ZURICH

Inflation Focus Q2

Key Points

- Exceptional policy measures will limit the severity of the global recession but are not expected to unleash inflation
- Headline inflation will be under significant pressure over the coming months, with bouts of deflation in some regions
- Core inflation will retreat as a surge in layoffs and unemployment is likely to lead to a collapse in wage growth
- Longer-term trends in inflation are also expected to be contained, due to still vigilant central banks

Source: iStock by Getty Images

Inflation slides as the global economy enters a deep recession

As expected, the near-term impact of the COVID-19 pandemic on inflation is deeply deflationary. Headline CPI inflation has slumped in most regions, in many cases approaching or falling into negative territory. This partly reflects the collapse in oil and other commodity prices, amplified by falling prices on services such as air travel, hotels, restaurants and leisure activities, which were severely affected by the COVID-19 lockdowns. These deflationary forces have been the dominant factors in an acutely recessionary environment, outstripping upward price pressure on some components, including food and medical material, and from supply chain disruptions.

Inflation expectations partly rebound on policy support and virus containment

While inflation is still falling, inflation expectations have partially recovered, as policy actions have been profound and lockdowns appear to have been successful in containing the virus, though the risk of a second wave remains. For these reasons, we continue to expect a deep, but short lived, global recession, where the initial collapse in economic activity is followed by a swift recovery in the second half of 2020.

Surge in unemployment will lead to longer-lasting inflation weakness

While growth should recover, all is not well. The economic cost of locking down economies has been heavy. US unemployment has surged to the highest level since the 1930s Great Depression, with more than 20mn Americans unemployed. Job losses have been less extreme in other regions due to the widespread use of subsidised part-time work and furloughing, but unemployment is set to rise there as well. While some job losses will be reversed as economies open up, a full recovery is unlikely. With a less tight labour market, less job security and permanent damage to some sectors of the economy, wage inflation, which was already benign, is expected to collapse. This will prolong the disinflationary impulse of the lockdown.

Massive stimulus prevents a global depression, at the cost of higher debt

Meanwhile, there has been a profound injection of stimulus into the global economy. Central banks have expanded their balance sheets by over USD 6tn in their effort to inject liquidity into the real economy while governments have rolled out large-scale fiscal stimulus packages. This was needed to prevent a much worse and deeply deflationary global depression but will lead to a further build-up in debt, both among governments and corporates.

Coordinated monetary and fiscal policies is appropriate in exceptional times

Monetary and fiscal policy actions have moreover been unusually synchronised. While the US fiscal deficit is approaching 10% of GDP and will rise further, the Fed has launched unlimited purchases of Treasury securities, which helps to absorb additional debt issuance and hold down borrowing costs. Similarly coordinated policies have been relied on in most regions, including emerging markets. Clearly, central bank liquidity has helped governments to extend fiscal spending at a critical time without being punished by higher borrowing costs. This is justified in an exceptional crisis but could have undesirable consequences if it becomes part of normality.

Longer-term inflation prospects remain benign, but need to be monitored

Whether the additional stimulus and the shift in central bank and government behaviours will be inflationary over the longer run depends on whether central banks have the means and the willingness to remove liquidity once conditions improve, and whether they are free to do so independently of the fiscal position. They clearly have the means as asset purchases can be reversed, and this makes QE different from purer versions of 'helicopter money'. They also have the willingness. Indeed, judging from the past decade, central banks have been too keen to tighten policy, which has contributed to persistently low inflation. While ongoing policy reviews are likely to lead to some changes in the way monetary policy is set, the inflation targeting framework is unlikely to be scrapped. We therefore stick to our view that inflation is unlikely to become a problem, also over a longer horizon. Central banks remain vigilant and are likely to tighten policy if inflation starts to build up. Since debt-heavy economies are extremely sensitive to changes in borrowing conditions, this should choke off any excess inflation.

More fundamental changes to the way central banks operate will be needed to generate higher trend inflation. That said, we cannot rule out pockets of higher inflation, and this needs to be monitored.

US

Inflation recovers but headwinds remain

Headline inflation fell by 0.8% MoM in April, pushing down the annual rate to 0.3%, the lowest since 2015. Measuring inflation is particularly tricky during the lockdown as only a limited number of prices are available given that many shops were closed during the survey period. Nevertheless, the price landscape is broadly what you would expect. Energy prices were a major drag given the steep fall in the oil price while transportation services, hotel and apparel prices also fell substantially. Core CPI fell by 0.4% MoM in April, which was the biggest monthly drop on record since the series began in 1957. Not surprisingly, the biggest impact came from sectors most affected by the lockdown and social distancing, like lodging away from home and airline fares. Price pressure is likely to remain muted in these sectors even as the economy is slowly reopening. The recovery of the oil price will somewhat mitigate the negative price impact, but energy prices remain a drag in the near term. Inflation rates are likely to recover in the coming months but despite the latest fall in the unemployment rate there is substantial slack in the labour market, which makes it unlikely that inflation will rebound strongly before the end of the year.

