HYMANS ROBERTSON

InflationWatch

November 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. However, 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 on inflation, consensus forecasts on future inflation rates, and our view on where the balance of risks lies in the outlook for inflation and interest rates.

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). 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 below the Bank of England's (BoE) 2% target in September, to 1.7%, after it rose slightly to 2.2% in July and August.
- Core inflation, which excludes volatile food and energy prices, has been falling more than the BoE expected but, alongside wage and service sector inflation, remains elevated.
- The Office for Budget Responsibility (OBR) expects a temporary rise in headline CPI from around 2% in Q3, to an average of 2.6% in 2025, driven by higher gas and electricity prices as well as the direct effect of the fiscal loosening in Rachel Reeves's 30 October budget.
- President-elect Trump's proposed tariffs and tax cuts have the potential to be stagflationary for the UK, assuming some retaliation by other countries. While the BoE would typically look through supply-side shocks, elevated inflation expectations are likely to prompt caution from the Monetary Policy Committee (MPC).
- The BoE cut rates by 0.25% pa at its August and November meetings, taking the bank rate to 4.75% pa.
- Materially positive real yields leave scope for the BoE to continue cutting. However, we expect it to do so gradually, given still-elevated core and wage inflation and the potential inflationary impact of the UK budget and US election.

The story to date

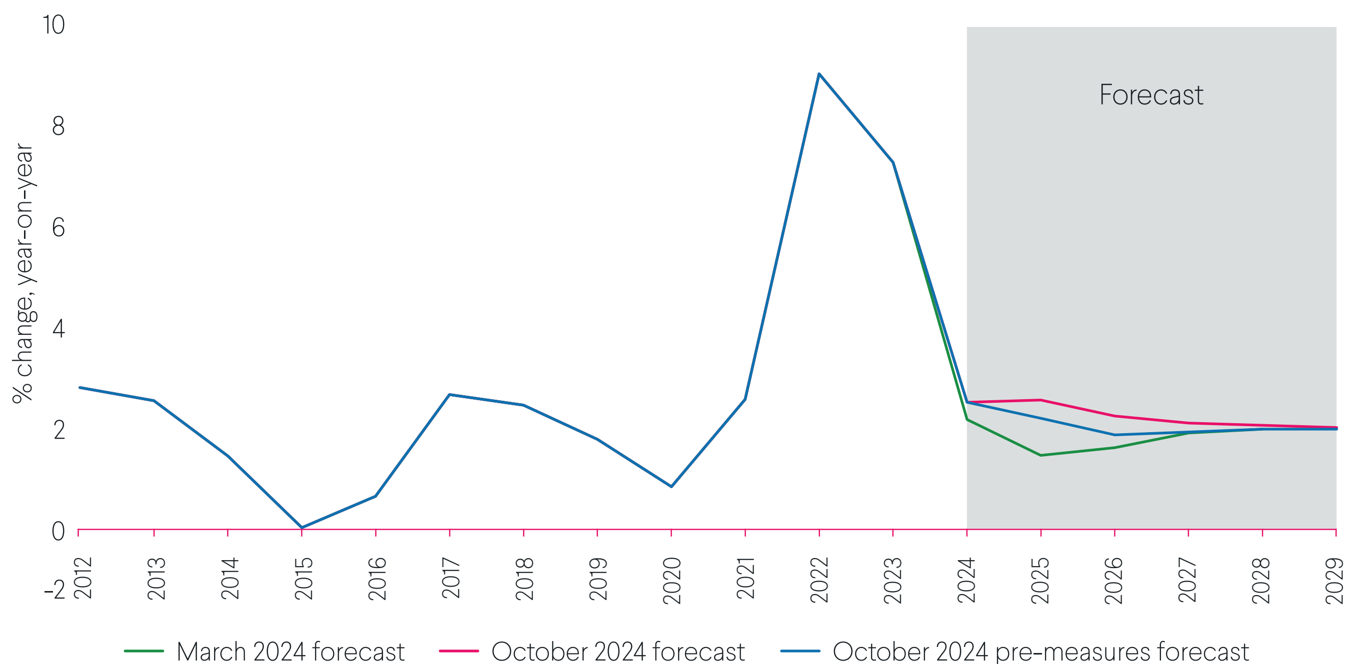
UK year-on-year headline CPI inflation came in at 1.7% in September, below market expectations and the BoE's 2% target. The latest headline reading is the lowest since April 2021 and precedes a slight increase to 2.2% in July and August from 2% in May and June.

The global shocks that drove up UK inflation have unwound, with food, energy and non-industrial goods prices disinflation accounting for almost all the fall in inflation since its peak of 11.1% in October 2022. Indeed, energy prices are expected to become a smaller drag on the headline measure.

Core CPI inflation, which strips out volatile energy and food prices, cooled to 3.2% year-on-year in September. Services CPI, which the MPC pays particular attention to because of the labour-intensive nature of the sector, surprised to the downside in September, easing to 4.9% from 5.6% in August – well below the BoE's forecast of 5.5%.

