Inflation Focus Q4

15 December 2023

Key Points

- Inflation is sharply down but not yet out, with progress on services inflation still incomplete
- Further falls in inflation are expected as restrictive monetary policy weighs on demand and labour markets
- Central banks tone down their hawkish guidance, but rates remain in restrictive territory
- A sharp repricing of the inflation and rates outlook in financial markets is vulnerable to temporary setbacks

Global inflation is falling quickly
Headline CPI inflation is falling at a rapid pace, surprising to the downside vs. market expectations in many regions in Q4. The declines continue to reflect disinflationary energy, goods, and food prices, but services dynamics have also started to improve. The change has been most notable in Europe, given rapidly diminishing energy and food inflation and economic weakness. However, while inflation rates are now coming down quickly, this does not mean that prices are falling. Indeed, the level of consumer prices in major economies have risen by an average of over 15% since the global pandemic, and are not expected to actually fall.

The disinflationary impulse from energy and goods should diminish
Looking forward, we expect inflation to continue to fall in the months ahead as global growth remains weak and the lagged effects of monetary tightening weigh on demand and activity. With oil and energy prices broadly stable compared to a year ago and goods price inflation back at zero, the disinflationary impulse from favourable energy and goods price base effects will diminish. This means that other components, in particular services, will need to pick up the baton to drive further progress. While we anticipate this happening, the transition is unlikely to be smooth as it hinges on labour markets easing back and pricing power and demand reducing more markedly.

Services inflation remains elevated, but the pricing environment is now changing
While goods price inflation has slumped and is now back at zero in major economies, services inflation is not yet consistent with central bank targets. Core services inflation, which strips out energy related components, remains elevated. The flipside of that is that businesses have retained pricing power, with margins remaining solid or even expanding amid brisk services demand following the global pandemic. These favourable conditions are unlikely to last, however, as demand for services is now slowing and businesses are reporting a more challenging pricing environment. We suspect that this will help to drive further progress on services inflation in the months ahead.

More signs that labour markets are weakening
Labour is a key input for services, and rapidly rising wages have been adding to upward price pressures in the sector. Tight labour markets and solid employment growth have also ensured that consumer spending has remained brisk, despite cost-of-living pressures and rising interest rates.

Looking forward, we expect a turn here as well. While the labour market situation remains favourable overall, there are increasing signs that conditions are softening. The gap between the number of job openings and the number of unemployed workers narrowed further in Q4 in the US. Wage growth also continues to fall, now tracking slightly above 4% annually, marking good progress though not yet consistent with inflation at target.

In Europe, unemployment is edging higher, particularly in the UK and Germany, but wage growth is still uncomfortably high. These high wage gains partly reflect a catch-up to surging inflation in the past, however, and should fade as inflation falls and hiring falls. High frequency wage data from online job portals also indicate that wage dynamics have started to moderate.

Central banks pivot in a dovish direction, with the Fed taking the lead
Rapidly falling inflation has been welcome news for central banks. The Federal Reserve pivoted in a dovish direction in the December policy meeting, signalling rate cuts in the first half of 2024. European central banks remain more cautious but have toned down their hawkish guidance and reduced inflation forecasts. Financial market pricings has moreover shifted aggressively and is now consistent with significant policy loosening next year. As fears around persistent inflation have diminished, long-term borrowing costs and government bond yields have additionally slumped while risk assets have rallied strongly. All of this has led to a significant loosening in overall financial conditions in Q4, that should help to support economic activity in coming months, while also reducing the risk of a sharper growth drawdown.

Progress on inflation remains incomplete, and central banks need to stay vigilant
While recent declines in inflation are positive, progress remains incomplete, and the path forward is unlikely to be as smooth as it has been over the past few months. Though we expect inflation to continue to decline, approaching target level towards the end of 2024, policymakers need to remain vigilant to ensure that positive developments do not stall.

