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UK: MAY INFLATION PREVIEW - LOOKING THROUGH THE BREXIT JITTERS

Berenberg Macro Flash

While the international backdrop for the UK has somewhat improved following the worst start to a year in financial markets since 2008, the domestic picture has deteriorated lately ahead of the EU referendum on June 23. But underlying fundamentals are sound and should warrant a rate hike later this year so long as the UK votes to stay in the EU and thus avoids the potential Brexit turbulences. Whilst we expect some downward revisions to the current assessment of growth and some wariness by the MPC about the impact of Brexit uncertainty on domestic demand, we would not read too much into a dovish tone. We address these issues one by one as we discuss what to look for in the May Inflation Report on Thursday:

Developments abroad – stabilising

The UK's major trading partner, the Eurozone, outperformed expectations in the first quarter. While Eurozone growth will soften again somewhat in Q2, the ECB's easing package of 10 March will help to contain international risks and support a recovery in lending to the real economy. We expect Eurozone growth to return to its 1.6% trend rate of growth later this year, led by the reformers in the periphery and supported by a modest fiscal stimulus in the core. The weaker sterling against the euro and continued growth in the Eurozone will boost demand for UK goods exports that have fallen away sharply since 2013.

The UK's second largest trading partner, the US, repeated the trend of recent years by underperforming the first quarter. But US growth should recover in Q2 reflecting robust underlying domestic conditions driven by the housing market and consumption. Further afield, some emerging markets have hit stabilised. They will be helped along now by modestly higher commodity prices and a weaker dollar. And in China - a frequent market concern - first quarter growth beat expectations and exports have recently found a firmer footing - up 10% yoy in March – following the devaluations in August last year and in January this year. This should help to negate hard landing fears and help stabilise global financial markets.

Developments at home – near-term softness as Brexit risk drags

Since the Bank of England (BoE) last published forecasts in February, employment gains have stalled, business surveys have weakened significantly and business investment has begun to contract sharply. The BoE will most likely put this down to softer global demand in Q1 and Brexit jitters in Q2. Nevertheless, the BoE will likely revise down its growth forecasts and raise its projections for the size of the output gap. Normally, this would lead to lower inflation forecasts in the Bank's model too. However, recent developments in oil and sterling will offset this.

While oil prices are still 35% down compared to a year ago, they have increased 25% since February. As a result, they will drag on inflation by less than the BoE had previously expected. Similarly, sterling has depreciated by 10% since last August in trade weighted terms, erasing half of the appreciation that took place between March 2013 and summer last year. That reduces the disinflationary pressure from import prices. The effects of oil and sterling might offset or even exceed the impact of weaker than expected domestic demand. We expect the central inflation forecast to overshoot the 2% target in 2018 to indicate that market pricing is too dovish relative to the committee's expectations. (The BoE use the market forecast for the policy rate in their central model estimate.)

Whereas employment has consistently grown faster than the BoE has anticipated during the recovery, nominal wage gains have been softer and are a little under 2ppt below the pre-crisis average. And while low oil prices have boosted wages in real-terms, low headline inflation has underpinned concerns by the MPC that a fall in inflation expectations may negatively affect nominal wage and price setting behaviour. Despite the pick-up in inflation during the last six months, nominal wages have not kept apace and real wage growth has slowed. Weaker domestic demand in the first half of the year plus uncertainty ahead of the Brexit vote have probably held back wage increases. Nominal wage gains will likely recover at a faster rate in the second half of the year, after near-term risks have passed, supporting the argument for rate hikes.

