April 9, 2020

Inflation Focus Q1

Key Points

- Exceptional policy measures will limit the severity of the global recession, but are not expected to unleash inflation
- Headline inflation will fall sharply over the next few months as both oil prices and global demand have plummeted
- Core inflation will also be weakened as a surge in layoffs and unemployment is likely to lead to a collapse in wage growth
- Supply chain disruptions could lead to spots of higher inflation, but this would be within an overall disinflationary environment

Source: iStock by Getty Images

Coronavirus containment measures trigger a deep global recession

The COVID-19 pandemic has amplified and accelerated the global growth slowdown that we had projected for 2020. Lockdown measures have triggered a synchronised collapse in economic activity, on a truly unprecedented scale, along with a 50% slump in oil prices and extreme volatility in financial markets. This comes at a time when the global economy is already vulnerable, with high debt levels, persistently weak growth, and elevated political and geopolitical risk.

Exceptional policy support will limit the severity of the crisis

Unprecedented policy measures have been forthcoming on a global scale, which will help to bridge the lack of earnings and income for businesses and households and support a return to normality once the virus crisis passes. This is why we expect a deep, but short lived, global recession, where the initial collapse is followed by a swift recovery in the second half of 2020. There are large risks around this outlook though, as it crucially hinges on measures to contain the virus being effective, with lockdowns not lasting beyond Q2. Moreover, while the scale of stimulus is unprecedented, policy measures do not fully absorb the economic cost of locking down societies. Some businesses will close down, unemployment and part-time working will soar, and there will be longer-term damage to some sectors.

The near-term impact of the coronavirus is deeply deflationary

Even if the global contraction proves to be short lived, the near-term impact on inflation will be deeply deflationary. Oil prices have halved, which will push producer and consumer price inflation into the red, and this deflationary impulse will be amplified by the collapse in global demand. Prices on virus-affected services such as air travel and hotels have already fallen sharply and rent freezes will be a drag on inflation in many regions. While disruptions to supply chains and stockpiling could lead to higher prices on some products, such as food and medical material, this will not be the dominant factor in a recessionary environment. Market implied measures of inflation expectations reflect this – they have slumped to historical lows despite massive stimulus injections.

Wages and core inflation will come under pressure as unemployment surges

While headline inflation will turn negative over the coming months, core, or underlying, inflation should normally be more resilient, due to the temporary nature of the crisis. These are not normal times though. Lay-offs and unemployment have surged and uncertainty is pervasive, given the unprecedented nature of events. In this environment, upward pressure on wages will likely collapse. This should lead to weaker core inflation dynamics over coming quarters, providing yet another mechanism for lower inflation.

Policy actions are unlikely to trigger pent-up demand and inflation

Moreover, the monetary and fiscal stimulus measures that have been rolled out are not expected to unlock higher inflation, at least not over the near to medium term. They provide support and substitute for lost income during the lock-down period but are unlikely to trigger a wave of spending once restrictions ease, as elevated uncertainty – around the virus, jobs, and economic conditions more broadly – will persist. A surge in lending is also unlikely, for similar reasons. Money multipliers, which capture the transmission from central bank liquidity to the broader economy, are therefore expected to weaken – just as they did after the global financial crisis. Stimulus measures should, however, provide a positive tailwind for financial assets, particularly given the low yield environment.

The longer-term inflation outlook remains benign, but needs to be monitored

Longer term inflation prospects will depend on whether central banks have the means and the willingness to take away stimulus once conditions are back to normal. Judging by the past, many central banks have tended to be too keen to remove stimulus, which has contributed to persistently low inflation. While ongoing policy reviews are likely to deliver some changes to central bank mandates and objectives over the coming years, a whole-hearted scrapping of inflation targets is unlikely. Given this, we do not expect these exceptional policy measures to more fundamentally raise the inflation outlook. Pockets of higher inflation are a possibility, however, and need to be monitored.

US

Inflation to fall before it recovers later this year

Inflation as measured by headline CPI had risen back above 2% in the final quarter of last year to match annual core CPI, which was stuck at 2.3% between September and December in 2019. Meanwhile, the Fed's preferred measure, Core PCE, stood at 1.5% YoY in December, further moving away from the Fed's target. While most inflation measures picked up at the beginning of 2020, the inflation outlook for the rest of the year significantly depends on how the crisis caused by the global spread of the coronavirus pans out. The slump in energy prices to a multi-year low, the massive slowdown in economic activity that is to be expected as well as the renewed strength in the US dollar will be a significant drag on inflation in the coming months. Later this year, inflation is expected to rebound when pent-up demand, supported by massive fiscal stimulus, will meet a potentially constrained supply capacity. This seems to be confirmed by inflation expectations rebounding from recent lows, although they remain well below even the relatively low levels observed at the beginning of this year.

