September 14, 2021

Inflation Focus Q3

Key Points

- Headline CPI inflation remains elevated, partly reflecting higher energy prices and Covid related effects
- Core inflation is benign in many regions, with the US an exception, and is not expected to become a problem
- Wages and inflation expectations are contained, with little evidence of pass-through from higher inflation to wages
- A hawkish shift among central banks confirms that they retain focus on price stability, limiting prospects for stickier inflation
- Uncertainty around inflation remains elevated, with rising infections and supply chain disruptions at the fore

Source: iStock by Getty Images

Why has consumer price inflation risen so sharply?
There are three main reasons why CPI inflation has risen: Higher oil prices (along with some other commodities), reopening effects, and excess goods demand in combination with supply disruptions. Oil price effects have pushed headline CPI inflation to a 10-year high globally, but core inflation (ex oil and food prices) remains relatively benign in most regions, with the US an exception.

When will upward pressure on consumer prices start to ease?
The **oil price** rose by 180% in March vs a year earlier, when oil prices collapsed during lockdowns. This is the largest percentage increase on record and helps explain a large part of the surge in headline inflation in H1 2021. The impact of this on inflation peaked in Q2 and, unless oil prices rise further, should diminish towards zero by early 2022.
Reopening effects reflect price dynamics in industries that were hit particularly hard during lockdowns, such as air transport, hotel accommodation, restaurant services, and leisure. Prices for many of these services fell in 2020 but rebounded sharply as economies reopened, leading to upward pressure on core CPI inflation. As prices have now caught up with pre-crisis levels, the pace of increase is likely to moderate going forward. Most of these price gains should therefore be transitory and fade over time.
The third bucket relates to **durable goods price inflation**. Goods demand has surged, boosted by lockdowns, cash handouts, investment in home office equipment, and strong auto demand. At the same time, supply of key inputs has been disrupted and transportation costs have erupted. This has caused larger goods price increases than expected, with electronics and cars at the fore. A combination of slowing growth, with a rebalancing towards services, and the response of supply to higher prices should ease pressures, though recent ASEAN lockdowns and a race among businesses to restock could delay normalisation. In contrast to the oil price and reopening effects, this inflation driver is likely to persist with elevated price pressures on some components lasting into 2022. That said, some of the most affected prices are moderating. Used car price inflation, which peaked at over 50% YoY in April is now running below 20% YoY. Lumber prices, which rose by 370% YoY in April are now falling at a pace of -17% YoY.

Producer price inflation has also spiked, but how sticky will it be?
Producer price inflation (PPI) has surged, reflecting rising energy, commodity, and intermediate goods price inflation. Producer prices are highly cyclical and tend to recover sharply after recessions, so this pattern is not uncommon. The pass-through from PPI to CPI inflation is also limited, partly because fierce competition restricts the ability to pass on price increases to the consumer. So far, this pattern holds. Although PPI inflation is likely to stay elevated into 2022, upward price pressures should ease back over time as demand peaks and the inventory cycle begins to normalise.

Wages have been rising in some markets, should we be concerned?
While there are pockets of high wage pressure, broader measures of wage inflation are contained. Pay growth has recovered to pre-crisis levels in the US and the UK, boosted by bottlenecks and Brexit related tightness. In many other regions, overall pay pressure is more modest. Labour market tightness is concerning but should begin to ease as health worries diminish and support measures are reduced. However, rising delta infections could delay this process and will be critical to monitor over the coming months. In the long run, trends that exert downward pressure on wages – automation, outsourcing, globalisation and a lack of unionisation – are expected to remain in place. We suspect they will keep the lid on broader wage pressures beyond the near term.

Central banks have turned more hawkish, will this derail the economic cycle?
Rate hikes have accelerated, particularly in Latin America, while the Fed has adopted a more hawkish stance and the ECB has reduced the pace of asset purchases. This shows that central banks are retaining their focus on inflation and that they are willing and able to tighten the policy stance when required. We do not expect this to derail the cycle, but it should help to dampen growth, choke off excess inflation, and anchor inflation expectations. This is a key reason why a return to the high inflation rates of the 1970s is highly unlikely.

Is uncertainty around inflation still unusually high?
Yes. Untested policy measures and elevated savings have already increased uncertainty, and supply chain and labour market pressures are adding to that.

