

Inflation Focus Q1



Key points

- Global inflation has bottomed, but is not expected to become destabilising
- US inflation is normalising, with prospects for fiscal stimulus providing an upside risk
- Most other DMs lag begin, with sluggish wage growth weighing on core inflation
- EM diverges, with Latam inflation falling appreciably while price pressures pick up in Asia

Inflation rises sharply as oil price effects diminish

Inflation has risen sharply in many regions, mainly as a result of fading headwinds from low oil prices. The turnaround in headline inflation rates is stark, with annual CPI inflation in the Eurozone reaching 1.1% YoY in December, up from only 0.1% mid year, and with producer prices in China accelerating from -6% YoY in early 2016 to 5.5% currently. While an increase in inflation was expected, the data have surprised to the upside, and the Citi inflation surprise index for the G10 economies has reached a six-year high. We expect another sizable move up in headline inflation rates in Q1, mainly reflecting base effects from oil prices, which reached a low of USD26/bbl in January 2016. This will largely be a temporal effect, however, that will fade over time.

Trump and oil boost inflation expectations

Market implied measures of inflation expectations have also appreciated sharply, rising from the extreme levels reached in 2016. A combination of events triggered the adjustment, with agreement to limit oil supply, the US election results, and stronger global economic data diminishing deflationary fears. US and UK inflation expectations are now broadly in line with the 2% inflation targets, but market pricing in the Eurozone and Japan still implies that inflation will perpetually undershoot target.

While most of the adjustment is likely to be behind us, we do not rule out a further rise in inflation expectations, particularly if fiscal measures are enacted more broadly.

Upside risk to US inflation, but a strong dollar remains a constraint

The regional divergence is also evident in the inflation data, with the US leading the way. US wage growth is firming, with earnings growth reaching a seven-year high in December, and with businesses reporting rising price pressures and difficulties filling job positions. While we anticipate a further rise in US headline and core inflation, the strong dollar will be a constraint, and we expect the move up to be controlled, with Fed tightening also proceeding at a gradual pace. Risks have shifted to the upside, however, as many of Trump's election pledges are inflationary. This is mainly a 2018 story though, given lags in policy implementation, with import tariffs a key exception.

Deflationary backdrop persists in Europe and Japan

Headline inflation is expected to rise further in the Eurozone and Japan, but underlying inflation will stay low, in large part reflecting a lack of wage inflation. This is partly structural, due to internal imbalances within the Eurozone and ingrained deflationary expectations in Japan. While we expect policy support and above trend growth to, over time, spur stronger wage inflation, a sharp acceleration unlikely.

Underlying price pressures are therefore expected to stay weak, justifying accommodative central bank policies, with the BoJ aiming for an inflation overshoot and the ECB maintaining asset purchases at least until the end of 2017. Policy divergence vs the US will persist, helping to underpin dollar strength, which will partly rebalance inflation across regions.

While inflation is picking up pace in Asia, it has peaked in Latam

There has been a rapid turnaround in inflation trends in China and in Asia more broadly, reflecting higher commodity prices and pass-through from weaker currencies. Chinese producer prices, which are well correlated with global goods prices, are now rising at a brisk rate after four years of deflation. This is likely to lend support to global trade prices over the near to medium term, helping global inflation to rebound. Excess capacity within the industrial sector remains, however, and limits the size of this effect.

Inflation in Latam, by contrast, has peaked. This is partly a commodity price effect, as currencies have stabilised. The deep recession in Brazil is also exerting more downward pressure on inflation than expected. The key exception is Mexico, which is now seeing rising inflation. This leads to an unusual north-south divide within Latam, with rising inflation in the North and falling inflation in the South.

