December 3, 2020

Inflation Focus Q4

Key Points

- Global inflation is in a bottoming process, but renewed lockdowns are likely to delay a recovery
- Core inflation will remain under pressure as labour market dislocations exert downward pressure on wages
- Businesses face a challenging environment with minimal pricing power in many industries
- Policy stimulus is unlikely to be inflationary over the near to medium term as uncertainty and job losses curtail spending
- Longer-term trends in inflation are also expected to be contained due to vigilant central banks

Source: iStock by Getty Images

Disinflationary forces will remain in place for longer

Global inflation has rebounded as services prices, which were severely impacted by the first round of lockdowns, have partially recovered. While the immediate impact on inflation of the collapse in demand is fading away, labour market dislocations will continue to weigh on inflation. Job security and confidence have been damaged and unemployment is high or artificially supressed. In this environment, wage inflation should weaken further, prolonging the disinflationary impulse of the COVID-19 crisis. Broader downward pressure on costs and prices will also persist, as corporates focus on rebuilding profit margins in an environment with weak demand and limited pricing power.

Renewed lockdowns will weigh on the recovery in inflation

The second wave of infections will hamper economic activity over the winter period. The pace of improvements in the US labour market has slowed and GDP growth should turn negative again in the UK and the EU. Unemployment is also edging higher Europe, despite extensions to furloughing and part-time work support. This will amplify the disinflationary impulse over the next few months, but the drag should be much less than during the first wave of infections. Lockdowns are not as severe, many emerging markets are faring better, and positive vaccine developments will bolster sentiment and spending and limit job losses.

Supply disruptions unlikely to trigger inflation, as capacity remains in place

Some feared that disruptions to the supply side of the economy could trigger higher inflation, as lockdowns and border closures led to a collapse in trade and production. This was not the case, however. Instead, the slump in global demand and the surge in under and unemployment dominated any inflationary impact from the supply side. Moreover, global supply chains have been resilient, and goods production and global trade have recovered strongly, with most capacity appearing to remain in place.

Services will face a challenging recovery, with weak pricing likely to persist

Many services, including air and cruise travel, hotels and leisure activity, still suffer from weak (or non-existent) demand. Some services capacity will likely be permanently lost, as the crisis has made business models unviable. This could lead to upward pressure on prices in select areas as a vaccine is rolled out, allowing social activities to resume. We do not expect services inflation to become a problem though. The shock that hit the sector is unprecedented and a more sustainable recovery will take time to build. Local labour markets, which are important for services, are weak, and this will bear down on labour costs.

Prospects for a shift towards debt-financed government spending is limited

Prospects for a longer-lasting, debt-financed increase in government spending, which could bring about a public spending led build-up in demand and inflation, look limited, despite a shift towards coordinated fiscal and monetary policy. In the US, a divided government is likely, which reduces prospects for a substantial public infrastructure programme. In Europe, the EU's recovery plan aims at strengthening government and private sector investment during the recovery phase. It is, however, limited in size and follows a collapse in output, which reduces its inflationary impact. In many other regions, stretched public finances limit the willingness and/or capacity of governments to engage in broader recovery plans. With this in mind, and given underlying weaknesses in the global economy, including elevated debt and a lack of growth drivers, the synchronised economic recovery that we expect for 2021 is likely to be relatively short-lived, with limited inflationary consequences.

Central banks should remain vigilant, but inflation uncertainty has increased

While fiscal spending should fall back over the coming year, central banks will stay accommodative. The Fed's shift to an average inflation target implies that rate hikes should be delayed compared to past economic cycles. After a decade of undershooting the inflation target, this is a good thing, but it is too early to judge if the new target will be achievable. This will depend on how the Fed behaves once the economy runs hot and inflation pressures start to build up. Moreover, given the Fed's continued focus on inflation, we expect it to stay vigilant and tighten policy if inflation starts to build up more strongly. The same holds for other major central banks. Since debt-heavy economies are sensitive to changes in borrowing conditions, this should choke off any excess inflation. That said, we cannot rule out pockets of higher inflation, and the uncertainty around longer-term inflation prospects has increased.