Immediate policy decision – rates on hold

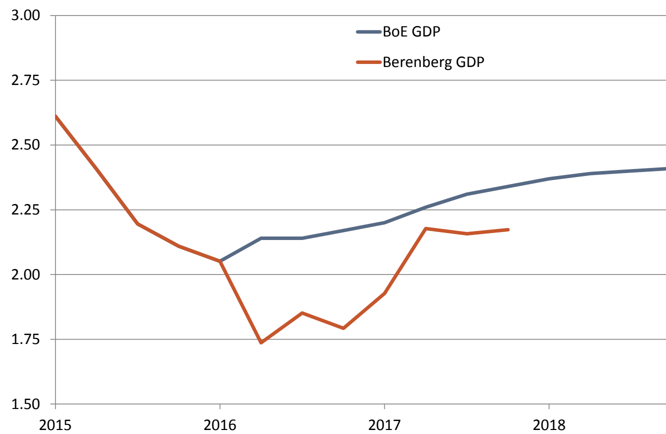
The chance of a rate change on Thursday is very slim indeed. In light of recent headwinds and the clear slowdown in domestic growth momentum, some members of the committee have suggested that a continued slowdown could lead to a discussion of a rate cut. But Q2 is half-way done, and monetary policy works with too much of a lag to be effective to counter the pre-EU-referendum softness. Instead, a cut would risk perpetuating fears that the on-going slowdown is due to risks beyond Brexit, we don't think it is. Since the Brexit risk blurs the outlook a lot, we expect the MPC to side-step this current softness and remain firmly in wait and see mode. While the MPC are data dependent, if they are drawn too much into a discussion of current risks and come off too dovish on Thursday, they would create a communication problem as these risks could dissipate quickly after the referendum if the UK votes to stay in the EU.

In our view, the EU referendum is a major distraction for the BoE for the time being. They would otherwise be preparing markets for a rate hike by now. UK growth has been remarkably stable at a trend of around 0.5% since mid-2014. Inflation is steadily recovering and the labour market is at full employment. If not for the referendum, we would have expected this to continue following the modest dent in Q1. Moreover, behaviour by households seems to be no longer consistent with the current low policy setting. Some of the bad pre-Lehman habits are returning. Consumer credit growth is at a decade high, saving is at a record low and household debt is beginning to grow as a percentage of GDP for the first time since 2008.

While we expect no policy change on Thursday, the combined effects of a cautious tone and downward revisions to growth will likely be taken as dovish. This may motivate markets to further push back rate hike expectations. However, when the referendum has passed and the UK stays in the EU, we anticipate a recovery in domestic momentum as a well as a shift to a more hawkish tone. Unless the BoE removes the explicit statement it has included in recent minutes that 'the Committee's best collective judgement was that it was more likely than not that Bank Rate would need to increase over the forecast period', we advise looking through the MPC's dovishness on Thursday until clearer guidance can be provided after the vote.

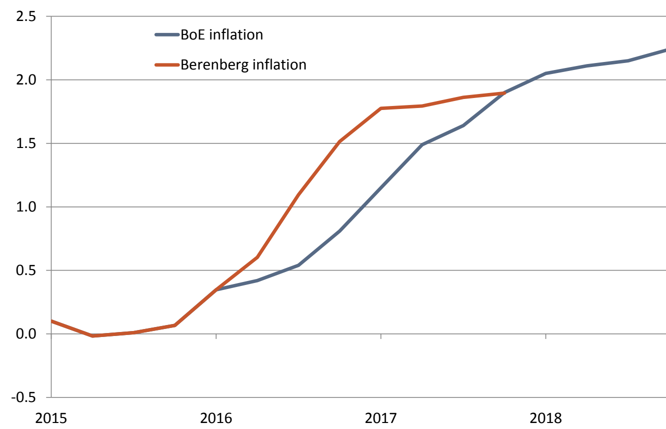
BoE's February Inflation Report forecasts compared to latest Berenberg forecasts

Chart 1: GDP



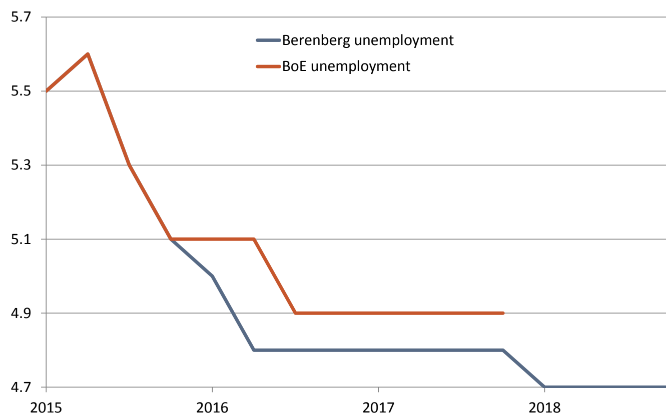
Source: BoE, Berenberg, ONS

Chart 2: Inflation



Source: BoE, Berenberg, ONS

Chart 3: Unemployment



Source: BoE, Berenberg, ONS