ZURICH

Inflation Focus Q3

15 September 2022

Key Points

- Inflation remains high but price pressures have begun to ease as economic activity and goods demand weaken
- Inflation trends diverge as Europe struggles with surging gas prices while US inflation is peaking
- Central banks maintain their focus on inflation, with tight labour markets calling for further rate hikes
- Recession risk is elevated as a growth slowdown is being engineered to contain inflation

Global price pressures ease as demand slumps and supply conditions improve

A key development over the past quarter is a sharp downshift in global growth, led by developed economies and weakness in China. Growth is tracking slightly below trend and leading indicators point to further weakness. Goods demand has slumped, along with demand for critical inputs. The semi-conductor cycle has turned and many commodity prices are falling, with the prices of lumber, wheat and copper all down by 20% since the end of May. The sharp slowdown in global growth has also led oil prices lower, though they remain highly volatile. Global supply conditions have continued to improve, with businesses reporting that delivery times, inventory levels, and order backlogs are rapidly normalising. This is a large shift compared to last quarter, and is playing out broadly as expected.

Inflation trends diverge as European gas prices surge, while US inflation is peaking

The energy situation in Europe has however deteriorated as a result of further cuts to Russian gas supplies. Surging gas and electricity prices imply that both headline and core inflation will rise further in Europe, with the winter season particularly challenging. Indeed, the near term outlook is likely to be stagflationary, with inflation staying high despite a recessionary growth environment. Fiscal measures will only partially offset the hit to real incomes, and households and businesses will struggle with surging energy costs.

In the US, meanwhile, pandemic related price pressures are improving. Prices of used cars and trucks where up a staggering 45% YoY in 2021 as demand surged on fiscal handouts while auto production froze because of a lack of semi-conductors and other components. Used car prices have now begun to fall, albeit from a high level, and the YoY inflation rate is likely to turn negative in the coming months. Similarly, prices of household appliances were up by almost 20% YoY in early 2021 and the inflation rate has now fallen to 3%. By contrast, shelter inflation, which was boosted by surging house prices, remains sticky, but is set to moderate as the US housing market cools.

Central banks maintain their focus on inflation

Central banks have continued to hike rates aggressively, confirming that they remain focused at getting inflation back towards target, despite the challenging energy situation and rapidly slowing growth. Financial conditions, most notably mortgage rates, have tightened already in anticipation of aggressive rate hikes. This is now having an impact on the real economy, with a slump in housing market activity in some regions, including the US. With global equity prices down by 20% year to date and household and business sentiment depressed by war and price pressures, this is not considered a good time for undertaking major purchases or business investment.

Given the size and speed of change in financial conditions, this will continue to lead demand and spending lower and help to reduce price pressures further. Indeed, we expect CPI inflation to come down meaningfully in the US over the next few months, but be stickier in Europe. Emerging markets continue to see diverse conditions. LatAm central banks have struggled to contain inflation amid FX weakness and fiscal support, but developments suggest we are now close to a peak. In EM Asia, inflation is picking up with a lag but should remain relatively benign, with a deteriorating external backdrop acting as a headwind.

With no slack in labour markets, further tightening is required

Despite sharply slowing growth, labour markets are extremely tight in most regions, with unfilled vacancies stubbornly high. Wage growth continues to track at a high rate in the US and the UK, and wage demands have risen in many other regions, with labour disputes also on a rise. While unemployment tends to respond with a lag, with businesses holding on to workers as long as possible, clearer signs that labour market pressures are easing will be required for the hiking cycle to turn. With inflation uncomfortably high and inflation expectations still at risk of becoming de-anchored, it is too early for a dovish pivot.

Elevated recession risk, with limited prospects for a soft landing

Recession risk has risen further as a result of aggressive policy tightening and the energy crisis in Europe. It remains challenging to generate a soft landing, where growth slows sufficiently to moderate inflation, but not by so much that it triggers a recession. Until they have convincing evidence that inflation is on a downward trajectory, central banks are set to maintain their hawkishs stance, with further hikes expected. This will keep recession fears and financial market volatility high over the coming months.

