Inflation Focus Q1

15 March 2024

Key Points

- Inflation falls further, but the pace of improvement has slowed and services inflation remains elevated
- Goods price inflation has already falllen sharply, and a further steep decline is not expected
- Inflation targets are within reach, and central banks signal that rate cuts will soon be forthcoming
- Dovish tilt by central banks reduces recession risk, but it remains critical that focus on inflation is maintained

Inflation continues to fall, but at a lower pace

After falling sharply towards the end of last year, inflation has continued to decline in early 2024 but at a more gradual pace. Goods disinflation, which was the key driver of falling inflation in 2023, has moderated, while services inflation has plateaued at an above-target rate. Energy prices are no longer adding to disinflationary pressures, with the oil price flat compared to a year ago. A key exception is European gas prices, which have fallen further and are now back at their levels prior to the Ukraine war. This is visible in declining electricity prices and should drive further improvements on the pricing side. Food price pressures are modest, although the effects of El Niño are leading to rising prices on some food commodities.

Prospects for inflation hinge on the services components

Prospects for inflation hinge on the service components, where price pressures remain high amid robust demand, tight labour markets and above-trend wage growth. There is also a catch-up effect at play as services price pressures were slower to pick up vs goods. While we anticipate inflation will ease here as well, the risk is that this decline takes longer than expected, in particular as economic activity is resilient while major central banks are getting ready to cut rates. This anticipated shift in policy has already instigated a significant loosening in financial conditions, which is supporting sentiment and spending globally, helping to maintain robust services demand. As a result, while inflation has already fallen notably, the path back to target is unlikely to be smooth and it is still too early to declare victory over inflation.

Goods price inflation has normalised, and a further steep decline is unlikely

While services inflation remains sticky, goods inflation fallen sharply, with inflation rates back at pre-Covid levels for key components. This is encouraging, but it also means that further goods disinflation is unlikely, in particular as demand for goods has started to improve. To drive further declines in headline CPI, services needs to pick up the baton.

Labour market tightness is a risk to the inflation outlook

The transition from goods to services disinflation requires labour markets to ease back and pricing power and demand to moderate. Labour markets, however, continue to hold up. In the US, the number of job openings is still exceeding the pre-Covid trend by almost one quarter and the economy is able to generate a large number of new jobs each month, to a large extent within services. In Europe, unemployment had begun to tick higher last year, particularly in Germany and UK where growth dynamics were especially weak, but recent data suggest an improvement in momentum. And while wage growth is on a downwards trajectory in most regions, it is still too high to be consistent with inflation at target, particularly in Europe. Solid labour markets also ensures that consumer spending is holding up relatively well in most regions, especially in an environment where energy costs have come down and interest rates are expected to peak soon.

Housing market tightness is feeding into sticky services inflation

Alongside consumer services such as leisure and travel, housing has been a key driver of elevated services inflation over the past year, due to rapidly rising rents and housing related costs and the high weight of housing in the CPI index, in many regions well above 20%. In the US, for example, the shelter component of CPI now accounts for two thirds of services inflation (ex energy), which is still running at over 5% YoY. Looking forward, leading indicators highlight that US shelter inflation should decline as rent growth on newly negotiated contracts has slumped after surging in the aftermath of the Covid crisis. That said, residential housing markets are tight in many regions, with limited supply, and there is potential upside risk to housing-related CPI components, both in the US and elsewhere. Given their importance in driving services inflation in many regions, these dynamics will be key to watch.

Central banks are confident that rate cuts are soon forthcoming

Falling inflation is goods news for central banks, which are either already cutting rates (LatAm and CEE), or getting ready to cut rates (developed markets and ASEAN). Despite some stickiness on the services side, major central banks, including the Fed and the ECB, continue to signal that rate cuts will soon be forthcoming, likely towards the middle of year. Their pragmatic stance is encouraging from a growth perspective, but it will be critical that they maintain focus on inflation in the months ahead as it continues to exceed inflation targets by a meaningful margin, with upward pressure on some price components persisting.

US
Services inflation remains too high

The latest batch of inflation data was a reminder that although price pressure is fading, inflation has not been fully vanquished yet. Both headline and core CPI inflation stood at 0.4% MoM in February. This resulted in annual rates of 3.2% and 3.8% respectively, both still too high for the Fed to commit to any near-term rate cuts, and investors have readjusted their expectations accordingly.

