ZURICH

Inflation Focus Q4

16 December 2022

Key Points

- Inflation remains high but the outlook is shifting, helped by disinflationary goods prices and slowing growth
- Inflation has peaked in the US, turning lower in LatAm, but remains sticky in Europe, with energy causing divergence
- Central banks emphasise their focus on inflation, with tight labour markets remaining a cause for concern
- Recession is expected as a growth slowdown is being engineered to contain inflation

Growth and inflation are expected to be down in 2023

The economic environment is shifting rapidly, with sharply falling global growth as a result of monetary tightening and the energy crisis. Europe is already deemed to be in recession, with the US set to follow. In China, the zero-Covid policy is being relaxed, with more stable growth and production expected over the course of 2023. The monetary environment has also shifted, with aggressive tightening in financial conditions and a sharp contraction in money growth. While inflation remains uncomfortably high, these fundamental changes should lead inflation lower over the coming year, though with large divergences across regions and sectors. In 2023, we expect inflation to fall in the US and Latam while it will be stickier in Europe. In Asia, inflation has picked up with a lag but we do not anticipate it getting out of hand with demand constrained.

Goods driven disinflation as demand slumps and supply improves further

Goods price inflation is already falling and further declines are expected. World trade has slumped and many of the most disruptive drivers of inflation have retreated. Prices of key commodities, including lumber, copper, and semiconductors are down significantly compared to a year ago. The key exception is the price of energy, which remains disruptive despite falling oil prices. Shipping rates have deflated and China producer prices, which are a good proxy for global export prices, are stagnating. Used car prices, which were rising at a rate of almost 50% YoY a year ago, are now falling. Prices of new cars are also beginning to moderate, with discounts being offered to entice buyers. Looking forward, goods price inflation should continue to ease as the disflationary impulse works its way through supply chains and demand weakens.

Services inflation picks up with a lag on strong demand and reduced supply

Prices on many services are still rising at a rapid pace, however. Demand for consumer services has been particularly brisk, boosted by a catch-up effect after the pandemic, while supply has been constrained, partly reflecting hiring difficulties in very tight labour markets. This imbalance has helped to bid up prices on many categories, including travel and leisure activities. Services demand is set to weaken as the squeeze on household finances makes discretionary spending on travel and leisure more vulnerable. This should help to contain price pressures within the sector, even if supply remains challenged.

Housing related inflation should fall back as housing markets deteriorate

We also expect housing related inflation, which is part of services and reflects rent and house ownership costs, to slow from its current elevated level. The housing market has been one of the first sectors to experience the full brunt of aggressive monetary tightening, with stalling activity and falling house prices in major regions. While it will take some time before it shows up in aggregate measures of inflation, this is a disinflationary tailwind that should build over the course of 2023.

Food prices remain inflationary, with supply challenged

Food prices are inherently volatile and not considered part of the core measure of inflation. But while many commodity prices are falling, food price inflation is still in double-digit territory in many regions. We suspect supply conditions will remain difficult, given elevated energy costs and war related disruptions, but a further sharp rise in food inflation from current elevated levels is less likely. With food being non-discretionary, the risk, however, is that elevated food prices lead to further labour market disputes, with calls for higher wages to compensate for the rapidly rising food prices.

Labour markets are not yet in balance

Labour markets remain very tight, with wage inflation still runing at a somewhat elevated level and participation rates still well below their pre-Covid levels. This is not only a US and UK story, with recent wage agreements indicating upward pressure on wages in the Eurozone as well. Central banks are focused on these imbalances and will likely want to see further signs of easing before moving towards a more dovish stance. Looking forward, we expect labour market pressures to ease as job openings are now declining and more timely data indicate that workers are becoming less inclined to move jobs while some sectors see hiring freezes and cutbacks.

Central banks retain their focus on inflation

As expected, central banks have maintained their focus on inflation, despite elevated financial market volatility and stresses within the financial system, with the UK pension and the Crypto crises at the fore. As a result inflation expectations remain well anchored. Until central banks have convincing evidence that inflation is on a persistent downward trajectory, they are set to maintain their hawkish stance. This will cause growth to decline further and should keep financial market volatility high over the coming months but also help to bring inflation down.

