May 5, 2017

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Inflation Focus Q2

Key points

- Global inflation has bottomed, but the underlying trend is very benign
- US inflation is normalising, and upside risk has receded on policy developments
- Most other DMs lag behind, though core inflation should start to reengage with shrinking slack
- Stronger inflation dynamics in Asia and a trade recovery reduce global headwinds to inflation

Headline and core inflation converge as oil price effects fade

As expected, headline inflation has slipped in many regions, following a sharp acceleration in late 2016. The rise and fall mainly reflects energy effects, which, in the absence of a rebound in oil prices, will remain a drag on inflation over the next few months. Over time, headline inflation should therefore converge back towards core inflation, which strips out volatile components and gives a better estimate of underlying inflation trends.

Core inflation is bottoming, but progress is painfully slow

While core inflation is stubbornly weak in developed markets, we maintain our view that it has bottomed, but that a move higher will be very gradual. This is clearest in the case of the US, which is furthest ahead in the cycle. With a tight labour market — unemployment is close to a 10-year low — employers are reporting difficulties in hiring staff and the quit rate, which is linked to wage inflation, is at a cycle high. Absent a sharp slowdown in the economy, which we do not expect, limited spare capacity should, over time, lead to a further pickup in wage growth. This will predominantly support services inflation, which makes up the bulk of the CPI index.

Over the past, a strong dollar, falling import prices, and deflationary global goods prices have slowed progress towards the Fed's inflation target. For stronger dynamics, global conditions clearly also have to improve. Europe is at the fore, given its role in the world economy and trade. So far, core inflation has failed to pick up in the Eurozone, where it has been hovering around 1% for the past few years. Though very weak, we should maybe not be so surprised by the lack of a pickup – the cycle is lagging the US cycle by roughly two years, as judged by the labour market, and US inflation only started to reengage in 2015. The Eurozone is now growing at above trend, with falling unemployment and some signs of skill shortages. Judging by historical relations, this suggests that wage inflation should reengage over time, though at a painfully slow pace given the disinflationary forces that are still present in the periphery and which were absent in previous cycles. We therefore expect Eurozone core inflation to gradually move higher over the next few years. In other words, we do not believe that Europe is quite like Japan, where inflation is still lingering around zero, despite stimulus and a stronger economy. Even there, however, there are tentative signs that services inflation is bottoming out.

Global headwinds that have held back inflation appear to be easing

EM Asia is also highly integrated in the global trade system and has been a source of deflation over the past few years. In China, producer prices have staged a sharp rebound, following a four-year stint of deflation. Though the surge in the PPIs is likely to fade, a return to outright deflation looks unlikely. Elsewhere in EM Asia, a closing of output gaps and stronger activity is supporting a pickup in inflation, though not so strong that central banks need to respond aggressively. Lastly, global trade has been extremely weak over the past five years, contributing to deflationary global goods prices. We are now seeing a rebound in trade, and world trade prices have also gained some momentum, over and above what we would expect given oil prices.

Latam is the only region where inflation is falling. This is not a source of global disinflation, however, as it is coming down from high levels, allowing central banks to cut rates faster than expected. Ultimately, this will be supportive for economic activity regionally and globally.

Taken together, headwinds that have held back global inflation appear to be easing, and this should help support inflation more broadly, serving to accentuate domestic trends, rather than offset them.

Upside, and downside, risks to inflation have receded

Upside risks to inflation, mainly stemming from the US, have receded over the past quarter. Protectionist rhetoric has so far not triggered any action, and it now seems likely that the pledged fiscal boost will be scaled down and it is doubtful that it will come through over the near term. Downside risks from Eurozone politics have also fallen, which should help sustain the much needed recovery in the region.

