ZURICH

Inflation Focus Q2

17 June 2022

Key Points

- Inflation rises further as the Ukraine war triggers a surge in energy and global food prices
- Central banks embark on aggressive policy tightening to limit a further broadening out of inflation
- A sharp tightening in financial conditions will weigh on demand and inflation, particularly in the second half of the year
- Recession risk is significant as a growth slowdown is being engineered to bring inflation lower

Inflation surges in Europe on war related price pressures

Inflation has risen further as a result of the war in Ukraine, led by higher energy, food and commodity prices. Europe has suffered the biggest impact, with Eurozone headline CPI surging to an all-time high of 8.1% in May, and UK inflation at a 40-year high of 9.1%. With strong links to Russia and Ukraine, Central and Eastern European countries are particularly exposed, in many cases struggling with double-digit inflation. LatAm is also under pressure, with rapid price rises despite steep rate hikes, in part fueled by past fiscal excesses.

By contrast, core measures of inflation have ticked lower in the US as some pandemic related drivers have diminished. This is encouraging, but the decline is too modest to be comfortable. Price pressures are easing more rapidly in China, where producer price inflation has slumped from a peak of over 13% in October last year to 6.4% in May. It is expected to fall further as lockdowns are rolled back and logistic bottlenecks improve. Given China's role in world trade, this will help to ease price pressures in global supply chains. In Asia, inflation has picked up more broadly throughout the region, but remains relatively soft compared to other areas.

Central banks embark on aggressive policy tightening

In response to the latest inflation prints, central banks have unleashed aggressive tightening, bringing forward rate hikes and hiking in much larger steps than we've grown accustomed to. The Federal Reserve raised rates by 75bps in June for the first time since 1994, and the ECB has pre-committed to a 25bp hike in July followed by a 50bp move in September. Even the Swiss National Bank, which had maintained a very dovish stance on relatively benign inflation, delivered a 50bp policy rate increase in the last meeting – their first rate hike in 15 years. Policy makers have clearly been spooked by the latest strong inflation prints, given still very tight labour markets, a broadening out in inflation pressure, and an upward drift in inflation expectations.

Financial conditions, including mortgage, auto loan, and unsecured borrowing rates, have already tightened sharply on anticipation of a hawkish shift. A key metric is the US 30yr fixed mortgage rate, which has surged from 3% last autumn to a hefty 6%. House price inflation in the US is still brisk but housing market activity slumped in May, and pass-through to prices should be expected. With global equity prices down by 20% year to date (MSCI All Country World Index) and household sentiment dented by war and surging prices on basic necessities, this is clearly not a good time for undertaking major purchases.

Given the size and speed of change in financial conditions, this will lead demand and spending lower, likely in the second half of the year, when pent-up spending on consumer services – travel, restaurants, leisure – begins to normalise. This should help to temper a further build-up in inflation. Indeed, we expect inflation to begin to come down more meaningfully in the US towards the end of Q3 but be stickier in Europe.

Labour markets hold the key to a normalisation in inflation

Labour markets are key for a normalisation in inflation. If nominal wages do not keep up with prices, purchasing power erodes and businesses face a more challenging pricing environment. Wage growth in the US and the UK remain uncomfortably high and not consistent with inflation returning to target.

Peak labour market tightness in these countries is likely to be behind us though, given a tick higher in jobless claims and unemployment and softer business hiring plans. Wage pressures are much more limited in the Eurozone. Wage demands have, however, picked up and labour markets are very tight, with many unfilled vacancies. The risk is that wage growth begins to drift higher here as well.

In bringing aggressive policy tightening forward, central banks hope to contain a further broadening out of inflation, by moderating growth expectations, slowing job growth, and tempering wage demand. While near-term risk to inflation remains to the upside given food and energy pressures, the latest central bank actions reduce the risk of inflation remaining sticky at a high level.

Generating a soft landing for the economy will be challenging

Aggressive policy tightening has, however, also increased recession and growth risk. It will be challenging to generate a soft landing whereby global demand slows sufficiently to dent the inflation trajectory, but not by so much that it tips the economy into a recession. Until they have convincing evidence that inflation is coming down, we expect central banks to maintain their hawkish stances, even if growth continues to slow. This will likely keep recession fears and financial market volatility high over the coming months. For now, inflation is too strong for central banks to pivot in a dovish direction.