UK

Weak sterling to support inflation

Inflation in the UK continues to be driven to a large degree by volatility in sterling. Helped by the stabilisation of the pound earlier in 2019 as well as a slowdown in economic activity, headline inflation continued to trend lower through most of last year, falling to a three-year low of 1.3% YoY in December before rebounding to 1.8% in January this year. Two opposing forces will impact inflation for the rest of the year. On the one hand, the expected fall in business activity due to spread of the coronavirus and the partial lockdown of the economy, as well as the fall in energy prices to a multi-year low, will be a significant drag on price pressures in the near term. However, the steep fall in sterling to the lowest level against the dollar since 1985 will support inflation rates via the cost of imported goods, particularly if the currency weakness persists. In the near term, deflationary forces are expected to have the upper hand, which is underlined by a steep fall in inflation expectations as well. However, once the crisis passes and the significant fiscal stimulus helps to lift demand later this year, inflation rates are likely to recover.

Eurozone

Inflation to fall sharply as pandemic hits the economy

The COVID-19 outbreak and the associated measures to deal with have caused a sudden stop to activity that will push the Eurozone into a deep, though hopefully short-lived, recession in H1 and push inflation sharply lower. However, assuming the virus outbreak is successfully contained, we should see a rebound in activity sometime in the second half of the year. The ECB has announced aggressive monetary stimulus, with its EUR 750 billion Pandemic Emergency Purchase Programme (PEPP) of asset purchases. Governments are also ramping up fiscal stimulus, and this should help generate a strong recovery once the pandemic comes under control. Fiscal and monetary policy stimulus will help support the eventual rebound in activity, but wage growth will likely remain weak for some time keeping core inflation very low even as the economy recovers. One risk to this scenario is if supply disruptions and shortages are so significant that eventually the prices of some goods start to increase sharply. This is not our central scenario for now, though the situation will need careful monitoring.

Switzerland

Back in deflation

Switzerland is back in deflation, with headline CPI inflation at -0.5% YoY in March, after temporarily turning positive in the prior months. Weakness is broad-based, as domestic price pressures are virtually non-existent and the strong franc has led to deeply deflationary import prices, resulting in negative core inflation as well. Going forward, we expect inflation to move further into negative territory, with deflation amplified by the COVID-19 triggered collapse in domestic and global demand along with the deep slump in oil prices. Services inflation, which has held up relatively well in past crisis, will likely fall sharply, reflecting broad-based lockdown measures. As a result of this, we have reduced our CPI inflation forecast for 2020, to -0.5%, with a gradual recovery back towards zero in 2021. This outlook assumes that the deep economic downturn in the first half of the year is followed by a sharp recovery in the second half of the year, however, and that the Swiss franc does not strengthen materially going forward. Should the lockdown prove to be longer lasting, or the economic and financial fallout greater, than currently expected, a much deeper deflationary episode is likely, particularly as the SNB does not have unlimited ability to fight appreciation pressure.

Japan

Recession will keep a lid on inflation

In 2019, Japan's nationwide CPI hovered within the 0%-1% band. This year it is likely to move closer to zero, while core CPI (ex. food and energy) is expected to remain relatively stable in the 0%-0.5% band. Soft inflation is likely to prevail, while the BoJ's 2% inflation target continues to be more dogmatic than realistic. We do not expect deflation to return, even though a recession is a given in the first half of the year. The economy contracted at a rate of 7.1% on an annualised sequential basis in Q4 2019 following the consumption tax hike and the impact of two major typhoons, while another severe negative print is expected in Q1 this year following the outbreak of COVID-19. Domestic producer prices turned down for the first time in six months in February, up only 0.8% YoY, dragged down by falling prices for petroleum and other materials-related categories. Downward pressure will persist following another sharp drop in oil prices and the negative impact of the coronavirus induced slump in demand. Wage statistics are distorted by sample changes, but wage pressure is obviously lacklustre. This year's 'shunto' wage negotiations confirm that base pay rises will be lower than last year, as the earnings outlook for companies continues to deteriorate.