UK

Inflation to stay weak

Headline inflation slowed to 0.8% YoY in April, the lowest level since 2016, as COVID-19 and the ensuing lockdown brought the economy almost to a standstill. Producer input prices tumbled to -9.8% YoY underlining the deflationary impact of the crisis and pointing to further near-term pressure on prices. According to Markit's PMI surveys, lower wage costs, fuel prices and office overhead costs led to a fall in average cost burdens in the service industry for the first time since the survey began in 1996. Service providers face the fastest rate of decline in average charges in the survey's history. The downward pressure on prices is expected to ease once the economy reopens and activity picks up. However, despite a partial recovery, energy prices remain very low compared to last year's levels and substantial spare capacity, also reflected in an elevated unemployment rate, will keep a lid on inflation. Sterling is expected to be under pressure again in the second half of the year as the end of the transition period looms and Brexit uncertainty resurfaces. The weaker currency will provide a limited counterbalance to deflationary pressure through higher import prices but inflation is expected to remain weak for the rest of the year.

Eurozone

ECB adds more PEPP as deflation fears resurface

Headline inflation in the Eurozone is currently close to zero, while core inflation is also well below the ECB's 2% target. Though the weakness in headline inflation is in part due to lower energy prices, the fear is that the large amount of excess capacity opened up by the COVID-19 pandemic and the deep recession it has caused will lead to the spectre of deflation haunting the Eurozone once more. However, policymakers have acted aggressively, with, for example, the ECB recently increasing its Pandemic Emergency Purchase Programme (PEPP) by EUR 600bn in June bringing it to EUR 1.35tn in total. Various Eurozone governments have also enacted large fiscal stimulus packages. Inflation expectations, as measured by the 5yr5yr forward inflation swap rate for example, have picked up from their recent lows in Q1. The upshot is that if we see the pandemic continue to improve, growth should pick up in the second half of 2020 and in 2021, and eventually inflation will stabilise as well, though probably still below the ECB's target and with the threat of deflation never too far away. Finally, even though overall inflation will remain low, in some specific sectors such as food, various supply constraints could see higher prices emerge.

Switzerland

Deep deflation

Monthly price changes turned deeply negative in March and April as the lockdown gripped the economy but recovered somewhat in May as conditions started to normalise. Given persistent weakness, however, annual CPI inflation slipped to -1.3% YoY, down from +0.2% in the beginning of the year. Core inflation is holding up slightly better, at -0.6% YoY, but both CPI measures are being dragged down by deflationary import prices, amplified by falling prices in services components that were severely impacted by the lockdown, including restaurants, hotels, transportation and leisure services. Going forward, we anticipate annual inflation rates to fall further into negative territory, but this partly reflects base effects, while monthly price changes should turn less deflationary, particularly within services. We therefore maintain our annual CPI inflation forecast for 2020 at -0.8%. While deeply negative, this still assumes that the deep economic downturn in the first half of the year will be followed by a sharp recovery in the second half of the year and that the Swiss franc does not strengthen materially going forward. Risk to inflation is to the downside, particularly as the SNB does not have unlimited ability to fight currency appreciation pressure.

Japan

Deflation is back again

We believe Japan will fall back into mild deflation amid the demand shock following the COVID-19 induced state of emergency. In April, core CPI, ex fresh food, fell below zero for the first time since 2016. Even though we are likely to see a snap back in May, as prices for some recreational items did not fall as much as expected in Tokyo despite a slump in demand, this should be a temporary phenomenon. Significantly lower energy prices are also contributing, despite the recent bounce. Corporate goods and service prices are back in deflationary territory, tumbling in April to a degree not seen in more than ten years. The steep drop in advertisement prices hit service prices particularly hard. As there are first signs of labour market weakness, we suspect that wages will be negatively impacted as well. Basic wages for full-time employees have stopped rising, but those for part-time workers have been hit recently, and the summer bonus is projected to fall 4.7% YoY. This semi-annual wage component is heavily dependent on corporate earnings, which have started to fall, as the latest MoF Survey has indicated. Meanwhile, consumer surveys show rising inflation expectations by households, which we believe reflects temporary scarcity of some daily necessity items during the partial lockdown.

