August 27, 2019

Inflation Focus Q3

Key Points

- Headline inflation remains below target in many regions, and inflation expectations have slumped along with growth
- Central banks loosen policy, but more profound actions will be needed to more sustainably improve the growth outlook
- Core inflation is set to remain benign, supported by modestly rising wages but with global headwinds intensifying
- While deflation is still some way off, geopolitical and political risks are large, with risks to inflation tilted to the downside

Source: iStock by Getty Images

Global growth slows sharply as trade disruptions escalate

Global growth is slowing sharply as a result of past policy tightening and escalating trade disputes, both between the US and China and more recently also between Japan and Korea. World trade is stagnating and the global manufacturing sector is in recession. With geopolitical and political risk set to remain high and uncertainty weighing on business sentiment and capex spending, there is little prospect for a more meaningful turnaround in global growth. For this to happen, more profound action would need to be taken, both on the monetary and fiscal front.

Inflation is weak in most regions, and producer prices are turning deflationary

Inflation, meanwhile, remains weak globally. Developed economies are, with a few exceptions, persistently failing to reach their inflation targets, with core CPI inflation in the Eurozone and Japan still not strong enough to rise above 1%. Inflation is also benign in emerging markets, as trade and supply chain disruptions weigh on growth and inflation, while last year's currency induced inflation impulse has faded. Producer prices have additionally started to fall in China, reflecting weak commodity prices and excess industrial capacity. This will be a disinflationary force for the global economy over the coming months. Alongside this, market based inflation expectations have slumped and are once again showing that investors doubt that central banks will ever be able to deliver higher inflation. As inflation has remained below target for most of the decade, this renewed weakening of inflation is a serious threat to central banks' credibility, and to their independence.

Central banks move to counter the slowdown, but policy space is limited

This is a key reason for why central banks have moved swiftly to inject stimulus into the economy – over half of major central banks (in a sample of 44) have cut rates over the past three months, with more to come, including from the Federal Reserve and the ECB. The hope is that the next downturn will be delayed and that damages from trade disruptions can be offset with monetary stimulus. By contrast, if the manufacturing slowdown is not arrested, weakness is likely to spread to labour markets and the broader economy, and induce a global recession. This explains why central banks are prepared to loosen policy despite very tight labour markets. Indeed, the US unemployment rate is still close to a 50-year low, wages in the UK are rising at the fastest rate since 2008, and the jobs to applicants ratio is at the highest level since the 1970s in Japan.

Monetary policy alone is unlikely to turn around growth dynamics

In our view, the Fed tightened too much and too swiftly over the past couple of years, as high global debt makes almost all economies vulnerable to higher interest rates. A reversal in the policy stance is welcomed, and will reduce one headwind for the global economy. However, headwinds from global trade disruptions are intensifying, and we suspect that it will be difficult for central banks, on their own, to turn around growth dynamics, particularly given that one third of tradable global debt is already negative yielding.

Inflation set to remain weak, though deflation is still a long way off

Given this background, the near-term outlook for inflation is likely to remain benign. On the one hand, slowing global export and producer price inflation will work their ways through the supply chain, weighing on inflation. On the other hand, tight labour markets should continue to support modestly rising wages, with deflation remaining a more distant threat. Risks are large, however, and tilted to the downside. An escalation and broadening out of the trade war would lead to a more severe recession. This, in our view, would be deflationary. By contrast, should the support mechanism broaden out beyond monetary policy, a rebound in growth in combination with tight labour markets could produce spots of higher inflation. That said, underlying weaknesses in the global economy, including a highly leveraged global economy and an extended economy cycle, makes this a less likely scenario.

US

PCE core inflation to rise only modestly

As indicated by the Fed, the recent weakness in inflation has shown to be transitory with headline CPI inflation reaccelerating to 1.8% YoY in July. Nevertheless, inflation hasn't managed to rise above 2% so far this year. On the other hand, core CPI inflation stubbornly remains above 2% and actually rose to 2.2% in July. Although the rise in core CPI inflation was relatively broad-based, individual components indicate that PCE Core inflation, which is the Fed's main focus, will move only moderately higher in the coming months. Having ticked up to 1.6% in June it remains well below the Fed's target, leaving room for further policy accommodation in the coming months.

There were no signs in recent data that the tariffs imposed on imports from China have had a significant impact on consumer prices. Should the US administration follow up on their recent announcement to impose a 10% tariff on the remaining USD 300bn worth of imports, we would expect to see some pass-through to consumers. However, as the US dollar has strengthened against most other currencies, and particularly against the Chinese Yuan, import prices in dollar terms are unlikely to rise significantly. As a matter of fact, despite all the tariffs already imposed so far, core import prices still fell by 1.8% YoY in July.

