September 10, 2020

Inflation Focus Q3

Key Points

- Global inflation is likely to have bottomed as the immediate deflationary impact of lockdowns is diminishing
- Core inflation will remain under pressure as labour market dislocations exert downward pressure on wages
- Policy stimulus is unlikely to be inflationary over the near to medium term as uncertainty and job losses curtail spending
- Longer-term trends in inflation are also expected to be contained due to still vigilant central banks

Source: iStock by Getty Images

Global inflation bottoms as the deflationary impact of lockdowns ease

Core inflation rates (ex energy and food) have slumped in most developed economies and are once again tracking well below central bank targets. The decline was driven in large part by components that were severely impacted by lockdowns, such as health, transportation and recreational services. As lockdowns have been removed and demand has picked up, inflation on some of these components has started to recover, helping to explain the bottoming out in inflation rates that now appears to be underway. Headline inflation rates have also stabilised, following the deep slump in Q2 that largely reflected the collapse in commodity prices.

Weak labour markets will continue to exert downward pressure on wages

While the immediate impact of the collapse in demand on inflation is now fading away, COVID-19 lockdowns and social distancing have created huge dislocations in labour markets that will be disinflationary. It is encouraging that unemployment in the US, which surged in Q2 to the highest level since the Great Depression of the1930s, has fallen back to a more normal but still recessionary level as businesses have opened up and fiscal support measures have prevented a broader collapse in demand. But despite recent improvements, the US unemployment rate remains at the highest level since 2012, and further job gains will likely be more challenging as the crisis leaves permanent scars on businesses and sectors. The extensive use of furloughing and part-time work has led to more stable labour markets in many other regions. These emergency measures will be phased out over time though, likely leading to a stream of job losses in the months and quarters ahead. As job security has dwindled, wage inflation, which was already benign, is expected to collapse. This will prolong the disinflationary impulse of the lockdown.

Support measures trigger a sharp but temporary increase in money growth

Unprecedented support measures have helped to absorb the cost of locking down economies and prevented a global depression. As monetary and fiscal policy actions have been unusually synchronised, with cash handouts and generous grants and loans to businesses, broader measures of money growth have spiked to levels that match or exceed prior highs. This has not created a surge in demand as social distancing and lockdowns have curtailed non-essential spending, instead leading to a rise in savings. While some of these additional savings will translate into higher spending over time, we do not expect this to lead to a build-up in excess demand and inflation, as elevated uncertainty around future job prospects and business conditions will cap overall demand, at least over the near to medium term.

Moreover, stimulus measures were taken during a period of immense stress and are expected to be tapered as conditions normalise, which means that money growth will gradually level off. While inflation may indeed be a monetary phenomenon, a temporary money injection is not sufficient to trigger an inflation flare-up.

The Fed's policy shift lead to a rebound in inflation expectations

As widely expected, the Federal Reserve has moved from a 2% inflation target to one of achieving an average of 2% over time. This is a dovish policy shift as the Fed should now aim to overshoot the inflation target for a period of time, following a decade of missing the target from below. This has boosted inflation expectations and reduced real interest rates and we cannot rule out that other central banks, which also struggle with low inflation, may move in a similar direction.

While we welcome the Fed's policy shift, it is too early to judge whether the new target will be achievable or not. This will depend on how the central bank behaves once the economy runs hot and inflation pressures start to build up. We await more details regarding how exactly the Fed will commit itself to 'behaving irresponsibly' at that stage of the economic cycle. For now, we note that, in the past, central banks have been too keen to tighten policy, which has contributed to persistently low inflation. Given the Fed's continued focus on inflation, within a defined inflation targeting framework, we suspect it will remain vigilant, even after this policy adjustment.

We therefore maintain our view that longer-term inflation prospects remain benign as more fundamental changes to the way central banks operate are likely to be needed to generate a larger rise in trend inflation. That said, we cannot rule out pockets of higher inflation, and note that uncertainty around longer-term inflation prospects has increased.

US

The Fed moves to an average inflation target

In July, headline CPI inflation rose by 0.6% MoM, the fastest rate since June 2009. For core CPI, which also accelerated to 0.6% MoM in July, it was even the steepest rise in almost three decades. However, these numbers should be taken with some caution as the pandemic and the ensuing lockdown over the past few months have caused significant distortions. Annual inflation rates have also accelerated as the economy emerges from the lockdown but look much less dramatic with 1.0% and 1.6% for headline and core CPI, respectively. Going forward, inflation rates are expected to recover further as service costs in particular have started to trend back up, not least the crucial shelter component.

