

Inflation Focus Q3



Key points

- Global inflation has bottomed, but the upward trend is tepid
- Recent weakness in US inflation is likely to fade, but it makes the global outlook more opaque
- Upsides to inflation are limited as long as wage inflation fails to improve
- Strong synchronised global growth reduces downside risks to inflation

Global economy at an inflection point, but inflation remains weak

The global economy is expanding at a brisk pace. Indeed, almost a decade after the global financial crisis, we finally see broad based and more balanced growth taking hold, reducing the dependency on exceptional stimulus and tentatively generating a self-sustained virtuous cycle. The better growth environment has been reflected in stronger earnings and has helped to spur investment and trade. Inflation, however, is still absent in most regions; it is tracking well below central bank targets in most developed economies

and has moderated further in emerging markets.

US weakness clouds the outlook, but is expected to be temporary

While inflation is weak, it has evolved broadly in line with expectations in most regions. One exception is the US, where both headline and core CPI inflation have fallen back, reflecting a broader based slowdown. Wage inflation has also stalled, despite unemployment at a cycle low and business surveys highlighting difficulties in filling position. The normalisation process that appeared to be underway has been set

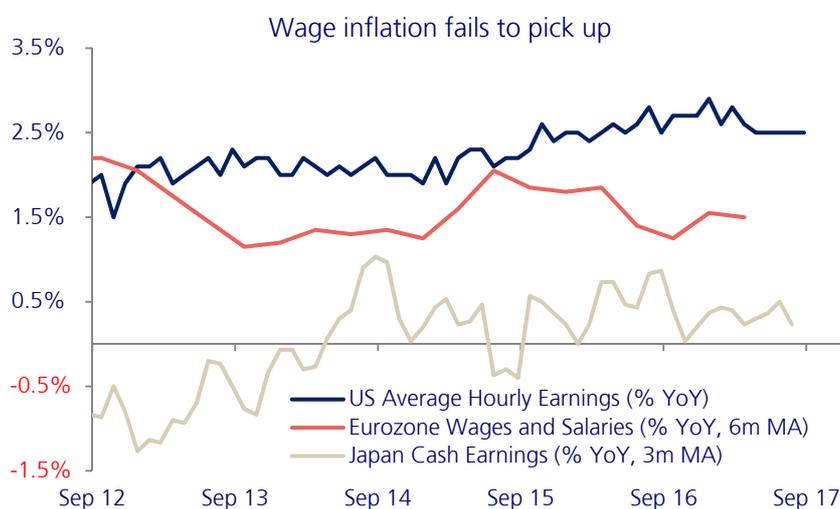
back, and belief in central banks' ability to control inflation has yet again been dented. Despite this, we expect a modest rise in US inflation later this year, as most of the weakness is likely to be temporary. With so many false dawns, however, stronger prints will be needed before "lowflation" fears diminish.

Inflation creeps higher in the Eurozone, amid stellar growth

Global factors are likely to be more supportive to inflation going forward, reflecting buoyant global demand. A significant development comes from the Eurozone, where underlying inflation is finally creeping higher. As the region is a driver of global trade and has a disproportionate impact on global pricing, this should help support inflation trends more broadly. The size of this effect will be modest though, as Eurozone inflation is expected to remain low for longer, with spare capacity still lingering within the region.

Risks to inflation are now tilted to the upside

Risks to inflation have tilted to the upside, given broad based and resilient growth dynamics. Yet market implied inflation expectations remain subdued at very low levels, suggesting a degree of complacency around inflation.



