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InflationWatch

February 2025

In the wake of the Covid-19 pandemic, inflation rose further and for longer than most market participants expected in many countries, including the UK. Expansive monetary policy and fiscal stimulus, supply-chain disruptions and a shift in demand from services to goods during the pandemic all placed upwards pressure on inflation. Moreover, the Russia-Ukraine conflict, and the resultant global supply-shock, exacerbated these price pressures.

Headline inflation has fallen significantly since its peak in October 2022 as supply-side disruptions have eased and tighter monetary policy has taken effect. However, underlying measures of inflation still point to stubbornness in price pressures.

We 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 lies in the outlook for inflation and interest rates.

We focus on the UK and the outlook over the next two to three 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:

- Year-on-year headline CPI rose to 2.5% in December, from 1.7% in September. Core inflation, which excludes volatile food and energy prices, unexpectedly fell in December, returning to September's level of 3.2%.
- With disinflation in goods, foods and energy prices in the rear-view mirror, and set to become a positive contribution in 2025, consensus forecasts suggest headline CPI will rise above 3.0% in the autumn this year.
- Underlying inflation pressures remain elevated: average weekly earnings growth rose 5.6% year on year in the three months to end-November, and service-sector inflation rose 4.4% in the 12 months to end-December.
- The national insurance (NI) increase announced in the October budget is a stagflationary shock: surveys suggest employers intend to respond by cutting back recruitment and/or by raising prices.
- Elevated real interest rates allowed the Bank of England (BoE) room to reduce rates in November and February, taking the base rate to 4.5% pa. However, the Monetary Policy Committee's (MPC) cautious wording, higher inflation forecasts and pay-survey data suggest only one to two further rate cuts this year.
- With growth and price pressures moving in opposite directions, the risks around this outlook are finely balanced. Should weaker employment growth result in dwindling domestic demand and a larger output gap, reducing inflation pressures, we expect the BoE to cut rates more quickly. However, if inflation pressures persist, the central bank is likely to stay cautious, despite the weak growth backdrop.

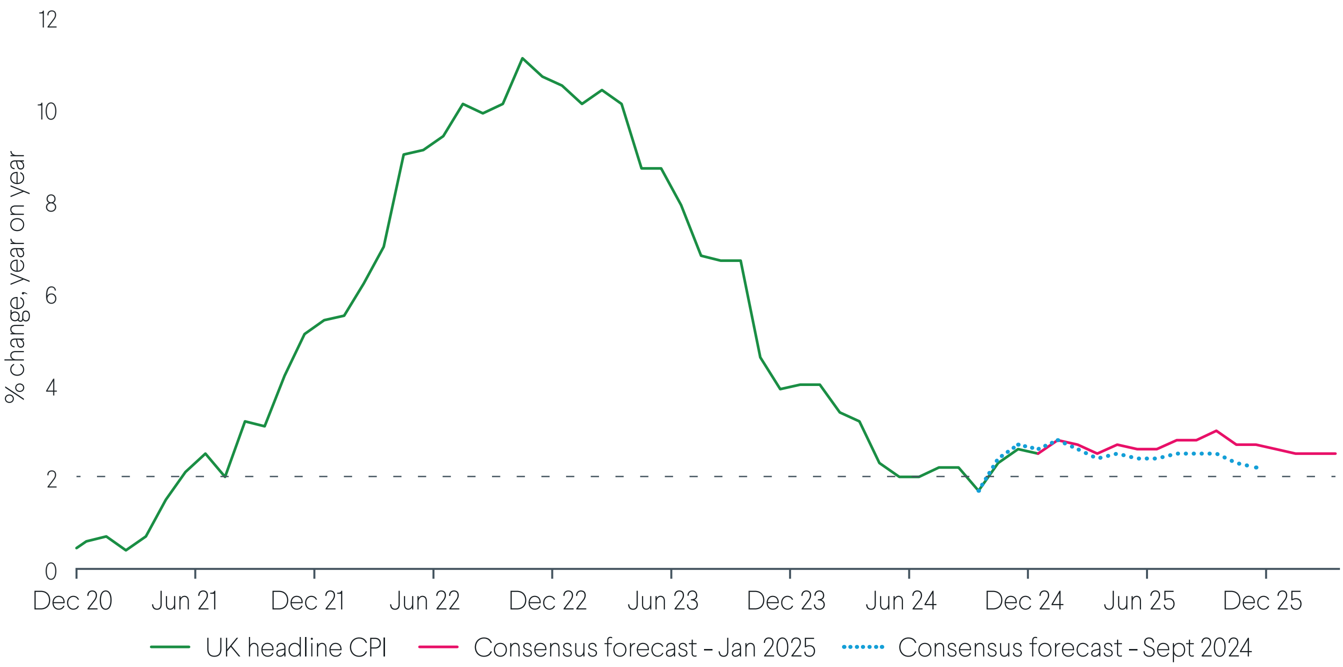
The story to date

The global shocks that drove up UK inflation have unwound. Food, energy and non-industrial goods prices disinflation accounts for almost all of the fall in inflation since its peak of 11.1% in October 2022. Energy prices have been a smaller drag on the headline measure recently and are expected to raise inflation in 2025. Indeed, disinflation in goods and food prices is in the rear-view mirror, while underlying inflation pressures remain elevated, contributing to forecasts for inflation to rise back towards 3% in 2025.

