Inflation Focus Q3

Key Points

- Headline inflation is likely to have peaked for now, as the tailwind from higher oil prices gradually diminishes
- Core inflation remains benign in most regions, but is expected to grind higher over the coming year
- US inflation is unlikely to become a problem, but a modest overshooting of the Fed's target should be expected
- Steady growth and falling unemployment should help to lift inflation trends in Europe and Japan
- Inflation is expected to have bottomed in emerging markets, reflecting weaker currencies and higher import prices

Source: iStock by Getty Images

Inflation reaches multi-year highs in many regions, helped by higher oil prices

Inflation reached multi-year highs in many regions in July, with annual headline CPI inflation at 2.9% in the US and 2.1% in the Eurozone, the highest levels since 2011 and 2012, respectively. The oil price has been a key driver of the upswing in inflation, with the annual increase in the Brent price peaking at over 60% in June. Assuming stable oil prices, this tailwind to inflation will gradually diminish. We therefore expect headline CPI inflation to have peaked for now in many regions.

Core inflation remains benign and is only expected to rise very modestly

Core inflation matters more for the medium-term outlook as it strips out the impact of volatile components. As we had expected, core inflation is benign in advanced economies, in many cases undershooting target by a wide margin. Countries have diverged, however, with the US, Canada and the UK now facing a period with above target inflation. Price surveys also indicate stronger inflation than we see in the CPI data, with rising price pressures in global supply chains. Emerging markets should also see higher inflation near term, due to weaker currencies. All this is consistent with our view that core inflation has bottomed globally. However, we do not expect inflation to become a problem, as peak global growth is already behind us, likely tempering further gains in inflation.

US inflation has reached target, and should remain contained

US core PCE briefly touched target in March and is currently tracking just below 2%. Although we expect a small overshoot vs target going forward, this is a good thing, in particular given persistent undershooting over the past. Worries about accelerating inflation are also misplaced, in our view. Wage restraints are likely to remain in place, given global competition and outsourcing, limiting aggregate wage growth. The impact of tariff hikes on inflation, in the US and in other regions, should also be modest, as new tariff measures only cover a small share of global trade. For the US, the strong dollar will also weigh on inflation going forward, redistributing some inflation away to the rest of the world. Finally, the Fed is not behind the curve, and further tightening should help to contain domestic activity and credit growth, both in the US and globally.

Early signs of stronger wage growth in Europe and Japan

Other advanced economies are still struggling with weak core inflation, at only 1.1% YoY in the Eurozone and 0.3% in Japan. Labour markets have, however, continued to tighten and there are tentative signs that wage growth is finally starting to edge up. Nominal wages have accelerated in Japan, partly reflecting strong corporate profits and higher bonuses, but also reflecting rising regular earnings. In the Eurozone, we also see tentative signs of stronger wage growth. Wage deals between large unions and employers in Germany and Spain, for example, imply an acceleration in negotiated wages, and Eurozone wide labour costs have partially recovered, up from 1.2% YoY two years ago to 2% currently. With productivity growth firmly in positive territory, wage inflation is still very benign in these regions and will not materially boost inflation, but should help to deliver a steady grind higher.

Inflation lows are likely to be behind us in emerging markets

The inflation outlook for emerging markets is also mixed. Broadly speaking, we expect inflation to have troughed, with currency depreciation now pushing import prices higher. Price controls and subsidies will limit the pass-through in some regions, particularly in Asia, but over time the impact should become noticable. Policy has, however, also become much less growth friendly, with rate hikes and tighter fiscal policy set to weigh on growth and inflation going forward. This will impact inflation with a lag and we anticipate that inflation in emerging markets will rise before it subsides again.

Central banks need to stay cautious, as the global economy remains vulnerable

In this elongated economic cycle, inflation has been persistently weak. With the exception of a short period in 2012, it has taken the Fed 10 years to get inflation back to target. Despite signs of a normalisation in inflation in some regions, we therefore reiterate our view that central banks need to be very cautious when removing stimulus, as the global economy is still fragile, with large imbalances persisting and huge dependencies on the US and China as drivers of growth. Recent pressure on emerging markets illustrates this.

