November 19, 2019

Inflation Focus Q4

Key Points

- Headline inflation falls along with global growth, triggering further rate cuts from central banks
- Core inflation is more resilient, as it remains supported by tight labour markets and modestly rising wages
- Central bank actions reduce the risk of deflation, but are unlikely to materially improve the growth outlook
- A combination of a trade truce and increased fiscal stimulus could pose an upside risk to growth and inflation

Source: iStock by Getty Images

Global central banks cut rates on slowing growth and weak inflation

As a response to slowing growth and weak inflation, central banks are injecting further stimulus into the global economy. The Fed has delivered three rate cuts and the ECB has restarted QE and cut the deposit rate further into negative territory. Emerging markets are benefitting from more favourable global financial conditions, allowing large rate cuts to be delivered across Asia and Latin America. Looking forward, the manufacturing cycle appears to be stabilising, but activity is vulnerable to global trade developments, with elevated uncertainty weighing on business sentiment and capex spending. Services activity has also weakened, albeit with a lag, and hiring intentions have deteriorated. Against this backdrop, we do not expect central bank actions to materially shift the economic outlook, with global growth likely to remain on a weak trajectory. In this environment, pricing power should remain constrained, limiting potential for inflation to surprise on the upside.

Core measures of inflation are resilient, supported by tight labour markets

Headline inflation rates have fallen back globally, alongside measures of inflation expectations. This partly reflects lower oil prices, which are down by almost 25% compared to a year ago. Core measures of inflation have been more resilient and continue to be supported by a combination of tight labour markets, modestly rising wages, and stronger pricing dynamics in the services sector. In the US, core PCE inflation—the Fed's favoured measure—remains within reach of the 2% target. With the unemployment rate at a 50-year low and growth at around 2%, further rate cuts from the Fed look unlikely, unless economic conditions deteriorate more markedly. In other developed markets, underlying inflation trends are much weaker, but stable, with core CPI continuing to hover around 1% in the Eurozone and 0.5% in Japan. Despite persistently low inflation, we expect central banks to remain on hold here too—mainly because policy space to inject further stimulus is limited.

Global goods prices are disinflationary, led by producer price deflation in China

Headline CPI has risen sharply in China, to the highest level since 2012, mainly as a reflection of higher pork prices due to the swine flu. By contrast, producer price inflation has turned negative for the first time since 2016, and this is now weighing on global goods prices. Given this deflationary headwind, we anticipate the PBoC will inject further monetary stimulus, despite rising headline CPI inflation. Outside of China, most emerging markets face a benign inflation outlook, helped by low oil prices, stable exchange rates and subdued growth. With global central bank liquidity on the rise again, financial conditions are likely to remain lenient, allowing further EM rate cuts. That said, we are likely past peak loosening, as policy rates have already fallen to historical lows in many regions.

Monetary policy alone is unlikely to turn around growth dynamics

In our view, the Fed tightened too much over the past couple of years, as high global debt makes almost all economies vulnerable to higher interest rates. The change in policy stance is welcomed, but we maintain that it will be difficult for central banks to turn around global growth dynamics on their own. The economic cycle is extended in many developed markets, with limited capacity to generate stronger growth, amid tight labour markets, weak productivity, and subdued investment. The world is also awash in liquidity so further monetary stimulus is by itself unlikely to materially shift sentiment and spending upwards, particularly given extended leverage in many parts of the global economy. The potential for more substantial China stimulus is also limited, given an increased focus on more balanced growth.

Inflation set to remain weak, though deflation is a long way off

The outlook for inflation is therefore set to remain benign over the coming year. Falling producer prices are working their way through the global supply chain, weighing on inflation. Tight labour markets should, however, continue to support wages, leading to a broadly stable outlook for underlying inflation, though risks remain tilted to the downside. That said, should the support mechanism broaden out beyond monetary policy, and a trade truce be agreed between China and the US, a rebound in growth in combination with tight labour markets could produce spots of higher inflation. Underlying weaknesses in the global economy, including a highly leveraged global economy and an extended economy cycle, makes this a less likely scenario, however.

US

Inflation is expected to rise modestly

Headline CPI inflation has remained much more stable so far in 2019 than in recent years, hovering in a relatively narrow range of 1.5% to 2%, with the latest print at 1.7% in September. Interestingly, core CPI inflation has been less well contained, accelerating to 2.4% in August, the highest level since September 2008. While the increase was partially boosted by changes in methodology regarding some core goods components, other key factors have helped to lift inflation as well, including shelter, transportation and medical services. In line with core CPI, core PCE inflation also accelerated to 1.8% in August before receding to 1.7%. The underlying trends in service inflation and a significant pickup in unit labour costs point to a modest acceleration of core inflation measures. Following the Fed's third rate cut, longer-term inflation expectations also rebounded at the beginning of Q4, although they remain low in a historical context. Further price pressure would result if the US government follows up on its threat to raise tariffs on all imports from China, including consumer goods. Although the outcome of the trade negotiations is difficult to predict, the latest signals seem to indicate that at least a suspension of further tariffs is currently more likely than not.

