ZURICH

Inflation Focus Q3

19 September 2023

Key Points

- Inflation is down but not out, with services inflation remaining troubling despite weakening demand
- Further falls in inflation are expected as rate hikes and credit tightening weigh on economic activity
- Central banks are maintaining 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

Global inflation is falling rapidly

Headline CPI inflation has fallen rapidly, led by disinflationary energy, goods, and food prices. The services component has begun to edge lower, though it remains elevated and far above central bank targets. The divergent inflation trends reflect the state of the real economy, with manufacturing and construction under pressure while services has enjoyed very strong demand in the first half of the year.

Looking forward, services activity has begun to slow more meaningfully and global growth has fallen to a below trend level. There are signs that monetary tightening is beginning to take a more meaningful toll on the economy, particularly in Europe, while weakness in China persists. As economic activity cools, this should help drive further declines in CPI inflation, primarily on the services side. While this is encouraging, the level of inflation is still too high.

The disinflationary impulse from goods prices is moderating

Core goods (ex energy and food) have been hugely disinflationary over the past year, driving CPI inflation lower in most regions. In the Eurozone, producer prices (PPI) for the industrial sector were rising at a pace of 43% YoY one year ago, but are now falling at over 7% YoY. In the US, core CPI goods price inflation (ex energy and food) has dwindled from 12.3% at its peak to 0.2%. Inflation rates on the most affected components, such as autos, have slumped, and are now in negative territory. While the weakness in the industrial sector should persist, further falls in goods price inflation will be more difficult to achieve as prices have already adjusted to a weaker demand environment, and supply conditions are unlikely to improve further. The economic slowdown in China has further amplified weakness in the global industrial sector, though its impact on global demand and activity. With targeted stimulus in China now forthcoming, local conditions are expected to stabilise limiting further disinflationary pressures emerging from China.

Food and oil prices pose upside risk to inflation

Energy and food prices have also helped to drive inflation lower, but conditions are becoming less favourable. Oil prices have risen by 25% in Q3 on OPEC+ measures to keep supply tight. This will feed into higher price rises over the coming months and is already visible in a small uptick in headline inflation rates in August. Similarly, food prices fell sharply into mid-year but are now at risk of rebounding on weather related supply shocks (eg El Niño) and geopolitical risk. As oil and food prices are non-core CPI components, they would normally not cause deep concerns among the world's central banks. However, the risk is that, after a prolonged period with elevated inflation, rising food and oil prices will renew and strengthen upward pressure on prices and wages, especially given still tight labour markets.

Labour markets are past peak tightness, but remain tight overall

Labour markets remain very tight, with unemployment rates at or close to historical lows. Data on job market imbalances indicate that we are likely to be past peak tightness, however. The gap between the number of job openings and the number of unemployed workers continue to narrow in the US, where wage pressures have come down meaningfully. In Europe, the unemployment rate has started to pick up, most notably in the UK and Germany, but wages are still rising at over 7% YoY in these countries. While some of this strength is likely to reflect past high inflation rates and should fade as we move forward, it means that policy is likely to stay restrictive for time being.

Limited progress on services inflation

Labour is the key component of costs for the services sector, and strong wage growth and solid demand are reflected in still uncomfortably high services inflation. Looking forward, price pressures should ease. Services resilience appears to be fading as business services such as logistics and transportation are impacted by the industrial slowdown while demand for consumer services is moderating. Moreover, upward pressure on market rents is slowing in some regions, including the US, which should ease the rent inflation component. While this is encouraging, progress on services inflation is limited so far, indicating that the fight against inflation is not yet over.

Central banks are maintaining their focus on inflation

As expected, central banks have maintained their focus on inflation. While most of the tightening is now likely to be behind us, they have adopted a fully data dependent approach and will keep policy tight until core and services inflation have fallen meaningfully further. The process should be quicker in the US compared to Europe given the size of the energy price shock that is still impacting on Europe. A key exception is LatAm, where central banks are now cutting rates after having been the first ones to start the hiking cycle over two years ago.

