May 16, 2018

ZURICH®

Inflation Focus Q2

Key Points

- US inflation is approaching target, but underlying trends remain modest and we do not anticipate a spike higher
- Inflation is low outside of the US, though global factors and tighter labour markets should lead to gains over time
- The mix of weaker currencies and higher commodity prices is expected to raise inflation in emerging markets
- Inflation is not expected to become a problem over the course of this economic cycle as global headwinds persist

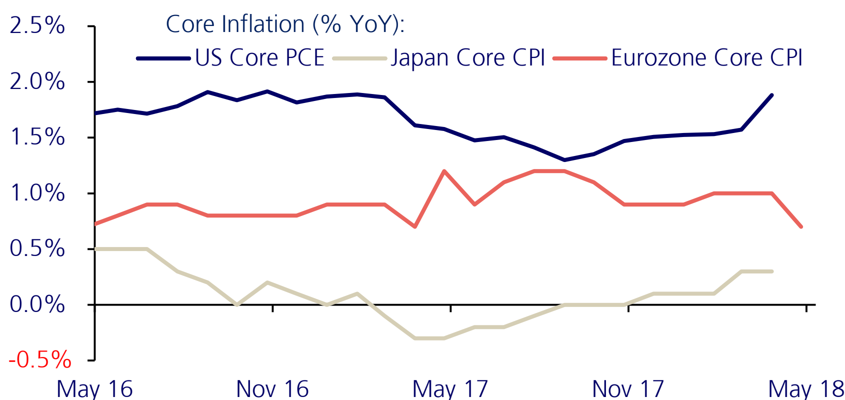
Source: iStock by Getty Images

The lows in inflation are behind us, with US inflation approaching target
The Fed's targeted measure of inflation, core PCE, is set to reach 2% shortly for the first time in a decade (except for a brief period in 2012). The US is unique though, and inflation is still weak elsewhere. Over the coming year we expect some of this weakness to wane given better growth, higher commodity prices, tighter labour markets and a bottoming of inflation in emerging markets. Inflation is unlikely to become a problem, however, as policy normalisation is set to take the edge off growth while spare capacity persists globally. Indeed, coupled with the ongoing trends towards outsourcing and automation, a sharp rise in inflation is unlikely to materialise over the course of this economic cycle.

Global factors should raise inflation over the near term
The global environment has become more reflationary as a result of the synchronised growth upswing. Oil prices are up 50% YoY, partly driven by stronger demand, and this will push up headline inflation over the coming months. While this effect will wane over time, the broader recovery in world trade and rising producer prices, including in China, should trigger stronger price pressures in global supply chains. We expect this to reduce the drag from weak goods and import price inflation in many regions.

Tight labour markets shift the balance towards stronger wage gains
The growth upswing has also triggered strong job growth and further falls in unemployment, now at cycle lows in many regions, and this should lead to a modest rise in wage inflation over the coming year. Aggregate wages move slowly, however, and there are only tentative signs of stronger wage dynamics in the Eurozone and Japan. Even in the US, the lack of a convincing acceleration in wages is puzzling. This is a key reason for why central banks need to tread cautiously in removing stimulus.

Global headwinds to higher inflation persist



Source: Bloomberg

The disinflationary impulse from emerging markets is diminishing
Falling inflation in emerging markets, most notably in Latam but also in Asia, contributed to weak global inflation trends over the past few years. This is now reversing, given rising energy prices and currency depreciations. Past monetary loosening also helped to spur growth, which is resulting in stronger domestic price pressures. Central banks are responding to this, ending policy loosening or initiating a rate hike cycle, which we anticipate will cap the upside to EM inflation.

Central banks will not be in a rush to remove support
Recent actions and rhetoric show that central banks are prepared to temper the pace of tightening in the event of continued weakness in inflation and wages. This will help sustain the cycle and support a rise in inflation towards target. The Fed, while normalising policy, is also emphasising the symmetry of the inflation target. We believe this is a prudent approach as it reduces the risk of a policy mistake amid still very benign wage and inflation trends.

