# InflationWatch

### Introduction

Following the pandemic, 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 hope our InflationWatch series helps clients assess the outlook for inflation. This paper provides:

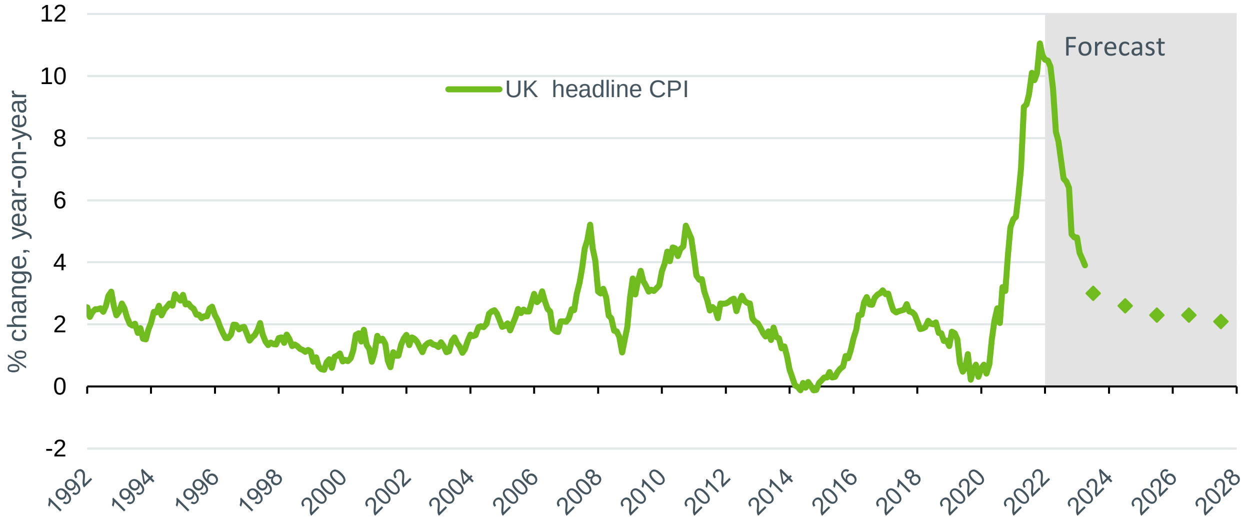
- An update on the latest position on inflation;
- Consensus forecasts on future inflation rates; and
- Our view on whether the risks to the consensus view are tilted to the upside or downside.

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 to target over the next few years .*




- Headline UK CPI rose by 10.5% year-on-year in the 12 months to December 2022, up from 10.1% y-o-y in September 2022, but below its 11.1% y-o-y peak in October, the highest annual rate since 1981.
- Latest consensus forecasts suggest that inflation will moderate over 2023, but remain elevated, averaging 7.3% y-o-y, and still be at an above-target pace of 4.8% y-o-y at the end of 2023. Inflation is not expected to return towards the Bank of England's 2% y-o-y target until 2028.

[1] Source: DataStream, consensus forecast as of January 2023, long-term forecast October 2023.

## Outlook indicators[2]

| Driver | | Metric | Latest | -3m | median/neutral |
|---|---|---|---|---|---|
| Inflation | | UK headline CPI, % y-o-y | 10.5 | 10.1 | 2.0 |
| | | UK core CPI, % y-o-y | 6.3 | 6.5 | 1.7 |
| Aggregate demand | | UK GDP growth, % y-o-y | 0.4 | 1.8 | 2.2 |
| Input costs | Goods | UK PPI, % y-o-y | 14.7 | 18.3 | 2.3 |
| | Energy | Gas prices, £/MMBTU, % y-o-y | 23.6 | -28.6 | 5.4 |
| | Energy | Oil prices $/barrel, % y-o-y | 8.3 | 12.2 | 5.8 |
| | Labour | UK unemployment rate (%) | 3.7 | 3.5 | 5.5 |
| | Labour | Average weekly earnings, 3-month average, % y-o-y | 6.7 | 5.8 | 3.1 |
| | Labour | UK vacancies (index, average = 100) | 176 | 187 | 100 |
| | Exchange rates | UK £ effective trade-weighted index, % y-o-y | -4.2 | -6.4 | 0.0 |
| Expectations | Consensus forecast | UK headline CPI in 18 months' time, % y-o-y | 3.3 | 3.6 | 2.0 |
| | Consensus forecast | UK GDP growth in 18 months, % y-o-y | 0.6 | 0.6 | 2.2 |
| | Market-implied inflation | UK 5y spot inflation in 5y time, % p.a. | 3.5 | 3.8 | 2.3 |
| | Inflation surprises | UK Citigroup inflation surprises, > 0 = upside surprise | 72 | 75 | 5 |
| Monetary policy | Money supply | UK M4 ex-IOFC (12m growth rate %) | 2.4 | 28.5 | 2.3 |
| | Current interest rates | Base rate % p.a. | 4.0 | 2.25 | 3.0 |
| | Market-implied interest rates | UK overnight index swaps, % p.a. in 24 months | 4.3 | 5.7 | 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.

