Inflation Focus Q2

16 June 2023

Key Points

- Inflation is down but not out, with services inflation remaining troubling amid strong demand
- Further falls in inflation are expected as rate hikes and credit tightening weigh on economic activity
- Central banks maintain their focus on inflation and will deliver further rate hikes if required
- The risk of policy overtightening is significant, given mixed inflation trends and growth divergences

Energy and food prices lead headline inflation lower
Headline inflation is falling as the disinflationary impulse from energy and goods is combining with a welcome slowdown in food inflation. Partly offsetting this is the services component of core inflation, which remains disruptive. The divergence in inflation trends reflects the bifurcated economy, where manufacturing and construction are in contraction while services activity is rebounding, boosted by post-pandemic pent-up demand for leisure and travel. While the weakening in inflation is welcome news, the level of inflation is still too high.

Goods prices should remain disinflationary
Further falls in inflation are expected, reflecting favourable base effects for food and energy as well as disinflationary pressures in the industrial sector. Supply chain dislocations have normalised and goods producers are now faced with weak demand, also reflected in falling world trade. This has led to a sharp turnaround in pricing dynamics on the producer level. Eurozone producer price inflation (PPI), for example, is down from 43% YoY in August last year to 1% in April. In China, PPI inflation has fallen deeper into negative territory and is tracking at the lowest level since 2015, at -4.6% annually. China PPI feed into world export prices, suggesting that global disinflationary pressures will persist for some time. While the downshift in supply chain price pressures is amplified by energy and commodity price declines, it will nonetheless help to anchor inflation expectations, and should temper price pressures more broadly.

Services inflation is finally edging down, but from a high level
Another positive development is that services inflation has finally begun to tick lower, helped by slowing house price inflation and spillover from lower energy and food prices. The level of services inflation is still too high though, as a result of solid demand and a strong pricing environment, along with a tight labour market. This component needs to fall materially to get inflation back to target. We therefore need to see a normalisation in services demand and a moderation in wage pressures. While labour markets are beginning to ease, with rising layoffs, falling job openings, and even a tick up in unemployment rates, wage growth is brisk and not yet consistent with a 2% CPI pace. Conditions have diverged however, with Eurozone and UK wage growth now running at a higher pace than in the US, where wage pressures have moderated more meaningfully.

Economic activity will weaken as a result of aggressive monetary tightening
While economic activity has been resilient, we expect a renewed slowdown in the second half of the year policy tightening curtail activity. These headwinds are visible in the lending standard surveys (published by the Fed and the ECB), which show a sharp tightening in credit conditions and a collapse in loan demand, reportedly reflecting a slump in investment and housing activity. The pace and scale of tightening that is underway is also seen in a sharp monetary contraction, with the stock of money (broad money M2) falling at an annual pace of -4.6% in the US, albeit from an elevated level. With these headwinds in place, core and services inflation should continue to grind lower in the months ahead.

Central banks maintain their focus on inflation, and will tighten further if needed
As we expected, central banks have maintained their focus on inflation despite bank stresses and financial stability concerns, and will tighten further if progress on inflation stalls. That said, a pause in the rate hiking cycle is now warranted in some regions to monitor the impact of past tightening. We are encouraged by developments in LatAm and the US, where inflation is coming down relatively quickly, while Europe is lagging behind, partly reflecting the larger energy and food price shocks that hit the region. A reacceleration in UK inflation is concerning and will lead to further tightening. In Asia, the inflation outlook remains relatively benign, helped by easing energy and food inflation. One exception is Japan, where higher inflation is welcome and price pressures are not expected to have peaked yet.

Risk of overtightening is high amid mixed inflation trends and growth divergencies
The risk of overtightening is elevated, given mixed inflation trends and growth divergencies that make it more difficult to judge if sufficient tightening has been delivered. We maintain our view that central banks are approaching the end of the hiking cycle, with the potential for rate cuts in some regions later this year, but this hinges on further progress on inflation. Until the stickier services component of inflation turns decisively lower, economic and financial conditions will remain volatile and unusually data dependent.