US

The Fed is close to reaching its inflation target

Headline CPI inflation accelerated to 2.5% YoY in April from 2.4% in March while core CPI remained at 2.1%, the same as the month before. The significant pickup in annual rates relative to the beginning of the year was caused by base effects as last year's massive mobile phone price cuts fell out of the comparison in March. On a monthly basis, CPI inflation rose to 0.2%, which was below consensus expectations, indicating that near-term price pressure is relatively modest. This is confirmed by a slowdown in producer price increases in April. Nevertheless, the rise in energy prices and generally tighter capacity will help to keep headline inflation above 2% for the time being. Core PCE re-accelerated to 1.9% YoY in March, bringing the Fed close to reaching its inflation target. Healthcare inflation is expected to rise back to its historical trend and shelter costs are likely to recover from their recent soft patch. Therefore, two major components are likely to support core inflation rates over the course of the year. Wage growth has so far failed to pick up significantly, despite the ever tighter labour market, so any wage-induced pressure on service inflation has been relatively limited so far. However, broader measures such as the employment cost index indicate more support for inflation rates going forward.

UK

Inflation is expected to moderate

Inflation continues to soften as the impact of the weaker currency is fading and the slowdown in economic activity is further reducing price pressures. Accordingly, headline CPI inflation has slowed down to 2.5% YoY in March from 2.7% in February and a peak of 3.1% last November. Core CPI has fallen as well, reaching 2.3% in March after 2.4% the month before. While we expect inflation rates to stabilise going forward further deceleration is likely to happen at a more moderate pace. Producer input price increases reached 4.2% YoY, slightly accelerating from 3.8% in March, indicating that the steepest fall lies behind us. Higher commodity prices, in particular energy, and the renewed weakness of the pound will have a positive impact on inflation rates. Sterling has fallen by more than 6% relative to the dollar since mid-April and is now back at the level it was at the beginning of the year. Wage growth has reaccelerated to the highest rate in three years, reaching 2.8% YoY in February, and the unemployment rate has fallen to the lowest since 1975. Higher wages will eventually feed through the value chain to put upwards pressure on prices, further slowing down the fall in inflation.

Eurozone

The ECB is likely to end QE this year despite low inflation

Headline and core inflation have been soft in the Eurozone so far this year. However, we expect both core and headline inflation to pick up over the next few quarters, albeit gradually. In Q1, Eurozone headline and core inflation averaged just 1.2% and 1.1 % respectively. What's more, in April, core inflation actually fell back to only 0.7% YoY, due to the different timing of Easter compared to last year, which affected holiday travel costs and services inflation in particular. However, we expect core inflation to bounce back as this temporary distortion unwinds. More fundamentally, there are tentative signs that wage growth is accelerating in the Eurozone as the recovery continues, while companies are also reporting some pricing pressures in their production processes. Recently, wage deals in Germany have been agreed implying around 3.0% annual wage growth in 2018 and 2019, after a 2.5% pace in 2017. Overall, this suggests that underlying inflation will pick up over the next few quarters, albeit gradually and it will still remain below the ECB's 2% target. Nevertheless, we expect the ECB to end QE this year with a taper of asset purchases in the final quarter of 2018, and to raise interest rates in 2019, though probably not before the middle of next year.

Switzerland

Weak domestic inflation offsets rising import prices

CPI Inflation has been flat since the turn of the year, at 0.8% YoY, following a sharp acceleration in 2017. Core CPI is weaker and soft domestic goods and services price inflation continue to offset rising import prices. Monthly price increases have picked up some momentum, however, with the headline CPI measure rising by a solid 1% over the past 3 months, and similarly for core CPI. This supports our view that deflationary trends are diminishing, and we expect annual inflation to edge up over the course of the year, averaging 1% in 2018, with risks now tilted to the upside. This is much stronger than the SNBs projection of only 0.6%, but we expect them to raise their forecast, in particular as the currency has weakened notably. Capacity pressures are also on the rise, especially in the manufacturing sector, and pricing power is set to improve modestly in the stronger global growth environment. While this should underpin the near-term profile for inflation, structural headwinds persist, above all in the consumer segment where prices remain uncompetitive. After a modest gain in 2018, we therefore expect inflation to flatten out in 2019. This justifies, in our view, a dovish stance from the SNB.

