Weekly Update

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Inflation – is the dog about to bark?


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With a number of central banks due to review monetary policy in the run-up to the US Federal Reserve's (Fed) meeting on September 26, investor attention has been drawn back to the outlook for inflation. Will the recent gradual pick-up begin to accelerate, and what is likely to happen to key rates?

In the US, inflation has languished well below the Fed's 2% target for most of the past decade according to its preferred gauge, the Personal Consumption Expenditure (PCE) excluding volatile items. However, the trend has turned more positive since end-2015 reaching 2% year-on-year (YoY) in July, the highest since 2012. In the eurozone, the pattern is similar but the level less elevated – the August core inflation rate hit 1% YoY and shows little sign of reaching the European Central Bank's (ECB) own 2% target, last exceeded back in December 2002.

The main difference between headline and core measures of inflation is that the latter exclude volatile items such as food and, in particular, energy. After the shale shock in 2014-2015 which drove Brent to below $30 per barrel, prices have recovered steadily, reaching $74 on average over the past six months. This in turn has pushed headline inflation well above core – 2.0% YoY in the eurozone and 2.3% in the US.

Another contributing factor to rising inflation has been tightness in labour markets, particularly in the US. With the August underemployment rate hitting a low since 2001, wage pressures have firmed steadily over the past six years with average hourly earnings hitting a cycle high at 2.9% YoY last month. In addition, 2018's massive US tax cuts have only added to overheating risk in the US economy. And tariffs on imports bring their own price pressures – US washing machine prices, which had fallen steadily in recent years, have shot up by 14% over the past twelve months.

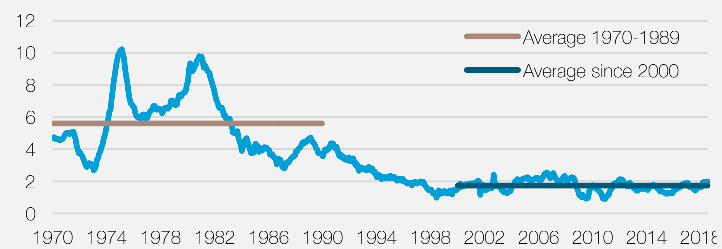
However, there are also a number of factors which have contributed to keep inflation well below historic levels – US core PCE averaged 5.6% per annum between 1970 and 1989 but only 1.7% since the turn of the millennium. These factors include technological change (e-commerce and online price comparison), cross-border supply chains (which have globalised deflationary pressures) and the tight control on wages kept by companies in the aftermath of the great recession of 2008-2009.

The experience of recent years has anchored consumer and investor expectations of inflation at low levels and the increase in prices we have seen this cycle has been slower to emerge and less pronounced than in previous decades. In addition, our expectation of weakness in oil prices suggests that YoY changes in headline inflation should ease lower by the end of this year.

Putting it all together. The gradual rise in core inflation measures suggests that the global economy is at last completing its recovery from the crisis. As a result, we expect central banks to continue normalization of monetary policy – the Fed remains on track to hike twice and the ECB to halt asset purchases by year-end. In this context, defensive, short maturity bonds will help protect against the likely rise in US and eurozone government bond yields.

Recent core inflation well below historic levels

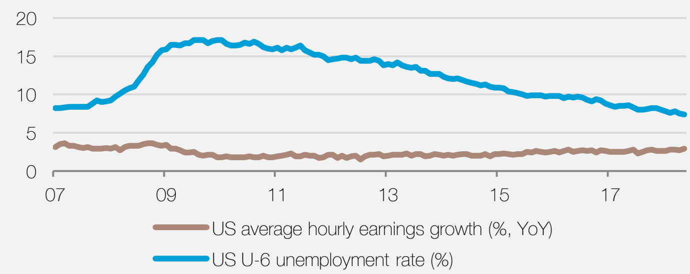
US Core Personal Consumption Expenditures index (YoY change, %)



Sources: SGPB, Bloomberg, BEA, 31/07/2018

Wage pressures firming with tighter job market

US unemployment rate and earnings growth (%)



Source: SGPB, Bloomberg, 31/08/2018

This week and next

EUROZONE

- Eurozone Sentix investor sentiment fell from 14.7 to 12 in September while the consensus was for 14.3.
- Eurozone industrial production was down -0.8% for the second consecutive month, worse than the expected -0.5%. This sent YoY change into negative territory, from 2.3% to -0.1% for the first time since January 2017. Also of note is the 1.8% MoM decline in Italy's industrial production.
- As expected, the ECB kept its deposit rate at -0.4%, unchanged since March 2016, and confirmed asset purchases would be cut to €15bn per month for Q4.
- The ZEW survey of German growth expectations continued its rebound to -10.6 in September, well above July's low at -24.7.

