Inflation Focus Q1

25 March 2022

Key Points

- Inflation to rise further as events in Ukraine trigger sanctions and a surge in commodity prices
- Central banks reach an inflection point, accelerating policy tightening despite slowing growth and high uncertainty
- Bottlenecks and imbalances ease on the improving pandemic situation, but the war will lead to new supply challenges
- Policy risk is elevated, as war and pandemic distortions make it difficult to distinguish the underlying trends

Bottlenecks and imbalances ease on the improving pandemic situation

Supply bottlenecks and excess goods demand have been a legacy of the pandemic, along with elevated inflation. As the Covid situation has improved, demand imbalances and supply bottlenecks have eased and upward pressures on some of the most affected price components, including cars, electronics, and furnishing, have begun to diminish. Labour market dislocations have also started to reduce, as extraordinary support measures have ended and health concerns diminished. This is playing out as we had expected.

Inflation to rise further as the war in Ukraine triggers a surge in commodity prices

Looking forward, however, the war in Ukraine will lead to a further rise in inflation, despite the negative impact that the conflict will have on global growth. Energy sanction and disruptions have triggered a sharp rise in oil and gas prices, from already elevated levels, that will feed through the economy and lead to further upward pressure on tranportation, energy, and production costs. In addition, Russia and Ukraine are important exporters of food commodities (eg wheat, corn, barley) and have an integral role in the global supply of fertilisers. Global food prices will rise, also reflecting the relatively high energy intensity of agriculture. The supply of key commodities for electronics and autos will also be impacted as the region is an important supplier, with renewed supply disruptions possible. As a result, there will be further and intense upward pressure on headline and core inflation in the coming months. Less wealthy regions will be disproportionally impacted given their higher consumption shares of food and energy, though some offsets from subsidies and price controls are likely.

Economic growth should be resilient, with labour markets remaining tight

While the economic outlook is highly uncertain and vulnerable to a further escalation in the conflict, we do not anticipate that the war will trigger a global recession. Global growth will slow materially but, as it is coming from a high level, is not expected to fall below trend.

As a result, labour markets will remain tight. Conditions are particularly challenging in the US where job openings continue to track well above the number of job seekers and wage inflation has risen. It is encouraging that people have begun to return to the job market as the Covid situation has improved, as seen in the rising participation rate, but this needs to continue to ease shortages. While wage inflation is still benign in Europe, the unemployment rate has fallen to record lows and wage demands are likely to grind higher in coming months.

Upside risk to services inflation as demand rebalances and cost pressures remain high

Global demand has begun to shift towards services as the pandemic situation has improved, taking some of the heat off the goods sector. While this should help to reduce excesses and imbalances, there is a risk that it will stoke higher services inflation, given a tight labour market and rising costs and rents. Consumer services were particularly hard hit by the Covid crisis, with prices lagging behind those in the rest of the economy. Businesses may seize the opportunity to raise prices, especially if pent-up demand for services is strong and energy costs surge.

To bend the inflation trajectory lower, aggregate demand needs to moderate. This will occur automatically to some extent as elevated energy and food prices will erode spending power. But as households (in aggregate) have built up a significant stock of savings and labour markets are very strong, there is a risk that imbalances between demand and supply persist.

Central banks are not prepared to look through the price shock

This explains why central banks have stepped up policy tightening, despite elevated uncertainty, slowing growth and financial market volatility. The Fed has begun to hike rates and is signalling a steep rate path ahead, while the ECB is planning to scale back QE purchases at a rapid pace. Indeed, a majority of global central banks have begun their rate hiking cycle. With these actions, policy makers have shown that they are committed to bringing inflation back to target. They are not prepared to look through another stint of strong price gains, even if they are supply related and accelerated by the war.

We believe these actions are required to temper demand and mitigate additional price pressure as far as possible. A pragmatic approach will be required, though, and central banks need to be prepared to step back should conditions begin to deteriorate or the crisis escalate. Policy risk is elevated as the war and pandemic distortions make it particularly difficult to distinguish the underlying trends in the global economy.

It is encouraging that longer-term inflation expectations remain moderate and consistent with targets. This is no time for complacency for central banks, however, despite the challenging geopolitical situation.