China

Inflation measures diverge

Remarkable divergences in China's inflation measures have developed. While consumer price inflation in February, at 5.2% YoY, backed off slightly from its nine-year *high* marked in January, core inflation (ex food and energy), at 1% YoY, fell to a nine-year *low*. Services inflation fell sharply, reflecting the impact of COVID-19 on service consumption. Transport and communication prices even fell 1.5% YoY. Food inflation remains the main driver for elevated CPI inflation. Pork inflation surged to another swine-flu related high of 135% YoY, despite several releases of pork reserves. Hoarding may have had an impact. Food inflation, up 21.9% YoY, was also driven by the outbreak of the novel coronavirus, with vegetable and fruit inflation accelerating. Overall, the supply shock impact due to the virus is the dominating factor, as consumer prices usually tend to come down following the Lunar New Year holidays, but not this year. Meanwhile, producer prices fell 0.4% YoY, mainly driven by raw materials, particularly oil and base-metal prices. Going forward, we expect inflation to inch lower. The recent drop in the oil price as well as easing supply side disruptions with workers returning to their factories will ease price pressures. This will enable the PBoC to loosen monetary policy even further.

Australia

Low for longer

Headline inflation inched up from 1.7% to 1.8% YoY in Q4 2019 but was still lower than the RBA's forecast. While widespread bushfires and drought conditions put upward pressure on food prices in December, muted inflation continues to be a dominant trend in other sectors. Wage growth was subdued as weak economic activity weighed on corporate profitability. Service prices also stagnated. Housing inflation was lacklustre as new dwelling purchases and rental costs remain weak. With the number of new COVID-19 cases rising in Australia, consumers are avoiding spending, putting downward pressure on core inflation. However, food and basic consumer goods might experience a short-lived rise in prices given the panic buying due to concerns over a wider spread of the coronavirus. With a slump in oil prices after OPEC and Russia failed to agree on an output cut, some industries such as transportation and mining might benefit from lower input costs. As risks of a technical recession become imminent amid extended lockdowns, the Reserve Bank of Australia (RBA) cut its policy rate to a lower bound of 0.25% and launched QE, targeting three-year bond yields at 0.25%. In its statement, the RBA also indicated little appetite for negative interest rates. We believe ultra-low inflation will be here to stay.

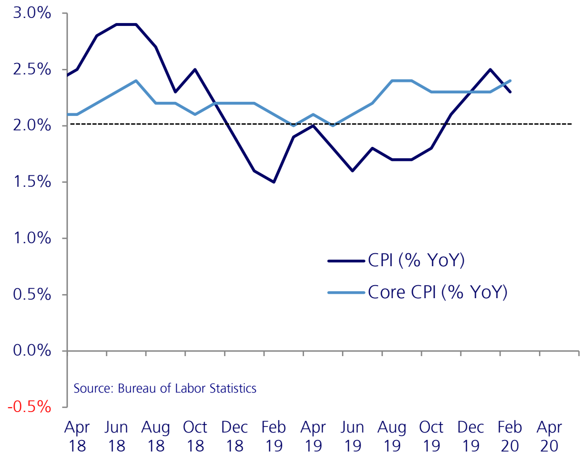
ASEAN

Low inflation provides room for policy easing

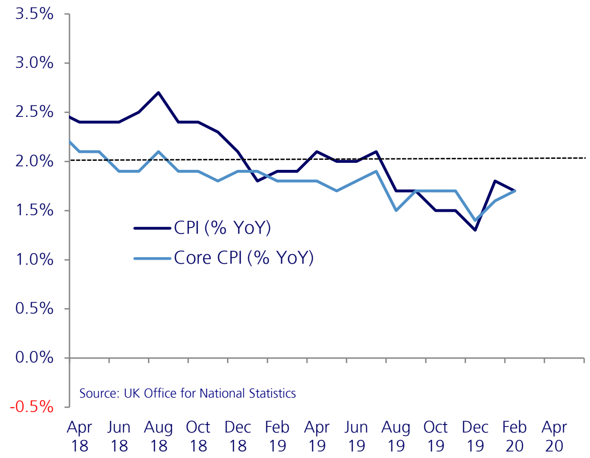
The latest data for February show inflation edged a bit higher in Indonesia while remaining benign in Thailand and the Philippines. In general, core inflation in most countries ranged below or at the long-term average, mainly driven by weakness in final demand on the back of subdued economic activity since last year, amplified by extended business disruptions tied to the COVID-19 outbreak this year. While households are concerned about a prolonged period of lockdowns and quarantine measures, food prices are expected to be volatile in the short term due to panic buying in several cities. Uncertainty around the duration of the COVID-19 outbreak has prompted several policy rate cuts since January. While inflation remains within a stable, low range, currency depreciation due to large capital outflows seems to be constraining central banks from delivering more aggressive rate cuts. Meanwhile, many manufacturers in the region will benefit from lower oil prices. However, lower oil prices are also unfavourable to large oil exporters in the region, mainly Malaysia and Indonesia.

