HYMANS ROBERTSON

InflationWatch – August 2023

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. Lately, this has been exacerbated by the global supply shock emanating from the Russia-Ukraine conflict and rising wages from tight labour markets.

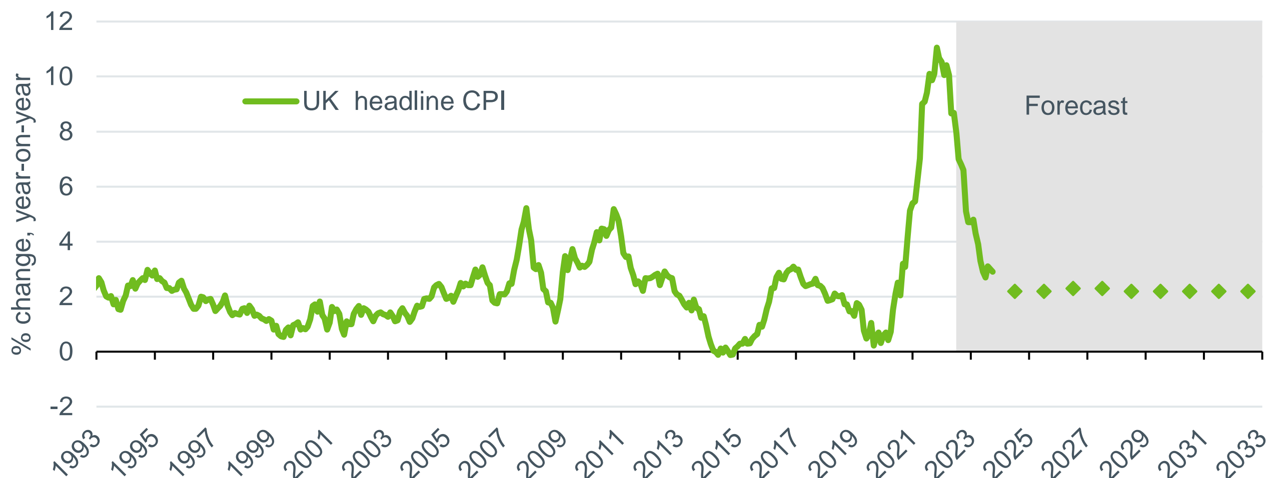
How high will inflation go, and for how long will it persist? Has the era of respectable growth rates and low inflation finally come to an end? We've introduced **InflationWatch** to help our clients assess the outlook for inflation. You'll find:

- 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 UK CPI rose 7.9% year on year in the 12 months to June 2023, down from 10.1% year on year in March 2023. Headline CPI fell more than expected in June, following several months of upside inflation surprises.
- Core inflation, which excludes energy and food prices, is proving more persistent. Although it fell by more than expected in June, to 6.9% year on year, it has actually risen by 0.7% over the last three months.

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

- Latest consensus forecasts continue to suggest that inflation will moderate over 2023, but remain elevated, and still be more than the double Bank of England's (BoE) 2% target, at 4.7% year on year, by the end of 2023.
- Medium-term consensus expectations are for UK inflation to stay slightly above the BoE's target over the course of the next 10 years. 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 we saw in the period after the global financial crisis.

Outlook indicators[2]

Driver		Metric	Latest	-3m	median/neutral
Inflation		UK headline CPI, % y-o-y	7.9	10.1	2.0
		UK core CPI, % y-o-y	6.9	6.2	1.7
Aggregate demand		Quarterly UK GDP growth, % y-o-y (expected for Q2 23)	0.1	0.2	2.2
Input costs	Goods	UK PPI, % y-o-y	0.1	8.4	2.4
	Energy	Gas prices, £/MMBTU, % y-o-y	-38.5	-61.8	4.3
	Energy	Oil prices $/barrel, % y-o-y	-35.2	-25.8	4.7
	Labour	UK unemployment rate (%)	4.0	3.8	5.5
	Labour	Average weekly earnings, 3-month average, % y-o-y	7.3	6.6	3.1
	Labour	UK vacancies (index, average = 100)	152	159	100
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	4.6	-2.7	0.0
Expectations	Consensus forecast	UK headline CPI in 18 months' time, % y-o-y	2.8	2.9	2.0
	Consensus forecast	UK GDP growth in 18 months, % y-o-y	1.1	0.7	2.2
	Market-implied inflation	UK 5y spot inflation in 5y time, % p.a.	3.5	3.6	2.5
	Inflation surprises	UK Citigroup inflation surprises, > 0 = upside surprise	66	55	0
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	3.0	3.2	2.4
	Current interest rates	Base rate % p.a.	5.0	3.5	3.5
	Market-implied interest rates	UK overnight index swaps, % p.a. in 24 months	5.5	3.8	3.5

The dashboard above shows the latest available reading for each indicator, 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.

