ECONOSIGHTS
with Diana Mousina

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Will inflation have a resurgence?

Key points

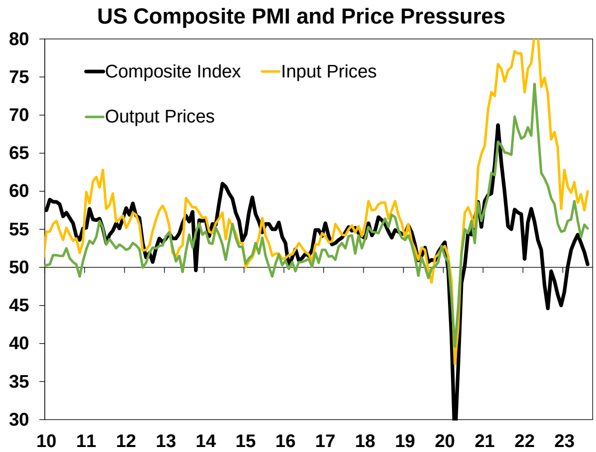
- A slowing in inflation data is leading to optimism that the fight against high inflation has been won.
- However, some leading indicators of inflation are turning up again. This includes some price indices in the PMI and ISM surveys, the likelihood of higher agricultural commodity prices, a broader lift in commodity prices, a rise in medium-term inflation expectations and a lift in real wages and higher consumer confidence which could see a rise in consumer spending.
- Upside inflation shocks could lead to renewed concern about further rate hikes, higher bond yields and the risk of a recession which would be negative for sharemarkets. While this is a risk, we still see inflation headed lower through 2023 and into 2024 due to the impacts of restrictive interest rates. But, it is worth watching the leading inflation indicators for signs of persistent upside inflation risks.

Introduction

Inflation data across most major economies has been slowing noticeability over recent months. While it may seem like the fight against inflation has been won by central banks, some recent leading indicators of inflation have ticked up again which could indicate that inflation may have a resurgence in late 2023/early 2024 which could take financial markets by surprise. We look at these issues in this edition of *Econosights*.

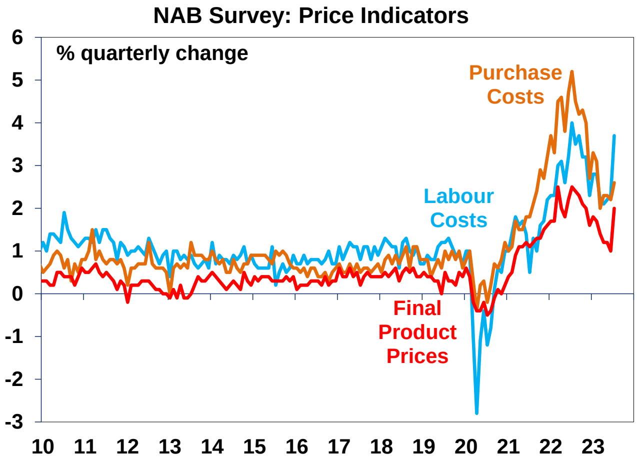
The PMI surveys

The Purchasing Managers Indices (PMIs) are a good leading indicator of global activity and contain sub-indices for input and output prices. After declining since mid-2022 input and output costs have stabilised in recent months and some look to be picking up again (see the chart below). This is also similar to the price indices in the US ISM index.



Source: Bloomberg, AMP

In Australia, the NAB business survey price indicators have also been trending up, especially in July (see the next chart) which could just be a one-off spike because of the decision to lift the minimum wage in June.

