February 21, 2019

Inflation Focus Q1

Key Points

- Headline inflation falls rapidly due to lower oil prices and slower growth, but this effect should fade over time
- Core inflation remains resilient but benign in most regions, supported by modestly rising wage growth
- US inflation is unlikely to become a problem, but a modest rebound after recent declines should be expected
- Inflation is expected be contained in emerging markets, reflecting slower growth and past policy tightening
- While inflation should be resilient in 2019, the longer term projection is weak in many regions

Source: iStock by Getty Images

Inflation is receding, but the underlying trend is resilient for now

Headline inflation has fallen back globally, mainly reflecting a 40% slump in oil prices in Q4 2018 which is now impacting inflation with a lag. In the US, headline CPI has slipped from 2.9% in mid 2018 to 1.6% currently, with similar declines in other major regions. Looking through the oil price effect and focusing on the underlying inflation trend, core inflation measures have been more stable, running close to target in the US and the UK while remaining broadly flat but at a low level in the Eurozone, Switzerland and Japan. Emerging markets have also seen sharp declines in headline inflation, as a stabilisation of currencies, helped by central bank actions, has put a lid on import price inflation while growth has slowed. Worries around rising inflation, which surfaced in the first half of 2018, have consequently receded, in line with our view that inflation is unlikely to become a problem over the coming year.

Tight labour markets should help to support inflation, despite slowing growth

Going forward, two opposite forces will shape the near term inflation outlook. The global economy has weakened sharply, with excess capacity opening up and employment growth slowing. This is disinflationary, and it is instructive that Chinese producer price inflation, which feeds into global goods prices, is set to turn negative in the coming quarters, for the first time since 2016. On the other hand, labour markets are very tight in developed regions, with unemployment at multi-decade lows in the US, UK, Germany and Japan, and wage inflation is edging higher – not only in the US but also in Europe and Japan. Inflation prospects will depend on which of the two forces will dominate – slowing growth or capacity constraints. We maintain our view that growth is likely to stabilise over the course of the year. Oil prices have also rebounded since the turn of the year, somewhat reducing the drag from the decline in Q4. Given tight capacity, we therefore expect the underlying inflation trend to be resilient in 2019. For the US, this means that the Fed's favourite measure of inflation, core PCE, is likely to creep higher over the course of the year.

Central banks turn more dovish, avoiding a potential policy mistake

The sharp slowdown in growth combined with financial turbulence caused a significant change in tone from the Federal Reserve, as it stepped back from its relatively hawkish stance and emphasised that it will be patient in its rate setting decision. This is a key move that releases pressure on global financial conditions and allows other central banks to adopt a more dovish stance, which should in turn help to sustain growth going forward. This has also supported market implied measures of inflation expectations, and in our view helped to avoid a potential policy mistake. As inflation is likely to be resilient, we do, however, view the current policy easing as a pause, and do not rule out a rate hike by the Fed later this year. The ECB and the BoJ, by contrast, are expected to leave their policy rates unchanged this year.

Inflation is unlikely to become a problem, despite more accommodative policy

While central banks have shifted their policy stances, we do not expect this to unleash inflation, despite rising wages and the inflationary impact of tariff hikes. Inflation dynamics are still very benign in large parts of Europe and Japan, as well as in China, which will help to contain global price pressures. Central banks are committed to their inflation targets, and policy will be adjusted should inflation show more meaningful signs of picking up. While the imminent risk of a policy mistake has been reduced with the Fed's dovish shift, political and geopolitical risk also remain significant, with global trade disputes still unresolved.

Looking forward, the window for getting inflation back to target is rapidly closing

Although we are encouraged by the Fed's more pragmatic stance, we maintain our view that a US recession is likely in 2020, and this would have significant global consequences. This also means that the window for getting inflation back to target is rapidly closing. Many regions, including the Eurozone, Switzerland and Japan, are consequently likely to enter the next recession with very low inflation, and policy rates still at or below zero. While inflation should be resilient in the near term, the longer term projection is therefore weak, with implications for monetary policy and bond yields.

