Inflation Focus 2018 Q1

Key Points

- Strong global growth is eating into excess capacity, which should help to normalise inflation over time
- Survey data indicate that price pressure are picking up, with businesses reporting rising input and output prices
- Wage inflation remains weak globally, underpinning our view that inflation is unlikely to suddenly become a global problem
- Central banks are removing stimulus in anticipation of higher inflation, which should also prevent a significant overshoot

Source: iStock by Getty images

Inflation continues to undershoot central bank targets by a wide margin

Global inflation edged higher in 2017, with gains in some regions offset by weak outturns elsewhere, most notably in the US. The median inflation rate in the OECD economies is 1.6% YoY, up from 1.3% a year ago but still far below central bank targets. Inflation expectations measures have risen, but still undershoot their historical levels in most regions. Emerging market (EM) inflation has also been subdued, allowing central banks to maintain a dovish stance. This has helped to spur growth but, with a few exceptions, has not led to a rise in EM inflation, as excess capacity persists.

Survey data now show a shift in global price pressures

While inflation data remain weak, the global economy is in a synchronised expansion, with growth above trend in most regions. This is the first time in a decade that this is happening on a sustained basis, and global excess capacity is diminishing. Judging by history, this should, over time, be reflected in higher price and wage inflation. Arguably, we are also seeing this in survey data. The global PMI input and output price components show that price pressures have risen in most regions. In the US, small businesses report that they are finding it increasingly hard to fill open positions and compensation plans have risen. In the Eurozone, deflationary headwinds in the periphery have eased, with a majority of businesses reporting that they are raising, rather than cutting, prices.

Large gap between 'soft' survey data and 'hard' inflation data

Inflation data, by contrast, have failed to firm. Core CPI inflation is flat at only half of the ECB's 2% inflation target in the Eurozone, and continues to hover just a touch above the zero line in Japan. The US, which is furthest ahead in the cycle, saw both CPI and wage inflation surprising persistently to the downside in 2017, in spite of a very tight labour market. Our view is that the US weakness mainly reflects temporary factors, which should wane. The link between inflation and activity also appears to be intact in the US, as the more cyclical components of the CPI index, including housing, recreational and food services, have risen as economic slack has diminished. We therefore maintain our view that, as the economy tightens further, US inflation should rise modestly, with other regions continuing to lag behind.

Inflation is not on the cusp of becoming a problem, despite strong growth

Following a period of sustained inflation weakness, a key question is whether we might witness a break higher in inflation, given strong and synchronised growth, tight labour markets and liquidity injections by central banks. In our view, this is unlikely. First, there is no evidence that wage inflation is about to accelerate sharply. Even in the US, were the labour market is running hot, the latest data show only a modest pickup in average earnings growth. Second, credit growth is solid but stable in most regions, and there is no sign of credit induced excess demand posing an upside risk to inflation. Third, central banks are now scaling back stimulus in anticipation of higher inflation. In our view, this should help prevent a significant inflation overshoot.

Emerging markets are unlikely to be a source of a general rise in inflation

With the growth turnaround and higher commodity prices, the disinflationary trend in EMs is now likely to be largely behind us. While there are pockets of higher inflation in some regions, we do not expect EMs to be a source of a general rise in inflation. Many EM central banks are focused on their inflation targets, and we expect them to adopt a less dovish stance going forward, which should help to cap the expansion and put a lid on inflation, as long as commodity prices do not spike higher. The weaker US dollar should also help to contain price pressures in these regions, despite a better growth picture.

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US

Core inflation is expected to move higher

While headline CPI Inflation was above 2% for most of last year, core CPI remained stubbornly low during the second half of 2017 despite an ever tighter labour market and a shrinking output gap. In December, the monthly CPI inflation rate slowed down to 0.1%, but core CPI accelerated to 0.3% MoM, lifting the annual rate to 1.8%. An important driver of higher core inflation was a pickup in medical care costs, which represent a significant component in the Fed's preferred inflation measure. The Fed does not expect to reach its inflation target of 2% before 2019 but with some of the base effects fading, the annual rate should continue to rise over the course of the year. In addition, firms' compensation plans rose to the highest level since 2000, signalling a pickup in wage growth which became more evident in January's labour market data. That could add to the slowly increasing price pressure reflected in the latest CPI data. The longer-term relationship between economic activity and inflation points to a pickup in inflation over the course of the year as well. So while we expect inflation to accelerate in 2018, the drop in PPI in December indicates that the risk for a near-term spike remains modest.

