ZURICH

Inflation Focus Q2

20 June 2024

Key Points

- Inflation targets are within reach and key central banks have started to cut rates
- Progress on inflation is insufficient, however, with services inflation remaining elevated
- Goods inflation has already fallen sharply, and a futher steep decline is not expected
- Policy loosening reduces growth risk, but it remains critical that the focus on inflation is maintained

Inflation falls further, but the grind lower is slow

Inflation continued to edge lower over the past quarter, with the pace of decline broadly in line with expectations. While price pressures dropped more sharply in some countries, including the UK where headline CPI inflation hit the 2% target, progress remains slow globally, especially compared to last year. As anticipated, it has proven difficult to transition from goods-led to services-led disinflation, and services inflation continues to hold up at an above-target pace. Moreover, goods disinflation has diminished as price preassures have already fallen sharply. Energy is also not adding to disinflationary pressures, with the oil price flat compared to three months ago, while European gas prices have risen. Food price dynamics are more encouraging, with a further decline in global food inflation, helped by receding El-Niño related pressures.

Goods disinflation is still in place, but leading indicators have turned

Goods disinflation has been the key driver of falling inflation rates over the past year, and further downside is now limited. The manufacturing sector, which has been in contraction over the past 18 months, has seen a pickup in momentum, helped by a rebound in the inventory cycle and an improving energy situation in Europe. Weak demand and overcapacity in China, visible in falling prices across the industrial complex, remain in place, but conditions have started to improve there is as well, also evident in easing deflation in trading partner imports from China. As a result, goods prices are unlikely to continue to fall as rapidly as they have over the past year. This means that to close the gap vs. target, services have to do more of the job.

Services inflation is too high, but housing related pressures are less of a concern

Services inflation, by contrast, remains elevated. This partly reflects brisk housing related price pressures, which still consitiutes almost two thirds of inflation in the US, and somewhat less than that in Europe. On the positive side, this is largely a lagged effect, and leading indicators continue to signal better dynamics as we move forward, with rent growth on listed properties having fallen sharply. The pass-through of housing inflation to CPI measures has been slower than anticipated, but the trend has shifted, and we expect housing related disinflation to become more visible in the months ahead.

Other services prices are also rising rapidly, given the backdrop of robust demand

While housing related price pressures have started to ease, other components of services inflation, the so called super-core (service CPI ex housing and energy services) continue to run at a high pace amid resilient demand, a solid labour market and above-trend wage growth. To some extent, there is also a catch-up effect, as prices on many leisure components slumped during the pandemic and are only now catching up with their pre-pandemic level. While we anticipate further progress here as well, patience will be required, given robust demand and evidence that businesses still have pricing power. The shift to looser monetary policy is also helping to keep sentiment and spending intact. While this is encouraging from a growth perspective, it makes it more challenging to close the inflation gap.

Labour markets are becoming less tight, with slowing wage and job growth

Labour markets are holding up well, with low unemployment and rising wages. This matters for services inflation for two reasons – solid household income growth means that consumers are likely to continue to spend, while rising wages mean that businesses are still seeing their cost base increase. The resilience of labour markets has been puzzling, particularly in Europe where the economy has hardly grown over the past year, and a key concern for central banks. Looking forward, however, leading indicators are signalling a turn in momentum here as well. These indicators include data from online job postings, the quit rate in the US, and the ECB's wage agreement tracker, which have all continued to slow. We anticipate this will be reflected in further declines in wage pressures going forward.

Central banks are cutting rates, with further loosening anticipated

A key development is that major central banks, including the ECB, have started to cut rates. With the Federal Reserve set to follow in H2, this will open the door for policy easing elsewhere, including in Asia, and allow for further rate cuts in Latam. While we expect further rate cuts in the months ahead, the rate cutting cycle is however likely to be relatively shallow given still resilient activity. Initial rate hikes are also likely to be gradual as progress on inflation is incomplete, and central banks need to stay vigilant for time being.

