MACRO NEWS 13/12/16

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UK UPDATE: INFLATION REACHES HIGHEST LEVEL IN TWO YEARS

Berenberg Macro Flash

Nov, yoy	CPI	Core CPI
Actual	1.2	1.4
Previous	0.9	1.2
Consensus	1.1	1.3
Berenberg	1.1	1.3

Will the BoE send the Treasury a Christmas card instead?
For the first time since 2013 BoE Governor Mark Carney won't be sending the Chancellor a letter in December explaining why inflation is more than 1% below the BoE's 2% target. Headline inflation rose to 1.2% in November, in line with expectations and up from 0.9% in October. Core inflation, which excludes volatile energy and food prices, rose to 1.4% from 1.2% the previous month.

Today's data show building inflationary pressure following the large Brexit-related depreciation in trade-weighted sterling. We anticipate a continued rise in inflation over the coming months, peaking at 2.8% in Q3 2017 before gradually declining thereafter.

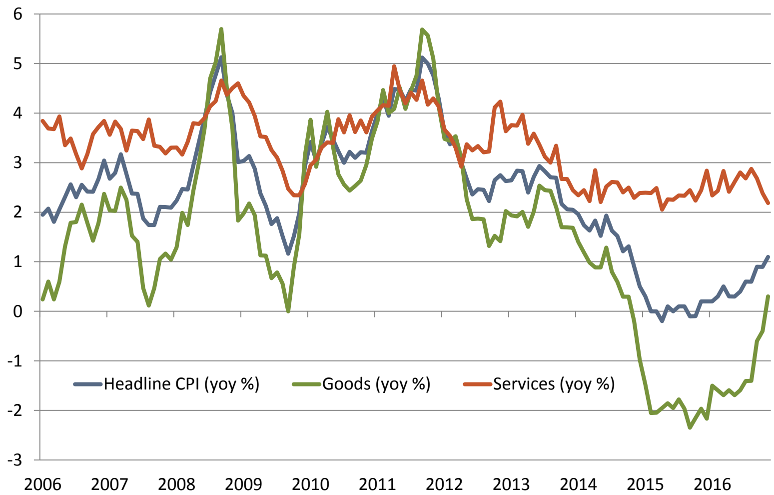
The main source of inflationary pressure in the UK is rising import costs.
While they have been a deflationary force for almost two years - due to the delayed effect of past sterling strength and the fall in oil prices - goods prices (which make up a little over 50% of the CPI basket) turned positive in November (0.3% yoy) having ticked up strongly in recent months – Chart 1. Meanwhile, domestic-oriented services inflation slowed a little to 2.2%.

The impact of the weaker exchange rate is most prevalent in goods prices since a large proportion of the goods purchased in the UK are manufactured abroad. After declining for almost three years on sterling strength, import costs have risen sharply following the c15% yoy depreciation in trade-weighted sterling. Separate ONS data on producer prices show that the cost of raw materials – often priced in USD - rose 12.9% yoy in November. Energy prices are adding inflationary pressure too. On a sterling basis oil prices are currently up c75% yoy and natural gas prices have more than doubled.

Rising inflation expectations – risk of rate hikes in 2017.
The current low level of inflation is positive for households. It supports real income growth and keeps borrowing costs down. But it won't last, and they know it. BoE survey data show that inflation expectations have risen in each quarter of 2016. The median expectation for the rate of headline inflation in 12 months time is 2.8% - Chart 2. Unless nominal wage growth surprises on the upside in 2017, rising inflation could cause real wages to decline for the first time since 2014. This will act like a modest drag on consumption growth in 2017 and 2018.

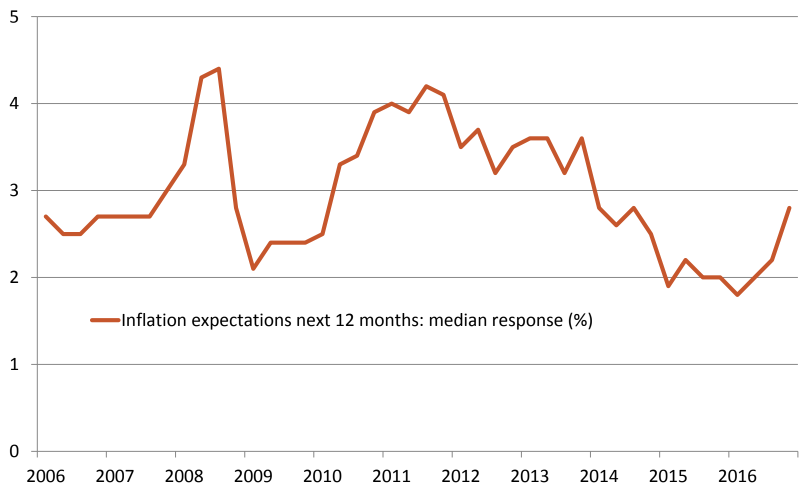
However, if GDP and wage growth surprises on the upside in the coming quarters (30% chance), the BoE is likely to reduce its estimate of the output gap and raise its forecasts for medium-term inflation – possibly above the 2% target - after the sterling effects have passed. In the meantime, if inflation expectations continue to rise the BoE could begin to tilt from its current neutral stance to a more hawkish one. It is not our central expectation, but there is a small chance the BoE hikes rates in 2017.

Chart 1: Inflation by type (yoy %)



Monthly data. Source: ONS, Berenberg calculations

Chart 2: Bank of England/TNS inflation survey. Median inflation expectations 12 months ahead



Quarterly data. Source: Bank of England/TNS

yoy %	NOV	OCT	SEP	AUG	JUL	JUN
CPI	1.2	1.0	1.0	0.6	0.6	0.5
Core	1.4	1.2	1.5	1.3	1.3	1.4

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