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US

Core inflation creeps higher while upside risks from policy have been reduced

Supported by the energy base effect, headline inflation reached 2.7% in February but fell back to 2.4% in March. Having been a drag on inflation until September last year, transportation has increasingly added to overall price pressure in recent months. However, the contribution from transportation and other energy-related items to inflation is expected to fade if oil prices remain close to their current levels. Headline inflation should therefore moderate over the course of the year. While the energy boost to the inflation rate is expected to disappear relatively soon, core components will continue to push prices up.

Service inflation, representing the lion's share in core inflation measures, has steadily been grinding higher in recent years. Housing and healthcare costs have been relatively constant contributors to rising core inflation and are expected to continue doing so. With President Trump so far not following up on his protectionist campaign rhetoric, the risk of higher inflation induced by tariffs has been reduced. And with the border adjusted tax not included in Trump's tax reform proposal another potential source of accelerating inflation seems to be off the table.

UK

Currency-induced price pressure is lifting inflation rates

Inflation rates have been boosted by a combination of a weak currency and the energy base effect, which reached its maximum in the first quarter. With a significant weight in the CPI basket, transport became the single most important contributor to headline inflation in March. While the oil price effect is expected to fade relatively soon, the impact of the weaker currency is still feeding through the value chain. Producer input prices have soared by more than 20% compared to a year ago in the first quarter, levelling off to an annual gain of 17.9% in March. Retail prices rose by 3.4% YoY if mortgage rates are excluded. Headline inflation will remain above the BoE's target for most of the year, but as it is mainly fuelled by transitory effects the BoE is expected to look through it as long as inflation expectations remain well anchored. Consumer inflation expectations are high but seem to have peaked late last year. While core inflation will be supported by the ongoing pricing pressure in the pipeline, the expected loss of economic momentum caused by Brexit related uncertainty will soften the impact.

Eurozone

Volatile inflation but underlying trend still subdued

Eurozone inflation has been volatile over the past few months because of the late timing of Easter this year compared to last year. Core inflation fell from 0.9% YoY in February to 0.7% in March, but then rose to 1.2% in April. The underlying trend is that core inflation is basically flat at around 1.0%. We expect Eurozone core inflation to increase over the next few quarters as the recovery continues, unemployment falls and wage growth accelerates. However, these trends are likely to be very gradual. Headline inflation, currently 1.5%, should move back closer into line with core inflation over the next few months as positive base effects from oil prices fade. Overall, there are still few signs of inflationary pressure in the Eurozone, though over the course of the next few quarters we still expect the ECB to steadily reduce the extraordinary amount of monetary accommodation that it is currently providing via QE and negative interest rates.

Switzerland

Higher inflation unlikely to trigger policy change

Headline CPI has risen sharply, up from -0.9% YoY one year ago to 0.6% in March, though this mainly reflects base effects from oil and import prices. As these will fade, core CPI, which is only 0.1%, gives a clearer picture of the underlying inflation dynamics. These are weak, but we continue to expect core inflation to edge up over the course of the year. This will mainly reflect higher services inflation, while goods price inflation is expected to be broadly absent, due to persistent headwinds from the strong currency and challenging conditions in the retail sector. Services prices, by contrast, appear to have bottomed, amid a rebound in the economy. While this is encouraging, inflation is far below the SNB's target, and has now been tracking at, or below, zero for the past six years. Wage inflation has fallen sharply as deflationary expectations have arguably become entrenched. Though the SNB has recently signaled a more positive outlook, we expect policy to be kept unchanged for time being, particularly as political risk remain significant, with the currency vulnerable to safe haven flows.

Japan

Service price inflation is bottoming

All CPI inflation measures, be it headline or core, nationwide or for Tokyo, are hovering around the zero line, far away from the Bank of Japan's 2% target. In the latest press conference following the BoJ's decision to keep monetary policy unchanged, Governor Kuroda explicitly mentioned that this target will not be achieved before FY2018. Indeed, even the majority of all BoJ policy members predict CPI ex fresh food to move to only 1.9% in FY19, excluding the effect of the scheduled consumption tax hike. However, there are first glimpses of prices moving a bit higher. Service producer prices for example, rose 0.8% YoY in March, the strongest since 1993, which is in line with further improvements in Japan's labour market conditions. This suggests that consumer service prices should also start to recover soon. Price components within business surveys, like the 'Tankan' or the 'Shoko Chukin' survey of small companies, confirm that output price expectations in the service sector have bottomed. While the 'shunto' spring wage negotiation round remains uninspiring, we note that wages are rising at a faster pace amongst SMEs.