US
A broadbased slowdown in inflation

Inflation rates remain elevated, but the latest batch of data showed a broad-based slowdown in price pressure. Headline inflation was 0.0% MoM in May, which is the first time in almost two years that prices did not rise on a monthly basis, leading to a slowdown in the annual rate to 3.3%. The monthly core rate was a modest 0.16%, the lowest since August 2021, pushing down the annual rate from 3.6%. to 3.4% The closely watched supercore rate, i.e. core services less housing, was even slightly negative for the first time in two-and-a-half years. The broad-based slowdown in price pressure was also emphasized by the Cleveland Fed's trimmed mean measure receding to 0.13%, the smallest pickup since January 2021. Finally, in addition to lower consumer inflation, producer prices fell significantly faster than consensus expected, underlining the softening inflation environment. We expect inflation rates to fall further in the coming months as the labour market weakens.Consumer spending is likely to slow, but the Fed will want to see more proof of falling price pressure before it starts cutting rates, particularly given that inflation surprised on the upside in the first quarter.

UK
Headline inflation slows markedly, but service prices remain an issue

Weaker price pressure has helped to push down the rise in charged prices to the lowest level in three years according to the latest PMI business surveys, bringing down input price inflation both in manufacturing and services. Meanwhile, consumer price inflation slowed substantially in April and May helped by a reduction in the regulatory cap on household energy bills. Headline CPI inflation dropped to an annual rate of 2.0% in May from 3.2% in March while Core CPI receded to 3.5% YoY. The significant drop in inflation is welcome, though the slowdown was slightly less pronounced than the Bank of England expected. Service inflation in particular remains uncomfortably high. At the same time, although the labour market is weakening and unemployment picked up to 4.4% recently, wage growth remains stubbornly high, making a near-term rate cut by the BoE unlikely.

On the whole, the broader trend towards further disinflation is expected to continue in the coming months as growth and spending are likely to slow from their solid pace in the first quarter. However, despite its recent dovish shift, the members of the Monetary Policy Committee want to see wider evidence that price pressure is receding before cutting rates.

Eurozone
Less pressure on the brakes from the ECB

The fact that the ECB was comfortable enough to cut rates by 0.25% in June is indicative of the progress that has been made on disinflation in the Eurozone compared to 2022. The rationale is sound: inflation is much closer to target than previously, and the policy rate is still restrictive. Yet, price growth does remain uncomfortably high. Eurozone HICP rose to 2.6% YoY in May from 2.4% in April. We have spoken of an uneven path towards the 2% target, and numbers like this exemplify this expectation. We maintain our view that European inflation is on a path back towards target and that the conversation will move back towards two-sided risks around that target. There are three important observations around May's number. Firstly, there were two large one-off factors that drove a large portion of the strength: a German train ticket subsidy coming out of the numbers, and a change in French health services pricing. Secondly, despite this warning it is important to note that the crucial headline level of service inflation rose faster than expected, reaching 4.1% YoY. Thirdly, non-harmonised national statistics measures of inflation fell on the month, and saw large discrepancies in services prices in particular. Calculation and weighting methodology explains these differences, but these measures tend to be closely correlated over time.

Switzerland
Disinflationary pressures broadening, while the SNB cuts rates again

After falling sharply in Q1, CPI reached a low of 1% YoY in March before rebounding to 1.4% in April and May. The uptick was driven by stronger price increases on imports and a rise in regulated rents. Despite this, inflation remains in line with the SNB's inflation forecast, which projects average inflation of 1.4% in Q2 and 1.5% in Q3. The combined producer and import price index also continues to fall at a rapid pace, down -1.8% YoY in May, and the data show that the disinflationary impulse has shifted from imported to domestic producer prices, which are falling at a monthly pace of -0.5%. Wage growth also slumped in Q1, when wages grew by a modest 0.6% YoY, down from an average rate of 1.8% over the past four quarters. This is consistent with recent labour market data that show manufacturing firms cutting back on jobs while also making use of short-time work, though services employment remains robust. Despite the small rebound in CPI inflation, we therefore maintain our view that underlying trends are benign, with some further declines in inflation expected.

As we had anticipated, the SNB cut rates for a second time in June, emphasising that underlying price pressures have continued to decrease. The central bank is expected to maintain its dovish outlook, with some further policy loosening likely later this year.

Japan
The BoJ to take a gradual approach in hiking rates

In May, Japan's CPI came in at 2.2% YoY, while the PPI reached 2.4%, in part driven by rising imported costs for producers amid a weak yen. GDP in Q1 was in contraction, driven by weak private and corporate spending. Looking forward, however, we expect generous wage rises from the 'Shunto' negotiations to boost real income and potentially stimulate spending in Q2. Stronger wage growth will also help to sustain higher inflation and, overall, inflation is expected to stay above 2% for this year.

