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EZ Inflation: How Sticky is it… Really?

Summary Extract:

"…while judging the precise speed/shape of the fall in Eurozone inflation is challenging, inflation risks are increasingly skewed to the downside. In particular the combination of those two key points above suggests that headline inflation as low as 2.5% by year end is not an unreasonable expectation…"

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Important disclosures are included at the end of this report

EZ Inflation: How Sticky is it… Really?

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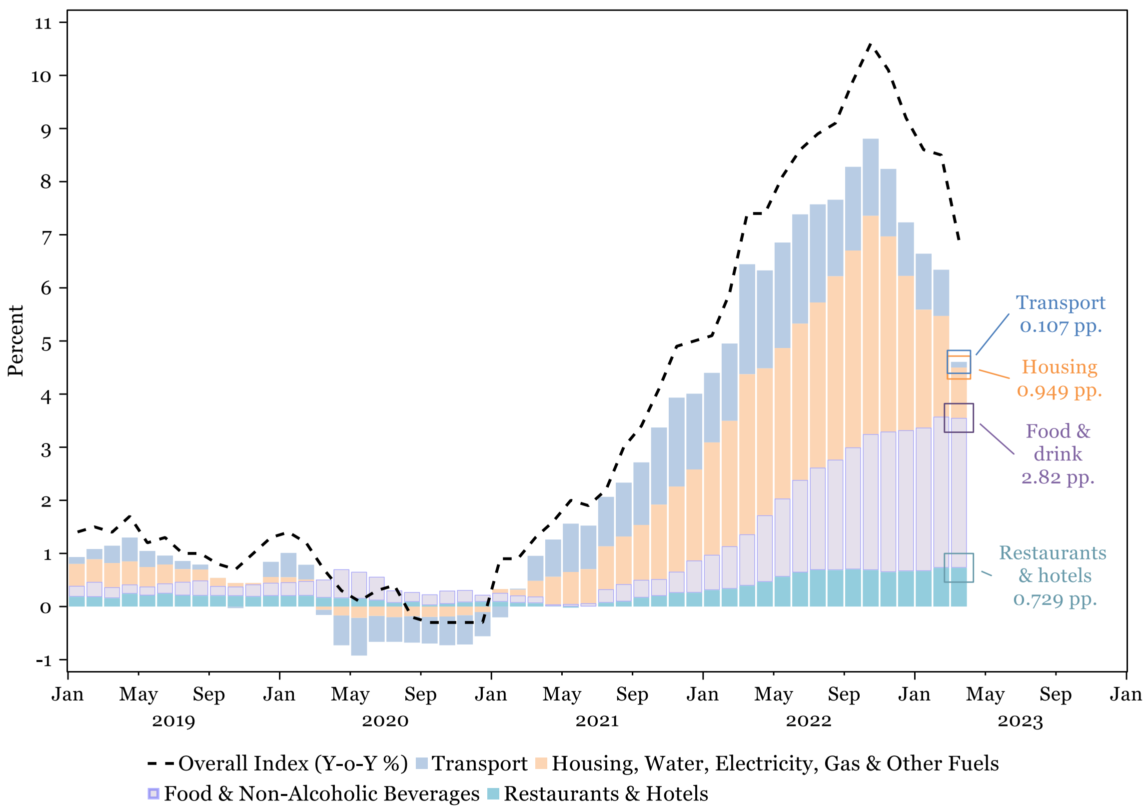
Summary Overview

"There are still significant upside risks to the inflation outlook. These include existing pipeline pressures that could send retail prices higher than expected in the near term. Moreover Russia's war against Ukraine could again push up the cost of energy and food. A lasting rise in inflation expectations above our target, or higher than anticipated increases in wages or profit margins could also drive inflation higher, including over the medium term."

Source: Christine Lagarde, 4th May press conference, available HERE

The widely held view in markets is that (i) the Eurozone growth outlook is relatively robust (e.g. compared to the US); and, somewhat linked to that, (ii) inflation is sticky, with inflation risks skewed to the upside. The conclusion, therefore, is that further ECB tightening is likely & necessary in 2H this year.

Fig 1: EZ headline CPI (Y-o-Y %) with contributions from key categories (pp.)