China

Producer price inflation is expected to peak

Falling food prices, down 4.4% YoY, were the main reason behind the significant drop in China's CPI in March to 0.9% compared to the first two months of the year, when headline inflation was up 1.7% YoY. Meanwhile, producer price inflation seems to be topping, following a multi-year deflationary trend. PPI was up 7.6% YoY in March, versus 7.8% in February, the first monthly decline since August 2015. A slowdown in industrial commodity inflation is the main reason. We believe that inflationary tendencies will not accelerate from here, due to base effects and the fact that credit and property market tightening measures should have an impact on the economy later this year. It is interesting to note that service price inflation is inching higher, mainly driven by accelerating healthcare costs. In the property market, we recognise continued divergence between the bigger and the smaller cities. For example, whereas property prices fell on a sequential basis in Shanghai and Shenzen, they rose 0.8% MoM in tier-4 cities. Overall, housing prices were up 11.4% YoY in China's top 70 cities on a population weighted basis, which looks robust. Further property tightening measures should continue to cool down the hot property market in major cities, where prices were up 30% YoY late last year.

Australia

Wage growth is needed to move to demand-pull inflation

In 17Q1, headline inflation was up 2.1% YoY, finally back within the 2-3% target band of the RBA. Underlying inflation also crept higher, just below 2%. The drivers of this recovery, regulated prices and fuel prices, are less impressive. Positive contagion to demand-pull inflation would require second-round effects on inflation expectations, as well as stronger wage growth. Most surveys are sending encouraging signs that inflationary expectations are bottoming out. However, employee earnings growth remains very weak, and, in fact, has turned marginally negative in real terms, putting pressure on households' disposable income. Going forward, we expect some of the recent boost in national income to spill over to wages. Full-time job creation has picked up, which should also help. Structural factors should contain the rebound in CPI, though. First, the retail market is turning more competitive, following the entry of new digital retailers. Second, housing price growth should moderate in H2, as tighter mortgage regulations bite. In summary, we see underlying CPI returning to 2% YoY this year, and headline CPI hovering around the mid-point of the 2-3% RBA target. The RBA should remain on hold this year.

ASEAN

Inflation pressures leave central banks '*en garde*'

2017 has marked the forceful return of inflation: 5.1% YoY in Malaysia (March) and 4.2% in Indonesia (April), breaching and reaching the top half of the central banks' respective targets of 3-4% and 4-6%. Transport prices account for most of the jump in both countries, with housing prices also contributing in Indonesia. We expect more tariff hikes for utilities in Indonesia in Q2. In Q3-Q4, fuel base effects should fade and headline CPI moderate. However, core inflation should edge higher, coinciding with the ongoing recovery in money growth. So far, companies have absorbed higher input prices by squeezing their margins, but, if consumption rebounds, they will increase retail prices too. We see signs that domestic demand is recovering in both countries, thanks to firmer activity in manufacturing and agriculture. Finally, food inflation is a wild card as weather forecasters assign a probability of 50% to the return of El Niño this summer. Regarding central bank action, our base case is for BI and BNM to stand pat. However, we expect their rhetoric to turn more hawkish and see a risk of rate hikes if the economic recovery gains strength or food inflation surprises to the upside. We see headline CPI at 4% YoY in Malaysia and at 4.5% in Indonesia this year.

Brazil

A monetary easing campaign with the pedal to the metal

Inflation has fallen sharply and is reaching the central bank target for the first time in nearly seven years. Anchored inflation expectations coupled with weak economic activity created fertile ground for a monetary easing campaign, which has been more aggressive than expected with 100bps rate cuts quickly becoming the norm.