US

Trump's policy has the potential to fuel inflation

Headline inflation has picked up over the last few months reaching 1.7% in November. As the oil price reached its low point in February 2016, the base effect will continue to push headline inflation higher in the coming months. Business surveys confirm that pricing pressure is building up in the pipeline. Core CPI has stabilised just above 2% but is expected to increase slightly as service inflation remains high, helped by acceleration in wage growth. Momentum in PCE Core has slowed down recently, but is expected to pick up again in the coming quarters and move closer to the Fed's target. Despite higher

gasoline prices and rising service costs, consumers' inflation expectations have fallen significantly. As the Fed is concerned about a de-anchoring of inflation expectations it will be reluctant to hike too aggressively if these measures do not rebound further. Market-based inflation expectations soared after Donald Trump's election victory. Most of Trump's campaign pledges, including higher tariffs, tax cuts or more fiscal spending, would indeed fuel inflation. It remains to be seen how many of his announcements will be implemented, but some positive impact on inflation is likely.

UK

Inflation will overshoot the BoE's target fuelled by a weak pound

Core CPI has remained relatively stable, reaching 1.4% in November. Headline inflation on the other hand, has been steadily accelerating to reach 1.2%, driven by a weaker pound and higher commodity prices. However, the main impact of sterling's drop in the aftermath of the Brexit referendum is still to come. Producer input prices soared by 12.9% in November compared to a year ago. This increasing price pressure will feed through the value chain to finally hit retail prices, which already stand 2.2% higher than last year. Higher retail prices are one of the main risks for the British economy as it will be a

significant headwind for consumer spending. Survey-based inflation expectations leapt to the highest on record in November (data since 1996). Inflation is expected to overshoot the BoE's target this year, but the BoE has already hinted that it will look through this as the price increase is mainly driven by temporary factors, unless inflation expectations are at risk of being de-anchored. If the British economy slows down as expected, inflation rates should also fall back towards the BoE's target. The peak is expected around the end of this year.

Eurozone

Core inflation expected to rise modestly

With the Eurozone recovery gathering pace at the turn of the year, it is likely that core inflation will gradually move up over the next months. Both the manufacturing and services sectors are reporting higher input prices according to the latest PMI surveys, and this is also translating into higher output prices, suggesting companies have some pricing power. Admittedly, because of the amount of slack in the labour market, wage growth in the Eurozone remains weak for now and wages are by far the biggest component of firm costs. However, as unemployment continues to fall the level of slack in

the labour market will diminish, which will feed through to at least some acceleration in wage growth. While the outlook for core inflation is for modestly higher levels, headline inflation will accelerate sharply early in the year because of base effects from oil prices. However, in setting monetary policy the ECB will look through this and focus instead on trends in core inflation and will therefore be likely to keep policy relatively accommodative. In addition, there remain numerous risks to the economic outlook, especially on the political front.

Switzerland

Deflationary pressures persist

Annual CPI inflation reached zero in December, ending a two year stint with negative readings. The latest leg up in the headline rate reflected statistical base effects and core CPI was unchanged at -0.3%, confirming that deflationary pressures persist in many parts of the economy. We expect inflation to turn mildly positive in 2017, and the rise is likely to be frontloaded as the drag from oil and import prices diminishes further. The underlying trend, however, will stay weak as upward pressures on prices are notably lacking. Wage inflation has slowed precipitously, reaching a multi-decade low

of only 0.5% YoY in 2016. This weakness is likely to persist as firms are under pressure to reduce costs. The retail sector is also struggling, with little room for price increases amid sluggish demand and uncompetitive prices. The weak nominal environment is also visible in the housing market, with falling rents and prices in some pockets of the market. The deflationary backdrop is a key reason for why we anticipate the SNB to keep policy unchanged in 2017, using a combination of negative rates and forex interventions to stabilise the franc.

Japan

Inflationary tendencies are creeping in, even though the BoJ's inflation target is still far away

Tokyo's core CPI (ex-fresh food) was down 0.6% YoY in December, lower than consensus had expected, with food, clothes and recreation items being the major drags. However, we believe that a cycle low has been reached, and we expect deflationary forces to wane and inflation to pick up modestly from here. The weaker yen and disappearing downward pressure from energy prices will boost goods inflation, even though the BoJ's inflation target of 2% is unlikely to be met anytime soon. Inflation expectations have already started to rise following the BoJ's 'comprehensive assessment'

of monetary policy, which suggested the focus has been moving away from the negative interest rate policy (NIRP). Demand-supply conditions for JGBs have also improved. Other measures of inflation expectations have bottomed out as well, as the Inflation Outlook within the latest Tankan corporate survey has shown. A modest increase in inflation is now expected. As for service prices, the wage outlook is crucial. Regular nominal wages are barely rising, and the winter bonus did not increase at all in 2016. However, as Japan's labour force is peaking, a medium-term uptick in wage inflation seems likely.

