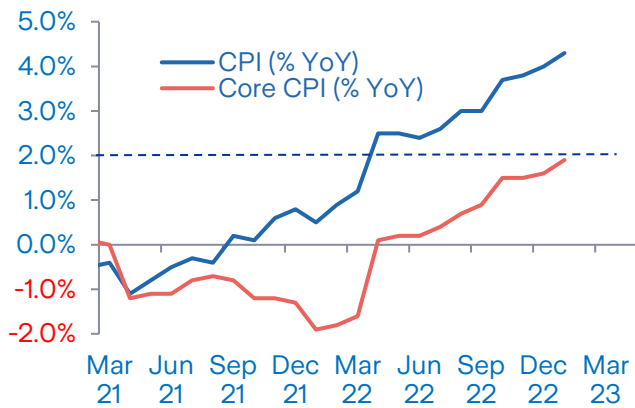
Source: Eurostat

### CH: Temporary pickup in inflation



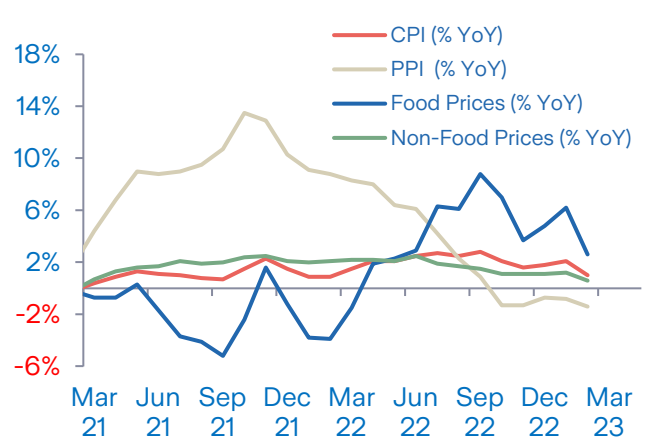
Source: Federal Statistics Office

### Japan: Higher for longer



Source: Ministry of Internal Affairs & Communication

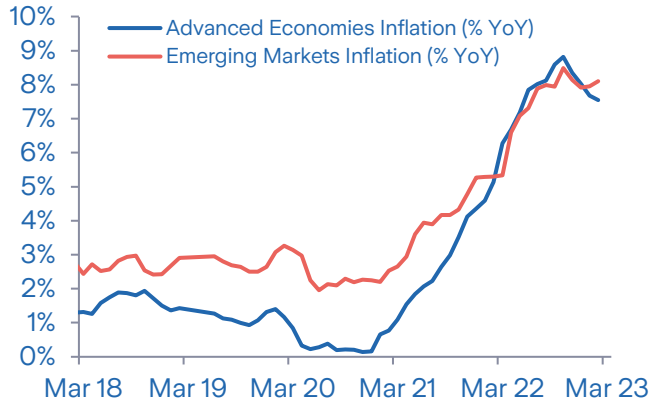
### China: Reopening should lead inflation higher