We expect inflation to remain benign and the currency to remain well bid as the carry trade is back in vogue and Brazil offers an attractive return. Nominal rates should still benefit from the monetary easing cycle and be preferred to inflation linked bonds. The equity market should also benefit. Economic activity is bottoming out but a sizeable output gap should guarantee that inflation remains in check over the upcoming quarters. Inflation has consolidated its downward trend, but the central bank will keep an eye on fiscal reforms that could still create havoc should they not materialize.

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

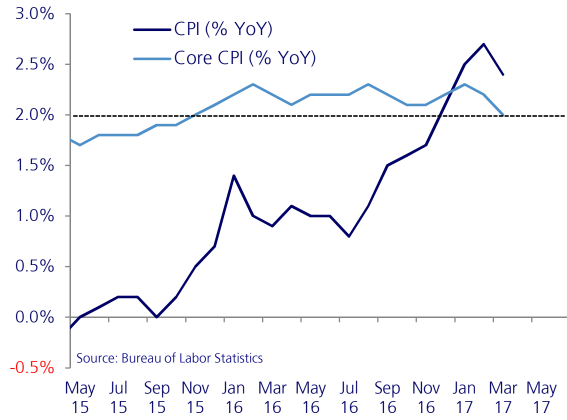
Central banks are in easing mode, while tightening is the norm in Mexico

In Chile, inflation has fallen to a three- year low and the economy is stuck in low gear. The mining strikes will not help growth and allowed the central bank to be more aggressive, with three rate cuts so far this year. We believe that there is room for a last cut if weak activity persists. In Peru, inflation is stable but a rate cut could be in the cards. In Argentina, the central bank hiked its reference rate for the first time since the new regime has been in place. As inflation expectations are sticky and wage negotiations difficult, a 150bps hike is a clear signal that they are serious about reducing inflation. In Colombia, the central bank keeps surprising with its pace of rate cuts as the slowdown is more pronounced than expected. We believe that there is room for more easing.

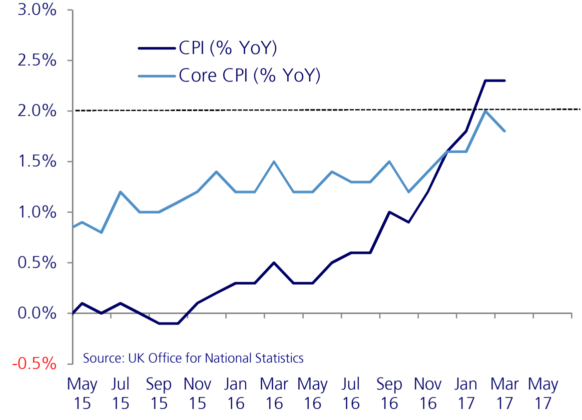
In Mexico, inflation is moving up fast with secondary effects that have forced the central bank to remain vigilant. Still, it hiked by only 25bps in its last meeting compared to the 50bps hikes that have been the norm. Coupled with the introduction of the FX swaps, it is a good signal that Banxico is back in charge. We believe that inflation will stabilize in the second part of the year and that could eventually allow Banxico to decouple from the Fed's hiking campaign.