US

The Fed moves to an average inflation target

Inflation rates have recovered since the economy reopened in the aftermath of the first COVID-19 wave, with the headline CPI rate at 1.2% YoY in October while core CPI came in at 1.6%. The Fed's favourite measure, core PCE, remains well below 2%, hovering around 1.3% over the past three months. In the near term, inflation is expected to remain muted as the economy faces new headwinds caused by the second wave of COVID-19. Later on, as the economy moves towards normalisation helped by the broader availability of a vaccine, inflation rates will rise further, as indicated by a number of recent business surveys that report higher input prices.

Following a review of its monetary policy framework, the Fed announced a crucial change in its policy approach by shifting its focus from an inflation to an average inflation target. The FOMC has committed to maintaining the current low target range for the federal funds rate until inflation has risen to 2% and is on track to moderately exceed 2% for some time. The Fed does not expect a rate hike before 2024. Although we think inflation will reach the Fed's target sooner than the FOMC's projection implies, we are unlikely to see any tightening in the coming year.

UK

Trade frictions may lift input prices, but overall price pressure is modest

Given the ongoing headwinds to economic activity and a likely contraction in the fourth quarter, inflation rates have hardly recovered from the lows reached during the peak of the crisis. Headline CPI inflation stood at only 0.7% YoY in October while core CPI was holding up better, rising back to 1.5%. The near-term path of input prices and inflation will depend on which sort of Brexit the UK faces at the end of the transition period. Whether there is a trade deal or not, trade frictions will increase in the coming months. An increasing number of firms report a lengthening of suppliers' delivery times. Much of the shipping delays were linked to bottlenecks at UK ports.

Rising freight costs and stretched supply chains played an important role in lifting the overall rate of input price inflation to the fastest in two years. To support economic activity as well as the functioning of financial markets the Bank of England (BoE) has significantly increased its asset purchase program and cut the Bank Rate to 0.1%. It is likely to keep its policy very loose in 2021. However, inflation is not expected to rise enough to force the BoE into tightening its policy as a significant amount of slack will remain in the economy.

Eurozone

Inflation to stabilise in 2021, but will stay well below target

The sharpest recession on record in the Eurozone has led to a deep slump in inflation in 2020, with core inflation at a record low of 0.2%, down from 1.2% in January, and headline inflation negative. The strong economic recovery we anticipate in 2021 should allow inflation to gradually stabilise, and we will probably see headline inflation move back into positive territory, depending on what exactly happens to commodity prices, especially oil prices. However, underlying inflation is likely to remain well below the ECB's target of "below, but close to, 2%" in 2021. As a result, we expect the ECB to continue with its aggressive QE and PEPP asset purchases through the whole of 2021. We also expect Eurozone governments to continue with substantial fiscal stimulus. However, even with this stimulus unemployment will likely remain high and wage growth subdued through the whole of 2021 given the substantial amount of slack that has built up in the economy, meaning that any pickup in underlying inflation will be slow.

Switzerland

Deflation persists

The pricing environment is deeply deflationary. Consumer prices are falling at an annual pace of -0.6%, following a recovery from the trough of -1.3% in June. Core prices are broadly stable, at -0.1% YoY, up from -0.8% in June. The rapid rebound in annual inflation partially reflects base effects, while underlying price pressures remain weak. The drag from domestic services prices, including leisure goods and transportation, is strong. Import prices are deeply deflationary, currently falling at -5.6% YoY, reflecting both the strong franc and a weak global pricing environment. With intense downward pressure on profit margins and costs, producer prices are falling across most components.