China

CPI inflation to moderate, while PPI deflation will deepen

Falling food prices are the main factor behind a rolling over in CPI inflation. China's consumer price inflation reached a nine-year high of 5.4% YoY in January, mainly driven by higher food prices following swine-fever induced supply constraints. As pork price inflation is now subsiding, the latest inflation print was three percentage points lower. Other food prices, like falling vegetable prices, are contributing as well, while non-food inflation is also falling, driven by falling transportation costs amid lower oil prices. Producer price inflation keeps inching lower, marking a four-year low of -3.7% YoY in May. The monthly drop was the steepest since the Global Financial Crisis. Falling raw material prices are driving producer prices lower, while prices for industrial goods are also falling. Even though the economy will pick up steam in H2, we believe price pressures are likely to persist, not at least due to weak labour market conditions. This will make it easier for the PBoC to relax monetary policy further, as industrial profits will continue to suffer. Property price inflation slowed markedly in Q1, partly due to price controls, but has recently started to pick up again. China's government follows a cautious housing policy, stating that "houses are for living, not speculation".

Australia

Deflationary pressures

Q1 headline CPI came in at 0.3% QoQ, slightly weaker than the last two quarters. As COVID-19 social restrictions, rising unemployment and a plunge in oil prices weighed on prices, we might see inflation crossing into negative territory in Q2. Lockdowns affected the service sector severely, causing a collapse in demand, particularly for recreational and dining out activity. While online shopping and home delivery provided some support, they are unlikely to fully absorb the potential loss in consumption. Meanwhile, the latest data show employment falling 7.3% and total wages paid down 5.4% between mid-March and the beginning of May, with the younger population aged under 30 having been hit the hardest. Also, demand for property rentals are likely to decline during the crisis period. Rent has barely risen in the last five years and will remain subdued throughout this year. A sharp fall in oil prices has led to lower fuel costs for households. Additionally, the government has offered free childcare services between April and June, another factor which will keep inflation low. Having said that, we expect CPI to bounce back in the second half of the year, supported by stronger demand amid an easing of restrictions.

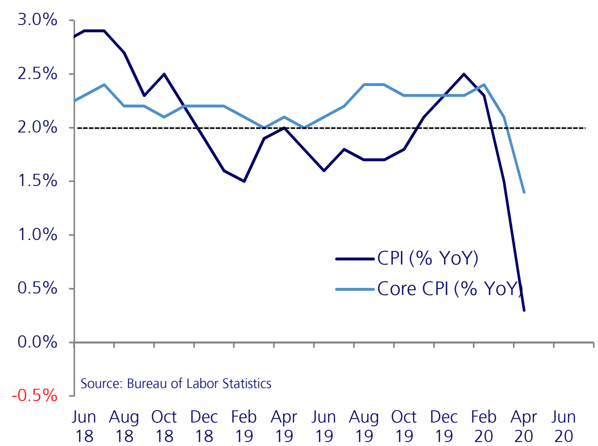
ASEAN

Some countries fall deeper into deflationary territory

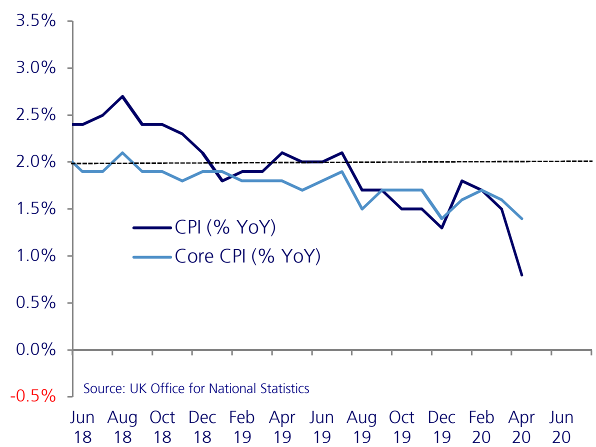
Consumer prices were on a sharp downward trajectory for ASEAN in April and May, with Malaysia, Singapore and Thailand falling deeper into deflationary territory. Even before the crisis, inflation was already at historical lows amid the economic slowdown in major economies. The number of Chinese tourist arrivals declined sharply in early February as the pandemic broke out in China, dragging on regional tourism and retail sales. Stringent containment measures starting from mid-March have slowed economic activity and consumption significantly, putting downward pressure on prices. While panic buys caused some surge in food and grocery prices, they were rather short-lived. A plunge in oil prices has lowered transportation costs for consumers while also translating into lower production costs. Having said that, a potential recovery in activity amid a lifting of lockdowns will probably support demand, pushing prices a little upward. However, infection curves have not yet sustainably flattened in Indonesia and the Philippines, likely slowing the pace of a consumption rebound post lockdowns as consumers remain cautious until the infection rate declines more decisively.

