

Inflation Focus Q2

Key Points

- Headline inflation rebounds on higher oil prices, but is still below target in many regions
- Core inflation is benign, but resilient, reflecting modest gains in wage inflation and a dovish shift in monetary policy
- Inflation is contained in most emerging markets, partly as a result of past policy tightening and slowing growth
- While inflation should be resilient in 2019, the longer-term projection is weak in many regions



Source: iStock by Getty Images

Inflation rebounds with oil prices, though core measures continue to be weak

The latest rise in oil prices, up by 40% since the end of last year, is putting upward pressure on headline inflation rates, which nonetheless remain below target in most regions. Underlying, or core, inflation is also soft. In the US, the Fed's favoured measure of inflation, core PCE, has fallen to 1.6% YoY, while core CPI is 1.2% in the Eurozone and less than half of that in Japan and Switzerland. Persistent inflation weakness along with a slowdown in global growth has driven down both market implied and survey based measures of inflation expectations. Most notably, the US Michigan Consumer Confidence survey of long-term inflation expectations has fallen back to an all-time low, previously reached in 2016 when deflation fears peaked. Emerging markets have also seen benign inflation, largely as a lagged result of past monetary policy tightening and weak demand. This has allowed some central banks to start cutting rates, including in Malaysia and the Philippines. The key exceptions to the low inflation story are Argentina and Turkey, where authorities are struggling to bring inflation back under control, amid weakening currencies.

Wage inflation has moved higher, but not enough to return inflation to target

Labour markets have tightened impressively, with the US unemployment rate at a 50-year low. While less striking, wage inflation has also edged higher and US hourly earnings are now rising at an annual pace of 3.2%, roughly half a percentage point higher than a

year ago, though still well below past cycle highs. This is not only a US story. UK unemployment is at a 45-year low in spite of Brexit uncertainty and wages are rising at the fastest pace since 2008. The Eurozone and Japan continue to lag behind, but wage inflation appears to be creeping higher there as well. However, once we account for productivity improvements, these wage gains are still not large enough to push overall inflation back to target. The flipside is that, despite rising wages, businesses are managing to maintain their margins as productivity gains compensate for rising labour costs. Exuberance in the labour market is clearly lacking.

A slowing cycle is the spanner in the works

Central banks are obviously concerned about the persistent weakness in inflation, which undermines their credibility. So far, the strategy has been to be patient, allow tightness in the labour market to build up and hope that inflation will eventually pick up. What we have seen so far broadly supports this view. However, time has run its course, and it is likely that the global economic cycle will reach its end before inflation has picked up more sustainably. This means that major economies will potentially enter the next downturn with low levels of inflation, raising the risk of deflation. Indeed, growth has already slowed quite sharply, leverage is extended offering little capacity to prolong the cycle, and stronger capex spending, which could boost productivity and strengthen growth, looks unlikely given uncertainty around the future of the global trade system.

We therefore suspect that while inflation should be relatively resilient over the near term, supported by tight labour markets and dovish monetary policy, longer-term prospects are weak.

Central banks try to extend the cycle, but there are limits to what they can do

As a response to this weakness in inflation, central banks are beginning to question if they need to change strategy. The Federal Reserve, for example, is undertaking a major review of its framework. One suggestion is to replace the inflation target with a price level target, wherein undershooting inflation persistently would need to be compensated for with a period of persistent over-shooting, and vice versa. Currently, this approach would imply looser policy for longer and, if successful, implies a higher path for US inflation over the coming years. In practice though, a low for longer scenario is already priced in by financial markets, which are now consistent with Fed rate cuts both this year and next. In our view, this is therefore unlikely to deliver sufficient additional change to shift the path for inflation over the next few years. For that, more transformational changes are likely to be needed. As of now, this looks unlikely. With this in mind, we are encouraged by the Fed's dovish shift, but do not expect it to materially change prospects for inflation over the near to medium term.