US

The Fed starts to tighten as inflation soars to the highest in decades

Headline CPI inflation hit another 40-year high in February, rising to 7.9% YoY, while Core CPI picked up to 6.4% YoY. On a monthly basis core price pressure moderated slightly with a notable shift from core goods to services as consumer spending patterns change. Shelter categories continue to rise at a robust pace, as expected, but food and energy remain key drivers of inflation. Given the surge in commodity prices caused by the war in Ukraine these price effects are unlikely to dissipate soon. Rising living costs keep weighing on consumers' minds with the University of Michigan's sentiment index falling to the lowest since 2011.

Consumers' inflation expectations over the next year rose to the highest level since 1981. Crucially, however, inflation expectations over the next five to ten years remain unchanged at 3% after ticking down the month before.

The Fed started to tighten its policy at its latest meeting, lifting the target rate by 0.25%. We expect further rate hikes at the upcoming meetings, but the stable anchoring of long-term inflation expectations will be an important factor for the Fed to consider as it is proceeding on its rate hiking path.

UK

Rising inflation expectations keep the BoE on a tightening path

Headline inflation ticked up to 5.5% YoY in February from 5.4% in January, marking yet another three-decade high. Core inflation also picked up, reaching 4.4% YoY after 4.2% the month before. Food and energy remain important drivers of price rises but core components drove inflation higher as well. Price pressure was more pronounced in the goods sector, but service inflation is firm too and is expected to remain so as consumer spending is likely to shift from goods to services once the Omicron wave subsides. Given the recent rise in commodity and particularly energy prices, headline inflation is likely to accelerate further before peaking later this year.

As expected, the Bank of England raised the Bank Rate by another 25bps to 0.75% at its latest meeting, with one member of the MPC voting against the rate hike. Despite the somewhat dovish tone the BoE is expected to tighten its policy further in the coming months as inflation will remain significantly above target. While the BoE has been willing to look through supply-driven price increases to some degree, the recent spike in longer-term inflation expectations will keep up the pressure on the MPC not to let inflation expectations become unanchored.

Eurozone

Higher oil and natural gas prices will lead to a further spike in inflation

Natural gas futures prices in Europe doubled from already elevated levels on the Russian invasion of Ukraine, though they have subsequently fallen back. Oil prices also spiked and then fell back. Energy inflation was already contributing around three percentage points to total inflation in February and food just under one percentage point. This latest spike will add further price pressures, with Eurozone headline inflation likely to reach above 6% in late Q1 and early Q2. Governments are trying to offset some of the impact on fuel prices by reducing petrol and diesel taxes temporarily. The ECB has also said it will taper QE more quickly because of rising inflation.

We expect headline inflation to gradually fall back in the second half of 2022, but to remain substantially above the ECB's target through the whole of this year. In terms of the impact on longer-term inflation, with inflation expectations already moving higher, it will be critical to see how wage negotiations are conducted. Higher wage demands are clearly likely, but so far we are not seeing evidence of an aggressive wage-price spiral developing in the region.

Switzerland

Inflation will track higher following the commodity price shock, but domestic price trends remain benign

Inflation surprised on the upside in February, with headline CPI reaching 2.2% YoY. While this primarily reflected energy effects, it nonetheless shifted the inflation profile higher for the year. With the war in Ukraine, there will be another boost to energy and commodity prices and we now see CPI averaging 2.4% in 2022, up from 1.1% previously. We have also raised the 2023 forecast as some of these effects could prove sticky. While our forecasts are above those of consensus, inflation is unlikely to become a problem in Switzerland. While volatile, monthly CPI price gains have slowed from mid-2021 as Covid-related price pressures have eased. The latest PPI print confirmed that inflation outside the energy sector remains benign while a stronger currency helps to contain import prices. Domestic inflation is running at around 1.3% YoY and although rent inflation, which has a high weight of 20% in the CPI basket, has accelerated, a tightening in financial conditions and a reactivation of the countercyclical capital buffer should contain housing market pressures going forward.

As anticipated, the SNB revised up the inflation forecast while maintaining a dovish stance in the March policy meeting. We expect rates to be left unchanged in 2022, with additional forex interventions if required.