US

Inflation rates to moderate in the coming months

Inflation rates have soared in the past few months with headline CPI rising to 5.4% YoY in June and July, the highest level since 2008. For core CPI, which accelerated to 4.5% YoY in June before ticking down to 4.3% in July, this was the highest level in three decades. Base effects and distortions related to the reopening of the economy and temporary supply chain disruptions help to explain the largest part of the recent price rises. On a monthly basis, many of these transitory factors like prices for used cars or airfares already show signs of easing. Overall, we expect inflation rates to moderate further in the coming months.

Nevertheless, some components like shelter costs are likely to be stickier and are expected to have an impact into next year, as well. House prices rose by 19% YoY in June. Rising house prices are expected to push up rents, particularly now that the eviction moratoriums are about to end and landlords may try to re-rent at higher rates. While inflation rates are expected to stabilise at a higher level than before the crisis, longer-term inflation expectations are still well anchored, reflecting the Fed's ongoing credibility regarding its focus on price stability.

UK

Inflation weakens but should re-accelerate

Headline CPI inflation fell markedly in July, to 2.0% YoY from 2.5% in June, while core inflation slowed to 1.8% YoY from 2.3%. The deceleration in inflation was largely caused by seasonal distortions to prices last year related to Covid. As the economy re-opened in July 2020 prices on a number of goods and services rose more than usual, thus weighing on the annual inflation rate when comparing prices this July to last year. Inflation is likely to bounce back later this year as some of these base effects reverse and others kick in.

Longer-term inflation expectations have risen since the beginning of the year. The Bank of England made no changes to its current policy at its latest meeting, but it is starting to prepare investors for a potential tightening in the future and provided some details regarding the expected policy path. It confirmed that reducing the balance sheet after the QE-induced gilt purchases will be a two-step process in which the Bank will first stop reinvesting maturing assets, followed by active sales at a later stage. The Bank also revised down the level of the Bank Rate at which it intends to stop reinvestments from 1.5% to 0.5% and introduced a new threshold of at least 1% for the active sale of assets.

Eurozone

Inflation is at the highest in ten years, but wage growth is still modest

Headline inflation hit a ten-year high of 3.0% YoY in August, and core inflation rose to 1.6%. Inflation statistics this year have been extremely volatile due to significant base effects from higher energy prices, changes in the HICP weightings, different timing of summer sales this year and last due to Covid, and the lapsing of a temporary cut to German VAT last year. However, this has mostly affected the goods sector while service sector inflation has been much less volatile so far. For example, core goods inflation jumped to 2.7% in August, from 0.7% in July, while service sector inflation only increased to 1.1% from 0.9%. Wage growth remains modest, and this is the biggest determinant of service sector inflation. Setting aside the volatility of the statistics, we do think underlying inflation will gradually move higher this year and next due to very strong growth and some pass-through of higher producer price inflation due to supply chain problems and higher energy prices. Nevertheless, we expect the ECB to keep a dovish stance, maintaining a significant amount of asset purchases well into 2022 and keeping policy rates at their exceptionally low levels.

Switzerland

Upward pressure on prices easing

Annual inflation has ticked higher, with headline and core CPI at 0.9% and 0.4% in August. Though annual inflation rates should rise further, this mainly reflects base effects while underlying trends are benign. Monthly price gains have declined following a peak in Q2 and are now running at below 0.1% MoM for headline CPI, and at 0% for core prices. Drilling down, prices on 40% of the goods and services that are included in the CPI basket are still below pre-Covid levels, showing that while pockets of higher inflation have emerged, pricing power is constrained in large parts of the economy. Domestic goods price inflation is consequently subdued, at 0.5% YoY compared to 2% for imported goods. Services inflation is also tracking at 0.5% YoY, but the overall number is boosted by rising rent inflation, while many other services components are weak. Soft domestic inflation is mirrored in the latest wage data, which shows nominal wages falling by 0.8% QoQ in Q2 despite strong economic activity.

Taking it all together, the latest data confirm that the low inflation environment persists, underpinning our view that the SNB will leave monetary policy unchanged for a longer period of time.