US

Core inflation is likely to pick up

Headline CPI inflation rebounded to an annual rate of 2.0% in April from its recent low of 1.5%, driven by a number of factors, not least the solid pickup in energy prices since the beginning of the year. Core CPI inflation also ticked up to 2.1% YoY, though it is still well below the levels reached in mid-2018. Nevertheless, the underlying trend indicates that the less volatile parts of inflation continue to be relatively solid. In particular, the medical services component in the PPI measure was showing a strong rebound from its recent weakness. Given that healthcare has a larger weight in the PCE core inflation measure compared to the CPI basket, we expect

the former to reaccelerate in the coming months. This is important, as it is the inflation measure that the Fed tends to focus on. In addition, despite the signs of slowing momentum in the housing market, house prices and thus shelter costs will help to lift core inflation in the coming months. Accordingly, the Fed may shift its dovish tone as the labour market is likely to remain tight for the foreseeable future. This could lead to a reassessment of investors' expectation on the Fed's future rate path, particularly regarding the timing of a potential rate cut.

UK

Higher core inflation if Brexit impasse is resolved

Price pressure has further moderated in recent months with headline CPI inflation falling below 2% for the first time in two years in January and stabilising at 1.9% in March. As sterling has been relatively stable over the course of the last twelve months, currency-induced price pressure via imported goods and services is likely to moderate going forward. This clearly hinges on the absence of major surprises with regard to the Brexit process where downside risks could still be a drag on the currency. Domestic price pressure has been muted for some time now, held back by relatively weak service cost developments, particularly with regard to rents and

insurance premiums. Due to the uncertain economic outlook, the economy is currently growing below potential, holding back inflationary pressure. Fundamentally, however, core inflation has some upside potential as the labour market is tight, underlined by wages growing at the fastest rate since 2008, and economic momentum is expected to accelerate once the future path of the UK becomes clearer and Brexit uncertainty vanishes. If this happens, the release of pent-up household and business demand could close the output gap in the short run and cause inflation to accelerate.

Eurozone

Lacklustre inflation and growth put pressure on the ECB to do more

Whilst Q1 GDP growth in the Eurozone came in stronger than expected, overall economic conditions are soft, and core inflation is still hovering around 1%, well below the ECB's target. Overall business confidence is subdued, while confidence in the manufacturing sector in Germany is at depressed levels, as it is one of the sectors most affected by the trade dispute between the US and China. Wage growth in the Eurozone continues to gradually pick up from low levels, but with demand conditions soft companies have limited ability to pass on higher costs to consumers and other businesses. As a result, there is little upward pressure on inflation. Indeed, inflation

expectations have fallen over recent months, increasing pressure on the ECB to consider what more it can do to stimulate growth and inflation in the region.

Switzerland

Little hope of inflation rising further

Inflation has risen over the past three months, mainly reflecting higher oil prices, with the headline CPI rate now at 0.7%. Core inflation is still below that, at 0.5%, with persistent weakness in both services and goods price inflation. Although the positive oil price effect will wane over time, annual CPI inflation should be broadly flat going forward and we forecast inflation to average 0.7% in 2019. This is well above the SNB's dovish projection of only 0.3% but far below the 2% inflation target.

Muted domestic price pressures are likely to persist as wage inflation is weak, at only 0.5% YoY. This is not

enough to move inflation higher, even after accounting for relatively weak productivity gains. The labour market is arguably tight, which could lead to further wage pressures building up over time. Offsetting this, however, is the slowing cycle, which should dominate over the coming year. With inflation set to stay weak, we expect the SNB to leave rates unchanged at least through 2020. With geopolitical risks still elevated, the focus on the currency is also likely to be maintained, with limited forex interventions to prevent a disruptive strengthening of the franc.

