Global Macro Views – Disinflation in the US and Euro Zone

December 22, 2022

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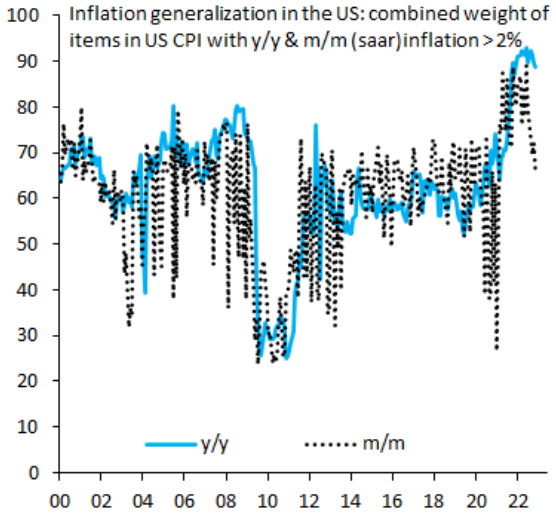
- We have been flagging a US disinflation dynamic since this summer.
- That's when inflation among CPI components became less broad-based, …
- which ended up leading the turn in core CPI inflation by about half a year.
- There are first signs a similar dynamic is now playing out in the Euro zone.
- Our month-over-month inflation generalization index has declined sharply, …
- as price increases for energy-sensitive components in the HICP start to slow.
- A turn in Euro zone inflation is coming. The ECB needs a dovish pivot.

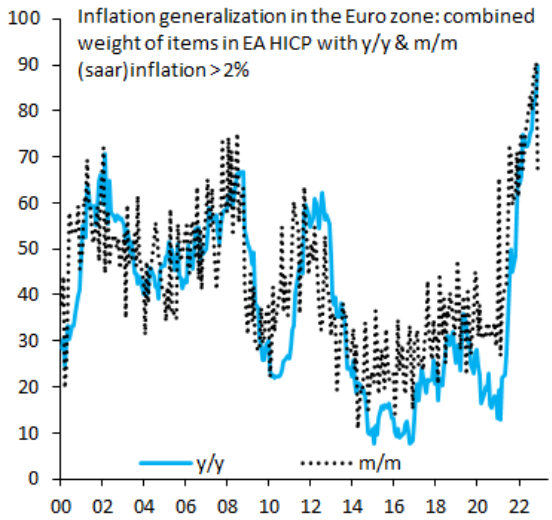
This summer we started banging the drum that US inflation was turning. That view was based on a close tracking of how broadly represented high inflation is among individual CPI components. From mid-2022, the combined weight of items with month-over-month inflation above two percent on an annualized basis started to fall sharply, a shift that led the more recent turn in core CPI inflation by about half a year. We are now seeing first signs of a similar shift in HICP inflation for the Euro zone. November saw a large drop in the combined weight of items with month-over-month inflation above two percent, as energy-sensitive items registered smaller price increases. Given our bearish view on Euro zone GDP, we think disinflation in the Euro zone will come faster than in the US. As a result, it is high time for the ECB to make a dovish pivot or else it risks tightening into a strong disinflation dynamic.

Exhibit 1: US inflation became less generalized this summer, …



Source: Haver, IIF

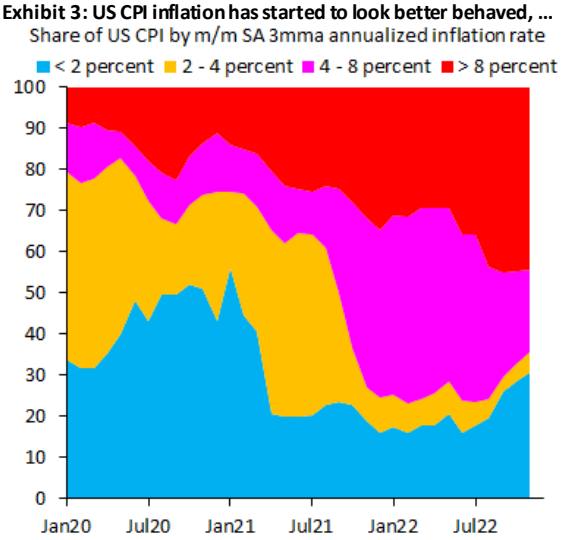
Exhibit 2: … and something similar may be happening in Europe.



