InflationWatch – May 2023

Introduction

Inflation has risen further and for longer than most market participants expected in many countries including the UK. Large monetary and fiscal stimulus, disruption to supply chains, and a re-orientation of demand from services to goods during the COVID-19 pandemic have all placed upwards pressure on inflation. This has latterly been exacerbated by the global supply-shock emanating from the Russia-Ukraine conflict and upwards pressure on wages from tight labour markets. How high will inflation go, and will it persist? Has the era of respectable growth rates and low inflation finally come to an end?

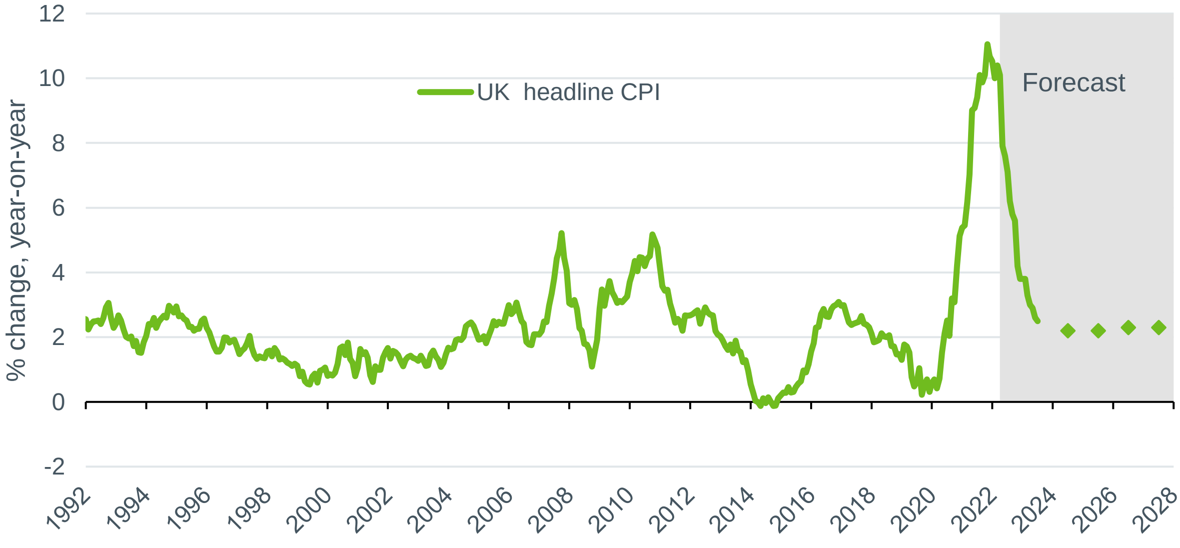
We have introduced "InflationWatch" to help clients assess the outlook for inflation. This paper provides:

- An update on the latest position on inflation;
- Consensus forecasts on future inflation rates; and
- 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]

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



- Headline UK CPI rose by 10.1% year-on-year in the 12 months to March 2023, down from 10.5% y-o-y in December 2022, but fell less than expected.
- Core inflation, which had been expected to fall, instead remained flat at 6.2% year-on-year.
- Latest consensus forecasts continue to suggest that inflation will moderate over 2023, but remain elevated, averaging 6.4% y-o-y, and still be at an above-target pace of 3.8% y-o-y at the end of 2023. Longer-term

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

consensus expectations are for UK inflation to remain slightly above the Bank of England's target over the course of the next 10 years.