Japan

Bank of Japan's inflation forecast for FY2021 is below its 2% target

Tokyo's core CPI inflation picked up steam in April to 1.3% YoY, the highest rate in more than ten years, if adjusted for the impact of the consumption tax hike. Tokyo tends to be a precursor of trends on a nationwide basis. The major push came from general services, and from overseas travel packages and accommodation in particular, probably in conjunction with the extended 'Golden Week' holidays. These prices tend to fluctuate, and we have to take into account that reduced fuel surcharges by airlines will be a drag on these prices going forward. Higher food prices also had an impact. We do not expect that core CPI will continue to inch higher, as slower increases in energy

prices will put a lid on price increases, and because two major mobile phone operators have announced a substantial cut in mobile phone charges as of June. The introduction of free childcare will dampen prices further. It is expected that inflation will rise in October by about 1% due to the consumption tax hike from 8% to 10%, but this impact is excluded in the forecasts provided by the Bank of Japan Board. In its latest median forecast, a rate of 1.3% is forecast for FY2020, and 1.6% for FY2021, clearly below the 2% price stability target. The BoJ will maintain its monetary policy through spring 2020.

China

Supply-side factors are driving inflation, but core inflation remains subdued

Consumer price inflation rose to 2.5% in April, mainly driven by higher food prices, with pork price inflation surging from 5.1% to a three-year high of 14.4% following disruptions in pork supply amid the African swine flu. Vegetable, fruit and egg prices also contributed to the surge in food prices. However, stripping out food and energy prices, core inflation, which is more relevant for monetary policy, remained steady in a 1.7%-1.9% range over the last few months. The VAT cuts introduced on April 1 should roughly compensate for higher food prices. Vehicle prices have already started to fall, dropping 0.2% MoM in April. Meanwhile, producer prices were up both on a sequential basis and on a YoY basis, to 0.9%,

with higher manufacturing, mining and final consumption prices contributing. Higher producer prices have a favourable effect on industrial profits. However, considering renewed trade tensions with the US and a tepid global recovery, we do not believe this trend will continue.

The PBoC cut the reserve requirement ratio (RRR) for small and medium-sized regional banks the day after US President Trump announced higher tariffs. It seems likely that the PBoC will continue to relax its monetary policy amid the trade tensions, though we do not expect any aggressive moves.

Australia

The RBA may shift to an easing bias amid below-target inflation and a less tight labour market

Australia's underlying inflation trend has weakened so far this year. Consumer price inflation fell from 1.8% in Q4 last year to 1.3% in Q1. Median weighted inflation declined from 1.7% to 1.2%, a three-year low, while the trimmed-mean rate fell to 1.6%, below the RBA's expectation of 1.75%. Both headline and underlying inflation rates are well below the RBA's target band of 2-3%. Monthly data show that inflation rates continued to fall in April. We believe these lower inflation readings will finally shift the RBA towards an easing bias, even though it refrained from cutting the policy rate in its recent policy meeting just two weeks before the election. The RBA remains caught between a strong labour market and a

weak housing market. We note, however, that the tight labour market is not boosting services inflation, which is softening as well. House prices continue to fall and are now down 9.4% from their 2017 peak on a nationwide basis, down 14% in Sydney, and are broadening throughout major cities. However, price falls are now moderating, and so far the burst of the housing boom seems to have been happening in an orderly manner, without any signs of distressed selling pressure. This suggests that the RBA has room to cut once or twice by 25bps each this year.

