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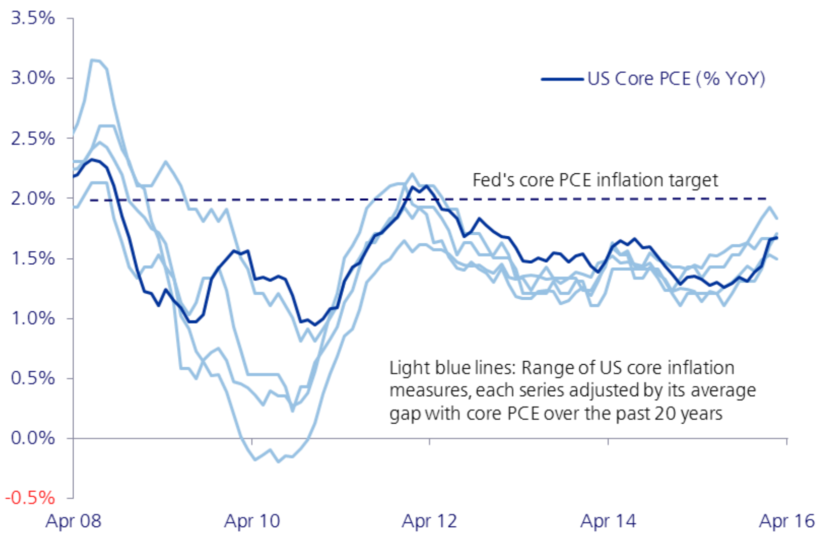
Inflation Focus Q2

Key points

- The oil price drag is diminishing, helping to strengthen inflation dynamics
- Trends have diverged, with stronger US inflation while weakness persists in other regions
- Downside risks to inflation dominate in the near term, absent a rapid rise in oil prices
- Though global inflation remains weak, persistent deflation is an unlikely prospect

The drag on inflation from oil prices is diminishing

Oil prices have moved higher over the past quarter, helped by a weaker dollar, reduced fears of a hard landing in China, and hopes of an agreement to limit oil supply. The drag of oil prices on inflation has also diminished, with headline inflation ticking higher in many regions. Assuming that oil prices stay at their current level, the inflation drag will reduce further in H2, albeit with some monthly volatility. As stronger prints materialise, market implied inflation expectations, which remain consistent with central banks perpetually undershooting inflation targets, should also firm. Overall, we expect fears of deflation to recede, but as inflation trends remain weak globally, with growth continuing to disappoint, central banks need to stay vigilant.



Inflation trends have diverged, but global price pressures remain weak

Diverging inflation trends have become more apparent over the past few months. In the US, a range of measures of underlying inflation have risen materially, in part reflecting stronger domestically generated services inflation. Going forward, this trend should continue, as labour markets have tightened meaningfully and as pass-through effects from the rise in the dollar are fading. Eurozone inflation, on the other hand, is anemic, with the peripheral economies continuing to exert downward pressure on wages, offsetting stronger dynamics in Germany. Nonetheless, the cyclical recovery in the region remains on track, with unemployment falling, and this should bolster underlying inflation going forward. In Japan, the central bank has failed to generate stronger price pressures, and confidence in the inflation target is broken. Inflation also remains weak in China, while overcapacity in the industrial sector in the region more broadly continues to drag on global goods prices. Even in Latam, price pressures are abating, reflecting the deep recession in Brazil and a stabilisation of currencies.

Suboptimal policy measures are failing to boost growth globally

Although headline inflation rates are likely to rise over the coming quarters, global growth remains weak. Policy measures, which have been too focused on generating currency weakening, have merely shifted inflation between regions. Paradoxically, the failure to tackle the problem of deficient global demand and persistently weak inflation today could lead to an inflation problem further ahead if policy makers are forced to adopt increasingly exotic policy options. This is unlikely to be an issue in the near term, however.

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US

Core inflation not far from the Fed's target anymore

Inflation in the US has picked up over the last few months. While headline CPI was up 1.0% in February compared to a year ago, Core CPI has accelerated to 2.2% YoY. Price increases have been relatively broad-based, but service inflation has been the main driver of core inflation with an annual increase of 3.1% in February. Since both the effects of a stronger dollar and weaker energy prices are increasingly dropping out of the annual comparison, we expect headline inflation to catch up with the core numbers later this year. Core PCE, the Fed's preferred inflation measure, has already accelerated to 1.7%, which is above the Fed's expectation for this year. Interestingly, the Fed has reduced its inflation forecast for the next year to1.8% despite its own expectation of unemployment being below the estimated natural rate for the next three years. Based on a tighter labour market, decent growth and the fading of the dollar and energy base effects, it is likely that the Fed will have to revise its inflation forecast to the upside in the coming months.