US

Core CPI slows but is still too high

CPI inflation rebounded in August, led by a rise in energy prices, with oil prices up 30% since early June. Headline CPI jumped from 3.2% YoY to 3.7% YoY while the core reading eased back from 4.7% to 4.3%, but the monthly rate was still slightly above expectations. Gasoline played a big part in the headline, while core was impacted by a spike in airfares, which tend to be volatile. Home rental prices were more encouraging and we see an improving outlook in the months ahead as rent growth eases. The CPI services component also improved, with the annual rate edging down from 6.1% to 5.9%. This is promising but progress is slow and the latest data highlight that the fight against inflation is not yet over, with the Fed likely to keep its hawkish stance for now. While the NFIB small business survey indicates that price plans remain on a downward trend, the reacceleration in prices paid revealed in August's ISM surveys will raise the Fed's attention. Similarly, the latest S&P PMI report shows that cost pressures regained momentum in August as input price inflation quickened on the back of greater fuel, wage and raw material costs. On the other hand, efforts to remain competitive dampened the pace of selling price inflation as customer requests for discounts and competitive pricing prevented substantial upticks in selling prices, a trend that we expect to continue.

UK

Price pressure begins to fade as consumer demand weakens

Driven by energy prices, headline inflation dropped by 0.4% MoM in July. The annual rate slowed substantially from 7.9% the month before to 6.8% while core inflation remained at 6.9% YoY. The slowdown in price pressure is reassuring, but inflation is still far too high and a range of service components remain sticky. Nevertheless, the latest leading PMI business survey shows that inflationary pressures continued to moderate in August, with input costs rising at the slowest pace for two-and-half years. The survey also shows that in response to weaker consumer demand, firms have begun to adjust their pricing strategies, with average prices charged increasing at the softest rate since February 2021.

Meanwhile, wage growth has accelerated despite a pickup in unemployment. The unemployment rate rose from 4% in May to 4.2% in June, but wage growth ticked up from 7.5% YoY to 7.8%.

Both inflation and wage growth will keep the Bank of England on its toes, making it likely that the Monetary Policy Committee will keep its hiking bias for now. On a positive note from the BoE's point of view, some indicators like jobless claims point at further weakness in the labour market that should eventually lead to falling wage pressure.

Eurozone

Services inflation remains troubling

Inflation trends are unusually divergent. Services and wage inflation are elevated while disinflationary pressures are intensifying in the industrial sector. At a headline CPI level, inflation has fallen sharply, down from a peak of over 10% last year to 5.3% in August. Within the industrial sector, producer price inflation has also slumped and is now tracking at -7.6% YoY. By contrast, core CPI remains sticky and is only down from a high of 5.7% to 5.3%. Wage inflation, which is a key driver of services inflation, is still running hot, with German wages and salary growth climbing to a historical high of 7.6% YoY in June. For inflation to return towards a 2% level, wage pressures have to moderate. While economic activity has weakened sharply, labour markets remain tight, with the Eurozone unemployment rate still at a historical low. Given this, the ECB is set to maintain a hawkish stance for time being, despite stagnating economic activity. This was confirmed in the September policy meeting, when the ECB hiked rates to 4%, while stating that it was too early to signal the end of the hiking cycle. This will help to contain inflation and underpins our view that inflation will continue to grind lower. The risk, of course, is that in the course of trying to deal with inflation, the ECB chokes off any remaining growth in the region.

Switzerland

Inflation falls further, but domestic price pressures are stickier

Inflation has fallen further in Q3, with headline CPI at 1.6% YoY in August, down from 2.2% in May. Core CPI has also continued to fall and, at 1.5%, is tracking well below the SNB's 2% reference level. The downshift in CPI inflation has been led by falling prices on imported consumer goods. This reflects disinflationary global goods prices and the strong franc. Domestic price pressures are still more elevated, with stickiness in both the goods and services components. Further up the supply chain, the combined import and producer price index confirms these diverging price trends, with import prices falling at an annual pace of -4.1%, while domestic producer prices are still rising at 1%. Looking forward, economic activity has weakened in Switzerland and globally, and this should help to contain wage and price pressures in the months ahead. Indeed, the unemployment rate has already edged higher in Switzerland. On the other hand, rising rents (regulated) and announced electricity price hikes will add to domestic price pressures in the quarters ahead. Given the SNB's preference for low inflation, we expect the central bank to maintain its hawkish stance for the time being, with ongoing FX interventions to strengthen the franc, along with the potential for at least one further rate hike.