Japan

The BoJ drops the FY 2019 time frame for reaching the inflation target

Bad weather conditions led to a surge in food price inflation earlier this year. Though this effect is waning, with fresh food prices moderating from +12.4% YoY in February to 6.3% in March, it is a component that has an impact on how households perceive inflation. The latest consumer confidence survey reveals that household price expectations indeed moved from 2.15% to 2.32%, a two-year high. Higher gasoline prices also may have had an impact. Service related price trends are mixed. While general private service inflation is miniscule, we believe rising labour costs will have an impact going forward, albeit only gradually. Public service prices are rising at a relatively steeper pace, driven by higher medical care prices. For monetary policy, the more important inflation measure is the core CPI definition ex fresh food and energy. Based on April statistics available for Tokyo, this measure stands at only +0.3% YoY and fell for the second month in a row on a sequential basis. This may have been one reason why the Bank of Japan finally dropped the reference to a definite time frame for its 2% inflation target. In the recent quarterly outlook, the BoJ board members issued an inflation forecast for FY 2020, ranging between 1.5% and 1.8% excluding the impact of the 2019 consumption tax hike.

China

Despite pockets of inflation, overall price pressures remain benign

Inflation will not be a hot topic in China this year, with price pressures even expected to ease somewhat going forward. Core CPI has been creeping higher over the last two years, but we expect it to stabilise around the 2% level. On an overall basis, falling food price inflation contributed to a notable fall in China's CPI in April to only 1.8% following the recent spike to 2.9% YoY in February. Part of this moderation has been seasonal, as Lunar New Year was celebrated in February this year. Despite higher fuel prices, non-food inflation remains stable overall. Food price inflation is expected to inch higher in the rest of the year as higher corn and soybean prices should push up pig feed prices and finally pork prices. This trend would accelerate if a 25% tariff were to be imposed on US soybean imports. But what is more important on an aggregate level is the persisting trend of deleveraging and slower credit growth in the economy, which will also keep a lid on rising labour costs. Producer price inflation is expected to pick up towards 4% in Q2 due to a base effect, but inch down again toward 2% for the rest of the year. In the property market we are observing a clear, and desired, price stabilisation in the tier-1 and top-tier-2 segment (the bigger metropolitan areas), while lower tier-2 and tier-3 cities are still showing an uptrend in property prices.

Australia

Modest inflationary pressures to keep the RBA on hold until 2019

In Q1 2018, underlying inflation has lifted to 1.95% YoY, closer to the central bank's 2-3% target. Wage growth also seems to have troughed: the wage price index ticked up to 2.1% YoY in Q4 '17. Improvements in employees' earnings are likely to occur slowly, however. Surveyed firms and labour unions foresee broadly stable wage growth this year. At 14%, the total underemployment rate has been sticky, as labour force participation has risen in conjunction with employment growth. We are confident that the labour market will tighten in 2018 and 2019: business confidence is close to all-time high levels, and fiscal and monetary conditions are likely to remain accommodative. Indeed, the RBA forecasts that underlying inflation will rise above 2% for the first time in 2020, thereby signalling that it is willing to wait for wage pressures to pick up.

Turning to the remaining drivers of inflation, we expect muted growth for retail prices. The cool down in property prices is also likely to weigh on inflation. One source of upward pressure could come from tradable inflation, as global oil prices continue their ascent and the AUD weakens slightly. Overall, we forecast headline CPI growth to reach 2.3% YoY in 2018, revising our last estimate slightly lower.