Wage data is not yet available, but reliance on part-time work support has been extensive and businesses are cutting back on jobs. Given this, wage pressures will be minimal. Against this deflationary backdrop, we expect CPI to continue to fall in 2021, at an average rate of -0.2% YoY, up from -0.8% in 2020. The second half of the year will likely bring stronger dynamics, helped by a weaker franc, but this is unlikely to be enough to raise inflation more substantially. The SNB is set to leave policy unchanged well beyond 2021, continuing to rely on negative interest rates and currency interventions to stabilise the currency.

Japan

CPI is expected to hover around zero in 2021

Disinflationary trends have re-emerged in Japan. For the first time since 2016, Japan's CPI is back in negative territory. Focussing on core inflation instead, we note that the so called 'core core' CPI used by the Bank of Japan (excluding fresh food and energy) tended to hover in negative territory during the first 13 years this century (apart from 2008), and is now revisiting this territory again, falling to -0.2% in October. This reflects the fact that the effects of last year's consumption tax hike and free preschool education and childcare are no longer distorting the YoY comparison. Meanwhile, the impact of the 'Go To Travel' campaign this year, particularly the delayed inclusion of Tokyo after the second wave of COVID-19 infections subsided, pushed accommodation prices down by more than 30%, which is expected to persist as long as the campaign is running. We expect it to be in place at least until mid-May 2021, if not even until August 2021, once the Paralympics have ended. Falling oil prices are reflected in falling energy prices (gasoline, electricity), which will exert downward pressure on prices into early Q2 next year. Meanwhile, the prices of semi-durable goods are starting to rise. Summing it up from a broader point of view, CPI is expected to hover around zero next year.

China

Neither too hot, nor too cold

We roughly concur with China's central bank (PBoC) view that there are neither strong inflationary nor deflationary pressures, even if both CPI and PPI are likely to show negative prints early next year. Consumer price inflation has been largely driven by food prices, particularly pork prices following the outbreak of the African swine flu in 2019. Pork prices had surged 135% by February this year, pulling overall consumer price inflation to a peak of 5.4% YoY. As pork supply had fallen significantly, the hog cycle has reversed, resulting in disinflationary forces on overall prices. CPI may even show negative prints in early 2021, but we think it is overdone to predict deflation.

Only if real rates were to rise on a sustainable basis, for example due to falling prices, would the PBoC cut interest rates, which we currently do not foresee. Meanwhile, after producer prices peaked at nearly 8% YoY in 2017 they have fallen since then, troughing at -3.7% YoY in May. While producer goods inflation has been trending down already for some time, consumer goods prices within the PPI category have fallen into negative territory only recently. Service prices are falling due to subdued activity in pandemic hit segments like travel and entertainment. Overall, we predict average CPI inflation to fall from 2.9% this year to 1.9% next year.

Australia

A benign inflation outlook

CPI rose by 0.7% YoY in Q3, reflecting normalising economic conditions following the reopening of the economy. However, the outlook for inflation remains weak. Growth in retail sales is levelling off on the back of diminishing pent-up demand in Q4. Also, a gradual withdrawal of the JobKeeper program is likely to weigh on household income and spending further ahead. Plenty of spare capacity and slack in the labour market should put a lid on wage inflation. Wage inflation was close to zero in Q3 on a QoQ basis, and there is little evidence that wages will pick up meaningfully in the months to come.

House prices have recovered decently along with the reopening of the economy. Yet we expect the rise in house prices will remain capped as high unemployment and low immigration will keep housing demand sluggish. Rents continued to fall in Q3, having factored in rent reductions for households that were under financial pressure. Rents should stay subdued due to weak demand and plenty of supply.

On a positive note, the reopening of Victoria after the second lockdown should allow economic activity to normalise, potentially lifting Victoria's retail prices. This will partly offset the price weakness seen elsewhere in Australia.