US

Services inflation shows sign of softening

Inflation rates keep falling with headline inflation receding from 4.9% YoY in April to 4% YoY in May, the lowest in more than two years. Core inflation is slowing too, to 5.3% YoY, though at 0.4% the monthly rate remains above the Fed's comfort zone for now. Meanwhile, the Cleveland Fed's trimmed mean inflation measure slowed to 0.2% MoM, lowering the annual rate to 5.5%. While inflation remains above target, there are increasing signs that price pressure is continuing to fade. The ISM Manufacturing survey's price component has been in contractionary territory for most of this year already, but price development in the service sector dropped to a post-Covid low in May and is now well within the pre-Covid range, indicating that pricing keeps normalising. Similarly, the Bureau of Labor Statistics' producer price measure slowed to 1.1% YoY with many categories now in negative territory, signalling further substantial falls in broader inflation in the months ahead. Even the labour market is probably less tight than many think, with fewer hours worked, unemployment rising and wage growth slowing. While it is too early for the Fed to signal an end to its policy tightening, it has kept rates unchanged for the first time in this hiking cycle as most indicators are moving in the right direction and the aggressive monetary tightening is taking its toll on the economy.

UK

Inflation remains elevated though input prices have weakened substantially

Headline CPI inflation decelerated markedly from 10.1% YoY in March to 8.7% YoY in April, helped by significant base effects. Despite the big drop, price pressure was stronger than expected. The acceleration of the monthly rate from 0.8% to 1.2% and the pickup in core inflation from 6.2% YoY to 6.8% YoY are concerning and show that inflation remains far too high. External factors like commodity prices are less relevant now and high inflation rates have increasingly domestic roots. On a more positive note, producer input price pressure has weakened substantially to 3.9% YoY from 7.3% YoY the month before, indicating that broader inflation rates will keep falling rapidly in the months ahead.

Meanwhile, the labour market remains tight with wage growth accelerating from 6.8% YoY in March, to 7.2% YoY in April almost matching the multi-decade high reached after the pandemic-induced recession. Therefore, wage pressure remains significantly above the BoE's comfort level making it very likely that the Bank will continue to tighten its policy in the near future.

Accordingly, gilt yields have risen, particularly for shorter durations, as investors are pricing in a higher target for the Bank Rate with the yield slope inverting the most since the financial crisis, signalling more headwinds for the economy.

Eurozone

Inflation surprises on the downside, but core is sticky

There has finally been some good news on Eurozone inflation, which was lower than expected in May. Headline CPI fell from 7% YoY to 6.1%, helped by falling food and energy inflation. Core and services inflation also ticked lower, with core CPI down from a high of 5.7% in March to 5.3%. Other pricing indicators have also softened, with producer price inflation at only 1% YoY in April, vs. 5.9% in March and a whopping 43% in August last year. The leading PMI survey also shows weakness in pricing components, particularly for manufacturers. While encouraging, the weaker core CPI partly reflected the introduction of a subsidised transportion ticket in Germany, so a partial reversal is likely. More troubling is the fact that wage growth is still very high, at 5.1% YoY. For inflation to return to target, wage pressures have to moderate sharply, which likely requires labour market conditions to deteriorate. Until this happens, the ECB is set to stick to its hawkish outlook despite weakness in the manufacturing and construction sectors and a sharp tightening in credit conditions. This was also confirmed in the June policy meeting. However, the risk is that in the course of trying to deal with inflation, the ECB chokes off the modest economic recover.

Switzerland

Inflation falling again after a brief overshoot

Having surprised on the upside in early 2023, inflation has fallen back in Q2, with headline CPI down from a peak of 3.4% YoY in February to 2.2% in May. Core CPI also softened but, at 2%, remains well above its historical average. Producer prices have stabilised, with the combined producer and import price index slumping from 7% YoY one year ago to -0.3% in May. The sharp decceleration in inflation reflects favourable energy base effects, a strong franc, and rapidly improving supply conditions. Looking forward, the Swiss and global economic outlook are challenged, with weakness outside of the service sector along with tighter credit conditions and a less favourable job market. This should help to contain price pressures and lead headline inflation lower in the months ahead. Core inflation is stickier though and should stay around 2% for time being, reflecting still solid services demand, rising rents, and a brisk wage growthof 1.8% in Q1.

The latest inflation outturns have, however, been weaker than projected by the SNB, and growth is also softening. Even the unemployment rate has ticked up, with the number of open position falling. We believe this should warrant the SNB to pause in the June meeting, though recognise that it's a finely balanced decision, particularly given a hawkish ECB.