US

Core inflation expected to creep higher

Inflation continues to creep higher as the economy grows above its trend rate and moves closer to its capacity limits. The labour market is getting tighter and filling open positions is becoming increasingly challenging for firms. The related small business survey component reached the highest on record in July. Pay rises in a number of industries have risen significantly above their historical averages. Nevertheless, despite the ever tighter labour market, average earnings growth across the whole economy remained at a relatively modest 2.7% YoY in July. Meanwhile, annual headline CPI rose to 2.9% in July from 2.1% at the beginning of the year. Core CPI inflation accelerated to 2.4% YoY from 1.8% over the same period with most components supporting the rise, indicating that core PCE should soon move back towards the Fed's target after briefly touching 2% in March. Producer prices were flat in July leading to a tick down in the annual rate to 3.3%. The latest business surveys show that input price pressure should moderate further, held in check by a stronger dollar and the recent fall in commodity prices. Though while core inflation is expected to slightly overshoot the Fed's target in the coming quarters, a significant acceleration is unlikely.

UK

Sterling weakness fuels a rebound in inflation

Inflation rates have been falling in the first half of the year but show signs of reaccelerating recently. Annual headline CPI inflation ticked up to 2.5% in July despite a flat MoM reading. There was no clear underlying trend as components moved in different directions. Core CPI remained at 1.9% YoY, down from 2.7% at the beginning of the year. Input prices continued to move higher, however, reaching 10.9% YoY after slowing to 3.9% earlier this year, indicating that inflation is likely to remain above the BoE's target for the time being. Currency weakness is a key driver of higher input costs as sterling fell to the lowest level in more than a year in August on Brexit uncertainty. Wage growth continued to decelerate, with growth in core wages (ex bonuses) ticking down to 2.7% YoY in June. Despite this, wage pressure and problems finding skilled candidates are key concerns in a number of sectors. The unemployment rate fell to 4% in June, the lowest level since 1975, but the latest drop mainly reflected a falling participation rate and the number of employed persons actually fell in June. With inflation expected to stay above target for the coming months, the headwinds for households' real purchasing power are likely to remain.

Eurozone

Latest deals between employers and unions point to stronger wage growth

Headline inflation in the Eurozone, at 2.1%, is currently at its highest levels since 2012, driven by oil prices. Eurozone core inflation has also picked up in recent months, as distortions caused by the different timing of the Easter holiday this year compared to last year have now dropped out of the annual comparison. However, at 1.1%, core inflation remains well below the ECB's target. There are, however, signs that reduced spare capacity and a healthier labour market are pushing wages up. The Eurozone unemployment rate continues to fall, hitting 8.4% in June, after being at 8.7% at the beginning of the year and 9.6% in January 2017. This should gradually feed through into higher core inflation. Indeed, wage deals announced between large unions and employers in both Germany and Spain, which typically act as a benchmarks for other deals, imply an acceleration in negotiated wage growth later in 2018 and in 2019. Any increase in core inflation is likely to be gradual and from a low base, and the ECB has recently indicated that although it expects underlying inflation to pick up, it is not planning to increase interest rates until well into 2019.

Switzerland

Inflation recovery will be tempered by a stronger franc

Headline CPI inflation rose to 1.2% YoY in July, which is the highest level since 2010, almost doubling since January. The rapid rise mainly reflects a weaker franc (on a year ago) and higher oil prices. Core CPI, by contrast, is unchanged at 0.5% and underlying price pressures are weak. Domestic goods price inflation is notably soft, tracking at only 0.5% YoY, and the recent rebound in the currency makes headwinds likely to persist. Services inflation, which is more important for the CPI basket, is also weak. While the labour market is tight, with an unemployment rate of only 2.6%, wage growth is subdued. Nominal wage inflation has recovered from an all time low of only 0.1% YoY in end 2016, but is currently only rising at 0.8%, which is not sufficient to push inflation higher, given productivity gains. With economic growth set to have peaked and the rebound in the franc, monthly CPI prints are set to weaken over the coming months. We therefore maintain our view of continued low inflation, with CPI inflation expected to average 1% in 2018 and 1.2% in 2019. This is slightly higher than the consensus and the SNB forecasts. The big picture, however, is one of persistent below target inflation, justifying a dovish stance from the SNB.