ASEAN

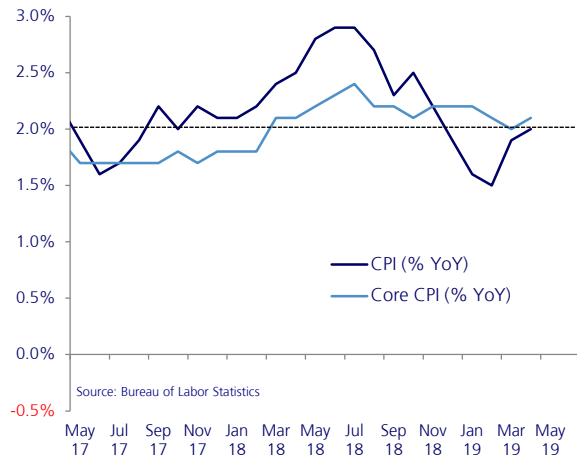
Inflation is contained in the region

We expect headline inflation to creep higher in Indonesia this year but to stay within the target range of 2.5-4.5%, while underlying inflation should be stable. Bank Indonesia has raised its policy rate by 175bps since May last year to defend its currency, but has kept rates stable since November. BI may refrain from cutting its policy rate this year due to concerns about its rising current account deficit, but may use other measures to provide liquidity. In Malaysia, CPI inflation has fallen within the last 24 months from a peak of 5.1% to -0.7%, and is now creeping back up above the zero line. Bank Negara forecasts a range of 0.7-1.7% this year, with room to rise above 2% next year. Following the latest cut of 25bps to its policy rate, we

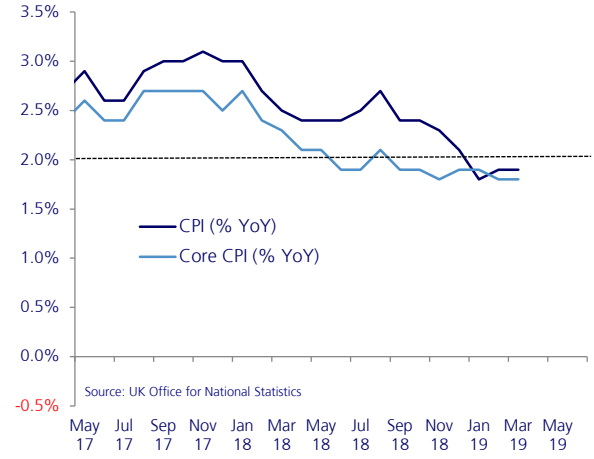
think there is room to cut more this year as the growth outlook continues to be tepid due to external (US-China trade war) and internal (tighter fiscal policy) reasons. In the Philippines, inflation fell to 3% in April, and remains within the central bank's target range of 2-4%. Despite higher oil prices and the impact of El Niño on crop harvests, inflation should be well contained this year and should enable the BSP to cut policy rates further following its recent 25bps cut to 4.5%. In Thailand, we expect the BoT to be on hold throughout this year, with an eye on financial stability despite muted inflation and growth concerns.

Current and historic inflation

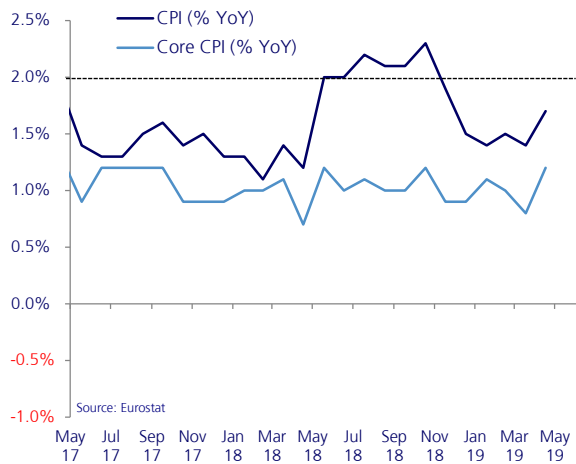
US: Inflation relatively solid



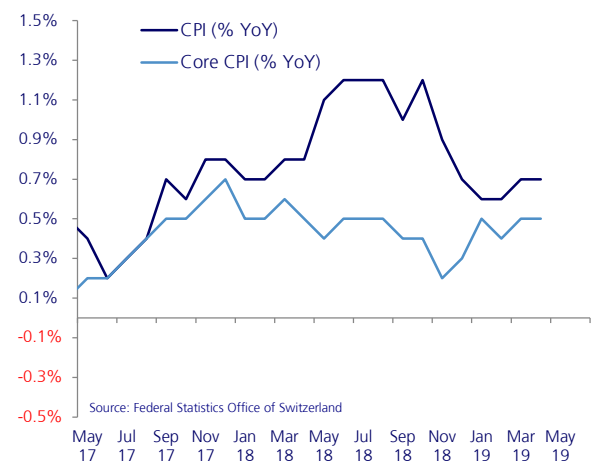
UK: higher core inflation if Brexit is resolved



