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UK INFLATION: MR CARNEY HAD BETTER BUY SOME FIRST CLASS STAMPS

Berenberg Macro Flash

UK inflation, November 2017

	CPI	Core CPI
Actual	3.1%	2.7%
Previous	3.0%	2.7%
Consensus	3.0%	2.8%
Berenberg	2.9%	-

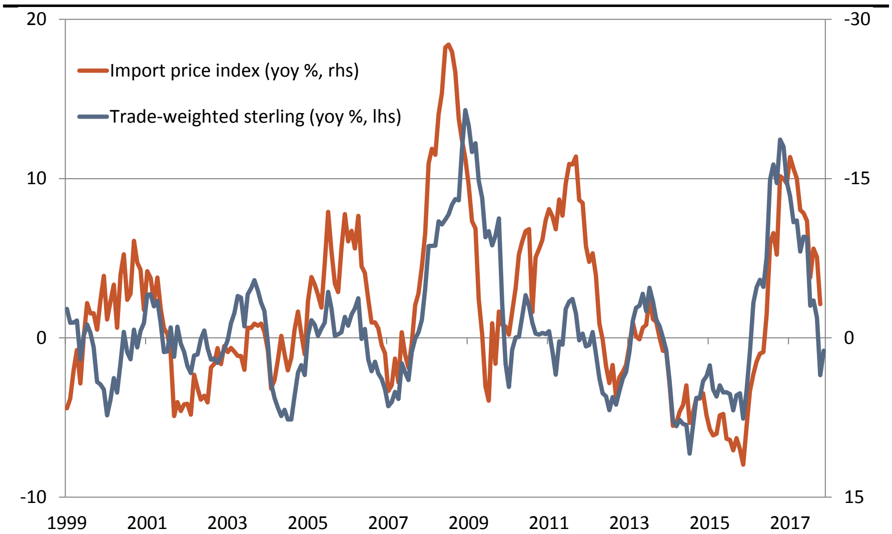
Dear chancellor Hammond…sincerely, governor Carney: Headline CPI inflation broke the 3.0% yoy barrier in November (3.1%) for the first time since March 2012 (after 3.0% in October). As per the BoE's mandate, governor Mark Carney now has the job of writing to chancellor Phillip Hammond to explain why the headline inflation rate has deviated by more than one percentage point from the bank's 2% target. This is the easy part. The annual headline inflation rate has risen to well above the BoE's mandated target of 2.0% since the Brexit vote in June 2016. The dramatic fall in trade-weighted sterling, reflecting markets' lowered expectations for long term UK growth, has caused a temporary surge in import price growth – Chart 1. While the Brexit-vote inflation surge will gradually fade from here on, underlying inflationary pressures are likely to continue build over time without modestly tighter monetary policy. The hard part for Mr Carney is ensuring that the headline rate eventually gets back to target even after the temporary import related surge passes. The BoE will need to balance the risk of not tightening too slowly and overshooting its inflation target for too long, against spooking Brexit-concerned households and firms with an excessive tightening of financial conditions.

The Brexit-vote driven inflation is peaking: Material prices rose by 7.3% yoy in November, well below the peak of 19.9% in January. Meanwhile, factory gate prices rose by 3.0% yoy. Prices were higher in all major categories of the consumer price index compared to a year ago, reflecting the broad based inflationary pressure. As Chart 2 shows, the recent rise in oil prices has started to contribute more strongly to the headline inflation rate again. As long as sterling remains at current levels, or higher, the pressure from import prices will fade over time. The headline inflation rate is probably peaking now. However, the stable gains in domestic spending and improving external backdrop, in an environment of cautious hiring and investment linked to Brexit nerves, is causing demand growth to exceed supply growth. Without tighter monetary policy, this growing underlying inflationary pressure will prevent the headline rate from returning to the 2% target on its own. Core inflation, which excludes volatile food and energy components, was 2.7% in November, having steadily risen over the past two years.

Households are still handling the higher inflation well: Currently, inflation is outpacing wage growth, causing real wages to decline temporarily. But instead of cutting back spending as inflation rises above wage growth, 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.

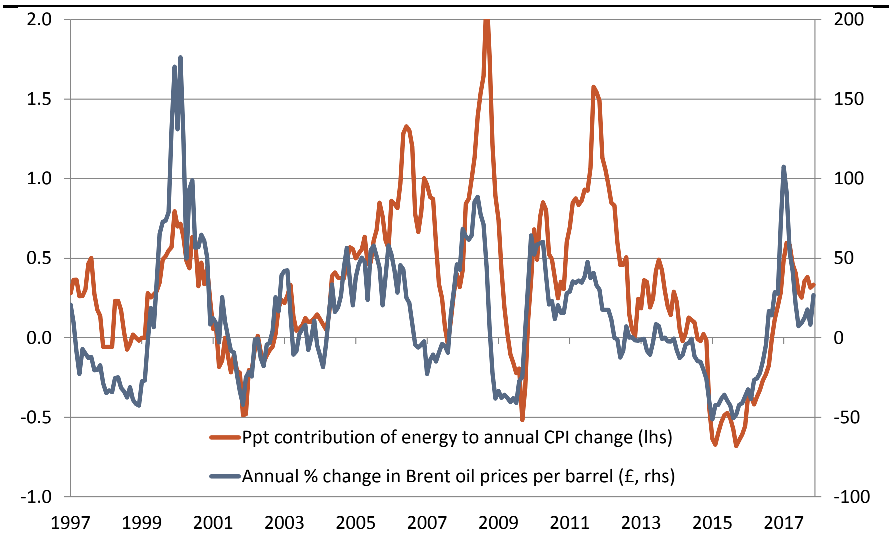
What to expect from the BoE on Thursday: We are not expecting any policy change on Thursday at the BoE's November Monetary Policy Committee Meeting. Instead, we will be looking for clues in the forward guidance for when the BoE will hike next. The MPC might decide to comment on market pricing directly as it did in the past – possibly indicating that the yield curve is too flat relative to the MPC's expectations for the path of rate hikes. This would start the bank's process of preparing markets for the next rate hike – probably in Q2. Thereafter, we'd expect even stronger guidance at the February 2018 Inflation Report when the BoE updates its economic forecasts. We look for two rate hikes in 2018 and one in 2019.

Chart 1: Trade-weighted sterling versus import price index (yoy %)



Monthly data. Source: Bank of England, Office of National Statistics, Berenberg calculations

Chart 2: Contribution of energy price inflation (ppt) to headline inflation and oil prices in sterling terms (yoy %)



Monthly data. Source: World Bank, Bank of England, Office of National Statistics, Berenberg calculations

yoy%	NOV	OCT	SEP	AUG	JUL	JUN
CPI	3.1	3.0	3.0	2.9	2.6	2.6
Core	2.7	2.7	2.7	2.7	2.4	2.4

Source: ONS

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