Current and historic inflation

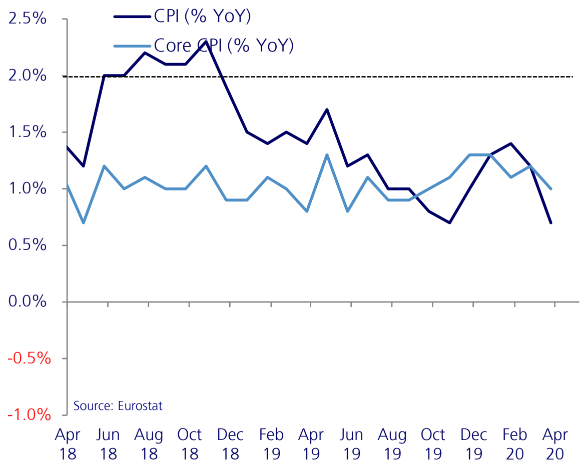
US: inflation to weaken with the economy



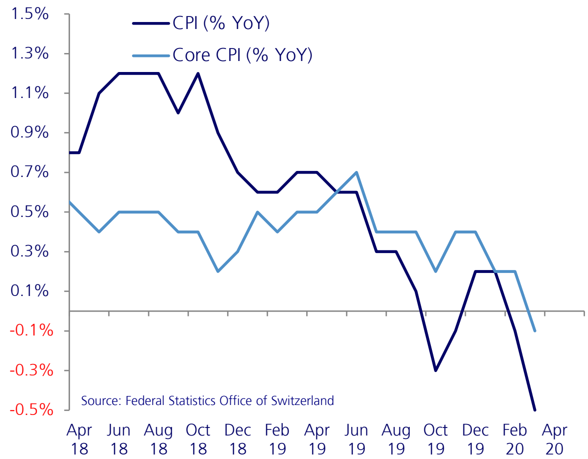
UK: Weak sterling will bolster inflation