China

From deflation to inflation on the producer level

China's consumer prices are stabilising above the 2% mark, up 2.1% YoY in December 2016. Both food and non-food items contributed. Core inflation remained at 1.9% YoY. More headline grabbing have been producer prices, which surged to the highest level in five years, up 5.5% YoY, much higher than consensus had expected. Producer price inflation had been hovering close to -6% at the same time a year earlier. Double-digit price increases have been registered in coal mining, metal smelting and chemical raw materials. While strong domestic demand has contributed, government induced cuts in production and transportation capacity have also

played a major role. As the government recognizes that these measures have been too drastic, some output restrictions have been eased, suggesting that PPI inflation will not continue at the same pace. The 2016 boom in the property market is slowly fading in the tier-1 segment, with Shenzhen, for example, even experiencing a minor drop in prices in November, though they are still up 33.8% YoY. We believe that the property cycle will continue to roll over in 2017 in those overheated parts of the market that have been affected by tightening measures.

Australia

CPI slowly climbing to 2% YoY

The rise in commodity prices, up 9% in December alone, is a game changer for Australia. Petrol and other energy prices are picking up, which should affect the transport component of the CPI basket (~11% weight). Moreover, the pressure on manufacturer input prices has increased, although few producers have raised output prices. Given Australia's economic reliance on the resource sector, higher metal and mineral prices translate into higher terms of trade, which should ultimately boost wages and demand-driven inflation. The signs of such a virtuous inflationary cycle remain hard to detect in data, though. Wage growth has stabilised at low

levels, and employee earnings are experiencing a timid recovery, but the labour market retains its excess capacity. A pickup in full-time job creation is necessary to stimulate wage growth. As for inflation expectations, they have seen only a modest increase. On the supply-side, retail prices should come under pressure from digital players. As for housing, which accounts for close to 1/4 of consumption expenses, we expect price growth to cool off this year. In conclusion, we see CPI growth climbing slowly to 2%, the bottom end of the RBA's target range. We expect no further rate cuts by the RBA, given its focus on financial risk management.

ASEAN

Headline inflation and producer prices to increase

Commodity prices have passed their trough, which is positive for Asian inflation. Food prices, the largest weight in Asian consumer baskets, have moved up recently, but the price direction going forward can vary strongly according to climatic conditions. In Indonesia and Malaysia, the transport index contribution to CPI is about to turn to slightly positive from deeply negative in 2016. Both countries have committed to reducing fiscal subsidies in 2017. Indonesia has already cut electricity subsidies, and will turn to fuel in March. In Malaysia, the local currency will likely stay weak this quarter, which should support inflation. As for manufacturing

prices, PPIs have turned around and PMIs signal mounting pressure on input prices. The transmission to demand-driven inflation through final prices has not occurred yet, as private consumption remains vulnerable. Malaysian wages keep falling. We are witnessing the start of a cyclical upturn in exports and terms of trade, though. It is too early to judge, but a firmer recovery would feed core inflation. We forecast a headline CPI of 2.5% YoY for Malaysia and 4.5% for Indonesia in 2017. The respective central banks will likely stand pat to contain the potential volatility of local asset flows, as the Fed normalises its policy.

Brazil

Green light for aggressive monetary easing

Inflation decelerated quickly in the last quarter of 2016 to end up at 6.3%, which is lower than the upper limit of the central bank's inflation target range. The deep negative output gap will keep inflation on its downward path and it could converge towards the 4.5% inflation target by the end of 2017.