Next week's key events	Per.	Prev.	Cons.
17 Sep Headline inflation, YoY	Aug	2%	--
20 Sep Consumer confidence	Sep P	-1.9	--

UNITED KINGDOM

- GDP rose +0.6% in the three months to July, up from +0.4% (from April to June), boosted mainly by services and retail sales.
- Total production output fell 0.5% for the three months to July versus the previous period, dragged lower by energy supply.
- The unemployment rate remained unchanged at 4.0% in July, its lowest level since 1975, while growth in average earnings increased from +2.4% to +2.6% YoY.
- Monetary Policy Committee members unanimously voted to keep the Bank of England rate unchanged at 0.75% as well as the level of corporate bond and Gilt purchases.

Next week's key events	Per.	Prev.	Cons.
19 Sep Headline inflation, YoY	Aug	2.5%	--
20 Sep Retail sales, YoY	Aug	3.5%	--

UNITED STATES

- Labour market conditions remain tight with unemployment still at 3.9%, a multi-decade low. Job creation stood at 201k in August while the number of Americans filing for unemployment benefits hit its lowest level in nearly 49 years at 204k. Average hourly earnings rose 2.9% YoY, the fastest pace since 2009.
- Headline consumer prices rose less than expected at +0.2% MoM in August, the same rate as July, taking YoY inflation to 2.7% from 2.9%. Core inflation slipped from 2.4% YoY to 2.2%.
- Producer price inflation eased from +3.3% to +2.8% YoY in August, lower than an expected +3.2%.

Next week's key events	Per.	Prev.	Cons.
14 Sep Retail sales, MoM	Aug	0.5%	0.4%
14 Sep University of Michigan sentiment	Sep P	96.2	96.6

ASIA & EMERGING COUNTRIES

- In Japan, stronger-than-expected business spending in Q2 (+3.1% QoQ after +1.3% in Q1) benefited real GDP growth which was revised up from 0.5% to 0.7% QoQ (+1.3% YoY).
- In China, imports (+20% YoY) grew faster than exports (+9.8%) in August, for the sixth consecutive month, while the trade surplus remained stable at $27.9bn. Trade surplus vs the US hit record highs ($36.8bn) as exporters front-load orders before Trump tariffs take effect. Consumer prices rose for the fourth month in a row to 2.3% YoY in August.
- Turkey's economic growth has already started to decelerate, falling from +7.4% YoY to +5.2% in Q2. Seasonally and calendar adjusted GDP only rose 0.9% QoQ.

Next week's key events	Per.	Prev.	Cons.
19 Sep Japan: Trade balance, ¥bn	Aug	-232	--
21 Sep Japan: Manufacturing PMI	Sep P	52.5	--

Sources: Datastream, Bloomberg, 14 September 2018, Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, ECB = European Central Bank

Our 6-month targets for currencies and commodities

	Thursday close	6mth target
EUR/USD	1.17	1.20
GBP/USD	1.31	1.32
EUR/CHF	1.13	1.16
USD/JPY	112	110
Brent	$78.3	$75
Gold	$1203	$1225

No changes this week.

Question time

Past performance should not be seen as a guarantee of future returns.

No Q&A this week.

Market performance

Past performance should not be seen as a guarantee of future returns.