Japan

Consumers are getting accustomed to inflation, with real wages likely to rise

A recent survey indicates that the acceptance of price increases among consumers has spread, while the outlook for price hikes remains in place. Though real wages are still hovering in negative territory (-3% YoY in April), they should turn positive in the second half of the year amid rising base wages, the solid 'shunto' wage negotiation round and the fact that inflation is likely to roll over amid lower import prices. Our outlook for solid consumption growth remains intact. Interestingly, services inflation has continued to increase, mainly due to price pressures in the 'housing repair & maintenance' and 'meals outside the home' categories. Though their weight in the Services CPI is just 13%, they accounted for more than half of the recent rise in services prices over the past year. Hotel prices and car rental charges have also risen significantly. Meanwhile, based on the Tokyo CPI data for May, the various measures of core inflation continue to deliver mixed messages depending on which of the various 'core' definitions is chosen. Overall, we think it is too early to argue that core inflation has started to fall, though it may be in a peaking process.

China

Producer price deflation gains steam, but a normalisation is expected into the second half of the year

China's disinflationary pressures became more entrenched in May, with the CPI up a meagre 0.2% YoY, core CPI inflation at 0.6% YoY and PPI deflation intensifying to -4.6% YoY, with the latter coming in below consensus expectations at a seven-year low. The snapback of inflation following the reopening of China's economy has already faded. Meanwhile, producer prices are being dragged down by falling energy and metal prices as well as lower consumer durable prices. Falling pork and vegetable prices remain a drag, while auto prices keep dropping due to price promotions, despite a recent pickup in demand. China's index of newly constructed residential buildings in 70 selected cities seems to have bottomed, though still down 0.7% YoY. As we expect property stabilisation measures to kick in soon, housing and rental prices should start to stabilise and then pick up later this year. An anticipated pickup in travel in the second half of the year should help to support a services price recovery. We also expect some policy support for the economy to be announced during the next major Politburo meeting in Q3, which should help to curtail further deflationary tendencies.

Australia

Inflation resurgence suggests that the RBA will maintain its tightening bias

Following a three-month decline, the monthly CPI has rebounded, accelerating from 6.3% to 6.8% YoY in April, surpassing consensus expectations of 6.4%. The Trimmed Mean CPI rose from 6.5% to 6.7%, buoyed by robust demand for holiday travel and accommodation, suggesting that inflation is likely to exceed the Reserve Bank of Australia's (RBA) forecast of 6.3% for June. Although the unemployment rate unexpectedly rose from 3.5% to 3.7% in April, the labour market remains tight, with total hours worked demonstrating robust growth in the economy. Wage growth remains a key focal point for the RBA as it assesses underlying inflationary pressures. The Wage Price Index stood at 3.7% YoY in Q1, staying within the 3-4% wage growth range, which is consistent with the RBA's inflation target of 2-3%. However, recent data reveals a notable increase in nominal unit labour costs during Q1, coupled with continued weakness in labour productivity. This suggests that inflationary pressures are likely to stay elevated. In response to the upward surprise in inflation, the RBA raised its cash rate from 3.85% to 4.1% in June. Given the uncertainties around the inflation outlook, the RBA is likely to stick to its tightening bias.

ASEAN

Broad-based disinflation allows central banks to remain on hold

Inflation across ASEAN countries continues to follow a declining trend as broad-based disinflationary pressures persist. In May, Indonesia's headline CPI decreased from 4.3% YoY to 4.0%, with inflation easing for both goods and services. Similarly, Malaysia saw a moderation in headline inflation, dropping from 3.4% YoY to 3.3% in April, primarily driven by subdued price pressures in sectors such as restaurants, hotels, and recreational services. Meanwhile, Thailand experienced a plunge in headline inflation, falling from 2.7% YoY to 0.5% in May, which is below the Bank of Thailand's target range. Core inflation also declined, indicating restrained demand-pull inflationary pressures. Despite expectations of stronger demand stemming from tourism, it appears that the impact on domestic demand and price pressures in Thailand is taking longer to materialise. In the Philippines, inflation remains above the central bank's target but continus its rapid decline. On the other hand, Singapore has exhibited stickier core inflation, propelled by tourism-related activity and services. Overall, inflationary concerns within ASEAN remain relatively subdued, reaffirming our expectations for most central banks to maintain their policy rates throughout 2023.