US

A substantial decline in inflation rates

Headline CPI inflation fell at an accelerated pace in October and November, slowing to 7.1% YoY from a peak of 9.1% in June. While still elevated there are multiple signs that inflation rates are continue to fall in many areas. Manufacturing business price pressure has weakened every single month since March 2022 and has now reached levels not seen since the pandemic. Many commodities, and oil in particular, are cheaper than at the beginning of the year, helped by the strong dollar. US Core inflation is weakening, too, with Core CPI inflation slowing to 6.0% YoY in November from 6.3% in October. The monthly rate of core inflation dropped to 0.2% in the latest data, the slowest since August 2021. Crucially, the decline in inflation was broad-based with the Cleveland Fed's trimmed mean measure seeing its slowest monthly growth since April 2021 at 0.37%. Nevertheless, service inflation has been relatively sticky despite a marked slowdown in rent increases. Given a still tight labour market and a tick up in wage growth the Fed's focus will be on the employment situation in the coming months. While it is too early for the Fed to claim victory the latest trends are promising, and we expect inflation rates to continue to fall substantially in 2023.

UK

Inflation to fall markedly as the economy is heading for recession

With energy as one of the major drivers, inflation remains stubbornly high as headline CPI inflation picked up from 10.1% YoY in September to 11.1% in October before falling back to 10.7% in November. Price pressure is expected to stay high in the coming months as the strong momentum in food and services prices is likely to be continue in the winter months. Energy prices will also impact inflation in 2023, particularly given Chancellor Hunts' announcement at the Autumn Statement that the energy price guarantee will be raised from the current level of GBP 2'500 to GBP 3'000 in April 2023. Non-energy goods' inflation is expected to slow down substantially as the economy falls into recession and consumer spending is weakening. Meanwhile, service inflation has been sticky in recent months, lifted by robust household spending and a very tight labour market. Currently, there are no strong signs of a wage-price spiral, but wage growth has picked up in 2022 and the BoE will be focused on developments in the labour market. We expect some further BoE tightening but the terminal rate will probably be lower than what markets currently expect. While core inflation will remain elevated through most of 2023 it is expected to slow down markedly as both consumer demand and wage pressure will ease as the economy contracts.

Eurozone

Record high inflation should fall back in 2023

Eurozone headline inflation hit double-digits towards the end of 2022, but looks to be in the process of peaking. For the first time in many months, headline inflation fell in November, to 10.0% YoY from 10.6% in October. The main impetus was a fall in energy inflation. Further falls in headline inflation are likely over the coming months as favourable base effects in terms of energy inflation finally kick in, though the data will remain volatile due to the many interventions at the national level in gas and electricity markets. While the fall in headline inflation will be welcomed by the ECB, the headline rate is still way too high from their perspective. What's more, core inflation also remains extremely high at around 5.0% YoY. Generous wage deals in recent months will also be a concern for the ECB. In November 2022, the German metal workers union, IG Metall, agreed to a wage deal with employers that, including some one-off payments, means workers will get around a 6% increase in salaries in 2023 and 4% increase in 2024. The upshot of stronger wage growth is that core inflation is likely to stay sticky even as headline inflation falls sharply, and the ECB is likely to maintain a hawkish stance and continue raising interest rates.

Switzerland

Inflation should peak in early 2023

Price pressures have eased materially, with CPI down from 3.5% in August to 3% in November. Consumer prices actually fell by 0.4% over the past three months, compared to a 3.2% rise in prices in the prior three months (annualised rates). Core inflation is back below 2% and inflation on imported consumer goods is falling, down from 8.5% YoY in August to 6.3% currently. Domestic producer prices are stable and even wage growth, which picked up sharply in the H1 2022, has moderated, down from 2% YoY in H1 to 1.4% in Q3. Looking forward, we expect inflation to reaccelerate in early 2023 as announced electricity price hikes will take effect, but it should peak shortly thereafter. A key reason for the inflation divergence vs the rest of Europe is the lower share of energy in the CPI. Energy costs have also not risen as much due to a more favourable energy mix, with a higher share of domestic and renewable energy.

As expected, the SNB hiked rates again in December, with one further hike in early 2023 likely. The labour market remains very tight and survey data suggest companies are still looking to expand their workforce. Moreover, the SNB has confirmed that its inflation target is highly asymmetric, with further tightening likely to be required to bring inflation back to 'well below 2%'.