US

The slowdown in core inflation not enough for the Fed to reduce the pace of tightening

Inflation rates remain far above target with headline CPI inflation reaching 8.6% YoY in May, fuelled by soaring energy prices. Meanwhile, core CPI continued to edge lower, slowing to 6.0% YoY from 6.2% the month before. Like in recent months distortive components such as a steep rise in airfares helped to push up service inflation. At the same time, stickier components keep adding to higher core inflation, particularly rents, which saw the strongest monthly pick-up in decades. Rising costs for interest rates, energy and wages remain a drag on business sentiment, though the latest business surveys show that price pressure is slowly abating, and supply bottlenecks are showing signs of easing. Nevertheless, the deceleration in core inflation has been too modest so far for the Fed to move away from its hawkish rhetoric in the near term despite increasing signs of growth slowing down in the coming months. The impact of financial tightening is increasingly visible in economic activity, housing, and the labour market but the FOMC is likely to keep up the current pace of tightening until core inflation is convincingly falling back towards more sustainable levels, which we expect to happen in the second half of the year.

UK

Soaring energy costs keep pushing inflation higher

Rising living costs continue to weigh on households' minds with consumer sentiment falling to the lowest level since records began in 1974, reflecting the real income squeeze and an increasingly uncertain growth outlook. Meanwhile, inflation rates accelerated further in April with headline CPI inflation reaching 9% YoY. The major driver of the latest surge in inflation was the significant jump in energy prices as the regulator Ofgem lifted its price cap. Core inflation rose less markedly than the headline number, up from 5.7% YoY the month before to 6.2% YoY. Given soaring inflation rates and a very tight labour market the Bank of England has lifted the Bank Rate in four steps since last December to 1% currently with more rate hikes expected at upcoming meetings despite a mediocre growth outlook. Although there are some signs of easing price pressure in business surveys and an expected slowdown in consumer spending due to the real income squeeze, inflation rates will remain significantly above target well into next year but are expected to peak in the coming months. This is particularly the case for headline inflation where rising energy costs keep feeding through while core inflation should see less of an upside pressure.

Eurozone

The ECB pledges action to deal with record high inflation

Eurozone inflation hit fresh record highs in Q2, at 8.1% YoY in May. Half of headline inflation is due to energy inflation reflecting high oil and natural gas prices. However, food price inflation is also accelerating, and will probably move higher in the coming months and quarters given the current geopolitical situation. What's more, core inflation is also accelerating as previous increases in companies input costs gradually feed through the production chain to consumer prices. So far, wage deals are higher than in recent years, but have remained relatively subdued. However, the longer headline inflation stays high, the bigger risk there is of a damaging wage-price spiral developing and hence the need for the ECB to maintain its credibility and control long-term inflation expectations. The ECB has said it will exit negative interest rate over the next few months, but this also increases the challenge of managing the impact on periphery bond markets and preventing so called 'fragmentation risks', i.e. a large widening in Eurozone government bond spreads. Indeed, as well as raising interest rates, the ECB may also in due course have to start buying government bonds again at some point.

Switzerland

A hawkish SNB, as inflation and wages surprise on the upside

Inflation surprised on the upside in May, with headline CPI reaching 2.9% YoY, or 0.7% MoM. The increase was broad-based, with large monthly price rises on many goods components, though pricing was more contained in services. Exceptions were household goods and furtniture, where Covid related price pressures appeared to ease, and housing, where inflation edged higher. Core CPI also rose but, at 1.7% YoY, undershoots inflation in the rest of Europe. Domestically generated inflation is contained, with services and domestic goods price inflation at 1.2% and 1.5%, respectively. Nominal wages rose sharply in Q1 though, up by 1.9% YoY. This is the strongest wage rise since 2009 and may signal a less benign environment going forward, although the pickup in wages partly compensated for stagnating wages in 2020 and 2021. Looking forward, we anticipate inflation to peak in 2022, but be sticky at a relatively high level in 2023.

The SNB surprised by hiking rates by 50bps in June, moving ahead of the ECB. The rate hike was motivated by a large and persistent rise in the SNB's inflation projection and by a shift in the view on the franc, which is no longer considered highly valued. It appears that, after being too dovish on inflation in the March meeting, the SNB may now have become too hawkish.

