InflationWatch

Introduction

Inflation has risen further and for longer than most market participants expected in many countries, including the UK. Expansive monetary and fiscal stimulus, disruption to supply chains, and a shift in demand from services to goods during the Covid-19 pandemic, all placed upwards pressure on inflation. More recently, this has been exacerbated by the global supply shock emanating from the Russia-Ukraine conflict and rising wages from tight labour markets.

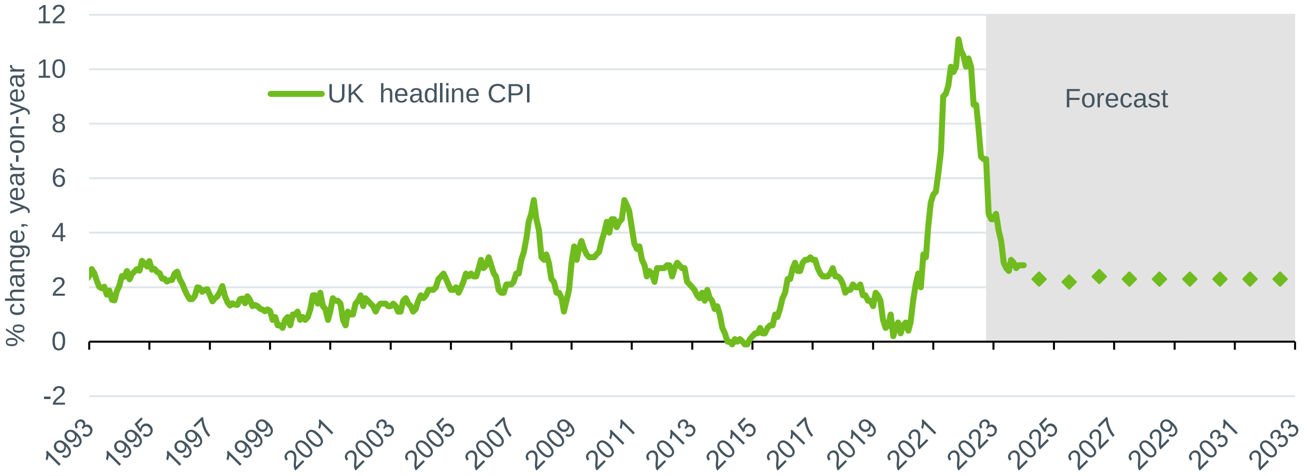
How high will inflation go, and for how long will it persist? Has the era of respectable growth rates and low inflation finally come to an end? We hope our InflationWatch series helps clients assess the outlook for inflation. You'll find:

- 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 five and six, under 'Decoding Inflation Indicators'.

What's the situation today?[1]

Annual CPI inflation rate is expected to fall sharply and return towards, but remain slightly above, its target over the next decade.



- Headline year-on-year CPI in the UK continued to trend downwards, falling to an 18-month low of 6.7% in September, from 7.9% in June 2023. The annual rate remained unchanged from August, defying market expectations of a slight decrease due to rising prices for motor fuels.
- Core inflation, which strips out volatile energy and food prices, also fell, but by less, declining from 6.9% to 6.1%, the lowest level since January. Core CPI also fell less than expected in September, with most of the quarterly decline between July and August, when core inflation came in well below expectations.