Core goods remain disinflationary, but services inflation is still stubbornly high, driven by shelter and non-shelter components. Part of the pickup in prices is likely due to start-of-year price resets, which won't be repeated in the coming months. The rise in owner-equivalent rents remains too high, but did slow in February. Price indicators in business surveys that had bounced up in January came down again in February, fuelling optimism that recent strong inflation prints were indeed a one-off. Inflation rates are expected to fall further over the course of the year, but growth and particularly consumer demand have been more resilient than expected. Accordingly, price pressure remains too high and monetary conditions will need to remain tight for longer to weaken demand enough to have a significant impact on firms' pricing power.

UK
Core inflation is too high for the BoE's comfort

Headline CPI inflation fell by 0.6% MoM in January although the large drop was probably distorted by seasonal factors. Annual rates remained at 4.0% for headline and 5.1% for core inflation, the same levels as in December. While price pressure in core goods remains very modest, services inflation is still significantly too high despite the weak print in January.

Inflation rates are expected to recede further in 2024 but service components will remain too elevated in the coming months for the Bank of England to commit to imminent rate cuts. Despite some signs of weaker employment conditions, the labour market remains tight and wage pressure is still too high for the BoE to feel confident about a sustainable drop in inflation. Average pay settlements for January were still above 5% YoY. According to the latest business surveys, higher labour costs remained the main factor, pushing up business expenses, especially in the service economy. Mirroring this, the latest data indicate a renewed acceleration in prices charged across the private sector economy. Therefore, monetary conditions will have to remain tight until supply and demand are less imbalanced.

Eurozone
The last kilometre

Eurozone inflation is now a far cry away from the double-digit levels of 2022, and most recently printed at 2.6% YoY in February. We project a further decrease this year to 2%, but the path there will not necessarly be straight, and the ECB is right to remain cautious about declaring an early victory over inflation. To date, the majority of the fall in inflation has come from energy, food and goods prices. Although we expect further modest downward pressure from these categories, we need a broadening of disinflation. Core inflation, which strips out food, energy and tobacco, remains above 3%. Services inflation in particular, at almost 50% of the overall inflation basket, remains the primary concern. This measure is seen as a gauge of domestically generated inflation, and is less at the whim of international prices. Whereas headline and core measures have fallen steadily since last July, services inflation has remained around 4% since November. A fall in this measure is likely a necessary condition for the ECB to begin easing policy. It will be crucial that wage growth slows further given that current high pace encourage domestic demand and increase the cost-base for firms. Despite record low unemployment, there are already signs of wage growth falling amid stagnant economic growth. This underpins our base-case view of a return to the ECB's 2% inflation target towards 2025.

Switzerland
Almost done

Inflation was materially weaker than expected in December and January while surprising somewhat to the upside in February. This left the annual rate at 1.2%, down from 3.4% one year ago and well below the SNB's lastest forecast, which has inflation averaging 1.8% in Q1 2024. While regulated rents are putting upward pressure on inflation, weakness elsewhere continues to drive the annual rate lower, and a widely expected winter bounce in inflation did not materialise. Disinflation is, however, primarily due to sharply falling prices on imported consumer goods, currently falling at a pace of -1% annually. Domestically generated inflation, by contrast, is still tracking close to 2%, and the latest labour market show wages rising a touch below 2%, which is materially above the 0.4% track rate prior to the Covid crisis. Moreover, the labour market remains tight, with a reacceleration in hiring and job openings in early 2024 after having slowed in 2023.

We therefore expect the SNB to leave rates unchanged in the March policy meeting, while cutting the inflation forecast and continuing to signal a dovish outlook, with rate cuts likely to be forthcoming by the middle of the year. We also expect the SNB to maintain its recent preference for a weaker franc.