Japan

Is wage growth finally kicking in?

The Bank of Japan is sticking to its 2% inflation target, though it recently revised down its median inflation projections to 1.2% for this fiscal year and to 1.5% and 1.6% for the following two years. We also expect yield curve control to remain in place at least until spring 2020, when the impact of the VAT hike has been evaluated, as this was particularly referred to in the BoJ's new forward guidance approach which was introduced in the last meeting. On a short-term basis, we think that tailwinds to headline inflation from energy prices will subside, as the oil price has fallen recently and the base effect should keep a lid to inflation. The focus is now on wages, a core target of 'Abenomics'. Wage growth surged to 3.3% YoY in June, a 21yr high, mainly due to higher summer bonus payments. However, nominal regular earnings, a better yardstick, were up 'only' 1.0%, which is nonetheless an improvement. This finally seems to mark the start of a rising trend, even on a real basis, which should help to spur consumption. At this stage we remain somewhat cautious, however, as a statistical change may have distorted even the bonus adjusted numbers. Compared on a same sample basis, wage growth may be more tepid than a first glance suggests.

China

Imported inflation set to pick up, but the overall price outlook remains tepid

Higher energy and food prices were behind a pickup in CPI inflation above the 2% mark in July, but core inflation remains stable at 1.9%. Producer price inflation, at 4.6% YoY in July, is expected to ease into the second half of this year as a higher base effect manifests, and may even fall into negative territory next year.

If the trade dispute with the US were to escalate, there would be an impact on inflation as import prices would move higher. However, substitution of US imports to those from other countries and lower prices set by US exporters would certainly help to limit the impact on inflation. However, the rather steep depreciation of the Chinese yuan will have an effect on the producer level via imported inflation, though less so on the consumer level, as domestic factors remain more powerful.

Monetary policy is becoming more supportive for domestic demand. The PBoC cut its RRR twice in Q2 and injected substantial liquidity over the summer through its medium-term loan facilities. We expect this monetary stimulus to continue into the second half of this year and provide support to the economy, though easing will be less forceful than in 2015-16. Overall, neither inflation nor deflation are major concerns for China's government.

Australia

Wage growth is increasing at a glacial pace

Inflationary pressures remain subdued, despite a pickup in the wage index to 2.1% YoY in Q2 and clear improvements in the labour market. Job vacancy ratios are close to all-time high levels and employers report their highest difficulty in finding labour since 2008. The unemployment rate has also edged down, though the underemployment rate is still elevated. With growth still holding up, we anticipate labour market slack to decline further. Given this, wage growth should increase, albeit at a very gradual pace, and from a low level. Other sources of domestic inflation also remain benign. Administered prices are expected to decelerate due to one-off government measures and residential property prices, which affect the CPI index, should decline further. Overall, we forecast CPI inflation to pick up very modestly, reaching 2.3% YoY in 2018 and rising to 2.5% in 2019, with risks to the outlook tilted to the downside.

The Reserve Bank of Australia (RBA) has reiterated that it will maintain its "hold-and-see" strategy, as it believes that it will take some time before full employment is reached and before inflation is comfortably within the target range. Additionally, the central bank has revised down its CPI forecasts for the next two years, which puts our prediction of a first rate hike in H1 2019 at risk of being delayed.

Indonesia

Stable administered prices to keep CPI within Bank Indonesia's target

The 2019 draft budget carves out a large share for fuel subsidies, roughly equal to the 2018 share. This indicates that administered prices, which account for the largest portion of the CPI basket, should be stable at least until the general elections in April 2019. Afterwards, non-regulated low-grade fuel prices could be hiked, but gas, electricity, and diesel prices should be stable.

For non-administered prices, we see three drivers of higher inflation. First, food prices are likely to slowly grind higher. Second, the rupiah has depreciated by close to 6% vs. the US dollar in the last three months. Third, the government is considering tariffs and non-tariffs measures on 500 import products in order to rein in the current account deficit. Although it is too early to precisely assess the impact, we see upside risks for inflation from these measures.