Inflation expectations have already risen back to pre-crisis levels, supported by the Fed's announcement to move away from its explicit 2% inflation target to achieving 2% on average over time. While the Fed didn't specify the time horizon or the look-back period over which the average inflation target should be reached, there will be more flexibility regarding its monetary policy and it's likely that inflation will overshoot 2% once the economy has fully recovered.

UK

Core inflation is expected to moderate in the coming months

Both headline and core inflation rates rose markedly in July with annual rates accelerating to 1.0% and 1.8%, respectively. The acceleration took most analysts by surprise but should be looked at with some caution as recent inflation numbers are at least partially distorted by the unwinding of lockdown measures during the pandemic and the difficulty to correctly measure the price of a number of goods. While some items were simply not available, price development was also impacted by unusual customer and supplier behaviour. For example, clothing prices, which provided one of the biggest upside surprises, helped to lift core prices, but this could have been caused by the fact that the usual discounting during the summer period did not happened (as many shops were closed). Going forward, inflation rates are expected to moderate as the economy continues to feel the headwinds of social distancing and partial lockdowns as well as the ongoing uncertainty regarding a potential trade agreement with the EU or the lack thereof. In addition to a modest growth environment the temporary VAT cut will help to keep inflation rates in check in the coming months.

Eurozone

Little inflation pressure for now

Inflation data in the Eurozone over the past few months have been extremely volatile, but the underlying trend has been down rather than up. Indeed, core inflation hit a record low of 0.4% YoY in August, though partly due to distortions created by the late timing of summer sales as shops and businesses reopened after the virus lockdown. A temporary cut in German VAT implemented in July for the rest of 2020 and designed to stimulate spending and the economy, has also weighed on overall inflation in the Eurozone, pushing it down by around 0.2 percentage points. The Eurozone economy is rebounding quickly from the COVID-19 induced recession and lockdown, but labour market slack is high and this is likely to remain the case for some time. The stronger euro is also weighing down on imported inflation. The upshot is that there are few signs of inflationary pressure in the Eurozone for now, and rather the concern is that inflation is still too low. This adds pressure on the ECB to do more to stimulate inflation, though given the large amount of stimulus it has already announced in recent months, it will probably be some time before it acts again.

Switzerland

Deep deflation, but likely to have bottomed

Consumer prices are now falling at an annual pace of -0.9%, following a recovery from the trough of -1.3% in May and June. Core prices are also in deflationary territory but are holding up slightly better, at -0.4% YoY, up from -0.8% in June. The rebound in annual inflation rates mainly reflects base effects while underlying price pressure remains weak. Both inflation measures are dragged down by deflationary import prices, amplified by falling prices in services components. Prices have, however, rebounded on some of the services that were severely impacted by the lockdown, including restaurants and hotels, likely supported by strong demand during the summer period, as Swiss residents chose to holiday at home. The overall pricing environment remains under pressure, however, with weak external demand and the strong franc continuing to exert downward pressure on prices, wages and margins.

We therefore maintain our CPI inflation forecast for 2020 at -0.8% but recognise that downside risk to inflation has mitigated over the past quarter as the recovery has been brisk and the currency has not strengthened further. The SNB is expected to leave policy unchanged throughout 2020 and 2021.

Japan

Prices continue to edge down

Despite the recent acceleration in Tokyo's CPI, most of Japan's inflation measures like core consumer prices, final consumer good prices, producer prices, services producer prices, export prices and import prices have dropped into negative territory while inflation expectations have fallen closer to zero. Falling energy prices have been the main drag so far this year. We also note some temporary, pandemic-related distortions in recent price data mainly for tutorial fees and travel related price categories. Considering rising spare capacity and a weakening labour market it is unlikely that the Bank of Japan's 2% inflation target will be achieved anytime soon. It is looking more and more symbolic in nature as inflation expectations seem to be anchored at a low level. Japan's M2 money supply growth has surged from 2.3% to 7.9% YoY within a year as banks have stepped up lending to companies covered by full government guarantees while the government has given fiscal support of JPY 20tn to households and firms. The respective JGB issuance has been bought by financial institutions. However, broader monetary aggregates are growing at a slower rate than in the US, the UK and the Eurozone, and were not able to generate rising capex or wages.

