InflationWatch

Introduction

Since the pandemic, inflation has risen further and for longer than most market participants expected in many countries including the UK. Strong demand, ongoing supply chain constraints and rampant energy and commodity price inflation continue to push prices higher. How high will inflation go, and will it persist? Has the era of respectable growth rates and low inflation finally come to an end?

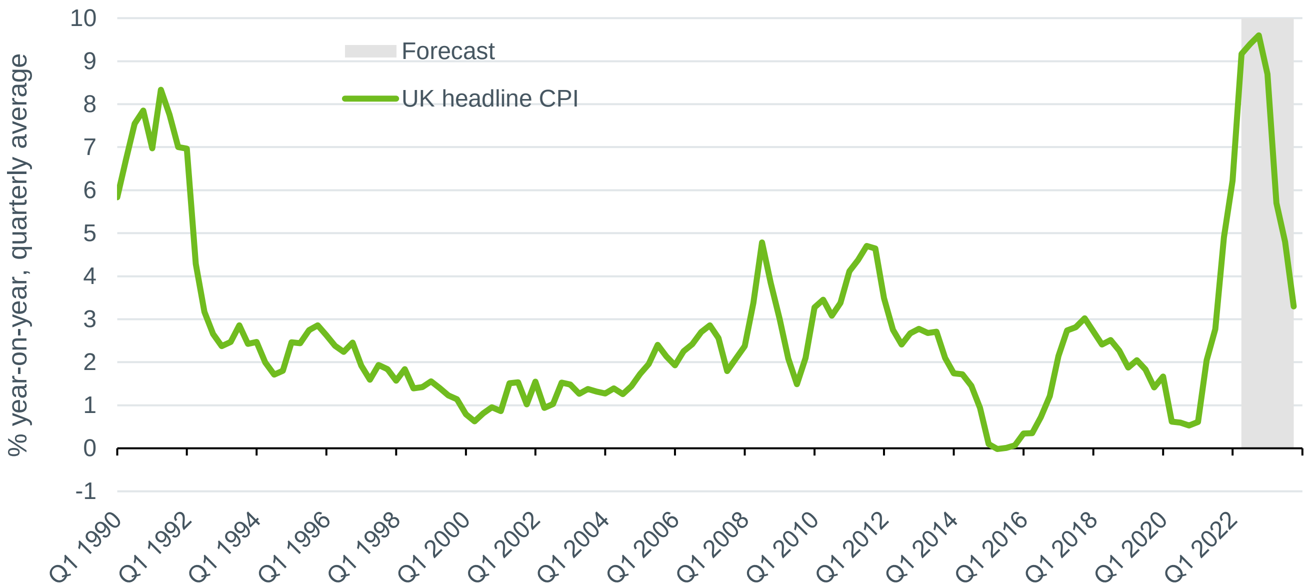
We have introduced "InflationWatch" to help clients assess the outlook for inflation, and we plan to publish it quarterly. This paper provides:

- 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]



- Headline UK CPI continued to climb, reaching 9.4% in June 2022, the highest level since inflation targets were introduced in October 1992
- Latest consensus forecasts inflation will peak at 10.1% year-on-year in October 2022 and will remain above 9.0% for the rest of the year, before moderating to 4.8% year-on-year by mid-2023 and then gradually fall back towards the 2% target over the next 5 years.

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

Outlook indicators[2]

Driver		Metric	Latest	-3m	median/neutral
Inflation		UK headline CPI, % y-o-y	9.4	7.0	2.0
		UK core CPI, % y-o-y	5.8	5.7	1.7
Aggregate demand		UK GDP growth, % y-o-y	8.8	6.7	2.2
Input costs	Goods	UK PPI, % y-o-y	16.5	12.1	2.3
	Energy	Gas prices, £/MMBTU, % y-o-y	56.0	460.8	4.6
	Energy	Oil prices $/barrel, % y-o-y	52.7	69.2	4.7
	Labour	UK unemployment rate (%)	3.8	3.8	5.5
	Labour	Average weekly earnings, 3-month average, % y-o-y	4.3	3.8	3.0
	Labour	UK vacancies (index, average = 100)	200.3	191.6	97.1
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	-3.5	-1.0	-0.1
Expectations	Consensus forecast	UK headline CPI in 18 months' time, % y-o-y	3.3	2.8	2.0
	Consensus forecast	UK GDP growth in 18 months, % y-o-y	0.9	1.4	2.2
	Market-implied inflation	UK 5y spot inflation in 5y time, % p.a.	3.6	4.0	2.3
	Inflation surprises	UK Citigroup inflation surprises, > 0 = upside surprise	114.7	85.0	4.6
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	11.1	3.8	2.0
	Current interest rates	Base rate % p.a.	1.25	0.8	2.0
	Market-implied interest rates	UK overnight index swaps, % p.a. in 24 months	2.6	2.3	2.0

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.

