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InflationWatch

August 2024

In the wake of the Covid-19 pandemic, inflation rose further and for longer than most market participants expected in many countries, including the UK. Expansive monetary policy and fiscal stimulus, disruption to supply chains and a shift in demand from services to goods during the pandemic all placed upwards pressure on inflation. The Russia-Ukraine conflict, and the global supply-shock emanating from it, exacerbated these price pressures.

Headline inflation has fallen significantly since its peak in October 2022, as supply-side disruptions have eased and tighter monetary policy has taken effect, but underlying measures of inflation still point to stubbornness in price pressures.

We introduced InflationWatch to help our clients assess the outlook for inflation. We include an update on the latest position, consensus forecasts on future inflation rates, and our view on where the balance of risks to the outlook for inflation and interest rates lies.

We focus on the UK and the outlook over the next 2–3 years. Our primary measure of inflation is the change, year on year, in the headline Consumer Price Index (CPI). But inflation in a modern, open economy is determined by a complex set of macroeconomic factors including aggregate demand, input costs, inflation expectations and monetary policy.

Highlights this quarter:

- Headline CPI fell to the Bank of England's (BoE) 2% target for the first time in almost three years in May, remaining there in June. However, inflation is expected to pick up slightly in the second half of 2024.
- Food, energy and non-energy industrial goods disinflation has run its course, with market participants' attention turning increasingly to domestic price pressures – those being strong wage growth and service-sector inflation.
- Amid progress against inflation, the BoE cut its base rate by 0.25% pa from a 16-year high to 5.0% pa in August. However, we expect the BoE to tread cautiously and focus on slowly reducing rates to less restrictive levels.

The story to date

UK year-on-year headline CPI inflation declined meaningfully over the second quarter of 2024, returning to the BoE's 2% target for the first time in almost three years. The global shocks that drove up UK inflation have mostly unwound, with almost all of the fall in inflation since its October 2022 peak of 11.1% accounted for by food, energy and non-energy industrial goods.

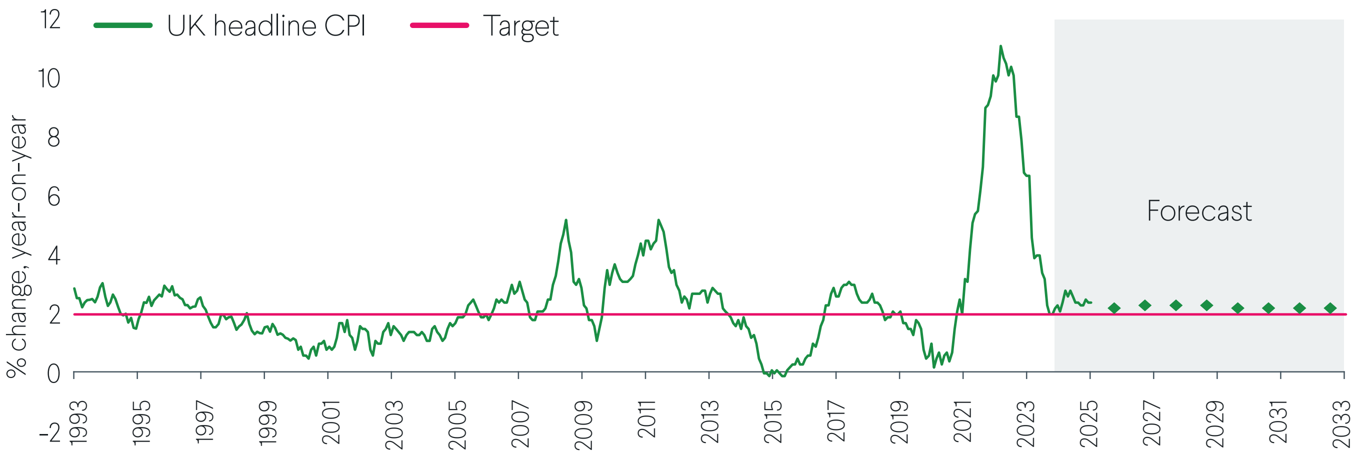
As the disinflationary effect from non-core CPI components dissipates, it should reveal the persistence of domestic price pressures. Core CPI points to a degree of stickiness: despite also easing, it remained at 3.5% year-on-year in June, underpinned by strong wage and services inflation. Indeed, recent data reveal much-better-than-expected growth, with UK business surveys reporting that costs arising from transportation, IT, wages and supplier fees all contributed to elevated price pressures. While input and output prices across the manufacturing and services sectors generally continue to ease, they remain elevated, and are doing so only gradually.

Amid progress against inflation, market-implied interest rates fell in July, with the market fully expecting at least two 0.25% pa cuts in 2024. The BoE subsequently delivered on the first of these expected rate cuts on 1 August, as it lowered interest rates by 0.25% pa from a 16-year high of 5.25% pa. The BoE struck a cautious tone after its decision, as it expects inflation to pick up over the second half of 2024. We expect the central bank to proceed cautiously and focus on reducing interest rates slowly to less restrictive levels.

What's the situation today?

