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UK INFLATION REACHES HIGHEST LEVEL SINCE NOVEMBER 2014

Berenberg Macro Flash

yoy	CPI	Core CPI
Actual	1.0%	1.5%
Previous	0.6%	1.3%
Consensus	0.9%	1.3%
Berenberg	0.9%	1.4%

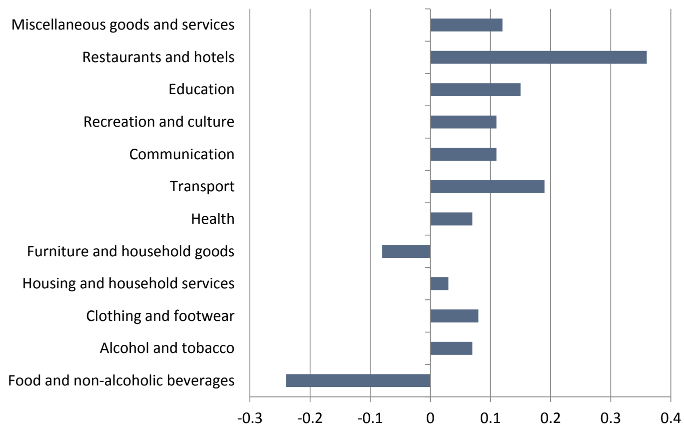
Headline inflation increased to 1.0% yoy in September, the highest rate since November 2014, up from 0.6% in August, and above expectations of 0.9%. Core inflation, which excludes volatile components like food and energy, increased to 1.5% from 1.3% in August. Interestingly, the 15% drop in trade-weighted sterling since the Brexit vote was not the major driver behind the rise in the headline and core rates. As Chart 1 shows, there were broad increases across most major components, with restaurants and hotels, transport and education making the largest positive contributions while the import sensitive food and beverages component made the biggest negative contribution.

The impact of weaker sterling on headline inflation will likely occur with a lag – circa three months. Many businesses have measures in place to protect against short-term currency fluctuations. In the coming months we anticipate a stronger inflationary effect from goods import prices – Chart 2. Energy costs are likely to rise sharply too - on a sterling basis a barrel of Brent Crude oil is up 30% yoy. We expect inflation to break-through the 2% target by early next year, peaking at around 2.6% in the summer, before gradually easing to around 2.0 by end of 2018.

Higher inflation will weigh on total consumption growth and affect spending patterns. Despite the low unemployment and strong employment gains over the past few years nominal wage growth has disappointed. Nominal wages are currently growing at just over 2% per year. The rise in inflation is likely to sharply reduce real wage growth or even lead to declining real wages for a short period. While solid household fundamentals should ensure total consumption continues to expand at a stable - albeit subdued – pace, household spending patterns are likely to be affected. Spending will increase on essential imported goods, such as food and energy, while discretionary purchases such as leisure, retail, hotels and the like decline.

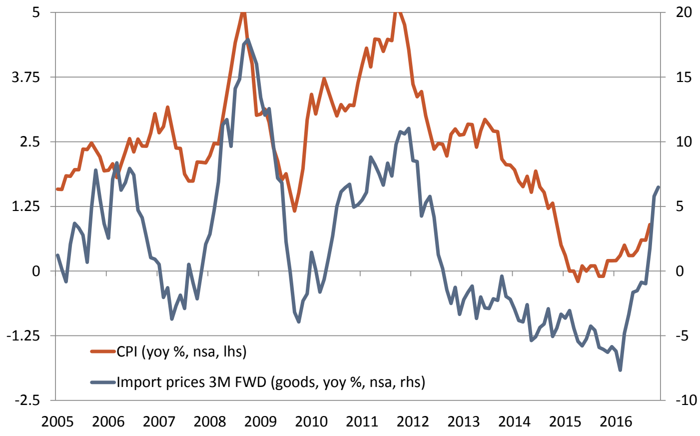
Implications for the Bank of England: The overshoot on inflation because of the sterling weakness would not prevent the BOE from easing again if the economy started to wobble – the BoE will look through transitory inflationary factors like oil prices and currency fluctuations. But the bigger-than-expected drop in sterling has done a lot of the work for the Bank of England and with resilient economic performance since the Brexit vote, we expect the BoE to stay on hold for now, easing monetary policy again only if economic conditions deteriorate.

Chart 1: Contributions to the 12 month CPI % change



Source: ONS

Chart 2: CPI inflation versus import prices (yoy, %)



Monthly data. Source: ONS, Berenberg calculations

yoy %	SEP	AUG	JUL	JUN	MAY	APR
CPI	1.0	0.6	0.6	0.5	0.3	0.3
Core	1.5	1.3	1.3	1.4	1.2	1.2