US
Headline inflation is falling rapidly

Headline CPI inflation fell further from 9.1% in June and 8.5% in July to 8.3% YoY in August while Core CPI reaccelerated to 6.3%. There are increasing signs that particularly headline inflation will continue to fall significantly in the coming months. A wide range of commodity prices including oil, copper, lumber, or wheat are now cheaper than a few months ago. This fall in input prices is increasingly reflected in business prices as well. Small businesses' plans to raise prices, though still at elevated levels, weakened significantly over the last two months to the lowest since January 2021 while the ISM Manufacturing's business price component showed the biggest two-month drop since 2008, indicating that price pressure is fading rapidly. Service inflation remains stickier for the time being, but most indicators are pointing at a slowdown as well. The ISM Services' prices paid component fell to the lowest in more than 18 months, for example. Despite increasing evidence of a marked fall in inflation rates the Fed is keeping up its aggressive rhetoric and is likely to move rates further into restrictive territory at upcoming meetings thus accelerating and exacerbating the expected growth slowdown.

UK
Energy price caps will keep a lid on inflation

Headline CPI inflation ticked down to 9.9% in August after reaching double digits in July for the first time since 1982. Core inflation picked up slightly, reaching an annual rate of 6.3%, up from 6.2% in July. Once again, soaring energy prices were the main driver behind elevated inflation rates. Given further rises in energy prices this trend could continue to push inflation higher in the coming months. However, the government's announcement to introduce an energy price cap will substantially change the inflation pattern by significantly reducing price pressures in the months and quarters ahead. While the BoE is unlikely to move away from its current stance in the near term, the energy price cap should help to keep households' inflation expectations and potential wage demands in check, supporting the longer-term objective of avoiding a damaging wage-price spiral. In addition, there are strong global drivers like falling commodity prices and lower freight costs pointing to reduced price pressure, which will allow the BoE to move to a less aggressive stance later this year given the expected slowdown of the economy.

Eurozone
Peak headline inflation will likely be over the winter months

Eurozone inflation hit a fresh record high of 9.1% in August and perhaps even more worrying core inflation also continues to creep up, to 4.3%. Russia reducing gas supply via the Nord Stream 1 pipeline to 20% of normal capacity mid-June and then switching off supply completely at the end of August pushed up European natural gas prices to record highs and will probably also push headline inflation higher over the next few months as well. However, the EU is developing a plan to cap energy prices and possibly break the link between electricity and gas prices. Intervention in the energy market will probably be combined with rationing of gas in some industrial sectors. Over time, the region is also planning to eliminate its dependence on Russian energy completely. The ECB aggressively raised rates by 75 bps in early September, which should also help at the margin. We expect the peak in headline inflation to be recorded over the winter months, before it falls back. But strong core inflation will likely persist for some time, keeping the ECB hawkish, even though the economy is heading into recession.

Switzerland
A hawkish SNB reduces upside risk to inflation

While annual CPI remains elevated, with headline at 3.5% and core at 2%, upward pressure on prices has moderated. Consumer prices rose by 0.5% over the past three months, compared to 1.5% over the prior three months. Producer prices, which surged in H1, recorded negative prints in July and August. Domestic price pressures also remain benign, with imported goods prices still accounting for the bulk of the inflation overshoot. That said, wage growth stayed brisk in Q2, up 2% on a year ago and broadly flat from Q1. This marks a stark contrast to the pre-pandemic decade when wages stagnated, and partly reflects the very tight labour market.

Looking forward, energy prices will continue to put upward pressures on inflation, with electricity prices set to rise sharply in coming quarters. By contrast, non-energy import price inflation should fall back, given a slump in external demand and easing supply chain pressures, along with the stronger franc. Rent inflation, which has a large weight in the CPI, should be contained, given measures to reduce housing market imbalances and a sharp tightening in financial conditions.

The hawkish SNB rate hike confirms their preference for low inflation, with further rate hikes expected in 2022.

Japan
Inflation expectations are rising

Tokyo's CPI approached the 3% YoY in August, the highest level in over 30 years (excluding the consumption tax hike). The spike was driven by the 10.1% surge in fresh food prices. Tokyo's core CPI (excl. fresh food) climbed to 2.6% while the new core CPI (excl. fresh food and energy) crept higher to 1.4%, having started the year in negative territory. Meanwhile, producer prices have risen to a 40-year high of 9%, pushed up by the remarkable 48% YoY surge of import prices, which was driven by energy prices and the weaker yen, as the USDJPY has risen from 115 to 145 this year. Inflation expectations among consumers and corporates have risen substantially, which is something new to the younger generation. Indeed, 58% of all households expect inflation to rise above 5%. Real wage losses are shallow, however. Labour market conditions are tight, and the planned minimum wage hike of 3.3% should contribute to a moderate impact on real income.