Annual CPI inflation fell to the BoE's 2% target in May and remained there in June. However, headline CPI inflation is expected to pick up and remain slightly above target, on average, over the long term.

CPI inflation rate forecast



Source: DataStream, short-terms CS forecasts are of July 2024 and long-term CS forecasts as of April 2024

- Headline year-on-year CPI slowed meaningfully, returning to the BoE's 2% target for the first time in three years in May, and remained unchanged in June.
- However, this decline was slightly smaller than expected in each of the three months and is largely due to falling energy prices and their interaction with the Ofgem price cap. The largest upward contribution to the change in annual CPI rate between May and June came from restaurants and hotels.
- Core CPI, which excludes volatile energy and food items, rose by 3.5% in the year to June, unchanged from the prior month and well below its recent high of 7.1% in the year to May 2023. However, at 3.5% year-on-year, it still points to underlying domestic price pressures.
- Consensus forecasts expect inflation to rise modestly above the BoE's 2% target in the second half of the year, to an average annual pace of 2.2% and 2.5% in Q3 and Q4, respectively, before slowing in 2025.
- Medium- to long-term consensus expectations are for UK headline inflation to remain slightly above the BoE's 2% target, on average. Economists point to a range of plausible reasons why this might be the case, including more persistent labour shortages, a greater prevalence of supply shocks, diminishing returns from globalisation, the transition to net zero, and looser fiscal policy than in the period after the global financial crisis (GFC).

Outlook indicators

Driver		Metric	Latest	-3m	median/ neutral
Inflation		UK headline CPI, % y-o-y	2.0	3.2	2.0
		UK core CPI, % y-o-y	3.5	4.2	1.7
Aggregate demand		Quarterly UK GDP growth, % y-o-y (consensus for Q1 24)	0.9	0.3	1.5
Input costs	Goods	UK PPI, % y-o-y	1.4	0.7	2.3
	Energy	Gas prices, £/MMBTU, % y-o-y	-14.5	-54.1	1.4
	Energy	Oil prices $/barrel, % y-o-y	16.0	9.6	3.8
	Labour	UK unemployment rate (%)	4.4	4.3	5.4
	Labour	Average weekly earnings, 3-month average, % y-o-y	5.7	6.0	3.2
	Labour	UK vacancies (index, average = 100)	128	133	100
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	1.2	4.6	0.0
Expectations	Consensus forecast	UK headline CPI in 18 months' time, % y-o-y	2.0	2.3	2.0
	Consensus forecast	UK GDP growth in 18 months, % y-o-y	1.2	1.0	1.5
	Market-implied inflation	UK 5y spot inflation in 5y time, % pa	3.4	3.4	2.5
	Inflation surprises	UK Citigroup inflation surprises, › 0 = upside surprise	22	18	0
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	0.8	0.1	5.9
	Current interest rates	Base rate % pa	5.3	5.3	3.8
	Market-implied interest rates	UK overnight index swaps, % pa in 24 months	3.7	3.7	3.8

Source: DataStream, Bloomberg, Bank of England, Consensus Economics. The data are to 31 June 2024. The -3 months columns shows the data three months earlier, ie March 2024

In our dashboard, above, you'll find the end-June reading for each indicator, except for UK vacancies and average weekly earnings, which are as at end-May, alongside the reading three months ago. We compare them with the long-term median, or assessed neutral, value. The tone of the colour indicates the strength of the signal. A darker tone indicates either a stronger inflationary or disinflationary signal, depending on whether red or blue, respectively.

Highlights

Headline CPI inflation registered a meaningful decline over the second quarter, returning to the BoE's 2% target for the first time in almost three years in May, and remained there in June. However, consensus forecasts had inflation coming in slightly below target.

Economists expect inflation to rise modestly over the next few months, averaging 2.4% year-on-year in the second half of 2024, before easing back to 2.3% in 2025.