Japan

Inflation pressures will recede, while wage growth remains firm

Tokyo's CPI, a leading indicator for nationwide consumer prices, had risen from its low of -1.2% in 2021 to 4.4% YoY in January this year, but then back to 2.9% in August. Core CPI (ex food and energy) stands at 2.6%. Firms have passed on most of the increase in higher input costs to the consumer, which suggests that inflation is likely to recede further in the months ahead, even though service inflation keeps creeping higher. Though at a decade high, CPI inflation would have been even higher by another two percentage points had mobile phone tariffs not been cut by nearly half, and had the cap on electricity and gas prices not been introduced in February this year. We note that the latter has recently been extended until year end. Gasoline related subsidies will be gradually reduced into next year. As for producer prices, we note that even though corporate goods price inflation receded by 20bps to 3.4% YoY in August, producer price inflation appears to be gaining some momentum on a sequential basis, up 0.3% MoM, mainly driven by higher petroleum and coal prices, but also increasing machinery prices. While wage statistics continue to be volatile, the upside trend for wages remains intact.

China
In and out of deflationary territory

Consumer price inflation's dip into negative territory may have only been a one-month event. CPI moved back from -0.3% YoY to +0.1% in August while producer price deflation receded from -5.4% YoY to -3% within two months, a trend supported by rising global commodity prices. Core inflation, stable at +0.8%, is mainly driven by core services inflation. We believe that CPI, PPI and core inflation are likely to move somewhat higher into next year as domestic demand is likely to recover and positive base effects will soon kick in for food and energy components. However, we need to wait for confirmation to see whether, and when, the GDP deflator is going to switch out of deflationary territory.

We expect monetary policy to remain loose, as the latest cut in the RRR by 25bps, the second this year, confirms. We also note that major banks have cut their deposit rates, a precursor to lower lending rates, to spur the ailing property market. Even though new home sales are still falling, we believe that the cut in the mortgage downpayment quota by ten percentage points will have a positive impact on new mortgage loans.

Australia
Inflation surprises on the downside but signs of stickiness remain

Inflation has consistently surprised consensus to the downside, driven by a notable drop in goods inflation following a steep rise last year. However, not all sectors mirrored the downtrend. Services inflation has soared on the back of rising rents, vacation travels, and insurance costs. Rents, in particular, surged by 6.7% YoY in Q2, the highest since 2009, due to low vacancies given tight housing supply and robust net migration. The labour market, despite tentative signs of loosening, remains historically tight. With wage hike decisions such as that of the Fair Work Commission coming into effect in Q3, wage growth is projected to rise further but is likely to stay in the range of 3% to 4%. Short-term inflation expectations declined after the downward surprise in inflation, prompting the central bank to pause its rate hikes since June. However, with ongoing signs of inflation stickiness, the possibility of one more rate hike by the RBA towards year end remains. Meanwhile, the bond market reflects the 'higher for longer' narrative, with government bond yields hitting a decade high recently. While yields might retreat from the recent surge, they are likely to remain at high levels until there is a convincing sign that inflation is brought under control.

ASEAN
In a sweet spot

The inflation trajectory across ASEAN continues to show disinflationary forces, with inflation in many countries hovering between 2 to 4%. Notably, Thailand's CPI even fell below the central bank's lower target of 2%. Headline inflation in both Singapore and the Philippines, despite surpassing 4%, indicates a clear downward trend. Singapore's core CPI, however, remains somewhat sticky due to robust services demand, in part driven by tourism. In the near term, challenges posed by El Niño, such as the delay of the harvest season, could strain food supply, thereby exerting upward pressure on food prices. Meanwhile, the probable reduction of fuel subsidies in countries like Indonesia and Malaysia might further contribute to a higher headline CPI. Nevertheless, a pronounced inflationary surge seems unlikely.

Overall, ASEAN is in a sweet spot, with growth holding up and inflation largely within comfortable ranges. This stability allows regional central banks to be relatively independent from the Fed regarding their policy direction. We anticipate rate cuts in most countries to come through in 2024.

Brazil
Tame underlying inflation will not be enough to accelerate monetary easing

After falling for 12 months, national CPI (IPCA) inflation reaccelerated in the beginning of the third quarter, rising from a low in June of 3.2% YoY to 4.6% YoY in August (up from 4% in July), which nonetheless was below market expectations of 4.7%. The downward surprise was broad based. Food and beverages continued to decelerate to 1.1% YoY, down from 2.2% the previous month, while electricity, vehicle prices, and gasoline contributed positively, driven by Petrobras' announcement on August 15 that it would raise the wholesale price of gasoline by 16% per litre and that of diesel by 26%.