US

Falling inflation rates set the stage for a less hawkish Fed

Price pressure is continuing to fade throughout the economy. Headline inflation ticked down to 3.1% YoY in November 2023 from 3.2% in October. Meanwhile, core inflation is stickier, remaining at 4.0%, matching the two-year low reached in October, helped by a slowdown in shelter costs and other service components. Importantly, input costs are growing at a slower pace and business surveys show that firms are increasingly reluctant or unable to raise prices as consumer demand is weakening and competitive pressure is rising. Although households' inflation expectations remain elevated, they are likely to normalise in line with the particular. The labour market is showing more and more signs of weakening, although the unemployment rate fell back to 3.7% in November after reaching the highest level since January 2022 the month before. The slowdown in the labour market will help to further mitigate wage pressure. Growth in average hourly earnings slowed to 4.0% in November 2023. Reduced wage pressure and falling inflation have allowed the Fed to take a less hawkish stance as there are fewer reasons to worry about a potential wage-price spiral. The latest FOMC statement indicates that federal fund rates have reached their peak and the Fed is likely to cut rates in the first half of 2024.

UK

Inflation falls rapidly as energy prices drop

Driven by a substantial fall in energy prices, headline inflation dropped to 4.6% YoY in October, down from 6.7% YoY in September while core inflation slowed from 6.1% YoY to 5.7% YoY. Price pressure is likely to fall further in the coming months and quarters as economic activity and demand remain muted. Producer prices fell on an annual basis in October, reflecting the weaker environment. Meanwhile, service inflation is stickier so the slowdown in core inflation will continue to lag the broader development, but a softer employment situation will reduce pressure on wages. Starting salary inflation slowed to the lowest in almost three years, though broader wage measures are still elevated and significantly above the Bank of England's comfort level. Weekly earnings excluding bonuses were 7.3% higher in October compared to a year ago. Receding wage growth will help to bring down service inflation, but it will take some time until the BoE is fully convinced that price pressure is sustainably moving back to target. Once inflation rates are on a sustainable path towards target and the risks of a persistent wage-price spiral dissipate, the Bank of England will start to loosen its policy.

Eurozone

Genuine signs of a slowdown

The Eurozone inflation outlook is unambiguously improving as recent data show a broad slowdown. We see good reason to believe inflation will persistently fall back to around the ECB's 2% target toward the end of 2024 and may even be below the target further in the future. However, the path there is unlikely to be smooth, and risk is to the upside in early 2024. Due to this risk, and a need for high confidence that inflation has been tamed, we only see ECB cuts in the second half of 2024. Headline Eurozone HICP has fallen to 2.4%, down from a peak of 10.6% in October 2022. Core inflation is now at 3.6% after consistently printing above 5% from October 2022 until September 2023. The majority of the improvement in inflation has been from helpful base effects in energy and goods prices. A significant fall in energy prices from the 2022 surges, negative industrial producer price inflation, and price cut intentions in the manufacturing sector have all aided inflation's decline. Goods inflation itself has now fallen to 1.7%. These categories are now less likely to reduce inflation in coming months. Services inflation is still considerably above target at 4%, but recent falls have been larger than expected. We think the peak in wage growth is behind us and see a weakening labour market in a weak economic environment in 2024 – which is closely related to our view of falling inflation in the region.

Switzerland

Inflation falls further, despite upward pressure from rising rents

Inflation has fallen further, with headline CPI at 1.4% YoY in November, down from 1.7% and weaker than expected. While regulated rents rose by more than anticipated, this was offset by weak food, energy, and core inflation. Services, in particular hotels and package holidays, softened, potentially reflecting slowing demand. The latest wage data were also encouraging, with nominal wage growth stable at 1.8% YoY in Q3. PMI business survey data additionally indicate that employment plans are softening, which should help to contain wage growth in the months ahead. Finally, the franc has strengthened further, particularly against the euro, and this will continue to constrain import prices.

While the latest CPI data point to pricing weakness outside of the rent component, we continue to expect inflation to rebound modestly in early 2024 as a reflection of rising rents, and energy and transportation prices, before settling down at a lower level later in the year.

