The Core Inflation Issue

Not surprisingly, the first drop in the annual rate of Eurozone inflation in 17 months to 10.0% in November from 10.6% in October has got a lot of attention. It follows a similar fall in US CPI inflation to 7.7% in October from 8.2% in September, moving it further below the high of 9.1% hit in June.

With oil prices declining to below $90 a barrel, down from over $120 in June, wholesale gas prices well off their summer peak and wholesale electricity prices falling sharply recently, we may well be past the peak in inflation. The Eurozone HICP rate could accelerate again in December, but it can be expected to fall sharply from early 2023 on positive basis effects as large monthly rises in 2022 drop out of the annual rate.

That is not to sound the all clear. The recent decline in headline inflation has been driven by falling energy prices. A fresh surge in gas prices in Europe next year cannot be ruled out if supply shortages emerge. Meantime, food price inflation continues to accelerate with the food, alcohol & tobacco sub-component of the Eurozone HICP rising by 1.3% in November, pushing the annual rate up from 12.4% to 13.6%.

In the US, food prices rose by 0.7% in October with the annual rate accelerating to 10.9%. Thus, there continues to be marked upward pressures on retail food prices. It is encouraging, though, that food commodity prices have fallen back sharply since mid-year, which should eventually see CPI food price inflation moderate considerably.

Energy and food prices are the two most volatile components of consumer prices. Thus, considerable attention is put on core measures of inflation which exclude these two less stable categories. Core inflation could prove much stickier than headline and be slower to fall back. The HICP rate, excluding food, energy, alcohol and tobacco, was unchanged at 5% in November in the Eurozone.

In the US, the Fed's preferred measure of core inflation, core PCE, has been generally stuck in a 4.9-5.1% range since April, coming in at 5% in October. In this regard, Fed Chair Powell has highlighted that the continuing tight labour market could presage a long period where inflation remains elevated and responds only slowly to a restrictive monetary policy.

The ECB is projecting, though, that both headline and core Eurozone inflation will decelerate to an average of 2.3% in 2024. Meanwhile, the Bank of England sees UK inflation falling well below its 2% target by end 2024. By contrast, the latest OECD forecasts are that inflation in the Eurozone and UK could still be running at close to 3% by late 2024.

Markets don't seem overly convinced that inflation will fall back to its 2% target in the foreseeable future. The OECD is forecasting very weak growth, with recession in some economies, for 2023-24. This should see monetary policy turn accommodative.

However, futures contracts are pricing in that interest rates will be around 3.25% in the US, 3.75% in the UK, 2.25% in the Eurozone at end 2024. Given the weak economic outlook, rates would be expected to be much lower, if inflation has been vanquished in two years' time. It suggests markets think inflation will prove quite sticky.

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