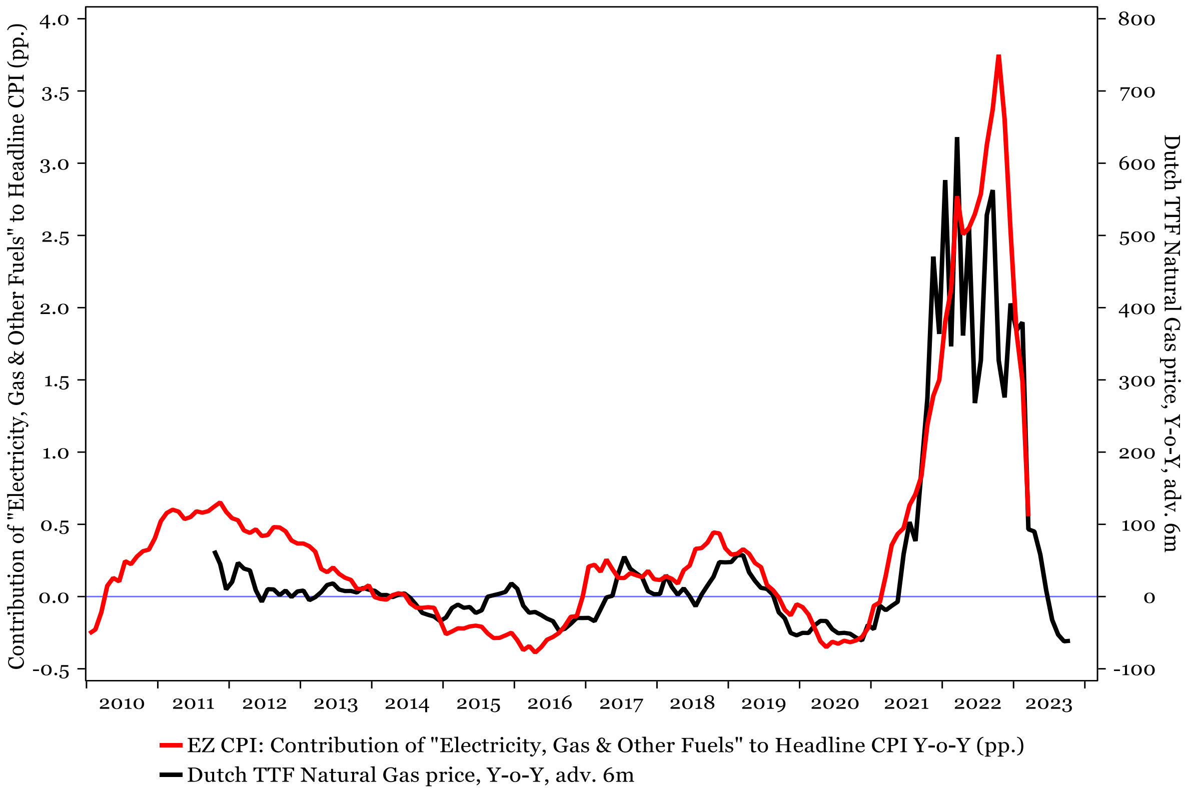


Source: Longview Economics, Macrobond

That view was reiterated by Lagarde at last week's press conference (see quote above). It's also reflected in rates markets, which are priced for another 35bps of ECB hikes by September (and only 85bps of cuts next year*). In the US, in contrast, the market is priced for 54bps of cuts by year end (from a peak in May), with another 149bps by the end of next year.

The key question, therefore, is: Have markets priced Eurozone inflation and growth correctly? Is Eurozone inflation sticky (or indeed stickier than the US)? And, how quickly will it fall (if at all)?

Fig 2: Contribution of "Electricity, gas, & other fuels" to Eurozone CPI (pp.) vs. European gas price (Y-o-Y %, advanced 6 months)



Source: Longview Economics, Macrobond

*With the market priced for flat between September and December 2023.

In our view, the evidence favours **a rapid fall in Eurozone inflation this year**. In particular:

(i) Most of the high inflation rate in Europe can be explained by **supply chain and commodity price shocks.** Those shocks are either rapidly dissipating, or have already reversed. In particular, Eurozone inflation is made up of 12 key categories. Of those, just three currently account for 4.4pp. of the 6.9% headline inflation rate.