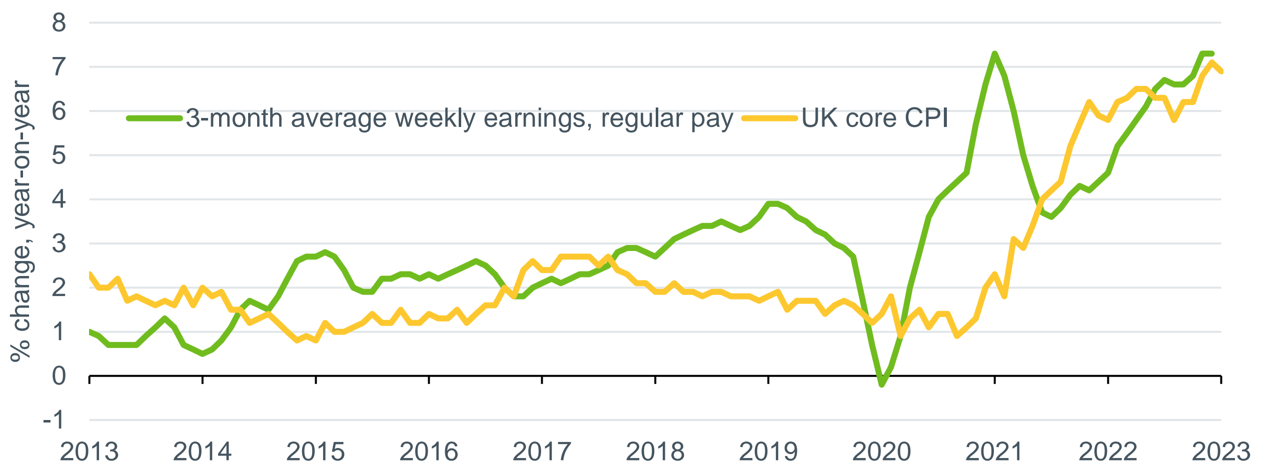
Highlights

- Year-on-year headline CPI inflation has continued to decline and is significantly below its October 2022 peak of 11.1%. While headline CPI inflation, at 7.9% year on year, remains well above the BoE's 2% target, it's expected to continue to decline as the large gains in energy and food prices of last year fall out of the annual calculation.
- The annual rate of producer price inflation (PPI) has continued to fall sharply, slowing materially from 8.7% year on year in March to 0.1% in June, as supply chains improve and year-on-year declines in commodity prices take effect. Given the recent decline in producer price inflation to very low levels, recent declines in UK CPI goods are likely to be sustained.
- The persistence in core CPI, which excludes volatile energy and food prices, is more concerning. UK core CPI rose to 6.9% year on year in June, from 6.2% in March, and remains close to its May 2023 peak. The BoE is concerned that strong nominal wage growth (see focus chart), amid unexpected economic resilience, is underpinning this persistence and thinks it will need to tighten policy further to rein it in.

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

- There have been tentative signs of a loosening in labour market conditions in recent months: the unemployment rate has edged higher, and vacancies have fallen. However, the unemployment rate remains historically low, and the recent rise is largely due to an increase in participation, rather than a rise in joblessness. Furthermore, vacancies are still well above longer-term averages.
- Against this backdrop, the BoE remains committed to returning headline back to target – the BoE increased rates by a cumulative 0.75% pa to 5.0% pa in Q2, including a surprise 0.5% pa rise in June. Further tightening is likely, given strong core inflation and nominal wage growth. However, given the aggressive rate hikes over the past year or so, ongoing declines in headline inflation, and the significant lag with which monetary impacts activity, the BoE is moving closer to the end of the rate-hiking cycle. After the massive overshoot of inflation, though, we expect the BoE to err on the side of keeping policy tighter for longer.

Focus Chart



- The UK economy has been more resilient than expected. Consumer spending, particularly in the more labour-intensive services sector, has kept pressure on tight labour markets. While the growth outlook is weak – consensus forecasts expect UK GDP to rise only 0.1% in 2023, followed by a weak recovery in 2024 – labour shortages continue to place upwards pressure on wages. Average weekly earnings (regular pay) rose 7.3% year on year in the three months to end-May 2023. This strength in nominal earnings is at odds with the BoE's inflation target, giving the BoE adequate justification to raise interest rates further and keep them higher for longer.

Our view

- While headline inflation is expected to fall reasonably sharply due to declines in energy and other commodity prices, ongoing pressure on core inflation means there's far more uncertainty around how far inflation will fall and where it'll ultimately settle. Overall, inflation risks have become more evenly balanced, with upside risks to near-term headline inflation easing alongside falls in energy prices, while medium-term risks intensify as fears over a wage-price spiral grow.
- 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 that the recent fall in energy prices may have the opposite effect, in time. The large rise in interest rates over the last 12 months will be a significant curb on economic activity and inflation, while the Bank of England's asset sales tighten financial conditions. Finally, market-implied inflation is not exceptionally high. This view takes account of a typical inflation risk premium as well as the government's shift from RPI as an inflation measure to CPIH (Consumer Price Index including housing costs).

- Given unexpected economic resilience, persistent core inflation and strong wage growth, more interest rate rises are likely. On the other hand, there's likely to be downward pressure on inflation as lower energy prices filter through and prior monetary tightening weighs on activity. We therefore tend to agree with the market view that the BoE is approaching the end of its 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.
- Deflationary 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 return to the ultra-low-rate environment we saw after the global financial crisis in the longer term. 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 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), thereby reflecting the amount of credit that has been advanced by banks. 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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