UK

Price pressure is slowly easing as the currency effect fades

Inflation remains one of the major headwinds for the UK economy as it continues to squeeze households' real purchasing power. However, the pressure is likely to moderate this year as the currency-induced acceleration in inflation is slowly fading. In addition, the recent strength in sterling will help to dampen import prices. Business surveys confirm that the rate of increase in input costs eased late last year, particularly in the manufacturing sector. Input price inflation is stickier in the service sector although wage growth has picked up only modestly despite an ever tighter labour market. The uncertain outlook with regard to the Brexit and the resulting drop in net migration will increase the upward pressure on wages. Headline CPI rose by 0.4% MoM in December while the annual inflation rate ticked down to 3.0% from 3.1% the month before. Core CPI slowed down to 2.5% YoY from 2.7% in November. We expect inflation to moderate further over the course of the year, although it should remain above the BoE's target. Input price pressure is diminishing with PPI falling to 4.9% YoY, the lowest since July 2016 and significantly below the peak reached in early 2017.

Eurozone

Core inflation to pick up gradually despite the stronger euro

We expect core inflation to rise modestly during the course of this year and next. Currently, Eurozone inflation remains subdued with core inflation around 1% and headline inflation running at 1.3%. However, there are signs of inflationary pressures building below the surface in various business surveys. The output prices component of both the Eurozone Services PMI and Manufacturing PMI have risen sharply in recent months, with the overall composite output price index at its highest level since early 2011. Indeed, the Eurozone economy is currently booming, and we expect growth will be at its highest level in 10 years in 2018. Wage growth at a Eurozone level has also picked up modestly and we expect it to rise further, especially as unemployment is falling rapidly because of strong growth. The stronger euro could weigh somewhat on inflation, however, overall we still expect a modest and gradual increase in core inflation over the next few quarters. We also expect the ECB to end its QE programme by the end of this year.

Switzerland

Inflation to stay well below the SNB's target

CPI inflation ended 2018 at 0.8% YoY, which is the highest level since March 2011, following a sharp acceleration from 0% one year ago. The rise mainly reflected diminishing import price deflation while domestic price pressures were broadly absent. Going forward, the hurdle for inflation to rise further will be higher, and we only see a modest acceleration in 2018, when we expect annual CPI inflation to average 1%. This is higher than the SNB's forecast and reflects our view that the strong global expansion will help return some pricing power to firms. Structural headwinds persist, however, particularly within the retail sector, likely limiting the pass-through to consumer prices. Wage inflation is also very weak, having fallen from around 2% YoY in 2008 to only 0.5% currently. Though businesses are reporting difficulties in filling open positions, it is unlikely to be a trigger for accelerating wages. The trade-weighted franc also remains expensive, particularly following the recent slump in the US dollar, so downward pressures on costs and prices will persist. With inflation set to stay weak despite stronger growth, we anticipate the SNB to keep its focus on the currency over the coming year, and a rate hike is not expected until well into 2019.

Japan

Inflation is inching higher, but expected to subside in 2019

At a first glance, inflationary tendencies seem to be accelerating in Japan. For example, Tokyo's CPI was up 1.3% YoY in January, clearly above the deflationary territory that was common until a year ago. However, looking at the various core measures, the picture is somewhat different. On a nationwide basis CPI excl. fresh food and energy (the ''new' core CPI) stands at only 0.3%, and if food and energy are excluded, 'old' core CPI is hovering around the zero line. Going forward, inflationary pressures are expected to increase into summer due to rising energy prices, higher import costs following a weaker yen, and rising personnel expenses due to labour market shortages. However, we expect core CPI to peak in the second half of the year if oil prices and the USDJPY rate stay at current levels and drift lower into 2019. It therefore seems unlikely that core CPI will move substantially above the 1% mark, thus remaining far away from the BoJ's 2% inflation target. Service sector inflation still remains tepid, despite some signs that dining and other leisure related service prices have started to creep higher. Finally, we note that inflation expectations are moving higher, albeit at a slow pace, according to both corporate and individual investor surveys.