Indonesia

The end of disinflation

The slowdown in CPI growth that started in June 2017 has likely come to an end. Last year, softer food prices and stable fuel prices weighed on headline inflation. Indeed, the government has been controlling supply and imports of agricultural products, which has weighed on the prices of food, the largest component of the CPI basket. Going forward, controls are likely to remain in place, but raw food prices have rebounded and will probably firm up ahead of the Ramadan season. As for electricity and fuel, the government has announced that it would not raise subsidised prices in either 2018 or 2019, years in which there will be local and general elections. More recently, the government has declared that it would also control retail prices for non-subsidised fuel. These measures should keep headline CPI within the 2.5%-4.5% target fixed by the central bank. However, the rupiah has depreciated by 3.5% against the USD year-to-date, and volatility in local assets is likely to persist as the US Fed normalises policy. This will push inflation higher, in our view. Bank Indonesia is unlikely to let the currency depreciation run too far though, and has stated that it would raise rates as a second line of defence after FX intervention. In the run up to June local elections, core inflation should also recover. Overall, we expect headline CPI to hover around 4.0% in 2018.

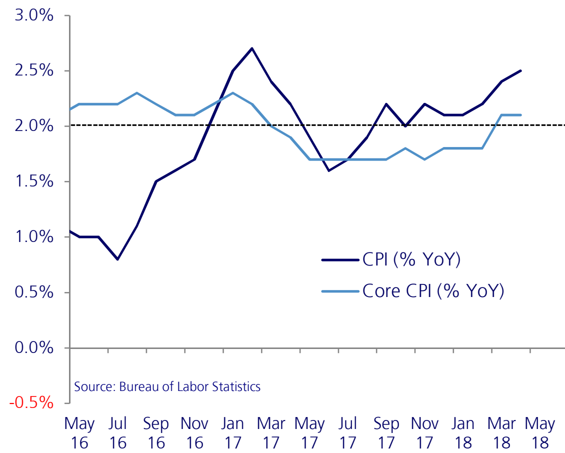
Malaysia

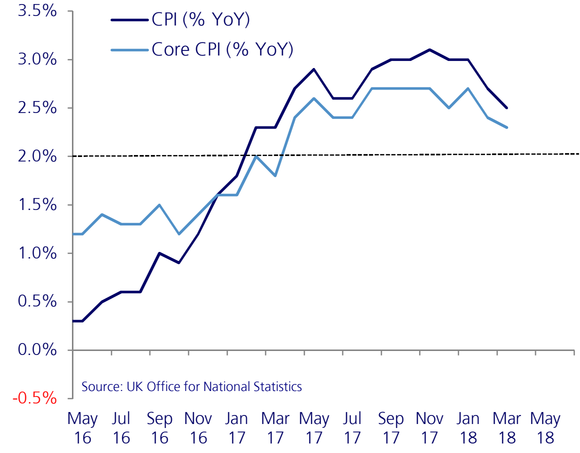
New regime's policies are likely to add to inflation

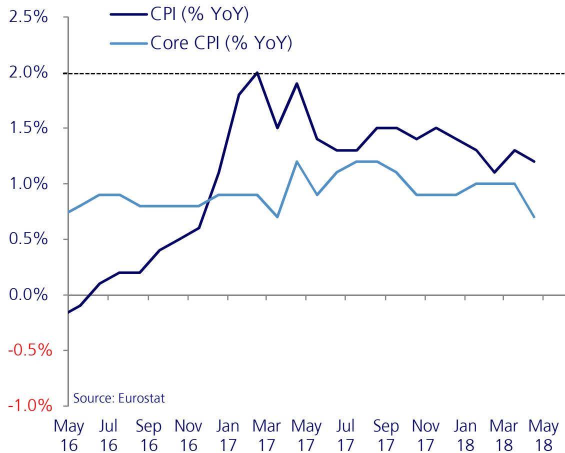
Unfavourable base effects for transport inflation are responsible for underwhelming headline inflation in Q1. Indeed, following fuel prices hikes in 2017, pump prices have remained rangebound in 2018, and even stable since a few weeks. Fuel and other staples prices theoretically follow a "market-based formula", but we suspect that prices have been kept artificially steady in the weeks preceding May general elections.