The central bank has regained its credibility. The conditions needed to initiate its monetary easing campaign, a decline of inflation expectations as well as the implementation of fiscal reforms, have both been going in the right direction, and the central

bank took notice, initiating its easing campaign in 2016 with two timid rate cuts of 25bps. The stable currency is another important element that has played its part in the disinflationary process. The still weak economic data will allow the institution to accelerate the pace of rate cuts going forward. This was confirmed by an aggressive cut of 75bps in its first meeting of 2017.

Despite a more restrictive Fed, the disinflationary process coupled with a lack of growth in Brazil will allow the central bank to be among the most aggressive globally in terms of monetary easing.

Latam

Regional inflation is set to converge, down in the south, up in the north

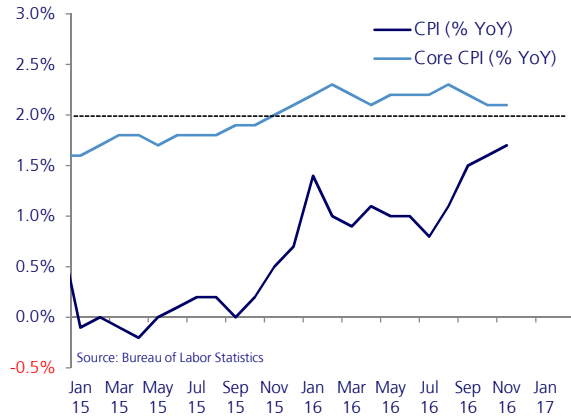
In Chile, inflation has fallen to a three-year low and is now below the central bank target. Economic growth will remain lacklustre allowing the central bank to cut its reference rate twice in 2017. In Peru, inflation remains stable within the target range. In Argentina, the central bank has cut its reference rate aggressively as inflationary pressures have subsided and a new inflation target regime has been implemented. Still, inflation will remain elevated in 2017. Surprisingly, Colombia's central bank cut its reference rate as inflation receded. We believe that it will remain cautious in its pace of rate cuts, however, due to the tax reform impact and

the need to anchor inflation expectations.

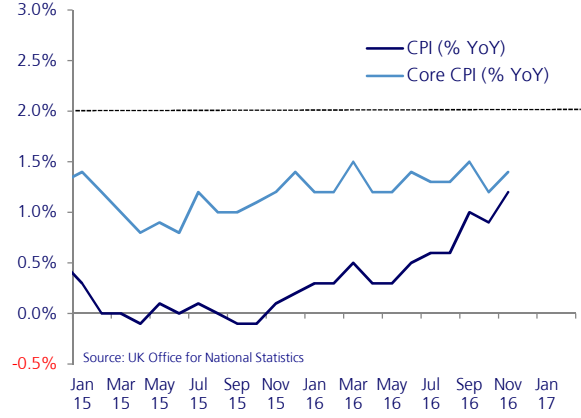
In Mexico, inflation was moderate in 2016 following a historical low the previous year. However, challenging times are ahead for the country as the outlook has significantly deteriorated. The liberalization of gasoline prices, a persistently weak currency and a 10% hike in the minimum wage are all converging towards a much higher inflation rate in 2017, with potential second round effects by the private sector. We envision an inflation rate close to 5%, which will require more rate hikes from Banxico despite its already having hiked its reference rate by 275bps.

