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InflationWatch

May 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. 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 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). 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:

- Energy price falls and their interaction with the UK price cap, alongside goods and food price disinflation, mean year-on-year headline CPI is likely to fall below target in the coming months.
- But with services inflation typically slowing less sharply, and wage growth remaining relatively high, there remains uncertainty over how quickly inflation will reach its target on a sustainable basis.
- We continue to expect the Bank of England (BoE) to cut rates this year. However, given the massive overshoot of inflation in 2022 and 2023, we expect the bank to tread cautiously by reducing rates slowly to less restrictive levels.

The story to date

UK year-on-year headline CPI inflation has fallen materially from its post-pandemic peak of 11.1% in October 2022 to 3.2% in March 2024. Prices in the UK rose at a slower pace than in the US for the first time in two years, meaning the UK no longer looks like an inflationary outlier among the major advanced economies, at least in terms of headline inflation.

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. These headline shifts have largely run their course, with the peak disinflationary impact from energy, food and goods prices expected to be seen in the next few months.

But supply-side risks remain, with developments in the Middle East and disruptions to shipping through the Red Sea. Domestic price pressures remain elevated, as evidenced by still-strong wage and service-sector inflation and a low unemployment rate, with core inflation, which excludes volatile energy and food prices, at 4.2% year on year, marking its sixth consecutive month above the headline rate. Positive real rates, which will rise as inflation falls, even if nominal rates are unchanged, may provide scope for rate cuts to a less restrictive territory, but we expect the BoE to proceed very cautiously.

What's the situation today?[1]

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

[1] Source: DataStream, consensus forecast as of April 2024.

- Headline year-on-year CPI in the UK continued to moderate over the first quarter to 3.2%, the lowest rate since September 2021. Inflation fell more than expected in January and February, coming in slightly above expectations in March.
- Core inflation – which excludes volatile energy and food prices – fell to 4.2% in March from 5.1% in December. Core inflation is still running at more than double the BoE's 2% target.
- Largely owing to downward revisions to the energy price cap, the latest consensus forecasts see inflation falling slightly under the BoE's 2% temporarily in spring and summer, before rising moderately 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.

Outlook indicators[2]

Driver		Metric	Latest	-3m	median/ neutral
Inflation		UK headline CPI, % y-o-y	3.2	4.0	2.00
		UK core CPI, % y-o-y	2.0	2.0	2.0
Aggregate demand		Quarterly UK GDP growth, % y-o-y (consensus for Q1 24)	-0.2	-0.2	1.5
Input costs	Goods	UK PPI, % y-o-y	0.6	0.1	23
	Energy	Gas prices, £/MMBTU, % y-o-y	-40.9	-54.1	1.4
	Energy	Oil prices $/barrel, % y-o-y	9.6	-8.5	3.8
	Labour	UK unemployment rate (%)	4.2	4.0	5.4
	Labour	Average weekly earnings, 3-month average, % y-o-y	6.0	6.7	3.2
	Labour	UK vacancies (index, average = 100)	133	134	100
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	4.6	5.2	0.0
Expectations	Consensus forecast	UK headline CPI in 18 months' time, % y-o-y	2.3	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	3.6	2.5
	Inflation surprises	UK Citigroup inflation surprises, › 0 = upside surprise	18	24	0
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	-1.5	-2.6	5.9
	Current interest rates	Base rate % pa	5.3	5.3	3.7
	Market-implied interest rates	UK overnight index swaps, % pa in 24 months	3.7	3.3	3.7

[2] DataStream, Bloomberg, Bank of England, Consensus Economics. The data quoted are to 31 March 2024. The -3 months column shows the data three months earlier, ie end of December.

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.

Highlights

Consensus forecasts expect headline CPI to come in slightly below the BoE's 2% target over the next few months before modestly accelerating above it in the second half of this year, averaging 2.5% over 2024.

While still very low, annual producer price inflation (PPI) rose 0.6% in March, up from 0.1% in December, when the rate turned positive for the first time since September 2023. This coincides with purchasing managers' indices (PMI) survey data, which suggest improved growth momentum over the first quarter was accompanied by reacceleration in business prices.

