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Briefing note

Headline inflation falls, but its decline disappoints

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Key messages:

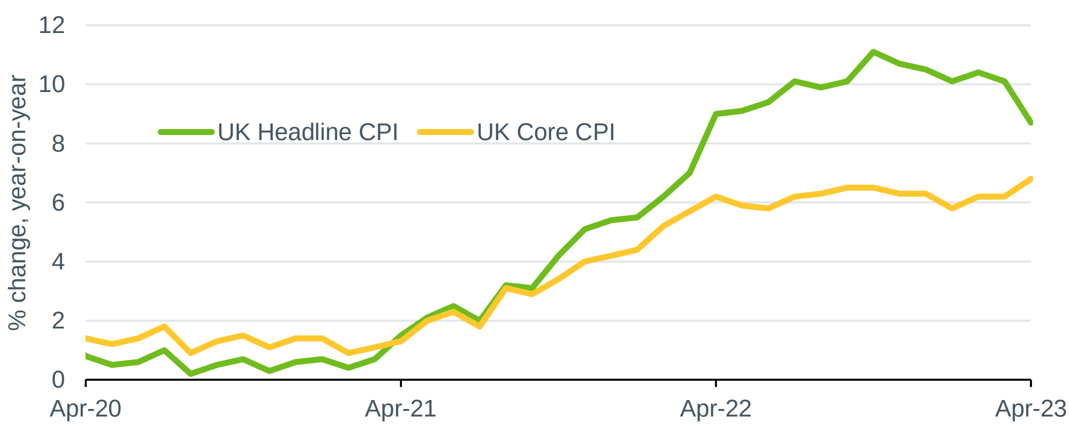
- Despite some positivity around a decline in headline UK CPI inflation, April's inflation release was disappointing.
- As anticipated, headline inflation is falling and is expected to continue to do so.
- However, ongoing pressures on core inflation mean there is far more uncertainty around how fast inflation will fall and where it will settle.

Despite some positivity around a decline in headline UK CPI inflation, April's inflation release made for some pretty ugly reading.

As anticipated, headline inflation is falling and is expected to continue to do so. However, ongoing pressures on core inflation mean there's far more uncertainty around how fast inflation will fall and where it will settle.

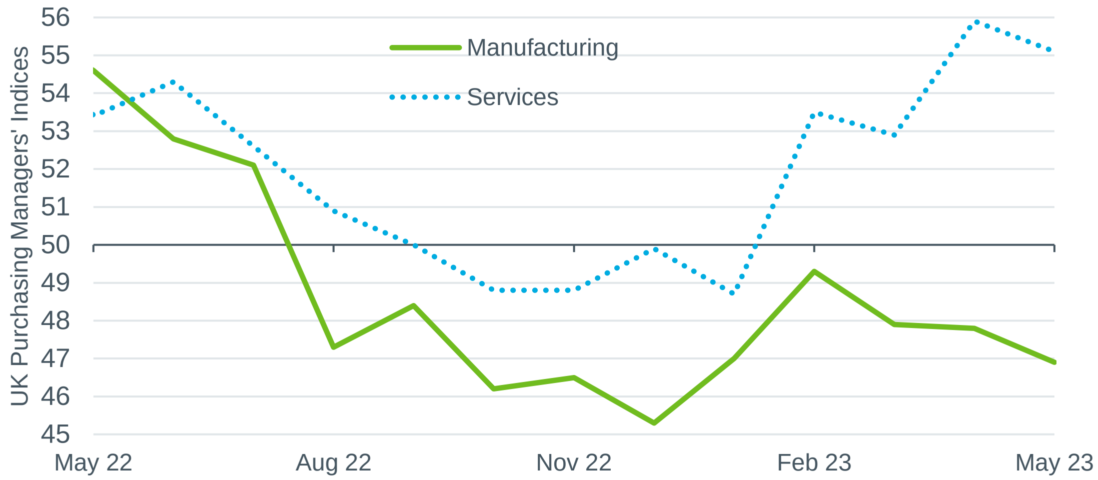
While headline UK CPI inflation fell from 10.1% year-on-year in March to 8.7% year-on-year in April, it did so less than markets or the Bank of England had expected. The large step down in broader energy inflation, which contributed around 1.4% to the fall in year-on-year headline inflation, was always expected to come through in the April data. Food and non-alcoholic beverages, which advanced 19.1% year-on-year in April, were a strong contributor to the higher-than-expected headline reading. Of more concern to central banks, and the key piece of information in the April release, is the year-on-year core CPI inflation, which excludes volatile energy and food prices. It accelerated from 6.2% to 6.8% (Chart 1).