Japan

Inflation surges to a 40-year high, but is expected to subside in 2023 and 2024

Rising inflation rates in Japan pale in comparison to Europe, but they are high compared to Japan's history, where even middle-aged Japanese, who are used to low inflation or deflation, have never experienced similar inflationary circumstances. Indeed, Japan's core inflation rate (excl. fresh food), surged to a 40-year high of 3.6% YoY in Tokyo in November. Energy and food are the main drivers of inflation, followed by durable goods. Rising inflation has contributed to lower consumer confidence, along concerns about Covid. Meanwhile, lower accommodation rates are a drag on inflation following travel subsidy programs.

Looking forward, in line with our global inflation outlook, we expect inflation to peak in the first half of 2023 and then to slowly subside into 2024 below the 1% mark. Considering the various definitions of core inflation in Japan, core CPI (excl. fresh food) is likely to peak out earlier but at a higher level than core CPI (excl. fresh food and energy). Significant yen depreciation in 2022 will have a delayed impact and will slow the decrease of inflationary pressures in 2023, while lower electricity rates and prolonged subsidies for fuel will help to curtail inflationary pressures. We expect wages to rise at a quicker pace in 2023.

China
2023 will see a swing from disinflation to inflation

China's headline inflation eased to 1.6% YoY in November, while core inflation fell to a 20-month low of 0.6% YoY, suggesting a still weak domestic demand environment. Food inflation, at 3.7% YoY, remains a drag despite still high, though subsiding, pork price inflation while vegetable prices keep falling. Home prices and rents are still falling as home sales continue to fall, down by more than 30% YoY. Recreation inflation remains low at 1.3% YoY but is expected to quickly pick up steam following the latest reopening measures by the government. Flight prices are already spiking higher, and broader mobility and box-office data confirm the upswing, which may also finally be reflected in increasing broader inflation trends later in 2023. Producer prices, still down 1.3% YoY at a 23-month low, are expected to remain in deflationary territory at least in H1 2023 due to base effects and contracting exports as evidenced by the surprising slump in November. Both producer and consumer goods deflation prevails for now. We anticipate rising producer price inflation once the property market turns more positive amid a series of government support measures, which may be more a story for 2024 than 2023, driven by higher demand for commodities.

Australia
Inflation remains high, but the slowing economy is starting to reduce inflation pressure

Inflation stayed high in Q3 2022. Headline CPI increased by 1.8% QoQ and 7.3% YoY, with rising food prices and housing costs being the key drivers. However, the new monthly CPI indicator, which covers around 60% to 70% of the quarterly CPI basket, showed that headline inflation fell from 7.3% to 6.9% YoY in October, far below consensus expectations of 7.3%. Given sharp increases in the cash rate by the Reserve Bank of Australia (RBA) since May, consumer confidence and retail spending have weakened materially, driving down inflation pressure from the demand side. While CoreLogic house prices have declined by over 7% between May and November 2022, they have yet to translate into lower housing costs, and rents continue to rise noticeably. From the supply side, the labour market remains very tight, with the unemployment rate hitting an all-time low of 3.4% in October.

Further ahead, inflation pressure should continue to ease, although CPIs will still likely exceed the RBA's target range in 2023. We expect that the RBA will hike its cash rate by 75bps in H1 2023, reaching a terminal peak rate of 3.85%.

ASEAN
Headline inflation moderates, but core inflation remains sticky

While Indonesia's headline inflation showed signs of easing in Q4, core inflation remains rather sticky. As the fuel price hike of about 30% in September is pushing transport costs higher, inflation should remain above the central bank's target range of 2-4% in the first half of 2023. We expect Bank Indonesia to hike by another 50bps in H1 2023, bringing the terminal peak rate in this tightening cycle to 6%.

In Malaysia, headline inflation has moderated, but core inflation has yet to ease. As administered price controls helped shield a large part of the commodities price rally, we expect Malaysia's CPI prints to fall within the top end of Bank Negara Malaysia's forecasted range of 2.2-3.2% for 2022. Going into 2023, an upside risk to inflation can arise from the phased targeted fuel subsidy scheme, which will lift fuel ceiling prices. However, easing global energy and commodity prices coupled with a potential economic slowdown will balance the upside risk to inflation.

Brazil
Inflation expectations for 2023 are stable

Inflation fell sharply from 12.1% YoY in April to 5.9% in November. The latest figures have shown not only a positive surprise (inflation falling more than expected) in volatile items but also in the core components. Regulated prices (e.g. gasoline and electricity) are down vs. a year ago, reflecting lower oil prices. Annual core inflation remains elevated but has decelerated for the fifth consecutive month, reaching 9.4% in November. The deceleration in core inflation reflects the aggressive tightening cycle and easing economic activity. Despite some evidence of softening in the labour market, real wages continue to rise however, making it difficult for inflation to fall significantly further. As a result, we expect inflation to grind lower during the coming months but remain above target.