UK

The BoE turns more dovish as inflation moderates

Both headline and core CPI inflation rates have been on a broad downward trend since the peak reached in late 2017/early 2018. Having accelerated to more than 3% YoY, both price measures moderated to 1.7% in September. Not surprisingly, substantial price swings in sterling have been a crucial factor in recent fluctuations in inflation rates. Given the lags in the feed-through of currency effects to consumer prices visible since the Brexit referendum in 2016 it is likely that we will see some further upside pressure on prices in the near term. However, the recent pickup in sterling and the significant reduction in no-deal Brexit risks should help to mitigate inflationary pressure going forward. Some upside risks stem from wage developments in a tight labour market but the uncertain outlook, a modest growth picture and a continuation of a sluggish global environment are expected to limit price increases over the forecast horizon. Reduced Brexit risks and fading inflation worries led the Bank of England to lean towards a more dovish stance with two MPC members even voting for an immediate rate cut at the BoE's latest meeting in November.

Eurozone

Core inflation remains stable, but at low levels

Headline inflation in the Eurozone has fallen sharply in recent months as the contribution from energy prices has reversed from being a boost to a drag given where oil prices are now and where they were twelve months ago. More fundamentally, underlying inflation remains stuck around 1%, well below the ECB's target. What's more, with GDP growth slowing, the risks to underlying inflation are to the downside. The ECB has recently re-started QE asset purchases and cut interest rates further into negative territory. However, we doubt this will do much to stimulate growth or inflation. Incoming ECB President Christine Lagarde will conduct a review of monetary policy objectives and instruments, but even this is unlikely to be a game changer for inflation, which we expect will remain well below target.

Switzerland

Prices are falling again

Switzerland is back in deflation, with headline CPI inflation slipping to -0.3% YoY in October. The core inflation measure is still rising, but only at 0.2% annually. Weakness was broad based, with both goods and services prices down on the month, and imported as well as domestically produced goods led inflation lower. We had expected inflation to turn negative, given the stronger franc and the slowdown in the global economy, but weakness was more pronounced than anticipated. The decline in services prices is particularly concerning, as inflation in this segment has held up well so far, and partly reflects weaker dynamics in health care prices.

Looking forward, inflation should rebound, helped by base effects from last year's oil price decline. The underlying trend is weak, however. Wage inflation, which accelerated in 2018, has fallen back again, and is only tracking at 0.5% YoY. As we had expected, the SNB did not cut rates in Q3, but put in place measures that limit the adverse impact of negative rates on banks and the economy. For now, we maintain our view that the SNB will remain on hold. However, the slump in inflation makes a further rate cut more likely, especially if global conditions deteriorate further, or if pressure on the franc intensifies.

Japan

Core inflation holds steady, but producer prices are falling again

Falling energy prices are the main reason headline inflation fell to 0.3% YoY in September from an average of 0.9% over the preceding six months. Meanwhile, underlying inflation (ex. fresh food and energy) is holding steady around 0.5% YoY. Historically a consumption tax hike had a major impact on headline inflation, but any influence was far less visible this year, after the tax rate was raised from 8% to 10% on October 1. Consumer price rises in Tokyo were unchanged at 0.4% in October, while underlying inflation ticked up only marginally to 0.7% YoY. The introduction of free childcare services roughly compensated for the impact of the tax hike. Netting out all special factors shows that prices even contracted marginally month-on-month in October. A lower tax rate has been applied to food and beverages, differing from the previous tax hike in 2014, while some utility charges are being subject to a delay in the tax hike due to transition measures. Meanwhile, producer prices have started falling recently, as have corporate goods prices for final consumer goods and raw materials. Service prices continue to creep higher, particularly in the culture/leisure category. Inflation expectations, as measured by market surveys, have inched lower but remain in the 0.5-1% bracket.