After the first rate hike in March, the Bank of Japan (BoJ) has kept its policy rate unchanged. In its June meeting, the BoJ signalled that they will eventually scale down the bond purchase program. The detailed plan will be announced in its July meeting. On the currency front, rate differentials between the BoJ and the US Federal Reserve continued to put severe pressure on the JPY, leading to heavy interventions by the Ministry of Finance in the FX market between April and May. Overall, we expect the BoJ will continue to take a gradual approach in hiking rates to avoid choking off desired inflation, and the market pricing of three rate hikes appears aggressive.

China

More stimulus is needed to strengthen inflation

While the Western world remains concerned about persistent inflation, China is experiencing the opposite with virtually no inflation. The latest CPI for May came in at just 0.3% YoY, falling below market expectations, while core CPI stood at 0.6%. The weakness in inflation is broad-based, with input prices remaining in negative territory at -1.4% YoY. The low inflation rate in China highlights the challenge of generating sufficient domestic demand. However, the country's strong export performance is a bright spot. In April, exports grew by 8.4% YoY, primarily driven by tech and electrical vehicle exports. The strength in exports might be attributed to overcapacity production, which has put downward pressure in producer prices and made Chinese goods competitively priced in overseas markets. Although recent policy measures to support the property sector have been well-received by the financial market, the overall deflationary environment in China underscores the need for further support to strengthen domestic demand and drive economic growth. Looking ahead, attention will be focused on the upcoming Third Plenum in July, where key long-term economic reforms will be discussed.

Australia

Still the case of higher for longer as fiscal spending is boosted

In Australia, the latest monthly CPI reading for April came in at 3.6% YoY, exceeding consensus expectations. The unemployment rate remains low at 4%, and employment growth continues to demonstrate strength. However, GDP for the first quarter indicated a notable slowdown in aggregate demand, which is a sign that monetary tightening has been effective in slowing down demand and helping to curb inflation. On the fiscal front, however, the 2024/2025 budget signals an expansionary stanceahead of the election in 2025, with measures such as income tax cuts and cost-of-living relief that includes assistance for energy bills and rent. While these subsidies may technically lower inflation by reducing energy and rent bills, the combination of tax cuts and increased public spending could potentially pose the risk of keeping inflation sticky down the road. The central bank (RBA) anticipates that inflation will only return to target next year, supporting our expectation that there will be no rate cuts this year. Given the current rate environment, the Australian Dollar (AUD) is likely to perform well while short-term 10yr yields are expected to align with those of the US for the time being. However, in the medium term, spreads may widen as the RBA eventually lags behind the Fed in the rate cut cycle.

ASEAN

Waiting for the Fed to cut

The latest CPI prints across ASEAN countries have picked up slightly, primarily driven by supply-side factors such as the impact of adverse weather conditions rice prices, which have a significant influence on the region's CPI baskets. However, overall inflation remains broadly stable, especially when volatile components such as energy and food are excluded. This trend also aligns with the fact that most countries in the region are experiencing sluggish below-trend growth. There are concerns that subsidy cuts in Malaysia could exert inflationary pressure. However, given the weak growth environment, we do not see a significant risk from the inflation front. The combination of sluggish growth and well-contained inflation suggests a case for rate cuts in the region. However, concerns about maintaining FX stability are holding central banks back from taking immediate action. In a surprising move, Bank Indonesia even raised its policy rate due to the rupiah coming under pressure from the strength of the USD in April. Looking forward, with the US Federal Reserve signalling potential rate cuts later this year, the headwinds for currencies are expected to ease. This should allow ASEAN central banks to adopt a more accommodative policy stance going into next year.

Brazil

After a strong slowdown earlier in the year, inflation rebounds

After falling strongly earlier this year, recent data show that inflation is firming, in part reflecting stronger core inflation. Brazil's main inflation metric, Aggregate CPI (IPCA), rose by 0.5% MoM in May, up 3.9% YoY (from 3.7% in April). This was above market expectations but still leaves inflation within the target range of 1.5% to 4.5%. Much of the rise in inflation was attributed to food prices, which have risen for eight consecutive months, followed by transportation costs.