China

Service inflation is trending higher

Even though the weight of food in the CPI basket has shrunk significantly over the last ten years, it still has the highest weighting and lower food prices had the biggest impact on decelerating consumer price inflation last year. At -1.4%, the food category showed the biggest price decline since 2003, contributing to most of the overall CPI decline from 2% to 1.6% in 2017. However, service inflation accelerated. The housing category was up 2.6%, leisure prices were up 3.6% and healthcare prices surged even more following the deregulation of medicine and healthcare services. Rising incomes and a firm labour market certainly underpin the rising trend in service inflation. For this year and next, we pencil in a rise of CPI inflation to 2.2%, which is still below the government's 3% target, but marks the end of goods price deflation. Producer prices surged 6.3% last year, after hovering in deflationary territory for almost five years. The elimination of excessive production capacities and higher labour costs will continue to have an impact. However, producer goods inflation has already peaked and should normalise to less extreme levels. Property price inflation is characterised by a dramatic shift: stabilisation in core cities, but a rising trend in smaller cities.

Australia

Waiting for wage growth

Both headline and underlying CPI were up 1.9% YoY in Q4 17, marginally higher than in Q3, but persistently below the RBA's target band of 2-3%. We maintain our 2.5% forecast for headline CPI in 2018, while acknowledging downside risks. Indeed, the quality of inflation remains disappointing. Utilities and regulated tobacco prices have driven cost push inflation higher, but prices of discretionary items have been subdued. Going forward, we expect ongoing competition in the retail space to weigh on retail prices for a few quarters more. Housing prices, which account for 23% of the CPI basket, should continue to contribute positively in 2018, as owner-occupier demand remains strong, but less so in 2019. Slower credit disbursement and weak wage growth have been responsible for tepid underlying inflation. We do not see the former picking up, given the extreme level of household debt. Wage growth should be lifted by the labour market tightening, albeit at a very slow pace given the high underemployment rate. Additionally, surveys show that employees feel too insecure to ask for wage increases and that the quit rate stands at a post-2008 low. The central bank, despite its optimistic tone, has adopted a wait-and-see strategy and will likely want to see at least two quarters of higher wage growth before hiking. In our view, this brings the timing of the next rate hike to early 2019.

ASEAN

Core inflation to increase

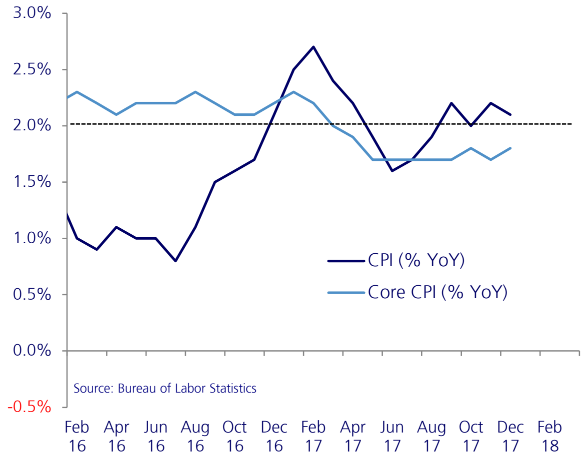
Higher oil prices are generating upward pressure on the transport component of ASEAN CPI baskets.

In Malaysia, where fuel subsidies have been cut, double-digit growth in fuel prices in Q1 18 will be only partly mitigated by a stronger ringgit. In parallel, monetary conditions remain benign, even after one rate hike by Bank Negara Malaysia, and fiscal policy will be loose in the next few months in the run-up to the elections. Wages are already growing at high levels but could edge higher, especially if the government decides to raise the minimum wage. Consumer surveys show that 80% of respondents expect prices to increase in the short run. Putting it all together, we expect core inflation to rebound in H1 18, before the elections. We see Malaysia headline CPI at 3.3% YoY on average in 2018, with upside risks.