Source: Haver, IIF

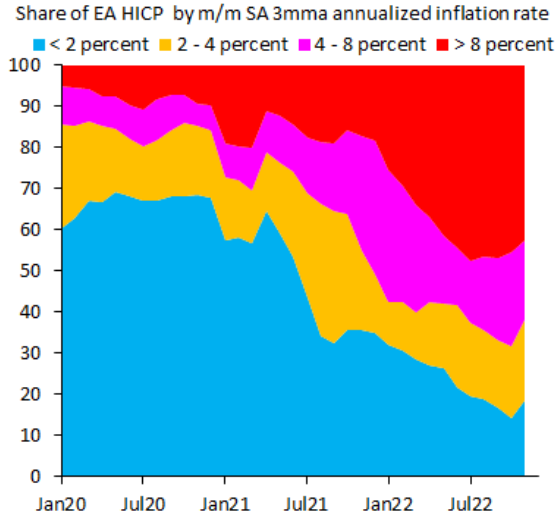
Typically, inflation generalization indices track the combined weight of items in the CPI that have year-over-year inflation above two percent. The use of year-over-year inflation means that these indices tend to lag high-frequency developments in inflation. As a result, we construct similar indices based on month-over-month inflation rates that are seasonally adjusted and annualized. Exhibit 1 shows these two metrics for the US CPI, underscoring just how sharply the month-over-month metric has diverged from the year-over-year one. The fall in our month-over-month index led the fall in core CPI inflation by half a year and we are now seeing a similar dynamic for the Euro zone. Exhibit 2 shows that inflation generalization on a month-over-month basis fell sharply in November, pulled lower as price increases for energy-intensive items in the HICP slowed. This signal is – admittedly – at an early stage and Euro zone inflation is still a lot more broad-based than in the US as Exhibits 3 and 4 show. However, given our bearish view on Euro zone GDP over the coming year, we expect the disinflation process to be more rapid than in the US.

Exhibit 3: US CPI inflation has started to look better behaved, …



Source: Haver, IIF

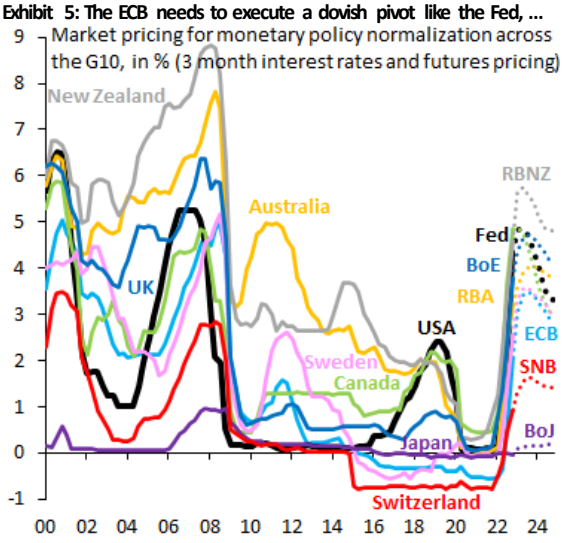
Exhibit 4: … while it's still early days in that regard for Europe.



Source: Haver, IIF

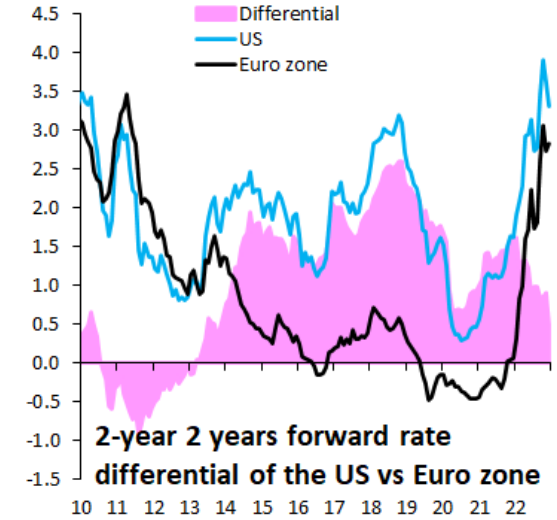
This means the ECB needs a dovish pivot of the kind the Fed recently executed. Markets currently price a bigger hiking cycle for the ECB than the Fed if you combine actual hikes that have already occurred plus hikes that are priced through 2024. In fact, looking across the G10, only Australia, New Zealand and the UK have hiking cycles that exceed the ECB at this point (Exhibit 5). The coming turn in Euro zone inflation means this isn't warranted, which means that ECB communication needs to shift if it wants to prevent tightening into this disinflation shift. That also means that the Euro will give back some of its recent gains against the US Dollar, which have come as markets have cut the terminal rate for the Fed even as they kept it roughly unchanged for the ECB (Exhibit 6). A return to Euro weakness will help the Euro zone digest the large competitiveness shock that is underway.

Exhibit 5: The ECB needs to execute a dovish pivot like the Fed, …



Source: Haver, IIF

Exhibit 6: … if it wants to avoid overtightening and deep recession.



Source: Haver, IIF