November 13, 2018

Inflation Focus Q4

Key Points

- Headline inflation has peaked, with the tailwind from higher oil prices now gradually diminishing
- Core inflation remains benign in most regions, but is expected to grind higher over the coming year
- US inflation is unlikely to become a problem, but a modest overshooting of the Fed's target should be expected
- Wage growth is finally moving higher, which will help to sustain higher inflation but is unlikely to become disruptive
- Policy tightening and slower growth should contain inflation in emerging markets

Source: iStock by Getty Images

Inflation is diverging, but the global trend remains modest

Headline inflation has risen globally, reaching or breaching central bank targets in most regions. The main driver has been the oil price, which was up by 50% compared to a year ago in the beginning of Q4. This effect has peaked along with global growth and headline inflation rates are now edging down. Looking through the oil price and focusing on core measures of inflation, the key takeaway is that inflation remains benign globally. There is divergence though, with core inflation close to target in the US, UK and Canada while Europe ex UK and Japan struggle with weak trends. Inflation has also risen sharply in many emerging markets (EMs) due to currency weakness. Policy has, however, responded sharply and will weigh on growth and inflation going forward. We therefore stick to our view that inflation remains anchored globally, with little risk of a significant inflation overshoot in developed markets, while most emerging markets should see inflation stabilise.

Tight labour markets are finally leading wage growth higher

Many labour markets are very tight, reflecting the late stage of the economic cycle and strong growth over the past year, with unemployment at or below multi-decade lows. Not surprisingly, wage inflation is finally starting to rise, and this dynamic is fairly broad-based across developed markets. Wage inflation is tracking at around 3% in the US and the UK, up from less than 2% during the cycle lows. Elsewhere, dynamics are weaker, but wage inflation appears to be edging higher in both the Eurozone and Japan. This is positive as wage growth has lagged behind in this cycle and is still far from excessive. We also do not expect higher wages to feed straight through to inflation as productivity gains will limit the impact on firms' costs and global competition will contain firms' pricing power. Central banks are also responding to the tightness in labour markets, raising rates and normalising balance sheets. This will take the edge off growth and help contain inflation expectations and nominal wages.

Trade tariffs will push prices higher in some regions, but only modestly so

Higher tariffs in the US and China will push prices higher. The US has imposed tariffs on a bit less than USD 300bn of imports and looks set to implement a 25% tariff on the majority of these imports by January. While sizable, this still amounts to less than 0.5% of US GDP. This is the key reason for why the inflation impact is expected to limited. The strong dollar will also offset some of the impact. Fears that these one-off tariffs would lead to a significant and persistent overshoot of US inflation are therefore overdone in our view. That said, if we were to see a further escalation of the trade war, moving beyond the US and China, a more substantive inflation impact should be expected. This is not part of our base case though.

Emerging markets will see higher, but not runaway, inflation

Emerging markets are past their inflation lows, reflecting both sharply lower currencies and higher oil prices. Policy has, however, tightened materially, with further rate hikes and fiscal tightening expected in many markets. This should help to contain capital outflows, stabilise currencies and reduce domestic demand, in some cases abruptly. We therefore do not expect the inflation impulse in EMs to develop into a vicious spiral, where higher prices and wages feed off each other. Instead, a drawn-out period with sluggish growth and downward pressure on prices and wages is likely. This should help to contain inflation expectations and limit another leg of currency depreciation. Clearly, EMs are facing more challenging times but, in most cases, this will not involve double-digit inflation rates.

Inflation expectations are still very benign

Market pricing of inflation is benign, with implied inflation expectations well below their long-term averages, both in the US and the Eurozone. With stronger wage growth and core inflation at target in the US and with trade tariffs posing an upside risk to inflation, inflation expectations should arguably be higher. That said, the economic cycle is at a late stage and the potential for a policy mistake is large. Indeed, looking beyond the near to medium term, downside risk to inflation still appears to dominate. In our view, this justifies why central banks need to remain cautious when removing stimulus, and why a sharp rise in inflation in core markets remains unlikely.