Brazil

Inflation is falling sharply, paving the way for rate cuts

Annual inflation has continued its downward trend, falling from 5.8% in Dec 2022 to 3.9% in May, returning to the central bank target band in March and reaching its lowest level since October 2020. Regulated prices have fallen by -0.9% YoY, mainly explained by fuel and electricity price. May inflation figures confirm the broad improvement in inflation dynamics, and the new fuel pricing policy implemented by the state-owned company Petrobras led to a sharp drop in the cost of gasoline and diesel. Furthermore, the inflation breakdown across components is also looking better as core inflation has now been decelerating for eleven consecutive months, reaching 6.7% in May. The sharp reduction in inflation has increased the odds of an earlier start to the monetary policy easing cycle. However, the sticky services component, robust economic activity, the dynamic labour market, and de-anchored inflation expectations support the pause implemented by the central bank despite the positive news on current inflation. Consequently, inflation developments are paving the way for the central bank to cut the rate, but we do not expect the easing cycle to be brought forward. We maintain our view that it will start in October.

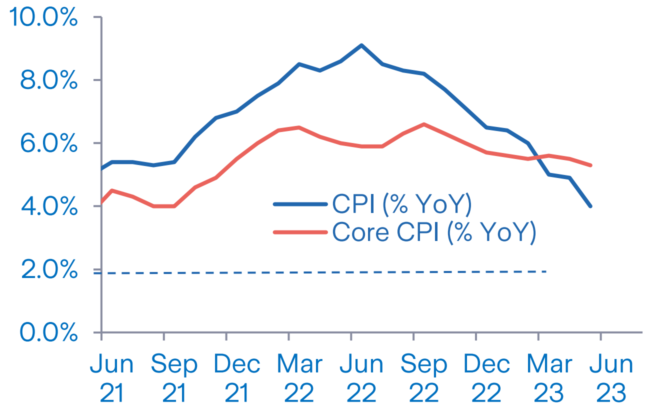
LatAm

The easing cycle is approaching

Despite resilient economic activity, inflation continued to ease during the last quarter, benefiting from favourable base effects and a significant drop in the non-core components, particularly energy and food prices. Core inflation is also easing but at a slower pace than headline, remaining the primary concern for central banks. The slowdown in inflation has consolidated in most countries in the region, and we expect the monetary policy easing cycle to start soon, with Chile being the first country to cut rates, likely during Q3 2023. In Chile, headline inflation decelerated from 12.8% in December 2022 to 8.7% in May, mainly explained by a sharp fall in energy prices. Core inflation remains sticky though and is easing slower than headline inflation, reaching 9.9% in May, which is a concern for the central bank. Nevertheless, with growth now weakening and inflation coming in below expectations, the way has been paved to start thinking about cutting rates. In Mexico, headline inflation is also falling more rapidly than expected, reaching 5.8% YoY after a negative monthly inflation rate in May,. The latest figures confirm a disinflation process but will not impact the monetary policy decision in the short term.