With inflation close to the 2% target since the middle of 2024, from a peak of over 11% in 2022, broader progress in reducing inflationary pressures – alongside elevated real interest rates – allowed the BoE to reduce rates 0.25% pa in both November and February, to 4.5% pa. This marked the third such cut since August 2024.

However, rising inflation forecasts (Chart 1) are likely to keep the BoE cautious on the pace of future rate cuts, despite an economy that is showing little to no momentum. The forecast rise in inflation is largely expected to be temporary and owes chiefly to higher energy prices. But underlying inflation pressures, as evidenced by strong wage and service-sector inflation, remain elevated. In addition to the higher spending announced in the October budget, the NI increase levied on employers is complicating the outlook for the MPC. Surveys suggest employers will respond by lower employment, which would weigh on growth and inflation, all else equal; however, they are also intending to pass on the cost increase in higher prices, which would raise inflation.

Chart 1: consensus forecasts suggest that inflation will rise further above the BoE's target in 2025



Source: Datastream and Consensus Economics.

A further complicating factor is a potential rise in US tariffs. While US tariffs on imports would be inflationary in the near term for the US, and most likely negative for UK, eurozone and global growth, the impact on the UK inflation is ambiguous. Disruption to, and the reconfiguration of, supply chains would be inflationary, but exchange rate movements will depend on relative trade policies and changes in risk sentiment. Meanwhile, weaker US and global demand for exports and lower prices of exports previously destined for the US would be disinflationary.

Outlook indicators

Driver		Metric	Latest	-3m	median/ neutral
Inflation		UK headline CPI, % y-o-y	2.5	1.7	2.0
		UK core CPI, % y-o-y	3.2	3.2	1.9
Aggregate demand		Quarterly UK GDP growth, % y-o-y (consensus for Q3 24)	1.5	0.8	1.5
Input costs	Goods	UK PPI, % y-o-y	0.0	-0.6	2.2
	Energy	Gas prices, £/MMBTU, % y-o-y	52.6	4.9	1.6
	Energy	Oil prices $/barrel, % y-o-y	-3.8	-24.6	3.8
	Labour	UK unemployment rate (%)	4.4	4.3	5.4
	Labour	Average weekly earnings, 3-month average, % y-o-y	5.6	4.9	3.3
	Labour	UK vacancies (index, average = 100)	117	120	100
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	3.3	6.3	0.0
Expectations	Consensus forecast	UK headline CPI in 18 months' time, % y-o-y	2.2	2.2	2.0
	Consensus forecast	UK GDP growth in 18 months, % y-o-y	1.3	1.3	1.5
	Market-implied inflation	UK 5y spot inflation in 5y time, % pa	3.4	3.3	2.5
	Inflation surprises	UK Citigroup inflation surprises, › 0 = upside surprise	10.6	4.0	0
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	3.0	1.4	5.9
	Current interest rates	Base rate % pa	4.5	5.0	3.8
	Market-implied interest rates	UK overnight index swaps, % pa in 24 months	4.0	3.5	3.8

Source: DataStream, Bloomberg, Bank of England, Consensus Economics. The data are to 31 December with some exceptions. The -3 months columns shows the data three months earlier, ie September 2024.

In our dashboard above, you'll find the end-December reading for each indicator, alongside the reading three months ago. For figures that only have data available as at November, we have compared this to the figure three months prior. 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

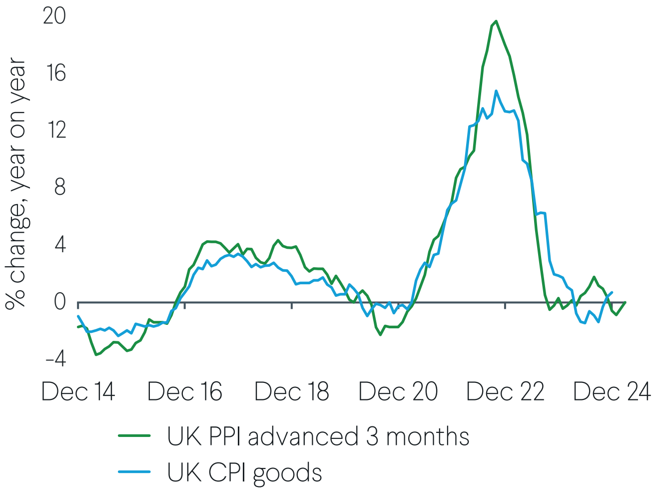
Headline CPI inflation rose to 2.5% in December from 1.7% in September. Although the December figure was lower than expected, and below November's figure of 2.6%, the fall was driven by volatile factors such as lower airfares, which are expected to reverse in January to drive inflation higher.