ASEAN

Additional lockdowns reduce inflation pressure

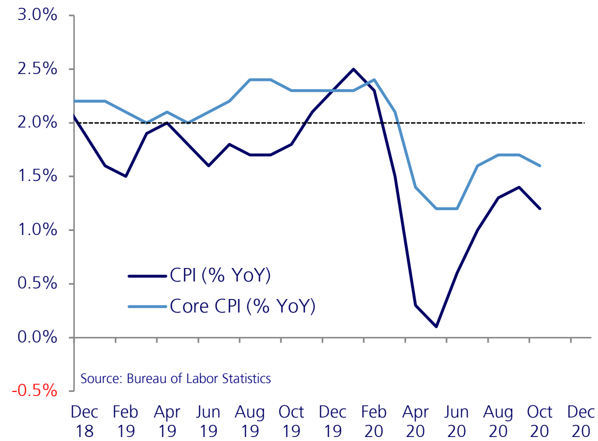
The recovery post lockdown helped lift regional inflation in Q3. However, this momentum quickly slowed in Q4 given faltering price pressure as pent-up demand faded. Furthermore, additional lockdown measures in countries like Malaysia and Indonesia have halted the recovery noticeably, reducing inflation pressure.

Elsewhere inflation remained flat. We expect Singapore's CPI to eventually move out of negative territory given a steady recovery in activity and generous government spending. To the contrary, Thailand should see inflation remain below zero for some time as the tourism sector will continue to suffer from border closures. Meanwhile, supply disruptions due to the typhoon season in the Philippines have raised its headline CPI. We expect the impact to be only temporary, however, and price pressure should ease again before long.

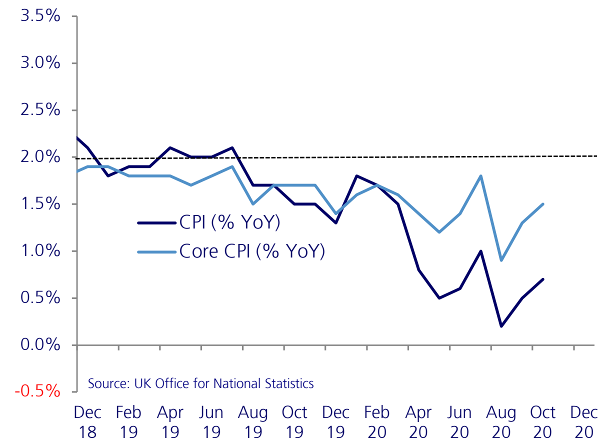
Overall, inflation should remain benign for an extended period as most economies will take time to reverse their output loss from the crisis. Muted inflation should allow ASEAN's central banks to deliver additional interest rate cuts in 2021 if needed.