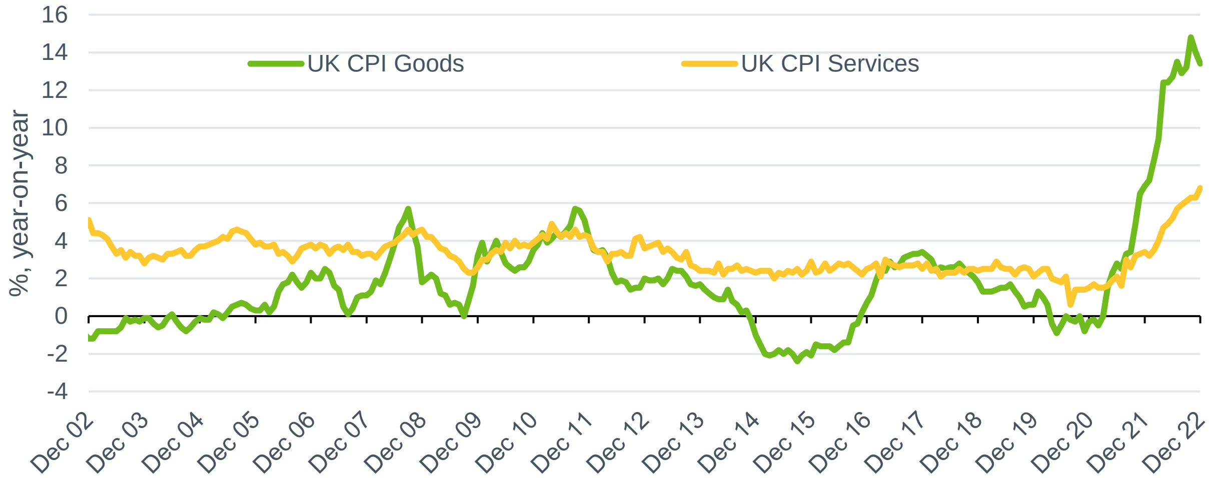
**Highlights:**

- 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.
- 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 increasing to 6.7% year-on-year in the 3 months to the end of December.
- Year-on-year GDP growth has continued to slow, now only marginally in positive territory. The UK is expected to experience the deepest recession of all G7 countries, with forecasts expecting a decline of -1.0% over 2023 followed by a weak recovery in 2024.
- The annual rate of producer price inflation (PPI) remains very elevated but continued to slow, lending support to the suggestion that producer and, hence, consumer goods price inflation has peaked.
- Looking at forward gas prices, which are far less volatile than the spot prices referenced in the table, and more closely correlated with wholesale energy prices, the upwards pressure on year-on-year inflation from energy prices has eased significantly. While forward gas prices are still more than double the level they were at the end of 2021, they have fallen dramatically in recent months. This compares with forward gas prices that were almost five times higher over 12 months as at end-September.
- While the government's Energy Price Guarantee will limit the near-term peak in consumer price inflation, it could add further price pressures in the medium-term, by preserving consumers' disposable incomes. The Guarantee is due to be replaced at the end of March 2023 instead of expiring as originally planned.

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

- Expectations of higher inflation can be self-fulfilling. Inflation surprises have become less positive, but inflation still surprises to the upside.
- 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 Q4 before delivering another increase in February, taking the base rate to 4.0% pa - above our estimate of long-term neutral levels. While interest rate expectations have come down dramatically from the levels touched in the wake of September’s ‘mini-budget’, they still reflect a little more tightening by the Monetary Policy Committee (MPC). We expect the MPC to pause soon to take account of the lagged impact that earlier interest-rate rises will have on growth and inflation. However, even though the UK faces the worst 2023 growth outlook among the major advanced economies, the Committee is likely to be cautious about easing policy while the labour market remains tight.

**Focus Chart: Headline and goods inflation is rolling over, but service sector inflation is still rising**




- Forecasters are confident headline inflation will come down in 2023, given falls in energy and food commodity prices. At an underlying level – excluding food and energy – easing supply-chain pressures should contribute to a more general fall in goods inflation. Against that, tight labour markets are leading to strong wage growth on both sides of the Atlantic, and service-sector inflation, which is a better gauge of domestically driven price pressures, is still rising and likely to be stickier (Focus chart above). As a result, despite the Bank of England’s forecasts for inflation to fall below target within the next 2-to-3 years, further near-term rate rises are targeting the risk inflation proves more persistent that expected.

## Our View

- Inflation is expected to remain high in the near-term before moderating sharply towards the end of the year and then gradually return to target over the next few years. Headline inflation pressures have continued to ease, owing to energy and food commodity price declines, but inflation pressures are broad-based, with strong wage growth maintaining upwards pressure on core inflation.
- Tight labour markets, ongoing inflationary wage rises, and still rising service sector inflation are upside risks. However, 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 has continued to fall and, allowing for a shift to CPIH from RPI and a typical inflation risk premium, is not exceptionally high.

- Interest rate expectations have eased back from recent highs, but still suggest policy rates will rise slightly further in the first half of 2023. While we agree the BoE are approaching the end of their tightening cycle, we think a significant loosening in policy in 2023 seems unlikely, unless downturns are more severe than expected, given the BoE's very downbeat assessment of the economy's supply capacity.
- In a change to our previous assessment, we believe inflation risks are more evenly balanced and that inflation will fall fairly rapidly over the next two years. In particular, upside risks to near-term headline inflation have eased alongside falls in energy prices.
- 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.<br><br>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<br><br>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, %<br>UK average weekly earnings – 3m average, % y-o-y<br>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<br><br>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, % 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 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.<br><br>All other things equal, increased money supply boosts economic activity which may be inflationary.<br><br>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, % pa | 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.<br><br>Higher interest rates increase the cost of credit across the economy. All other things being equal, this reduces economic activity and inflation. |