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

- The latest consensus forecasts are for inflation to fall sharply between October and November, largely due to Ofgem's energy-price-cap reset, before settling at 4.5% year-on-year by the end of 2023 – still more than double the Bank of England's (BoE) 2% target.
- 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: 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	6.7	7.9	2.0
		UK core CPI, % y-o-y	6.1	6.9	1.7
Aggregate demand		Quarterly UK GDP growth, % y-o-y (consensus for Q3 23)	0.5	0.5	2.3
Input costs	Goods	UK PPI, % y-o-y	-0.1	0.4	2.4
	Energy	Gas prices, £/MMBTU, % y-o-y	-39.7	-38.5	2.6
	Energy	Oil prices $/barrel, % y-o-y	8.2	-35.2	4.6
	Labour	UK unemployment rate (%)	4.2	4.0	5.5
	Labour	Average weekly earnings, 3-month average, % y-o-y	7.8	7.5	3.2
	Labour	UK vacancies (index, average = 100)	144	151	100
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	6.1	4.6	0.0
Expectations	Consensus forecast	UK headline CPI in 18 months' time, % y-o-y	2.4	2.8	2.0
	Consensus forecast	UK GDP growth in 18 months, % y-o-y	0.9	1.1	2.3
	Market-implied inflation	UK 5y spot inflation in 5y time, % p.a.	3.6	3.5	2.5
	Inflation surprises	UK Citigroup inflation surprises, > 0 = upside surprise	49	66	0
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	-4.1	0.1	6.0
	Current interest rates	Base rate % p.a.	5.3	5.0	3.5
	Market-implied interest rates	UK overnight index swaps, % p.a. in 24 months	4.6	5.5	3.5

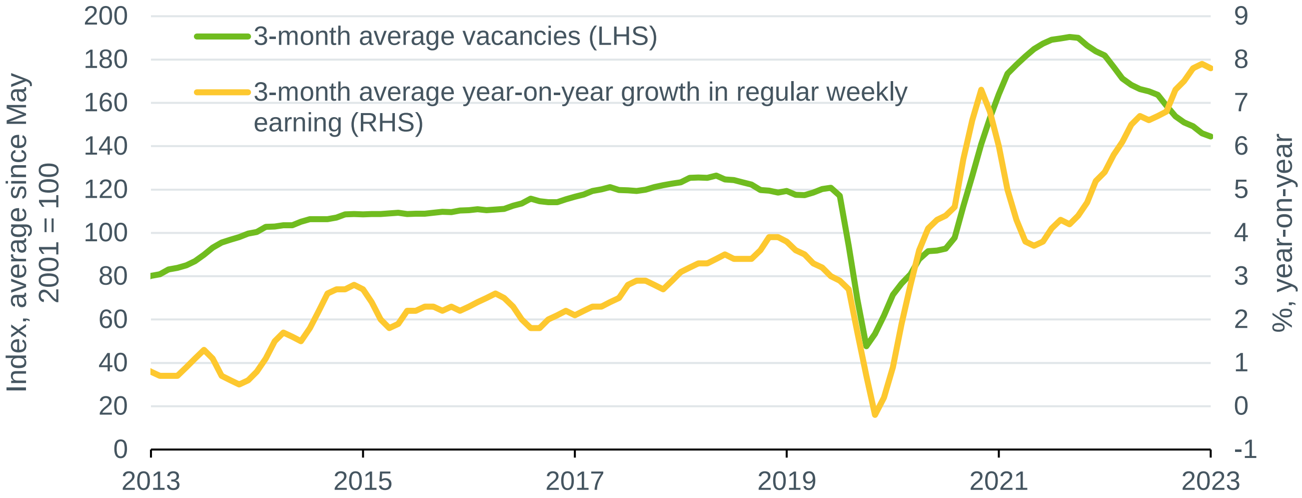
The dashboard above shows the latest available reading for each indicator, alongside the reading three months ago, and compares them with the long-term median, or assessed neutral, value. The tone of the colour indicates the strength of the signal. A darker tone indicates either a stronger inflationary or disinflationary signal, depending on whether red or blue, respectively.

