InflationWatch

Introduction

Since the pandemic, inflation has risen further and for longer than most market participants expected in many countries including the UK. Large monetary and fiscal stimulus, disruption to supply chains, and a re-orientation of demand from services to goods during the COVID-19 pandemic have all placed upwards pressure on inflation. This has latterly been exacerbated by the global supply-shock emanating from the Russia-Ukraine conflict and upwards pressure on wages from tight labour markets. How high will inflation go, and will it persist? Has the era of respectable growth rates and low inflation finally come to an end?

We have introduced "InflationWatch" to help clients assess the outlook for inflation, and we publish it quarterly. This paper provides:

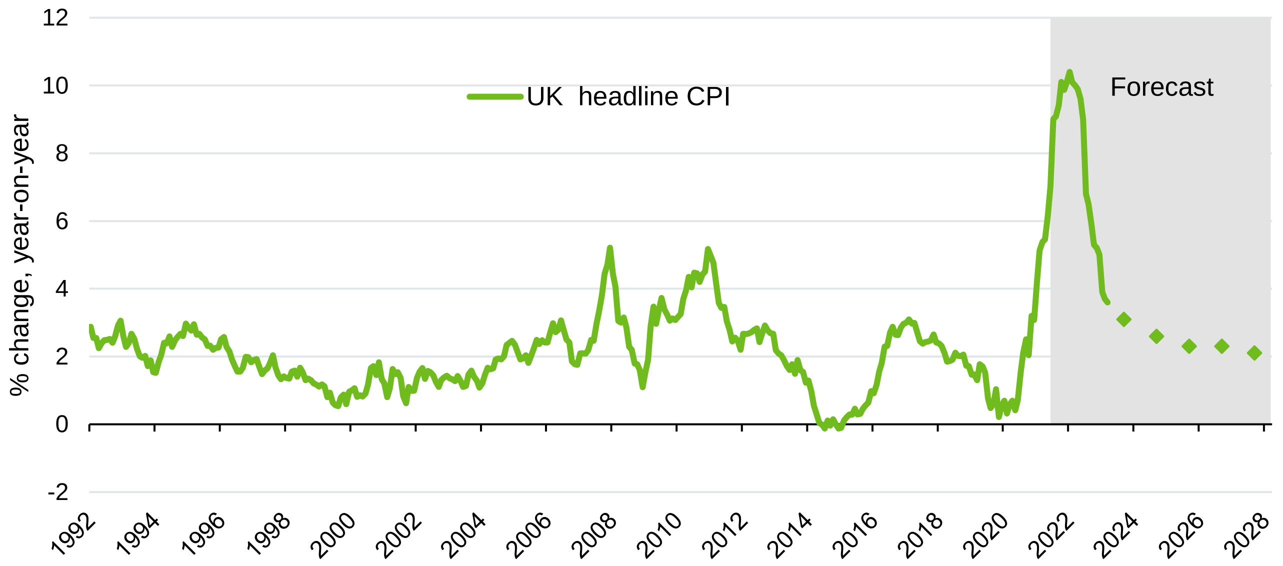
- An update on the latest position on inflation
- Consensus forecasts on future inflation rates
- Our view on whether the risks to the consensus view are tilted to the upside or downside.

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 stance. Further details of the indicators we use to track each factor are provided in the appendix.

Current Situation[1]

Annual CPI inflation rate is expected to fall sharply and then return to target over the course of this decade



- Headline UK CPI rose by 10.1% in the 12 months to September 2022, up from 9.9% in August and returning to July's level, which was the highest annual rate since inflation targets were introduced in 1992.

[1] Source: Datastream, consensus forecast as of June 2022

- Latest consensus forecasts inflation will peak at 10.4% year-on-year in October 2022 and will remain above 9.0% for the rest of the year, before moderating to 5.9% year-on-year by mid-2023 and then gradually fall back towards the 2% Bank of England target over the next 5 years.

Outlook indicators[2]

Driver		Metric	Latest	-3m	median/neutral
Inflation		UK headline CPI, % y-o-y	10.1	9.4	2.0
		UK core CPI, % y-o-y	6.5	5.8	1.7
Aggregate demand		UK GDP growth, % y-o-y	1.8	4.4	2.2
Input costs	Goods	UK PPI, % y-o-y	15.9	16.3	2.3
	Energy	Gas prices, £/MMBTU, % y-o-y	-28.6	56.0	5.3
	Energy	Oil prices $/barrel, % y-o-y	12.2	52.7	5.6
	Labour	UK unemployment rate (%)	3.5	3.6	5.5
	Labour	Average weekly earnings, 3-month average, % y-o-y	5.4	4.4	3.1
	Labour	UK vacancies (index, average = 100)	192.9	200.0	97.9
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	-4.0	0.3	0.1
Expectations	Consensus forecast	UK headline CPI in 18 months' time, % y-o-y	3.0	3.3	2.0
	Consensus forecast	UK GDP growth in 18 months, % y-o-y	0.8	0.9	2.2
	Market-implied inflation	UK 5y spot inflation in 5y time, % p.a.	3.8	3.6	2.3
	Inflation surprises	UK Citigroup inflation surprises, > 0 = upside surprise	75.0	114.7	4.8
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	11	11.2	2.1
	Current interest rates	Base rate % p.a.	2.25	1.25	3.0
	Market-implied interest rates	UK overnight index swaps, % p.a. in 24 months	5.7	2.6	3.0