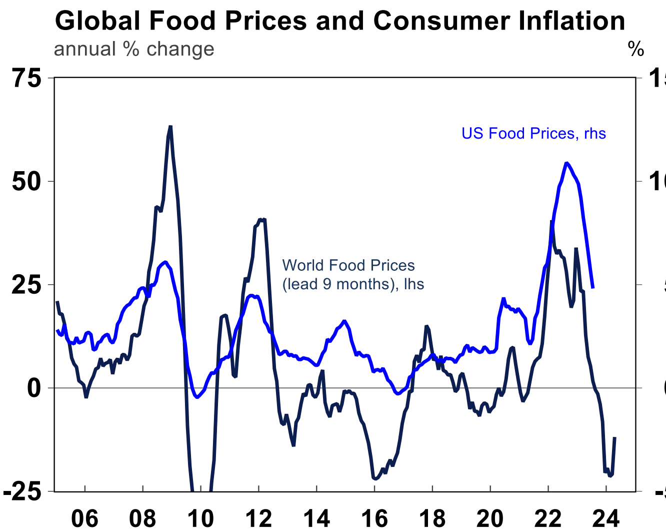


Source: Bloomberg, AMP

The trends in these price surveys are worth watching, as they tend to lead the hard inflation data.

Weather events and commodity prices

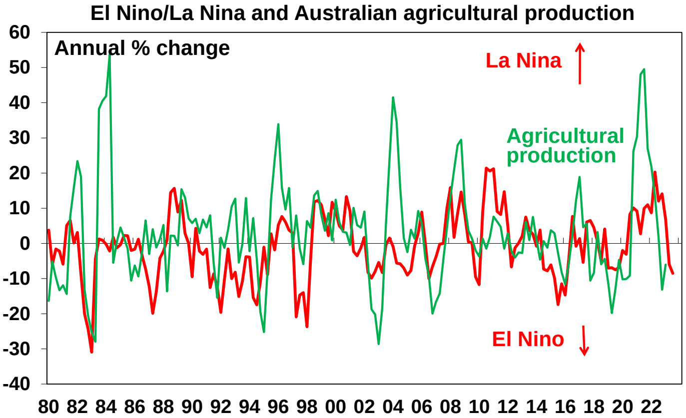
Extreme weather events can cause disruptions to food production and supply leading to volatility in food prices. While central banks usually look through spikes in prices, the events of the past few years have shown that temporary price changes can seep into numerous components of the supply chain. After large increases in food prices throughout 2021-22, food inflation is expected to slow further (see chart below).



Source: Macrobond, AMP

Australia's Bureau of Meteorology has issued an "El Niño" alert for spring which occurs when sea surface temperatures rise in the tropical Pacific. The impact of El Niño is varied around countries as it typically brings drought to western Pacific countries like Australia, rains on the coast of South America and storm to the central Pacific. A way to measure the intensity of air pressure changes which detects weather events like El Niño or La Niña is through a "Southern Oscillation Index" or SOI which measures air pressure differentials in the South Pacific. A higher SOI is associated with La Niña weather and higher agricultural production (because of an increase in rainfall) in Australia and a lower SOI occurs with El Niño and lower Australian agricultural production (because of drier conditions) - see the chart below. However, the impact on inflation is mixed. Usually, El Niño is associated with higher agricultural prices because of lower production but last year's La Niña high rainfall events also led to high inflation because of reduced supply, so the impact of weather changes is not clear-cut. However, there is a risk that El Niño leads to higher Australian agricultural prices over the next 3-6 months. For countries outside of Australia, the IMF found that El Niño also tends to be inflationary as non-fuel commodity prices rise, fuel prices increase (as coal and crude oil demand rises as there is lower output from hydroelectric power plants) and governments may decide to restrict supply of agricultural commodities.

El Nino/La Nina and Australian agricultural production



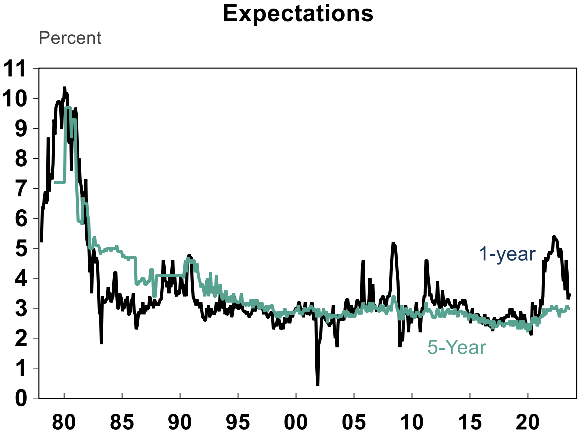
Source: Bloomberg, AMP

Beside these weather disruptions, many commodity prices have been increasing lately including gas, coal and oil prices which will add to higher near-term inflation.