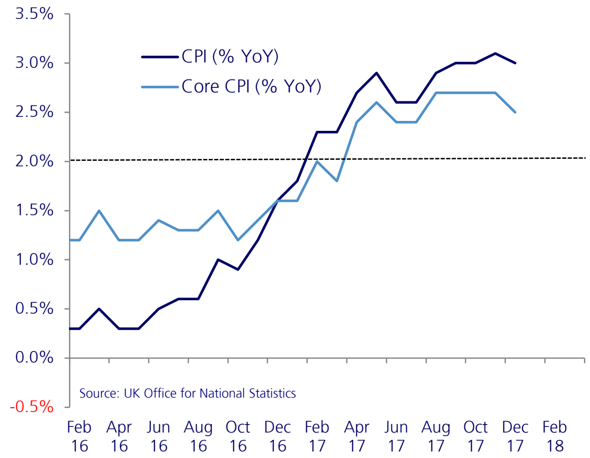
In Indonesia, we expect a modest recovery of core inflation as consumption growth improves thanks to more targeted fiscal spending. The government has frozen fuel prices until April, when it will assess whether to adjust them higher. In our opinion, the government is more likely to absorb oil price pressure via the fiscal deficit, to avoid burdening consumers in a year of regional elections. We forecast Indonesia headline CPI at 4.0% YoY in 2018, which should leave Bank Indonesia comfortably on hold.