As expected, the SNB left rates unchanged in the December meeting, while cutting its inflation forecast. We don't expect further rate hikes but suspect the SNB will maintain a relatively hawkish guidance until near-term price pressures wane, with further FX interventions as required.

Japan

Inflationary pressures receding

The latest inflation data for November confirm that headline and core inflation rates are receding. Tokyo's core CPI (ex. fresh food) fell from 2.7% YoY to 2.3%, below consensus expectations, mainly due to lower electricity and gas charges, while core-core CPI (ex. fresh food and energy) softened from 3.8% YoY to 3.6%. Food prices were the major drag, falling 0.9 ppts to 6.4% YoY, and will remain the major disinflationary force in 2024. In seasonally adjusted terms, core-core CPI was unchanged MoM, the lowest rate since the end of 2021. Strong inflationary trends are still visible in hotel accommodation charges, which were up a hefty 62.5% YoY, mainly due to a lower base last year, but also because prior subsidies are running out and inbound tourism is surging. By contrast, producer price inflation keeps tumbling, down nearly ten percentage points within twelve months to only 0.8% YoY, mainly driven by lower oil prices. Interestingly, despite the disinflationary forces, both households and firms are sticking to their strong inflation outlook. The anticipated upward wage-price spiral keeps building, with headline wages up 1.5 YoY and full-time scheduled wages up 1.8% YoY in October.

China

Deflationary forces persist, particularly for food, energy, and property

Both CPI and PPI fell deeper into deflationary territory in November, with the CPI down from -0.2% to -0.5% YoY and the PPI down from -2.6% to -3% YoY, both weaker than consensus had expected. Pork prices tend to have a major impact on China's inflation rates. Indeed, pork prices fell 3% MoM and were down 31.8% YoY, pushing food price deflation to -4.2% YoY. Transportation fuel prices were another contributor to the bigger than expected price drop, falling 2.7% MoM and 2.9% YoY. It is also worth noting that even tourism related prices fell nearly 6% MoM, with the YoY rate down from double digit rates to 6.8% YoY. Meanwhile, producer price deflation is still being driven by falling commodity prices. However deflationary forces are less acute, with core CPI (ex. food & energy) stable at 0.6% YoY. Looking forward into 2024, we believe both consumer and producer prices to slowly move into positive territory on a YoY basis, the latter driven by rising commodity prices. Property price deflation is persisting, with new home prices down 0.4% MoM and 0.6% YoY in October, while existing home prices dropped 0.6% MoM and 3.4% YoY.

Australia

Sticky inflation reflects the resilience of demand and a tight labour market

Inflation is declining more slowly than expected, but the downward trend remains intact. Compared to other developed economies, Australia's inflation appears more persistent, still close to 5%. This reflects the domestic economy's resilience and a still very tight labour market. Services inflation, in particular, remains high. Rent inflation has been elevated at around 10% YoY in the last two quarters and is expected to stay high for a while, driven by housing supply not keeping up with demand, exacerbated by factors like reduced average household size and robust population growth. Overall, there is considerable uncertainty regarding the pace and extent of disinflation, which will keep the Reserve Bank of Australia (RBA) on a hawkish path for longer. We expect the RBA to maintain its current rate at least for the first half of next year, and rate cuts will only come through in H2, depending on the inflation trajectory and the global rate environment. Despite volatility, bond yields should have further room to fall as we expect the policy rate to have peaked with rate cuts likely to come through in H2 2024.

ASEAN

The disinflation trend persists on the back of slower growth

Inflation continues to ease across ASEAN, with an October average of 2.8% in Indonesia, Malaysia, Singapore, Thailand, the Philippines, and Vietnam, reflecting slower regional growth. Thailand notably experienced deflation of -0.3% YoY for the first time in two years, indicative of a marked economic slowdown, with Q3 growth at just 1.5% YoY, significantly below consensus expectations. Within ASEAN, there is some divergence as Singapore and the Philippines have inflation rates still above 4%. Singapore CPI is driven by services inflation, and higher food prices due to weather related disruptions have led to higher headline CPI in the Philippines. Meanwhile, Indonesia's and Malaysia's inflation rates are hovering close to 2%, reflecting weaker but not collapsing growth. However, Malaysia's inflation is expected to rise next year, with the 2024 Budget indicating reductions in fuel and food subsidies that have previously helped dampen inflationary pressures. Despite weak growth and disinflation trends, ASEAN central banks, with the exception of Vietnam's, have resisted cutting rates due to concerns about FX stability amid high US rates. However, moderate policy rate cuts are expected in most ASEAN countries in 2024, aligning with the Federal Reserve's potential easing cycle.