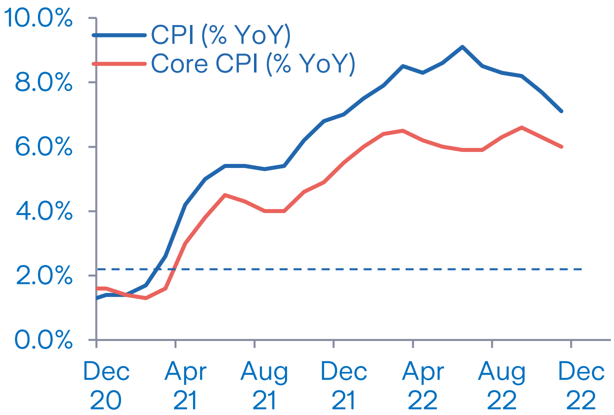
Inflation expectations for 2023 have stabilised slightly above 5%, which is encouraging. However, it is unclear if the incoming administration will reverse the federal fuel tax cut, which would drive up inflation during Q1 2023. Furthermore, the increase in public spending planned by the next administration should increase inflation expectations for 2023. Therefore, we believe the balance of risks is biased to the upside in the short term. The central bank will likely start a gradual monetary easing cycle in H2 2023.

LatAm
Inflation will likely reduce sharply, but remains elevated

Inflation in the region is showing signs of peaking as external and internal pressures are easing. The level of inflation remains elevated, however, amid high food prices and sticky core components. Looking forward, we expect a sharp decline in inflation in 2023 but it will remain above target until 2024. In **Chile**, inflation has been volatile in Q4, reaching 13.3% YoY in November. Food prices have risen, reaching 24% YoY, while energy prices have peaked but remain high. We expect the central bank to start cutting rates in Q2 2023. In **Mexico**, inflation has already peaked and is expected to fall further, driven by lower demand, more stable commodity prices and base effects. Core inflation is concerning, but import and producer price pressures are waning. We expect core CPI to decelerate at a slower pace, staying above headline CPI for several months in 2023. Banxico is expected to be one of the last LatAm central banks to start cutting rates, and the monetary easing cycle will likely begin in Q4 2023. The inflation outlook for **Argentina** remains one of the most challenging in the world. The risk of triple-digit inflation has risen amid economic imbalances that pressure inflation to the upside and the expected increases in utility tariffs and public transportation prices, which are needed to reach the government's fiscal targets.