UK

Inflation is supported by weak currency and solid wage growth

Headline CPI inflation has been hovering around 2% YoY for most of this year with a slight acceleration to 2.1% in July. The price increases were relatively broad-based, with lower energy prices more than compensated for by other components. Core inflation ticked back up to 1.9% in July after falling to the lowest level in more than two years in May. The pickup was supported by a solid rise in service inflation, a trend that is likely to continue for the time being. Despite Brexit uncertainty and the first quarterly GDP contraction since 2012, the labour market remains tight and growth in core wages (ex bonuses) accelerated to 3.9% YoY in June, the highest level since 2008. In addition to wage-induced inflation, the steep fall in sterling will be a tailwind for inflation through higher import costs, particularly when the base effect from lower energy prices fades later this year. Clearly, the currency impact crucially depends on which Brexit scenario plays out. An agreement with the EU is still possible, which would lift the pound and mitigate inflation pressure. However, if the UK leaves the EU without an agreement, which is increasingly likely, sterling will weaken further, pushing up prices even more.

Eurozone

The ECB prepares more stimulus, but it is unlikely to be a game changer

Eurozone headline inflation has fallen back to around 1% recently on the back of declining energy and service sector inflation, while core inflation has been stuck in a tight range at around 1% since mid-2017. Inflation expectations also remain stuck at low levels despite promises of fresh stimulus by the ECB. With growth slowing, wage deals are unlikely to be as generous as in the last few years, as workers' bargaining power has been reduced. The upshot is that inflationary pressures are muted, and the burden is on policymakers to find ways to boost growth and inflation. Indeed, with the Eurozone at risk of falling into recession in the next few quarters, the ECB appears to be preparing to announce a significant monetary stimulus package in September, including restarting QE and cutting interest rates further into negative territory. However, without an accompanying government fiscal stimulus package, this is unlikely to make a significant difference in the outlook, and inflation is still likely to undershoot the ECB's target.

Switzerland

Inflation slipping as the currency strengthens

Inflation has fallen back again, with headline CPI at only 0.3% YoY in July. Weakness was partly driven by seasonal food and energy, and these effects are likely to wane. Looking forward, however, the Swiss franc has appreciated by 5% since May (on an effective exchange rate basis), and this will weigh on import prices and contain broader price pressures going forward. With import and producer prices now in deflationary territory, at -3% and -1% respectively, we have revised down our 2019 and 2020 CPI inflation forecasts, to 0.5% and 0.7%. Moreover, risks to the outlook are tilted to the downside, as domestic price pressures remain weak, with growth slowing sharply and commodity prices declining along with global growth.

Pressure is mounting on the SNB to stave off further currency appreciation as the ECB restarts stimulus. Our view is that the SNB will try to avoid further rate cuts and focus on forex interventions. Policy space is limited, however, and further cuts to the deposit rate cannot be ruled out. While it would help to stabilise the currency, it would not be a constructive policy move as it puts pressure on banks and amplifies financial imbalances, but is unlikely to materially improve economic prospects.

Japan

The impact of the consumption tax hike on inflation will be subdued

Core consumer prices, ex food and energy, continue to meander in a narrow range below 1% YoY for Tokyo and just above 0% on a nationwide basis. Different to previous instances when the consumption tax was hiked, we do not foresee a steep surge in prices after October 1st, when the VAT will be hiked from 8% to 10%. Even though the impact over the next four quarters following the consumption tax hike will contribute to an increase in CPI inflation by not even one percentage point, free education will subtract 0.6 basis points, while lower mobile phone service charges will deduct another one tenth of a percentage point. The only component where a steeper price increase is currently visible is that of mobile phones following the release of a new generation of Android phones. On a producer price level utility prices are rising, while petroleum and coal prices are a drag. Wage statistics do not provide a clear picture due to statistical changes in terms of the sample of surveyed workers. This effect will only start to evaporate early next year. A read-through suggests that wage increases keep hovering in the 0.5%-1% range, with summer bonuses contributing most to the recent rise. We do not expect the Bank of Japan to significantly change its monetary policy approach in the months ahead.

China

CPI rises on surging food prices, while producer prices are falling again

Consumer price inflation moved to a 17-month high of 2.8% in July while the core CPI remained stable at 1.6%. Surging pork prices (+27% YoY) caused by swine flu, as well as fresh fruit prices (+39% YoY) explain most of rise. The impact is expected to last for some time due to reduced pork supply. Higher food prices tend to impact real income and consumer confidence negatively. However, China's CPI is expected to increase less after September due to a negative base effect.