US

Inflation stabilises but stays modest

Inflation has slowed down markedly in recent months. A significant part of the slowdown was driven by the transportation component, which was dragged down by the fading energy base effect, as well as by a significant one-off impact from price cuts in the communication sector in spring. The slowdown in inflation is broader based, however, with important components such as housing and medical care costs contributing to the softening. Nevertheless, while overall price pressure remains relatively weak, most inflation measures have stabilised recently. Business surveys show that input costs have started to climb again and firms feel increasingly able to raise prices. Headline

CPI inflation accelerated slightly in July, both on a monthly and on an annual basis, reaching 0.1% and 1.7% respectively, after 0.0% and 1.6% in June. Core CPI remained at 1.7% YoY. The latest inflation data confirm that pricing pressure remains modest and producer prices measured by PPI were actually falling in July, dragging the annual rate back below 2%. While solid increases in key core CPI components, like medical services and owners' equivalent rent, point to stronger core CPI measures later this year, the acceleration is likely to remain muted.

UK

Inflation has peaked but price pressure remains high

Inflation rates continued to fall as the feed-through of the steep fall in the pound slowly fades. The annual CPI inflation rate remained at 2.6% in July, while the MoM rate was -0.1%. The price pressure in the value chain continues to normalise with PPI input prices 6.5% higher than a year ago, down from 10% in June and 20% at the beginning of the year. However, recent business surveys point to stronger cost pressures, in particular in the service sector, with the August rate of price inflation being the fastest in six months. The ever tighter labour market is one reason, leading to higher staff costs, but energy costs and prices for imported goods have contributed to higher input costs

as well. The manufacturing sector also saw an acceleration of purchase price inflation in August, for the first time since the beginning of the year. One reason for this is the rising cost of commodities. However, the overall rate of increase still remains well below the records seen earlier this year. Therefore, while it seems unlikely that inflation will reaccelerate to levels seen at the beginning of the year, price pressure remains high and continues to be a headwind for both households and firms.

Eurozone

Tentative signs of inflation picking up

There are tentative signs that underlying inflation in the Eurozone is picking up, albeit from low levels and at a gradual pace. Core inflation in Q3 has averaged 1.2% YoY so far. By contrast, over the past few quarters Eurozone core inflation was averaging around 0.9% after adjusting for temporary distortions due to the different timing of holidays this year compared to last. Although wage growth remains subdued, companies appear to be regaining pricing power due to stronger growth in the Eurozone. Service companies' selling price expectations, as reported by the PMI survey, are picking up for example. Inflation remains well below the ECB's 2% target. However, stronger

economic growth as well as constraints on how many more Eurozone governments bonds the ECB can buy, suggest that the bank will soon announce a reduction in its €60bn a month asset purchase programme. One risk to the inflation outlook is the recent strength of the euro, which, if sustained, could subtract around 0.2-0.3 percentage points off inflation in each of the next two years and could force the ECB to adopt a more dovish pace of tapering and language than it would otherwise.

Switzerland

Weaker franc unlikely to spur inflation

The trade-weighted franc has depreciated by almost 3% since Q2, and this should lend some support to inflation going forward. Despite this, we have left our benign forecast unchanged at 0.5% for this year and next, as downward pressure on wages and prices persist in many parts of the economy. Headline inflation, which ticked down to 0.3% YoY in July, is likely to move higher over the coming months, but this will mainly reflect base effects due to very weak prints last summer. Core inflation, also at 0.3%, gives a better indication of longer-term trends. The monthly prints have been weak recently, reflecting fairly broad-based price falls in in both services and goods

components. A cheaper franc will help to offset this weakness, and we therefore continue to expect underlying inflation to edge up, albeit at a gradual pace. With inflation expected to track well below the SNB's target for the foreseeable future, policy is anticipated to stay unchanged for the time being, particularly as political uncertainty abounds, and the move in the currency could prove short lived.