Japan

Out of deflation into record high consumer inflation expectations

Japan's inflation data have been distorted until recently, as the government-imposed cut of mobile phone tariffs is no longer impacting price statistics. The base effect has been out of the way since the start of the new fiscal year on April 1, 2022. However, consumer price inflation remains low in an international comparison. Using Tokyo's May CPI release as a leading indicator for nationwide data, core CPI ex fresh food inched higher to 1.9% YoY, which pales compared to the recent Eurozone headline CPI release of 8.1%, for example. Using the CPI measure that excludes food and energy, core inflation remains low at only 0.3%. However, this number does not reflect how consumers perceive inflation, as food and energy are a large part of daily expenditures and at the same time the main inflation contributors. It is thus not surprising that the expected inflation rate, which is calculated using statistics on the degree of respondents' anticipated price rises in the Consumer Survey for May, stands at a record high of 3.9%. Meanwhile, real wages are back in negative territory, down 1.2% YoY in April, while producer price inflation has risen from -2% YoY in late 2020 to 10% in April, before retreating slightly in May. Import prices have surged 43% YoY, and explains part of that move.

China

Inflation is not a major topic for now

As in many other countries, China's latest inflation data failed to meet the government's target, however, China is undershooting, not overshooting its goal! Headline CPI in May stood at 2.1%, below the target of 3%, having climbed higher from its through of -0.5% in autumn 2020. Pork prices are now falling less, as the oversupply has started to shrink, and are likely to exert some upside pressure on inflation in the second half of 2022, but core inflation is expected to remain stable around 1% YoY. Meanwhile, the speed of sequential producer price inflation has slowed markedly and nearly came to a standstill in May. In YoY terms, producer price inflation receded from a peak of 13.5% in October last year to 6.4% in May. We expect producer price inflation to soften further in the second half of the year due to a more favourable base effect, but also due to easing logistic bottlenecks as Omicron infections are receding. The downturn in China's housing market since last year, with home sales in 30 major cities tumbling by half, has even pushed down housing price inflation from above 11% YoY pre-Covid to below zero in April. However, a stabilisation is expected as local governments have eased housing restrictions substantially, laying the ground for a pickup in demand and prices in the second half of this year.

Australia

Inflation is rising, but tighter monetary policy limits upside risk

Australian inflation has continued to increase during the quarter, with the headline CPI rising to 5.1% YoY in Q1, driven by increases in fuel and housing. The RBA has reacted by both acknowledging the risk of higher inflation and aggressively tightening monetary policy to bring inflation under control. In the statement of monetary policy (SOMP), the RBA increased its headline inflation forecast for 2022 to 5.9%, up from 3.25% in February. The RBA has also acted more decisively in tightening monetary policy, increasing interest rates by 25bps in May and 50bps in June to 0.85%, with further rate hikes likely.

The more decisive monetary tightening from the RBA has materially reduced the risk of inflation remaining elevated for the longer term. The Australian mortgage market is dominated by variable home loans, and a higher mortgage rate will translate to a decline in demand-side inflation. Supply-side constraints and a tight labour market will take longer to resolve, but the inflation rate is expected to steadily decline in 2023.

ASEAN

Upside risks to inflation remain a key consideration

In Indonesia, inflation data hit a five-year high, but Bank Indonesia (BI) has yet to pull the trigger by raising rates, bucking the tightening trend seen globally and regionally. While fuel prices will likely be contained in the near term following the additional allocation for energy subsidies and compensation to Pertamina and PLN, the two state-owned energy companies, we see upside risks to food inflation as nearly all domestic demand for wheat and soybean, and around half of the country's meat and sugar needs, are imported. We expect BI to eventually deliver its first rate hike at the next meeting on June23.

In Malaysia, the central bank, BNM, already took the pre-emptive step of raising interest rates by 25bps in May. We expect core CPI to accelerate till Q3 as demand side pressures rise on the back of the economy re-opening to international travel, strong upcoming industrial production numbers and private consumption gathering steam. Despite these demand tailwinds, Malaysia's services output is currently hampered by an acute foreign worker shortage, which has yet to improve.