China

Producer price deflation continues

Consumer price inflation surged to a seven-month high in October, mainly driven by higher pork prices due to the swine flu. Indeed, pork prices have doubled within just one year. This distortion becomes evident once looking at the core CPI ex. food and energy, which is holding steady at 1.5% YoY, while non-food inflation even fell to 0.9% YoY, the lowest level in five years. Going forward, we would not be surprised if CPI inflation were to rise toward 5% early next year around the Lunar New Year, before it should retreat due to a more favourable base effect. The government has also taken measures to restore the pork supply, which should help to limit the impact. Meanwhile, producer price deflation continues, as the PPI contracted by 1.6% YoY, even though it seems to be stabilising on a sequential basis. We believe the PBoC is likely to be more concerned about dis-inflationary PPI tendencies than surging pork price inflation, as a potentially deflationary spiral would need to be tackled by loser monetary policy. The one-year medium-term loan facility (MLF) rate has been cut by 5bps, with more expected to come, which should also be reflected by a lower Loan Prime Rate (LPR) into next year. We also expect at least another cut of the Reserve Requirement Rate (RRR).

Australia

Underlying inflation remains muted

Headline inflation edged up in Q3 from 1.6% to 1.7% YoY with a pickup in prices for both tradable and non-tradable goods. As a large portion of tradable goods are imported, their prices moved higher amid a sharp depreciation of the Australian dollar in late July. Furthermore, higher tradable goods inflation was partly driven by increasing food prices due to severe droughts across large areas of New South Wales and Southern Queensland. For non-tradable goods, despite a pickup in prices, the overall trend still points to weak momentum as housing inflation remains historically low. Underlying inflation also stood at a subdued level given that the trimmed mean CPI came in unchanged at 1.6% YoY in Q3. From a cost perspective, plenty of slack in the labour market is putting a lid on wage growth while weak global oil prices keep domestic energy costs in check. From the demand side, downbeat consumer confidence suggests that consumers continue to be cautious about spending although tax refunds have added some extra income for Australian households. Having said that, muted inflation will probably persist for some time, giving the RBA some room to follow through its easing bias.

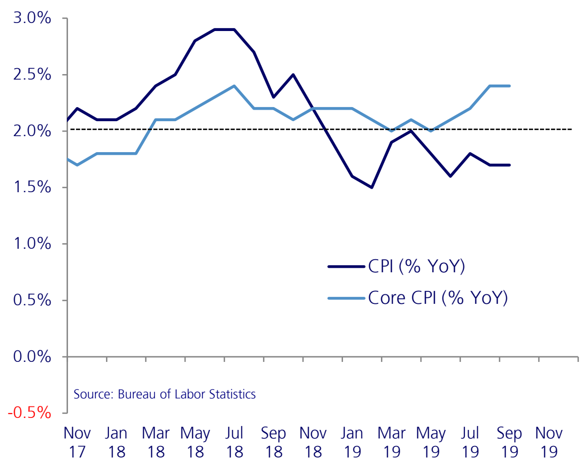
ASEAN

Absence of price pressures puts a lid on inflation

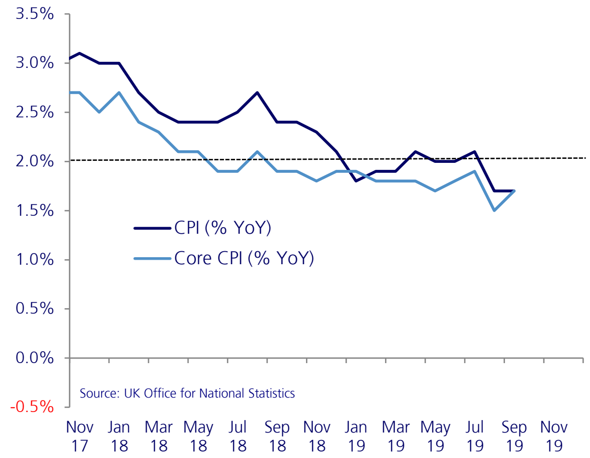
The equally weighted ASEAN-5 CPI slid from 1.5% to 1.2% YoY in September with headline CPIs for most countries hovering below their long-term average. Headline inflation in Singapore and Thailand was below 1% while the figures for other economies ranged from 1.5% to 3.5% YoY, falling to the mid to lower bound of central banks' targets. A downtrend in global oil prices has put downward pressure on domestic production costs in most countries. In Singapore, the Open Electricity Market initiative, which allows consumers to choose their electricity suppliers more flexibly, was probably the driver for a decline in electricity costs in August and September. Even without this distortion, CPI for other goods and services remains lacklustre on a broad-based basis. In Indonesia, food prices seem to have peaked in May, which means food inflation is likely to be contained. As the drought situation in Thailand improved, food prices also decelerated. Therefore, we believe that inflation will remain benign in the medium term. After a series of synchronised policy rate cuts in the region since July, most central banks are likely to be on hold till the end of 2019.