Current and historic inflation

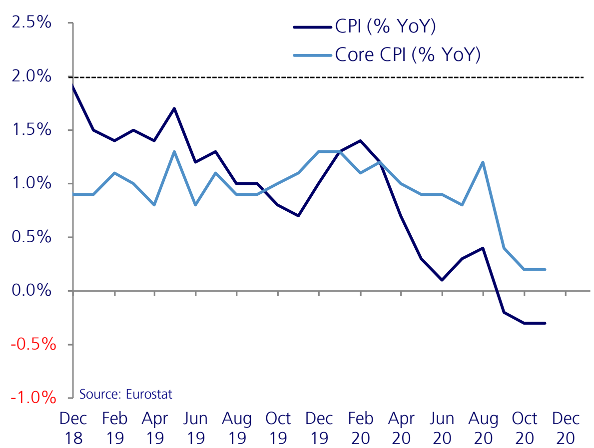
US: inflation set to be muted near term



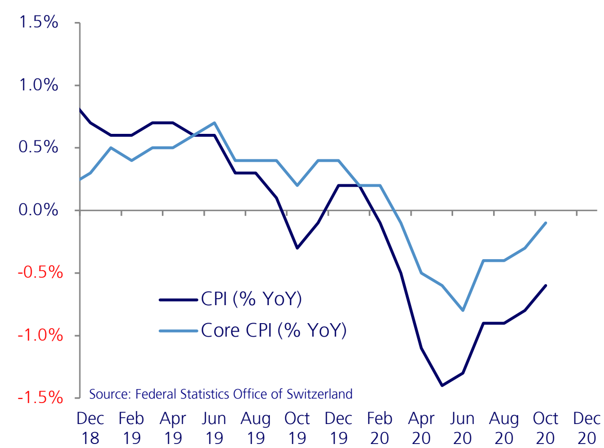
UK: weak growth and benign inflation



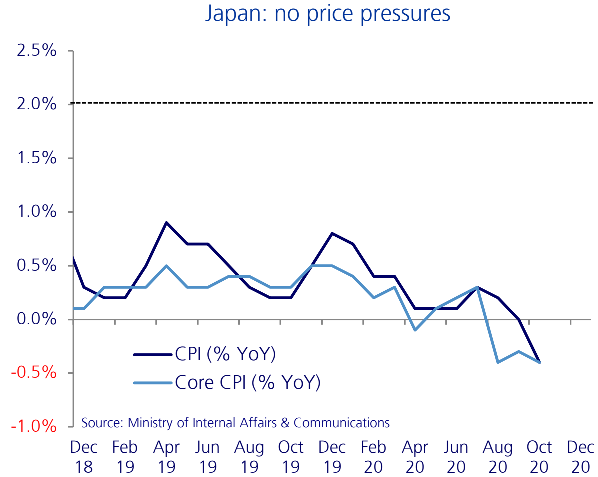
Eurozone: inflation should stabilise



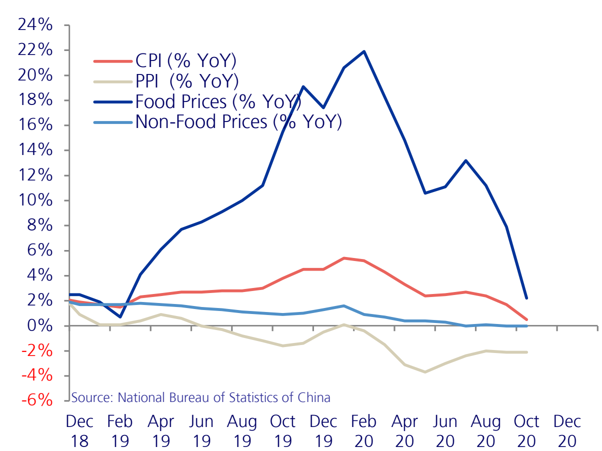
CH: deflation persists



Japan: no price pressures



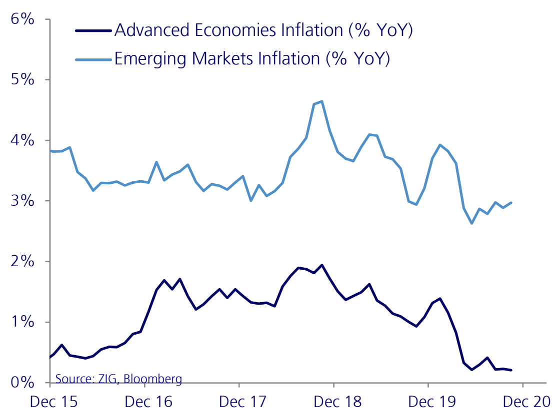
China: neither too hot nor too cold



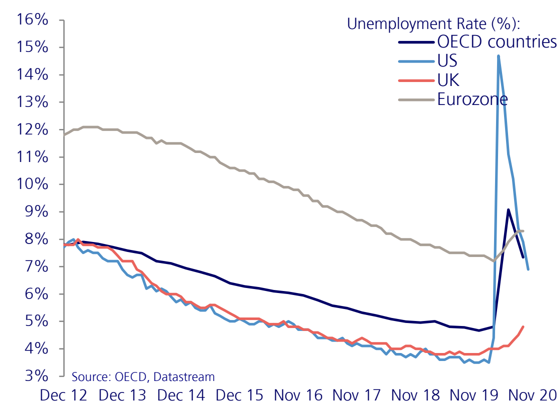
* Dashed lines show inflation targets or equivalent