Looking forward, inflation expectations remain unanchored and the ability of the central bank (BCB) to bring inflation to the mid-point of the target range depends on the implementation of fiscal policy and the stability of the Brazilian real. The BCB has moderated the pace of rate cuts and its forward guidance, given the backdrop of sticky inflation and a relatively hawkish US Fed. This, in combination with political events in the region (elections in Mexico), has hit investor sentiment. As the Brazilian government lowered its fiscal targets and President Luiz Inacio Lula da Silva inched closer to intervention in the operations of state-owned firms, a depreciation of the Brazilian real was triggered. Looking forward, this limits space for monetary loosening in Brazil in the near term.

LatAm

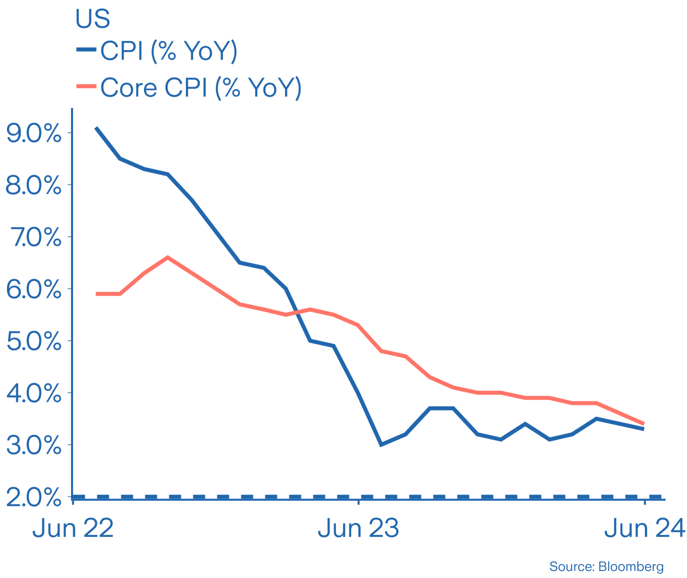
Inflation remains on a downward trend despite temporary distortions

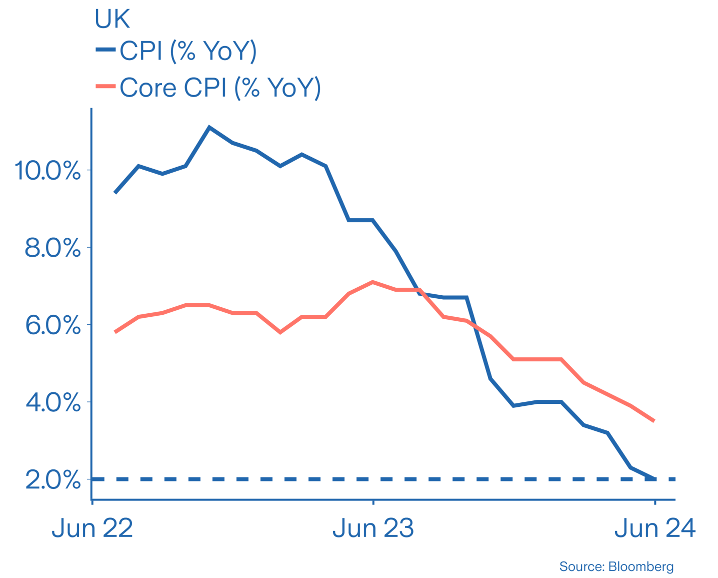
LatAm central banks have moderated their easing cycles based on the expectation that the US Fed will keep interest rates elevated for a longer period than initially predicted.

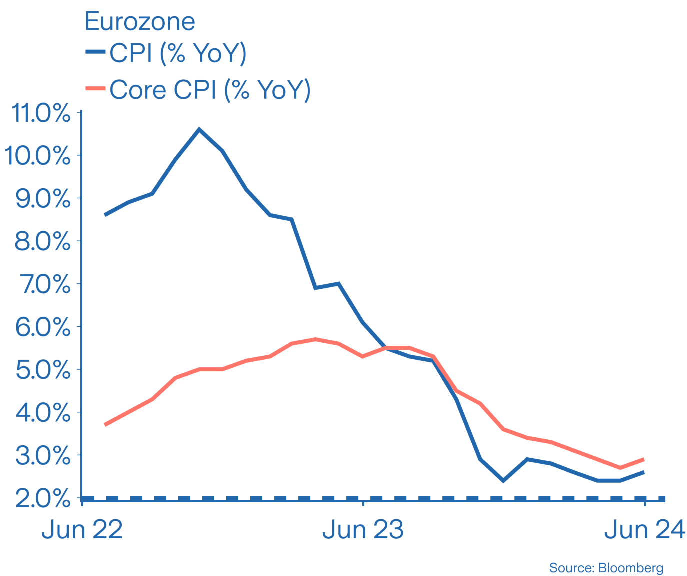
In Chile, inflation rose by 0.3% MoM and 4.1% YoY in May, in line with expectations, but above the central bank's target range of 2.0 to 4.0%. Although headline inflation came in line with expectations, inflationary pressures in the non-volatile CPI components could hamper a rapid convergence to the target range midpoint of 3%. However, the appreciation of the peso should drive a deceleration in the more volatile components over coming months, and this is a key reason why we still aticipate inflation to close the year at around 3.6%.