Current and historic inflation

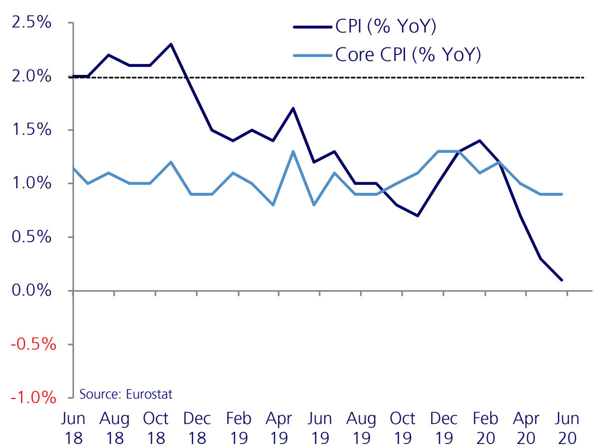
US: headwinds will remain for longer



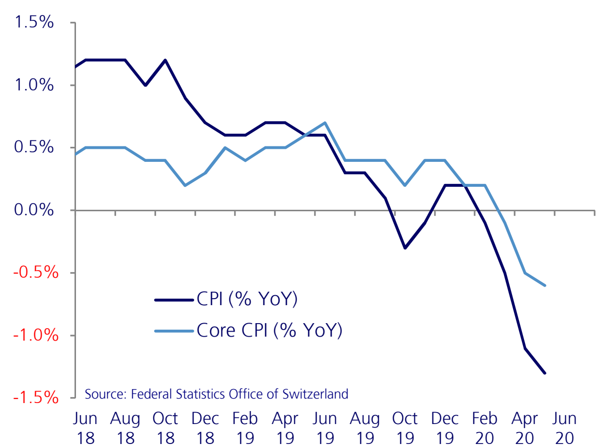
UK: inflation will stay weak



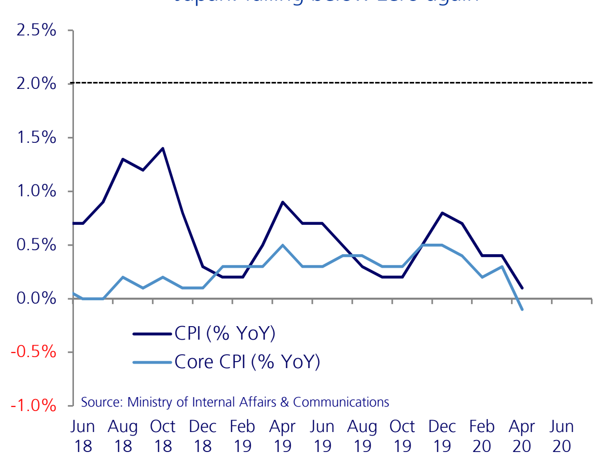
Eurozone: ECB acts on deflation fears



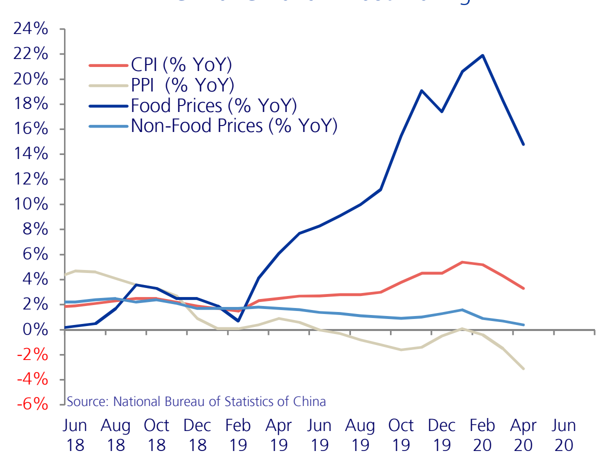
CH: deflation will persist



Japan: falling below zero again



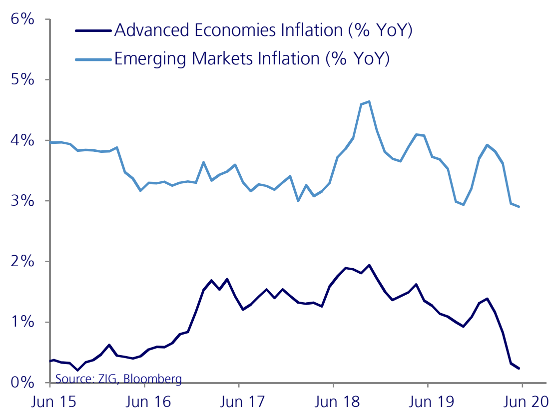
China: CPI and PPI both falling



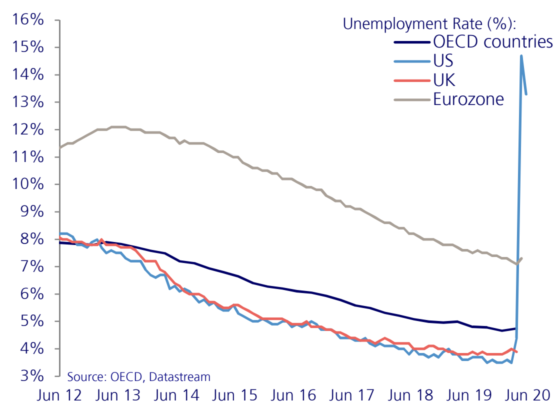