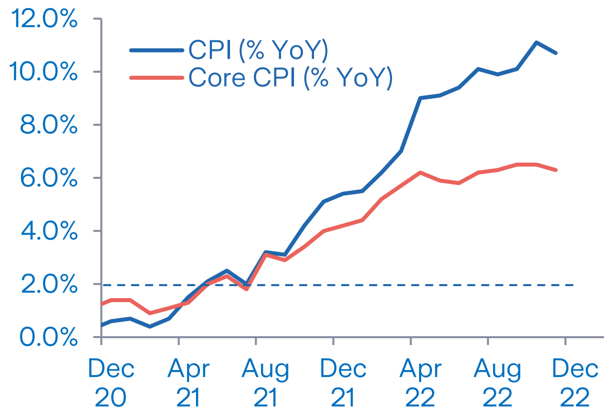
Current and historic inflation

US: Inflation peaking



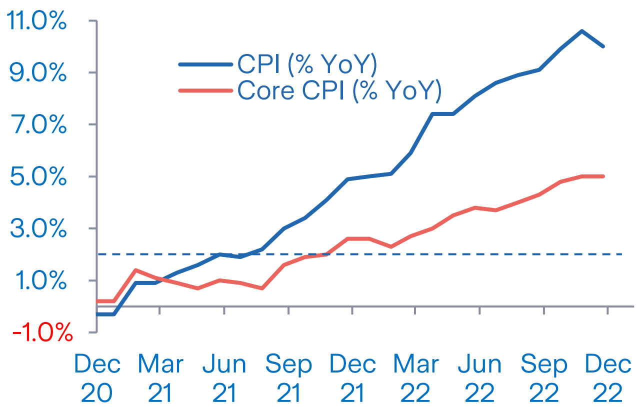
Source: BLS

UK: Inflation to fall as recession hits



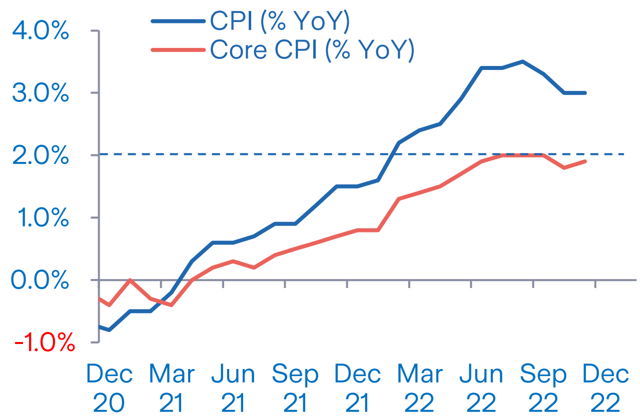
Source: ONS

EZ: Record high inflation to ease in 2023



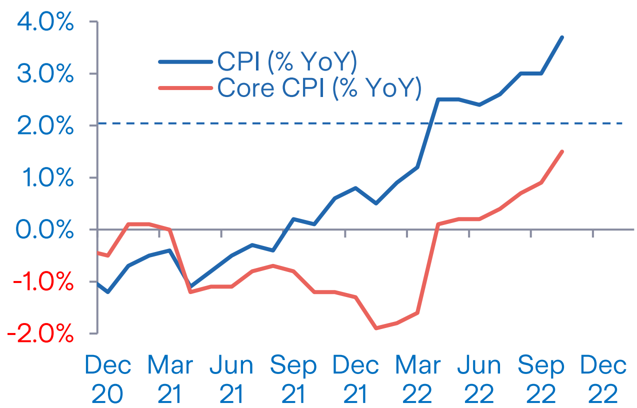
Source: Eurostat

CH: Inflation remains benign



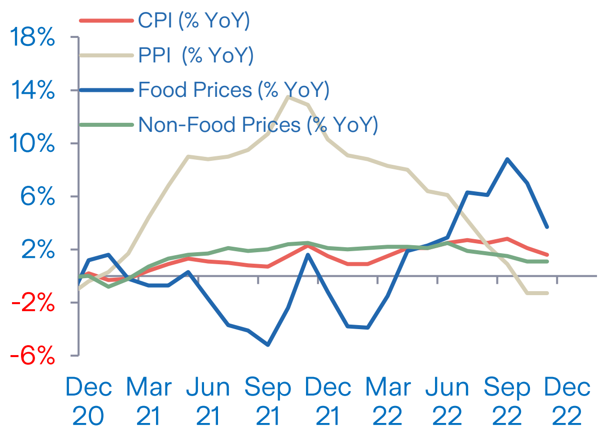
Source: Federal Statistics Office

Japan: Stickier inflation on yen depreciation



Source: Ministry of Internal Affairs & Communication

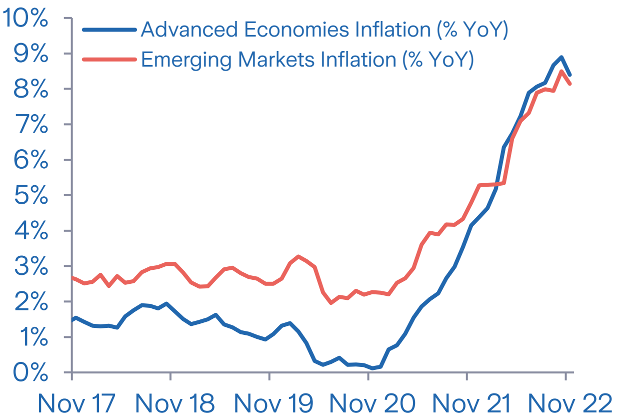
China: More inflation and less disinflation in 2023