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US

Core inflation is hovering around the Fed's target

With the labour market getting ever tighter and the unemployment rate significantly below the Fed's estimate for the neutral non-inflationary rate, it is no surprise that the FOMC is increasingly focusing on the potential for inflation to surprise to the upside. While price pressure has increased and has become one of the key issues in company surveys, the latest readings confirm that inflation is not about to surge. Headline CPI inflation slowed to 2.3% YoY from 2.7% in September while core CPI remained at 2.2% YoY; both numbers were below consensus estimates. PCE Core again just reached the Fed's 2% target on a rounded basis. Rising wages in a tight labour market will feed through the supply chain and support inflation, but at the same time the housing sector is showing clear signs of weakening with house prices rising at the slowest pace since the end of 2016. Shelter costs are likely to decelerate as well, offsetting other components of core inflation. Households' longer-term inflation expectations also remain very low, despite the strong economy. So far, trade tariffs have had only a minor impact on overall inflation but this could change if the US follows up on its threats to further extend the tariffs on imports from China.

UK

Wages grow at the fastest rate in almost a decade

Inflation has been moderating recently despite renewed weakness in sterling and a very tight labour market. The consistently low unemployment rate is supporting wages with average weekly earnings growth accelerating to 2.7% YoY in August. Excluding volatile bonus payments, wages even rose by 3.1% YoY, the highest rate since January 2009. While accelerating wage growth may increasingly attract the BoE's attention, the latest inflation data should help to lower anxiety. Headline CPI slowed to 2.4% YoY in September from 2.7% in August while core CPI ticked down to 1.9% from 2.1%. Following the fall in the oil price since early October (down by 18% from its peak), and in line with current inflation, households' inflation expectations have moderated as well, particularly for the year ahead. The moderation in inflation is a welcome relief for both households that saw their real purchase power squeezed as well as for the BoE which is stuck between Brexit worries and inflation risks. Inflation is expected to remain above target for the foreseeable future as is indicated by a slight reacceleration of input prices, which is likely to persist, particularly if Brexit uncertainty keeps putting pressure on the pound.

Eurozone

A modest increase in core inflation is expected, despite a slowdown in growth

Core inflation in the Eurozone has been hovering around 1.0% since mid-2017, while headline inflation has been driven much higher by the steady rise in oil prices (which lasted until the beginning of Q3). In October, Eurozone inflation was 2.2% on the headline measure, and 1.1% on the core measure. Headline inflation should gradually fall back, assuming oil prices stay around current levels. However, we expect core inflation will increase over the next few quarters, supported by stronger wage growth, especially in 2019 when many of the more generous wage deals recently agreed upon in Germany and Spain, for example, actually kick in. However, the increase in core inflation is likely to be very gradual. Although the unemployment rate continues to fall in the Eurozone, to 8.1% in September from 8.6% at the beginning of the year, overall it is still some way above the Non-Accelerating Inflation Rate of Unemployment (NAIRU), implying there is still spare capacity in the Eurozone economy. What's more, with Eurozone growth expected to slow to a more modest pace in 2019 compared to 2018, the pace of job creation is likely to moderate as well. Finally, extra stimulus from the ECB is unlikely in 2019, unless economic conditions deteriorate substantially.

Switzerland

Inflation is plateauing well below target

Inflation is levelling out after a rapid rise over the past year. Headline CPI inflation fell back to 1% YoY in September, reflecting a fading impulse from import prices and as such was anticipated. Core CPI also ticked down to 0.4% YoY, which is more concerning. Inflation in the services sector has fallen back to only 0.4%, led by soft trends in health care and housing rents. Domestic goods price inflation is also weak, currently tracking at only 0.5% YoY, with downward pressure on costs and profit margins persisting.

We expect this underlying weakness to last into 2019, for three main reasons. Wage growth is still below 1% and this is too low to drive inflation higher given productivity gains. The franc has also strengthened compared to a year ago, which will weigh on import prices. Global and Swiss growth have peaked, which will weigh on the economy and likely reduce pricing power somewhat. We therefore anticipate inflation will only edge up very modestly in 2019, averaging 1.2% YoY. This is the highest level for a decade and a touch above the consensus view, but still well below the 2% inflation target. We expect the SNB to stay put, and do not foresee a rate hike until well into the second half of 2019.

