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InflationWatch

February 2024

Since the Covid-19 pandemic, inflation has risen 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, further exacerbated these price pressures.

We've introduced InflationWatch to help our clients assess the outlook for inflation. In this issue you'll find:

- 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. You'll find full explanations of the indicators we use to track each factor on pages six and seven, under 'Decoding Inflation Indicators.'

The story to date

UK year-on-year headline CPI inflation has fallen dramatically from its post-pandemic peak of 11.1% in October 2022 to 4.0% at the end of 2023, and is expected to moderate further. The decline in inflation owes much to a steep drop in energy prices and falls in non-energy industrial goods prices, alongside moderating food prices.

While welcome, these impacts have largely played out, and supply-side risks remain, with developments in the Red Sea posing a threat to global supply chains and energy prices. Domestic price pressures are elevated, as evidenced by still-strong wage and service-sector inflation and a very low unemployment rate, with core inflation, at 5.1% year on year, now higher than the headline rate.

While further declines in headline inflation open the door to interest-rate cuts in 2024, elevated domestic price pressures, supply-side disruption in the Middle East and still-strong labour markets are likely to keep the Bank of England (BoE) cautious on any pre-emptive loosening of monetary policy.

What's the situation today?[1]

The annual CPI inflation rate is expected to dip below target in 2024 but remain slightly above, on average, over the next decade.

CPI inflation rate forecast

- Headline year-on-year CPI in the UK fell short of expectations in October and November before slightly accelerating to 4% in December. This is the first time the rate has increased since February 2023.
- Core inflation, which excludes volatile energy and food prices, fell to 5.1% in December from 6.1% in September. Markets were expecting prices to ease further in December, but the annual reading was unchanged from the month before as a rise in service inflation offset a decline in goods inflation.
- Nonetheless, latest consensus forecasts see inflation falling further, and even dipping below the BoE's 2% target in mid-2024, before rising above it in the second half of 2024.
- Medium-to-long-term consensus expectations are for UK inflation to stay slightly above the BoE's target. Forecasters point to a range of plausible reasons why inflation, and interest rates, might be higher over the medium term. These include expectations of 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.

[1] Source: DataStream, consensus forecast as of December 2023.

Outlook indicators[2]

Driver		Metric	Latest	-3m	median/ neutral
Inflation		UK headline CPI, % y-o-y	4.0	6.7	2.0
		UK core CPI, % y-o-y	5.1	6.1	1.7
Aggregate demand		Quarterly UK GDP growth, % y-o-y (consensus for Q3 23)	0.5	0.3	2.3
Input costs	Goods	UK PPI, % y-o-y	0.1	0.4	2.4
	Energy	Gas prices, £/MMBTU, % y-o-y	-54.1	-39.7	2.6
	Energy	Oil prices $/barrel, % y-o-y	-8.5	8.2	4.1
	Labour	UK unemployment rate (%)	3.8	4.1	5.5
	Labour	Average weekly earnings, 3-month average, % y-o-y	6.2	7.8	3.2
	Labour	UK vacancies (index, average = 100)	135	139	99
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	5.1	6.1	0.0
Expectations	Consensus forecast	UK headline CPI in 18 months' time, % y-o-y	2.3	2.4	2.0
	Consensus forecast	UK GDP growth in 18 months, % y-o-y	1.0	0.9	2.3
	Market-implied inflation	UK 5y spot inflation in 5y time, % pa	3.4	3.6	2.5
	Inflation surprises	UK Citigroup inflation surprises, › 0 = upside surprise	24	49	0
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	-1.2	-4.1	6.0
	Current interest rates	Base rate % pa	5.3	5.3	3.5
	Market-implied interest rates	UK overnight index swaps, % pa in 24 months	3.3	4.6	3.5

In our dashboard above, you'll find the latest available reading for each indicator, 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.

[2] DataStream, Bloomberg, Bank of England, Consensus Economics. The data quoted are to 31 December 2023. The -3 months column shows the data three months earlier, ie end of September.

Highlights

Producer price inflation (PPI) remains very low, turning marginally positive in December for the first time since September 2023. This is likely to continue to weigh on goods price inflation in the near term; it has fallen from 6.2% in September 2023 to 1.9% in December 2023.