Overall, we expect headline CPI to hover around 3.5% YoY in 2018, still within the 2.5%-4.5% target fixed by Bank Indonesia (BI). BI has already hiked its policy rate by 125bps this year but, since the rupiah has so far failed to rebound against the US dollar, further policy rate hikes are likely.

Malaysia

Inflation to recover from tax holiday shock after summer

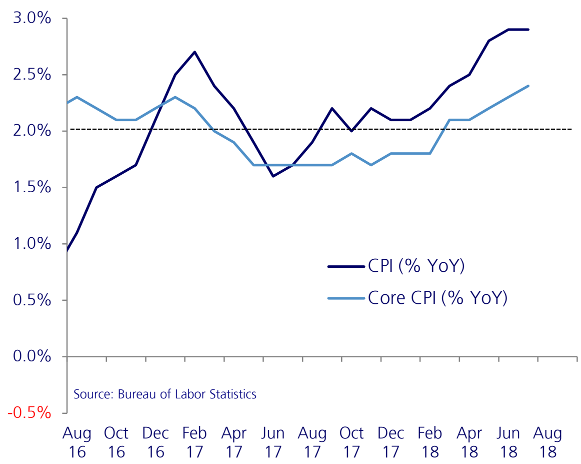
Prime Minister Mahathir's first 100 days in power have concluded and brought some clarity on his economic agenda. The former Goods and Services Tax (GST) was scrapped on June 1st and will be replaced by the Sales and Services Tax (SST) on September 1st. The temporary tax holiday led to a collapse of CPI in June, but inflation should gradually pick up from September. Though the details are not yet available, we expect the new SST to be less inflationary than the old GST, in particular due to the lower coverage of goods. Together with the one-off effect of the tax holiday, this should help to contain inflation in 2018.

Other measures will be more inflationary, however. A 50% hike in the minimum wage is considered, though this should only be gradually implemented, along with a modest increase in transport prices.

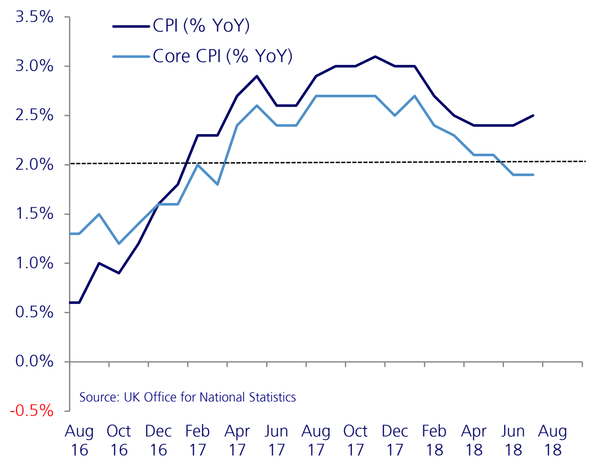
Overall, we revise our average CPI forecast down to 1.5% YoY for 2018, accounting for the temporary impact of the three-month tax holiday. Subdued inflation and decent growth will probably leave the central bank on hold this year.