Japan

Yield curve control to remain in place in 2019

A solid boost from energy prices drove national core CPI up to 1.0% YoY in September. The push from higher oil prices is expected to peak in early 2019. Meanwhile, core-core CPI ex-fresh food and energy remains stuck below 1%. Going forward, wage growth is likely to continue on its modest rising trend and gradually feed through to inflation. Indeed, companies are reporting increasing capacity constraints and the labour market continues to tighten. The consumption tax hike, which has been confirmed by the government and is scheduled for October 2019, will also add to inflation. The Bank of Japan (BoJ) estimates the inflationary impact of the tax hike at +50bps.

Despite these inflationary tailwinds, we do not expect the BoJ to meet its 2% CPI target any time soon. The BoJ itself revised its CPI forecast lower, and hopes to reach its target in 2020 instead of 2019, as initially projected. This suggests that the yield curve control mechanism will remain in place in 2019. To keep the interbank market active and reduce the squeeze on banks' profitability created by accommodative monetary policy, the BoJ's asset purchases will follow a more flexible timing.

China

Inflation in check, growth in focus

Headline inflation ticked up to 2.5% YoY in September, led by a surge in food inflation. Supply disruptions in the pork and vegetable segments were to blame for higher inflation. Food inflation is likely to be sustained in the run-up to Chinese New Year, but will level off after the festivities. In contrast to headline inflation, core inflation remains well contained. Going forward, rising housing rents will probably push core CPI higher. That said, higher housing costs are likely to be partly offset by special tax rebates for households. These tax deductions cover social security payments, accommodation, education and health costs, and will be implemented from January 2019 on.

The yuan's depreciation and the escalation of trade tariffs are likely to impact PPI prices, but will have limited effects on CPI. Overall, inflation is not a main concern for China's government.

The Chinese authorities are now fully focused on supporting growth, especially consumption and private sector activity. Monetary policy has been loosened via another RRR cut and is expected to remain accommodative in the first half of 2019.

Australia

Core inflation to stay low for longer

Both headline and core inflation moderated in Q3 and returned to below the Reserve Bank of Australia's (RBA) target band of 2 to 3%. Underlying inflation was disappointingly weak in Q3. Downward pressures on housing and household goods prices, two major components of the CPI basket, are expected to persist in 2019. However, the labour market continues to tighten, and we expect wage growth to gradually rise. In September, both the underemployment and unemployment rate fell, with the latter reaching the RBA's NAIRU estimate of 5%.

Despite this milestone, the central bank retained a neutral tone and reiterated its focus on wage growth rather than employment data. The RBA also sounded more cautious in its assessment of the consumer's financial situation, which has become more precarious in the context of falling property prices. We think that the central bank will maintain its "hold-and-see" strategy and probably deliver its first rate hike towards the end of 2019.

Indonesia

Inflation under control until April 2019 elections

Inflation picked up above 3% YoY in September, as food and non-subsidised fuel prices edged higher. Despite this increase, CPI inflation will remain contained within the 2.5%-4.5% target fixed by Bank Indonesia (BI) in 2018. Indeed, the government continues to manage food supply and control electricity and fuel prices. We expect fuel subsidies to remain in place until the general elections in April 2019. After the elections, we think that the government will be forced to scrap parts of the subsidy schemes to relieve the economic pressure on state-owned oil and gas companies. This will probably push inflation higher in H2 2019.

While inflation remains under control in the near term, Bank Indonesia (BI) is facing difficulties in supporting the currency as the rupiah remains close to all-time lows. The central bank paused in October, and non-monetary measures such as oil import substitution, tariffs on consumer goods imports, and a new FX hedging tool are being tested. Going forward, we expect policy tightening in the US to force Bank Indonesia to follow suit and deliver at least one more rate hike.

Malaysia

Tax hikes to deliver a modest push to CPI

As expected, core inflation picked up above zero in September after falling for two consecutive months. The turnaround was mostly visible in services prices and was likely driven by the new Sales and Services Tax (SST), introduced after three months of tax holiday. Headline CPI remains weak, dragged by weak food and transport inflation. CPI inflation is tracking at ~1% YoY for 2018, but will probably tick up in 2019. Indeed, the government will introduce a system of targeted fuel subsidies, which will cap the amount of subsidies and limit them to certain categories of cars. Additionally, the government will increase taxes on sugary drinks, online services, gaming, property and corporate incomes. These tax hikes remain modest and will only partly compensate for the revenue loss from the Goods and Services Tax cancellation. Based on the 2019 budget, we see inflation picking up modestly next year, helped by the 10% boost to the minimum wage and the shallow increase of selected taxes. We expect the central bank to be comfortable with inflation and stand pat.