Japan
Real wage increases are finally expected

To achieve inflation sustainably around the 2% target, Japan needs to establish steady increases in real wage growth, and 2024 will be a decisive year that determines whether the desired virtuous cycle of wage increases and inflation can be realised. Last year was still characterised by negative real income growth, which hampered private consumption and brough Japan close to a recession. 2024 has started favourably, with the Trade Union Confederation starting this year's 'shunto' wage negotiations with a request for a 5.85% wage increase (incl. seniority based wage increases), 1.36 percentage points higher than last year. This is just a starting point for the negotiations. Ultimatley, a lower outcome is expected by the end of the spring wage negotiations, particularly for smaller companies, but it is highly likely that the increase will still be materially higher than last year. We expect the final wage rise agreement to come in somewhere between 4-5% and note that some companies have already agreed in full to the trade unions requests. Meanwhile, Tokyo's headline inflation rose to 2.6% YoY in February, up from 1.8%, while the core rate excluding fresh food and energy fell 20bps to 3.1%. We expect the Bank of Japan to end its negative interest rate policy (NIRP) at its April meeting.

China
Deflationary forces persist

China's CPI rose 0.7% YoY in February, following several months in deflationary territory. However, we do not read too much into the spike as it likely it reflects Lunar New Year distortions. As a more realistic proxy, we use the average of January and February, which still shows slight deflation at -0.1% YoY, following the December reading at -0.3%. We would not be surprised to see positive CPI readings only towards the second half of the year. Goods price deflation eased slightly to -0.9%, while food prices fell 3.4%. Pork prices tend to be an important driver of inflation. At -8.6% YoY for January/February the reading was not as dramatic as December's -26%, but it seems the improvement has not continued into March. Meanwhile, services inflation is gaining some steam, with the travel CPI up 12.5% YoY in the first two months this year, though it is likely to drift lower after Lunar New Year. Despite house price inflation remaining slightly positive, rents keep falling. Producer price deflation, at -2.3% YoY in February, persists for the 17th month in a row in YoY terms and is likely to remain an issue for some time amid overcapacity problems and the soft housing market. Weak PMI input and output price indicators confirm our tepid view.

Australia
Headline inflation falls, but services inflation remains sticky

Inflation in Australia has continued to fall faster than consensus expectations in the last quarter, primarily due to a decline in goods inflation, mirroring a broader global trend. Retail sales data, which lean towards goods consumption, also indicate a lacklustre trend. However, services inflation, especially rental costs, remains persistent. Looking forward, the household spending indicator suggests that spending on services is still strong. A tight housing supply coupled with robust rental demand, partly driven by strong immigration inflows, continues to pressure rental costs. There have, however, been tentative signs of a loosening labour market, with the unemployment rate exceeding 4% for the first time in two years while quarter-over-quarter wage growth has decreased. Although the overall direction of inflation is downward, reaching the Reserve Bank of Australia's (RBA) target is expected to take some time, making the precise timing of the RBA's rate cuts uncertain. We anticipate the central bank will deliver the first rate cuts towards the fourth quarter of this year, aligning with current market expectations.

ASEAN
Inflation might pick up in the near term but should remain range bound

Most ASEAN countries have maintained inflation rates within a manageable range of 2-4% while Thailand is grappling with deflation and sluggish economic growth. We anticipate inflation will remain benign across the region, given that growth continues to stay below trend and the overall supply-demand dynamics appear balanced. However, some inflationary pressure could arise from a spike in food prices, mainly due to increased rice prices resulting from El Niño's effect on the rice supply. This is notable in Indonesia and the Philippines, where rice constitutes a large portion of the CPI baskets. Meanwhile, the full impact of the subsidy phase-out in Malaysia is expected to drive inflation higher in Q2.

We expect the majority of central banks in the region will implement rate cuts in the second half of the year, aligning with the trajectory of the US Federal Reserve's rates. The exceptions are Bank Negara Malaysia due to concerns about an inflation spike following the subsidy removal and the State Bank of Vietnam, which already delivered significant rate cuts last year.

Brazil
Inflation continues to fall

After three months of increases, the rate of change in CPI fell to 0.4% MoM in January, down from 0.6% at end 2023 but exceeding market expectations of 0.3%. The 12-month rate fell to 4.5%, down from 4.6%, which was also higher than the market's forecast of 4.4%. This brought it within proximity of the central bank's inflation target range of 3% ± 1.5%. Food, with a 1.4% MoM increase, was the primary driver of the rise in monthly CPI. Conversely, fuel prices, which decreased by 0.7% MoM, negatively impacted the rate, while core inflation rose by a more modest 0.2% MoM.