We do not expect major monetary policy changes before Governor Kuroda's term ends in spring next year. An extension of the band around the yield target is likely to be an option in Q2 2023 or later. However, the MoF may intervene in the currency markets to stabilise the depreciating yen.

China

Inflation remains contained

Contrary to many other countries, inflation is not a concern in China. Indeed, consumer price inflation, at 2.5% YoY in August, is hovering below the PBoC's ceiling of 3% and has been falling on a MoM basis. Higher pork inflation has been offset by lower vegetable inflation, while energy prices have declined, and transportation inflation has receded. House prices were down 1.7% YoY in July, according to the 70-cities newly built residential building prices, reflecting the property market downturn. Core inflation, at 0.8% YoY, fell to a 16-month low as the economy kept suffering from Covid related lockdowns, drought related electricity shortages and the weak property market. Meanwhile, producer price inflation fell by nearly two percentage points to 2.3% YoY in August reflecting falling energy and base metal prices, with both producer- and consumer-goods producer price inflation declining. The base effect should help to keep producer price inflation low for the rest of the year. The PBoC is taking a less dovish tone in its inflation outlook, as it is concerned about increasing inflationary threats once the economy re-opens. We believe re-opening may become a topic once the National People's Congress (NPC) has concluded in spring next year, but not anytime soon.

Australia

Inflation is elevated, with restrictive monetary policy required

Inflation in Australia remains elevated, with headline CPI for Q2 increasing by 1.8% QoQ and 6.1% YoY, driven by rising food prices and housing costs. The underlying CPI, as measured by the trimmed mean, has increased from 3.7% in Q1 to 4.9% YoY. The increase in core inflation highlights that inflation pressures are broadening and transitioning from higher fuel costs to the wider economy. In the August Statement of Monetary Policy, the RBA increased its inflation forecast for 2022 to 7.8% and the 2023 inflation forecast to 4.3%, and the revisions indicate that the RBA acknowledges that it will take a sustained period of restrictive monetary policy to bring the CPI back to within its target band of 2% to 3%. The RBA acted and increased the cash rate to 2.35% at its September meeting, while market pricing indicates that the cash rate will increase to 3.25% by the end of 2022. We believe that monetary tightening is starting to have an impact on the housing market and will contribute to a slower pace of inflation and economic growth in 2023. However, the pace of decline in underlying inflation will be gradual due to supply-side constraints, in line with a tight labour market and increased geopolitical tensions.

ASEAN

Inflation picks up steam, prompting more tightening

In Malaysia, headline inflation accelerated at 4.4% YoY in July, while core inflation also picked up at its quickest pace in more than six years at 3.4%. Bank Negara Malaysia projects domestic inflationary pressure to peak in Q3 before normalising and maintains that core inflation is likely to hit the high end of their projection range at 2-3% this year. While producer prices have gained 10.2% YoY for the first seven months of the year, expectations are for PPI inflation to increase at a softer pace in H2 as commodity prices, while still volatile, may trend lower from their peaks.

In Indonesia, headline CPI showed some easing from volatile food prices, but remained firmly above Bank Indonesia's 2-4% target range for a third month, while core CPI rose to a three-year high at 3%. The recent removal of fuel subsidies (resulting in a 30% hike in fuel prices) in order to rein in the budget deficit will trigger a jump in inflation in H2, pressuring the central bank to pivot away from its accommodative stance to a tightening one.

Brazil

Inflation expectations have fallen, helped by tax cuts

Tax cuts on fuel, electricity, public transport, and communications and the reduction in gasoline prices explained the negative MoM inflation prints in July and August, significantly reducing inflation pressures for 2022. Furthermore, the recent fall in oil prices will likely lead to additional cuts in gasoline prices by Petrobras in the short term. On the other hand, despite prices for food and services decelerating, they continue to push inflation to the upside. The labour market also remains tight, leading to a rise in real wages, making it difficult for services inflation to decelerate further. Headline inflation decelerated from 11.9% YoY in June to 8.7% in August, while core inflation remains stable and seems to have peaked, reaching 10.4% in August. Monthly inflation will likely accelerate in September due to the reduction of the tax cuts impact, but it is still expected to register falling prices MoM. Inflation expectations for 2023 have stabilised at around 5%, while the government indicated in its budget proposal for the next year that it will maintain federal tax cuts through 2023.