Inflation expectations

US short-term inflation expectations have come down from their 2022 highs and medium-term inflation expectations are still well contained but have drifted higher over the past months (see chart below) and are around 3% - the top end of central bank's target range. Inflation expectations need to remain anchored to keep actual inflation contained.

US University of Michigan Consumer Inflation Expectations



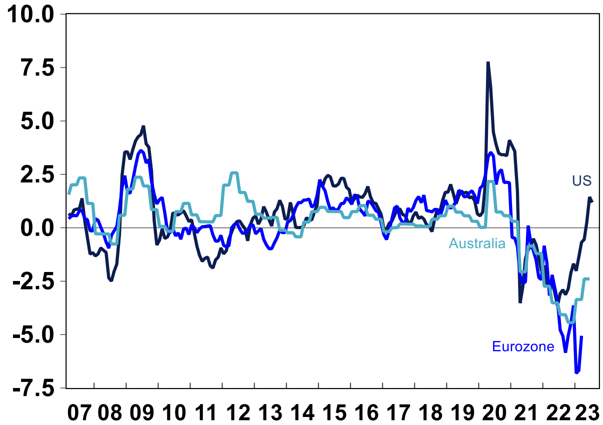
Source: Macrobond, AMP

Real wages and consumer confidence

The slowing in headline inflation has led to a rise in real wages growth (real wages is the difference between nominal wages and inflation) around the world – see the chart below (although real wages growth is still negative in Australia and the Eurozone). A rise in real wages means a lift in consumer purchasing power and could see consumers increase spending as purchasing power increases, which could lead to a rise in inflation again as consumer spending increases.

Global Real Wages

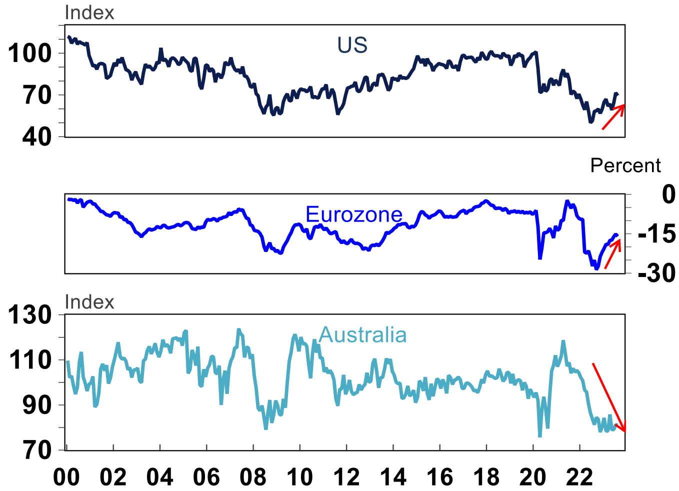
annual % change, wages - consumer price inflation



Source: Macrobond, AMP

The increase in real wages growth appears to have led to a rise in consumer confidence (see the chart below) in the US and Eurozone. Australian consumer confidence is still around record lows.

Global Consumer Confidence



Source: Macrobond, AMP

Implications for investors

Inflation could start surprising to the upside again in the near-term leading to renewed concern about further rate hikes, higher bond yields and the risk of a recession which would be negative for sharemarkets. While this is a risk, we still see inflation headed lower through 2023 and into 2024 due to the impacts of restrictive interest rates. But, it is worth watching the leading inflation indicators for signs of persistent upside inflation risks.

In the medium-long term, inflation is likely to be higher compared to its low average in the decade prior to COVID because of: the reversal of globalisation towards onshoring/friend shoring, bigger governments and more intervention in sectors, an increase in government defence spending leading to bigger budgets, a decrease in the working age population and an increase in the dependency ratio and the impacts of climate change. There may be some offset from productivity improvements related to technology (and more specifically artificial intelligence) which could help to keep inflation down.

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