Source: National Bureau of Statistics China

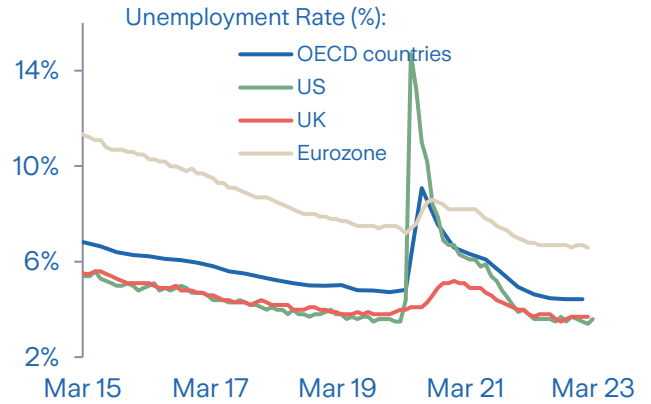
## Key indicators

### Headline inflation remains elevated



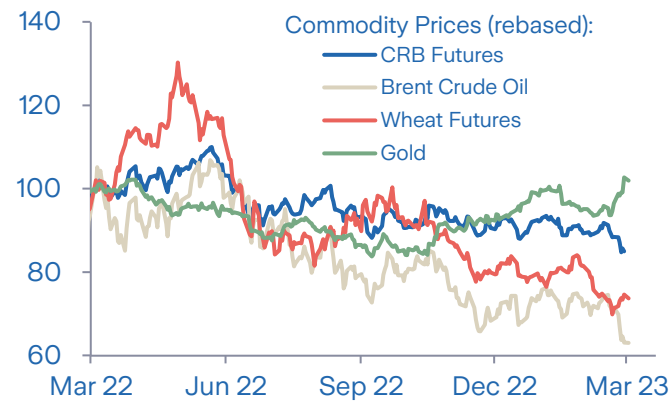
Source: ZIG, Bloomberg; average across regions

### Labour markets too tight



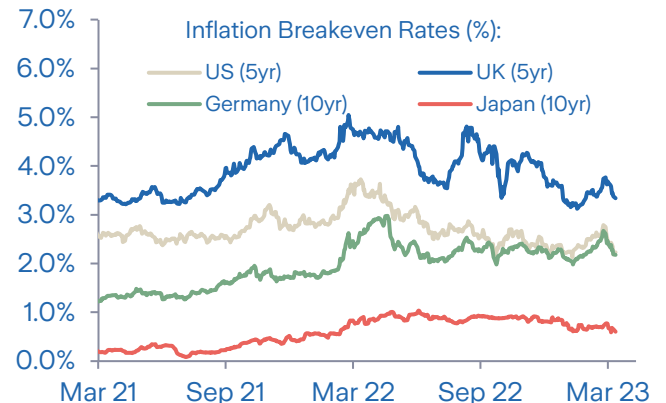
Source: Bloomberg

### Commodity prices remain disinflationary



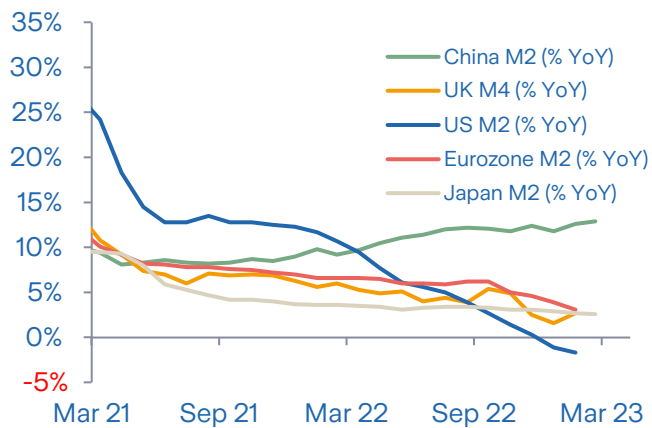
Source: Bloomberg; Commodity price indices

### Inflation expectations remain contained



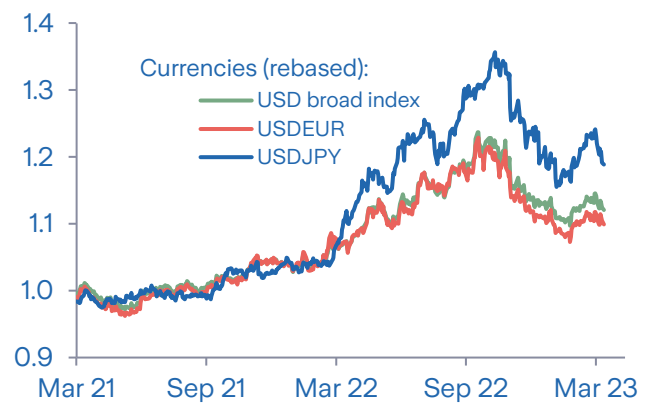
Source: Bloomberg

### Monetary tightening is underway



Source: Bloomberg

### Dollar weakening



Source: Bloomberg

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