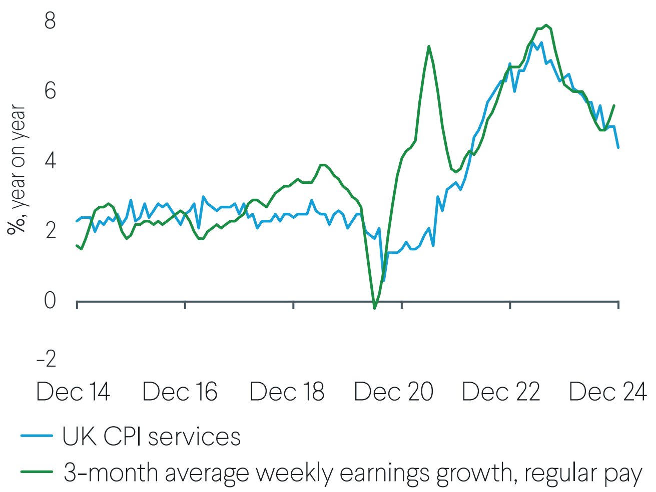
Core CPI inflation remained at 3.2%, having risen to 3.5% in November, before falling back by more than expected in December. However, at 3.2% and well above the BoE's target rate, core inflation points to persistence in underlying domestic price pressures. Services CPI, to which the MPC pays particular attention because of the labour-intensive nature of the sector, surprised sharply to the downside in December, easing to 4.4% from 5.0% in November, and well below the forecast 4.9%.

While they remain below the levels reached in 2022, gas prices rose considerably year on year over the fourth quarter, feeding through to Ofgem's higher energy-price cap. Indeed, higher electricity and gas prices are partly why headline CPI inflation is forecast to temporarily rise close to 3.0% in 2025.

While trade-weighted sterling weakened in the fourth quarter, the year-on-year change remains positive. All else being equal, weaker sterling tends to increase domestic inflation, as the UK imports more than it exports. When sterling depreciates, the costs of imported goods – like raw materials and fuel – rises and can increase production costs and lead to higher consumer prices.

Charts 2 and 3: producer price inflation suggests goods price disinflation is over, while wage growth suggests limited further easing of services inflation in the near term





Source: Bloomberg and datastream.

Annual producer price inflation (PPI), while still low, looks to have bottomed out. This suggests that CPI goods disinflation, a large contributor to the decline in inflation since its 2022 peak, has largely run its course. Furthermore, strong wage growth, which re-accelerated to 5.6% year on year in the three months to November, is likely to slow the fall in services inflation. While the former, alongside energy and food prices, is something the BoE might be more inclined to 'look through', the latter is harder for the central bank to ignore. Allowing for productivity growth of 1.0–1.5% pa (which is perhaps optimistic given the trend of the last decade), wage growth closer to 3.0–3.5% year on year would be more consistent with the BoE's 2% inflation target.

Having said that, there are some signs the labour market is loosening. The level of vacancies has continued to normalise, and unemployment has edged up to 4.4%, although this is still relatively low. As mentioned above, the government's proposed increase in NI announced in the October budget is creating a dilemma for the BoE. Employment intentions are falling in response to the rise in employer's labour costs, but firms are also anticipating raising prices. This is driving growth and inflation in opposite directions, representing a stagflationary shock.

Even allowing for the 0.5% pa reduction in interest rates to 4.5% pa since our last InflationWatch, interest rates, in our estimation, remain at restrictive levels. This should allow some further easing, but the forecast rise in headline inflation and ongoing persistence in underlying inflation suggests the BoE will adopt a cautious approach.

Our view

Disinflation in energy, food and goods prices has accounted for almost all of the decline in inflation since its 11.1% peak in October 2022. With this in the rear-view mirror, inflation is forecast to rise in 2025, reaching, and perhaps even exceeding, 3.0% year on year. While the increase is expected to owe a lot to energy prices and, hence, be temporary, wage and service-sector inflation point to some persistence in underlying domestic price pressures.

A restrictive monetary policy setting should allow for a few more interest-rate cuts, but we expect the BoE to proceed with care. The MPC's cautious wording, higher inflation forecasts and pay-survey data suggest only one to two further rate cuts this year, slightly less than the market was anticipating immediately after the February rate cut.

The risks around this outlook are finely balanced. The economy is stagnating, and the announced NI increase has driven growth and inflation in opposite directions: employment intentions have fallen while expected price growth and services output prices have risen, as employers cut back recruitment or look to pass on the NI increase via prices. Should weaker employment growth result in dwindling domestic demand and a larger output gap, reducing inflation pressures, we expect the BoE to cut rates more quickly. However, if inflation pressures persist, despite the weak growth backdrop, the central bank is likely to stay cautious.

On a longer-term view, we expect inflation volatility to be higher in the coming decade. Diminishing returns from globalisation, supply-chain disruptions from climate change, geopolitical tensions and political opposition to immigration as a cure as well as more persistently tight labour markets all make for a more fragile supply side. On the demand side, we expect the major advanced economies, including the UK, to adopt more proactive fiscal policy, making a return to the loose monetary, tight fiscal policies of the post-global financial crisis (GFC) era less likely.

However, we expect central-bank mandates to remain intact and inflation, on average, to track close to central-bank targets, even if volatility is higher. While we believe inflation and 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 GFC. 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 it 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 our author below.

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