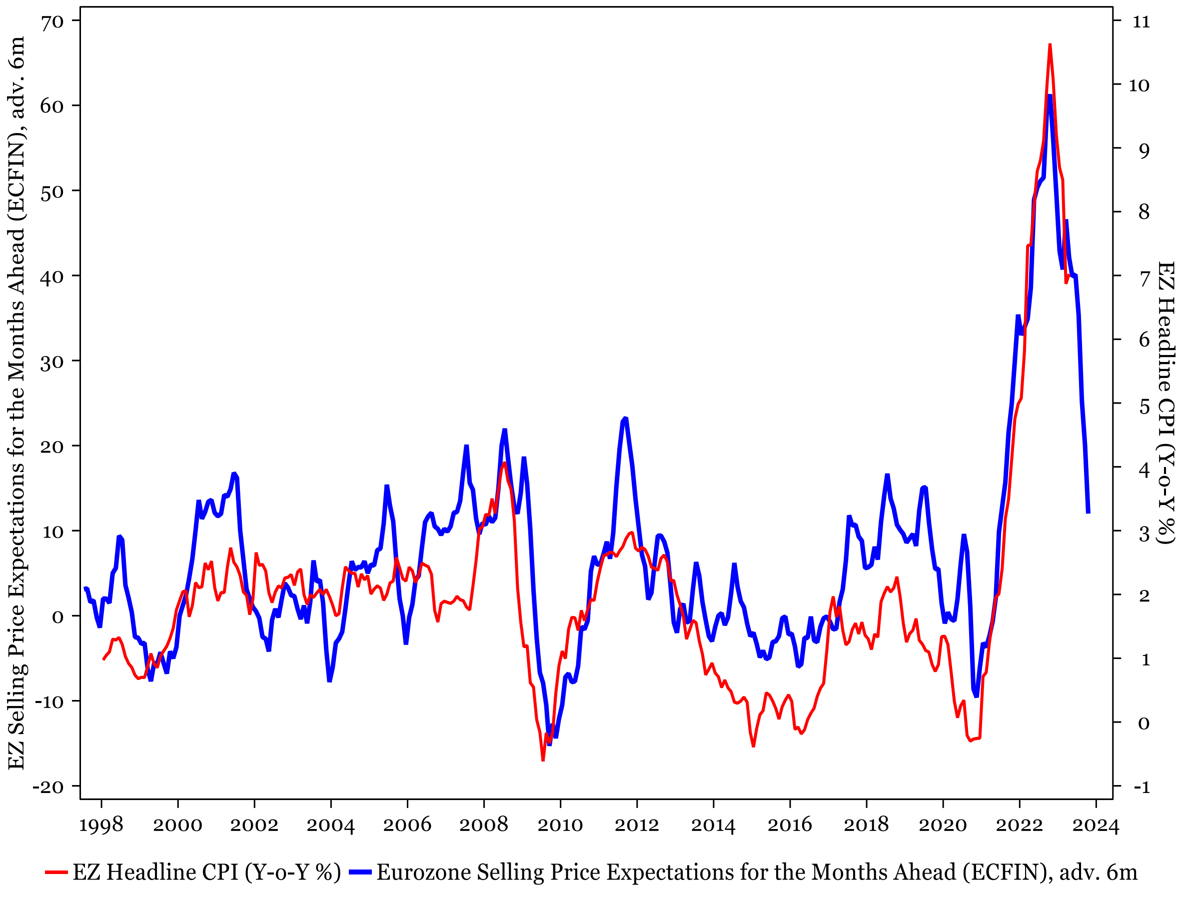
In other words, while those three price groups only have a 42% weighting in the CPI basket, they account for 64% of Europe's inflation. Amongst the other categories, inflation in Europe is only 2.5% Y-o-Y (fig 7).

As we show in **point 1** below, the combined inflation contribution from those (high inflation) categories should fall from 4.4pp. currently to around +0.5pp by year end.

(ii) **Leading indicators, as well as Europe's poor macro outlook, suggest that inflation should fall sharply** as the labour market continues to soften, as wage inflation eases, and as the credit cycle turns lower (**point 2**). Other 'non-commodity' sources of Eurozone inflation, therefore, which are principally *domestically generated*, should therefore also ease later this year.

As such, and while judging the precise speed/shape of the fall in Eurozone inflation is challenging, **inflation risks are increasingly skewed to the downside**. In particular the combination of those two key points above suggests that headline inflation as low as 2.5% by year end is not an unreasonable expectation**.

Fig 3: EZ headline CPI (Y-o-Y %) vs. monthly selling price expectations (6m adv)



Source: Longview Economics, Macrobond

**E.g. That would happen if the inflation contribution from the 'commodity' categories fell from 4.4pp. to 0.5pp. (as we make the case for in point 1) while the contribution from 'non-commodity' inflation categories fell modestly from 2.5pp. to 2.0pp..

Key Points

1. Supply side (and commodity price) shocks are reversing.

Most of Europe's high inflation can be explained by major supply side shocks and their related commodity price spikes. That has particularly influenced four 'top level' CPI categories, including: (i) food & drink; (ii) household energy costs; (iii) transport; & (iv) restaurants and hotels. Those four categories account for over half (56%) of the CPI basket (table 1).

Those shocks have now dissipated/unwound and are increasingly, therefore, **generating a major disinflationary impulse in the EZ economy**.

Indeed, of those four categories, high **transport** inflation has already reversed. At its peak, that category contributed +2.1pp to headline CPI (in March '22, due to the oil price spike associated with the Russian invasion). On the latest data, it's contributing just +0.1pp to headline CPI. Currently the oil price is down 37% Y-o-Y in EUR terms. Usually, when that happens, it's not long before transport CPI becomes deflationary, typically detracting ~0.5pp. from headline CPI, see fig 8. We'd therefore expect something similar in coming months.