The dashboard above shows the latest available reading for each indicator, and the reading 3 months ago, and compares 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:

- Year-on-year headline and core CPI inflation rates have risen further and remain very elevated. Recent sterling weakness will exacerbate imported inflation in the near-term.
- Unemployment rate for June to August 2022 decreased to 3.5%, the lowest since December to February 1974 and well below its long-term average level. In June to August, the number of unemployed people per vacancy fell to a record low of 0.9. Labour markets remain tight, placing greater upwards pressure on wages, with average weekly earnings rising 5.4% year-on-year.
- Year-on-year GDP growth is slowing and is no longer so obviously above trend. Growth forecasts are expected to fall below trend year-on-year in 18 months' time. The UK is forecast to enter a recession which should reduce aggregate demand and help to re-align supply and demand.
- The annual rate of producer price inflation (PPI) remains near record-highs but has slowed for the second consecutive month, perhaps alluding to a peak in PPI and, hence, consumer goods price inflation (see Focus Chart below).
- Commodity prices have eased off from their recent highs as global growth concerns weigh on the demand outlook. Gas prices fell from £27.4 per MMBTU in September 2021 to £19.5 per MMBTU in September 2022, a 29% decrease. Oil prices rose 12% year-on-year, a modest increase relative to recent very volatile history. While the government's Energy Price Guarantee will limit the near-term

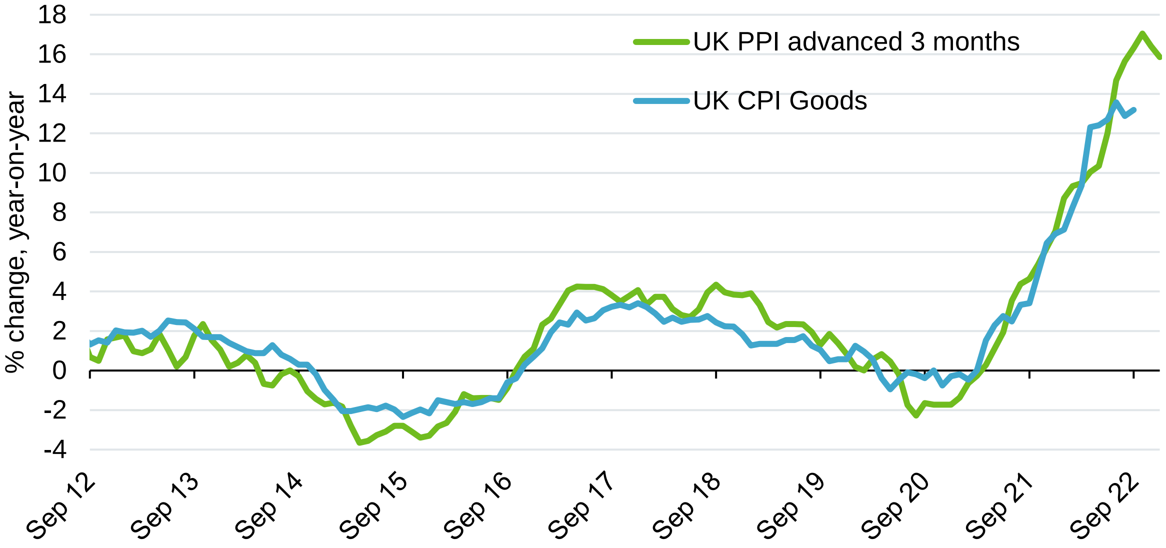
[2] Datastream, Bloomberg, Bank of England, Consensus Economics

peak in consumer price inflation, it could add further price pressures in the medium-term, by preserving consumers' disposable incomes.

- Expectations of higher inflation can be self-fulfilling. Inflation surprises have become less positive, but inflation still surprises to the upside.
- Growth in the money supply remains above longer-term levels and there remains a significant "overhang" from rapid expansion in the monetary base in 2020; this is typically inflationary.
- While the Bank of England base rate, currently 2.25% p.a., remains below our estimate of long-term neutral levels, monetary conditions have meaningfully tightened via interest rate expectations. Overnight index swaps suggest the Bank of England base rate will rise to very restrictive levels in 2023, which is already impacting activity via the mortgage and unsecured lending markets.