US

Inflation should creep higher in 2019

After rising to 2.9% YoY in mid 2018 and reaching the highest level since 2012, headline CPI inflation quickly fell back to only 1.6% in January. Not surprisingly given the sharp drop in energy prices in the final quarter of 2018, the main driver of the slowdown in inflation was the volatile transportation component. Even if energy prices remain stable in the coming quarters, the base effect will be a drag on headline inflation for the rest of the year. Meanwhile, core inflation is expected to keep a healthy pace given the solid economic momentum and a feed-through of higher service costs. Housing costs, a key ingredient to core inflation, are expected to soften as the housing market is cooling but this is happening relatively slowly and will be more pronounced in the second half of the year. After being a drag for some time now, health care costs seem to have bottomed last year and may be more of a tailwind for core inflation going forward. This will also have a positive impact on PCE Core inflation. After briefly reaching 2% in July, and therewith the Fed's target level, PCE Core fell back to 1.9% in December. We expect the Fed to hit its inflation target over the course of the year but the upside is limited.

UK

Inflation should stabilise, unless there is a hard Brexit

Headline CPI inflation slowed to 1.8% YoY in January, the lowest level in two years. A steep drop in energy prices in Q4 2018, a weaker economic environment caused by a global slowdown and Brexit uncertainty as well as a stabilisation of the pound in the second half of last year have all contributed to lower inflation. Core inflation, which is more representative of the underlying price pressure, has hovered around 2% for almost a year now. Interestingly, despite headline inflation falling to a two-year low, both households' long-term and short-term inflation expectations rose in December, the latter to the highest in five years. It is too early to say whether the divergence between actual and expected inflation will continue, but it would pose a challenge to the BoE as they could be pushed to hike rates earlier to keep a lid on inflation expectations. In any case, the Brexit process will have a major impact on inflation in 2019. Should the UK leave the EU without an agreement, the subsequent slump in sterling would boost inflation as it did after the referendum in 2016. If such an outcome can be avoided a rebound in the currency would help to keep inflation in check, allowing it to stabilise around the BoE's target.

Eurozone

Headline inflation falls sharply due to oil prices, core inflation still subdued

Headline inflation in the Eurozone is falling sharply, as lower oil prices compared to 12 months ago depress energy inflation. In January, headline Eurozone inflation was 1.4% compared to 2.2% in October 2018. Assuming oil prices stay around current levels, headline inflation will continue falling over the next few months. More importantly, from the ECB`s perspective, core inflation in the Eurozone remains subdued, still stuck at around 1%, well below its target. While stronger wage inflation in 2019 should put some upward pressure on core inflation, the current weak demand conditions mean that companies may be unable to raise their prices and will instead be forced to take some of these higher wage costs as a hit to their profit margins.

The upshot is that core inflation is only likely to rise modestly at best. As a result, the ECB will have to keep interest rates low, and we no longer expect it to raise rates at all in 2019. Instead, further monetary easing, such as another liquidity operation for banks, is more likely.

Switzerland

Inflation weakness will persist

Inflation has weakened over the past few months, with negative monthly inflation prints for both headline and core CPI in January, leaving the yearly inflation rates for these indices at 0.6% and 0.5% respectively. Weakness in the headline index is dominated by lower oil prices. This effect will continue to weigh on inflation in the first half of the year, with annual inflation likely to briefly dip into negative territory again over the coming quarters. Core CPI has also softened, with the monthly rate now tracking at -0.2% in the past three months. As we have highlighted before, this reflects broad based weakness, with both domestic and imported goods prices as well as services prices all converging to an inflation rate at around 0.5% YoY. Wage inflation has also slipped, to only 0.5% YoY in 2018 Q3, down from 0.8% in the prior two quarters. Without a much weaker franc, which we do not anticipate, or a further rise in oil prices, a rebound in underlying inflation looks unlikely, particularly as growth is slowing and labour market conditions are turning less favourable. With inflation weakness persisting, we anticipate the SNB to leave policy unchanged through 2019, continuing to lag the ECB in its rate decision.