Table 1: Eurozone CPI components, weightings, and inflation rates (HICP)

Category	Current CPI weighting	Current inflation rate (Mar 23)	Contribution to headline
01 Alcoholic beverages and tobacco	3.8%	7.3%	0.3%
02 Clothing and footwear	5.2%	4.7%	0.2%
03 Communication	2.7%	0.3%	0.0%
04 Education	1.0%	4.4%	0.1%
05 Food and non-alcoholic beverages	16.1%	17.5%	2.8%
06 H'hold equmt., furnishings & maintenance	6.8%	8.5%	0.6%
07 Health	4.9%	2.6%	0.1%
08 Housing, water, gas and electricitity	15.2%	4.6%	0.9%
09 Miscellaneous goods and services	9.9%	5.3%	0.5%
10 Recreation and culture	8.9%	6.3%	0.5%
11 Restaurants and hotels	10.5%	8.5%	0.7%
12 Transport	15.0%	0.6%	0.1%
Total	100.0%	6.9%	6.9%

Source: *Longview Economics, Macrobond*

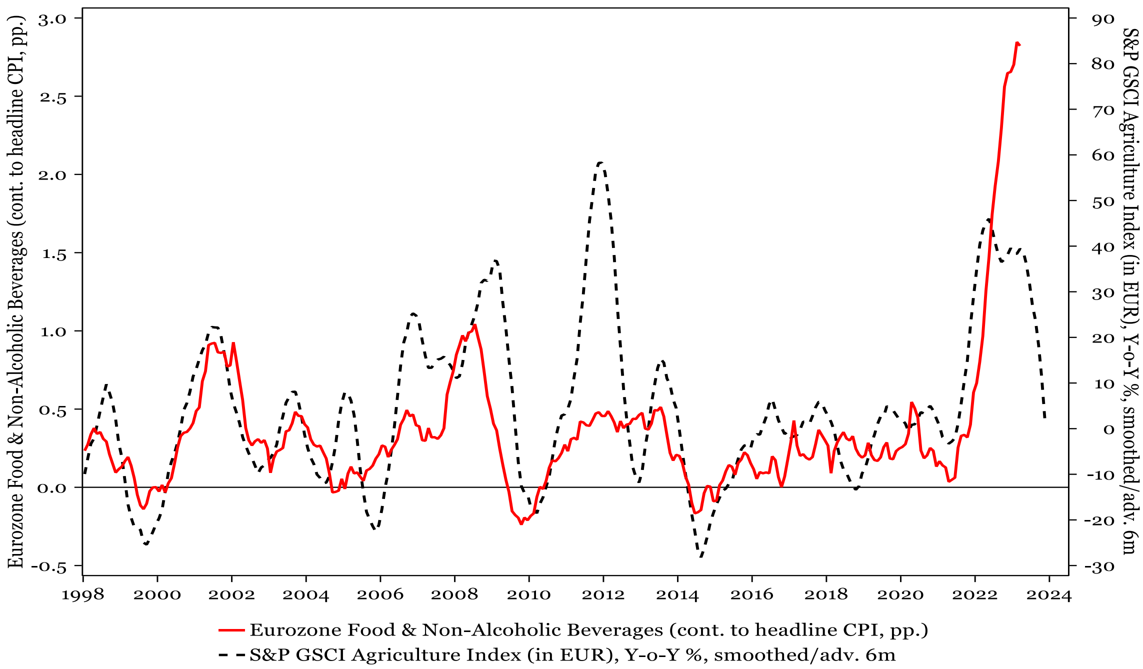
Similar dynamics are emerging in the other three categories. In particular:

- **Housing, water, gas & electricity**, i.e. 'HWGE' (15% weighting in CPI): Inflation in this category was driven rapidly higher by gas prices last year (see fig 10), with HWGE inflation rising to 23% Y-o-Y at its peak in October. That pushed headline CPI higher (which also peaked in October, i.e. at 10.6%). At that time, HWGE accounted for 4.1pp. of headline CPI.

  Usually, it takes about 6 months for gas price changes to impact this category. With gas prices having fallen sharply from their peak 12 months ago, household 'energy inflation' component of HWGE has now *started* to fall, see fig 2 (NB it's currently 4.6%, and only contributing 0.9pp. to headline CPI, see table 1). Given the usual time lags, though, and with gas prices making new lows in recent months (and currently down 62% Y-o-Y), downward pressure on CPI should increase. Indeed, gas price falls of this size usually become deflationary (& detract about 0.25pp. from headline CPI). That was the case, for example, in 2020 and 2015 (see fig 2).