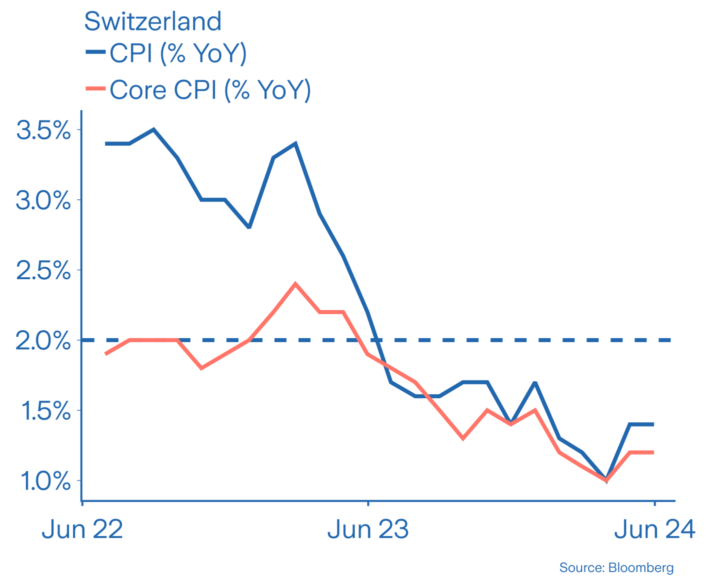
In Mexico, CPI inflation fell -0.2% MoM in May, below market expectations and leaving the annual rate at 4.7% YoY. Food and energy prices rose, but slower core inflation offset the advance. Although we anticipate that inflation will slow during the second half of the year, currency depreciation and political uncertainy pose a risk, alongside government measures that seek to boost wages.