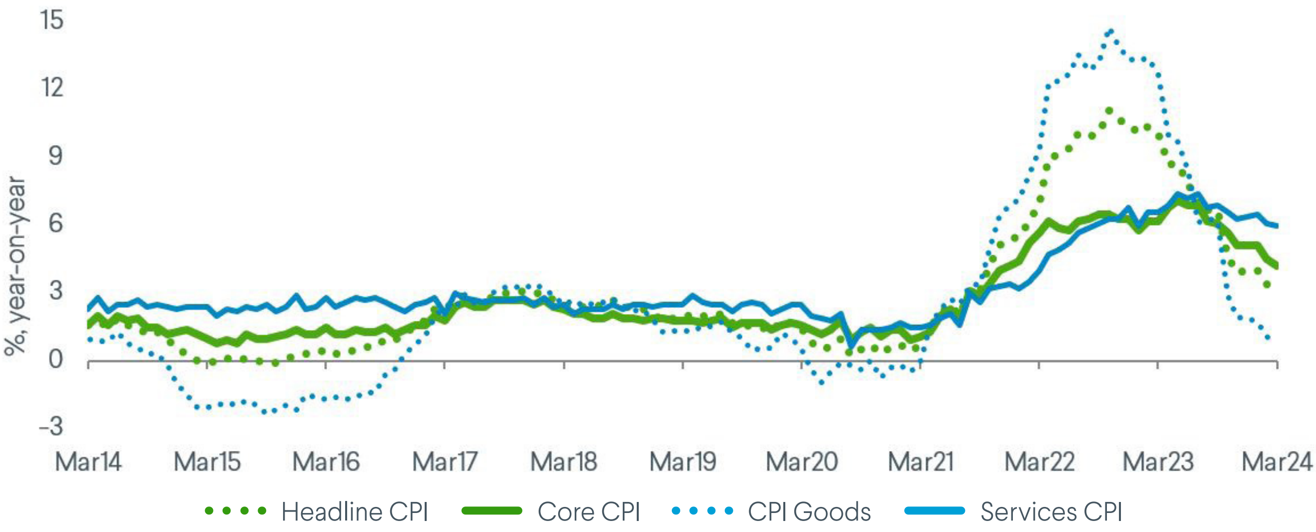
Oil prices rose in the first quarter on the back of ongoing supply cuts, conflict in the Middle East and disruptions to shipping through the Red Sea. These developments continue to pose an upside risk to the inflation outlook.

The BoE held borrowing costs at 16-year high of 5.25% pa in March. However, financial conditions have tightened via a renewed rise in interest-rate swap rates, to which mortgage rates are closely linked, and a rise in sovereign bond yields. Markets were expecting between one and two 0.25% pa interest-rate cuts at the end of March 2024, down from between six and seven interest-rate cuts at the beginning of the year. Near-term interest-rate pricing is now broadly consistent with our view that the BoE will be cautious about easing policy too early. This is particularly important given some of the credibility concerns it has faced in the wake of high inflation in recent years, and the critical role it plays in managing inflation expectations with interest rates while communicating the direction of monetary policy.

The UK money supply has been contracting since May 2023. Although the pace has slowed, it still shrank 1.5% in the 12 months to February 2024. Some commentators 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's less money chasing an equal, or greater, amount of goods and services, which is expected to place downwards pressure on prices. Indeed, some even suggest very weak monetary supply growth poses a material downside risk to UK inflation forecasts.

Headline CPI inflation is expected to fall a little further, floating around the 2% target and settling somewhat above it by end of 2024. Attention increasingly turns to core CPI – now above the headline CPI – as it becomes the main driver of consumer price inflation (see focus chart below).

Focus Chart: domestic price pressures are easing, albeit much more slowly than headline inflation



Although on a slow downtrend, consumer services price inflation – watched closely by policymakers as a measure of genuine, domestic-driven inflation pressure – remains elevated, at 6% year-on-year. This in part due to strong wage growth, which is also running at a year-on-year pace of 6%. This contrasts with goods price growth, which dropped to 0.8% in March. Core inflation at 4.2%, with a combination of strong wage growth and sticky underlying services inflation, are still likely to be a source of caution for BoE, even if headline inflation dips below target in the near term.

Our view

Headline CPI growth has come down a lot since peaking in October 2022, thanks to falling energy prices and goods and food price disinflation. These impacts have largely run their course, and their downwards influence is expected to peak in the next few months. Developments in the Middle East and disruptions to shipping through the Red Sea continue to pose a material upside risk to the inflation outlook. However, for now, pandemic-era inflation feels unlikely, given weak manufacturing activity and a more manageable rise in freight costs.

Core CPI remains above headline consumer price inflation, underpinned by strong domestic inflation pressures owing to service-sector price and wage-growth inflation. In our previous edition of InflationWatch, we noted that markets were a little too optimistic about the timing and scale of interest-rate cuts in 2024. Rises in market-implied interest rates since – which, at the time of writing, anticipate between one and two 0.25% pa interest-rate cuts in 2024 – are much more in line with our expectations from the BoE in 2024. While evidence of domestic price pressures will mean the BoE treads cautiously, further progress on these measures, alongside positive real interest rates that will rise as inflation falls even if rates are left unchanged, should open the door to modest easing in 2024.

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. That said, we don't discount the possibility of them undershooting, or the risk of a switch to a regime of permanently higher inflation.

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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