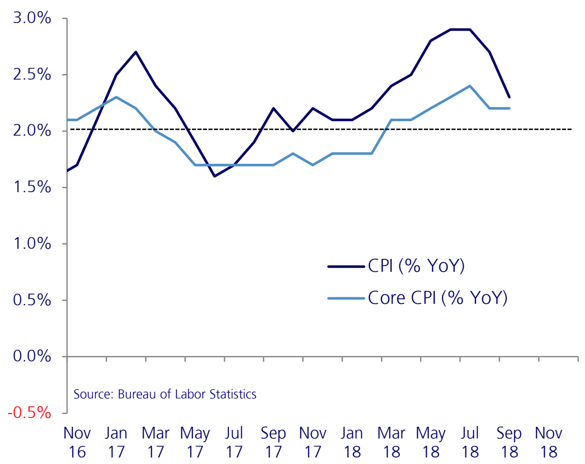
Consumer Prices (Annual Percentage Change)*

	Zurich's Point Estimate			Consensus Forecasts	
	2017	2018	2019	2018	2019
US	2.1	2.3	2.2	2.5	2.3
UK	2.7	2.4	2.0	2.5↑	2.2
Eurozone	1.5	1.7	1.7	1.7	1.7↑
Switzerland	0.5	1.0	1.2	1.0	1.0↓
Japan	0.4	1.0	1.1	0.9	1.1
China	1.6	2.1	2.3	2.1	2.3
Australia	1.9	2.0	2.4	2.0	2.2
Asia	1.7	n/a	n/a	2.1	2.3
Argentina	38.0	n/a	n/a	45.3↑	27.4↑
Brazil	3.5	n/a	n/a	4.3↑	4.2
Chile	2.2	n/a	n/a	3.0↓	3.2
Mexico	6.0	n/a	n/a	4.6↑	3.7↓

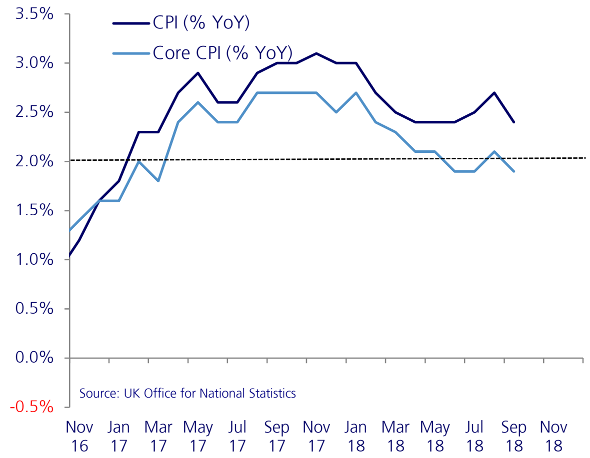
* Consumer prices are shown as annual averages. Asia is ex-Japan and ex-Australia. Consensus forecasts are from Consensus Economics Inc. Inflation rates refer to year on year changes. Data used is either from Bloomberg or Datastream unless otherwise specified. Argentina, Brazil, Chile and Mexico show consumer price increases from December to December. Arrow show changes over the last month.