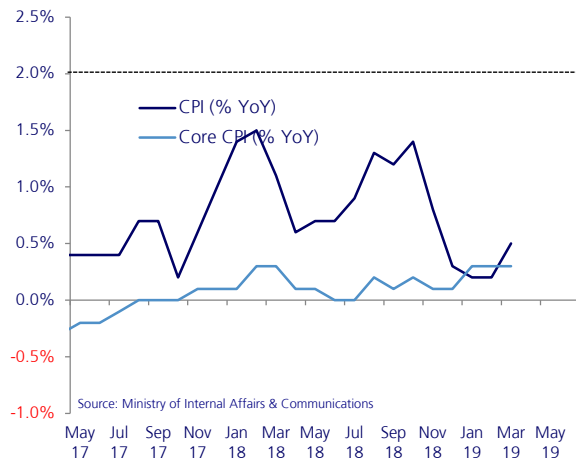
Eurozone: inflation to remain lacklustre



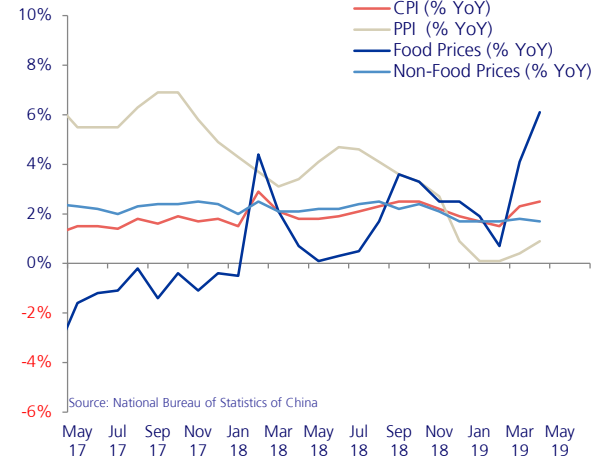
CH: stable but low inflation



Japan: core CPI unlikely to rise further



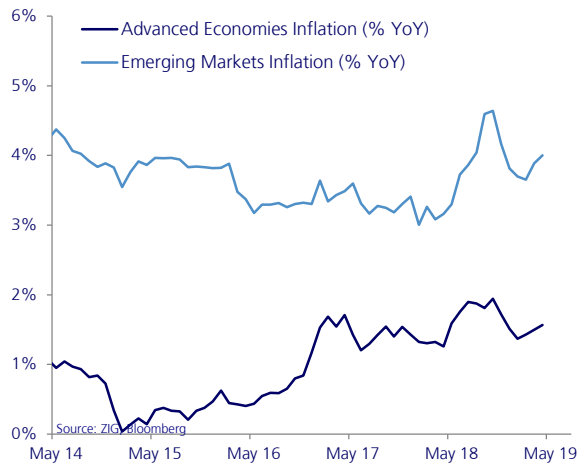
China: PPI edges higher as stimulus kicks in



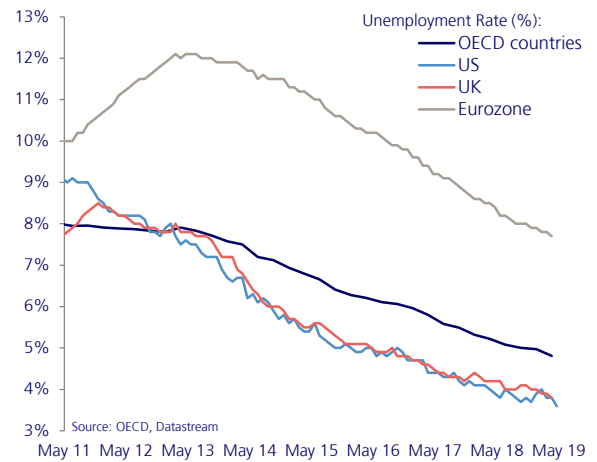
* Dashed lines show inflation targets or equivalent