Slower than expected inflation in August would not be enough to accelerate Brazil's monetary easing in a scenario where economic activity remains resilient.

Thus, the Central Bank is expected to maintain its forward guidance and cut the Selic rate by 50pbs increments at each of its next three meetings, bringing the rate to 11.75% by the end of 2023. However, a resurgence of inflationary pressures could slow down the pace of cuts.

LatAm
Chile starts the rate cutting cycle

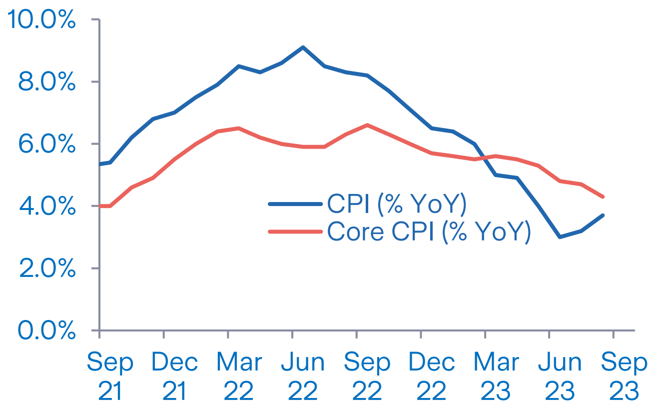
While indicators of economic activity have surprised positively in Latin America, they show a slowdown, both reflecting higher interest rates and China's stagnation. On the other hand, although inflation has maintained its downward trend, some inflationary risks persist and could eventually slow down the pace of rate cuts.

In Chile, inflation has continued to decelerate, rising by 0.1% MoM in August, down from 0.4% MoM in July. This was weaker than market expectations of 0.4%. The annual rate of inflation was 5.3%, down from 6.5% in July. Inflation that excludes volatile components also showed a decline. While inflation remains above the Central Bank's target, it also continues to decelerate at a faster rate than the Bank had expected. This is encouraging, but there are some factors that could generate short-term price pressures such as the recent CLP depreciation and oil price increases, as well as the impact on food prices from El Niño.

In Mexico, annual CPI inflation has also decreased. Core inflation has room to slow further, aided by accumulated MXN appreciation and weaker global prices changes. This supports our expectations that policymakers will hold interest rates unchanged over the near term.