The faster reduction in current inflation and the stabilisation in inflation expectation for 2023 support our view that the tightening cycle has already ended, with the Selic rate at 13.75%.

LatAm

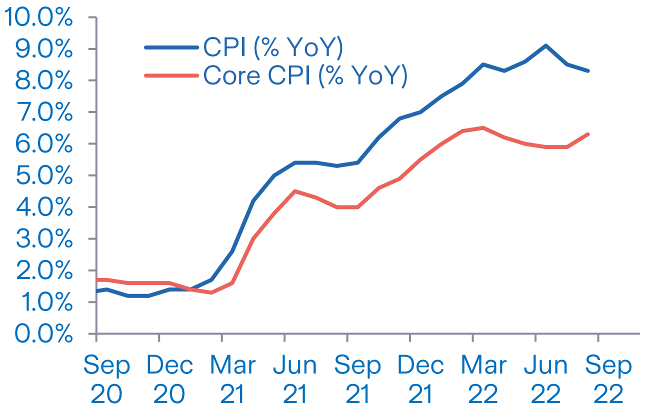
Inflation is close to peaking in Chile

Inflation has continued to accelerate, with higher food prices the common driver across the region, while inflation expectations for 2023 remain elevated. In **Chile**, headline inflation reached 14.1% YoY in August. Despite widespread inflation pressures, currency depreciation and rising food and energy prices (up 22% YoY and 24% YoY, respectively), remain the main drivers of rising inflation. Nevertheless, we believe inflation is peaking and will likely gradually decelerate due to the recent fall in commodity prices and the narrower currency risk premia after the constitutional referendum. We also expect economic growth to turn negative in 2023. The high degree of indexation in the economy means however that inflation will likely stay above target in 2023.

In **Mexico,** concerns around inflation remain high, confirming further tightening ahead. Headline inflation has continued to accelerate, reaching 8.7% YoY in August, while core inflation reached 8.1% YoY, its highest level since November 2000, with all components increasing annually. We expect inflation in Mexico to peak in September. Food-related and services prices will likely remain under pressure, while energy pressures will continue easing.