China

Easing CPI inflation and PPI deflation

As expected, consumer price inflation has eased while producer prices (PPI) have fallen from nil to -3.7% YoY. We now believe that producer price deflation has troughed and that oil prices may pick up a bit while cement prices will continue to rise in line with strong infrastructure investment. Modest consumer price inflation and easing producer price inflation are a boon for the PBoC's monetary policy, which we expect to remain accommodative to the economy with more RRR cuts in the offing. Pork prices had risen substantially following supply disruptions due to the swine-flu outbreak last year (prior to the COVID-19 pandemic), but the impact is now levelling off. The weight of pork prices in the CPI basket will rise significantly but with a lag, and by then pork prices are likely to fall again, putting downward pressure on consumer prices going forward. Meanwhile, flooding in Southern and Central China caused by heavy rainfall has put upward pressure on food prices. Non-food price inflation has receded to zero, the lowest in more than a decade. Rising prices for transportation and communication were offset by falling prices in categories like entertainment, travel, education and clothing. We expect property price inflation to be contained in line with the hawkish stance on the property sector by local governments.

Australia

Prices expected to rebound but remain weak

Inflation fell by 0.3% YoY in Q2, the largest decline since the early 1960s. The steep drop in Q2 CPI had been widely anticipated, given a number of deflationary factors including temporary free childcare, falling oil prices and a two-month lockdown that hampered consumption. Looking ahead, prices are likely to rise robustly in Q3. In fact, retail sales have recovered strongly since the removal of countrywide lockdowns in late May. Free childcare and pre-school education ended in June and global oil prices bottomed out in late April. These developments will help to reduce downward pressure on inflation in the September quarter.

Nevertheless, we doubt the strong rise in prices will last long as the pent-up demand effect eventually fades away. Wage growth remained slow in August on the back of elevated unemployment and rents have been declining with some states encouraging rent reductions for low income households. On top of that, Victoria's lockdown, lingering fears around a second wave of COVID-19 infections and border closures mean restaurants and shops will continue to struggle, even though part of the weakness will be offset by rising needs for takeaway food and online shopping.

ASEAN

A pickup in demand lifts inflation

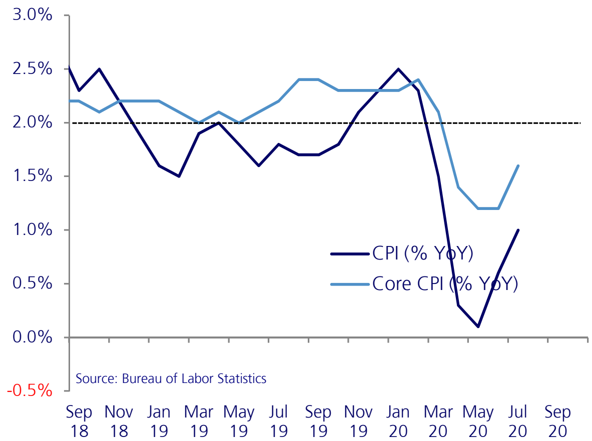
As expected, Q2 CPI data were extremely weak in ASEAN, with a few countries experiencing deeply negative inflation including Malaysia, Thailand and Singapore. Lockdowns and collapsing fuel prices were the two main drivers. Along with an easing of restrictions across the region between late May and early June, prices have come back up, and negative CPI readings in Malaysia, Thailand and Singapore became less extreme in July and August as transport costs picked up in tandem with improving oil prices. Some initial rebounds in recreation service prices are also encouraging.

Looking forward, we believe inflation rates will move higher in the region. Mobility data showed retail and recreational activities have reached at least 80% of the pre COVID-19 level in most countries. The Philippines were the only exception due to a renewed two-week lockdown in Manila since early August.

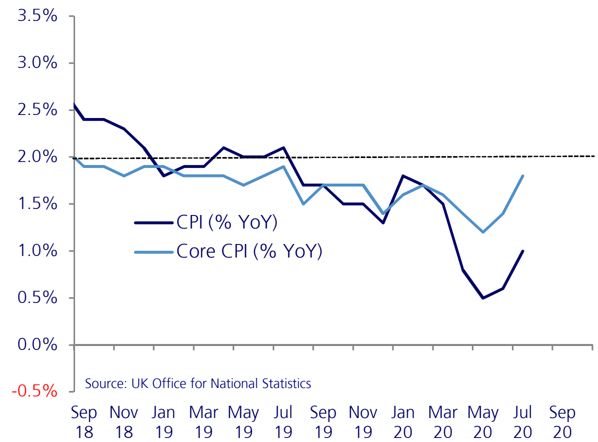
While prices are likely to rise in Q3, we expect overall CPIs to still undershoot most central banks' targets in 2020 given how deep prices have fallen. On top of that, the recovery in demand remains fragile due to ongoing risks of new virus clusters, as we have recently seen in Vietnam and Singapore for example.