Key indicators

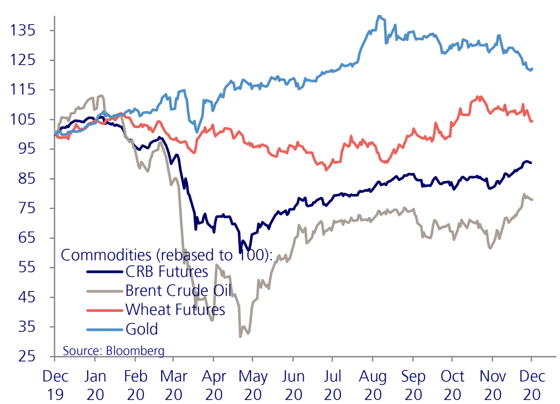
COVID-19 is disinflationary



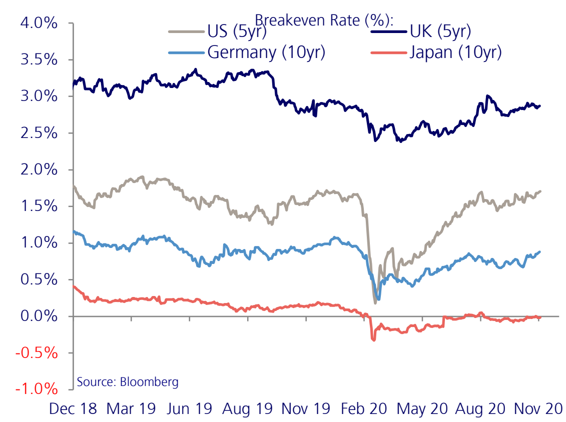
Elevated unemployment cap wages



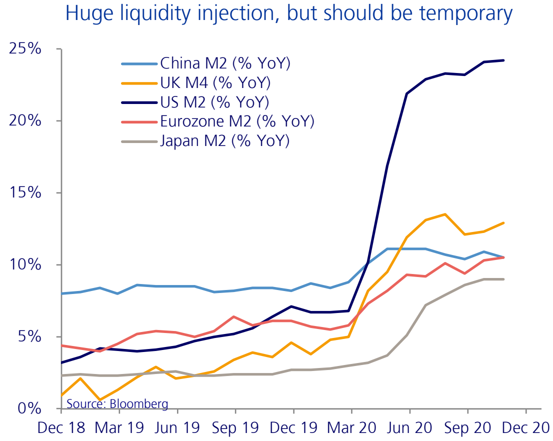
Commodity prices no longer deflationary



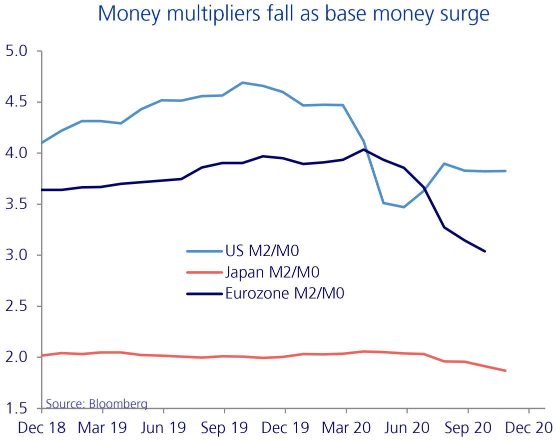
Policy support bolster inflation expectations



Huge liquidity injection, but should be temporary



Money multipliers fall as base money surge



Disclaimer and cautionary statement

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001632(01/16) TCL

ZURICH®