Chart 1: Headline CPI is falling but core CPI is still rising



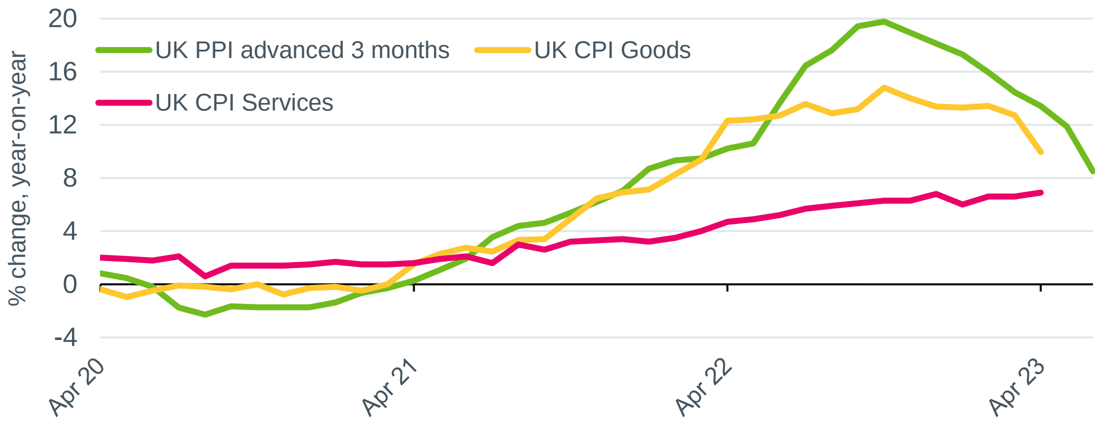
Not only have recent growth and inflation data exceeded expectations, May's flash Purchasing Managers' Indices suggest that growth remained solid in May. While there's a stark divergence between surging demand in the services sector and an ongoing downturn in the manufacturing sector (Chart 2) as the post-pandemic shift from goods to services continues, robust service sector demand is likely to hamper efforts to control inflation.

Chart 2: Service providers are struggling to meet demand while spending is diverted away from goods to services, weighing on demand in the manufacturing sector



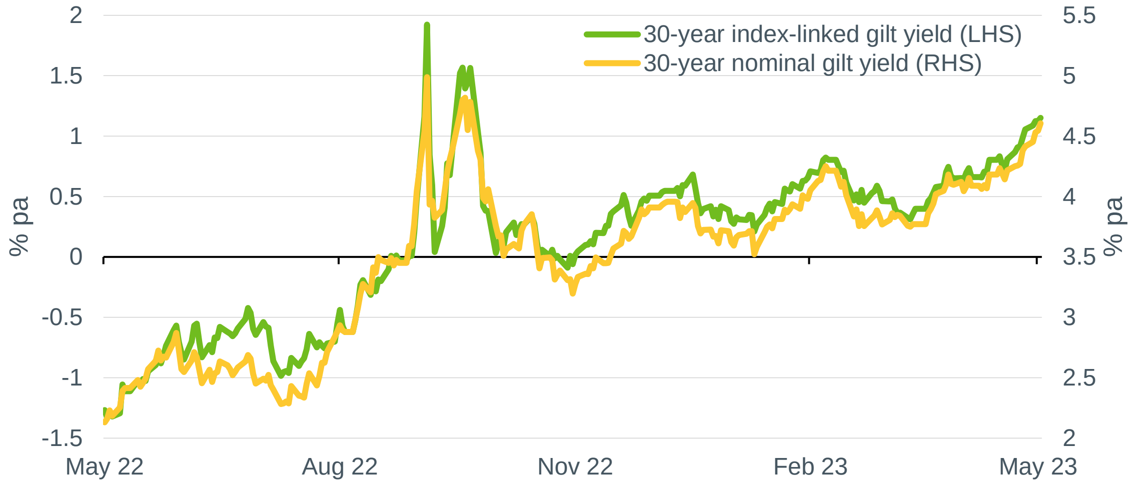
Goods price inflation continues to decline as supply chains improve, but prices in the services sector are showing no sign of abating, with tight labour markets contributing to rising input and output costs. Since the service sector is far more labour-intensive, services play a particularly significant role in the core inflation rate upon which central banks are focused. The ongoing decline in UK producer price inflation suggests recent falls in goods CPI will be sustained (Chart 3), but year-on-year wage growth at around 7% points to ongoing pressure on core inflation. That means greater uncertainty around the extent of the potential fall in inflation and where it will settle.

Chart 3: Falling producer price inflation augurs well for a further fall in goods inflation, but strong wage growth introduces greater uncertainty to the path of services inflation



April's inflation disappointment will have no doubt added to recent upwards pressure on yields. This will have compounded the impact of US debt ceiling concerns, accelerating gilt sales by the Bank of England (quantitative tightening), heavy gilt supply to finance wide budget deficits, and recent messaging from the Bank of England on its recent shortcomings. These include the fight against inflation and the suggestion that the UK is indeed in the midst of a wage-price spiral. As of the morning of 25 May, 30-year index-linked gilt yields were up 0.8% pa over the quarter and 0.6% pa year-to-date. Equivalent nominal gilt yields were up 0.8% pa and 0.7% pa over the same respective periods (Chart 4). Implied inflation, as measured by the difference between nominal and index-linked gilts of the same maturity, has fallen more at shorter terms, given larger relative rises in real yields.

Chart 4: real and nominal yields have risen back towards levels seen in the wake of ill-fated "mini budget" in the autumn of 2022



A lot of monetary tightening has already been delivered, the lagged impact of which will increasingly weigh on economic activity going forward. Despite this, recent inflation releases, and in particular measures of underlying domestic-driven inflation, suggest the Bank of England may have to do more, rather than less. These inflation concerns, and the challenging technical backdrop, suggest we are in for a further period of yield volatility in the near term. Yields do look elevated relative to longer-term fair value, and it would not be surprising to see yields decline as concerns eventually move back from inflation towards growth. However, it looks like a significant decline in economic activity may be required for this to happen.

If you have any questions on anything covered in this Briefing Note, please get in touch.