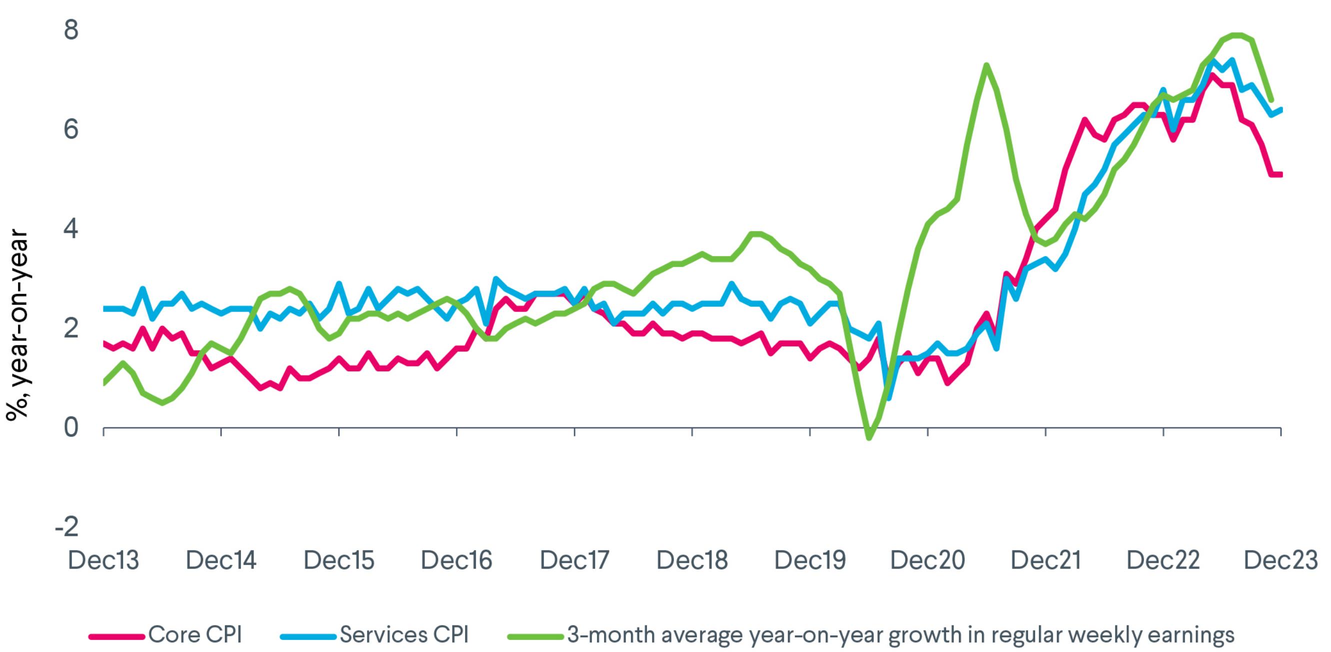
Large year-on-year falls in oil and gas prices augur well for further declines in energy prices and the prices of energy-intensive goods. Industrial demand has been weak, and European storage levels have been at near-record levels due to increased supply from imported Liquified Natural Gas (LNG).

The BoE held borrowing costs at 5.25% pa in February 2024, the same level as throughout Q4 last year. However, financial conditions have modestly loosened via a fall in interest-rate swap rates, to which mortgage rates are closely linked, and a decline in sovereign bond yields. This may add to the BoE's caution around easing policy too early. The bank has faced credibility concerns in the wake of high inflation in recent years, and it plays a critical role in managing inflation expectations with interest rates while communicating the direction of monetary policy.

The UK money supply has been contracting since May 2023, and although the pace has slowed, it still shrank 1.2% in the 12 months to December 2023. Some commentators may point to this as cause for optimism about further declines in inflation. Simply put, a fall in the money supply relative to real output suggests that there is less money chasing an equal, or greater, amount of goods and services, which is expected to place downwards pressure on prices.

Headline CPI is expected to fall further in 2024, but at a slower pace than in 2023. Falls in energy prices and goods and food price disinflation – large detractors from headline inflation over 2023 – have largely run their course. Also, previously high inflation is, to some extent, embedded in price setting, and earnings growth and low unemployment are likely to mean core inflation falls more slowly (see focus chart, below).

Focus Chart: domestic price pressures are easing, but are still elevated



Service-sector price and wage inflation – two closely watched measures by the BoE – have started to ease, albeit from elevated levels, which is a good sign for core inflation. But elevated service-sector and wage inflation are signs of genuine domestic price pressures. Core inflation at 5.1% is likely to be a source of caution for the BoE.

Our view

Recent declines in inflation should be welcomed, but tight labour markets and strong wage and services inflation mean the pace of decline is likely to slow. Easy wins from falling energy prices and goods and food price disinflation are largely in the rear-view mirror. And here, too, there are risks, as developments in the Red Sea pose a threat to global supply chains and oil prices. However, for now, pandemic-era inflation feels unlikely, given weak manufacturing activity and a more manageable rise in freight costs.

Further progress on inflation and the weak economic outlook should open the door to rate cuts from the BoE this year. But policymakers may be a little more cautious in reducing rates than markets currently expect, given domestic price pressures, credibility concerns, and the pre-emptive loosening of financial conditions via declines in interest-rate swap rates and sovereign bond yields .

Nonetheless, we think inflation and interest rates will settle at levels above those seen in the recent pre-pandemic history, but not as high as suggested by longer-term forward nominal gilt yields.

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 ultimately 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.

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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 is no surplus capacity in the economy.
Input costs – goods	UK Producer Price Inflation (PPI), % y-o-y	PPI 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 as a metric is a good indicator for CPI goods – the trends in PPI tend to show up in the CPI goods data three months later. On that basis, 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 – 3-month 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 also 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 5-year spot inflation in 5 years' time, % pa	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 that it could be higher and markets' 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.

Driver	Metric	Interpretation
Monetary policy – money supply	UK M4, % y-o-y	M4 is the preferred measure of the total amount of money in the economy. All other things equal, increased money supply boosts economic activity, which may be inflationary. M4 as a measure gives us advance notice of what to expect – M4 changes will typically show up in CPI 18 months later. On that basis, money supply growth is a leading indicator of consumer price inflation.
Monetary policy – interest rates	Base rate, % pa	Technically, this is 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, this is 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.

Important Information

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