Outlook indicators[2]

Driver		Metric	Latest	-3m	median/neutral
Inflation		UK headline CPI, % y-o-y	10.1	10.5	2.0
		UK core CPI, % y-o-y	6.2	6.3	1.7
Aggregate demand		Quarterly UK GDP growth, % y-o-y (expected for Q1 23)	0.2	0.6	2.2
Input costs	Goods	UK PPI, % y-o-y	8.7	14.5	2.4
	Energy	Gas prices, £/MMBTU, % y-o-y	-61.8	23.6	4.7
	Energy	Oil prices $/barrel, % y-o-y	-25.8	8.3	5.6
	Labour	UK unemployment rate (%)	3.8	3.7	5.5
	Labour	Average weekly earnings, 3-month average, % y-o-y	6.6	6.7	3.1
	Labour	UK vacancies (index, average = 100)	171	178	100
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	-2.7	-5.7	0.0
Expectations	Consensus forecast	UK headline CPI in 18 months' time, % y-o-y	2.9	4.2	2.0
	Consensus forecast	UK GDP growth in 18 months, % y-o-y	0.7	-0.2	2.2
	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	55	72	5
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	3.2	10.6	2.3
	Current interest rates	Base rate % p.a.	4.3	3.5	3.0
	Market-implied interest rates	UK overnight index swaps, % p.a. in 24 months	4.0	4.3	3.0

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:

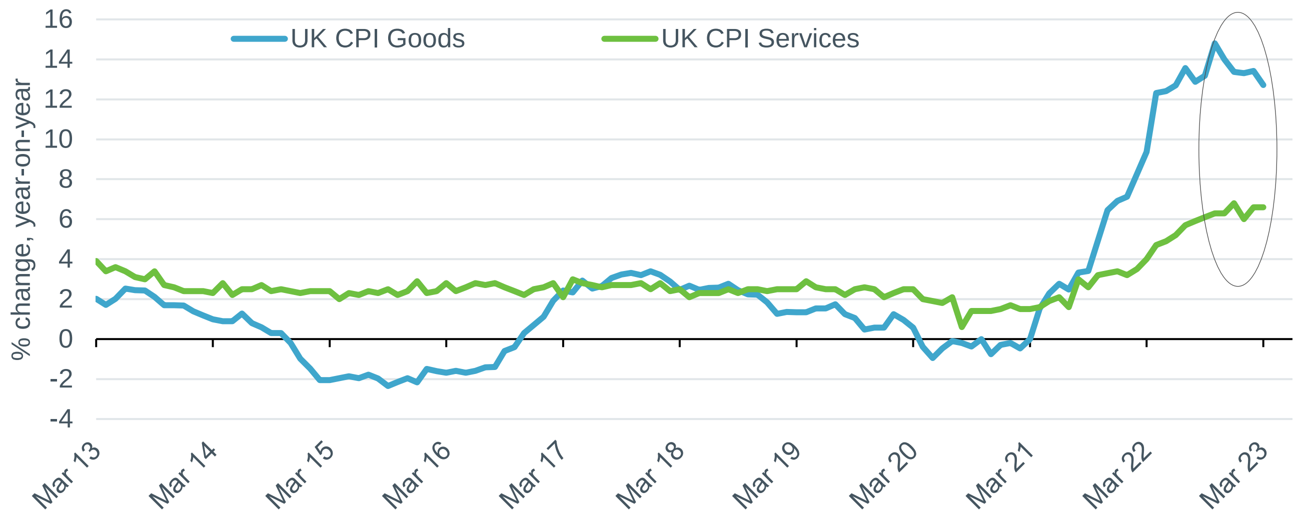
- Year-on-year headline CPI inflation appears to have peaked but remains elevated against the Bank of England's target. Core CPI, excluding volatile energy and food components, also remains elevated and has fallen less.
- Year-on-year GDP growth has continued to slow and is expected to be only marginally positive in Q1, albeit outperforming downbeat expectations due to a resilient services sector. That said, the UK may yet fall into a recession later as high inflation and the lagged impact of interest rate rises weigh on consumers and homeowners. Consensus Forecasts are expecting UK GDP to contract -0.2% over 2023 followed by a weak recovery in 2024.
- The annual rate of producer price inflation (PPI) has continued to fall sharply, slowing materially from 14.5% year-on-year in December, to 8.7% in March. While still elevated relative to history, continued declines in producer price inflation lend support to the suggestion that producer and, hence, consumer goods price inflation has peaked.
- Oil & gas prices are now significantly below levels seen in the wake of Russia's invasion of Ukraine last year. The recent modest decline in year-on-year headline inflation has been helped by a slight deflationary impulse from fuel, but the UK will not see the first step down in broader energy inflation until the April inflation print that is released in May, due to the impact of the energy price guarantee scheme. As a result, the energy component is expected to move from being a material positive contributor to inflation to being an increasingly negative contribution in the coming months.
- There has been some evidence of a loosening in labour market conditions in recent months: the unemployment rate has edged higher, and vacancies have fallen. However, unemployment is still very low versus history, and vacancies remain near record-high levels. As a result, labour shortages continue to place upwards pressure on wages, with average weekly earnings growth still growing at a