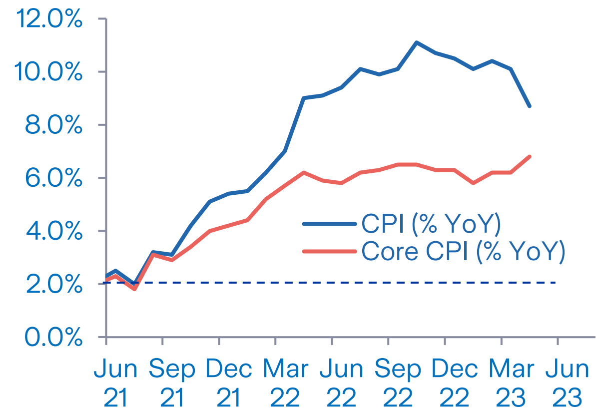
Current and historic inflation

US: core also softening



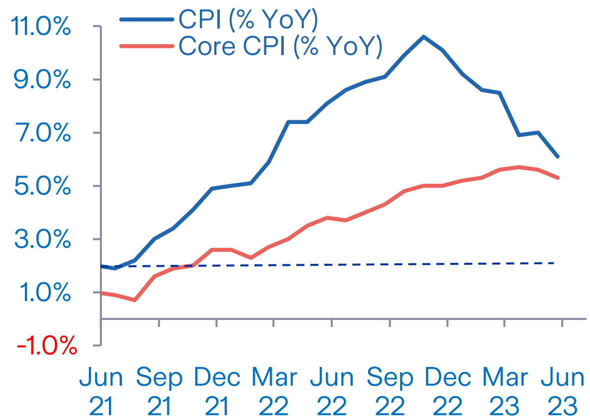
Source: BLS

UK: domestically driven reacceleration



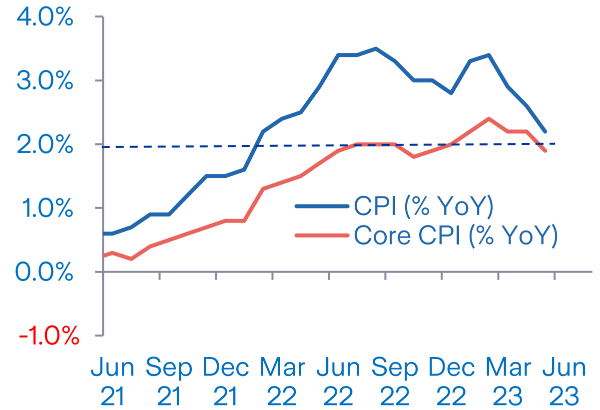
Source: ONS

EZ: core is troublesome



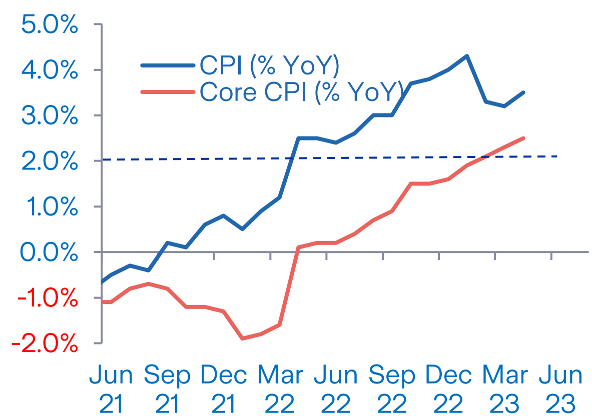
Source: Eurostat

CH: inflation moderating



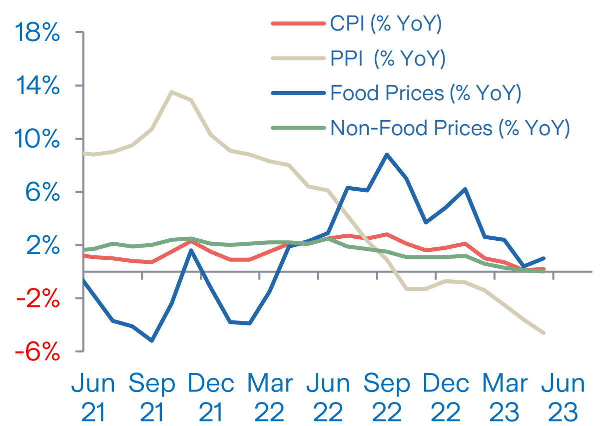
Source: Federal Statistics Office

Japan: not yet peaking



Source: Ministry of Internal Affairs & Communication

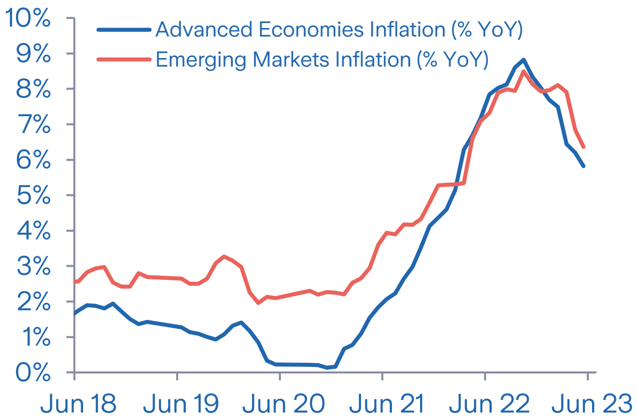
China: deep producer price deflation



Source: National Bureau of Statistics China

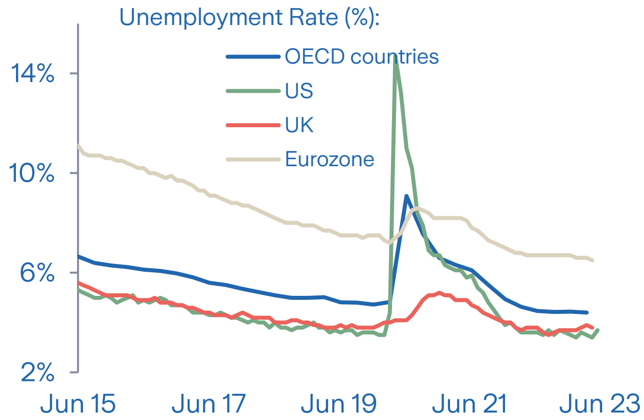
Key indicators