* Dashed lines show inflation targets or equivalent

Key indicators

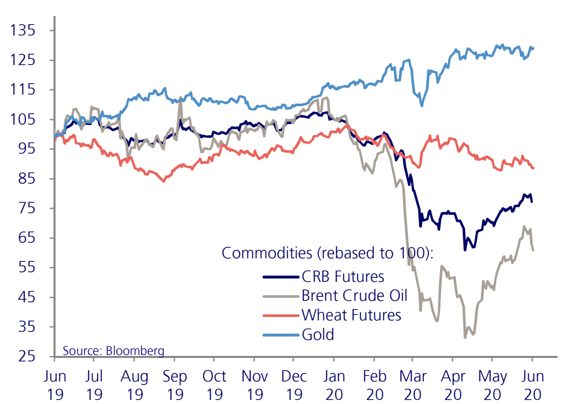
Inflation declining



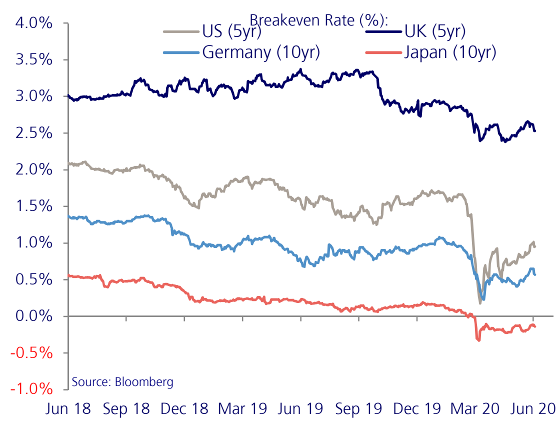
Unemployment will cap wages



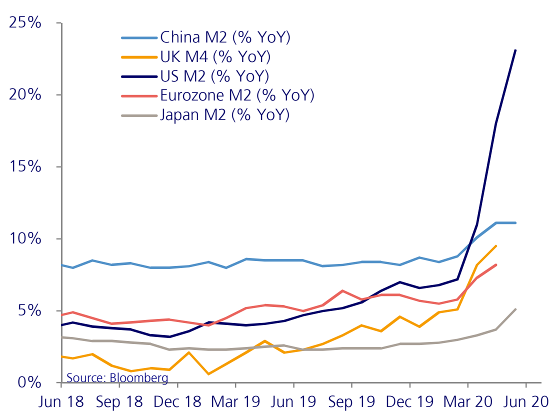
Oil prices recovering but still deflationary



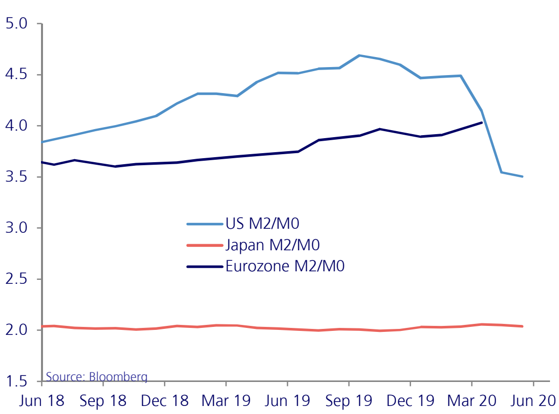
Inflation expectations remain weak



Liquidity injection



Money multipliers expected to fall



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