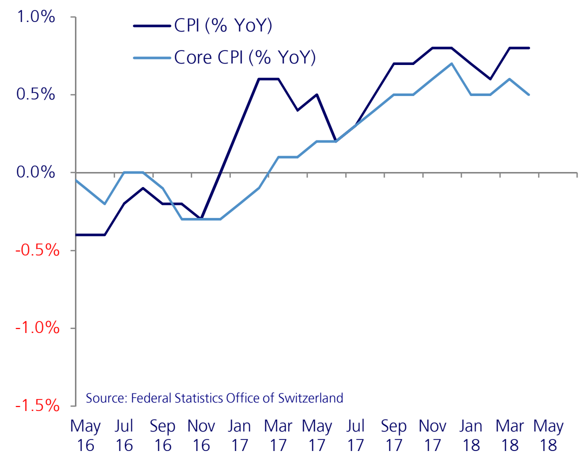
Going forward, the policies implemented by the new government are likely to be inflationary. A hike of the minimum wage will probably put pressure on core inflation, as the labour market is already tight. The other fiscal measures also appear more generous, and are expected to boost private consumption. The pass-through to consumers will be controlled by the government, however. Scrapping the Goods and Service Tax and restoring fuel subsidies should limit cost-push inflation. Headline CPI is likely to rise from depressed Q1 levels to hover around 3.0% YoY in 2018. This stays within the forecast range of Bank Negara Malaysia, and we therefore expect the central bank to stand pat this year. However, our forecasts remain subject to policy uncertainty. The announcements made by Prime Minister Mahathir during his first 100 days in office will be critical.