Japan

CPI rebasing and special factors keep distorting price statistics

As is the case every five years, Japan's CPI statistics underwent a rebasing in June, which pulled down the core June CPI YoY rate by 0.7 percentage points and has been backdated to January 2021. The downward revision to mobile phone tariff inflation in the new 2020 basket has intensified the drag on underlying inflation from 0.6% pts to 1.1%pts, even though this impact will wane in April next year. Higher energy prices and lower lodging prices, should the 'Go To' campaign be revived, will also have a major impact on CPI statistics. If adjusted for all special factors, June core CPI inflation stands at +0.3% YoY instead of the official rate of -0.9% YoY and is roughly unchanged compared on a two-year horizon. Interestingly, despite negative CPI prints, households' expected inflation is creeping above the 2% mark. While CPI inflation remains contained, corporate goods prices are rising faster, mainly driven by commodities like energy, metals, and chemicals. Meanwhile, corporate service price inflation remains shallow. Wage statistics remain continue to be volatile, with base wages only rising marginally, while overtime pay has risen significantly. However, the summer bonus, which made up 40% of total labour cash earnings in June, was a drag on total wage growth.

China

Rising producer price inflation has a limited impact on rather stable consumer prices

China's producer price inflation remains hot at 9%, a 12-year high, pushed by rising commodity prices. Though China's authorities were able to curtail some of the speculative price rises for metals, energy has been the core driver for higher producer prices, not at least due to extreme weather conditions. However, there is still no spillover to consumer prices, with the latest reading for August at only 0.8% YoY. Higher oil prices keep pushing CPI inflation, but pig price deflation remains the major drag. Pork prices fell 43.5% YoY in July following oversupply after the swine flu abated. Recently, the government has tried to counter pork price deflation by purchasing frozen pigs for central reserves and has promised to reverse the severe price drop. Despite these measures, CPI inflation is likely to remain low for the time being, particularly when it comes to services prices, impacted by a rather weak labour market and soft consumption amid the recent Covid Delta variant related lockdown measures. We expect the gap between PPI and CPI inflation to narrow significantly towards the end of this year and into next year. In the medium term, a wave of new university graduates will keep a lid on wage inflation and will at the same time foster innovation with disinflationary tendencies.

Australia

Q3 inflation should be soft as activity dropped due to lockdowns

As expected, Q2 inflation rose sharply to 3.8% YoY largely due to transitory factors and base effects. Core inflation remains modest at 1.7%, a sizable gap compared to the RBA's 2-3% target. Besides the fall in activity in Q2 2020, childcare subsidies during this period also lowered the base last year and pushed up the headline CPI. Those factors will unwind in Q3. More importantly, Australia has reimposed lockdowns in major parts of the country since the beginning of Q3. It will probably translate into a sharp fall in consumption, especially in the services sector. Overall, CPI is therefore likely to be soft in Q3.

House prices were up by 17.4% YoY in August, but the pace of the monthly increase has slowed. Some initial data also show a considerable drop in home sales, linked to current lockdowns across Australia. We think the RBA will maintain its cash rate close to zero in the next couple of years. However, the path towards monetary normalisation has already started with the tapering of QE in September. The RBA will reduce its asset purchases from AUD 5bn to 4bn per week until mid-2022.

ASEAN

Low inflation should support low policy rates

Inflation should not be a concern in the ASEAN region as lockdowns have been a severe drag on consumer demand. The Philippines remains the only exception, with the CPI hovering above 4% since the beginning of the year. Elsewhere, the latest CPI inflation data for June and July largely fell, notably in Malaysia. The weaker CPI was partly due to electricity bill subsidies for households, which will last till the end of September this year.

While the PMI input price components have eased, the level has stayed elevated, reflecting stubborn supply bottlenecks. Production disruptions in major hubs like Vietnam and Malaysia put more pressure on regional supply chains. After month-long lockdowns, some countries, including Indonesia, Thailand, and Malaysia, have started to see a decrease in new Covid cases. Vietnam is still struggling to contain the pandemic and has imposed even more severe restrictions. Overall, Q3 has been a challenging period for the region.

On a brighter note, subdued inflation has allowed regional central banks to maintain their policy rates at low levels. We do not expect any policy rate hikes this year. The first interest rate hike in the region is likely to be in H2 2022, depending on the recovery trajectory and global yield environment.