Current and historic inflation

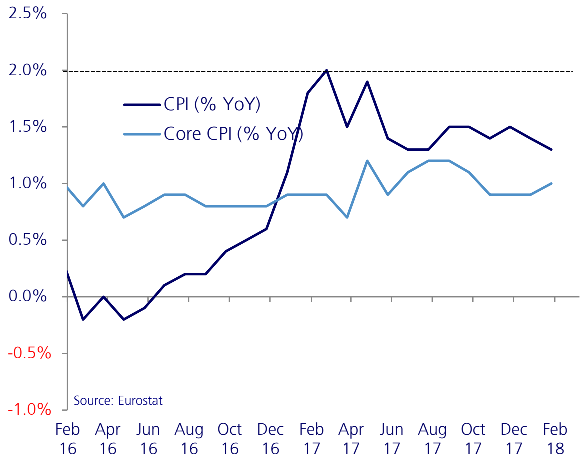
US: core inflation expected to rise



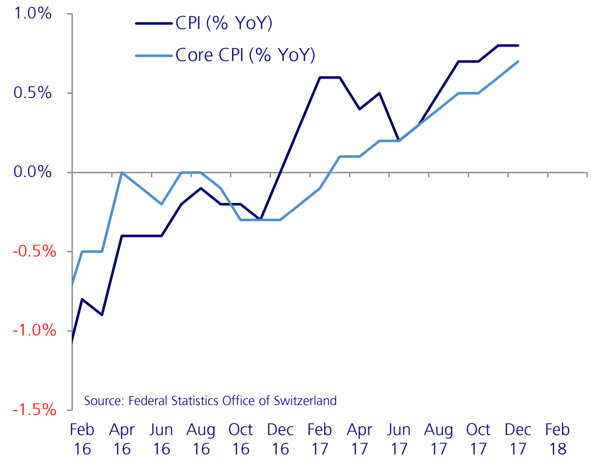
UK: currency effect is fading



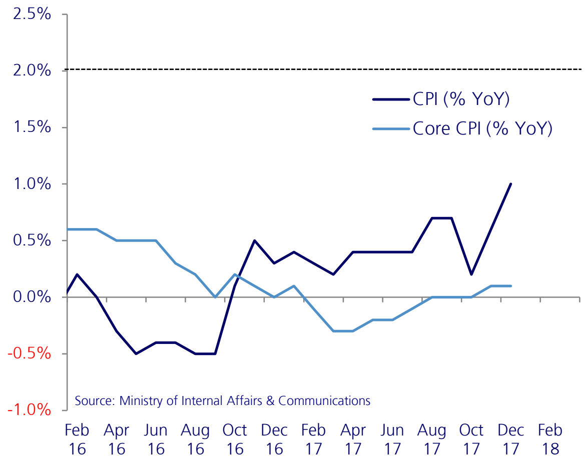
Eurozone: still very low inflation



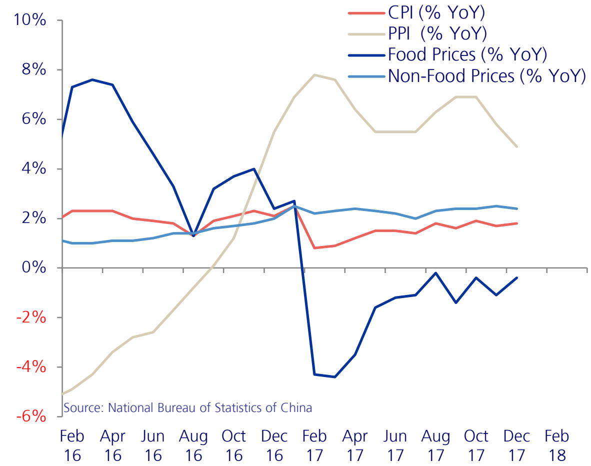
CH: inflation to remain well below target