Meanwhile, the trend for producer prices is diverging, as they have fallen into negative territory for the first time in three years, down 0.3% in July due to falling raw material prices. As we expect steel prices to fall further following reduced property construction business, the negative impact is not expected to wane any time soon and will have a negative effect on industrial profits.

We believe that the PBoC will add more liquidity, cut the RRR, expand the medium-term loan facility and improve the monetary transmission mechanism. A policy rate cut is only likely in the case that growth decelerates further following new US tariffs on Chinese consumer goods imports, likely to be imposed after the Christmas shopping season.

Australia

Below target inflation to persist

Consistent with global trends, Australia stands at a crossroad of subdued growth and muted inflation. Q2 headline CPI rose from 1.3% to 1.6% YoY, mainly driven by a surge in fuel prices. The trimmed mean CPI remained at 1.6% YoY, below the RBA's target of 2-3%. In August, the RBA downgraded its 2019 GDP forecast from 2.6% to 2.4%. As the growth outlook is bleak, demand led inflation should be limited. From a cost perspective, although a rise in fuel prices drove Q2 headline CPI higher, core CPI remained immune. Q2 wages edged up to 0.6% QoQ but the year-on-year figure remained at 2.3%. The unemployment rate held at 5.2%, exceeding the RBA's estimate of the NAIRU (non-accelerating inflation rate of unemployment), which was revised down to 4.5% in June. Wage rises are therefore likely be contained. While house prices stabilised, a high level of household debt and subdued final demand put a lid on further price appreciation.

As inflation is not a concern, the RBA has some room to ease its policy. We expect another 25 bps cut towards the end of this year. Accommodative fiscal policies will also support the economy through tax cuts. However, these moves, while mitigating certain downside risks, might not help to avert weaker momentum.

ASEAN

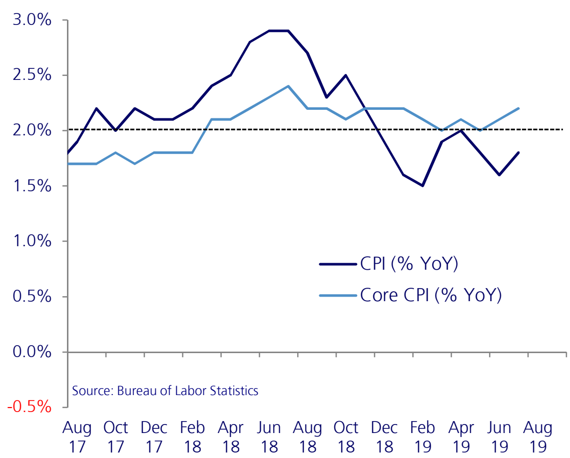
Broad-based economic weakness contains inflation

Price pressures in the region remain lacklustre amid subdued final demand and sluggish growth. The ASEAN-5 equally-weighted CPI drifted close to 1.8% YoY in June, with only the CPIs of Indonesia and the Philippines comfortably falling within the respective central bank's target range. While food and energy prices, which are sensitive to weather conditions and fuel price volatility, tend to push inflation higher, broad-based economic weaknesses kept momentum in check. While CPI inflation in Indonesia was roughly steady at 3.3% YoY in July, core inflation fell marginally, reflecting weak underlying activities. The headline CPI in Malaysia keeps wavering at a low level of 1.4% YoY. Thailand's headline index edged up a bit close to 1%, driven by a rise in food prices due to droughts and the outbreak of the African swine flu. Nevertheless, it struggled to kiss the lower bound of the BoT's target range of 1%-4%.

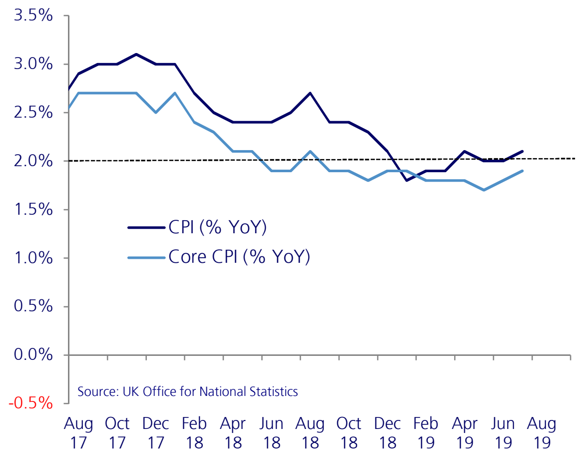
Sluggish growth, the absence of price pressures and rising concerns over intensifying external headwinds prompted a series of central banks to cut their policy rates in August. We expect at least one more round of cuts towards the year end. Meanwhile, several delayed infrastructure projects will soon be restarted in Malaysia and the Philippines, supporting growth and upward price pressure to some degree.