Current and historic inflation

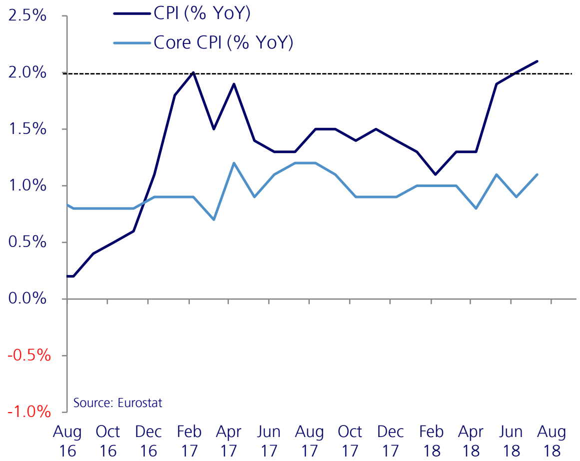
US: core inflation set to creep higher



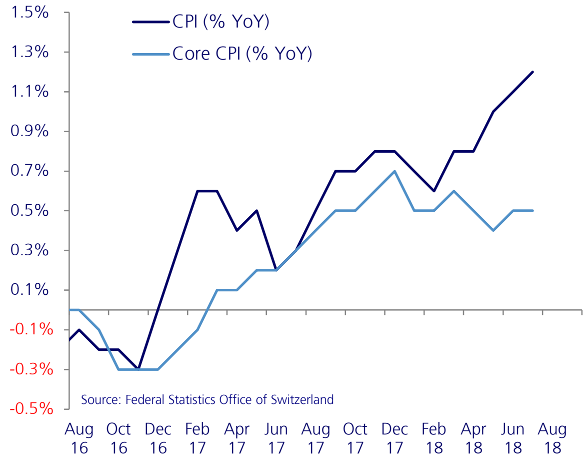
UK: sterling weakness fuels inflation



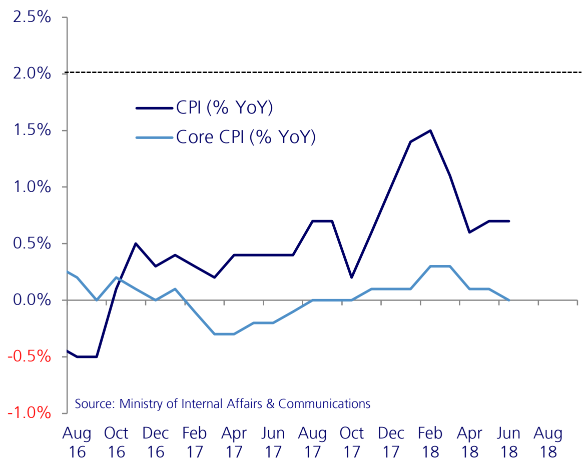
Eurozone: core inflation to remain weak



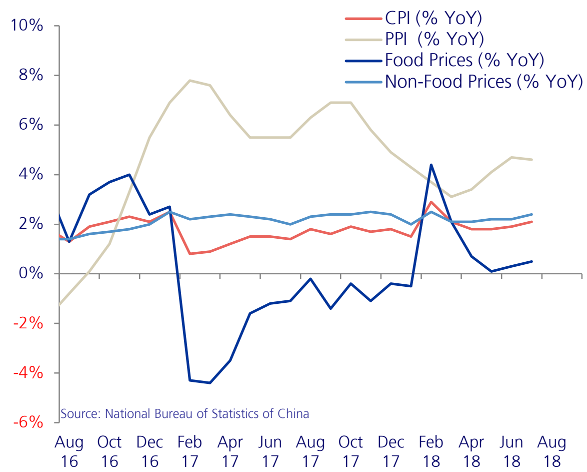
CH: stronger franc should reverse upswing



Japan: not reaching the inflation target



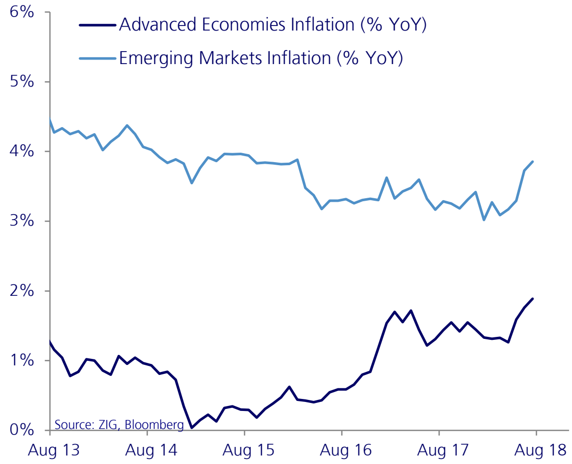
China: domestic inflation is tepid



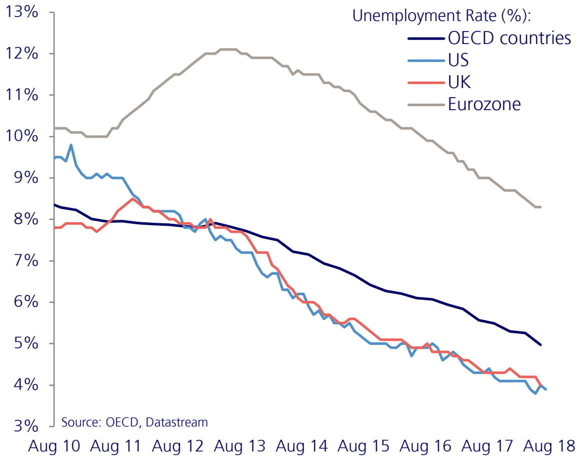
* Dashed lines show inflation targets or equivalent