Despite a total of 250bps in rate cuts since the onset of the cutting cycle in mid 2023, which brought the policy rate to 11.25% in January, it remains significantly above the neutral level projected by the Central Bank. We therefore expect the cutting cycle to persist through 2024. This will likely occur at an accelerated pace in the near term, with anticipated cuts of 50 basis points in both the March and May meetings.

A resurgence of inflationary pressures is the main risk to policy normalisation. Indeed, inflation forecasts for 2025 and beyond are flat at 3.5%, reflecting skepticism that the BCB will be able to sustainably reach the inflation target.

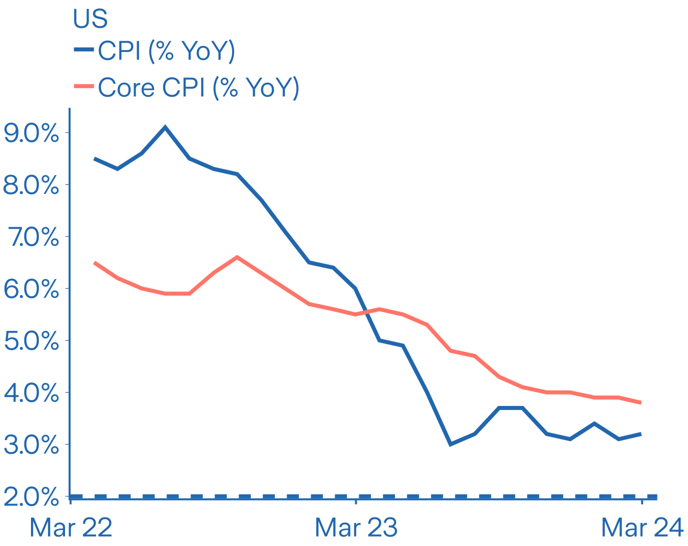
LatAm
Inflation is moving closer to inflation targets

The central banks in the region will continue with an accommodative monetary policy throughout 2024.

In Chile, inflation rose 0.6% MoM in February, with the annual rate rising from 3.8% YoY in December to 4.5%, exceeding market expectations of 4.1%. At the beginning of 2024, the weights of the Consumer Price Index basket were modified. Based on the previous weights, the annual increase was 3.6% YoY. In this context, we anticipate that overall inflation will converge to 3.0% by the end of 2024. Furthermore, we maintain the view that the Central Bank will continue its cycle of reducing the policy rate, cutting it by 100 basis points in the April meeting, leaving it at 6.25%. However, if inflation picks up again, this could impact the magnitude of cuts.

In Mexico, February's inflation slowed down to 0.1% MoM in February, from 0.9%, with the annual rate at 4.4%. Core inflation also fell, at 4.6%, down from 4.8%. This was driven by a decline in goods price inflation, which offset increases in service prices. We anticipate that both general inflation and core inflation will fall below 4.0% during the second half of 2024. Given this, Banxico is expected to start cutting rates on March 21, and we expect it to close 2024 with the rate at 9.0%.

Current and historic inflation



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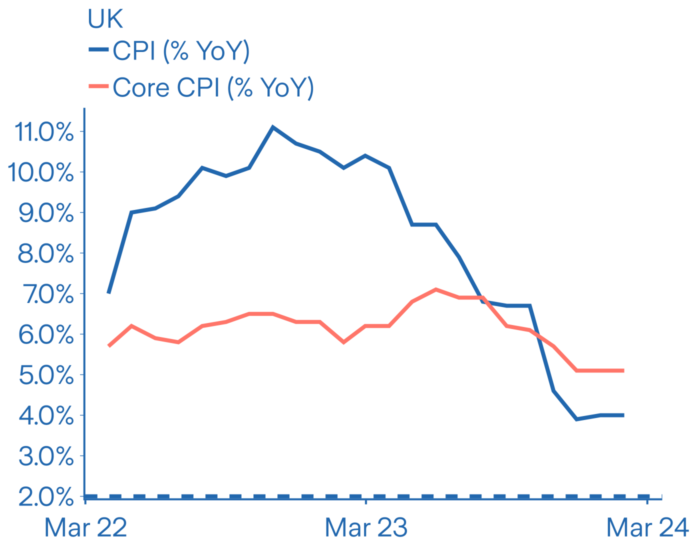