Inflation down on food and energy



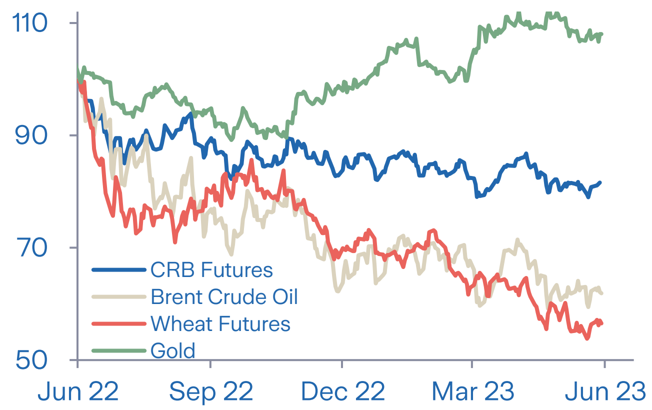
Source: ZIG, Bloomberg; average across regions

Labour markets still too tight



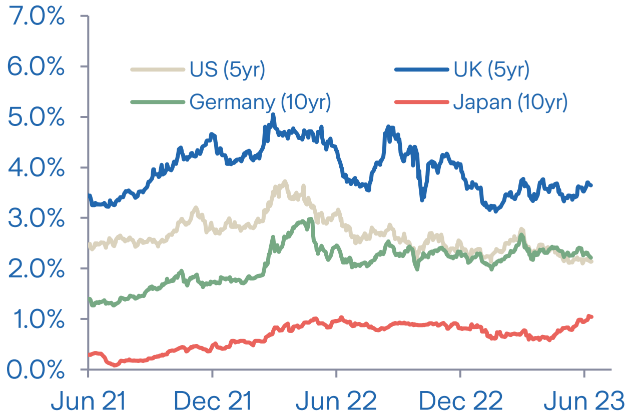
Source: Bloomberg

Commodity prices remain disinflationary



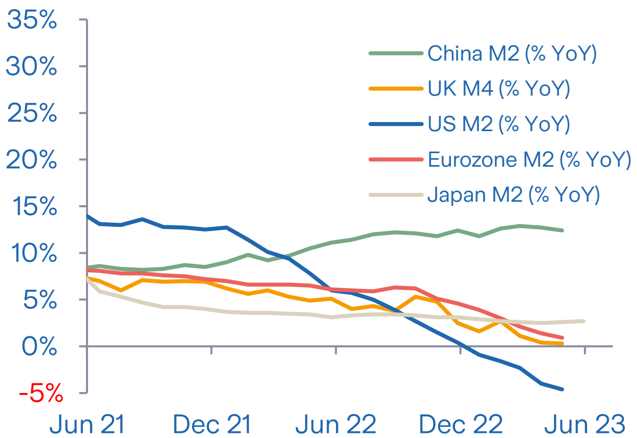
Source: Bloomberg; Commodity prices rebased to 100 in June 2022

Inflation expectations ticking up in UK and Japan



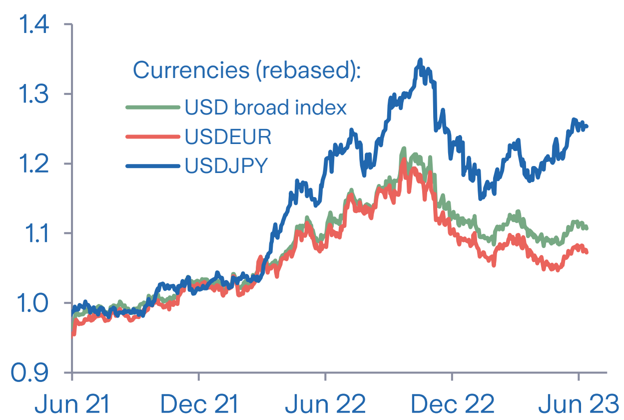
Source: Bloomberg

Sharp monetary tightening underway



Source: Bloomberg

FX drives inflation divergence



Source: Bloomberg Note: Higher value implies stronger dollar

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