Key indicators

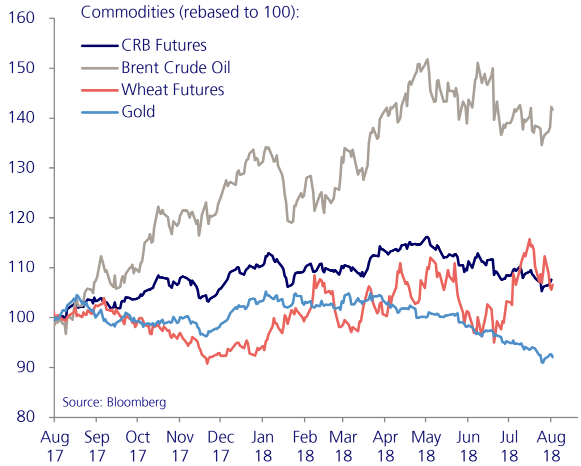
Oil price drives inflation higher



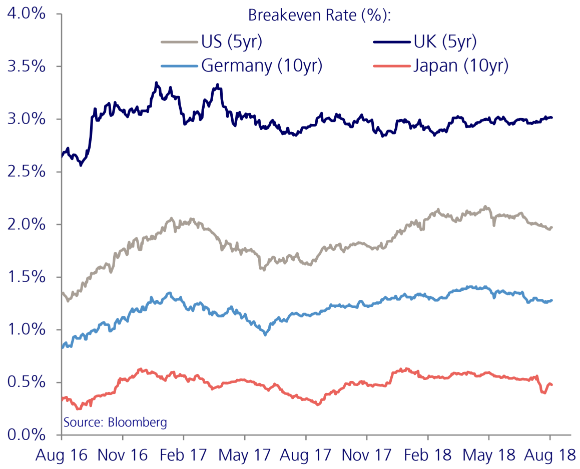
Tight labour markets



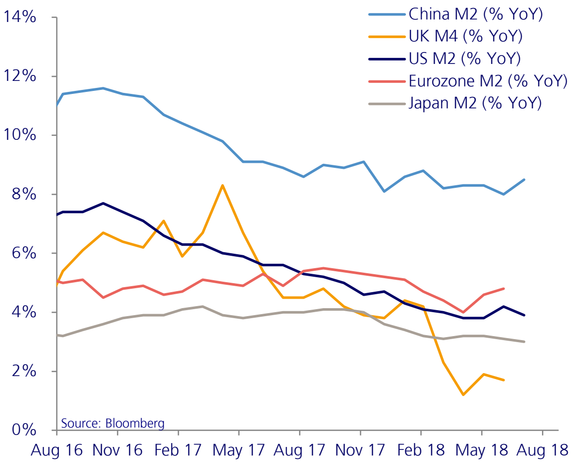
Oil prices stabilise



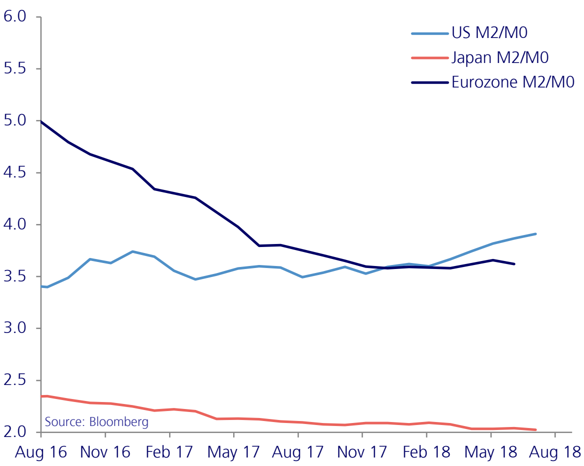
Inflation expectations still low



Credit growth slowing globally



Money multipliers bottom as QE comes to an end



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