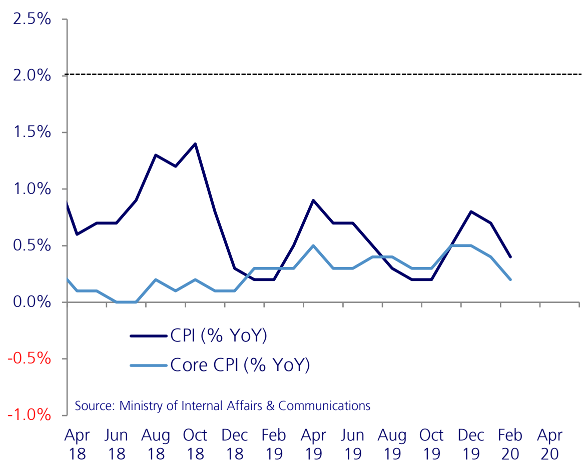
Eurozone: inflation to recede, again



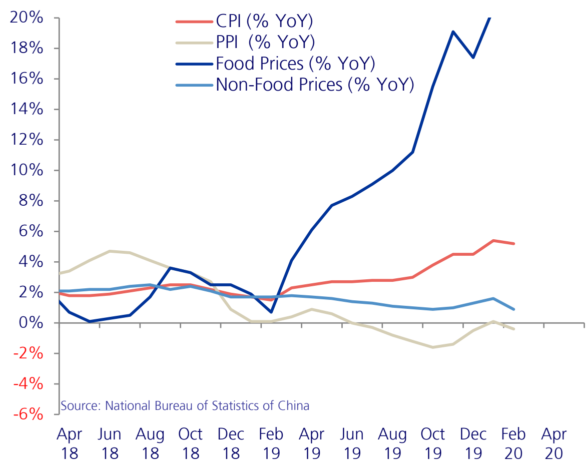
CH: deep deflation



Japan: weakness to persist



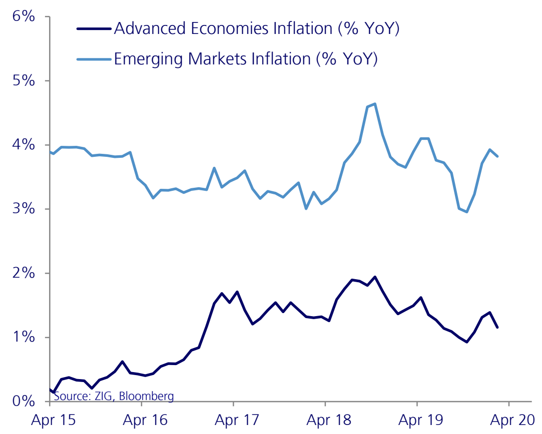
China: diverging dynamics



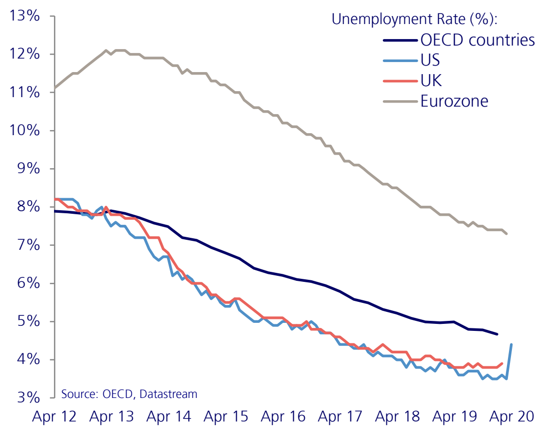
* Dashed lines show inflation targets or equivalent

Key indicators

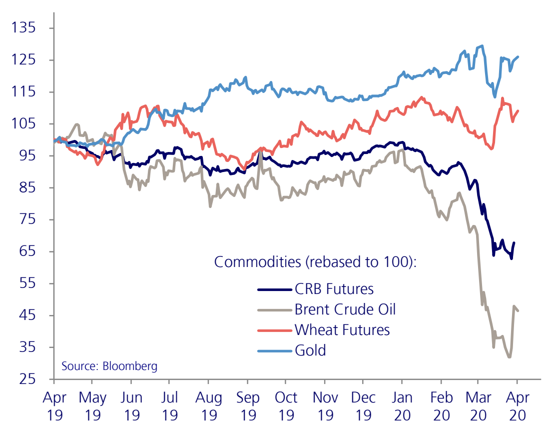
Inflation will slump



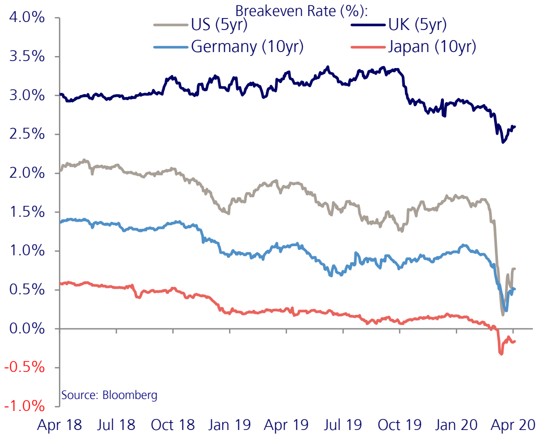
Unemployment should cap wages



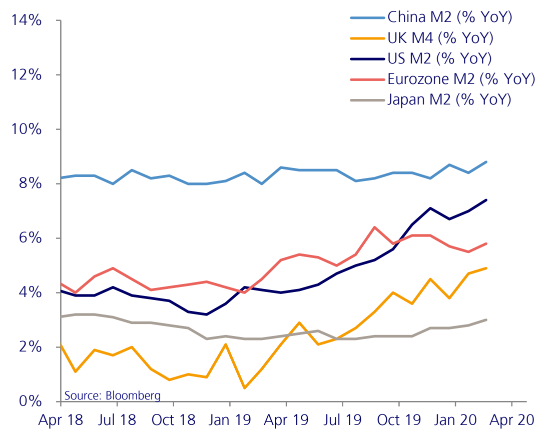
Oil price collapse will be deflationary



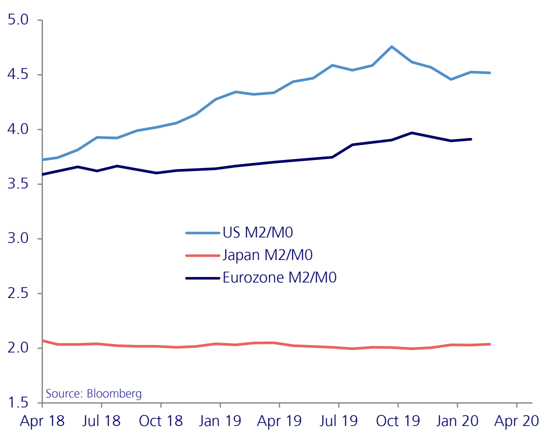
Inflation expectations show severity of crisis



Lending growth set to weaken, despite stimulus



Money multipliers will collapse, again



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