Current and historic inflation

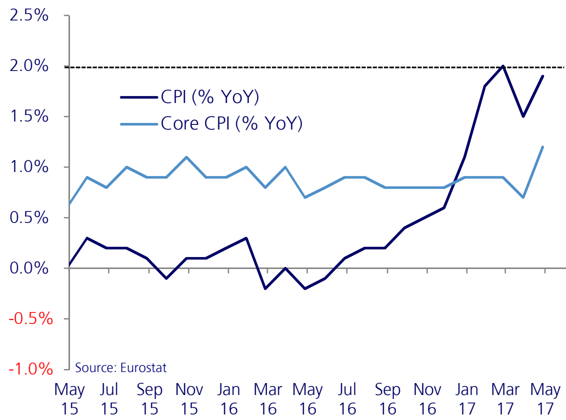
US: energy effects have peaked



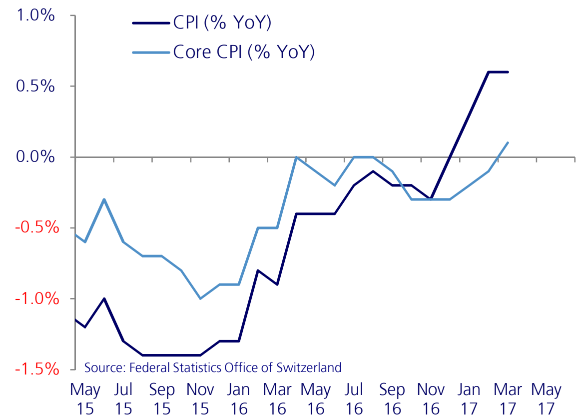
UK: currency effects lift inflation



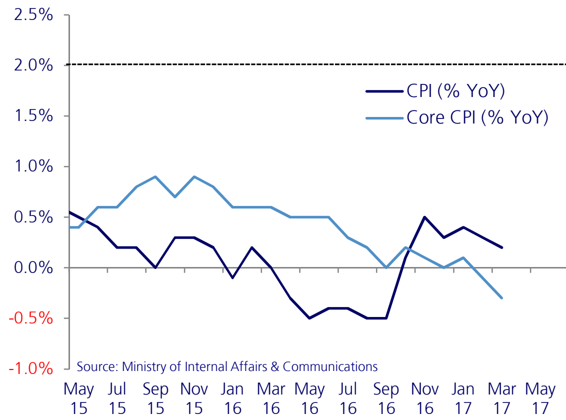
Eurozone: volatility, but core inflation still weak



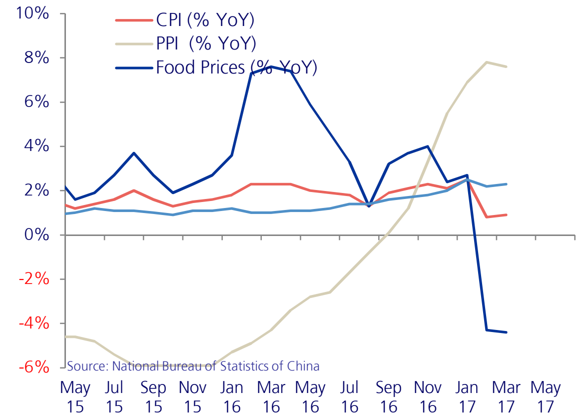
CH: large base effects will fade



Japan: no sign of an inflation pickup

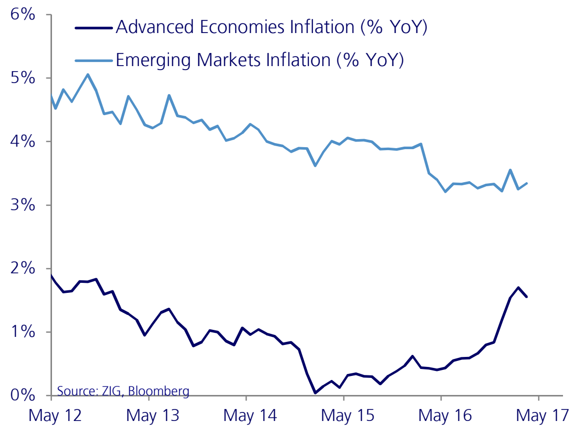


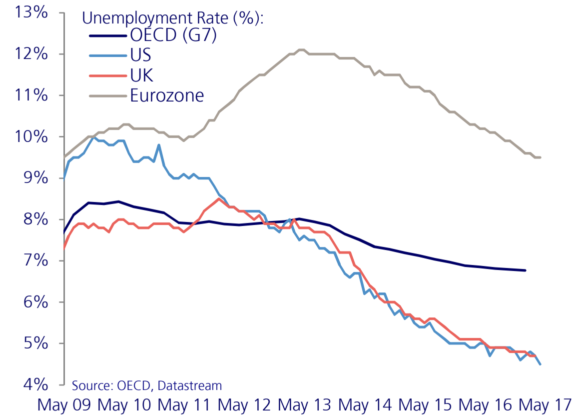
China: swift turnaround in producer prices