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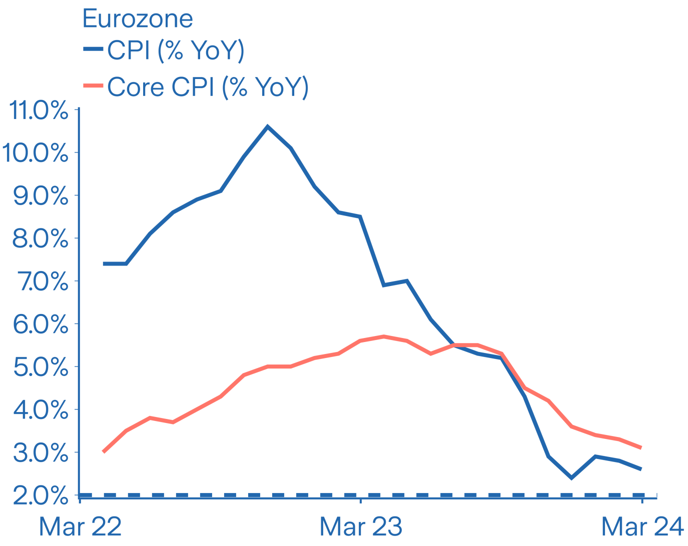

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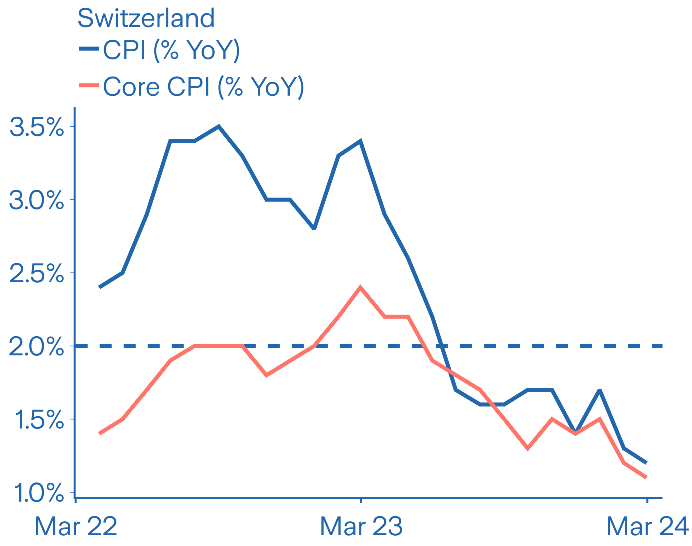

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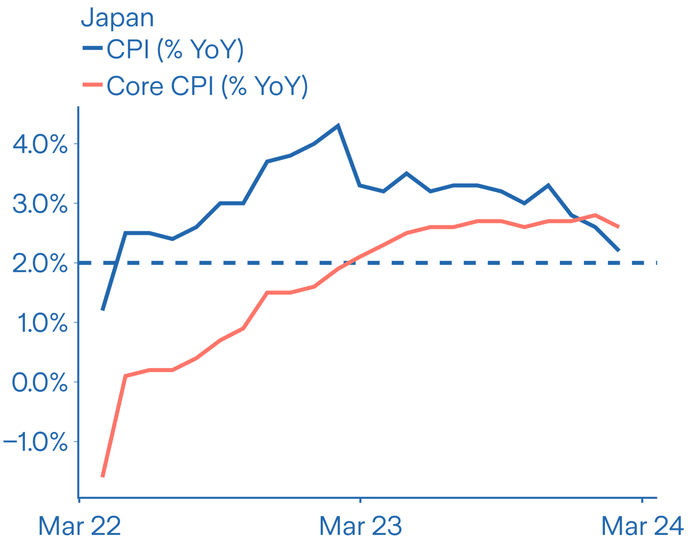