Current and historic inflation

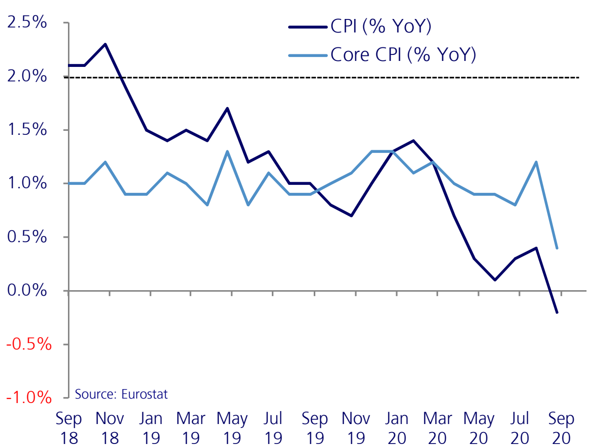
US: Fed aims for an inflation overshoot



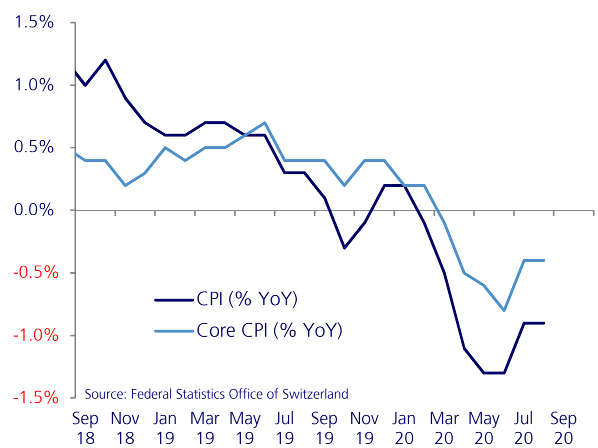
UK: inflation should moderate



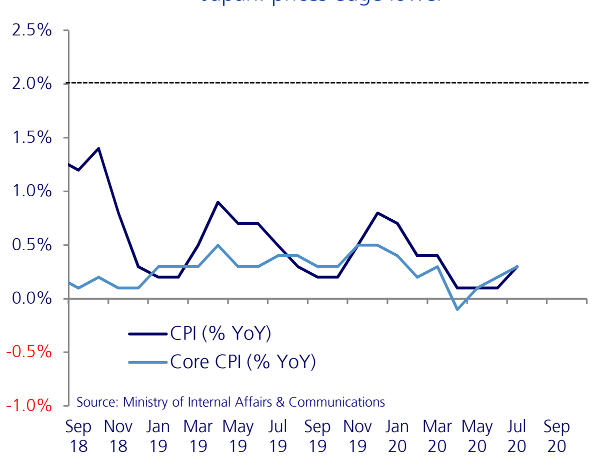
Eurozone: disinflation puts pressure on the ECB



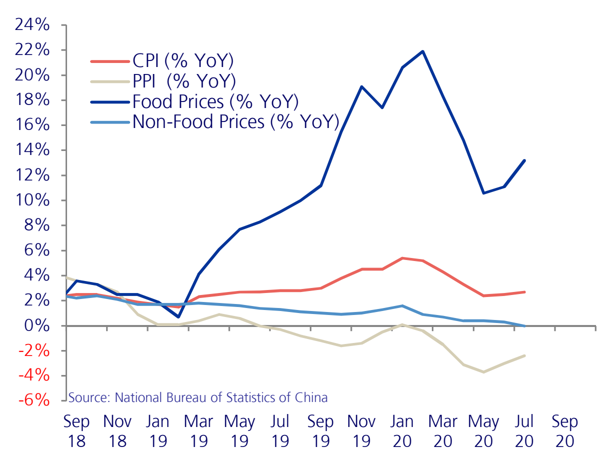
CH: deflation persists, but past its low