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

robust pace of 6.6% year-on-year in the 3 months to the end of February 2023, adding to speculation that further interest rate hikes will be required.

- Expectations of higher inflation can be self-fulfilling. Inflation surprises have become less positive, but inflation still surprises to the upside. Businesses are still budgeting for high pricing expectations in the next year due to continued pressure on wages.
- Growth in the money supply has fallen back towards longer-term levels and, while there remains a significant "overhang" from rapid expansion in the monetary base in 2020, the money supply is moving back towards trend levels.
- The Bank of England increased the bank's policy rate twice in Q1 2023, to 4.25% pa, taking monetary policy further into restrictive territory. Recent upside inflation surprises and strong wage growth, on the back of ongoing tightness in the labour market, mean further interest rate rises are likely. However, the recent decline in inflation is likely to accelerate in the coming months as lower energy prices filter through to CPI data, and higher rates are expected to increasingly weigh on economic activity as fixed-term mortgages expire and homeowners re-mortgage at significantly higher interest rates.

Focus Chart: Service sector inflation remains sticky



- Not only have recent growth and inflation releases surprised to the upside, but April's purchasing managers' indices suggest growth accelerated in April. While there remains divergence between surging demand in the services sector and the ongoing downturn in the manufacturing sector, the recent upturn in demand has been accompanied by a rekindling of price pressures. Manufacturing prices continued to decline as supply chains improved, but prices in the services sector show no sign of abating, with tight labour market contributing to rising input and output costs. Given the service sector is far more labour-intensive, services play a particularly significant role in the core inflation rate upon which central banks are focussing on.

Our View

- While headline inflation is expected to fall reasonably sharply due to falls in energy and other commodity prices, continuing pressure on core inflation means there's far more uncertainty around the extent of the fall in inflation and where it'll ultimately settle.
- Despite not being included in core inflation measures, we think prior increases in energy prices – by raising businesses' costs – have placed upwards pressure on core inflation. It stands to reason the recent fall in energy prices may have the opposite impact in time. The large rise in interest rates over the last 12 months will act with a significant lag on economic activity and inflation, while the Bank of England's asset sales also

tighten financial conditions. Finally, market-implied inflation, allowing for a shift to CPIH from RPI and a typical inflation risk premium, is not exceptionally high.

- Given recent upside inflation surprises and strong wage growth, further interest rate rises are likely. As inflation is likely to continue to fall as lower energy prices filter through, and prior monetary tightening weighs on activity, we agree with markets that the BoE are approaching the end of their tightening cycle. However, for the BoE to pause raising rates, they will likely require evidence of sustained falls in core inflation and wage growth. Interest rate cuts look unlikely until there is a material loosening of the labour market and a rise in unemployment.
- We believe inflation risks are more evenly balanced and that inflation will fall rapidly over the next two years. Upside risks to near-term headline inflation have eased alongside falls in energy prices. However, the unexpected resilience in economic growth and labour markets mean that there's far more uncertainty around the extent of the potential fall in inflation and where it will settle.
- 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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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.