Brazil

Inflation maintains a downward trend as the monetary policy stance remains restrictive

After three months of slowing, CPI inflation rebounded from 0.2% MoM in October to 0.3% in November, slightly above what the market anticipated. Annual inflation was 4.8%, down from 5.1% the previous month, but slightly above market expectations. Core inflation showed an increase of 0.4% MoM, mostly driven by easing demand pressure. Within the aggregate CPI components, disinflation is widespread, and annual inflation rates for key components have been stable in the second half of the year.

Despite the 150bp of cuts to the Selic rate since the easing cycle began, the policy rate adjusted by expected inflation remains above the central bank's neutral rate, meaning that policy remains restrictive. As inflation continues to fall, this should allow the central bank to continue with 50bp rate cuts at coming meetings. Nevertheless, a resurgence of inflationary pressures seems to be the main risk that could affect policy normalisation. Inflation forecasts for 2025 and beyond are also stagnant at 3.5%, which reflects scepticism that the central bank will be able to achieve and commit to the 3% inflation target (+/- 1.5pp) from 2025 on.

LatAm

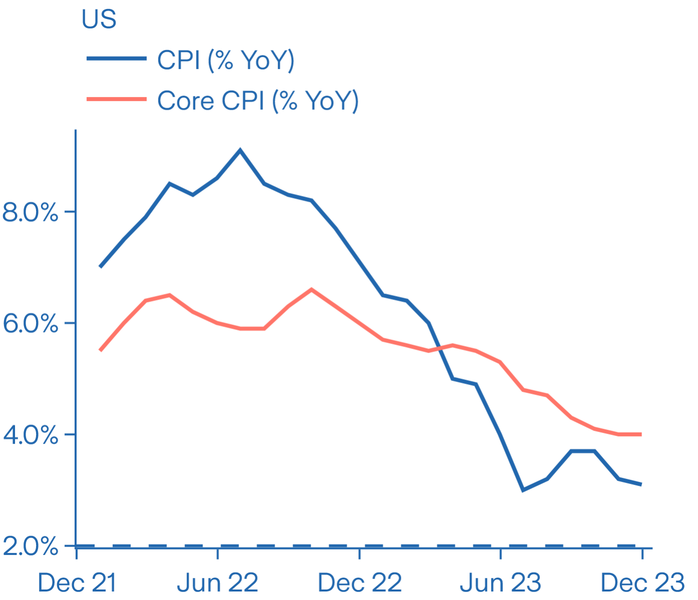
Annual inflation continues to fall

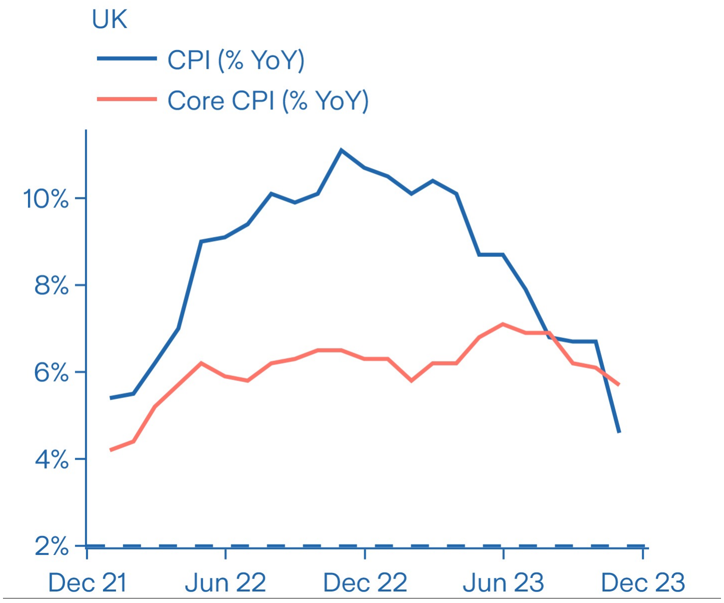
Inflation indicators continue to decelerate in the region, affected by slowing economic activity and external headwinds.