- **Food and drink** (16% weighting in CPI). This category is the largest current driver of Eurozone inflation (accounting for 2.8pp. of the latest 6.9% headline reading). Usually, and unsurprisingly, inflation in this category follows the path of food prices (in EUR terms) with a roughly six month time lag (see fig 4). Of note, in the chart below, we have smoothed the S&P agriculture index by 6 months. This month, 'ag prices' are down 25% Y-o-Y (and have been shrinking Y-o-Y in February, March, & April). That should, therefore, push CPI food inflation much lower this year (at least, in our view, to around 1pp. by year end, from 2.8% currently), i.e. resulting in a 1.8pp fall in headline inflation, all else equal.

Fig 4: EZ Food & drink contribution to headline CPI (pp.) vs. S&P Agriculture prices (Y-o-Y, in EUR terms, smoothed 6m & advanced 6m.)



Source: Longview Economics, Macrobond

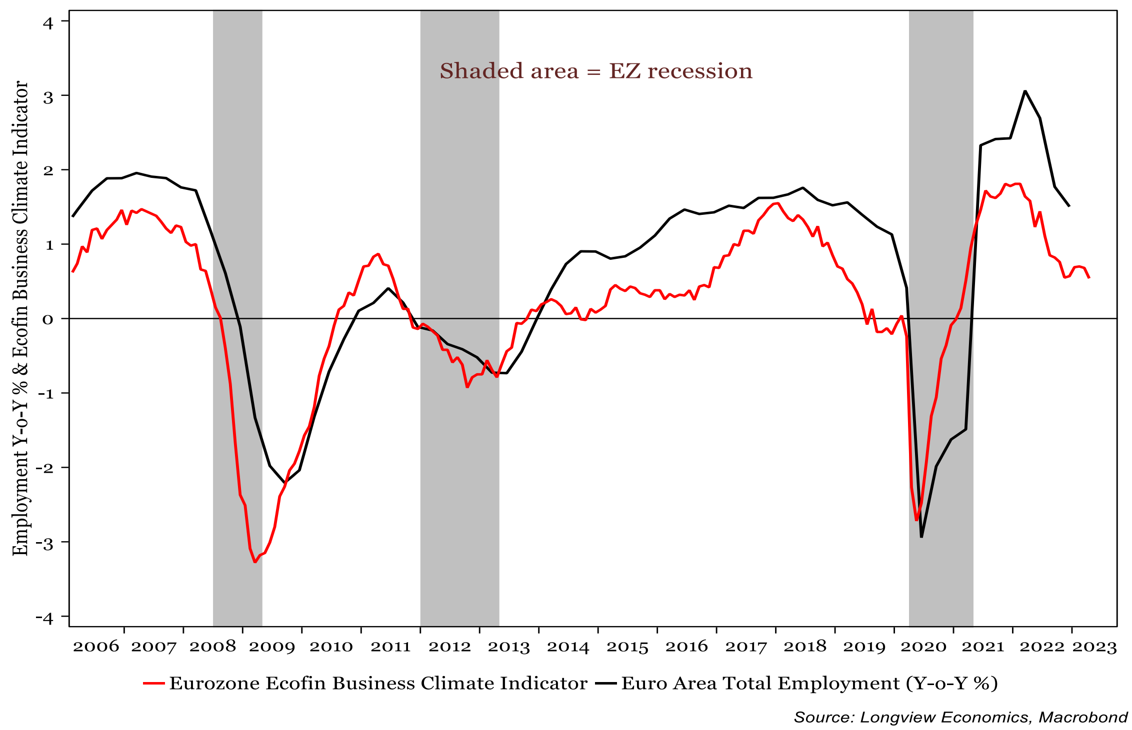
- **Hotels and restaurants** (11% weighting). Given that food and energy prices are key input costs for hotels & restaurants, this category is making a larger than normal contribution to headline CPI (i.e. 0.7pp, vs. +0.2 to +0.3pp normally). As the impact of weaker food/energy prices feeds through, therefore, hotel & restaurant inflation should also ease (probably detracting about 0.3pp from headline inflation by year end), see fig 9.

2 Leading indicators, and the Eurozone macro backdrop, point to weaker inflation (i.e. from domestically generated sources). The evidence for that includes:

(i) **Price expectations surveys, which have turned sharply lower** in recent months. That includes expectations for both goods and services (see figs 3 & 6). Those indicators, as the charts show, typically lead goods and services inflation by between 6 – 9 months.

(ii) **Growing signs of labour market weakness.** Jobs growth in Europe has decelerated (albeit from high levels) in recent quarters. The high frequency data, which measures business health/confidence, suggests that the deceleration should continue (with job growth likely to have fallen to around/below 1% by the middle of this year***). Wage inflation, therefore, which has stopped increasing/started to stabilise, is likely to come under pressure. Other key signs of weakness in the economy are notable and include (i) sharp falls in manufacturing new orders (fig 11); (ii) the large contraction in retail sales; and (iii) falling house prices in key economies (inc. Germany & the Netherlands).

