

## Flash Note

# Europe chart of the week – inflation

### Peak headline inflation?

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The euro area flash HICP report came in on the softer side of expectations, with both headline and core inflation falling by 0.1 percentage point in August, to 2.0% and 1.0%, respectively.

The support from non-core components of euro area inflation may have peaked during summer months, including energy and food prices, unless oil prices in EUR terms rebound more substantially.

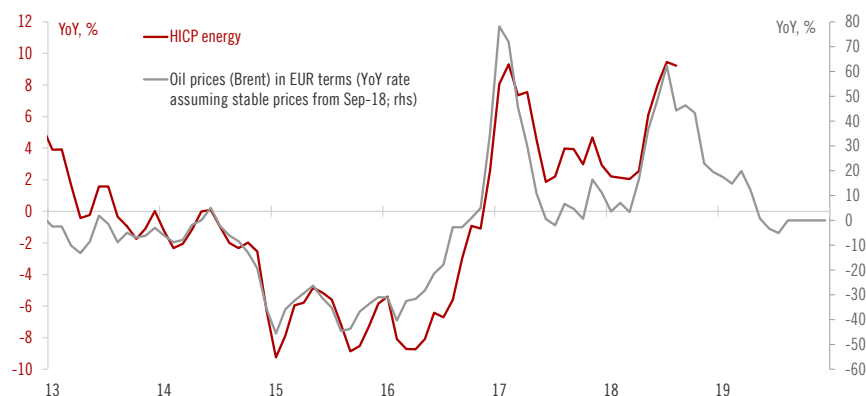
Our ECB scenario remains unchanged, with an end to net asset purchases in December 2018 and a first 15bp hike in the deposit facility rate in September 2019 expected. However, until we see a larger and more sustained rebound in core inflation, the balance of risk will remain tilted towards a delayed normalisation process.

Although the ECB's mandate is defined in terms of headline inflation (targeting an annual rate of "below, but close to 2%" over the medium-term), over the past few years, the central bank has been mainly focused on *underlying* consumer price dynamics, including core inflation. Looking forward, there are reasons to believe that changes in *headline* inflation will gain importance as we move closer to policy normalisation. In particular, there is evidence that the pick-up in wage growth, which is fuelling the ECB's optimism over the medium-term outlook for price stability, has been driven by higher inflation based on backward-looking expectations.

Unfortunately, it looks like the support from higher energy prices could be fading again. Our chart below suggests that **HICP energy inflation is likely to have peaked in July (at 9.5% YoY) unless oil prices rebound and/or the EUR/USD exchange rate depreciates more substantially**. Meanwhile, food inflation has eased somewhat in recent months.

This leaves the burden on core prices for services and non-energy goods to sustain higher inflation rates close to 2% over the medium-term. We estimate that ECB staff projections are consistent with core HICP rising from 1% today to about 1.3% in Q4 2018, before accelerating to above 1.5% over the course of 2019. However, following today's soft core HICP print of 0.96% YoY in August, **the risk is that the ECB staff will need to revise their projections for core inflation lower at the September meeting**, especially the 2019 median projection, which currently stands at an elevated 1.6%. While this should not prevent the ECB from ending QE net asset purchases in December 2018, it may increase the risk of a delayed normalisation process in 2019.

#### Euro area HICP energy inflation and oil prices



Source: Pictet WM – AA&MR, Eurostat, Bloomberg

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