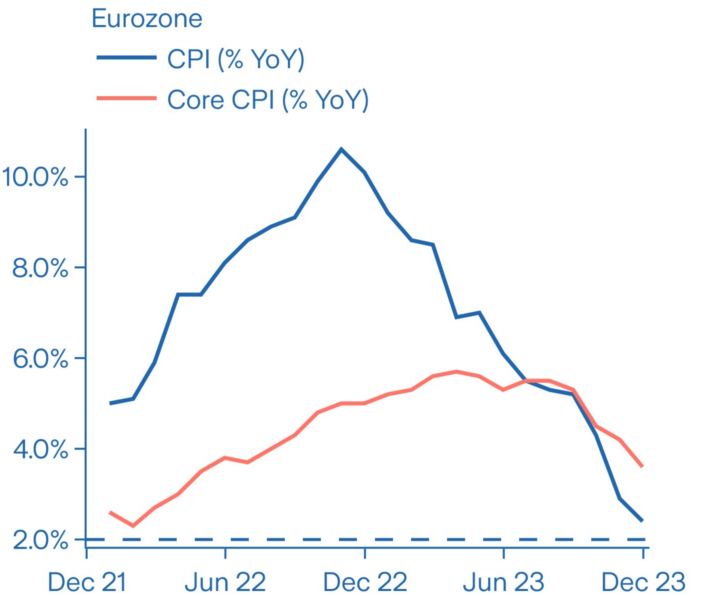
In Chile, although annual inflation maintained its downward trend in November, falling from 5.0% to 4.8%, the monthly rate reached 0.7%, well above market expectations of 0.2%. The pickup was explained by volatile food and non-alcoholic beverages and transportation costs. Inflation without volatile components slowed from 6.5% to 6.0%. Since the sharp rise in monthly inflation is likely to be transitory, it should not cause the central bank to deviate from its rate cutting cycle. We anticipate a cut of 50 bps in the last meeting of the year, leaving the rate at 8.5%.

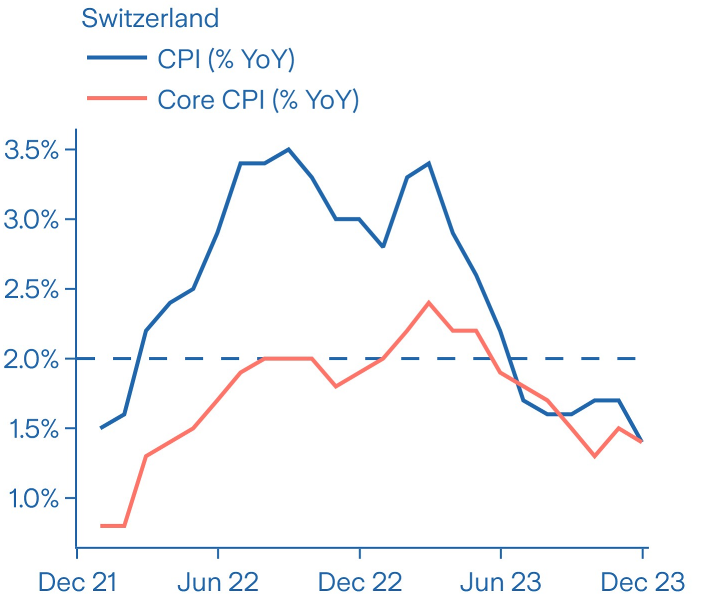
In Mexico, CPI inflation in November rose by 0.6% MoM, up from 0.4% but slightly below market consensus, with annual inflation at 4.3%, slightly up from the previous month. Core inflation, by contrast, fell from 5.5% to 5.3%. Although inflation is above the target range of 2%-4%, it should not affect monetary policy in the short term, with no further rate hikes expected. However, it does increase the probability that Banxico will not begin its cycle of rate cuts until the second quarter of 2024.