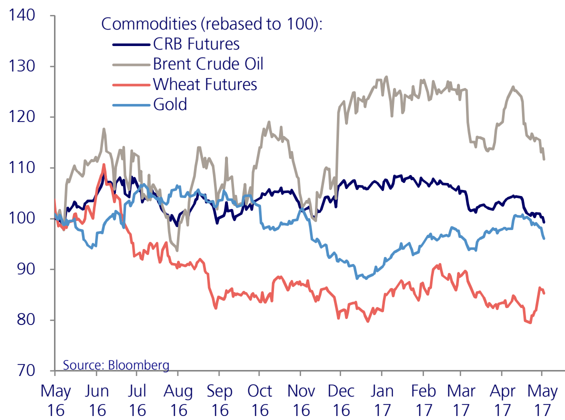


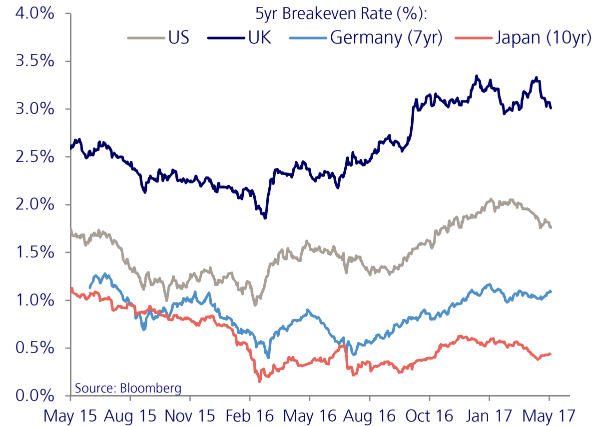
* Dashed lines show inflation targets or equivalent

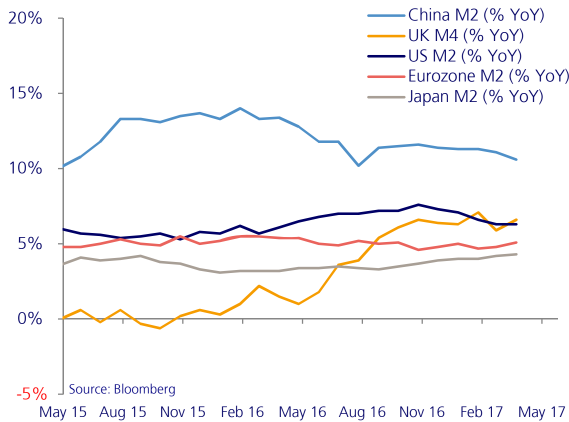
Key indicators

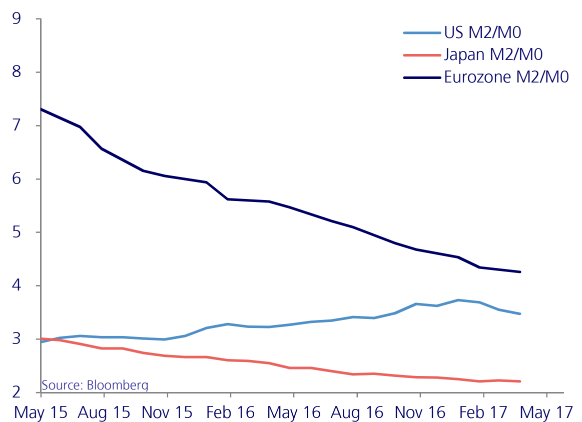












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