Japan

A tale of diverging inflation expectations and faulty wage statistics

Capital markets seem to be acknowledging that inflation is not around the corner in Japan, as 6yr breakeven rates have tumbled from the prior 0.4-0.7% range to only 0.2% recently. We believe core CPI (including energy, excluding fresh food) will fall back to 0% later this year if oil prices and the yen stay roughly where they are now. Investor expectations about inflation are somewhat in contrast to consumer expectations, with the latter starting to discount the consumption tax hike on October 1 from 8% to 10%. Domestic corporate goods prices continued to decline early this year both on a sequential as well as on a YoY basis.

It is now evident that wage statistics have to be interpreted very cautiously following a scandal about the faulty labour survey, in which only a sample of big firms in Tokyo was used without proper adjustments. Regular wages were up less than 1% recently, roughly unchanged on a real basis, and far away from the 2.5% level the Bank of Japan would like to see in order to bring inflation closer to their target. Twenty years have passed since the Bank of Japan introduced ZIRP, the 'zero interest rate policy'. Going forward, we do not foresee major changes in BoJ policy this year.

China

Producer price deflation is around the corner, urging looser monetary policy

Consumer price inflation has fallen to a 12-month low of 1.7% YoY and is well below the PBoC's upper target of 3%. Soft domestic demand and lower energy prices are the main drivers. Non-food inflation also stands at 1.7%, a two-year low. Other categories also gave evidence of softer inflation prints. Transportation inflation fell significantly, while recreation, medical and housing inflation seems to be stabilising, but it is too early to judge whether this is only a temporary phenomenon. As for medical prices, a new bidding system has been introduces recently for some medical categories, which resulted in a significant cut of around 50% in these categories. It is likely that the test phase will be expanded and cover a broader scope of medicine and more regions. This would exert downward pressure on consumer prices overall, if implemented. The bigger concern, however, is the rather dramatic decline of producer price inflation that declined from 7.8% two years ago to only 0.1% early this year, with factory gate prices already in deflationary territory. This does not bode well for industrial profits, with smaller private companies already in the doldrums in particular, as real interest rates are rising. Deflationary tendencies are reinforcing pressure on the PBoC to loosen monetary policy even further, with potential rate cuts in the offing.

Australia

As the central bank shifts to a neutral stance, the focus will be on the speed of falling house prices

As expected, Australia's central bank, the RBA, kept its policy rate unchanged at its latest MPC meeting, but lowered its 2019 GDP growth forecast from 3.5% to 3%, and its inflation forecast by 0.25 bps to 2%. The RBA's stance has clearly shifted from a tightening bias to neutral. While the weak global economic environment and falling house prices were acknowledged, the strong labour market is the main reason for an overall balanced RBA stance. In Q4 last year, headline inflation rose by 0.5% QoQ while the YoY rate inched down to 1.8%, with core inflation still below the RBA's target range. Wage growth was solid at 0.5% QoQ and 2.3% YoY in Q4, but real wages were up only 0.5%, which will not give a big boost for consumption.

The main focus this year will be on the housing sector as house prices have already fallen nearly 8% from their peak and are not yet showing any signs of stabilisation, with a negative impact on building approvals and construction activity. We suspect that consumer sentiment will be negatively affected, despite a strong labour market. However, there are no signs of forced selling in the housing sector, which is encouraging. Business conditions tumbled at the end of 2018, but there have been signs of some stabilisation recently.