Fig 5: EZ Ecofin business indicator vs. total employment growth (Y-o-Y %)

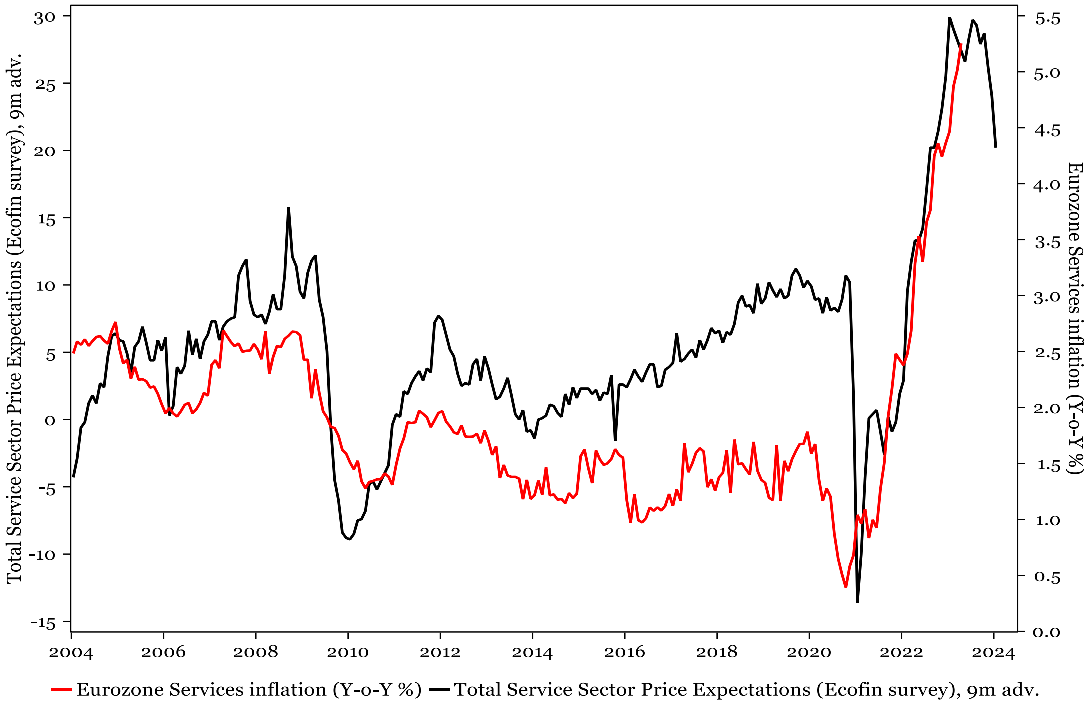


***I.e. when the data is released (latest Eurozone employment data goes to Q4 2022).

(iii) **The turn lower in the credit cycle (and the strong case for a Eurozone wide recession).** Of note, and as we show HERE, Europe is in the midst of a 'tight money shock' which should generate recessionary conditions later this year. That, if it happens, should add to the sources of dis/deflationary pressure in the economy.