Brazil

Convergence to the inflation target is delayed

Headline CPI inflation continues to increase, reaching 9.7% YoY in August with all components contributing positively. Core inflation also accelerated to 6.1% YoY and is now above the upper range of the central bank target. Regulated prices and industrial goods prices were the main contributors to inflation during the last months. The former has been affected by the pandemic's base effects and by higher electricity tariffs due to the drought. The latter continues to reflect supply chain bottlenecks due to the pandemic. Also, services prices have been under pressure as the economy reopens.

Amid a broad deterioration in the inflation outlook, the Central Bank of Brazil (BCB) has adopted a hawkish stance, announcing it would raise the policy rate above its neutral level and increasing the Selic rate by 175bps over the last two meetings to reach 5.25% in August. Despite the hawkish statement, inflation expectations for 2021 and 2022 continue to rise.

We expect that inflation will continue to increase, converging to the central bank target in 2023 and with the BCB raising the rate to 7.5% by year end. Still, risk is biased to the upside, especially if inflation continues to surprise to the upside and the government fails to deliver a 2022 budget proposal compliant with the spending cap.

LatAm

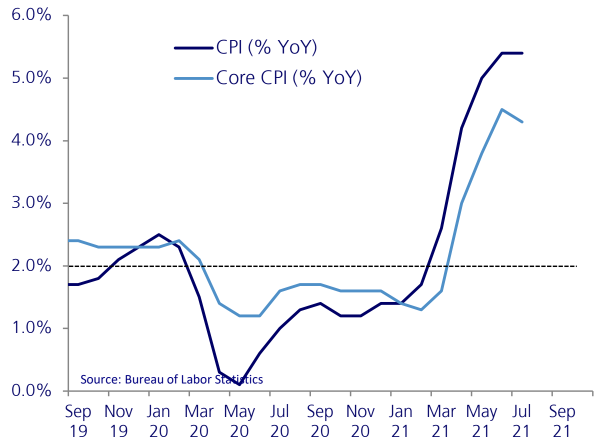
Rising inflation risk forces hawkish shift among central banks

Inflation risk in LatAm has increased, as not only the transitory effects of the pandemic are affecting prices. In Chile, the economic recovery continues to surprise to the upside, mainly driven by strong consumption due to pension fund withdrawals and unprecedented fiscal stimulus. Headline and core inflation rose to 4.8% and 3.8% respectively in August as domestic demand has increased, the output gap has closed, and supply restrictions remain. The central bank has accelerated the tightening process, hiking the policy rate by 75bps in August, signalling that it will raise the rate to its neutral level of 3.5% by H1 2022, and revising the inflation forecast significantly to the upside for 2021 mainly due to high consumption and the idiosyncratic currency depreciation of CLP.

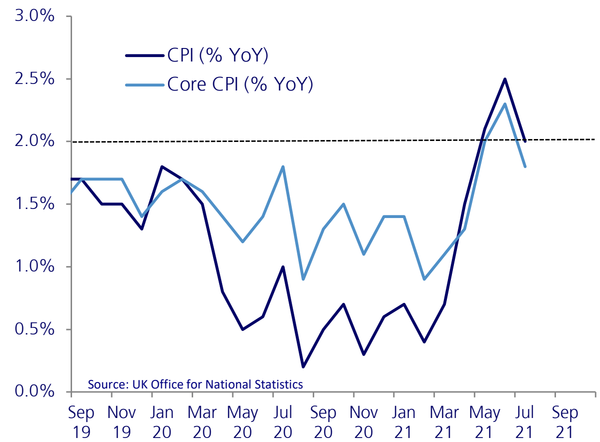
In Mexico, headline inflation decelerated from 5.8% to 5.6% in August, which was helped by the price control on liquefied gas. However, we expect headline inflation to remain high and not converge to target until Q1 2023, while core inflation continues to increase mainly due to rising goods prices. Due to global inflation pressure, cost pressures, and core inflation persistence, inflation risk is biased to the upside. We expect another 25bp hike to the policy rate in Q4 2021 while further movements should be data dependent.

