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UK INFLATION – DROP IN AIR FARES REVERSES MARCH GAINS

Berenberg Macro Flash

UK CPI, April

yoy	CPI	Core CPI
Actual	**0.3%**	**1.2%**
Previous	0.5%	1.5%
Consensus	0.5%	1.4%
Berenberg	0.5%	1.5%

Inflation unexpectedly slowed to 0.3% in April from 0.5% in March. A 14.2% mom decline in air fares stripped away the 0.1 ppt air fares added in March - when they jumped temporarily due to the early Easter. Declines in the prices of clothing, vehicles and social housing rent also contributed to the drop in the headline rate. Core inflation, which strips out the volatile energy and food components dropped to 1.2% in April from 1.5% in March - versus expectations of 1.4%. Monthly data are volatile, so we do not pay too much attention to modest shifts around what is broadly a gradual upward trend. The headline rate has steadily increased from its low of -0.1% in October last year and should continue to experience a mechanical rise as the past effects of transitory factors continue to wash out. Still, there is considerable uncertainty to the inflation outlook as we discuss below.

Risks to inflation outlook: The return of inflation to the 2% target over the medium-term will depend upon the evolution of several factors. Short of a Brexit, we expect headline inflation to gradually edge higher during the course of 2016, increasing to 1.9% by the end of 2017. Most of this rise will be mechanical as the past effects of strong sterling and sharp falls in the price of oil and other commodities wash out. But this expectation rests on a number of assumptions about the transitory and underlying factors that have driven inflation dynamics in the last few years:

- First, that oil remains at or around its current price of $45-50 over the medium-term
- Second, that sterling only modestly appreciates after June 23, and remains below its trade-weighted peak in November 2015
- Third, that the strong competition in the supermarket sector which has led to falls in food prices begins to ease a little
- Fourth, that wage gains will begin to rise at faster rates now that the labour market has reached full employment - exceeding 3% yoy by early 2017

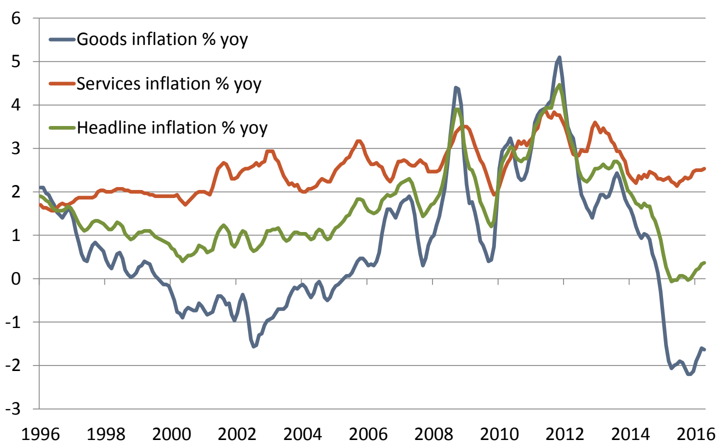
In line with the last few years, further large swings in the price of oil and other commodities cannot be ruled out. Likewise, from both an employment and wage perspective, the labour market has not progressed in line with expectations so far in this recovery. And it remains to be seen how much of sterling's past strength will be regained if the UK votes to stay in the EU and markets begin to bring forward their expectations of the first rate hike. As such, the recent precedent for inflation to surprise versus expectations might continue, with risks around the outlook roughly balanced on the upside and downside.

Bottom line - the UK has benefited from low inflation. The risk of outright deflation continues to remain very low. As Chart 1 shows, services costs, which account for 48% of the weight in the headline index, have been growing at rates of 2% per year or faster for over a decade. The large falls in the headline rate since 2014 are largely due to cheaper goods, which account for 52% of the weight in the headline index. Low inflation has helped boost real incomes during a time when nominal wage gains have been unusually soft relative to the level of unemployment in the economy. And given that household consumption has been growing faster than overall GDP, there is little evidence that low inflation has led households to postpone spending amid expectations of lower prices in the future. Whilst low inflation might give the inflation targeting Bank of England a headache, it is mostly a welcome boost for UK households and the economy overall.

UK Inflation, April

yoy %	APR	MAR	FEB	JAN	DEC	NOV
CPI	0.3	0.5	0.3	0.3	0.2	0.1
Core	1.2	1.5	1.2	1.2	1.4	1.2

Chart1: Headline, services and goods inflation



Source: ONS. 3M MA

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