Current and historic inflation

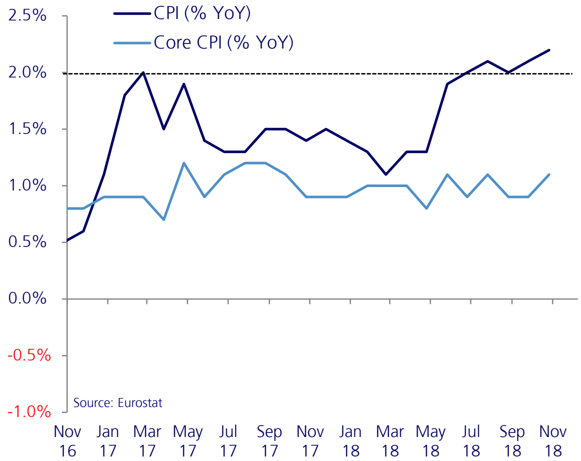
US: core inflation set to stabilise



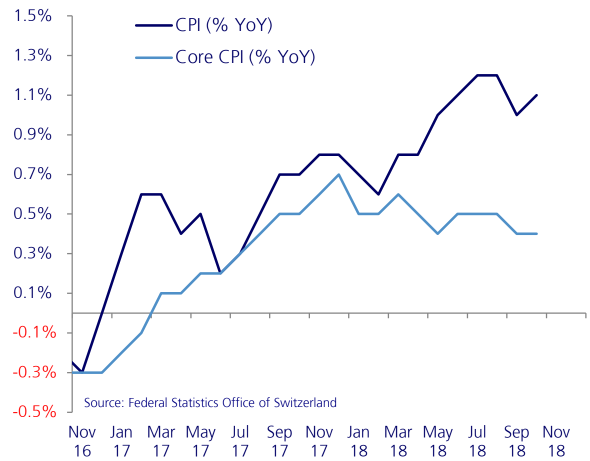
UK: inflation moderating



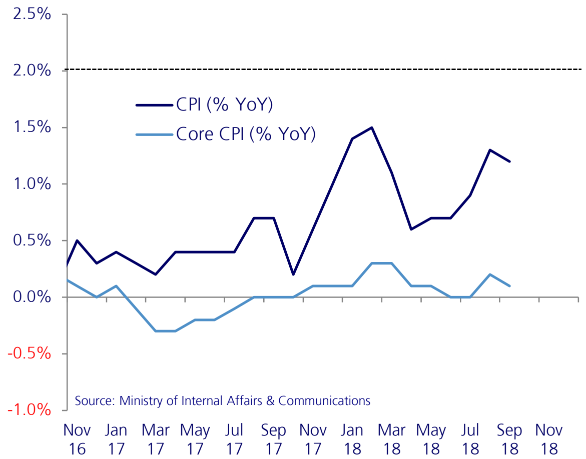
Eurozone: core inflation should edge higher



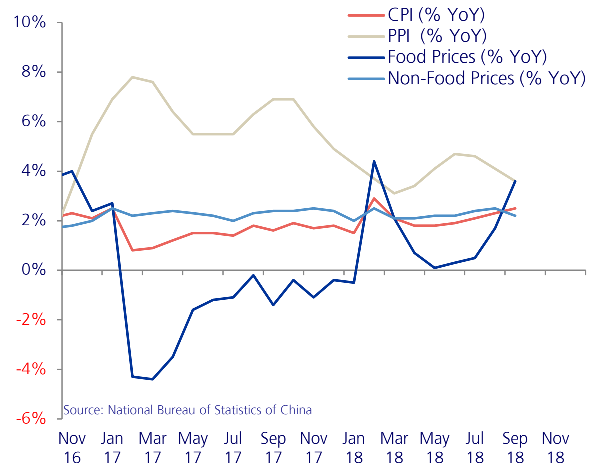
CH: core weakness will persist



Japan: BoJ will not meet its target any time soon



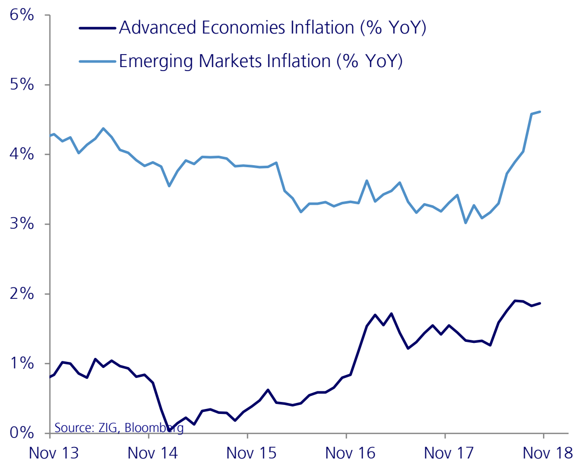
China: inflation in check



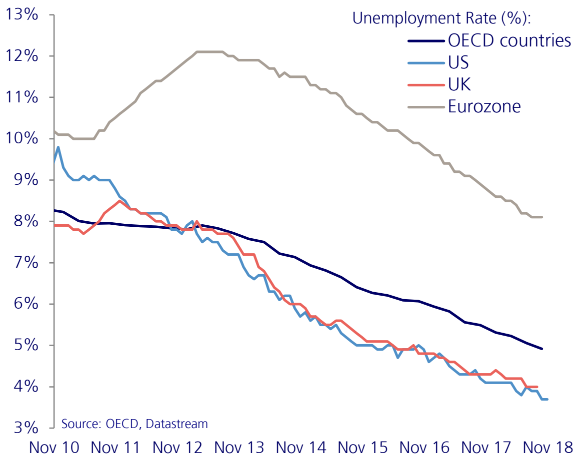
* Dashed lines show inflation targets or equivalent