Japan

Still far from the BoJ's 2% target

We prefer to look at the CPI data for Tokyo instead of nationwide data, as Tokyo is one month ahead in publishing CPI statistics. Tokyo's CPI for August stood at 0.5% YoY, while it was zero excluding fresh food and energy. Even though this was slightly ahead of expectations, we regard this more or less as noise. Effectively, these numbers are still far away from the Bank of Japan's 2% inflation target, and the BoJ Governor recognised that in a TV interview at the Jackson Hole central bankers' meeting. The BoJ lowered its inflation forecast for the current fiscal year from 1.4% to 1.1% in July. Energy inflation has accelerated, but is expected to peak soon. While part-time wages have

accelerated over the course of this year, this has not spilled over to full-time wage growth. Regular wage growth is still hovering around only 0.5% YoY. The BoJ has silently begun tapering its JGB purchases to nearly half the still official commitment of JPY 80tn per year, as it already owns 40% of the total market. While Governor Kuroda highlighted that 60% are still available, we think that is unlikely, as institutional investors will not be willing to sell their core holdings. The 10yr JGB yield continues to be anchored at 0%.

China

Tepid CPI and slowing property price inflation

Falling meat prices (pork -15.5% YoY) were the main drag on CPI inflation of only 1.4% YoY in July, while non-food inflation, at 2%, fell to the lowest level this year. Gasoline and diesel prices fell, while healthcare and tourism related prices keep rising. As we expect CPI inflation to stay below 2% in the second half of the year, it is expected to remain clearly below the official 3% target this year. We have pencilled in a rate of 1.7% for this year and 2.3% for next year. Producer price inflation picked up sequentially due to rising steel prices, but held steady on a YoY basis at only 5.5% in July. Capacity cuts and stricter environmental regulation has had a positive impact on metal prices, while

coal and petroleum prices keep falling. We expect monetary policy to remain neutral for the rest of the year. Property price inflation in the top 70 cities eased to 0.5% MoM and 9.3% YoY in July. Home prices stayed flat in tier-1 cities on a sequential basis, and it is interesting to note that price momentum has started to ease even in smaller tier-2 and tier-3 cities, with both categories showing price increases of 'only' 0.4% MoM. We predict a slowdown in real estate investment for the rest of the year due to falling price momentum and developers suffering from funding constraints.

Australia

CPI slowly rising as the output gap turns less negative

Australia has escaped the "lowflation" regime experienced in 2016, mainly under the impulse of higher administered prices. Electricity prices jumped by ~10 - 20% in July, which will impact headline CPI to the upside in Q3. There are signs that cost-push inflation is starting to filter through expectations: the Melbourne Institute Monthly Inflation Gauge has risen to its highest level since May and 10yr breakeven rates are stabilising. The PMI input price component is on an upward trend but the output price index is stagnating, which shows that it will take some time before businesses pass on higher costs to consumers. As for core inflation, it bottomed to ~1.9% in H1. We expect it to grind slightly higher in H2, as investment increases

and the output gap turns less negative. Further upside will depend on the evolution of housing prices and wages. On the housing side, uncertainty is high: leading indicators point to a cooling-down later this year, but dwelling price growth has surprised to the upside so far. Wage growth shows tentative signs of bottoming, but the rebound should be shallow and slow in our view. Indeed, employment gains and wage increases remain concentrated in lower-paid public service sectors. Overall, we see 2017 headline CPI tracking slightly above 2% and underlying CPI settling around 2%. As CPI returns to the bottom of the RBA's 2-3% target range, we see the central bank comfortably on hold this year.

ASEAN

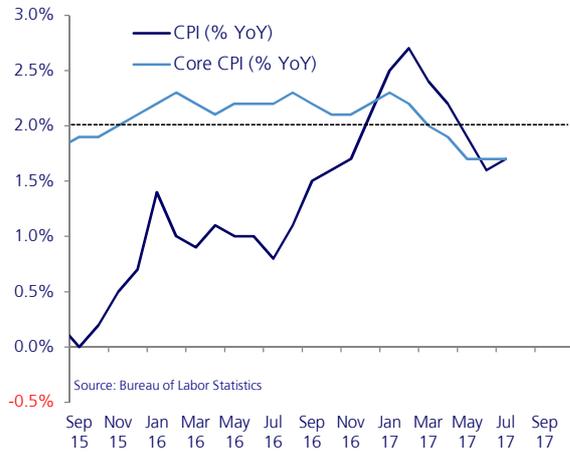
Headline inflation weaker for longer and divergent paths for core inflation