Brazil

Fiscal measures are likely to reduce short-term inflation pressures

Inflation has stayed high and should end the year far above the target. The rising cost of energy and fuel continues to be the primary concern. However, annual headline inflation seems to have peaked in April, decelerating from 12.1% YoY to 11.7% in May, as upward pressure from food and electricity prices has eased. Despite the decrease in the headline, the composition of inflation is still a concern. Core inflation rates accelerated to 10.1% YoY on average, while service inflation accelerated to 8%. As the presidential election approaches, the political pressure to reduce inflation has increased, with its short-term path likely depending on the fiscal measures discussed in Congress.

Congress is debating a bill to cut the state VAT on electricity, gasoline, telecom, and public transportation. We expect the Lower House to approve the bill, despite the local government's resistance, reducing inflation pressure in the short term, but increasing the fiscal risk, especially considering the possibility of easing the spending cap anchor again. The central bank continued tightening, and we expect a terminal rate of 13.5%. However, the balance of risks is upside-biased, and we cannot rule out further rate hikes if fiscal pressure intensifies.

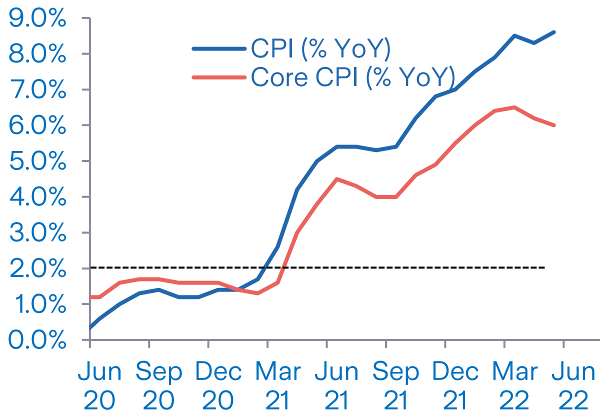
LatAm

Energy and food prices are the main inflation drivers

Inflation risk in the region remains high as near-term inflation expectations (for 2022) have continued to increase, with higher food and energy prices as common factors across the region. However, longer-term inflation expectations (for 2023) remain contained, due to the hawkish stance of central banks that started hiking interest rates in 2021. Nevertheless, inflation is likely to remain above the various targets until 2024. In Chile, inflation has not yet peaked, hitting 11.5% YoY in May, its highest level in decades. The main driver is still the increase in demand during 2021, supported by the vast fiscal stimulus and the anticipated pension fund withdrawals. However, the inflation surprises of the last quarter have been explained by external cost pressures stemming from food and commodity prices and by global supply chain bottlenecks. In Mexico, headline inflation is high and pressures continue to come from different sources. However, inflation stabilised during the last two months, reaching 7.7% in May, as the energy component ticked lower. Core inflation is sticky, accelerating from 7.2% to 7.3% in May, driven by both merchandise items and food-related services. We expect inflation to stay around the current levels in Q3 and then start a gradual downward trend.