Japan

The impact of rising energy prices will be contained by public price controls

February's headline CPI moved higher than consensus had estimated, from 0.5% to 0.9% YoY. However, it makes sense to focus on the various core CPI measures. The new core CPI (excl. fresh food and energy), at -1% YoY, remains in deflationary territory. If we exclude special factors such as the administered cut in mobile phone charges and the base effect from the GoTo travel campaign, the new core CPI increased slightly to 0.6%, which better reflects the inflationary picture. The global rise in commodity prices following the Russia-Ukraine war is mainly reflected in higher energy prices in Japan, followed by a smaller impact on food prices. However, government price controls and subsidies are cushioning the surge in input prices, so the overall price outlook remains rather contained. However, current as well as potentially new supply chain bottlenecks could exert further upside price pressure, which could push core CPI (excl. fresh food) towards the 1.5-2% YoY range. Base wage growth remains low at around 0.5% YoY, but overtime and bonus payments should lift overall wage growth toward the 1% mark. We expect the Bank of Japan to revise up its inflation forecast in its upcoming Outlook Report in April.

China

The PPI-CPI gap is expected to shrink

We believe China's substantial PPI-CPI gap will shrink further, though at a slower pace than previously expected. Producer price inflation fell from a 26-year high of 13.5% YoY in October last year to 8.8% in February. The decline was mainly driven by cost-push inflation in sectors such as mining. Fossil fuel prices are expected to remain elevated not at least due to geopolitical tensions, but the National Development and Reform Commission (NDRC) has taken steps to release emergency reserves and has intervened in the spot and futures markets to stabilise prices. Meanwhile, electricity prices remain stable following electricity price reform.

Consumer prices, both headline and core CPI measures, are stable around the 1% level, mainly impacted by still falling pork prices due to increased supply.

CPI inflation is expected to remain stable for now amid the cautious consumption outlook following another surge in Omicron infections but may pick up later this year as pork price inflation will pick up again due to the base effect. Property price inflation remains contained for now, not at least due to price controls as well as lacklustre demand.

Australia

Inflation is rising, but tighter monetary policy hinges on how wage inflation is interpreted

2021 Q4 inflation statistics surprised to the upside, even when focussing on core measures. Headline inflation stood at 3.5%, but what matters is that both the 'trimmed mean' and the 'weighted median' core measures spiked higher to levels last seen in 2014, with the former up 1% QoQ and 2.6% YoY. Since then, input costs, particularly energy prices, have accelerated further and are likely to be passed on to consumers. For the RBA, Australia's central bank, two aspects need to be watched: Will inflation expectations creep higher and will a wage-price spiral develop? So far, the RBA believes that the latest cost-push inflation may prove to be temporary, and that rising wage growth may be contained, which is the reason for remaining patient, with a policy rate hike likely only in Q3 this year. However, according to the March meeting minutes, we note that the Board agreed that the risks to the outlook for wage growth appear to be skewed to the upside. We believe the RBA is likely to base its judgment about wage inflation on a variety of measures, including unit labour costs. The jury is still out as to whether higher wage inflation will give the bank cause to tighten monetary policy earlier than consensus is expecting.

ASEAN

Inflation is expected to be rather contained in Indonesia and Malaysia

In Indonesia, CPI was up 2.1% in the first two months of the year but is expected to rise further into Q2 on higher commodity prices. Early May marks the end of the fasting period, Lebaran, as well as the Hari Raya festive season, when food prices tend to rise. While rising energy prices will likely be mitigated by direct and indirect subsidies, we believe consumer price inflation is likely to move higher but stay within Bank Indonesia's (BI) target range of 2%-4%. Inflation may creep higher in the second half of the year as subsidies on higher energy prices are likely to be reduced cautiously, urging BI to hike policy rates by 25bps two or three times until year end, as long as currency stability is maintained.

Meanwhile, Bank Negara Malaysia (BNM) acknowledged upside risks in its inflationary outlook but sticks to its view that these risks will be capped and core inflation will remain modest. Rising commodity prices might push consumer prices higher, but the BNM is likely to look through this temporary rise. We incorporate one 25bp policy rate hike in H2.

Brazil

Inflation risk remains biased to the upside

Headline and core inflation reached 10.5% and 8.4% in February, above market expectations, with food prices accelerating. The rise in headline services prices was driven by the annual hike in tuition fees, but other services prices are also under upward pressure. Inflation risks have risen significantly since the outbreak of war in Europe and inflation expectations for 2022 show a significant rise from 5.7% to 6.5% due to rising agricultural, metal, and energy prices as well as a possible shortage of fertilizer and supply chain bottlenecks. The higher-than-expected inflation in February and the announcement that Petrobras will increase gasoline and diesel prices, by 19.2% and 24.9% respectively, also drove this movement.