Current and historic inflation

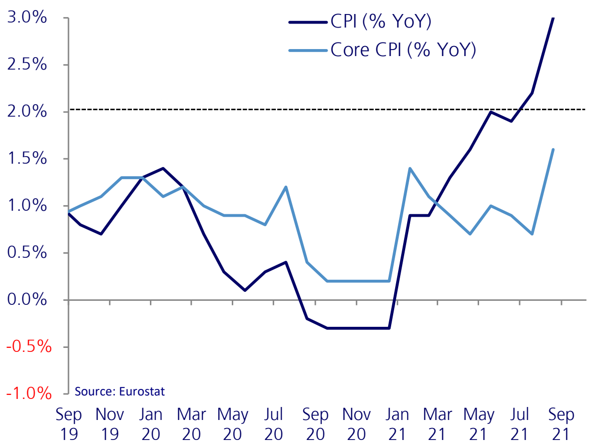
US: inflation to moderate in coming months



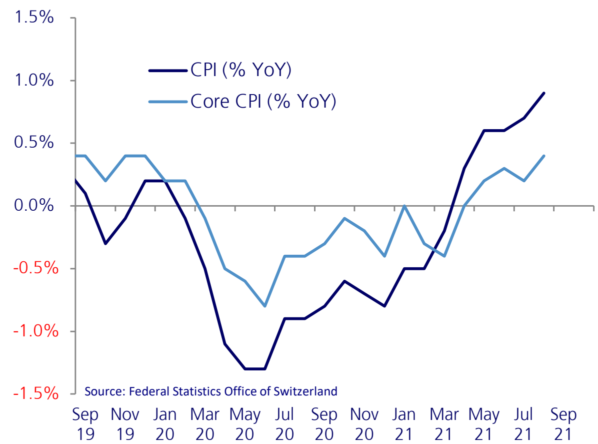
UK: re-acceleration expected



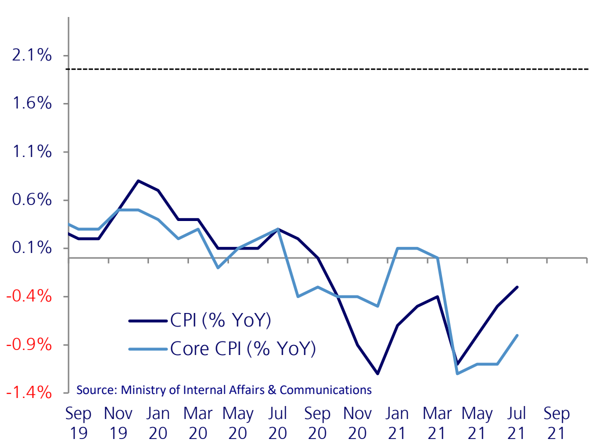
Eurozone: core CPI anchored by modest wage growth