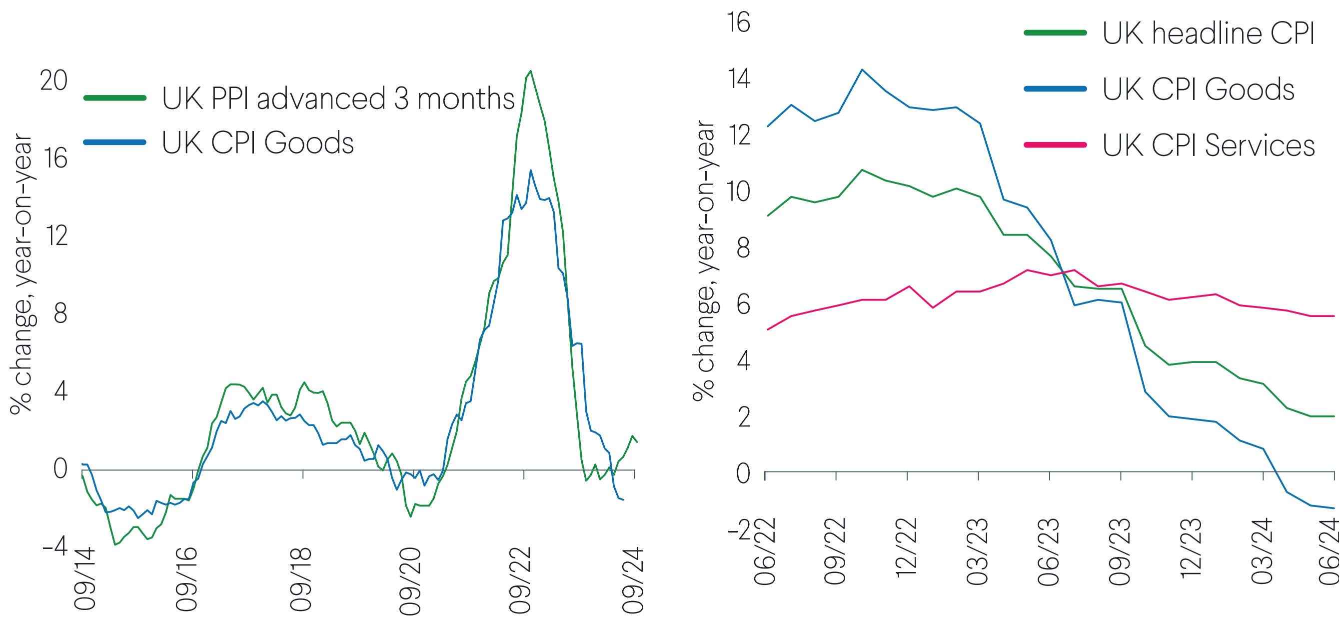
Annual producer price inflation (PPI) has picked up in recent months, albeit from a very low base. This increase has coincided with better-than-expected second-quarter growth and business activity data. Purchasing managers' indices (PMI) surveys have reported wage increases, shipping costs and raw materials prices as contributing to elevated price pressures. We explore this in more detail in our focus charts below.

Gas prices are still lower year-on-year, but easing utility price deflation is likely to become an upwards contributor to July's inflation, as Ofgem cut the price cap less than in July 2023. Furthermore, the change in oil prices remains positive year-on-year.

While core CPI, which excludes volatile and food prices, has also eased, it remains above both the headline measure and the BoE's target.

The unemployment rate has risen slightly, and vacancies have continued to normalise, but the enduring strength of the labour market is highlighted by still-strong average weekly earnings growth, which was running at a year-on-year pace of 5.7% in the three months to end-May.

Focus Chart: Goods price disinflation looks to have run its course, while service-sector inflation is easing more slowly



Source: Bloomberg

When advanced by three months, PPI has proved to be a useful leading indicator of consumer goods inflation. Since peaking in October 2022, it's been in freefall, dipping below zero a year later. However, PPI has picked up in recent months. This rise, albeit from low levels, might feed through to CPI goods inflation in the coming months. At the same time, year-on-year wage growth remains strong. This suggests services inflation will remain sticky, while goods price disinflation has largely run its course. Indeed, these dynamics go some way towards explaining why headline inflation is forecast to rise again in the second half of 2024.

The BoE lowered its base rate from a 16-year high of 5.25% pa, to 5.0% pa, on 1 August. Amid progress against inflation, expectations of a rate cut rose, which the BoE subsequently delivered on at its meeting. Despite the rate cut, monetary policy remains restrictive. Given the falls in inflation, monetary policy continued to tighten throughout 2024 as real rates rose, despite base rates being held constant.

The decision to lower interest rates was a tight one, with Monetary Policy Committee (MPC) members voting 5:4 in favour of the rate cut. The BoE struck a cautious tone after its decision, as it expects inflation to pick up slightly over the second half of this year before easing in 2025. As disinflation from non-core components dissipates, attention will increasingly turn to domestic inflationary pressures. At the time of writing, markets expect at least one more 0.25% pa rate cut by the end of the year.

Our view

Headline CPI has slowed meaningfully over the second quarter, returning to the BoE's 2% target for the first time in almost three years after reaching a peak of 11.1% on October 2022. Almost all of this decline is owed to energy, food and non-energy industrial goods disinflation. As these effects fall out of the annual CPI calculation, further declines in inflation will become reliant on an easing in underlying domestic inflation pressures.

Wage growth, and hence service-sector inflation, should continue to ease, albeit slowly, as wage negotiations take place in the context of a lower-inflation environment. However, still-elevated levels of realised wage growth, service-sector and core inflation, as well as better-than-expected growth are likely to influence the BoE to take a cautious approach to further cuts.

Nonetheless, lowering rates doesn't necessarily mean adopting a stimulative stance – still elevated, but easing, underlying inflation pressures can be consistent with a gradual reduction in interest rates to slightly less restrictive levels.

Disinflationary factors such as demographics, technological innovation and globalisation are expected to temper inflation over the medium to long term. However, the risk of a switch to a regime of permanently higher inflation remains elevated. While we believe interest rates will decline from current levels, we don't foresee a longer-term return to the ultra-low-rate environment we saw after the GFC. We expect nominal interest rates to bear a closer relationship to real growth and inflation, and volatility to remain higher, in the coming decade than in the last.

If you'd like to discuss anything covered in this publication, please get in touch with your usual Hymans Robertson Consultant or one of our authors below.

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