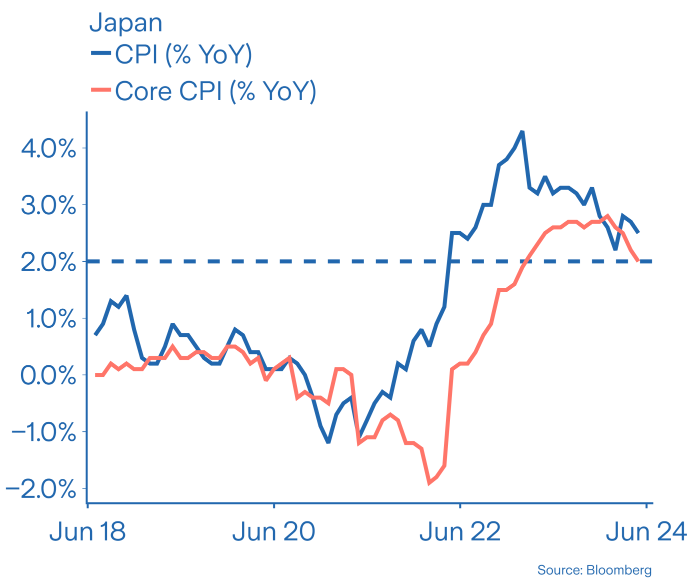
Current and historic inflation

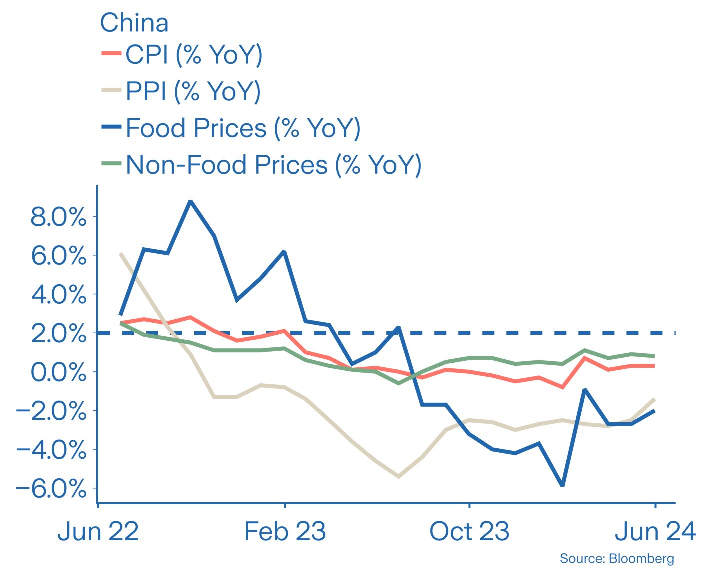




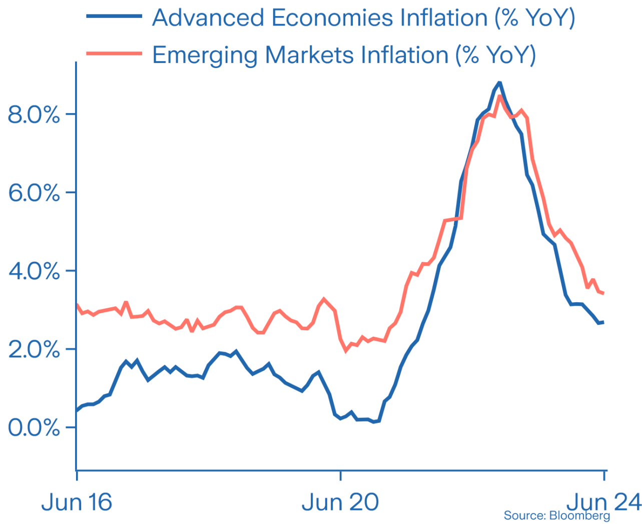


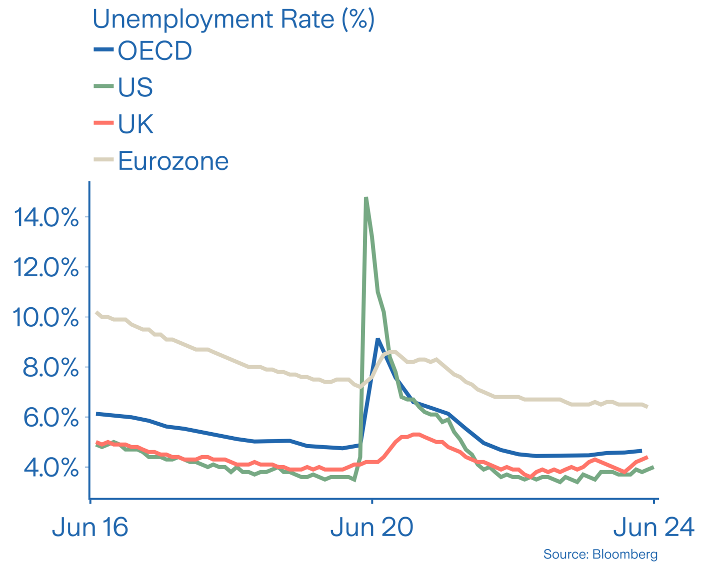


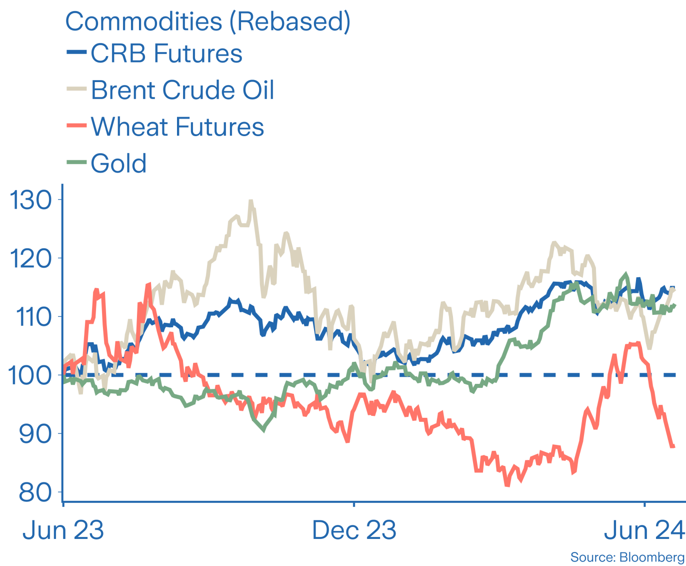