Japan: prices edge lower

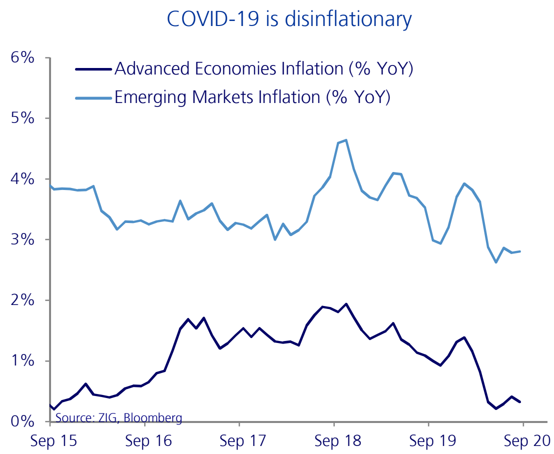


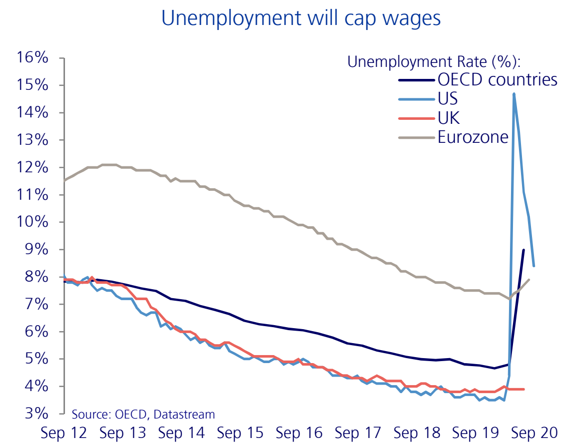
China: little inflation outside of food

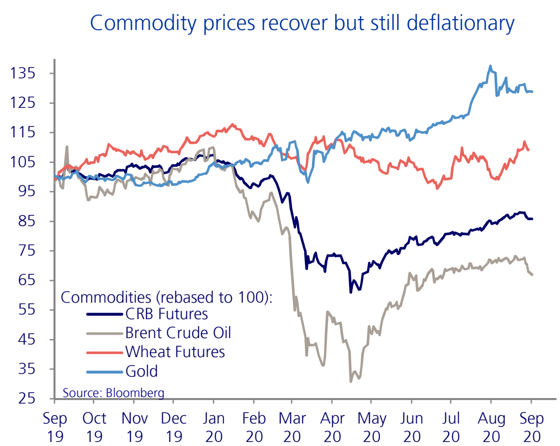


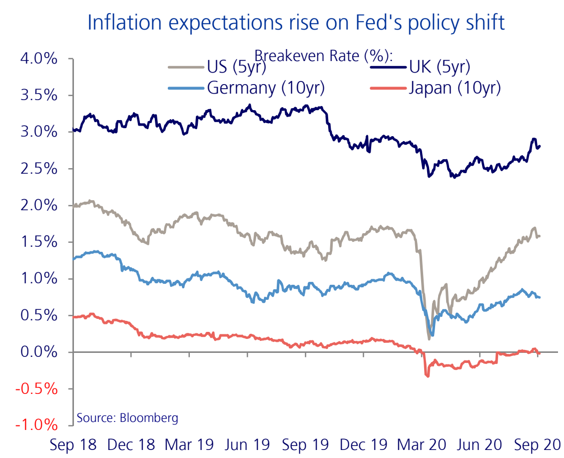
* Dashed lines show inflation targets or equivalent

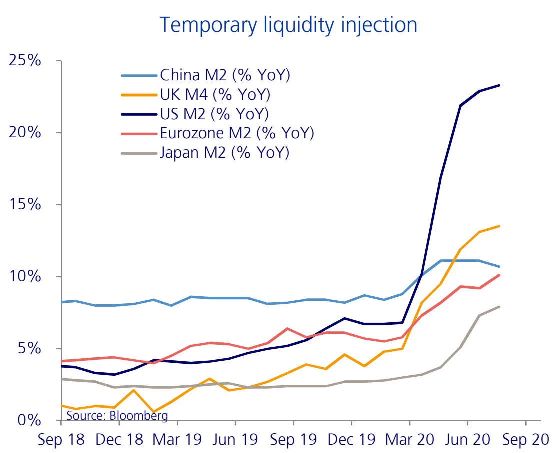
Key indicators

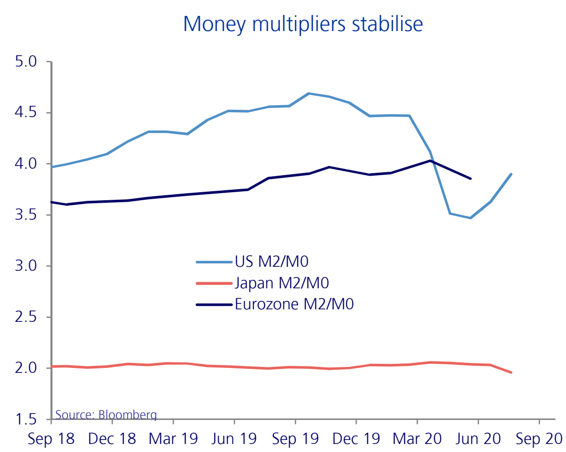












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