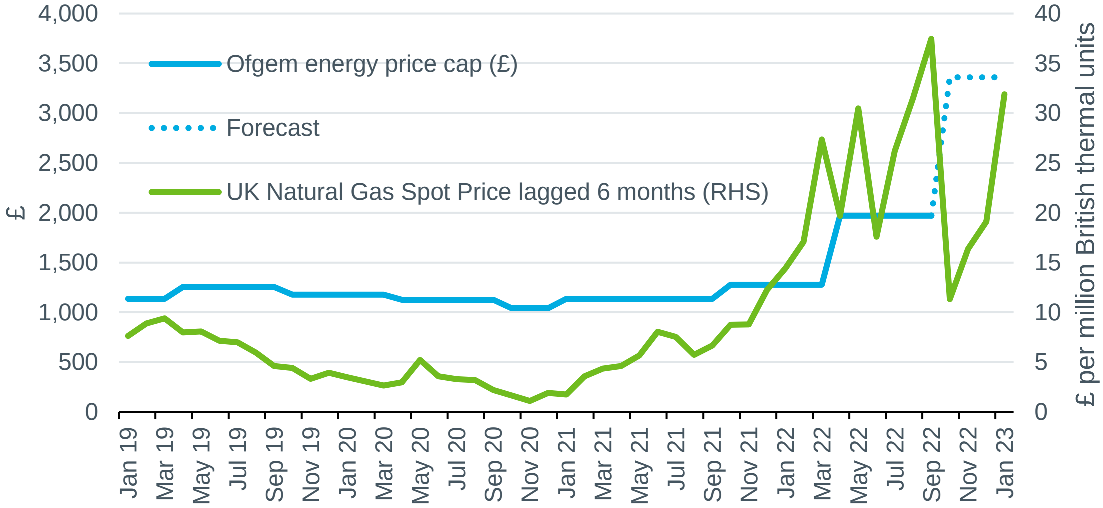
Highlights:

- Realised year-on-year GDP remains well above long-term average levels; this could be inflationary if there is no surplus capacity in the economy. However, growth forecasts are expected to moderate sharply, and fall below long-term median levels by the end of 2023.
- Producer price inflation ("PPI") remains well above its long-term average, and continues to climb, which points to more upward pressure on consumer prices if companies pass on increases in their costs.
- Wholesale gas prices have fallen back from recent highs but remain significantly above long-term averages, and their level at the same time last year, due to the ongoing disruption of Russian gas supplies to continental Europe. Oil prices have fallen slightly, though annual increases in energy costs remain well above the median. These uncharacteristically high year-on-year increases in energy costs have placed upwards pressure on headline inflation measures.
- The unemployment rate remains close to its all-time minimum at 3.8%, whilst earnings growth remains above its long-term average. Low unemployment, above-target wage growth and vacancies at extremely elevated levels, point to inflationary capacity constraints.
- Recent sterling weakness will increase imported inflation, contributing to near-term inflation.
- Expectations of higher inflation can be self-fulfilling. Inflation has continued to surprise to the upside and near-term forecasts have continued to move higher. However, medium-term inflation expectations have fallen over the last 3 months.
- 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.

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

- Base rates have risen a further two times since 31 March 2022, to 1.25% p.a., and the markets expect monetary policy to tighten further to combat higher inflation, with market-implied rates rising to restrictive levels over the next 2 years.

Focus Chart: UK spot gas prices and Ofgem energy price cap[3]



- Our focus chart this quarter shows Ofgem's energy price cap over time, compared with the gas spot price 6 months earlier.
- The forecast rise in the price cap in October will place significant further upwards pressure on headline CPI inflation, underpinning forecasts for October to represent the peak in headline inflation but also lending upside risk to those forecasts.

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. Inflation has risen ahead of consensus forecasts, in line with our view last quarter that near-term risks were skewed to the upside.
- We believe near-term inflation risks are skewed to the upside due to supply chain issues, increasing energy, raw material, and input costs, tight labour markets, and sterling weakness, all of which are inflationary. In which case, interest rates may need to rise further in the short-term than the market expects to bring inflation under control.
- However, high energy prices and inflation are weighing on real disposable incomes and monetary policy is rapidly turning less accommodative, both of which are seeing aggregate demand forecasts revised downwards. Medium-term inflation expectations are also moderating. We believe inflation may therefore fall faster in the medium-term than currently forecast.
- 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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[3] Source: Bloomberg, datastream, Cornwall Insight forecast of October 2022 Ofgem Energy price cap

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.