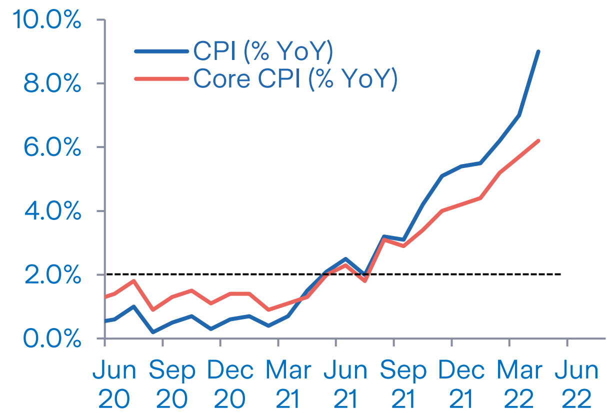
Current and historic inflation

US: Slowing core, but uncomfortably high



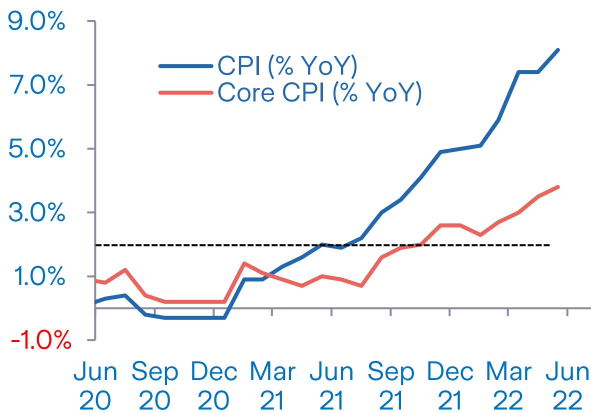
Source: BLS

UK: Soaring energy costs keep price pressure high



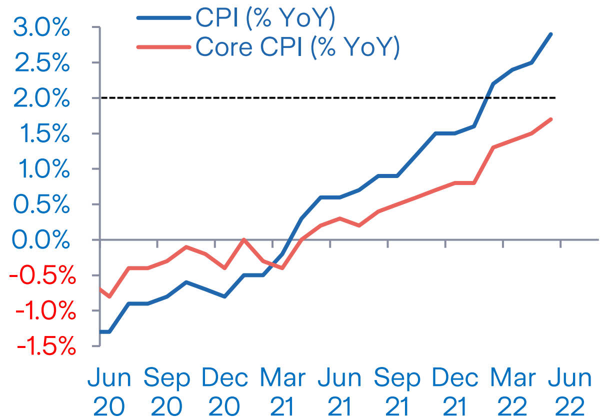
Source: ONS

EZ: Food and energy prices surge



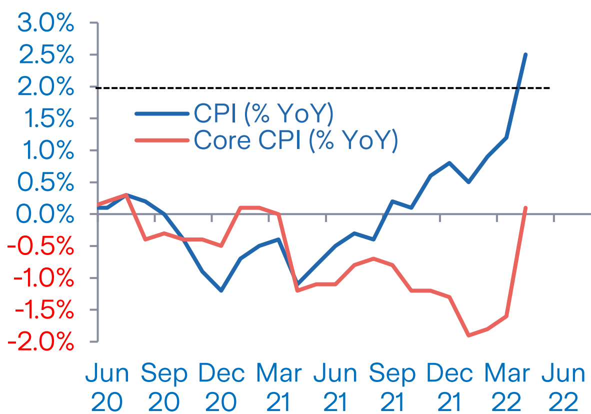
Source: Eurostat

CH: Still moderate domestic price pressures



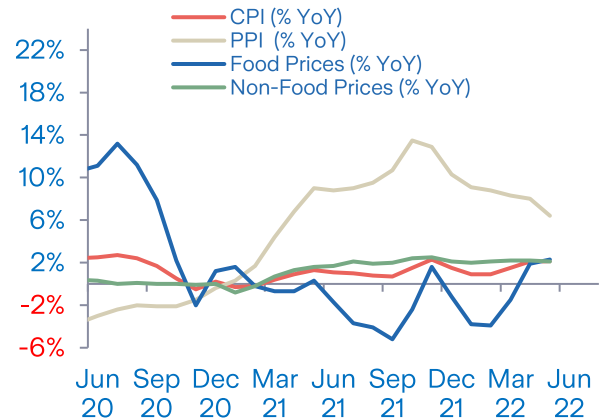
Source: Federal Statistics Office

Japan: Distortions drive inflation higher



Source: Ministry of Internal Affairs & Communication

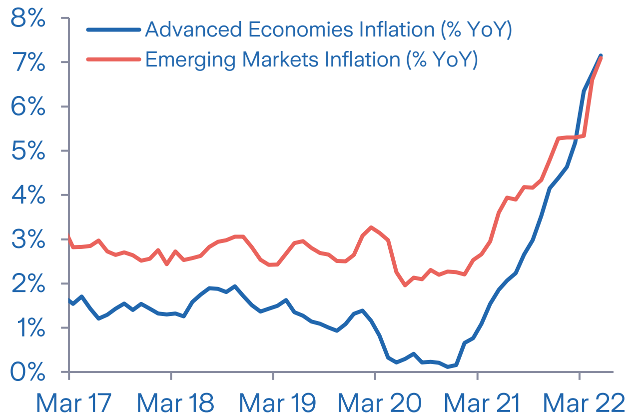
China: Producer price inflation falling further