Current and historic inflation

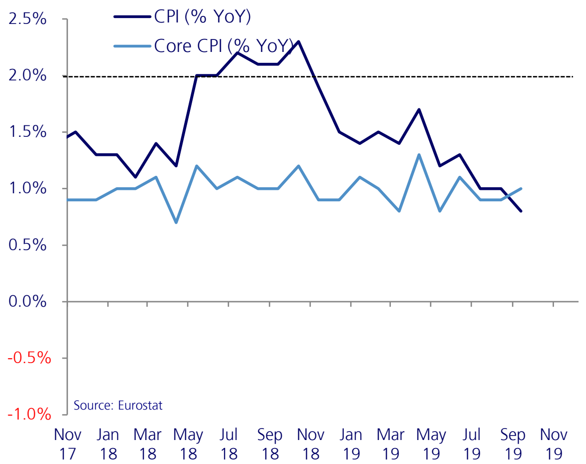
US: inflation close to target



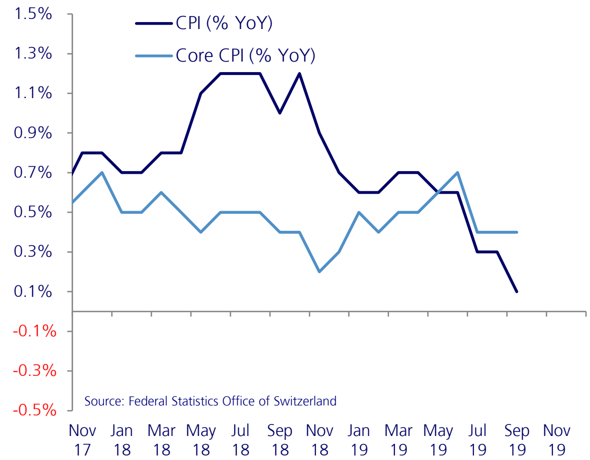
UK: Brexit decisive for inflation prospects



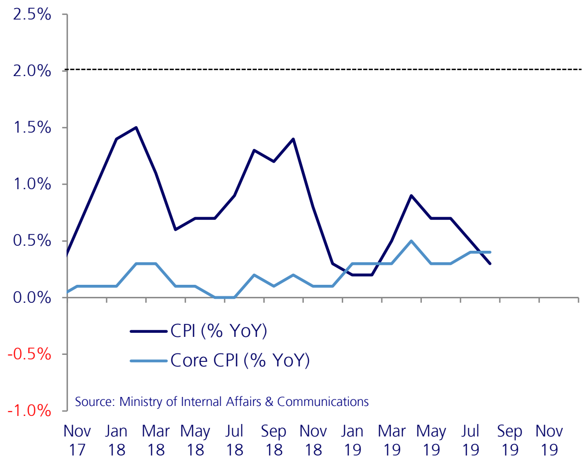
Eurozone: core inflation set to remain weak