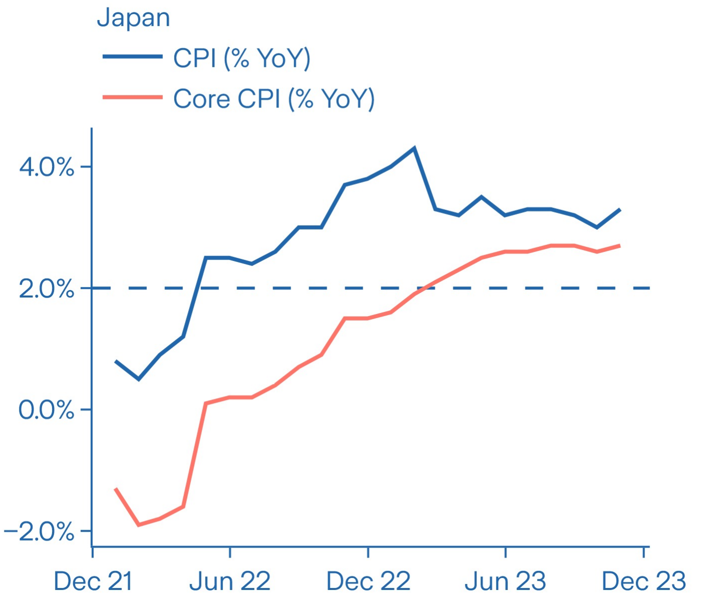
Current and historic inflation

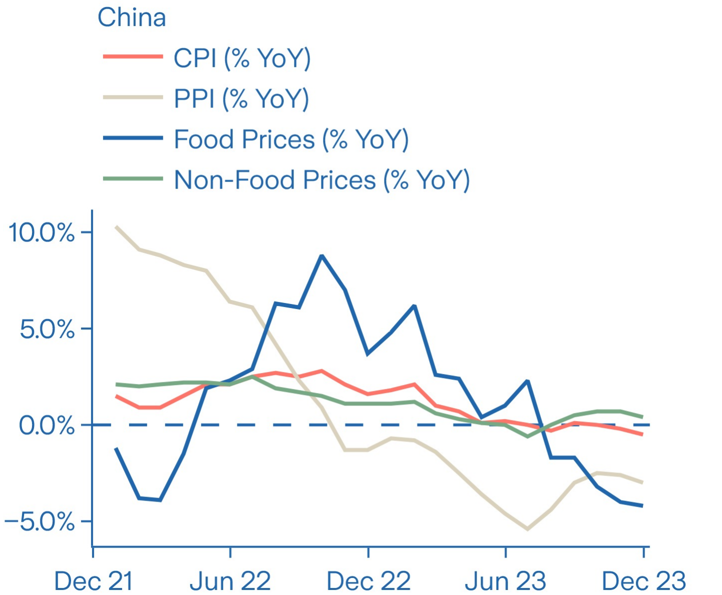




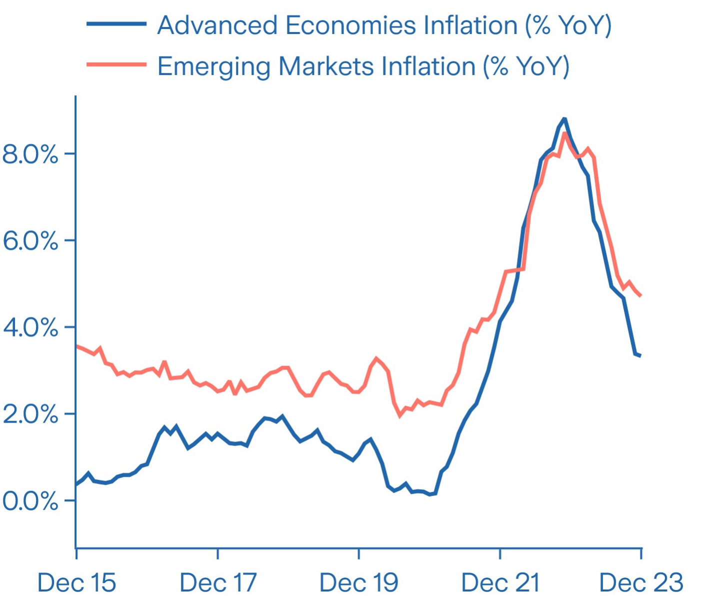