Highlights

- Having peaked at 11.1% in October 2022, year-on-year headline CPI has generally stayed on a downwards trend, coming in at 6.7% in September 2023. Inflation is expected to continue to decline as energy and food prices ease, after last year's sharp rises.
- Given significant falls in gas prices over the last 12 months, Ofgem's energy-price cap, based on typical household usage, fell over 50%, to £1,834 pa, from £3,549 pa 12 months ago. Although the Energy Price Guarantee limited the average bill to £2,500 pa, the new price cap still implies around a 30% fall in the average energy bill. Inflation is expected to have fallen to 4.7% year on year in October, largely as a result of this. Additionally, year-on-year food-price inflation has moderated significantly in recent months, with month-on-month food prices falling for the first time in two years in September.
- Partly reflecting a struggling manufacturing sector, which surveys suggest has now been in recession for 16 months, and partly due to a further easing of supply chains, producer price inflation (PPI) has been negative, year-on-year, since July. This bodes well for further declines in year-on-year consumer goods price inflation, which fell to 6.2% in September, from 8.5% in June.

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

Focus Chart



- The BoE will be more concerned that three-month average weekly earnings growth remained at 7.8% year-on-year in September (Focus Chart). This is inconsistent with meeting the bank's inflation target over the medium term and is a sign of domestic, demand-driven inflation that the BoE can and should address to avoid a wage-price spiral.
- Here too, though, there are tentative signs of an easing of inflationary pressures in the data. While labour markets remain tight in a historical context (ie a greater demand for, than supply of, workers), the unemployment rate ticked up from 4.0% to 4.2% in the June to August period. Also, vacancies have been trending downwards since peaking at an all-time record high in the spring of 2022 (Focus Chart). If these trends continue, as might be expected given the weak growth outlook, it would be reasonable to anticipate an easing in year-on-year wage growth.
- Furthermore, the BoE took interest rates further into restrictive territory in Q3, raising the base rate 0.25% pa to 5.25% pa, before pausing in September and also leaving rates unchanged in November. This has been compounded by rises in longer-term gilt yields, which have acted to further tighten financial conditions. We suspect the lag between interest-rate rises and their impact on economic activity has increased, largely due to the prevalence of fixed-rate mortgages and post-pandemic savings. However, we think the impact of past interest-rate rises will increasingly weigh on consumers and businesses as mortgages and loans are refinanced at higher rates.
- The UK money supply contracted year on year in Q3 and was 4.1% lower in the 12 months to end-September. A fall in the money supply relative to real output suggests there's less money chasing an equal, or greater, amount of goods and services, which is expected to place downwards pressure on prices. Some commentators may point to this as cause for optimism about further declines in inflation.

Our view

- While there have been positive developments regarding inflation in recent months, it feels that the easy wins due to easing energy and food-price inflation have largely played out. Indeed, consensus forecasts suggest further declines will be more gradual beyond October, with year-on-year CPI inflation expected to fall to 4.5% by the end of 2023, before easing to 2.8% in December 2024. Forecasts also suggest UK CPI inflation will remain above target over the long term, averaging 2.3% year-on-year.

- Falling energy prices have been a key contributor to the downtrend in headline inflation over the last 12 months, and so any reversal could slow the pace of decline. An extension or expansion in oil production cuts by Saudi Arabia and Russia, or an escalation of the events in Gaza/Israel, pose key risks to oil prices and headline inflation forecasts.
- There are a number of reasons why central banks would not raise interest rates in response to supply-driven price increases. However, any potential second-round effects from oil-price rises, alongside sticky core inflation and strong wage growth, would explain why the BoE may proceed cautiously with rate cuts.
- Nonetheless, if inflation evolves in line with forecasts, this should still allow the BoE to loosen policy modestly over the next few years, particularly given the extent of the rise in interest rates and gilt yields in 2023 and the weak growth outlook.
- In prior InflationWatch editions, we agreed with the market that interest rates were nearing a peak, but we emphasised that they might have to stay at restrictive levels for longer to rein in inflation. This view is increasingly becoming the base case among market participants. We have little issue with the near-term implied path of interest rates, but we don’t think interest rates will remain as high for as long as is suggested by forward nominal yields.
- Disinflationary factors such as demographics, technological innovation and globalisation are expected to temper inflation over the medium to long term. However, we believe the probability of a switch to a regime of permanently higher inflation has increased. 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.

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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.
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.

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