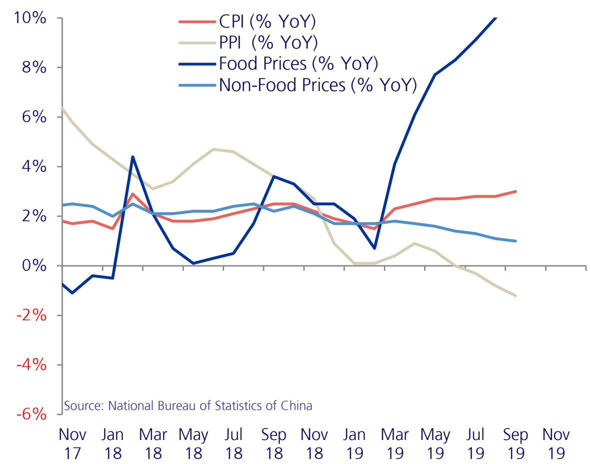
CH: back in deflation



Japan: failing to reach inflation target

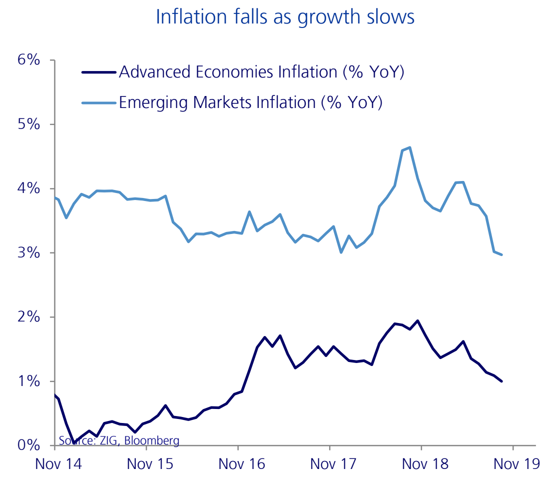


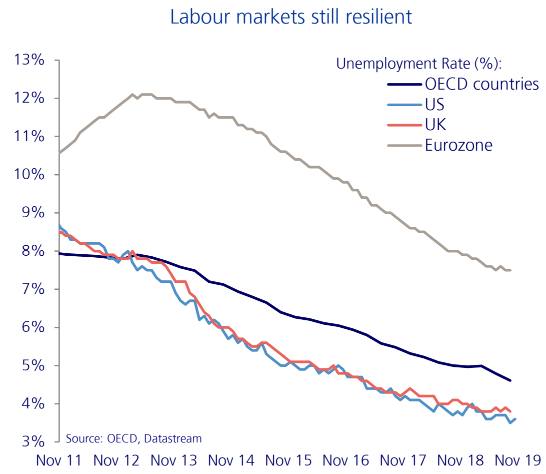
China: diverging dynamics

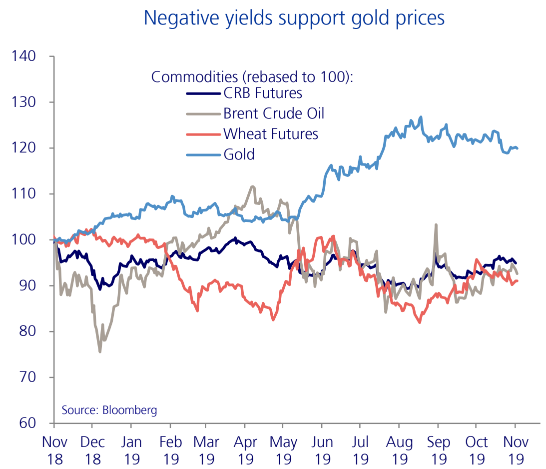


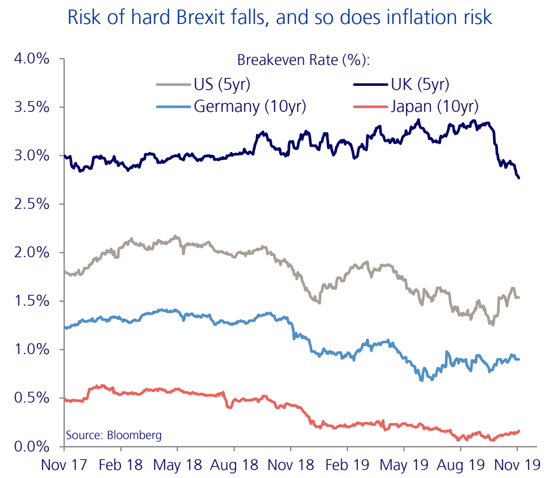
* Dashed lines show inflation targets or equivalent

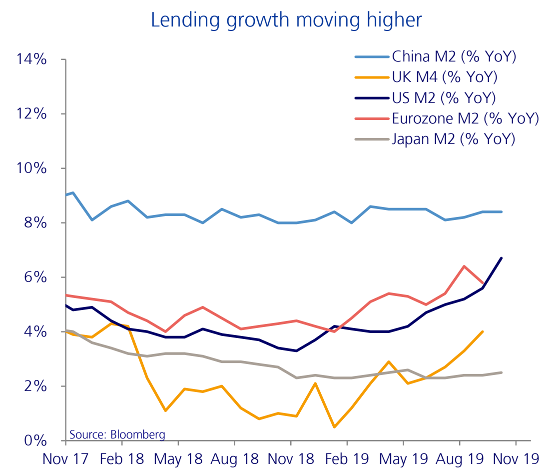
Key indicators

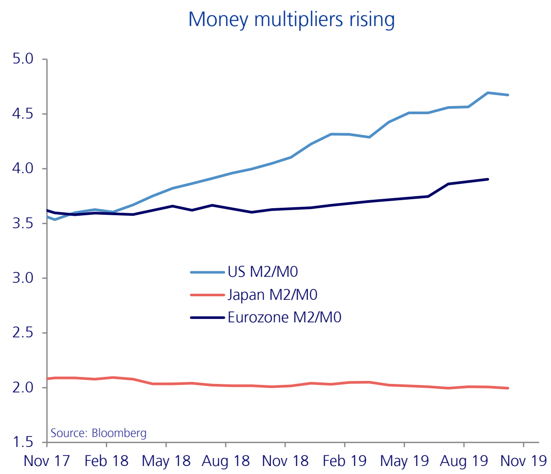












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