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RISING INFLATION WARRANTS NOVEMBER RATE HIKE

Berenberg Macro Flash

UK inflation, September 2017

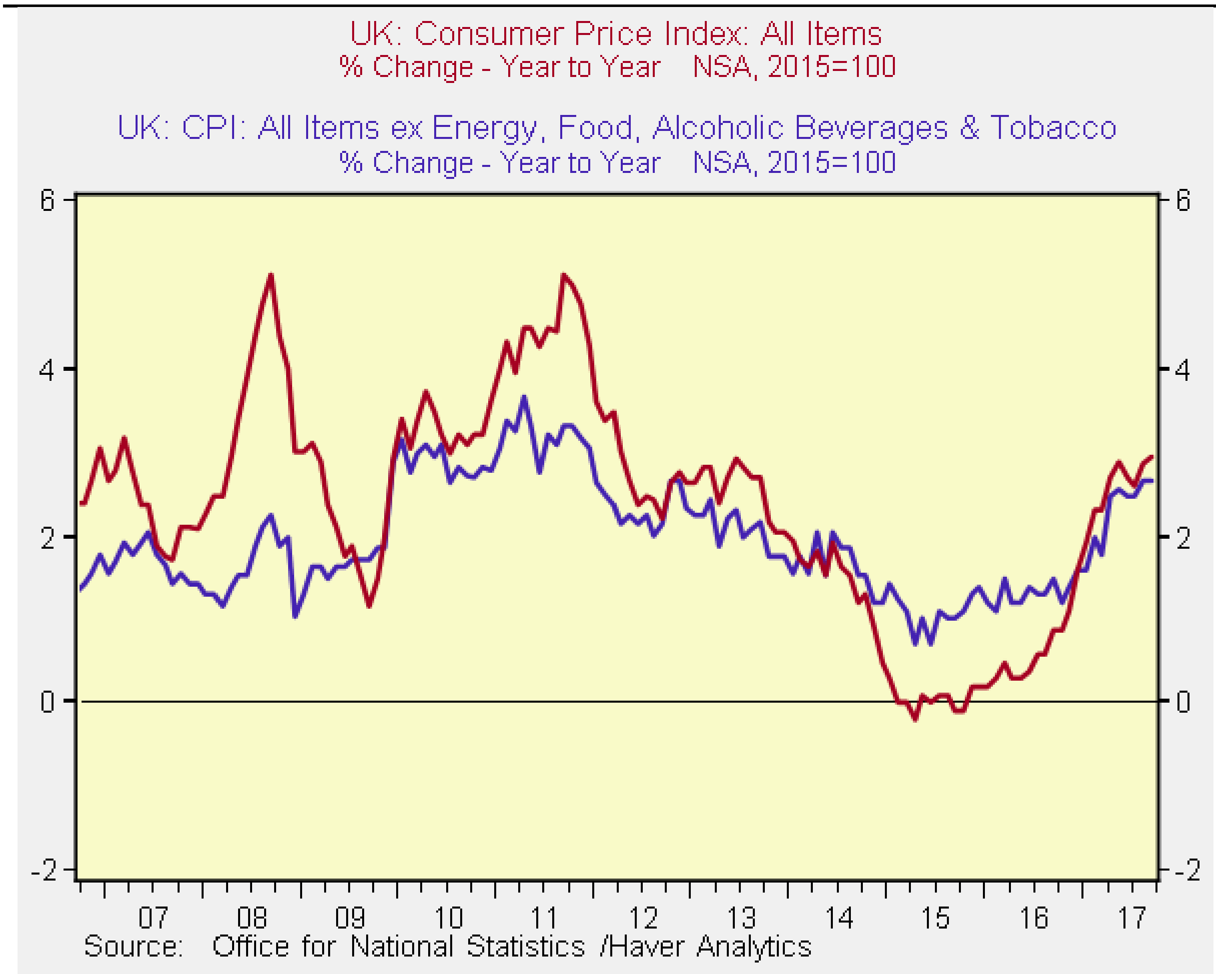
	CPI	Core CPI
Actual	3.0%	2.7%
Previous	2.9%	2.7%
Consensus	3.0%	2.7%
Berenberg	2.9%	2.7%

At 3.0%, headline inflation reached its highest rate since March 2012 in September (vs. 2.9% in August). The headline inflation rate has risen to well above the BoE's mandated target of 2.0% since the Brexit vote as the c12% fall in trade-weighted sterling has caused a temporary surge in import prices. Data on producer prices shows that firms are absorbing much of the surge in import costs. While raw material prices rose by 8.4% yoy in September (down from 15.3% in April), factory gate prices rose by just 3.3% yoy (3.6% in April). Prices were higher in all major categories compared to a year ago reflecting broad based inflationary pressure. While the headline inflation rate will probably peak in Q3 before gradually tracking down next year - as long as sterling remains at current levels or higher – the stable gains in domestic spending and improving external backdrop since the Brexit vote, amid cautious hiring and investment, is causing demand growth to exceed supply growth. Core inflation, which excludes volatile food and energy components, was 2.7% in September, having steadily risen over the past two years – see chart. We expect this imbalance between demand growth and supply growth to persist into the medium-term. Therefore, as the effects of higher import prices on headline inflation fade, underlying inflationary pressures will remain elevated.

The market could be underestimating the pace of rate hikes: In line with its recent guidance we expect the BoE to hike for the first time by 25 bps at its November MPC meeting. Thereafter, we expect a continued tightening to sustainably return inflation to close to its 2% target, with four 25bps hikes in total between now and the end of 2019 (two in 2018 and one in 2019). While the market now expects the first hike in November, having recently brought forward its expectations from as late as 2019, current pricing suggests the market is anticipating only one further hike in 2018. We therefore expect the BoE to strengthen its guidance after the first hike, leading to a somewhat steeper gilt curve and possibly a stronger sterling on a trade-weighted basis by the turn of the year. As long as the BoE goes early and slowly with its tightening we do not expect any major negative effects on real GDP growth or employment. The first 25bps hike will have trivial effects on the real economy, removing no more than a third of the emergency stimulus the BoE introduced back in August 2016. Moreover, monetary policy will remain highly accommodative well into the medium-term. Even if the bank rate were 100bps higher, the real policy rate would remain negative and the bank's balance sheet large by historical standards.

The risks to consumers from rising inflation are exaggerated: Despite the media excitement and some predictions that households would reduce their spending as inflation rises to 3% this year, the reality is far more sanguine. Currently, inflation is outpacing wage growth, causing real wages to decline temporarily. But instead of cutting back spending as inflation rises above wages, households are simply opening up their wallets to spend more in order to meet their growing real demand for goods and services. And after a tough year, there is finally light at the end of the tunnel. Households could already be past the worst of the real wage squeeze. While headline inflation might remain elevated at close to 3% in the coming months, as it gradually trends downward towards its medium-term underlying rate (c2.3%) and nominal wage growth accelerates, real wages will likely start to rise again early next year. While household confidence has dropped this year, continued gains in labour demand and a recovery in real earnings should underpin a rebound in household confidence next year.

Chart 1: Headline CPI inflation and core inflation



yoy%	SEP	AUG	JUL	JUN	MAY	APR
CPI	3.0	2.9	2.6	2.6	2.9	2.7
Core	2.7	2.7	2.4	2.4	2.6	2.4

Source: ONS

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