Food prices have collapsed year-to-date, which has weighed on headline inflation in Asia, where food accounts for a large share of the national CPI baskets. The negative base effects of food and fuel inflation are likely to linger into Q3, which should put a lid on headline CPI. Weather forecasters have a neutral assessment on El Niño, which should keep food prices contained in Q4, but uncertainty remains. Looking at core CPI, the trajectories vary across countries and tend to mirror economic activity. Malaysian core inflation follows a slow but steady upward trend, as private consumption improves. High inflation expectations and growing wage pressure suggest that core

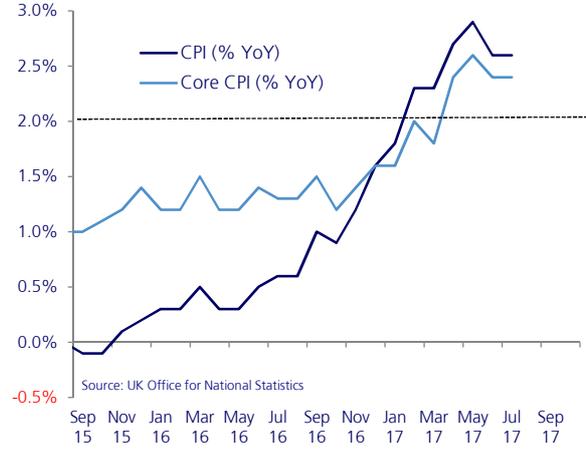
CPI will continue its ascent in H2. In Indonesia, core CPI has weakened year-to-date in conjunction with softer household consumption. We expect domestic demand to improve slightly in H2 as a result of looser fiscal policy and recovering private investment. We foresee 2017 headline inflation settling at ~3.9% YoY in Indonesia and ~3.8% in Malaysia. Bank Indonesia will likely retain an accommodative bias. The central bank will look pragmatically at economic and lending data, while observing the consequences of the Fed and ECB announcements on financial markets. Bank Negara Malaysia will probably adopt a more hawkish tone, but is unlikely to hike rates this year.