Interest rates

Interest rates	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-37 bp	-1 bp	→	0 bp	-2 bp	-1 bp
3mth Euribor (EUR)	-32 bp	0 bp	→	0 bp	1 bp	1 bp
3mth Libor (USD)	233 bp	1 bp	→	-1 bp	64 bp	101 bp
3mth Libor (GBP)	80 bp	0 bp	→	17 bp	28 bp	50 bp
10-year US Treasury bond	296 bp	9 bp	↑	-2 bp	55 bp	77 bp
10-year German bond	42 bp	7 bp	↑	-5 bp	0 bp	2 bp
10-year French bond	73 bp	4 bp	↑	-11 bp	-6 bp	4 bp
10-year UK bond	150 bp	9 bp	↑	14 bp	32 bp	36 bp

Credit

Credit	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0.0%	→	0.4 %	-0.5 %	0.0 %
BAML EURO Corp HY	0.3%	↑	0.6 %	-0.2 %	0.8 %
BAML GBP Corp IG	-0.5%	↓	0.1 %	-1.5 %	-0.5 %
BAML US IG	-0.2%	↓	1.3 %	-2.2 %	-1.0 %
BAML US HY	0.4%	↑	1.7 %	2.2 %	3.3 %
JPM Global EM Sov. Plus	0.6%	↑	0.1 %	-5.7 %	-5.2 %

Exchange rates

Exchange rates	Last	1wk		3mth	YTD	12mth
EUR/USD	1.17	0.6 %	↑	-0.9 %	-2.7 %	-1.7%
EUR/CHF	1.13	0.6 %	↑	-2.9 %	-3.6 %	-1.5%
GBP/USD	1.31	1.4 %	↑	-2.0 %	-2.9 %	-0.8%
USD/JPY	112	1.1 %	↑	1.4 %	-0.6 %	1.3%
USD/BRL	4.21	3.7 %	↑	13.1 %	27.0 %	34.2%
USD/CNY	6.84	0.1 %	↑	7.0 %	5.2 %	4.6%
USD/RUB	68.2	-1.5 %	↓	9.2 %	18.3 %	17.7%

Government bonds*

Government bonds*	1wk		3mth	YTD	12mth
United States (3-7yr)	-0.5 %	↓	0.6 %	-1.0 %	-2.1 %
United Kingdom (3-7yr)	-0.3 %	↓	0.1 %	-0.5 %	-0.9 %
Germany (3-7yr)	-0.3 %	↓	0.2 %	0.3 %	-0.3 %
Japan (3-7yr)	0.0 %	→	-0.2 %	-0.2 %	-0.3 %

Equities*

Equities*	Last	1wk		3mth	YTD	12mth
MSCI AC World	518	0.8 %	↑	0.3 %	2.9 %	9.5 %
Eurostoxx 50	3,334	1.1 %	↑	-4.0 %	-1.9 %	-2.0 %
DAX	12,056	0.8 %	↑	-6.5 %	-6.7 %	-4.0 %
CAC 40	5,328	1.6 %	↑	-2.2 %	3.1 %	5.4 %
S&P 500	2,904	1.0 %	↑	5.2 %	10.1 %	18.5 %
FTSE 100	7,282	-0.5 %	↓	-4.4 %	-2.1 %	2.8 %
SMI	8,960	1.6 %	↑	3.8 %	-1.3 %	2.4 %
Topix	1,710	1.0 %	↑	-4.9 %	-4.8 %	6.7 %
IBOV Brazil	74,687	-2.3 %	↓	3.6 %	-2.3 %	-0.1 %
MICEX Russia *	2,357	1.6 %	↑	3.8 %	11.7 %	14.8 %
MSCI EM	1,018	0.0 %	→	-9.2 %	-10.1 %	-4.9 %
SENSEX 30 India	37,718	-1.4 %	↓	6.1 %	12.7 %	18.5 %
Hang Seng (H-K)	27,014	0.3 %	↑	-10.6 %	-6.8 %	0.3 %
Shanghaï Composite	2,687	-0.2 %	↓	-11.9 %	-18.8 %	-20.6 %

Commodities

Commodities	Last	1wk		3mth	YTD	12mth
Brent	$78	2.3 %	↑	2.5 %	17.5 %	42.2 %
Gold	$1,203	0.3 %	↑	-7.3 %	-7.7 %	-9.1 %
Silver	$14.2	0.4 %	↑	-16.1 %	-16.3 %	-19.7 %

Source: DataStream, on 14/09/2018. 1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7 year returns. Figures are rounded.

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