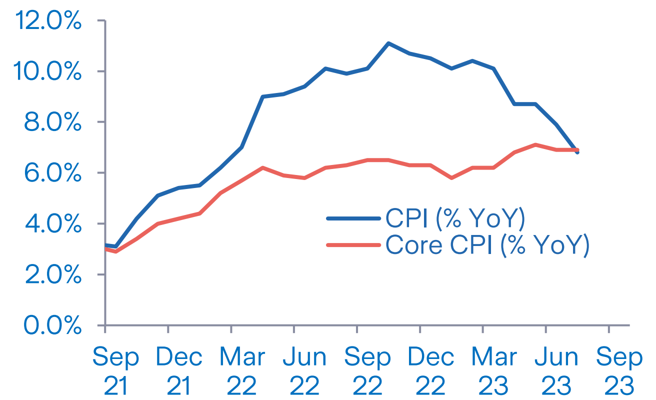
Current and historic inflation

US: core to fall further



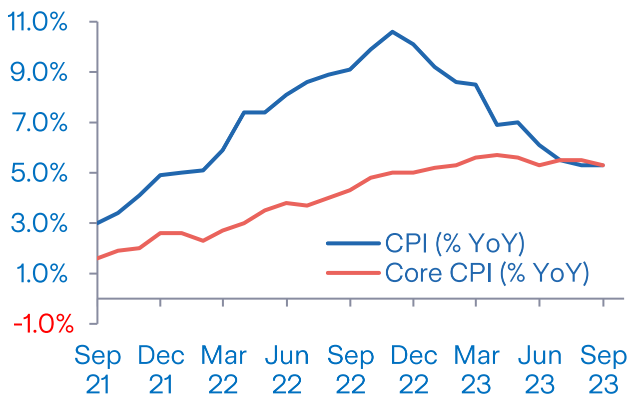
Source: BLS

UK: demand weakness should weigh on inflation



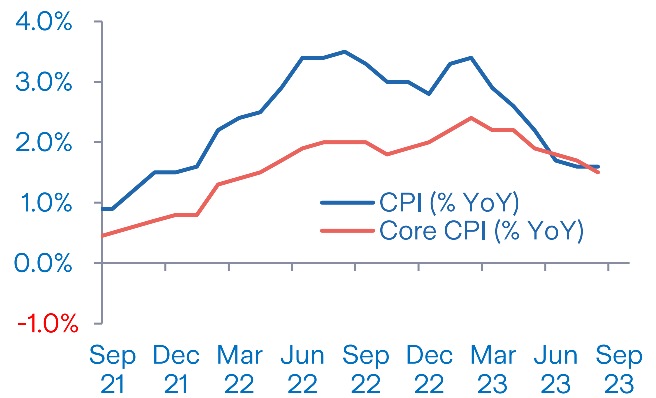
Source: ONS

EZ: sticky and far above target



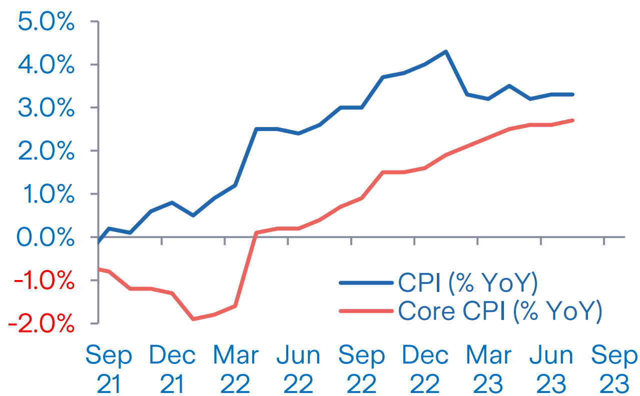
Source: Eurostat

CH: inflation falls further on strong currency



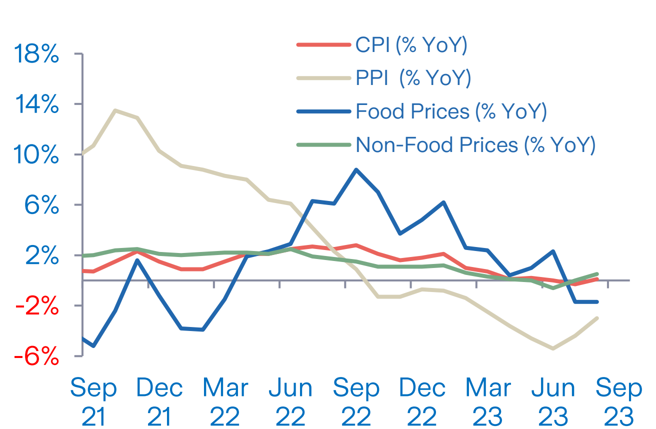
Source: Federal Statistics Office

Japan: not yet peaking



Source: Ministry of Internal Affairs & Communication

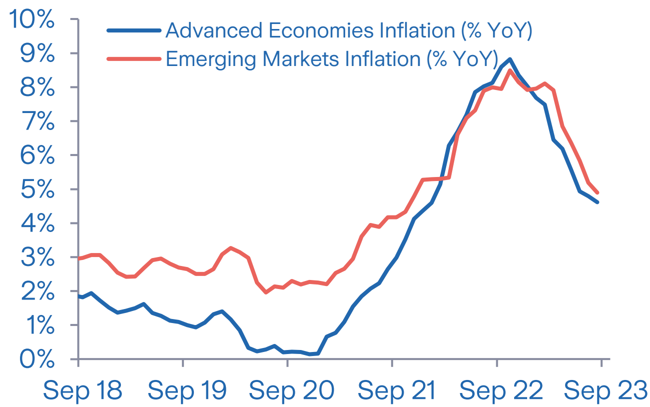
China: disinflation has broadened out



Source: National Bureau of Statistics China

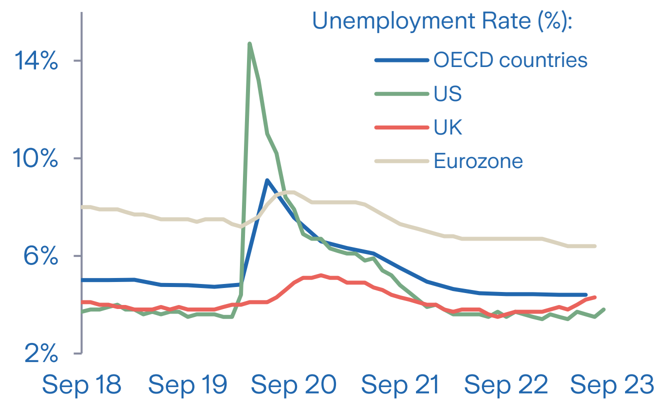