The central bank (COPOM) continued tightening, raising the Selic rate by 100bps to 11.75% in March. The statement signalled another hike of the same magnitude in May. COPOM also stated that the terminal Selic rate of 12.75% should be enough for inflation to converge to the target over the policy horizon. However, they acknowledge that the balance of risks is upside biased and opened the door for additional rate hikes if needed. We expect inflation pressures to remain high in the short term.

LatAm

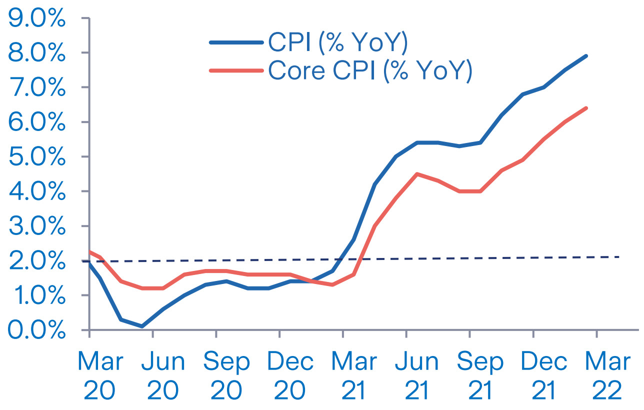
External shocks affect inflation, delaying its deceleration

Inflation continues to accelerate in the region, with a general increase in prices, while core inflation maintains its upward trend. The outlook is challenging given the external commodity price shocks, leading to higher food and energy prices, which represent around 18.5% and 8.5% in the CPI basket repectively. Inertial inflation (ex energy and food and some other volatile components) is also building, adding additional pressure.

In Chile, headline and ex-volatile inflation reached 7.8% and 6.5% in February, respectively. The sustained increase in core inflation and de-anchoring of inflation expectations are concerning for the central bank, which we expect to hike the policy rate by at least 175bps in March. In Mexico, the inflation outlook has deteriorated. Core inflation is sticky, with upward price pressures due to high commodity prices and rising global food prices. We expect Banxico will not have the flexibility to reduce the pace of tightening in the next meeting. In Argentina, inflation accelerated to 52.3% YoY in February. Additional inflation pressures are expected due to the spike in commodity prices, tariff increases, and the primary fiscal deficit agreed to with the IMF. Although a tightening of price controls is likely, it will not be enough to ease inflation.