Focus Chart: UK producer prices index and CPI goods[3]

The faintest hint of a peak?



- PPI advanced 3 months is closely correlated with CPI for goods which suggests PPI is a good leading indicator of consumer price inflation. While PPI is currently much higher than its long-term average, if recent falls continue, we expect CPI goods inflation to follow suit in the coming months.

Our View

- Inflation is expected to remain high in the near-term before moderating sharply in 2023 and then gradually return to target over the next few years. Headline inflation pressures eased slightly, owing to commodity price declines and the energy price guarantee, but there is evidence of inflation pressures broadening out, with ongoing increases in core inflation and upwards pressure on wages.
- In contrast to our previous assessment, we think the near-term risks are perhaps more evenly balanced than before, but the risk of high inflation persisting for longer than consensus expects has increased, primarily driven by tight labour markets and ongoing inflationary wage rises. Interest rate expectations have eased back from recent highs, but still suggest policy rates will have to rise much further, and stay higher for longer, than 3 months ago. We think market pricing of interest rates is broadly reflective of the outlook.

[3] Source: Bloomberg, datastream

- Deflationary factors such as demographics, technological innovation and globalisation are expected to drive inflation down to its target level. However, we believe the probability of a switch to a regime of permanently higher inflation has increased.

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Appendix - Decoding Inflation Indicators

Driver	Metric	Interpretation
Aggregate demand	UK GDP growth, % year-on-year ("y-o-y")	GDP growth is the primary measure of economic activity (aggregate demand). Strong demand growth can be inflationary if there remains no surplus capacity in the economy.
Input costs – goods	UK Producer Price Inflation ("PPI"), % y-o-y	Measures the change in price of the goods and fuel purchased by UK manufacturers. Higher input prices feed through to consumer prices if manufacturers are able to pass cost increases through to consumers. PPI advanced 3 months is closely correlated with CPI for goods which suggests PPI is a good leading indicator of consumer price inflation.
Input costs – energy	UK Natural Gas Spot Price, £/MMBTU, % y-o-y Oil prices $/barrel, % y-o-y	Higher energy and fuel prices feed through to consumers directly in the price paid for energy and indirectly by increasing the price of goods purchased. Wholesale energy prices tend to be very volatile, and consumers are typically protected by energy price caps and/or fixed price contracts, but higher prices can have an impact on consumers if sustained.
Input costs – labour	UK unemployment rate, % UK average weekly earnings – 3m average, % y-o-y UK vacancies	The unemployment rate has little impact on input costs until it falls below a critical threshold. At that point labour costs can rise rapidly as firms compete to hire additional staff. The threshold has fallen in recent years as the UK labour market has become more flexible. Very high levels of vacancies are indicative of labour market tightness and are a leading indicator of wage rises as employers adjust pay to attract and retain staff.
Input costs – exchange rates	UK £ effective trade-weighted index, % y-o-y	A sharp devaluation in the currency feeds through to consumers in the price paid for imports and indirectly by increasing the price of goods purchased. The impact fades as consumers and firms substitute cheaper goods produced locally.

Expectations – consensus forecasts	UK headline CPI in 18-months, % y-o-y UK GDP growth in 18 months, % y-o-y	Increases in expected inflation can be self-fulfilling if individuals demand wage increases that reflect future prices rises and firms pass higher labour costs through to consumers (the "wage-price spiral"). Consensus forecasts reflect the inflation expectations of a large panel of professional economists.
Expectations – market-implied inflation	UK 5y spot inflation in 5y time, % p.a.	Market-implied inflation reflects the price market participants are willing to pay to purchase inflation protection. This reflects their expectations of future inflation, but also their assessment of the risk it could be higher and their appetite to bear this risk. Market-implied inflation therefore usually overstates the level of inflation ultimately realised. A change in market-implied inflation is usually more significant than the absolute level.
Monetary policy – money supply	UK M4 ex IOFC, % y-o-y	M4 is the preferred measure of the total amount of money in the economy. It includes cash and bank balances excluding those of intermediate other financial companies ("IOFC") and so also reflects the amount of credit that has been advanced by banks. All other things equal, increased money supply boosts economic activity which may be inflationary. Money supply advanced 18 months is correlated with CPI which suggests money supply growth is a leading indicator of consumer price inflation.
Monetary policy – interest rates	Base rate, % p.a.	Technically the interest rate paid on reserves held at the Bank of England or charged by the bank in its role as lender of last resort. Typically, very close to the policy rate. Higher interest rates increase the cost of credit across the economy. All other things being equal, this reduces economic activity and inflation.