Current and historic inflation

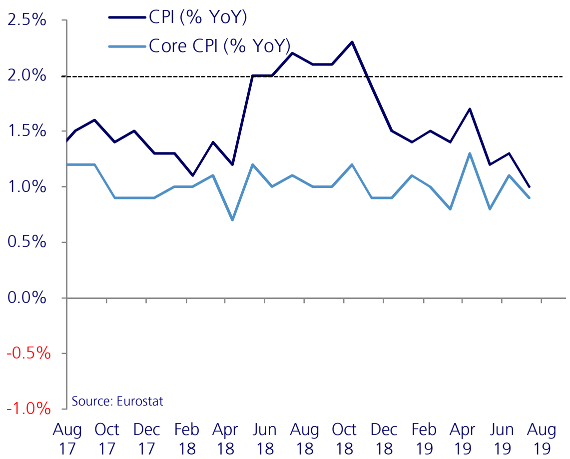
US: inflation is not a problem



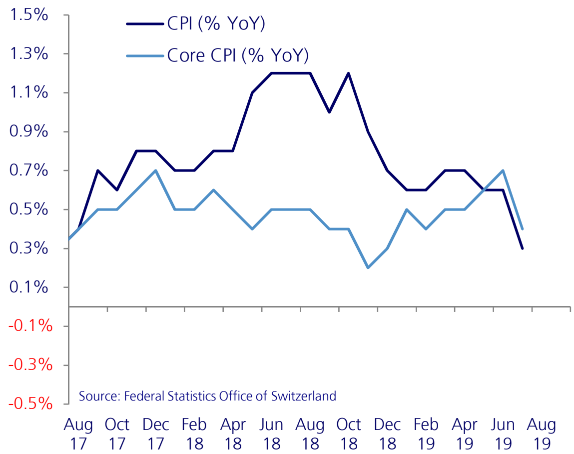
UK: resilient inflation due to Brexit



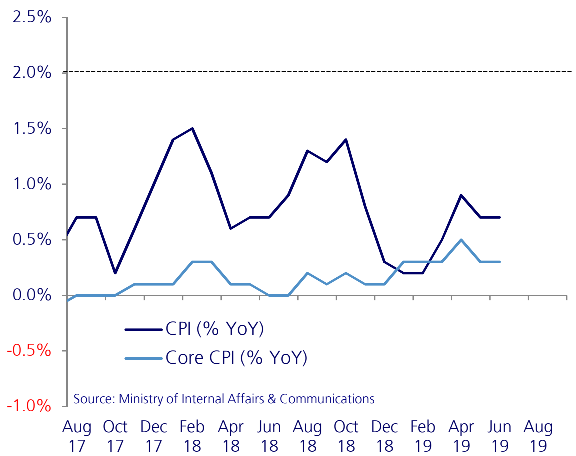
Eurozone: ECB stimulus will not drive inflation higher



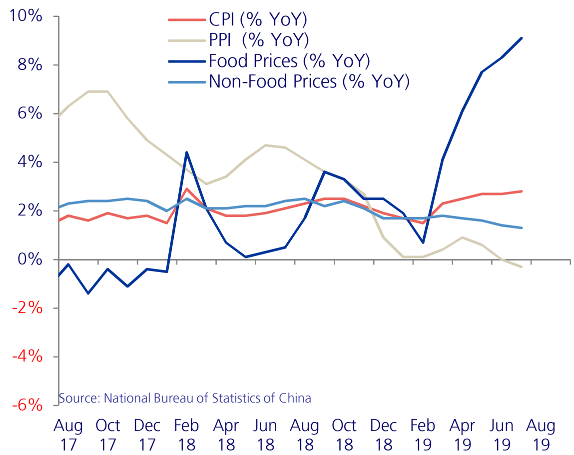
CH: strong franc weighs on inflation



Japan: underlying trend set to remain weak



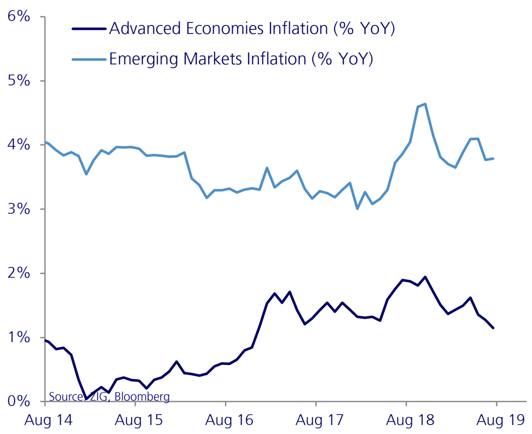
China: PPI in deflationary territory again