Current and historic inflation

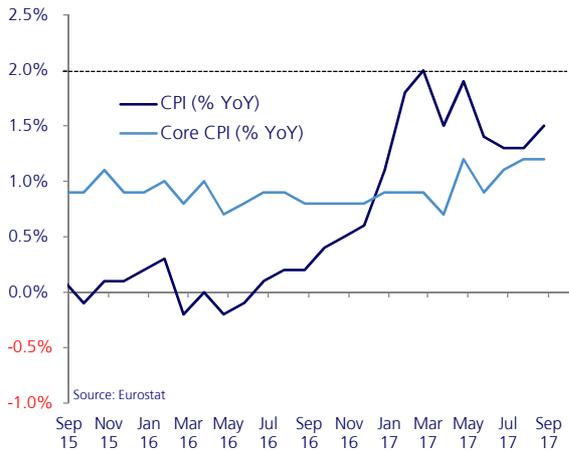
US: modest rebound expected



UK: inflation peaking but will remain high



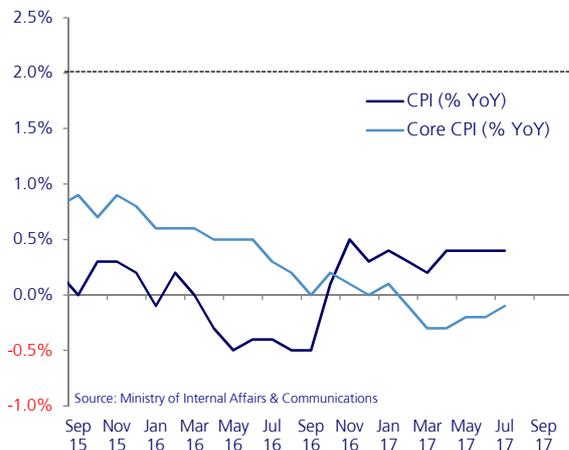
Eurozone: core inflation edging up



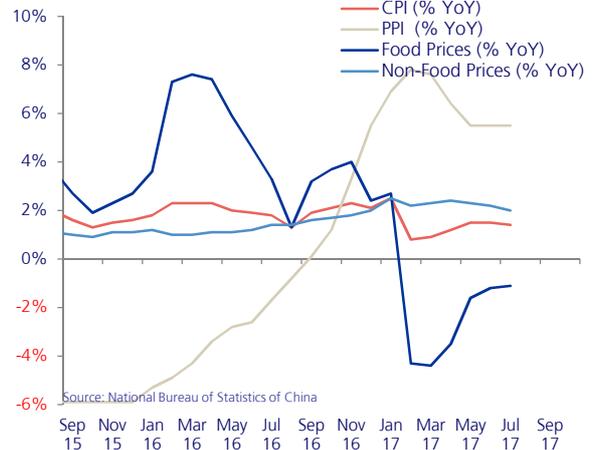
CH: inflation to plateau at a low level



Japan: still far away from target



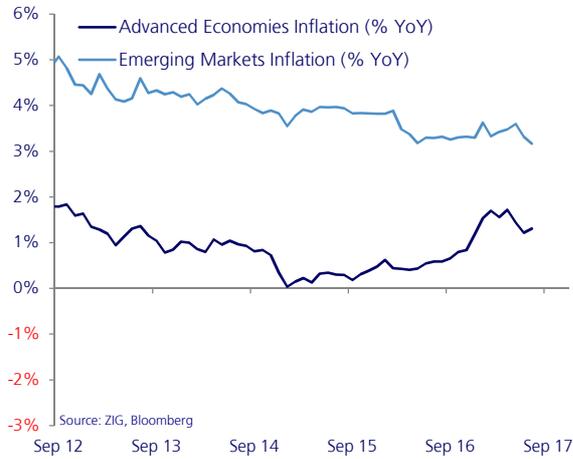
China: inflation will stay tepid



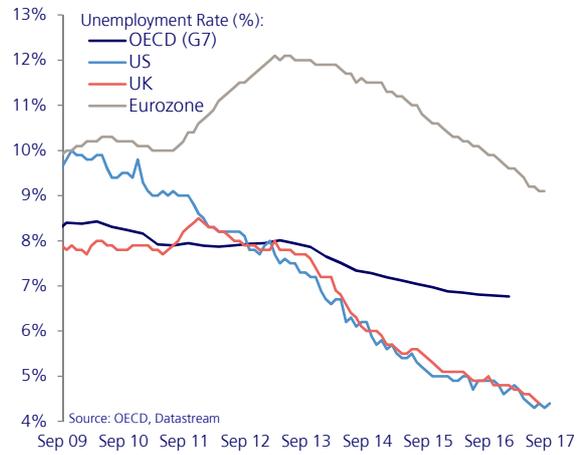
* Dashed lines show inflation targets or equivalent

Key indicators

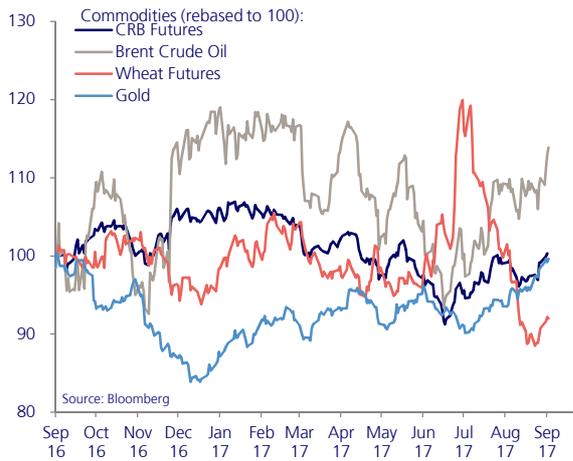
Uptrend still in place in advance economies