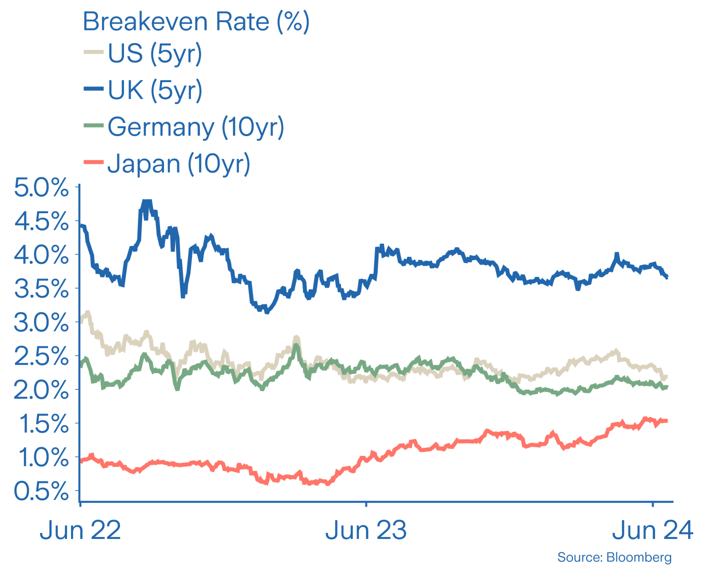


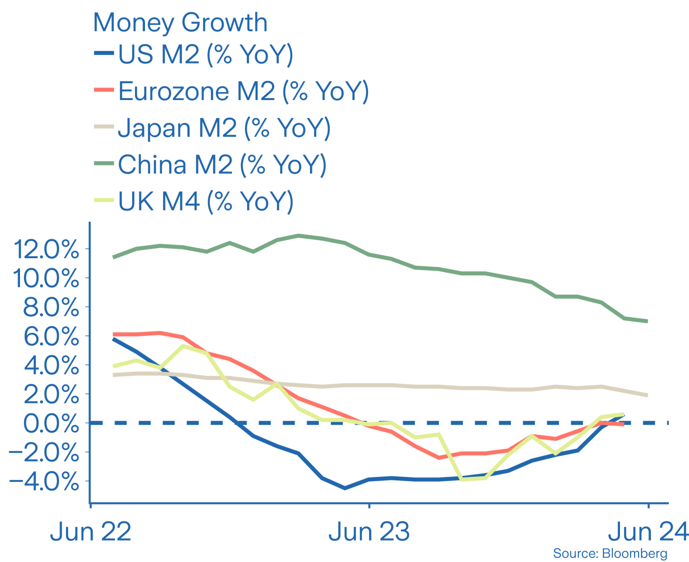
Key Indicators

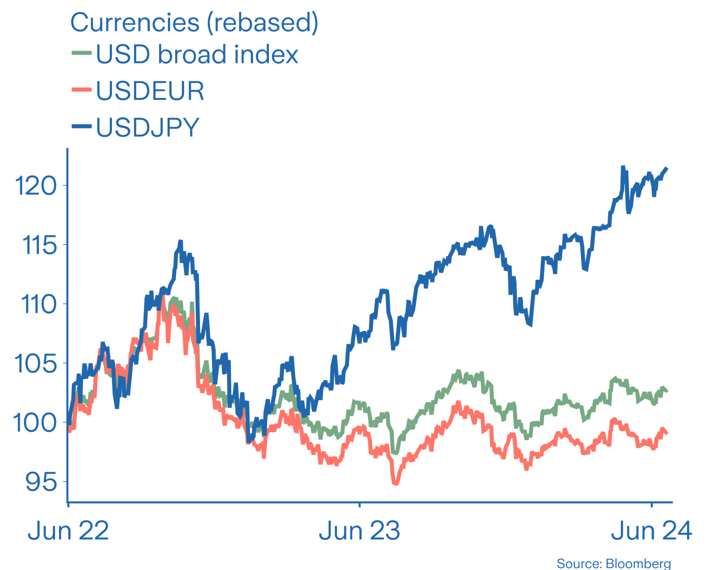












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