Chancellor Rachel Reeves's 30 October budget delivered a larger-than-expected increase in net spending and borrowing. Given the front-loaded nature of the spending, the OBR expects inflation will be 0.4% higher than would otherwise have been the case in 2025 and 2026, averaging 2.6% and 2.3% year-on-year, respectively **(Chart 1)**.

Chart 1: front-loaded nature of spending announced in the budget is expected to raise near-term inflation



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

Furthermore, while President-elect Trump's tariffs are likely to have a minor impact on UK GDP, the economy is exposed to imported inflation should countries retaliate, via rising costs and potential sterling weakness. While tariffs represent a supply-side shock the BoE would usually look through, already-elevated inflation expectations mean tariffs are likely to make the MPC more cautious about cutting rates.

Sustained disinflation encouraged the BoE to cut interest rates by 0.25% pa at its August and November meetings, taking the bank rate to 4.75% pa. Materially positive real yields and ongoing disinflation leave scope for the BoE to continue to cut rates. However, given still-elevated underlying inflation measures and the inflationary risks mentioned above, the MPC is likely to focus on bringing rates down gradually, to less restrictive levels, as opposed to adopting stimulative settings.

Outlook indicators

Driver		Metric	Latest	-3m	median/ neutral
Inflation		UK headline CPI, % y-o-y	1.7	2.0	2.0
		UK core CPI, % y-o-y	3.2	3.6	1.9
Aggregate demand		Quarterly UK GDP growth, % y-o-y (consensus for Q3 24)	1.2	0.7	1.5
Input costs	Goods	UK PPI, % y-o-y	-0.7	1.2	2.2
	Energy	Gas prices, £/MMBTU, % y-o-y	4.9	-14.5	1.6
	Energy	Oil prices $/barrel, % y-o-y	-24.6	16.0	3.8
	Labour	UK unemployment rate (%)	4.3	4.2	5.4
	Labour	Average weekly earnings, 3-month average, % y-o-y	4.8	5.4	3.3
	Labour	UK vacancies (index, average = 100)	119.7	125	100
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	6.3	1.2	0.0
Expectations	Consensus forecast	UK headline CPI in 18 months' time, % y-o-y	2.2	2.0	2.0
	Consensus forecast	UK GDP growth in 18 months, % y-o-y	1.3	1.4	1.5
	Market-implied inflation	UK 5y spot inflation in 5y time, % pa	3.3	3.4	2.5
	Inflation surprises	UK Citigroup inflation surprises, › 0 = upside surprise	-1	22	0
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	3.4	0.7	5.9
	Current interest rates	Base rate % pa	4.8	5.3	3.8
	Market-implied interest rates	UK overnight index swaps, % pa in 24 months	3.5	3.9	3.8

Source: DataStream, Bloomberg, Bank of England, Consensus Economics. The data are to 30 September with some exceptions. The -3 months columns shows the data three months earlier, ie June 2024.

In our dashboard, above, you'll find the end-September reading for each indicator, except for the current base rate, where we have shown the latest figure since the November MPC meeting, 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

The large fall in headline CPI inflation in September, to 1.7%, more than reversed the mild rises seen in June and August, meaning that inflation declined over the quarter.

Core CPI inflation also eased, thanks to cooling wage and service-sector inflation. However, at 3.2%, core inflation points to persistence in underlying domestic price pressures and, therefore, remains the focal point for the BoE. We explore the current state of the labour market and its implications for CPI below.

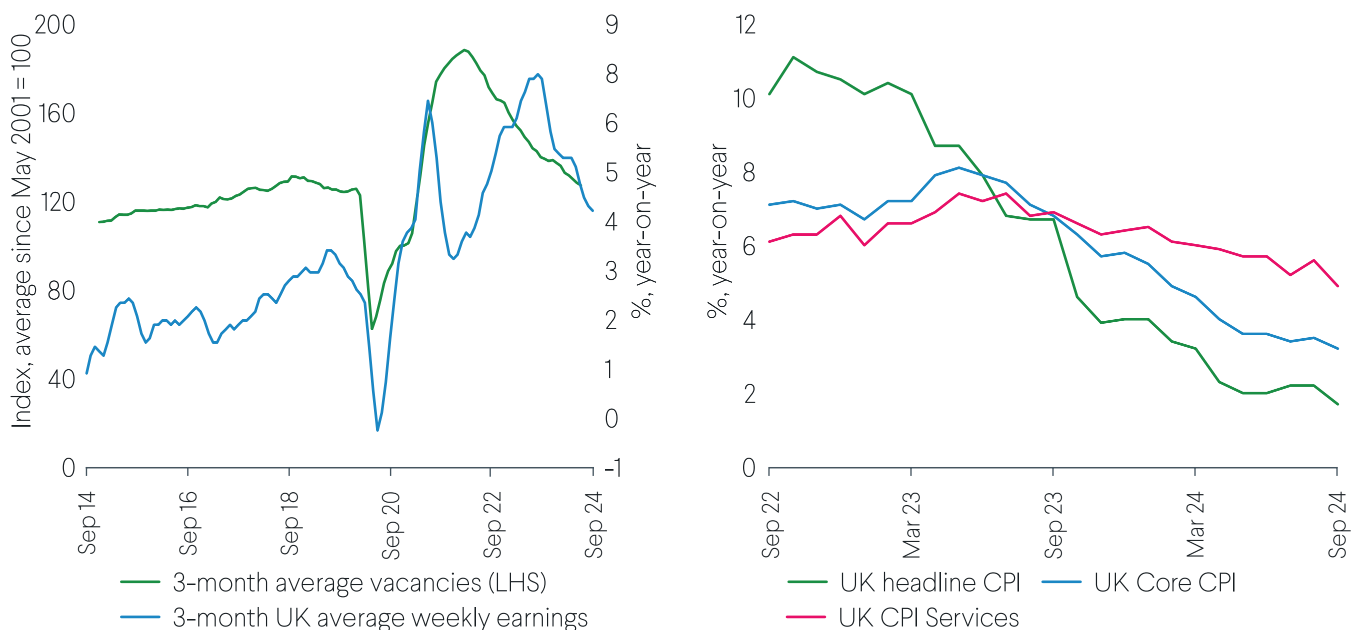
Annual producer price inflation (PPI) slowed in July and August, eventually turning negative in September. Indeed, the latest manufacturing PMI survey data showed that input and output price inflation eased, with the former slowing particularly sharply. This is important because, when advanced three months, PPI has proven to be an effective leading indicator for goods price inflation.