UK

A weaker pound will help lift inflation

A strong pound and weaker commodity prices kept inflation down last year and the beginning of this year. In addition, wage growth has not significantly accelerated despite a relatively tight labour market. One reason for this was a strong influx of foreign workers that helped to put a lid on wage growth and service inflation. Annual headline inflation was only 0.3% in February while Core CPI stood at 1.2%. However, the trade-weighted pound has depreciated by about 13% since its peak in July last year and energy prices have increased sharply from their lows reached in January. Economic growth is likely to slow down as the uncertainty with regard to the referendum on the UK's EU membership acts as a headwind for the economy. Nevertheless, while wage growth will remain moderate for the time being, we expect inflation to pick up gradually in the coming months as the effects of higher commodity prices and a weaker currency are increasingly being felt.

Eurozone

Headline inflation to approach core inflation in H2

Headline inflation in the Eurozone fell back below zero early in the year as low oil prices pushed energy deflation further into negative territory. However, oil prices have since rebounded and we expect headline inflation will move back into positive territory and closer to core inflation in H2 2016 as negative base effects unwind. Eurozone core inflation has been hovering around 1% the past few months, though it has been volatile, distorted in part by the impact of this year's early Easter on travel fares. Going forward, continued falls in unemployment should see employment costs gradually pick up, putting upward pressure on core inflation. For instance, in Germany unions are asking for large pay increases in a number of the key manufacturing sectors, though negotiations are still ongoing and no final agreement has yet been reached. However, the recent strength of the euro could offset these inflationary forces somewhat. Overall, a modest pickup in core inflation the rest of this year and next remains the most likely outcome.

Switzerland

Deflation is here to stay

In line with our expectations, CPI inflation rose sharply in Q1 as the large negative drag from low import and oil prices on annual inflation diminished. Inflation is still deeply negative though, with headline and core CPI at -0.9 and -0.5 (% YoY) respectively. The deflationary environment is also visible in profit margins, which remain under pressure, and in wage inflation, which has fallen by half and is now tracking at only 0.6% YoY. With persistent overcapacity in manufacturing and retail trade, a sluggish labour market and weakness in the housing market, we expect deflation to persist through 2016, particularly as base effects will be less favourable going forward. The risk of deflation becoming entrenched has reduced though, as services inflation has turned positive again following a period with negative readings. We anticipate that the SNB will maintain its dovish stance. Although a broadening out of stimulus is required to move inflation sustainably higher, this is highly unlikely. Downside risk to inflation therefore persist.

Japan

The inflation outlook keeps deteriorating, putting pressure on the BoJ

Tokyo's core CPI (ex fresh food) fell from -0.1% YoY to -0.3% in March. We believe core CPI will remain in negative territory throughout the year, far away from the Bank of Japan's 2% inflation target. The BoJ is now focusing more on the 'ex fresh food & energy' core CPI definition, which, at +1.1%, looks more favourable in that respect. However, this cannot hide the fact that inflation expectations have fallen as well. The corporate price outlook in the latest quarterly Tankan survey revealed that a downside parallel shift in the price outlook curve by 0.2 ppts has occurred, with corporations now expecting prices to rise only 0.8% in one year and 1.2% in five years. The negative trend is also visible in the consumer confidence survey, in which the expected inflation rate fell to 2.19% in February, marking its fifth successive decline. News from the wage front is also not very encouraging. Even though real wages have now moved into positive territory, this year's 'shunto' spring wage negotiation round shows an average wage hike of only 2.09%, which is 0.25 ppts below last year's outcome. Pressure by the government for larger pay increases has not been effective.

China

Food inflation is back again

Food inflation surged to 7.6% YoY in March, mainly on higher pork and vegetable prices. Some inconsistencies in data between those published by the NBS and the MoC suggest that real food inflation is even higher. However, non-food core inflation remains low at only 1% YoY, as prices of personal services declined significantly in March. This leaves the overall CPI unchanged at 2.3% YoY, well below the official projection of 3% for this year, which should make it easier for the PBoC to loosen monetary policy, particularly as higher food inflation is a volatile component that should not be targeted. PPI deflation narrowed to -4.3% YoY, lower than the 5.9% seen from August to December last year. Both the base effect and higher commodity prices are having an impact. PPI rose 0.3% MoM, the first monthly increase since July 2014, which may indeed have helped industrial profits to recover. Meanwhile, inflation is picking up in the property market, with the Soufun 100-city price index accelerating to 1.9% MoM and 7.4% YoY. Prices surged particularly in the area in and around Shenzen and Shanghai, where cooling measures have now been implemented.