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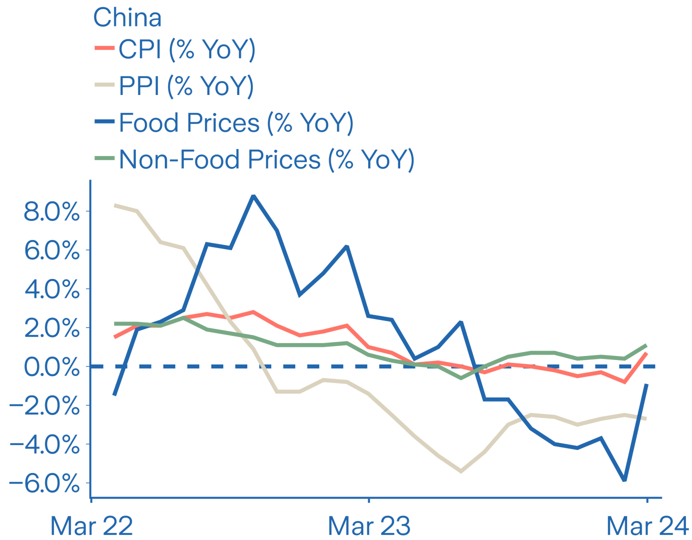

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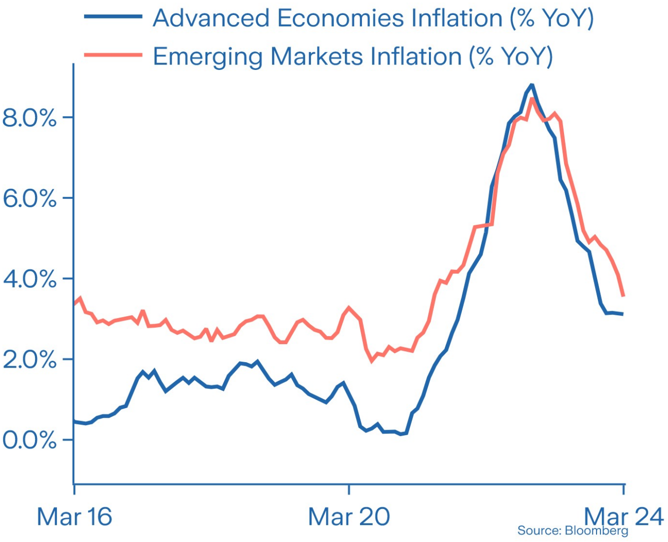
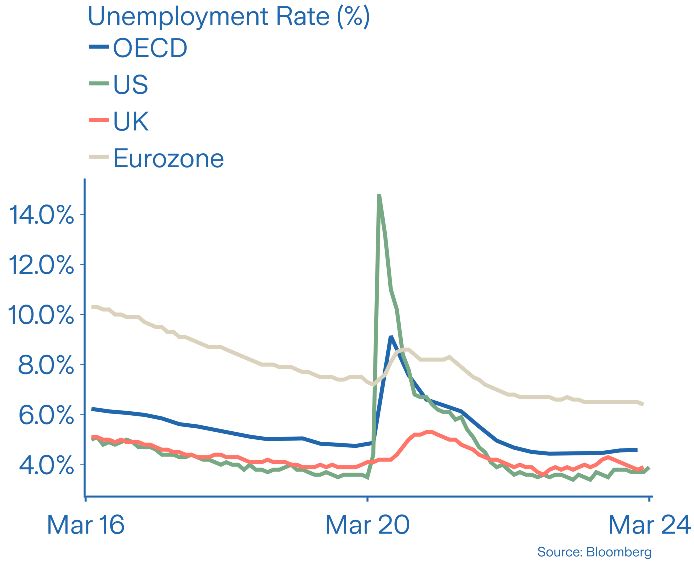
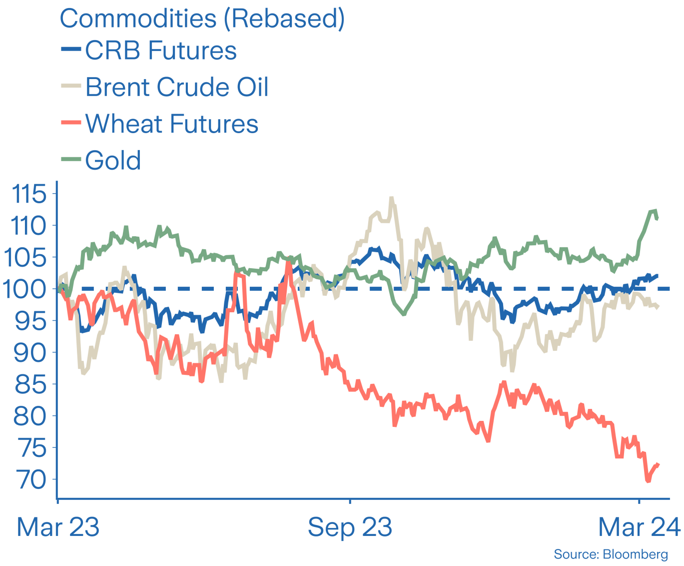
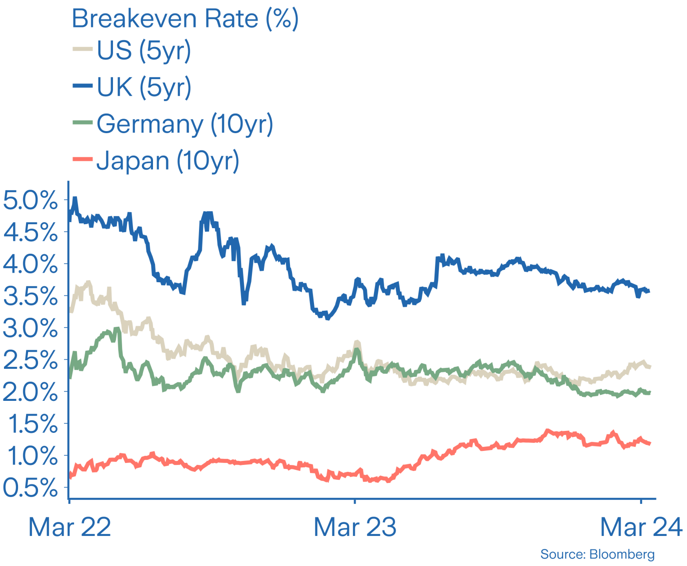
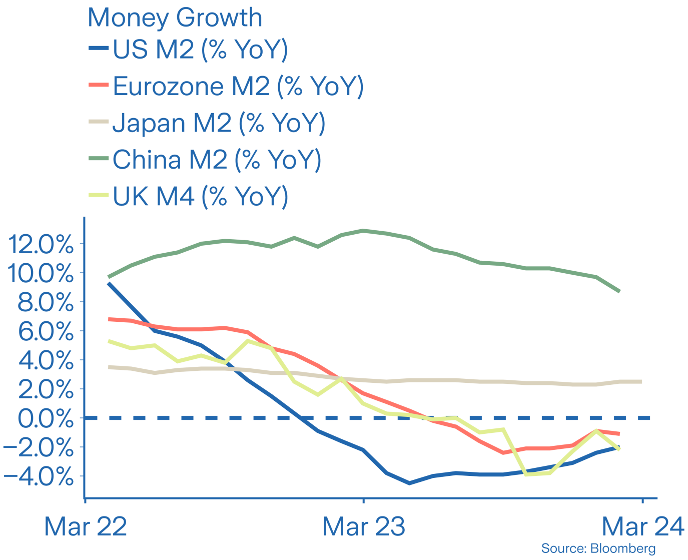
Key Indicators