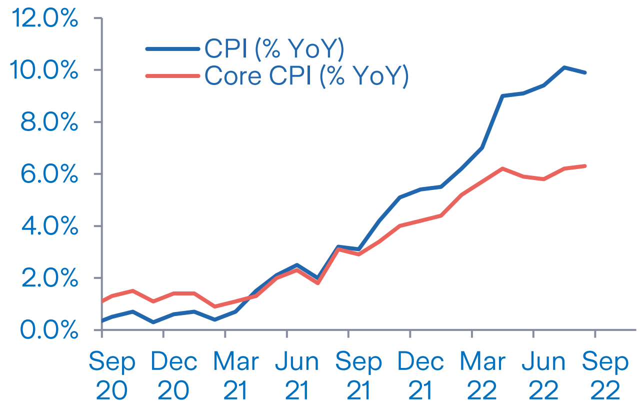
Current and historic inflation

US: Inflation is peaking



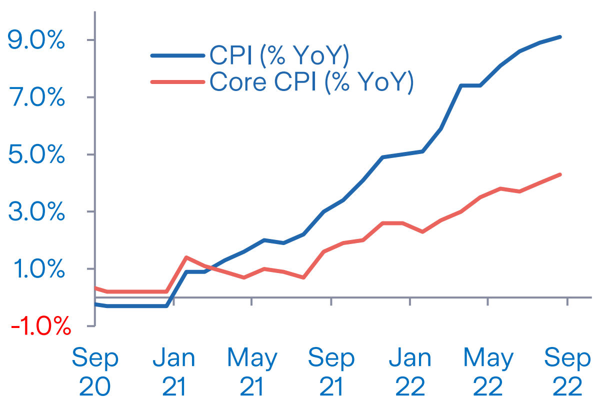
Source: BLS

UK: Energy price cap to keep a lid on inflation



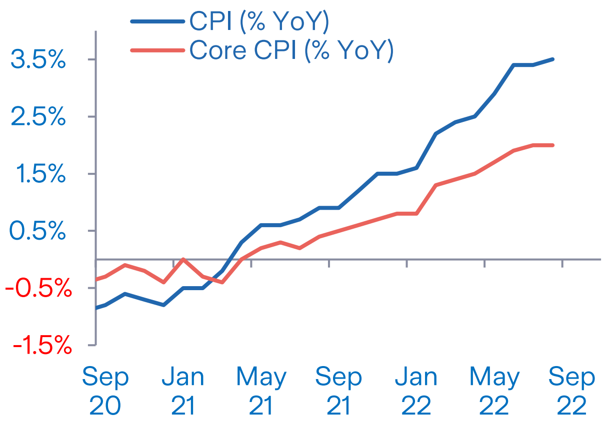
Source: ONS

EZ: Energy stokes inflation



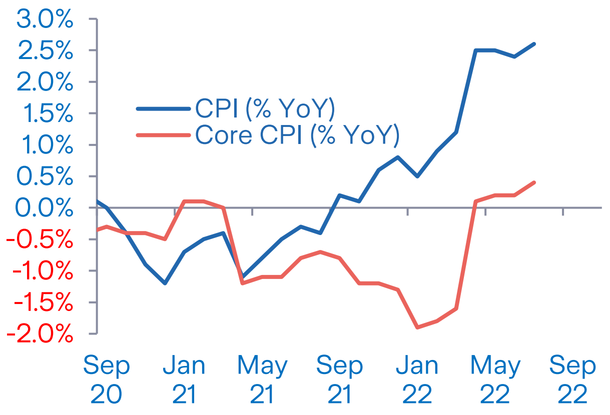
Source: Eurostat

CH: Upward pressure eases



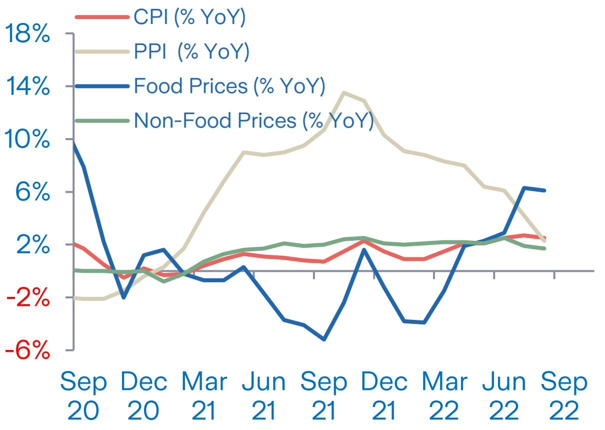
Source: Federal Statistics Office

Japan: Inflation and inflation expectations rising



Source: Ministry of Internal Affairs & Communication

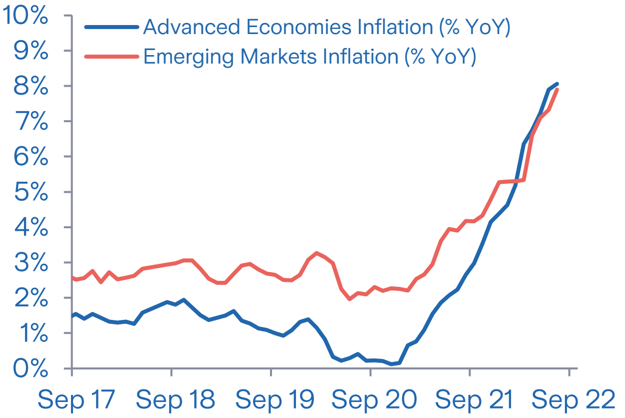
China: PPI inflation slumping



Source: National Bureau of Statistics China