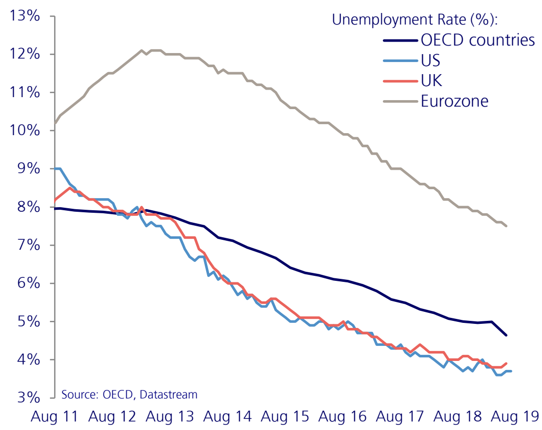
* Dashed lines show inflation targets or equivalent

Key indicators

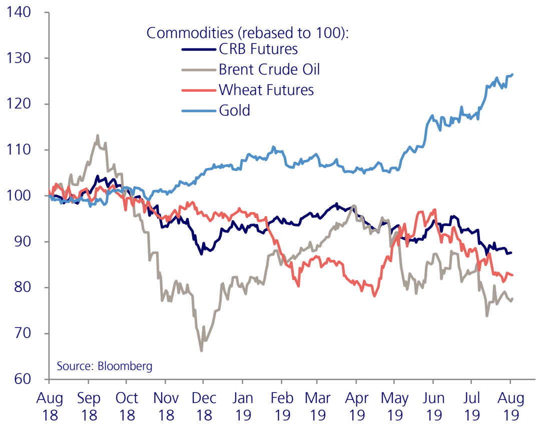
Inflation ticks down on lower oil prices



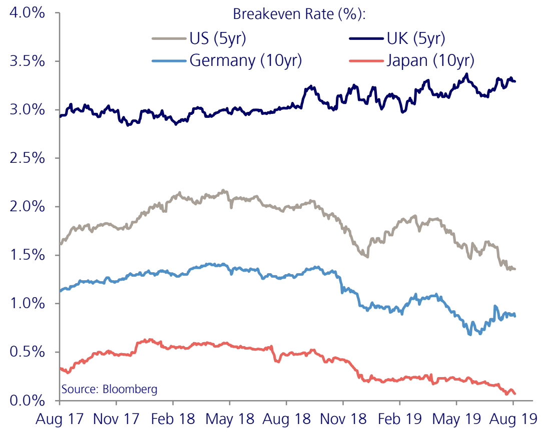
Labour markets remain resilient



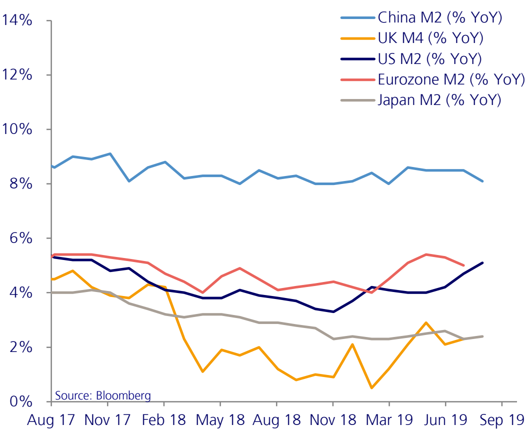
Gold prices surge as recession fears rise



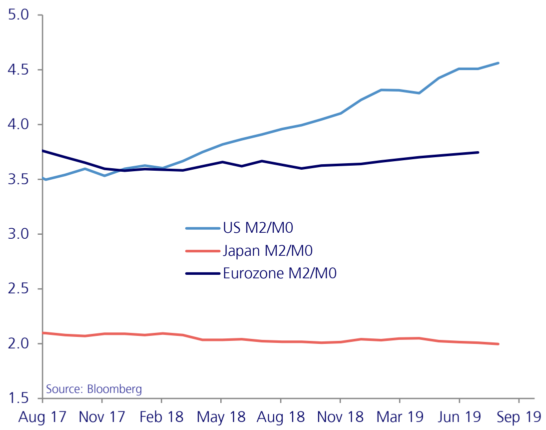
Weak inflation expectations, except for in the UK



Lending growth is resilient



Money multiplier rising in the US



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