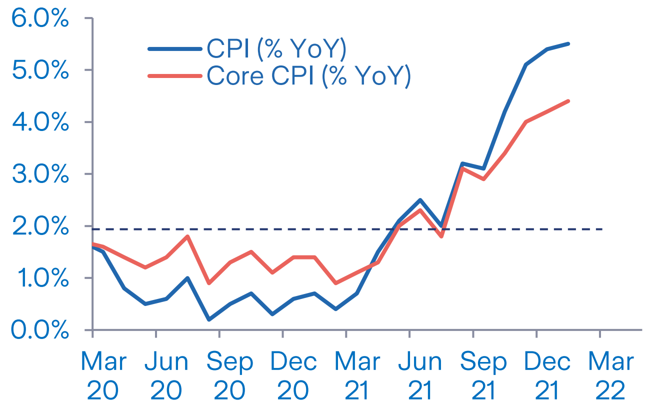
Current and historic inflation

US: Fed tightens policy as inflation surges



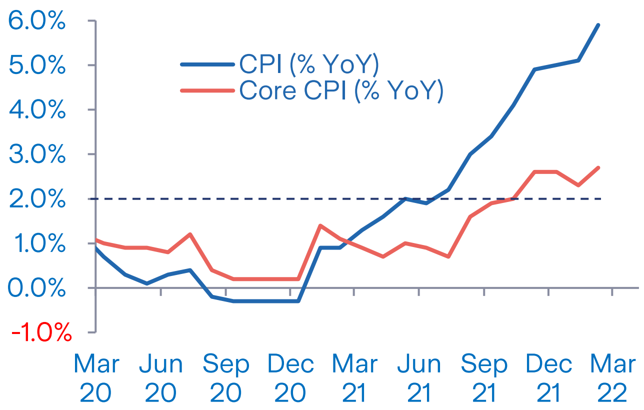
Source: BLS

UK: BoE responds to persistent inflation pressures



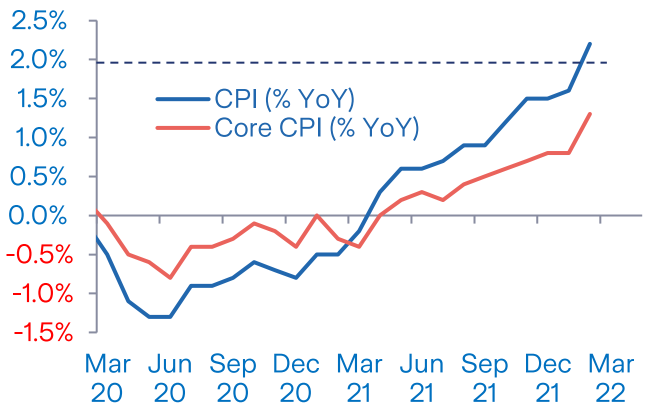
Source: ONS

EZ: Inflation will rise further as energy prices rise



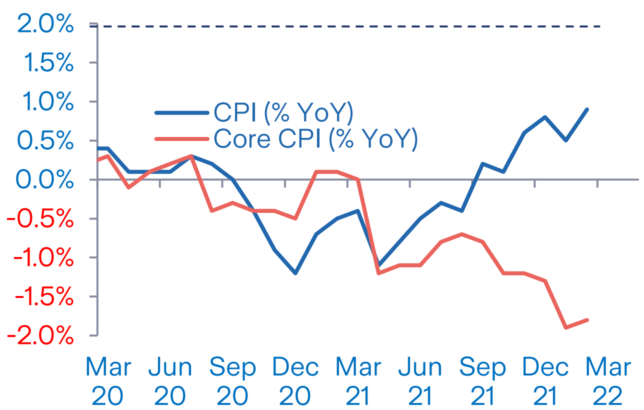
Source: Eurostat

CH: Domestic price pressures are more muted



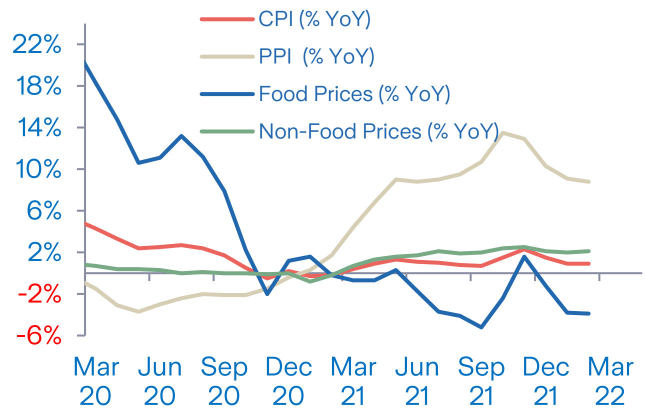
Source: Federal Statistics Office

Japan: Public measures will contain inflation



Source: Ministry of Interal Affairs & Communication

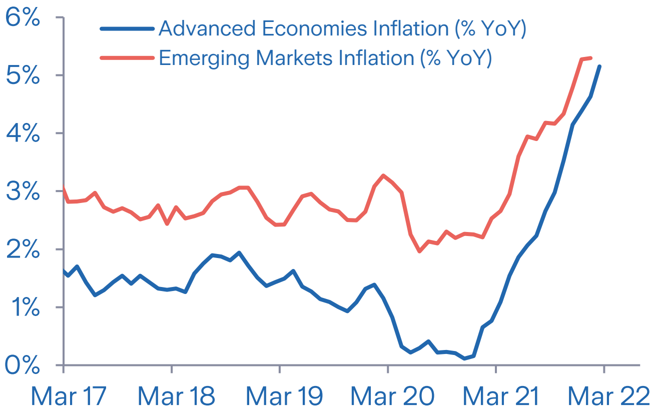
China: PPI falling back