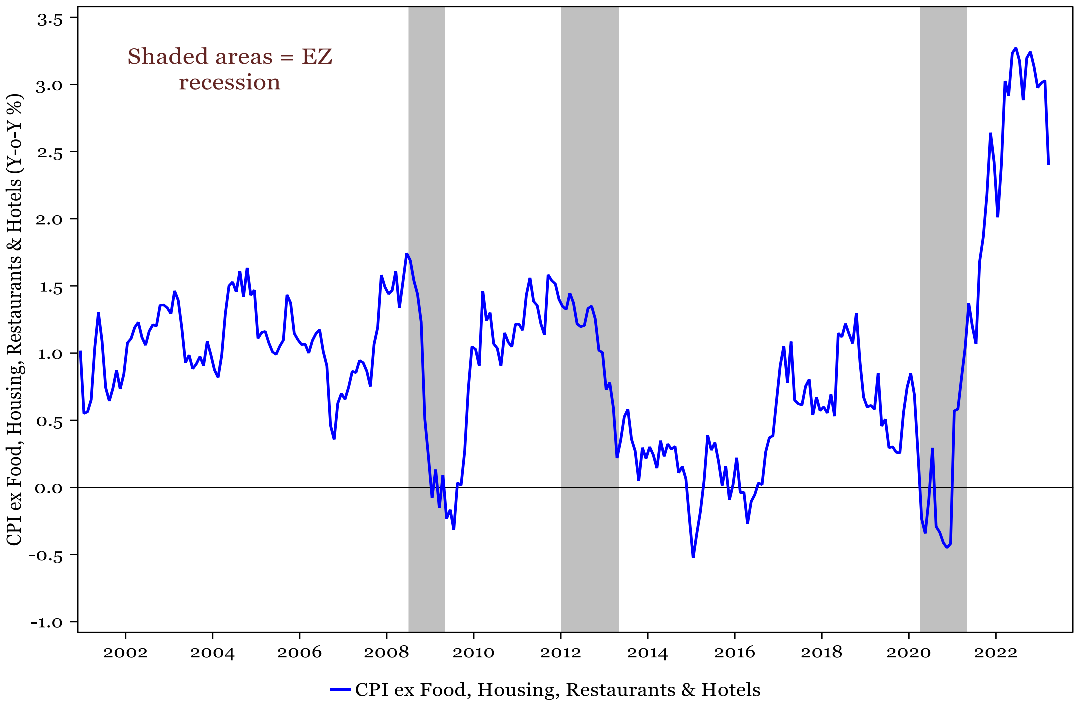
Appendix: Key charts

Fig 6: EZ services (Y-o-Y %) vs. service sector price expectations (adv 9m)



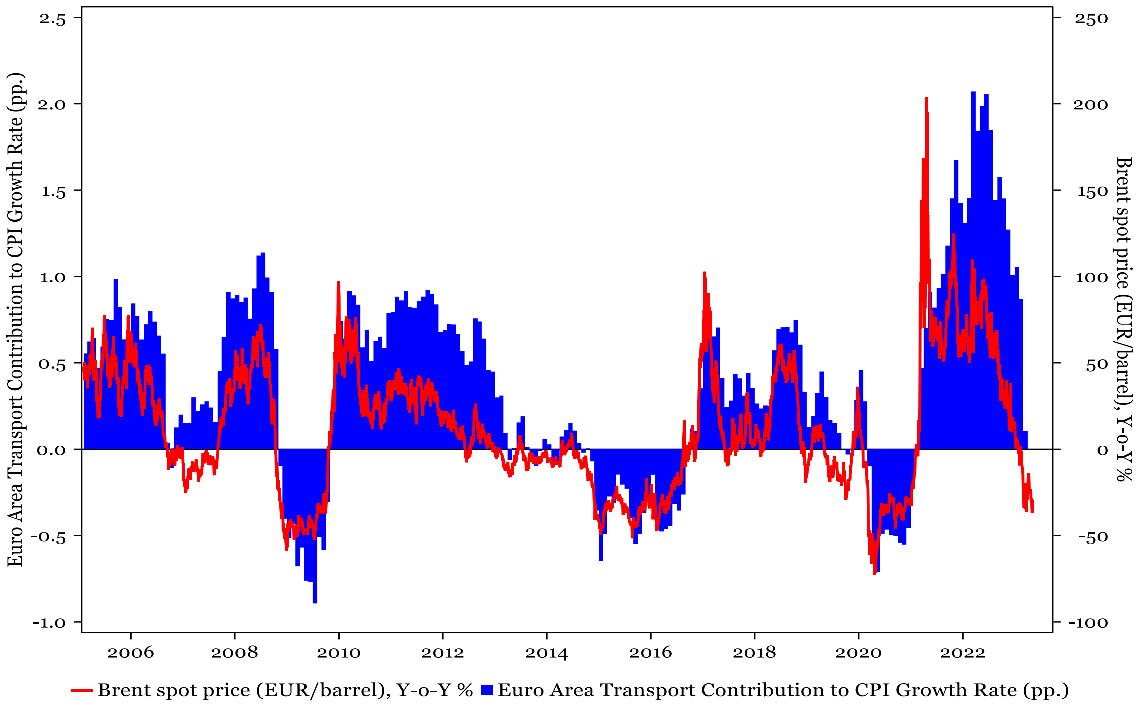
Source: Longview Economics, Macrobond

Fig 7: Eurozone CPI ex. Food, Housing, Restaurants & Hotels (Y-o-Y %)



Source: Longview Economics, Macrobond

Fig 8: Contribution of transport inflation to Eurozone CPI (pp.) vs. Brent spot price (EUR/barrel, Y-o-Y %)