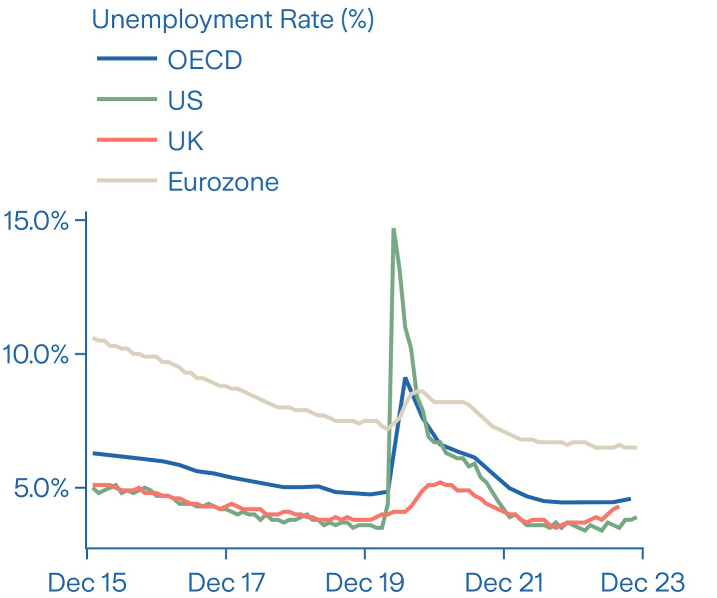


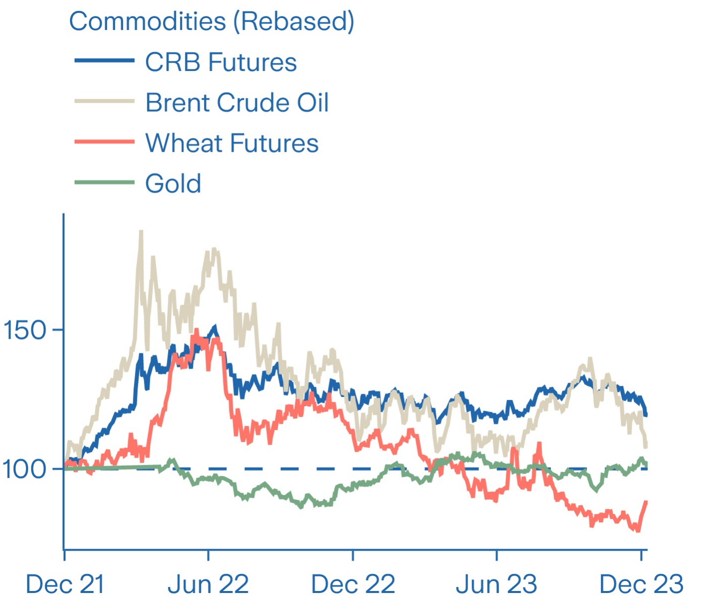


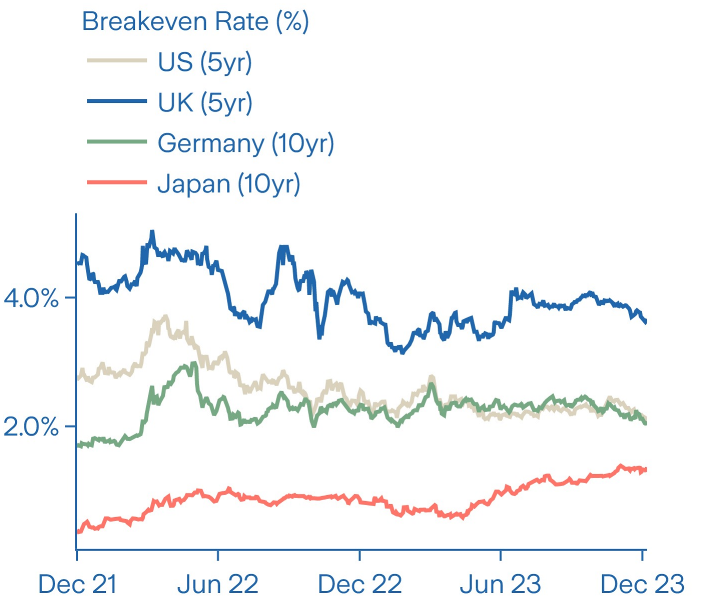