Current and historic inflation

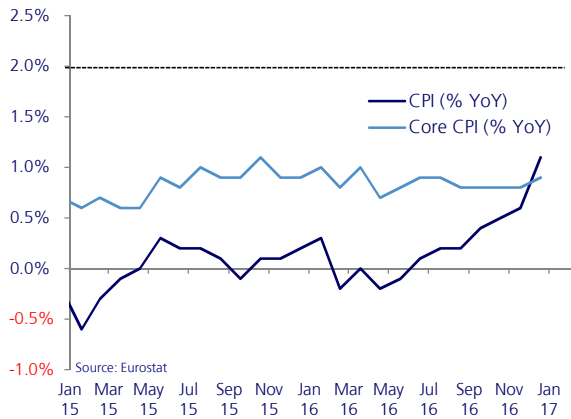
US: inflation approaching target



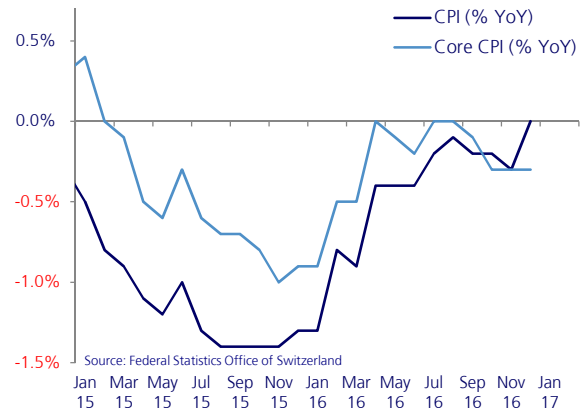
UK: currency will push inflation higher



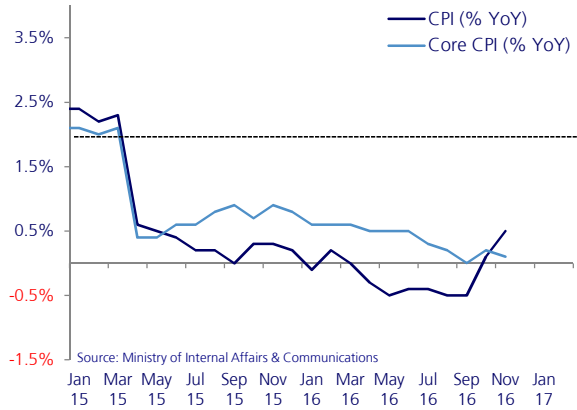
Eurozone: core inflation still weak



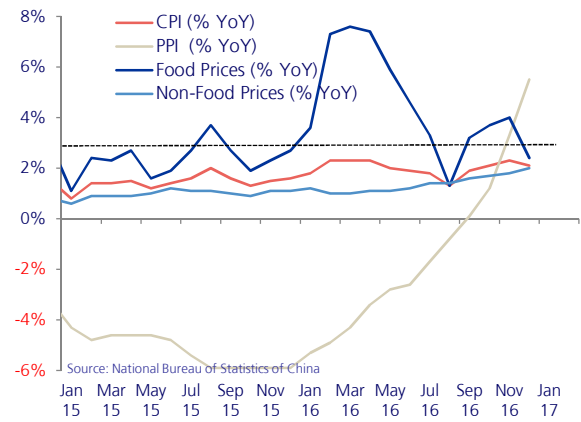
CH: deflationary headwinds persist



Japan: BoJ missing target by a wide margin



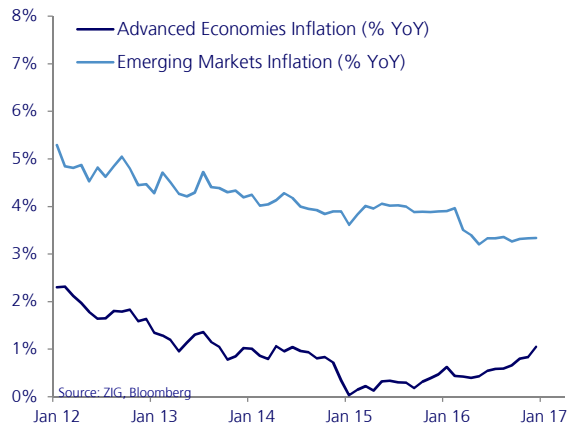
China: rapid turnaround in PPI inflation



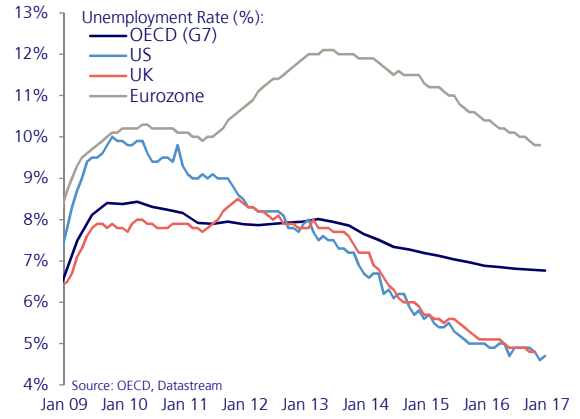
* Dashed lines show inflation targets or equivalent

