21 September 2023

Global Markets Research

Research Alert

Flagging upside risks to inflation

War, protectionism, diseases and climate have and will send commodity prices up

Headline inflations have moderated; but CRB index and food inflation crept up in July

Every 1ppts increase in CRB or FAO index could increase world inflation by 0.05ppts

Impact of climate change, war, protectionism and diseases on food and energy prices

"My view is that it will be difficult to return to the earlier world in which inflation tracked in a very narrow range. The increased prevalence of supply shocks, deglobalisation, climate change, the energy transition and shifts in demographics mean either steeper supply curves or more variable supply curves. While this doesn't mean that the inflation target can't be achieved on average, it does mean that inflation is likely to be more variable around that target." – Closing remarks of ex-RBA Governor Philip Lowe

We could not agree more. Climate change, together with war, protectionism and diseases have and will continue to threaten food supply and boost global commodity prices. Already, we saw this during the periods of lockdown during the COVID-19 pandemic which saw a disruption in global supply chain, sending the FAO Price Index (FAO) spiralling upwards by 3.2% y/y in 2020 and 28.1% y/y in 2021 and world inflation accelerating from 3.2% y/y to 4.7% y/y for the same years. No doubt, Russia invasion of Ukraine has a larger impact on prices. In 2022, the FAO Price Index shot up by 14.2% y/y, while the CRY Index, which includes hard commodities like energy, spiked 35.5% y/y. World inflation jumped to 8.7% y/y in 2022 and is expected to stay elevated at 7.0% y/y for the whole of 2023 before moderating to 4.9% in 2024, based on IMF forecast.

Inflation has moderated globally; some central banks have dialled down expectations of further rate hikes

As it is, headline and core inflation rates have moderated globally as compared to the beginning of the year. Policy makers for some majors have started to dial back expectations for more rate hikes but others, like the ECB, continued to reiterate that inflation remains too high and thus, they are prepared to raise rates further and intend to hold policy at a restrictive level until they are confident that inflation is moving sustainably down towards their 2% target. RBA also pledged to do more if required despite assessment that inflation expectations had remained stable.

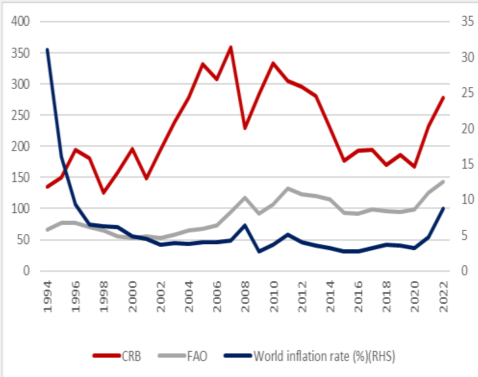
…but commodity prices are flaring up again

1. Brent have scaled to above $95/barrel as of the point of writing after OPEC+ leaders extended their crude oil production cuts
2. The FAO Food Price index rose by 1.5ppts in July largely driven by prices for vegetable and rice. The FAO Vegetable Oil Price Index jumped 12.1% m/m after Russia's decision to end implementation of the Black Sea Grain Initiative. The FAO All Rice Price Index increased 2.8% m/m after India's prohibition of non-parboiled Indica exports on 20 July. In fact, this index rose another 9.8% m/m in August, to its 15Y high and the United Nation warned that the latter raised food security concerns for the poorest countries and potentially exacerbate high domestic food inflation in many countries.
3. Over a longer term, impact from climate change which has resulted in and will continue to result in shortages and price hikes for soybeans, olive oil and rice.

Figure 1: Commodity prices have started to tick up in July

Source: Bloomberg, UN

Figure 2: Upside risks to world inflation, transient or permanent



Source: Bloomberg, IMF, UN

Highlights from the World Economic Forum's article entitled "Record temperatures are driving food prices higher. Here are some of the crops facing the biggest impacts" include:

- 160m hectares or 16.2% of wheat is at moderate to extreme risk of drought
- 97m hectares or 33.9% of soybean is at moderate to extreme risk of drought
- 134m hectares or 12.9% of maize is at moderate to extreme risk of drought. According to NASA, maize crop yields could be down 24% by 2030 as a result of climate change.

Our thoughts on how far rates can go and for how long

While one can argue that central bankers will largely focus on core prices in their monetary policy decision making, the volatile food and energy prices, be it transient or permanent, cannot be ignored as they account for a huge proportion of most household spending and will have a spillover/profiteering effect to general prices. This is already observed in the latest ECB monetary policy statement and decision, where rates were hiked amidst an upward revision in inflation outlook due to energy and not core.

Based on our simple calculation, it is also estimated that every 1ppt increase in the CRB or FAO index has increased world inflation rate by 0.05ppts each in the past 10 years (Correlation: 0.64 and 0.94) and +0.03 and +0.06ppts in the past 20 years. Our study also showed that in general, the impact is more prevalent for European economies. The negative impact in Japan, US and Canada could be due to the saving nature in Japan or that inflation could have been driven by other factors, like services in the US during the period of time.

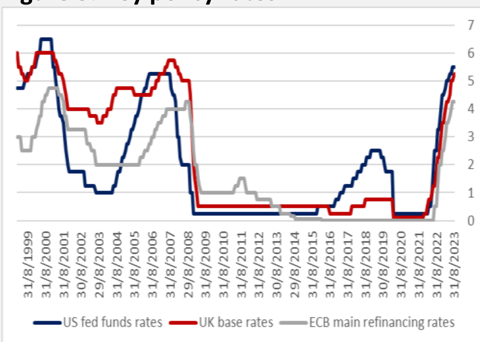
	Correlation between inflation rates & CRB, FAO		**Impact from 1ppts change in CRB, FAO on inflation rates**	
	CRB	**FAO**	**CRB**	**FAO**
Canada	0.54	0.78	0.04	-0.19
France	0.55	0.76	0.08	0.07
Germany	0.63	0.82	0.04	0.16
Italy	0.63	0.80	0.14	0.20
Japan	0.39	0.48	-0.03	-0.48
United Kingdom	0.66	0.80	0.02	0.22
United States	0.59	0.83	0.04	-0.03
Average	**0.57**	**0.75**	**0.05**	**-0.01**

Source: UN, Bloomberg, IMF, HLL Global Markets

As such, a "hawkish pause" is especially apt at this juncture and while we expect most central bank rates to have peaked or near peak at this cycle, we are also cognizance of the fact that policy rates have scaled higher peaks prior to this and a much lower inflation environment. While the ECB's main refinancing rate last peaked at 4.75% in 2000 and was typically left unchanged for 3 months, the Bank of England has brought the cash rate as high as 6.00% in February 2000 for 1 year, 7.50% in June 1998 for 4 months and even higher at 17.0% in 1980s. More importantly, the fed funds rate reached as high as 6.00% in Feb 1995 and 6.50% in May 2000 and was left unchanged on average of 5-8 months.

To conclude, we expect one more rate hike for the Fed to 5.50%-5.75% followed by a pause in 1H of 2024 and rate cuts in 2H of 2024. We expect ECB's main refinancing rates to have peaked at 4.50% and BOE to likely pause after hiking by another 25bps to 5.50% tonight.

Figure 3: Key policy rates



Source: Bloomberg

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