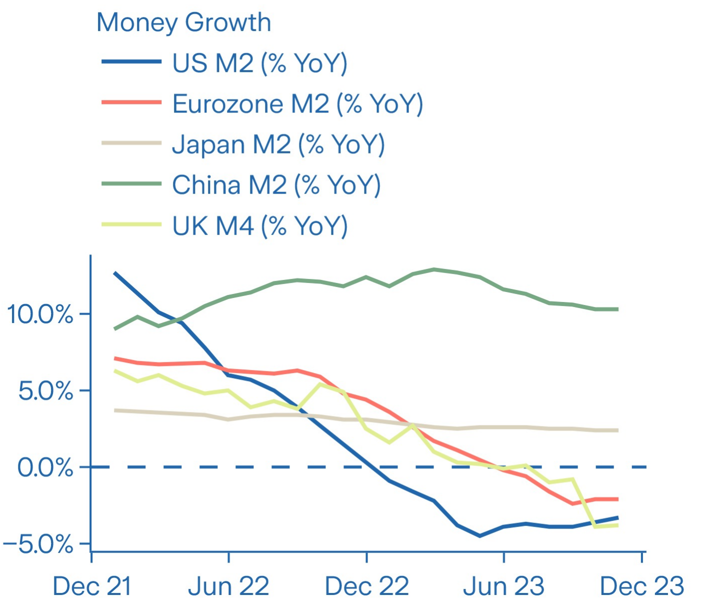
Key Indicators

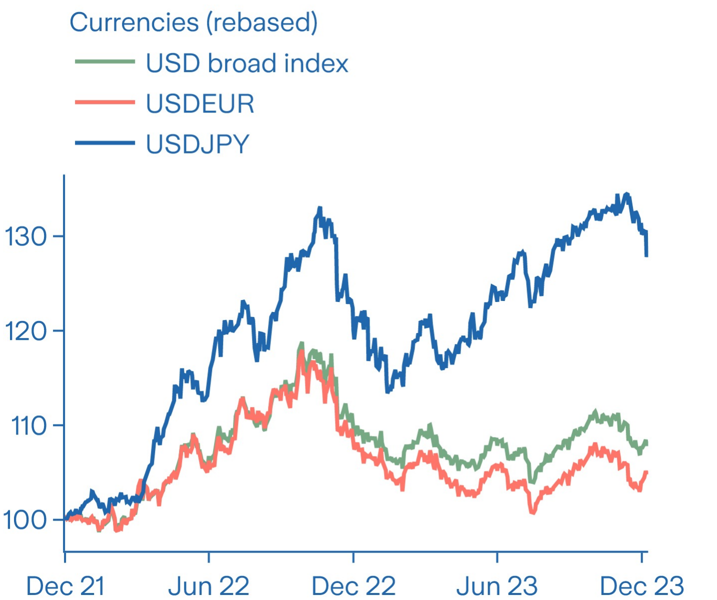












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