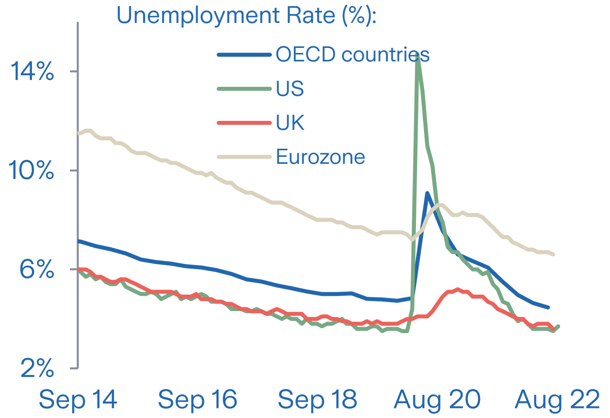
Key indicators

Food and energy continue to drive inflation higher



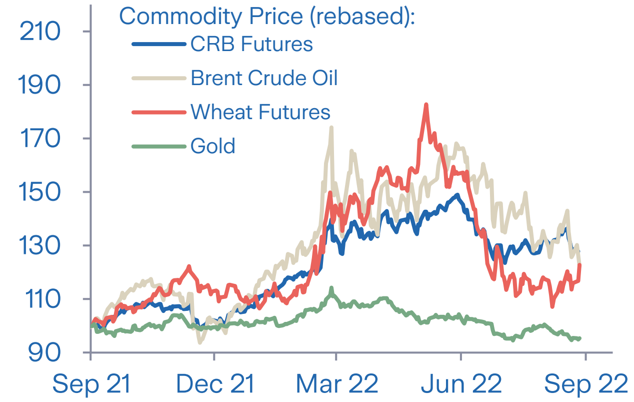
Source: ZIG, Bloomberg

Labour markets remain extremely tight



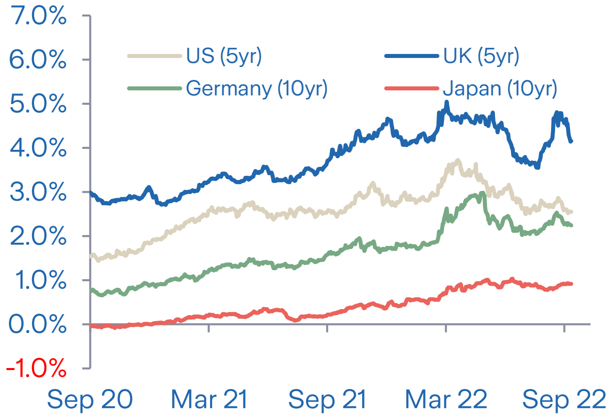
Source: Bloomberg

Commodity prices down from their peaks



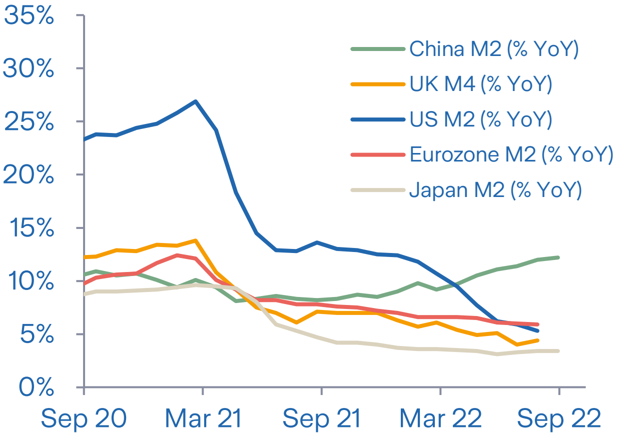
Source: Bloomberg

Inflation expectations are contained



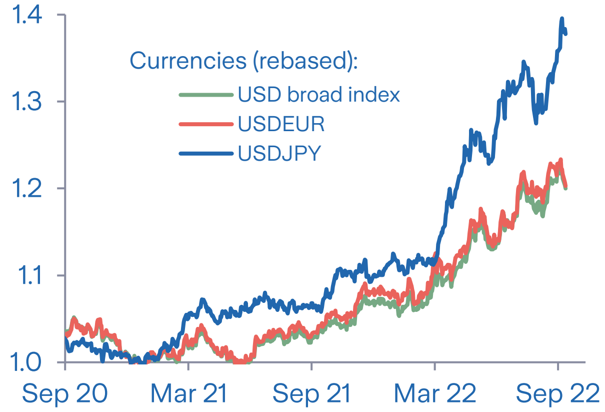
Source: Bloomberg

Money growth back to normal



Source: Bloomberg

Currency moves drive inflation divergence



Source: Bloomberg

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