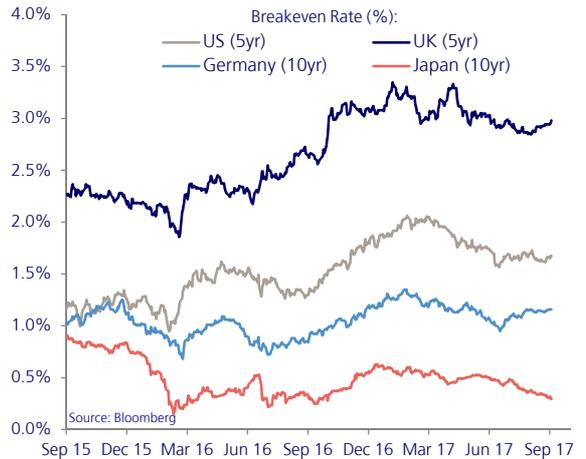
Little slack left in some regions



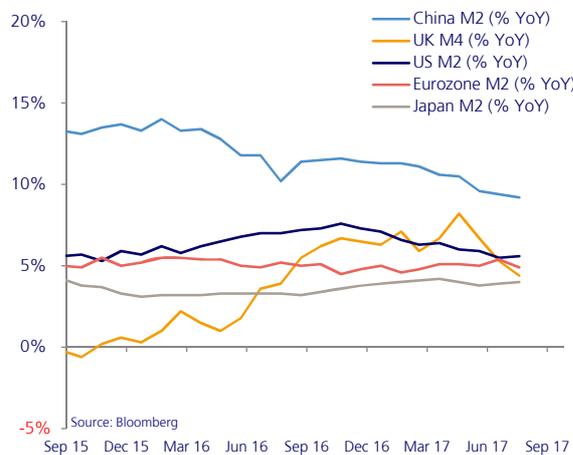
Commodity prices rising



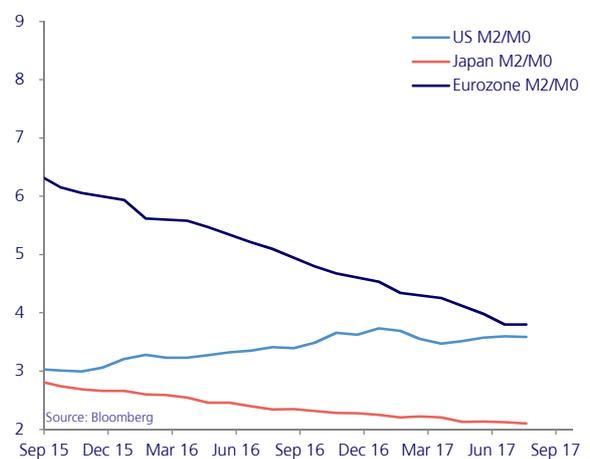
Inflation expectations mostly edging higher



Lending growth not a problem



Money multipliers not a cause for concerns



Consumer Prices (Annual Percentage Change)*

	Zurich's Point Estimate			Consensus Forecasts	
	2016	2017	2018	2017	2018
US	1.5	2.0↓	2.2	2.0↓	2.0↓
UK	1.0	2.5	2.2	2.7	2.6↓
Eurozone	0.2	1.5	1.6	1.5	1.3↓
CH	-0.4	0.5	0.5	0.4↓	0.6↓
Japan	-0.2	0.5	1.0	0.5	0.8
China	2.0	1.7	2.3	1.8	2.1
Australia	1.4	2.0	2.5	2.1↓	2.3
Asia	1.7	n/a	n/a	1.8	2.1
Argentina	38.3	n/a	n/a	22.2↑	15.6↑
Brazil	6.7	n/a	n/a	3.5↑	4.2
Chile	3.1	n/a	n/a	2.3↓	2.9
Mexico	3.2	n/a	n/a	6.1↑	3.9

* Arrow show changes over the last month. 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.

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