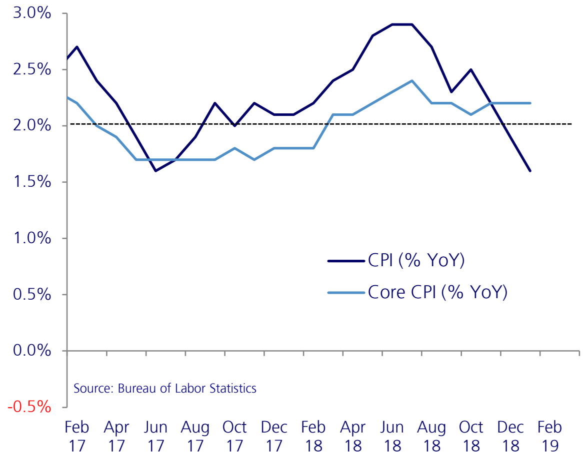
ASEAN

Inflation remains broadly in check

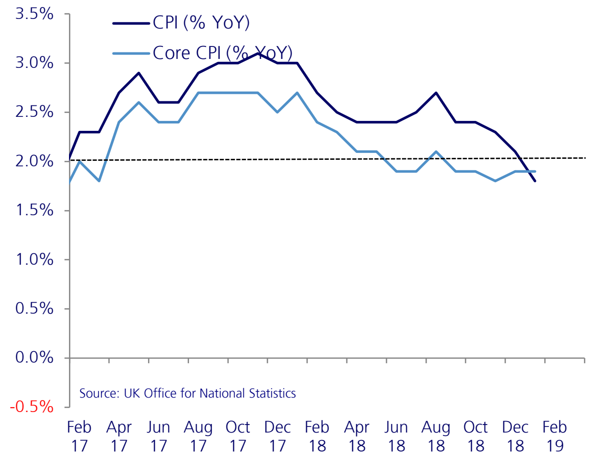
Inflationary pressures remain well contained in most ASEAN countries, as the falling oil price has kept headline inflation in check so far this year. However, in Malaysia, the re-introduction of the sales and service tax and a new system of targeted fuel subsidies, with caps and limits, should push inflation higher in the second half of 2019, though we still expect inflation to remain below the central bank's target range of 2.5%-3.5%. In Indonesia, we expect some of the fuel and utility subsidies to be phased out after the general election, but headline inflation should still remain within Bank Indonesia's (BI) target band. BI has been proactive in 2018, hiking its policy rate in several steps from 4.25% to 6%. In the Philippines, it seems likely that inflation will move back to the central bank's target range soon, enabling it to shift its policy from inflation containment to supporting growth. In Thailand, it even seems likely that inflation will again undershoot the BoT's medium-term target of 1%-4%. In Singapore, core inflation is creeping higher due to rising service prices, but should remain within the MAS's target range. Overall we note that many ASEAN central banks have moved to a more dovish tilt recently.

Current and historic inflation

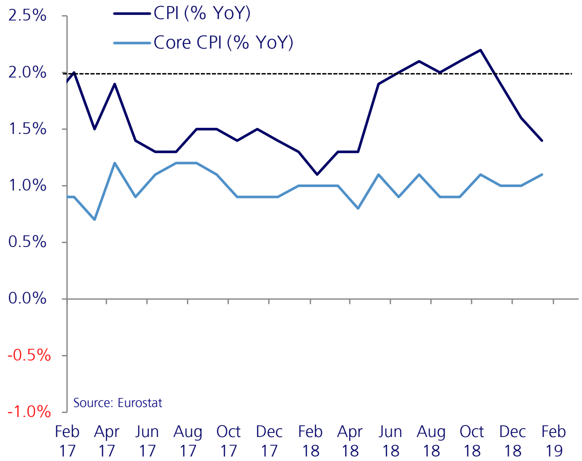
US: core inflation holds steady



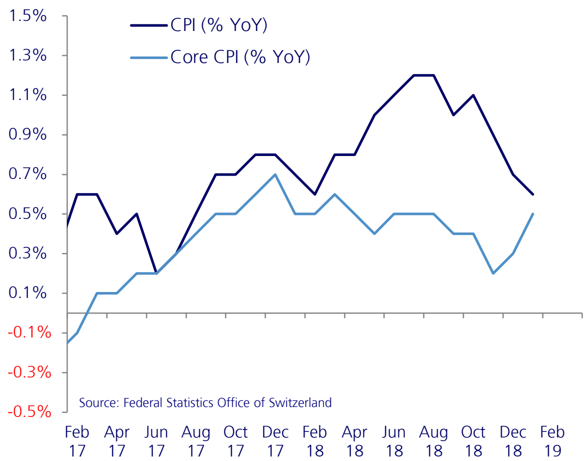
UK: inflation stabilising, but Brexit will be decisive