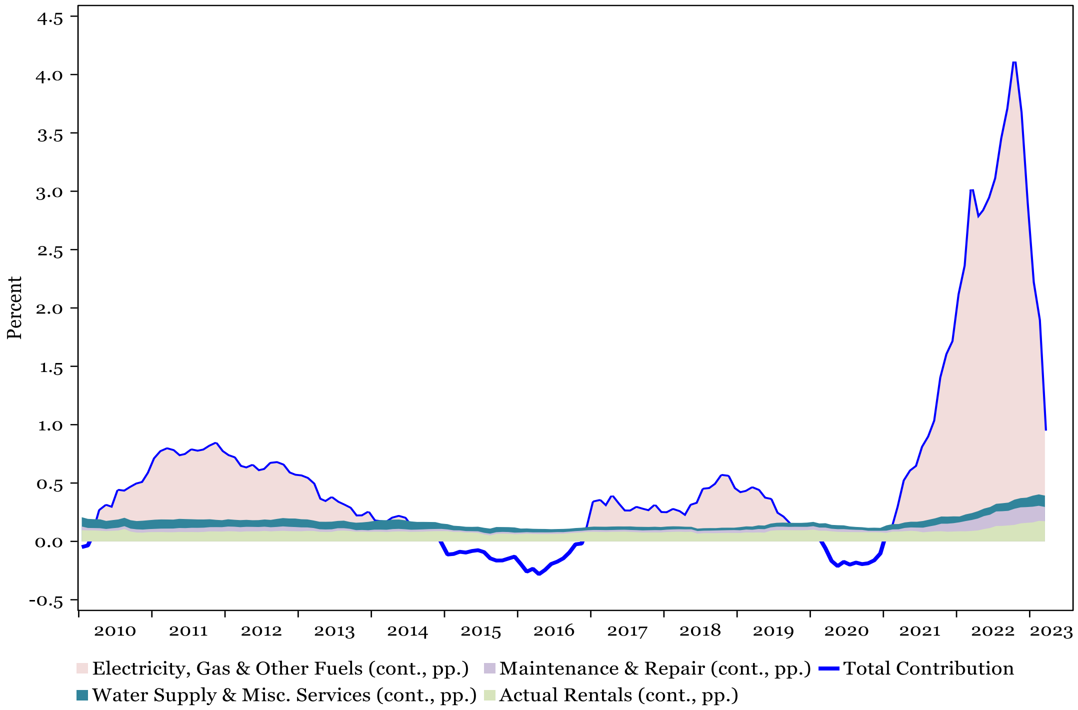


Source: Longview Economics, Macrobond

Fig 9: Contribution of restaurant & hotel inflation to Eurozone CPI (pp.)

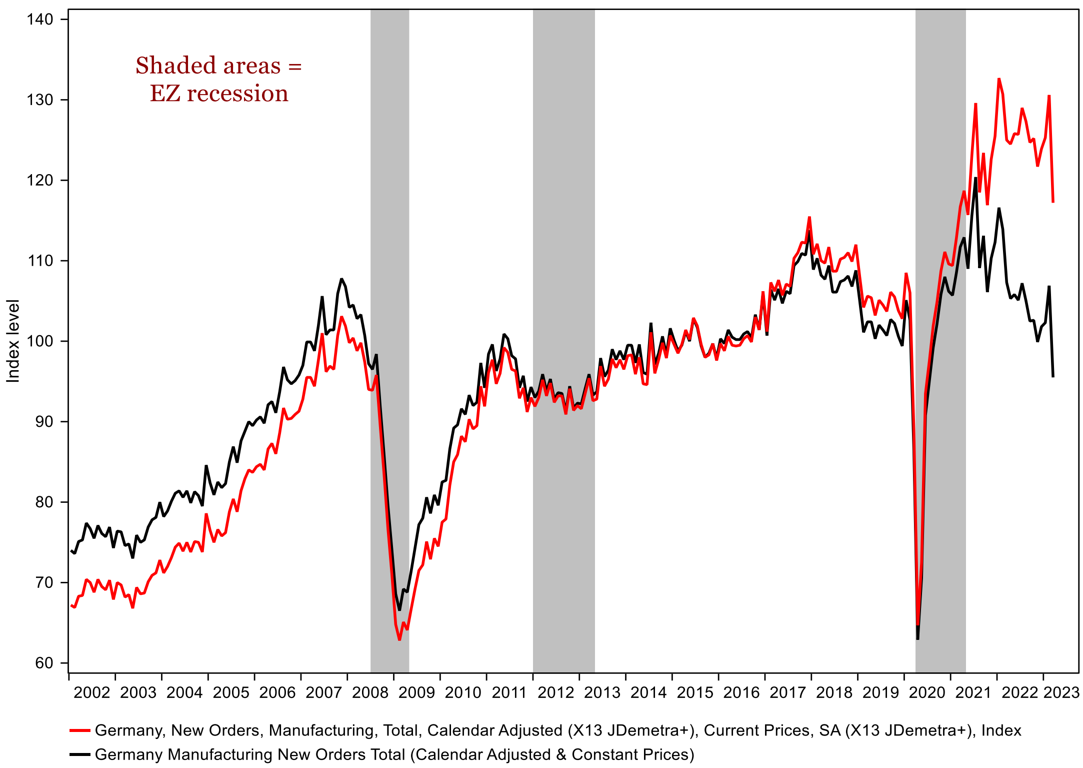
Source: Longview Economics, Macrobond

Fig 10: Housing, water, gas, & electricity contribution to headline CPI (pp.)



Source: Longview Economics, Macrobond

Fig 11: German new orders (real vs. nominal)



Source: Longview Economics, Macrobond

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