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UK INFLATION INCREASES IN JULY - NO SIGNS OF BREXIT EFFECT JUST YET

Berenberg Macro Flash

UK CPI, July

yoy	**CPI**	**Core CPI**
Actual	0.6%	1.3%
Previous	0.5%	1.4%
Consensus	0.5%	1.4%
Berenberg	0.6%	1.5%

Headline inflation in the UK increased to 0.6% yoy in July from 0.5% in June, in line with our expectations. Core inflation, a measure of underlying inflation that subtracts volatile components such as food and energy, slowed to 1.3% yoy in July compared to 1.4% yoy the previous month. The impact of the Brexit vote will take time to feed through into inflation. The changes in the components of July inflation reflected the improving underlying economic conditions pre-vote. Prices continued to fall for food and non-alcoholic beverages, due to strong competition in the supermarket sector. Most of the upward pressure came from components linked to growth in discretionary spending such as (1) restaurants and hotels and (2) recreation and culture.

Inflation above 2% by Q1 2017: The Brexit vote has altered the outlook for inflation (see chart) - which will be hit by conflicting forces in the coming quarters. Whereas the depreciation of the pound will be inflationary, the weakness in demand will be disinflationary. The rise in import prices from the 18% drop in trade-weighted sterling since last November will dominate over softer demand, leading to a faster rise in inflation towards the 2% target than we had expected before the referendum (under the assumption of no Brexit). Alongside the inflation data, the ONS publishes data on producer prices. Input prices increased by 3.3% mom in July, versus expectations of a 1.0% rise. This was the fastest rise in monthly input prices since December 2010 and reflects the weaker sterling.

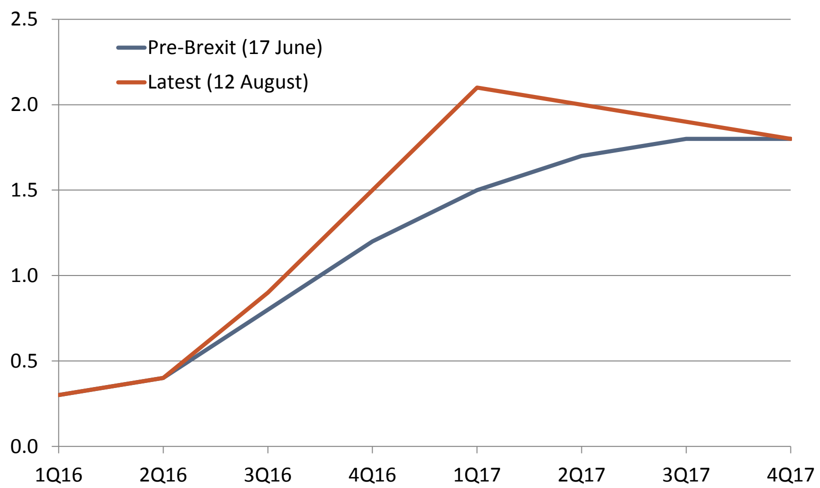
Real wages set to decline: The expected sharp rise in inflation presents downside risks to the outlook for consumption. Consumption is the largest component of GDP (two-thirds). Nominal wages grew by 2.3% yoy in May. But nominal wage growth will slow over the medium-term as unemployment rises. During the euro crisis, nominal wage growth slowed to a less than 1% yoy. With inflation rising to at least the 2% target by early next year, real wages will probably decline during 2017. As such, even as the post-vote shock eases up and confidence stabilises, consumption growth will remain below trend over the medium-term.

Brexit could be inflationary in the long-run. Looking far ahead, i.e. to the post-EU UK, the outlook for inflation becomes highly uncertain. In the long-run, inflation is simply the product of demand and supply conditions. Less access to the single market could reduce investment, trade and immigration which would hurt the supply potential of the economy. As such, Brexit might prove to have a modest long-term inflationary effect and could lead to a rise in long-term interest rates. This would be bad news for an economy like the UK that carries a large stock of debt.

UK CPI, July

yoy %	JUL	JUN	MAY	APR	MAR	FEB
CPI	0.6	0.5	0.3	0.3	0.5	0.3
Core	1.3	1.4	1.2	1.2	1.5	1.2

Chart1: Berenberg CPI inflation forecasts pre- and post-Brexit vote



Yoy %. Source: ONS, Berenberg forecasts.

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