Australia

Inflation to stagnate as wage growth slows

Australia has been experiencing tame inflation with headline and underlying CPIs hovering around 2% YoY. We expect inflation to stay at this level, which represents the bottom end of the RBA's target band. This leaves the central bank some room for action, but the RBA is unlikely to cut rates further given relatively solid economic data. Despite healthy employment growth, wage growth has been decelerating for a few years, reaching only 2.2% YoY last quarter. March PMIs have confirmed the downward trend in wages, which will probably dampen consumer spending. Housing, a sizeable share of the CPI basket, will continue to moderate, especially in Melbourne and Sydney. Consumers are anticipating an improvement in economic conditions, while inflation surveys reveal weak expectations. On the corporate side, both PMI and NAB surveys have signalled a strong growth in input prices that has not translated into higher selling prices. We do not think that higher commodity prices will affect inflation this year as most markets remain oversupplied.

ASEAN

Soft demand and a fading El Niño should keep inflation in check

The latest Malaysian and Indonesian headline CPIs have ticked up to 4.2% and 4.5% respectively, boosted by a spike in vegetable prices, which we see as temporary. El Niño-triggered droughts have delayed crop planting, especially in Indonesia, which has been importing rice from Vietnam to rebuild its inventories. Governments have communicated softer energy prices to fuel end users, but we expect no major cut this year. Core CPIs for Malaysia and Indonesia should rise within the respective central bank target ranges in 2016 as we foresee solid, but not buoyant, domestic demand. In Malaysia, the competitive electronic sector is fuelling wage growth, but remains dependent on the global demand recovery. In Indonesia, consumer and business confidence levels have benefitted from public economic stimuli, but are still patchy. Malaysian and Indonesian headline CPIs should hover around the 3.5% and 4.5% marks in 2016. We see two upside risks: a more hawkish Fed, which could stop the Asian currency rally, and a potential agreement on oil supply levels, which could inflate energy prices.

Brazil

Inflation has peaked but don't expect monetary easing

Inflation has peaked helped by administrated prices rolling over, but core inflation remains quite sticky. The diffusion index is high, so inflation is still broad-based, and the currency weakness pass-through is noticeable in the expanding ratio of tradable to non-tradable prices. The central bank stressed that the severity of the recession was noticeable in the output gap, which is much more disinflationary than initially thought. Regardless of the political noise, the next move will be an easing of the monetary policy as the currency appreciation, the worsening of the labour market and the subsequent collapse of demand will require action by the central bank. However, we believe that the fiscal deterioration, FX volatility, a still complicated balance of risks for inflation, and political uncertainty will limit its freedom of movement in the coming months. More than ever, it is time for the institution to regain its credibility as the jury is still out on that matter considering that expected inflation is still above the ceiling.

Latam

Inflation has troughed in Mexico and is peaking in the Andeans

In Mexico, inflation has troughed and recent prints are showing signs of life. We expect it to increase gradually, but steadily towards a three-handle, which will remain close to the multi-decade low and within the central bank target bands, making it an exception in the region. Banxico will remain vigilant on the currency front and we expect two hikes for the remainder of the year.

In Chile, inflation has stabilised due to a stronger currency, manageable wages and output growth that is way below potential. The central bank is close to the end of its pre-emptive hiking cycle.

In Peru, inflation has also stabilised and we don't envision rate hikes in the short-term, although the central bank might hike later in the year. The outlier is Colombia, where inflation reached a 15-year high pushed up by food due to El Nino, FX pass-through and indexation. We believe that the El Nino effect is waning and the currency has stabilised — so the peak is close. Still, the central bank will continue to hike.

Consumer Prices (Annual Percentage Change)*

	Zurich's Point Estimate			Consensus Forecasts	
	2015	2016	2017	2016	2017
US	0.1	1.5	2.0	1.3	2.2
UK	0.0	1.2	2.0	0.7 ↓	1.8
Eurozone	0.0	0.7	1.7↑	0.3 ↓	1.4 ↓
CH	-1.1	-0.6	0.3	-0.6 ↓	0.2 ↓
Japan	0.5	0.1	1.6	0.0 ↓	1.6 ↓
China	1.4	1.5	2.0	1.5	1.7
Australia	1.5	2.0	2.5 ↓	2.0	2.5 ↓
Asia	1.6	n/a	n/a	1.6	2.2
Argentina	24.1	30.0	20.0	32.1	19.0
Brazil	10.7	7.5	5.8	7.3 ↑	5.7
Chile	4.4	3.7	3.3	3.6	3.0 ↓
Mexico	2.1	3.1 ↑	3.4	3.4	3.4

*Consumer prices are shown as annual averages. Asia is ex-Japan and ex-Australia. Consensus forecasts are from Consensus Economics Inc. Inflation rates refer to year on year changes. Data used is either from Bloomberg or Datastream unless otherwise specified. Argentina, Brazil, Chile and Mexico show consumer price increases from December to December. Arrow show changes over the last month.

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