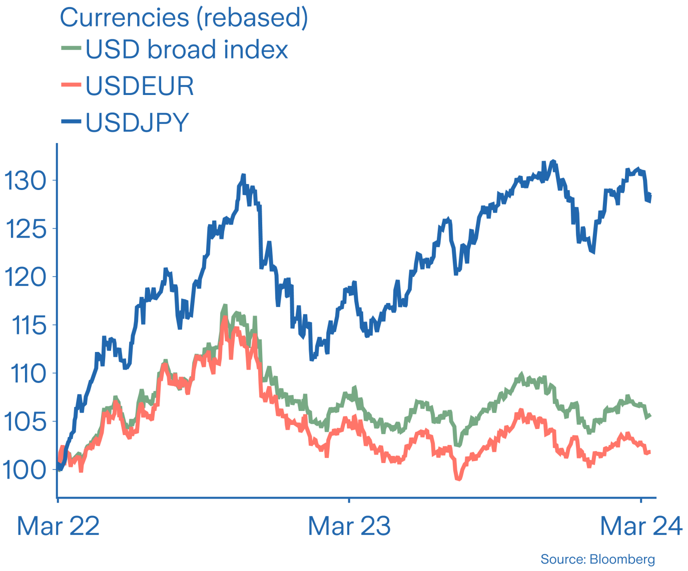












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