Gas prices rose year-on-year over Q3, feeding through to Ofgem's higher energy-price cap. Indeed, higher electricity and gas prices are part of the reason the OBR expects inflation to temporarily increase, to 2.6% year-on-year in 2025.

The trade-weighted sterling exchange rate strengthened over Q3, reflecting a more gradual path for rate cuts in the UK than in the US and eurozone. All else being equal, stronger sterling is positive for domestic inflation. When sterling appreciates, the costs of imported goods, like raw materials and fuel, decrease and can help to reduce production costs and lead to lower consumer prices.

There is evidence of gradual easing in the labour market, which is encouraging from an inflation perspective. The unemployment rate has risen to a still relatively low 4.3%, and the level of vacancies continues to normalise, indicating demand for workers is easing. Three-month average weekly earnings growth slowed to 4.8% year-on-year in September, down from 5.4% in June **(Chart 2)**. While wage growth has eased, it remains elevated – allowing for productivity growth of 1–1.5% pa, we suspect wage growth of 3.0–3.5% year-on-year would be more consistent with the BoE's 2% inflation target.

Charts 2 and 3: wage and service-sector inflation are easing but remain elevated



Source: Bloomberg

Furthermore, while inflation in the more labour-intensive service sector has eased from 5.4% year-on-year in June to 4.9% in September, it is also still running well above a level consistent with the BoE's target **(Chart 3)**.

The BoE cut the base rate from a 16-year high of 5.25% to 5.0% pa in August, subsequently cutting interest rates again, to 4.75% pa, in November. Despite the lowering of borrowing costs, real short rates, at 3.1% pa, are more than double the UK's forecast long-term real potential growth rate. This leaves scope for the BoE to reduce rates further to less restrictive levels.

However, while the labour market is continuing to ease gradually, it remains tight. This, alongside the inflationary risks associated with the UK's October budget and President-elect Trump's potential tariffs, means the MPC is likely to cut rates only gradually. Having said that, with the most recent overnight index swap rates (12 November at time of writing) expecting the base rate to be reduced 0.5% pa over the next 12 months, we would not be surprised to see a slightly faster pace. We expect between three and four 0.25% pa cuts in 2025.

Our view

Headline CPI returned to the BoE's 2% target in May but fell below it in September. Inflation reached a peak of 11.1% in October 2022, with food, energy and industrial goods disinflation accounting for almost all the decline. The OBR expects higher electricity and gas prices to contribute to inflation's rise towards the end of 2024, reaching an average 2.6% year-on-year in 2025.

Services CPI, while falling more than expected in September, is running above the BoE's target. Labour-market conditions are easing, albeit slowly and from tight levels. This ought to help alleviate service-sector inflation.

The OBR anticipates the measures announced in the Autumn Budget will add 0.4% to average year-on-year forecast inflation over 2025 and 2026. This development has caused the market, and forecasters, to scale back the number and pace of expected rate cuts in 2025.

We expect the BoE to proceed cautiously and reduce interest rates slowly to less restrictive levels. We stress that cutting nominal rates does not necessarily mean adopting a stimulative monetary stance. This is because real interest rates are materially positive. We expect the BoE to cut rates between three and four times in 2025, which is now slightly faster than the market expects (as of 12 November 2024).

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 inflation, and interest rates, will decline from current levels and conceivably undershoot their targets, we don't foresee a longer-term return to the ultra-low-rate environment we saw after the global financial crisis. 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 they did 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.

Chris Arcari
Head of Capital Markets
chris.arcari@hymans.co.uk

Robert Kotlar
Investment Research Analyst
robert.kotlar@hymans.co.uk

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