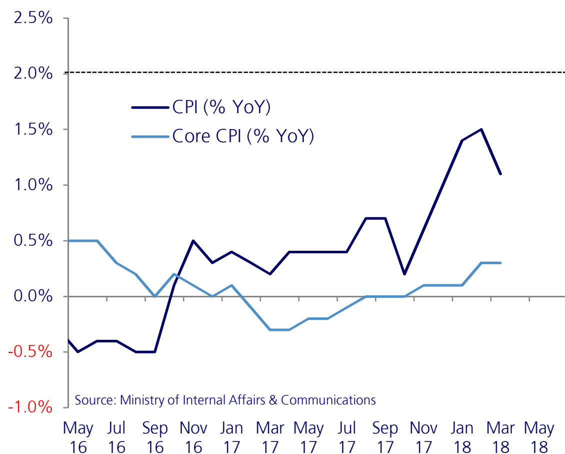
Current and historic inflation

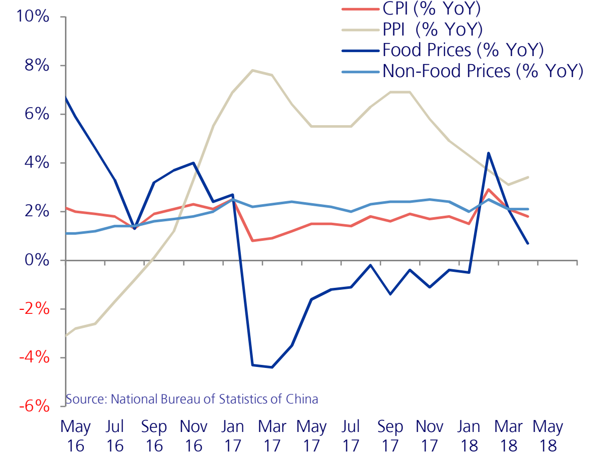






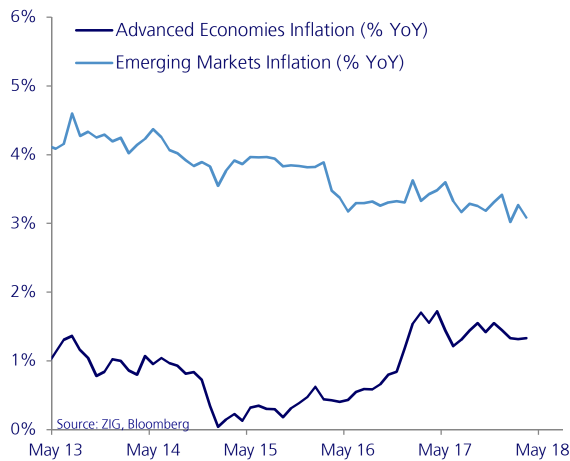


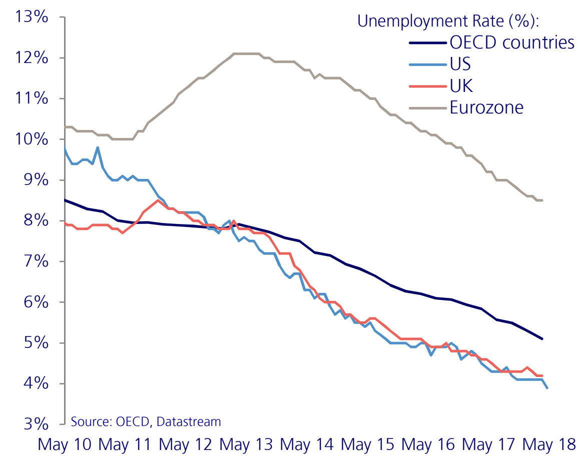


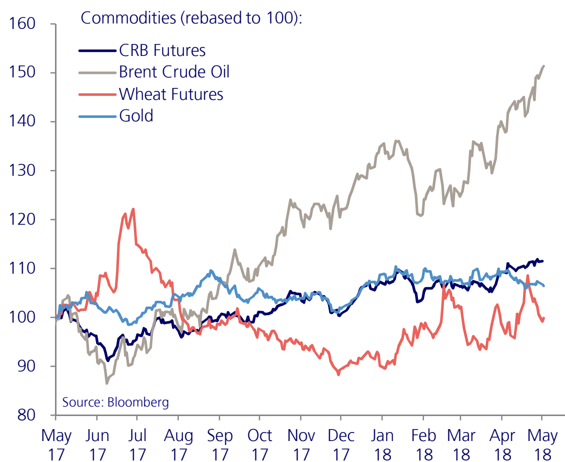


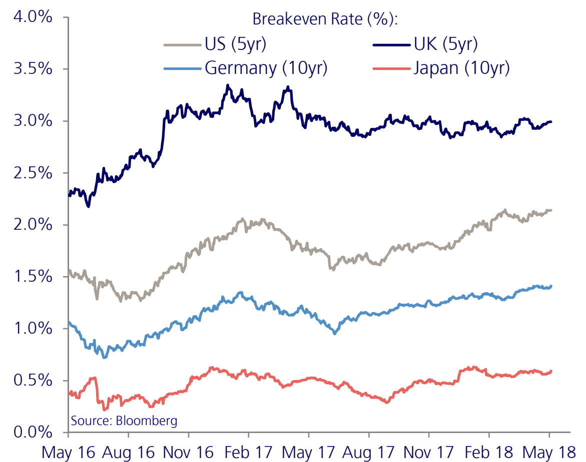
* Dashed lines show inflation targets or equivalent