Source: National Bureau of Statistics China

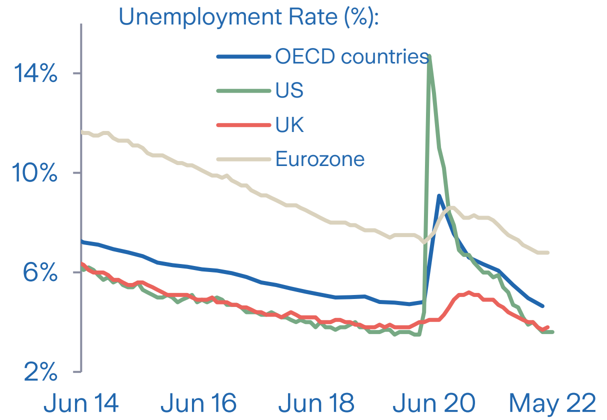
Key indicators

Food and energy drive inflation higher



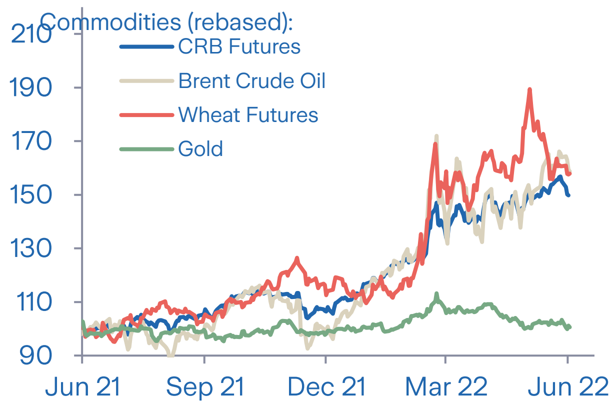
Source: ZIG, Bloomberg

Likely past peak tightness in labour markets



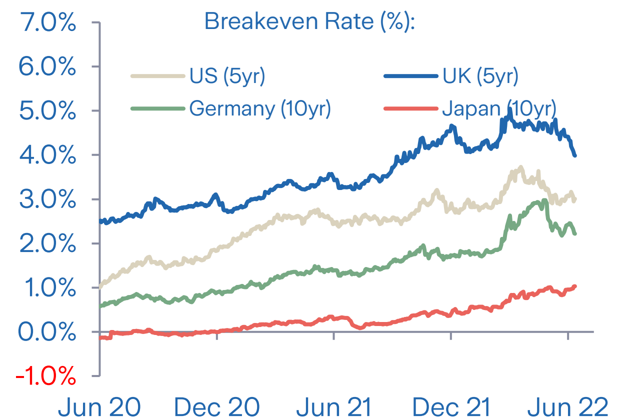
Source: Bloomberg

Commodity prices elevated



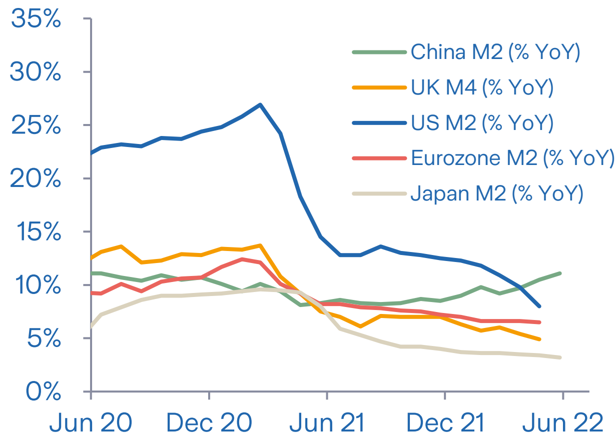
Source: Bloomberg

Inflation expectations fall on hawkish central banks



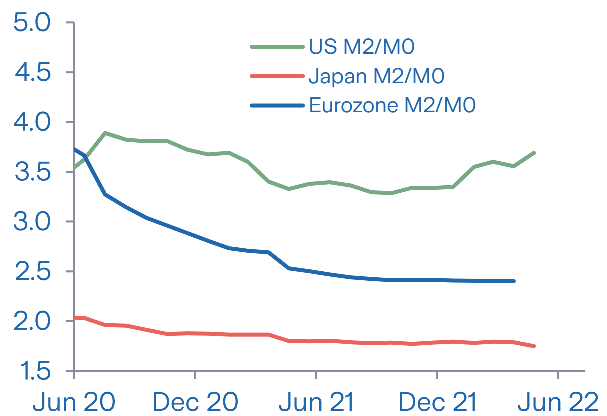
Source: Bloomberg

US money growth rapidly normalising



Source: Bloomberg

Money multipliers remain low



Source: Bloomberg

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