Key indicators

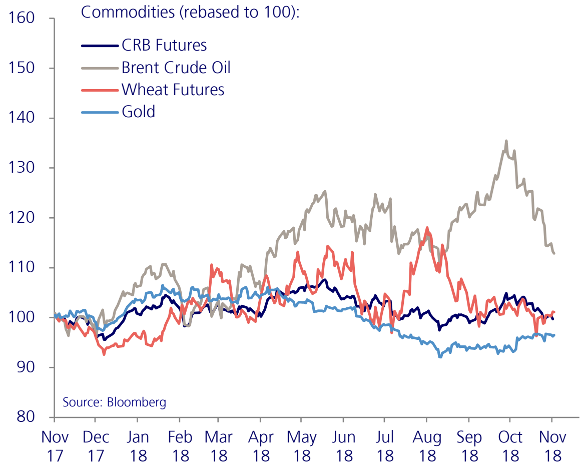
Inflation higher on oil prices and currencies



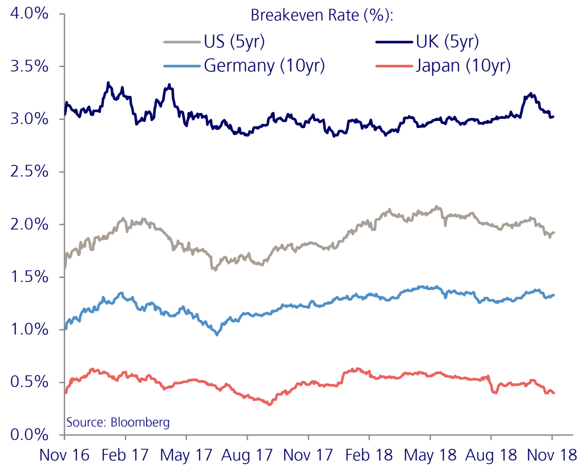
Tigh labour markets



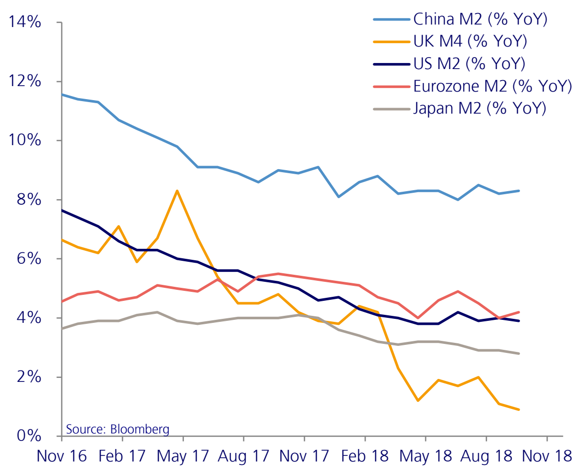
Oil price impulse wanes quickly



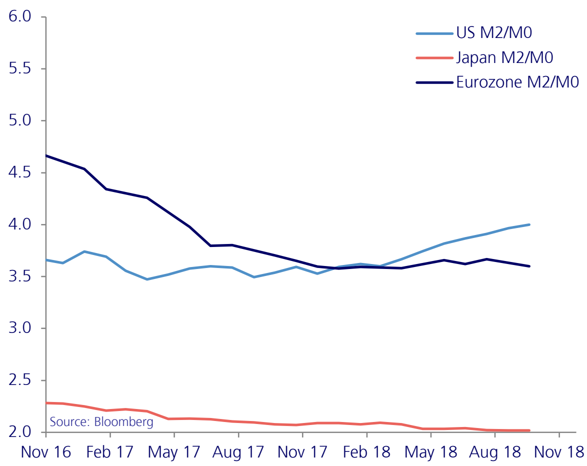
Inflation expectations still benign



Credit growth not excessive



Money multipliers bottom as QE ends



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