Source: National Bureau of Statistics China

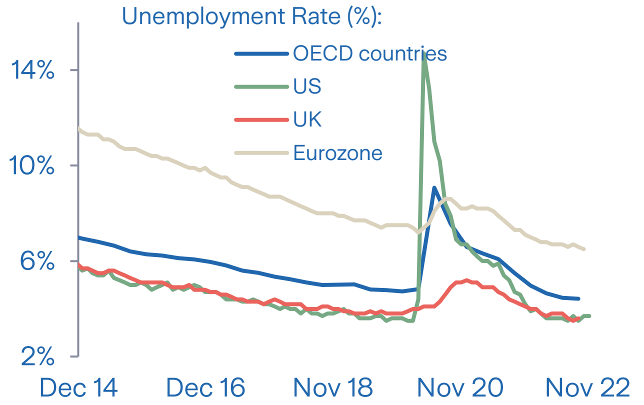
Key indicators

Headline inflation remains elevated



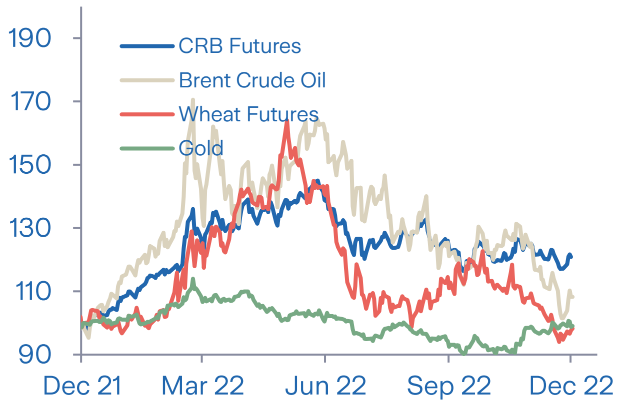
Source: ZIG, Bloomberg; average across regions

Labour markets still too tight



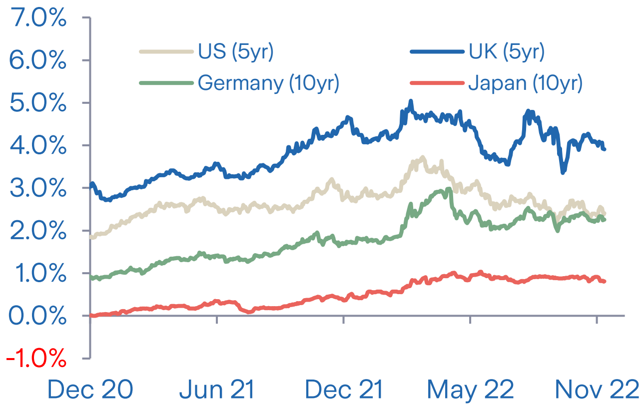
Source: Bloomberg

Commodity prices disinflationary



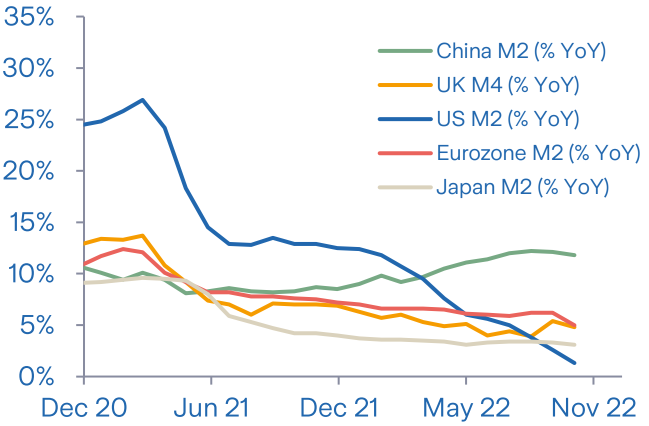
Source: Bloomberg

Inflation expectations remain contained



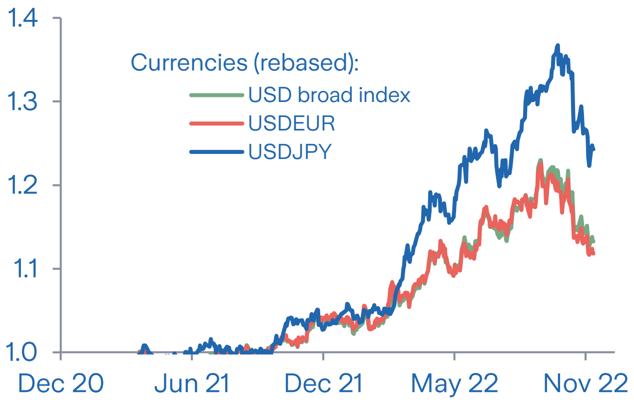
Source: Bloomberg

US Money growth slumps



Source: Bloomberg

Dollar weakening



Source: Bloomberg

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