Source: National Bureau of Statistics China

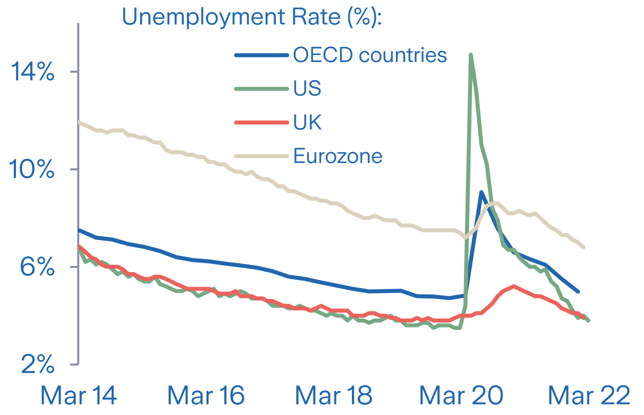
Key indicators

Energy drives inflation higher, with more to come



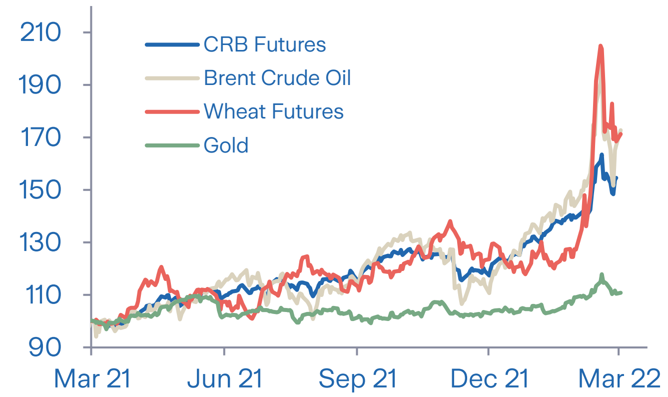
Source: ZIG, Bloomberg

Upside risk to wages amid tight labour markets



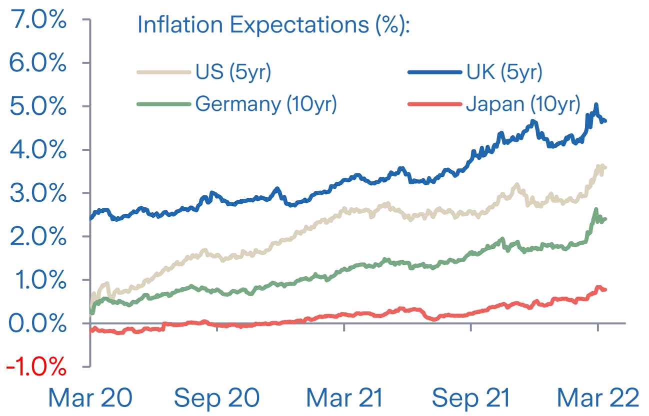
Source: Bloomberg

Food and energy prices surge on Ukraine war



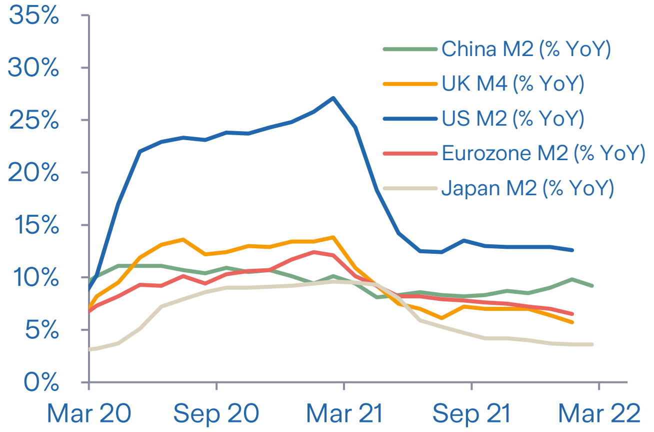
Source: Bloomberg

Central banks will take notice



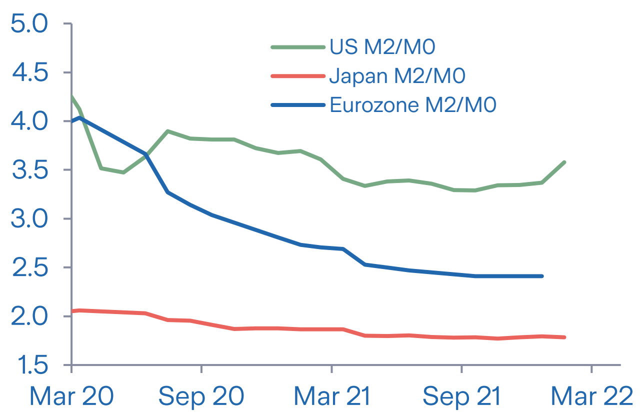
Source: Bloomberg

US money growth still running at a high rate



Source: Bloomberg

Money multipliers firming in the US



Source: Bloomberg

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