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Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 20 3465 2672

UK: CORE INFLATION STRENGTH IS KEY FOR BOE OUTLOOK

Berenberg Macro Flash

April, yoy	CPI	Core CPI
Actual	2.7%	2.4%
Previous	2.3%	1.8%
Consensus	2.6%	2.3%
Berenberg	2.5%	2.1%

Inflation in April hit the highest rate since September 2013. Headline inflation increased to 2.7% in April, up from 2.3% in March and above consensus estimates of 2.6%. Meanwhile, core inflation, which excludes the volatile energy and food components, surged to 2.4% from 1.8% the previous month. The ONS noted that, with Easter falling in April this year, 'air fares were the main contributors to the increase…although this balanced out a downward effect of similar magnitude in March 2017'. Air fares increased by 18.6% yoy. This suggests that the headline, and core, rates could slip back a little next month. But the headline rate will continue to tick up thereafter as the remaining effects of the sterling depreciation since the Brexit vote pass through. Increasing prices of clothing, electricity and vehicle excise duty all contributed to the uptick in April. CPIH (CPI inc. owner occupiers' housing costs) - the ONS's preferred inflation series - was 2.6% in April, up from 2.3% in March. *Note: The Chancellor could alter the BoE's official target to CPIH later in the year. The BoE currently targets CPI.*

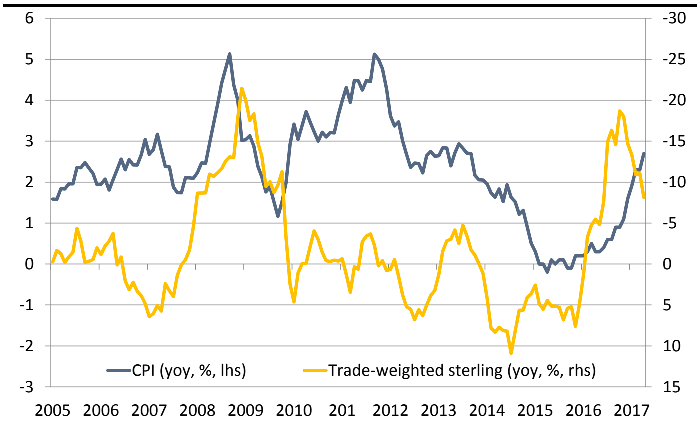
Inflation will peak soon: The major sources of upward pressure to the headline inflation rate, (1) the exchange rate and (2) energy prices, seem to have peaked – Charts 1 and 2. It will take a few more months for these cost pressures to fully pass through. We expect headline inflation to peak at 2.9% in Q3 2017 before easing a little thereafter, but remain above the BoE's 2% target through 2018. Despite the dramatic decline in the exchange rate immediately after the Brexit vote and the rise in the oil price in sterling terms since mid-2016, these inflationary forces are relatively benign compared to recent history. During the financial crisis, sterling declined by c30% on a trade-weighted basis, while oil reached almost £70 a barrel. Then in 2012 oil hit nearly £80 per barrel. During both periods headline CPI peaked at 5.1% before dropping sharply thereafter. This time around, sterling is down only c10% on a trade-weighted basis since June 23, and c16% below the November 2015 peak, while the current oil price is still cheap at a little over £40 per barrel.

Monetary policy outlook – first hike in Q1 2018. The continued uptrend in underlying inflation – Chart 3 – and robust economic growth will serve to increase the growing hawkishness – based on its current guidance of a gradual tightening over the medium-term – of the BoE. While the BoE will look through the near-term rise in inflation from the currency depreciation, it will eventually tighten in response to the continued rise in domestic cost pressures it forecast at the May Inflation Report. Barring an unexpected and protracted drop in demand at home or in a major trading partner such as the Eurozone or the US, we look for a first hike of 25bps in Q1 2018.

Could the BoE surprise with a hike this year? Maybe. Despite the BoE's high tolerance for above-target inflation, the most recent minutes from the BoE's MPC meetings stated that, for 'some' members, 'it would take relatively little further upside news on the prospects for activity or inflation for them to consider that a more immediate reduction in policy support might be warranted'. As we have argued before, we see a 40% chance of a first hike in 2017 – on the basis that underlying inflationary pressures could build more quickly than currently anticipated. Today's upside surprise on core inflation suits our call. But progress to the first hike will not be easy. The BoE faces inflation uncertainty stemming from the different speeds at which current demand and supply are reacting to Brexit, and challenges communicating its policy guidance amid lower long-term growth.

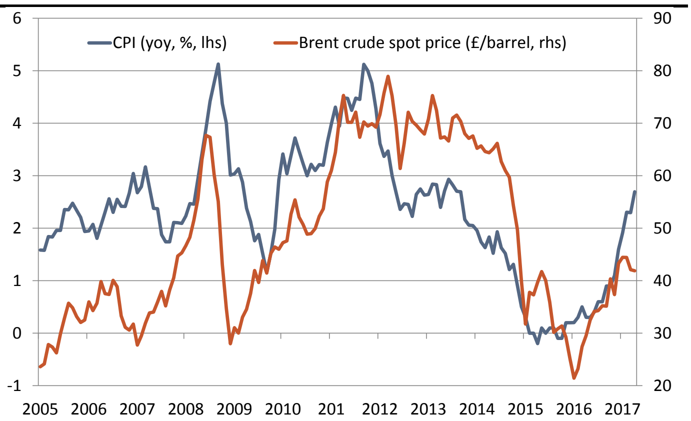
For a detailed analysis of the last 20 years of UK monetary policy and insights for Brexit, please see 'UK: Lessons from two decades of BoE policy', 2 March 2017.

Chart 1: Headline inflation and trade-weighted sterling (annual change %)



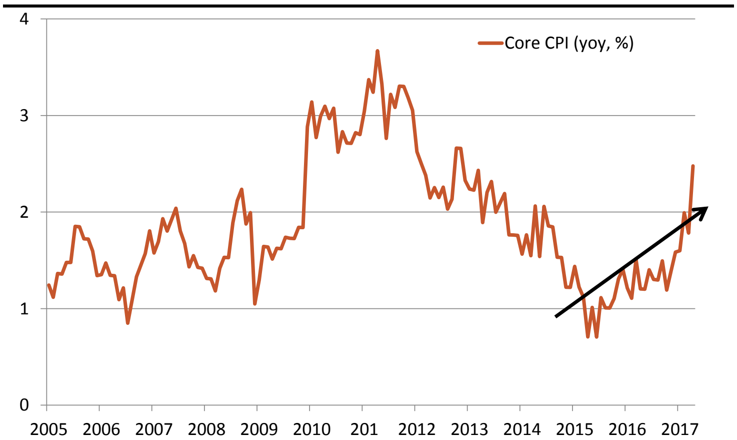
Source: ONS, Bank of England, Berenberg calculations

Chart 2: Headline inflation (annual change %) versus oil price (£/barrel)



Source: ONS, Bank of England, World Bank, Berenberg calculations

Chart 3: Core inflation (annual change %)



Source: ONS, Bank of England, Berenberg calculations

yoy%	APR	MAR	FEB	JAN	DEC	NOV
CPI	2.7	2.3	2.3	1.8	1.6	1.2
Core	2.4	1.8	2.0	1.6	1.6	1.4

Source: ONS

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com