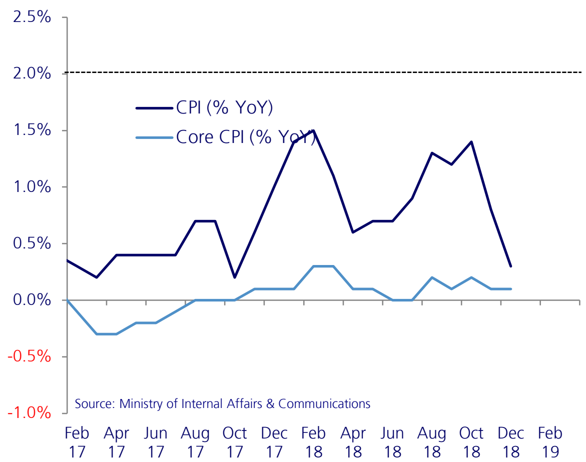
Eurozone: core inflation still too low



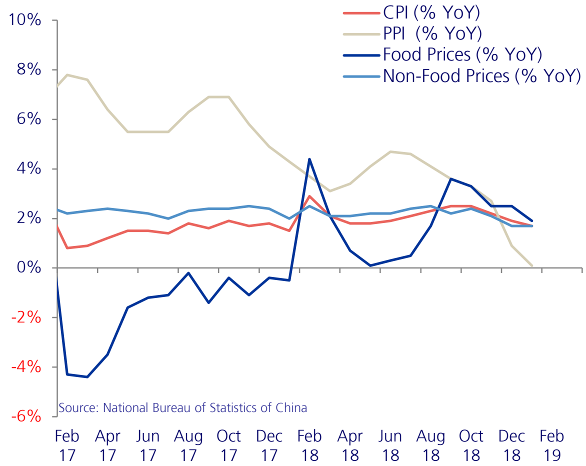
CH: core rebounds but weakness will persist