Key indicators

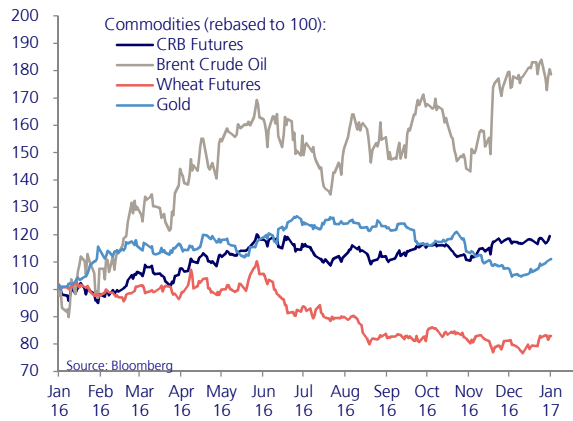
Inflation rises on higher oil prices



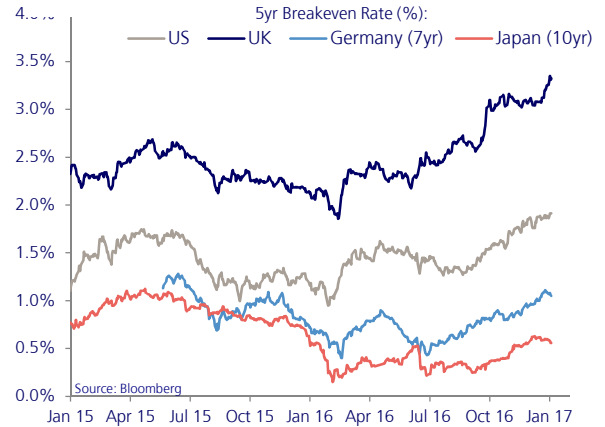
Little spare capacity in the UK and the US



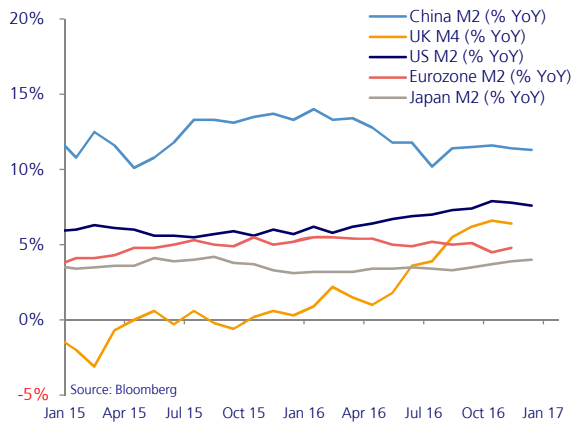
Deflationary oil impulse is diminishing



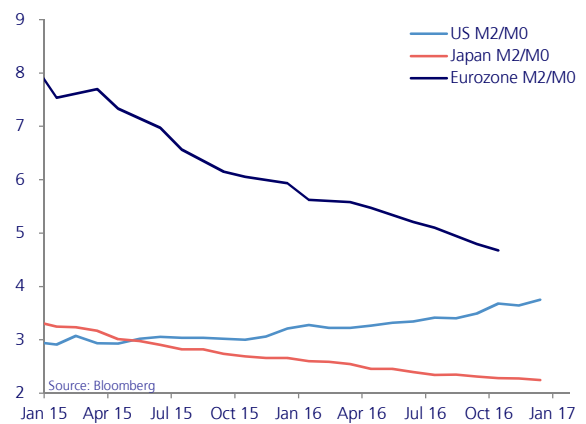
Inflation expectations normalising



Credit growth reengaging



US money multiplier edge up



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