Key indicators

Global disinflation



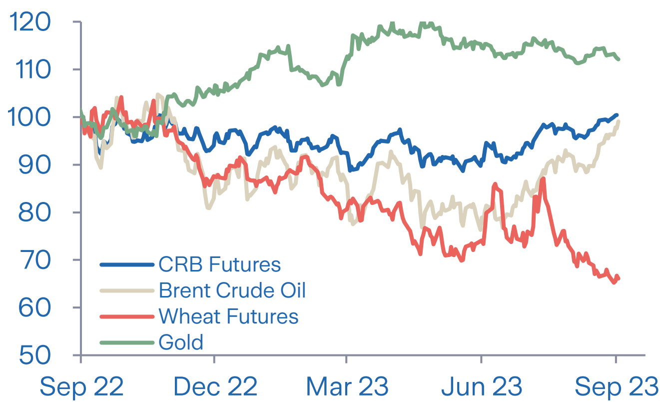
Source: ZIG, Bloomberg; average across regions

Unemployment edging higher in some regions



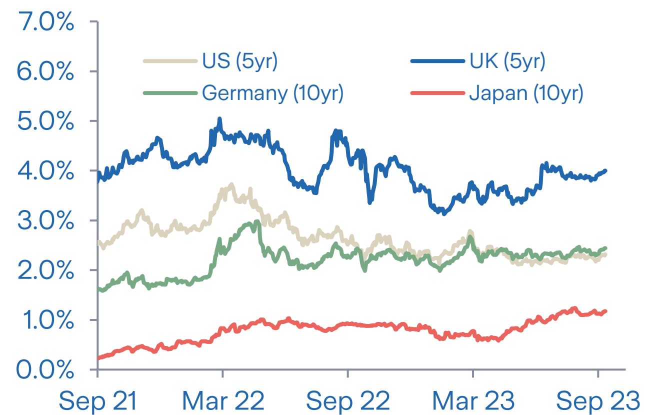
Source: Bloomberg

Oil prices rise on lower supply



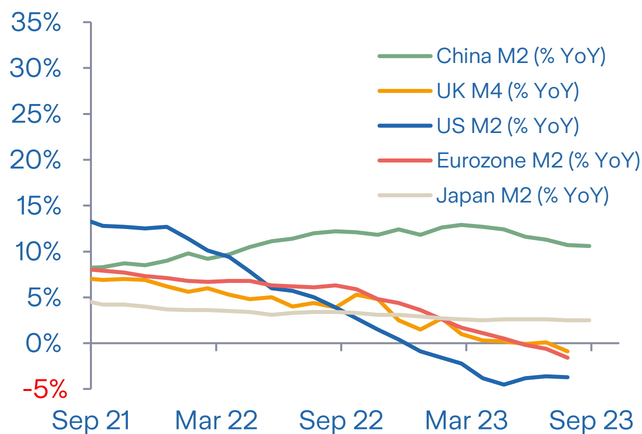
Source: Bloomberg; Commodity prices rebased to 100 in June 2022

Inflation expectations broadly stable



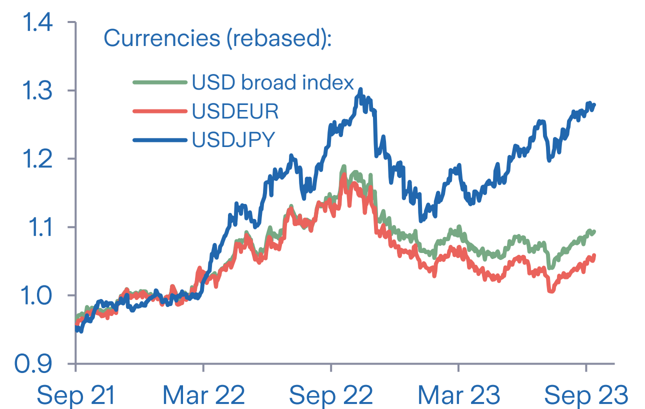
Source: Bloomberg

Sharp monetary tightening underway in the west



Source: Bloomberg

FX drives inflation divergence



Source: Bloomberg Note: Higher value implies stronger dollar

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