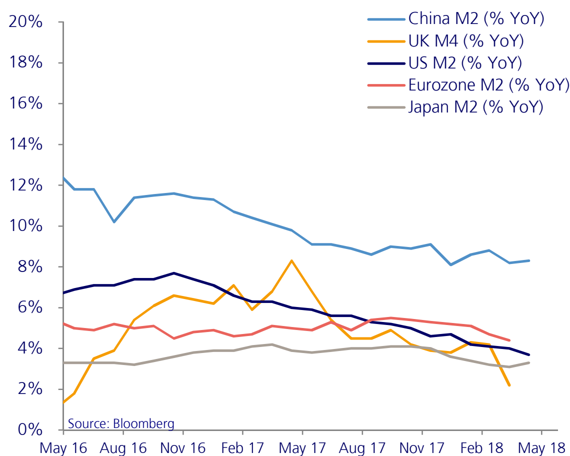
Key indicators

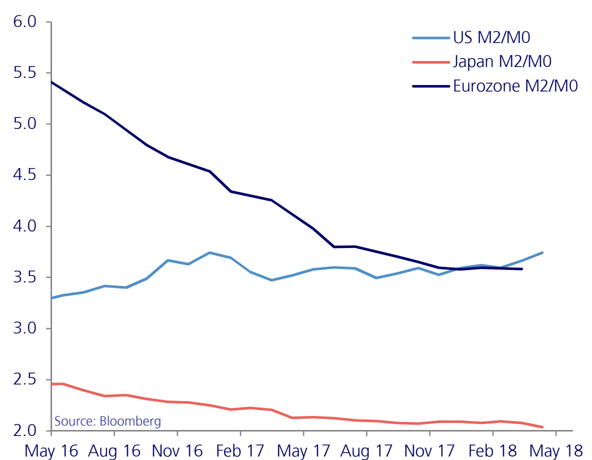












Disclaimer and cautionary statement

This publication has been prepared by Zurich Insurance Group Ltd and the opinions expressed therein are those of Zurich Insurance Group Ltd as of the date of writing and are subject to change without notice.

This publication has been produced solely for informational purposes. The analysis contained and opinions expressed herein are based on numerous assumptions concerning anticipated results that are inherently subject to significant economic, competitive, and other uncertainties and contingencies. Different assumptions could result in materially different conclusions. All information contained in this publication have been compiled and obtained from sources believed to be reliable and credible but no representation or warranty, express or implied, is made by Zurich Insurance Group Ltd or any of its subsidiaries (the 'Group') as to their accuracy or completeness.

Opinions expressed and analyses contained herein might differ from or be contrary to those expressed by other Group functions or contained in other documents of the Group, as a result of using different assumptions and/or criteria.

The Group may buy, sell, cover or otherwise change the nature, form or amount of its investments, including any investments identified in this publication, without further notice for any reason.

This publication is not intended to be legal, underwriting, financial investment or any other type of professional advice. No content in this publication constitutes a recommendation that any particular investment, security, transaction or investment strategy is suitable for any specific person. The content in this publication is not designed to meet any one's personal situation. The Group hereby disclaims any duty to update any information in this publication.

Persons requiring advice should consult an independent adviser (the Group does not provide investment or personalized advice).

The Group disclaims any and all liability whatsoever resulting from the use of or reliance upon publication. Certain statements in this publication are forward-looking statements, including, but not limited to, statements that are predictions of or indicate future events, trends, plans, developments or objectives. Undue reliance should not be placed on such statements because, by their nature, they are subject to known and unknown risks and uncertainties and can be affected by other factors that could cause actual results, developments and plans and objectives to differ materially from those expressed or implied in the forward-looking statements.

The subject matter of this publication is also not tied to any specific insurance product nor will it ensure coverage under any insurance policy.

This publication may not be reproduced either in whole, or in part, without prior written permission of Zurich Insurance Group Ltd, Mythenquai 2, 8002 Zurich, Switzerland. Zurich Insurance Group Ltd expressly prohibits the distribution of this publication to third parties for any reason. Neither Zurich Insurance Group Ltd nor any of its subsidiaries accept liability for any loss arising from the use or distribution of publication. This publication is for distribution only under such circumstances as may be permitted by applicable law and regulations. This publication does not constitute an offer or an invitation for the sale or purchase of securities in any jurisdiction.

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001632(01/16) TCL