Japan: inflation inching higher

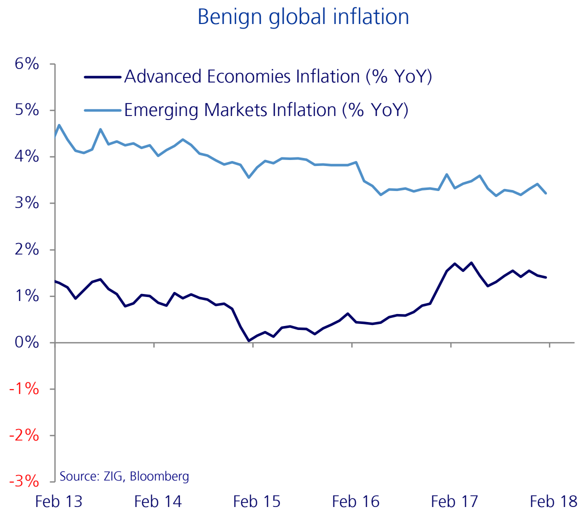


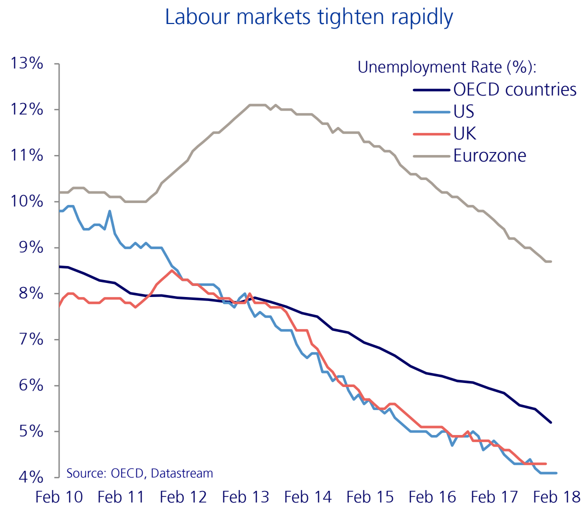
China: PPI inflation peaking

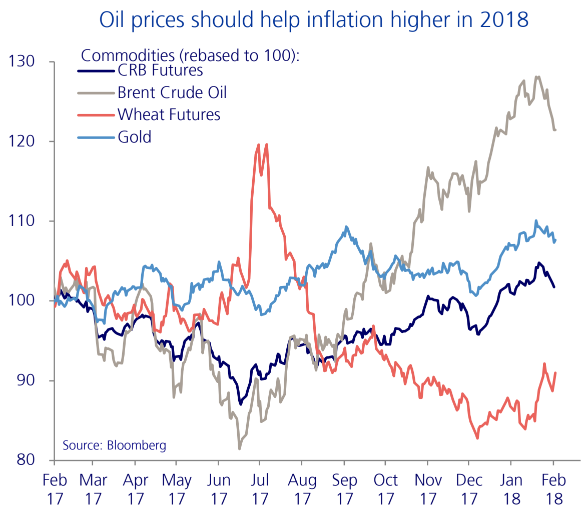


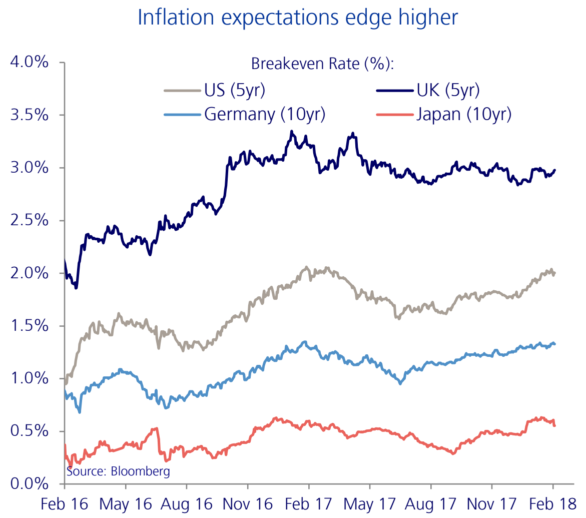
* Dashed lines show inflation targets or equivalent

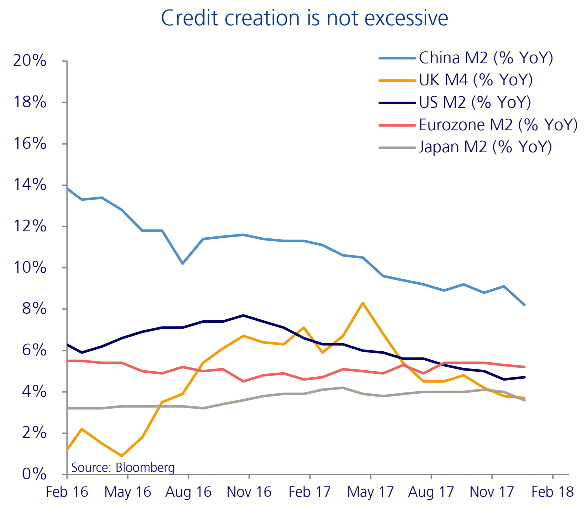
Key indicators

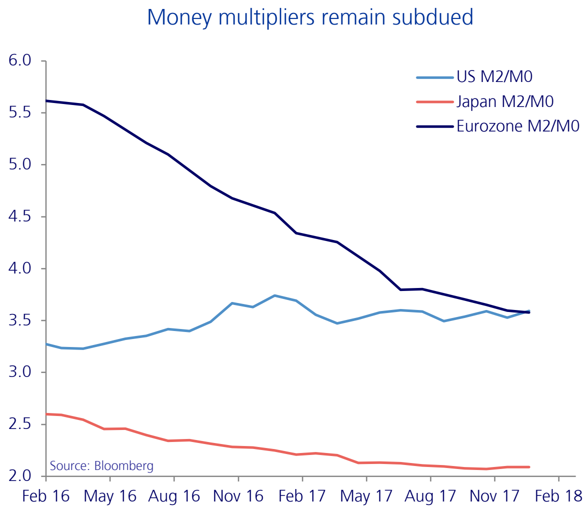












Consumer Prices (Annual Percentage Change)*

	Zurich's Point Estimate			Consensus Forecasts	
	2016	2017	2018	2017	2018
US	2.1	2.2	2.0	2.1	2.1
UK	2.7	2.4	2.0	2.6	2.2
Eurozone	1.5	1.5↓	1.7	1.4	1.6
CH	0.5	0.8	1.0	0.8↑	1.0
Japan	0.4	0.9	1.0	0.9↑	1.1
China	1.6	2.4↑	2.3	2.2	2.2
Australia	1.9	2.5	2.5	2.1↓	2.3
Asia	1.7	n/a	n/a	1.7↓	2.1
Argentina	28.0	n/a	n/a	18.6	13.4
Brazil	3.5	n/a	n/a	4.1↑	4.2
Chile	2.2	n/a	n/a	2.6	3.0
Mexico	6.0	n/a	n/a	4.0↑	3.7

* Consumer prices are shown as annual averages. Asia is ex-Japan and ex-Australia. Data used is either from Bloomberg or Datastream unless otherwise specified. Argentina, Brazil, Chile and Mexico show consumer price increases from December to December. Arrow show changes over the last month.

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