Key indicators

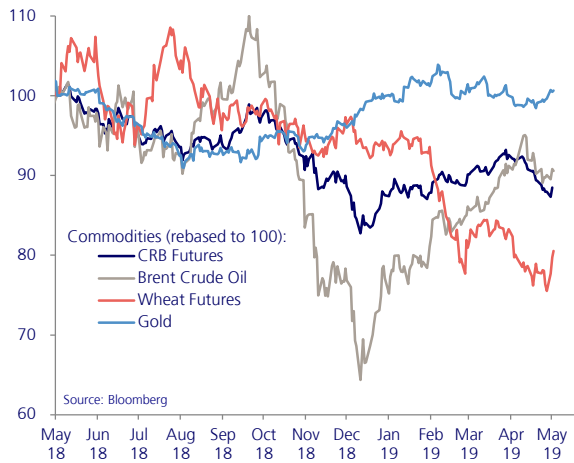
Inflation ticks up as oil prices rebound



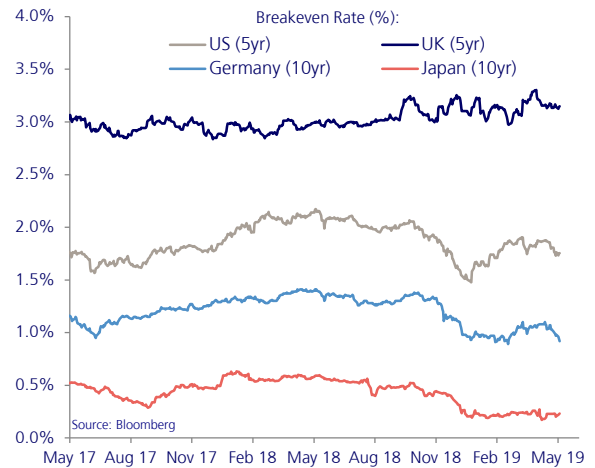
US unemployment at a 50yr low



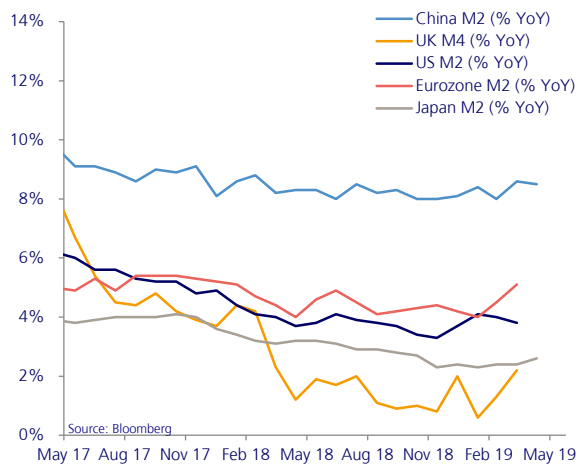
Oil price impulse will start to wane



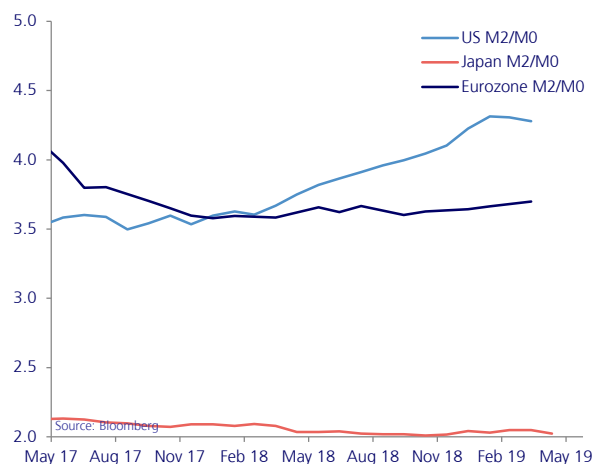
Inflation expectations remain weak



Credit growth rising modestly



Money multipliers bottoming



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