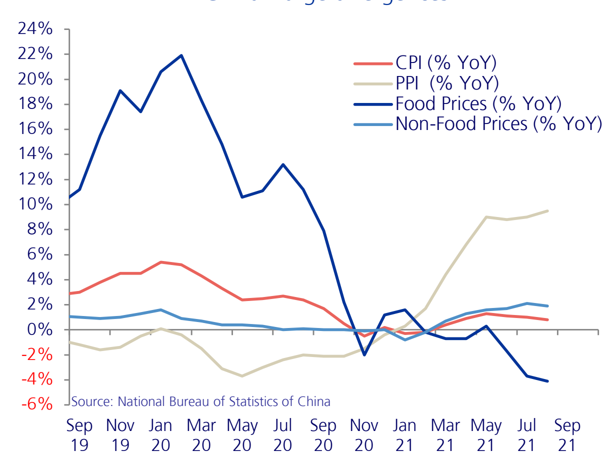
CH: upward pressure should ease



Japan: trends are benign



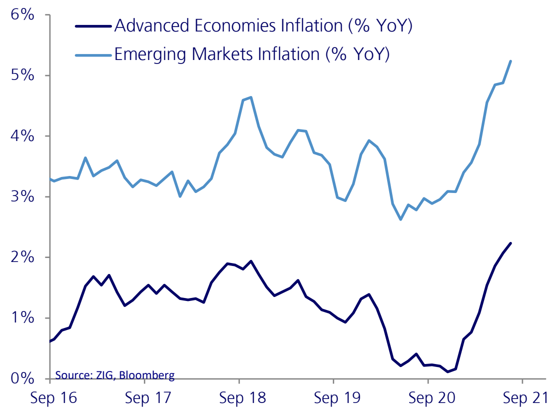
China: Large divergences



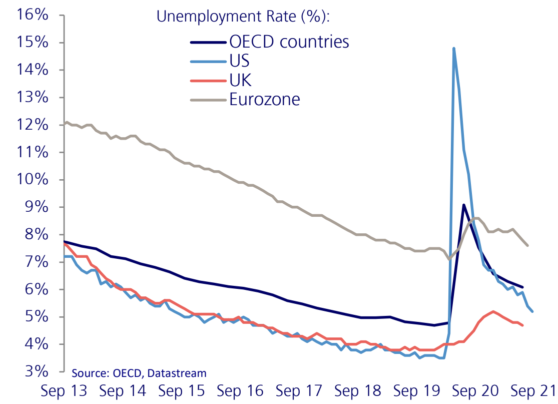
* Dashed lines show inflation targets or equivalent

Key indicators

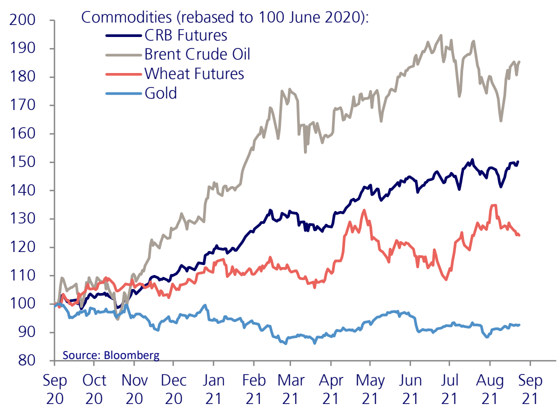
Inflation spikes to 10yr high



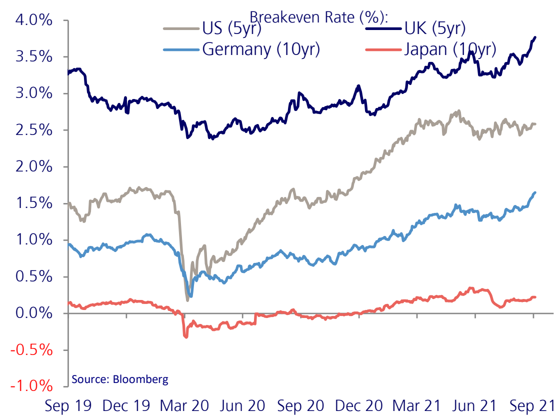
Labour markets improving rapidly



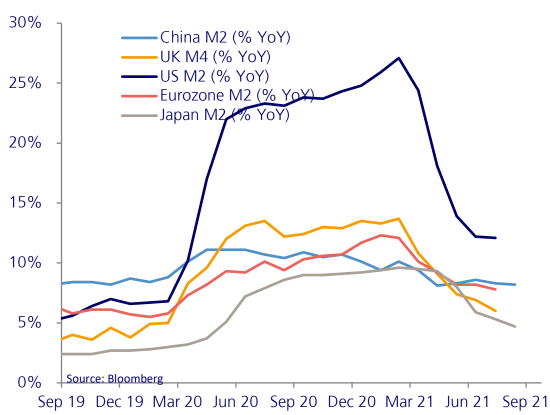
Commodity prices tentatively stabilising



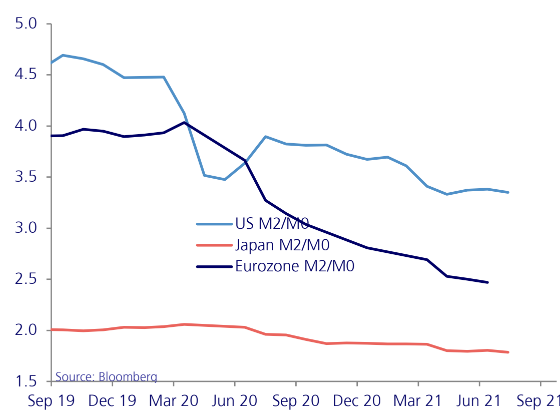
Inflation expectations rising but remain contained



Money growth slowing sharply



Money multipliers still low



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