Japan: core CPI remains close to zero

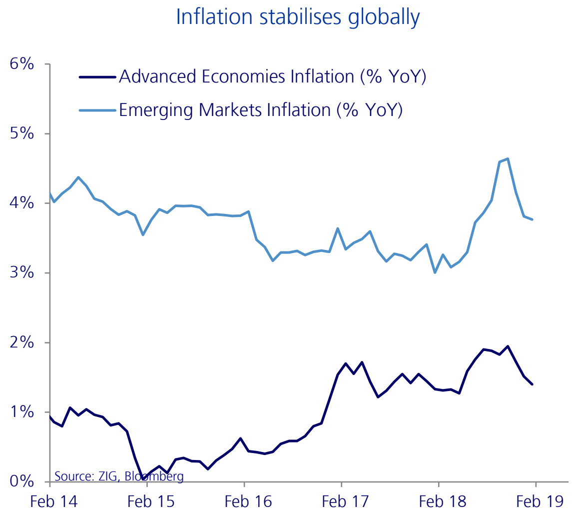


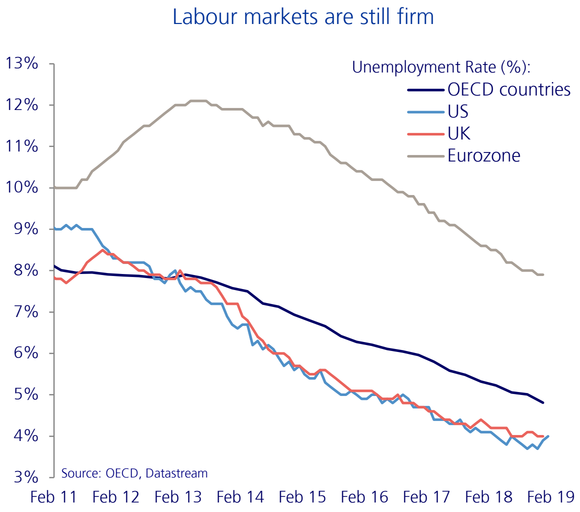
China: PPI edges towards deflation

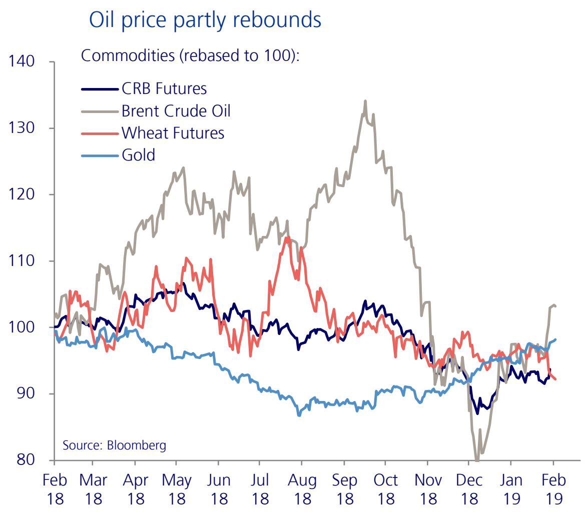


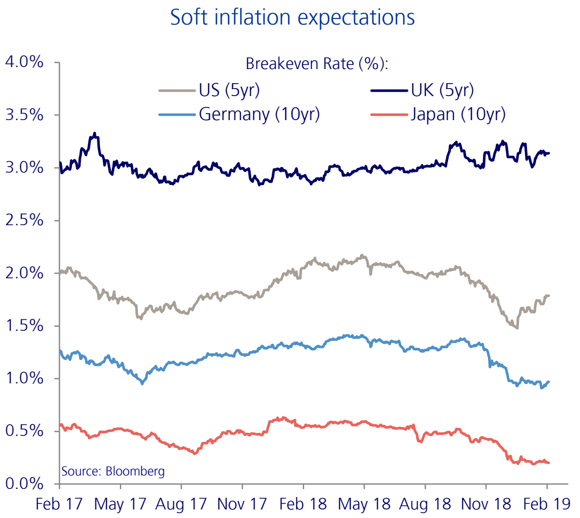
* Dashed lines show inflation targets or equivalent

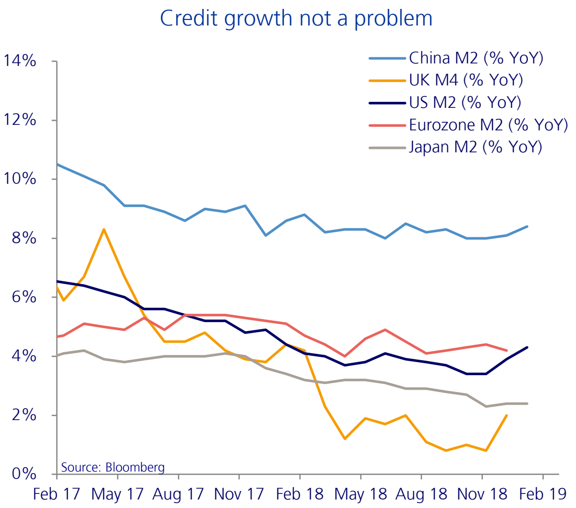
Key indicators

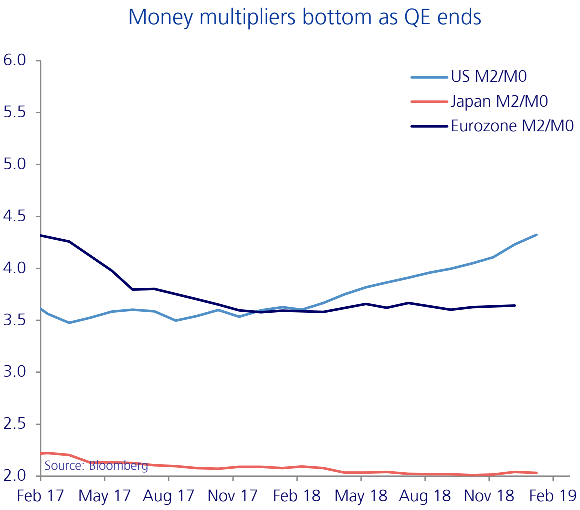












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