MACRO NEWS 21/03/17

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UK: UPSIDE SURPRISE ON HEADLINE AND CORE INFLATION INCREASES PRESSURE ON BOE TO HIKE

Berenberg Macro Flash

Feb, yoy	CPI	Core CPI
Actual	**2.3%**	**2.0%**
Previous	1.8%	1.6%
Consensus	2.1%	1.7%
Berenberg	2.0%	1.8%

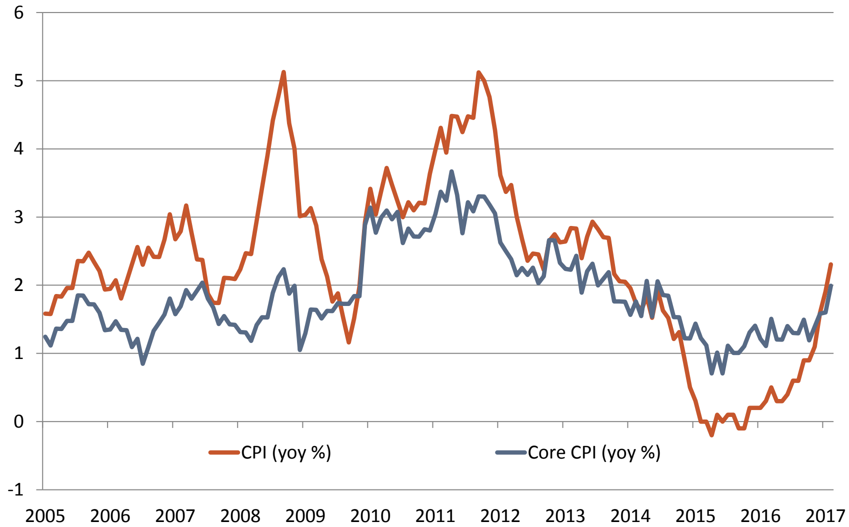
The price of Brexit: Even before Brexit creates any barriers to trade – at least two years away – UK households are already forking out more for German cars, Italian cheese and French wine. Thanks to the 13% fall in trade-weighted sterling since the Brexit vote (down 12% versus the euro), prices of imported goods are rising sharply. In February, headline inflation (CPI) hit its highest rate – 2.3% yoy - since September 2013, increasing from 1.8% in January, and beating expectations of 2.1%. Linked to the weak currency, factory input costs rose by 19.1% yoy in February. Meanwhile, underlying inflationary pressures continue to build amid limited spare capacity, tight labour market conditions and continued strong demand at home and abroad. Core inflation, which excludes the volatile food and energy components, rose to 2.0% in February from 1.6% in January. CPIH (CPI inc. owner occupiers' housing costs) - the ONS's preferred inflation series - was 2.3% in February, up from 1.9% in January. Note: The Chancellor could alter the BoE's official target to CPIH later in the year. The BoE currently targets CPI.

How much could rising inflation hurt consumption? We expect headline inflation to peak at 3.0% in Q3 2017 before easing a little thereafter, but remaining above the BoE's 2% target through 2018. The sharp rise in inflation will squeeze household incomes in 2017 and 2018 even as tight labour market conditions will likely lead to a modest rise in nominal wage growth from current rates of around 2.5% yoy (3M average). Critically, we do not expect the sizeable real income squeeze to fully pass through into real consumption in the coming years. Instead, we look for only a modest easing of real consumption growth; from 3.0% in 2016, to 2.3% in 2017 and 1.9% in 2018. Household balance sheets have strengthened since the Lehman-crisis; debt-to-income is lower, household wealth has risen, and thanks to low oil prices, households have enjoyed three years of solid real wage gains. Feeling confident after seven years of economic growth, the UK consumer started to gear up again last year. By increasing borrowing and saving less to target a desired level of consumption, we expect households to smooth spending over the medium-term as rising inflation squeezes real incomes.

BoE's tolerance for rising inflation could be tested soon: Remember the key guidance in the BoE's March Monetary Policy Committee meeting minutes, that for 'some' committee members it would 'take very little further upside news on the prospects for activity or inflation to consider that a more immediate reduction in policy support might be warranted'. That guidance came in addition to Kristen Forbes, a known hawk, voting for an immediate 25bps rate hike in the bank rate. With inflation set to rise further over the course of this year, today's data is rather 'big' upside news. As we have repeatedly argued alongside our above consensus projections for real GDP growth since the Brexit vote (2.0% and 1.7% in 2017 and 2018 versus Bloomberg consensus of 1.6% and 1.3%, respectively), there is a clear case for tighter monetary policy in the UK. In a non-Brexit scenario, the BoE would have probably hiked by now. Worryingly for the BoE, inflation expectations are rising well above the 2% target – Chart 2. By pushing up pricing and wage decisions, rising inflation expectations reduce the likelihood that inflation will fall back to the target after the FX effects have passed – increasing the need for action.

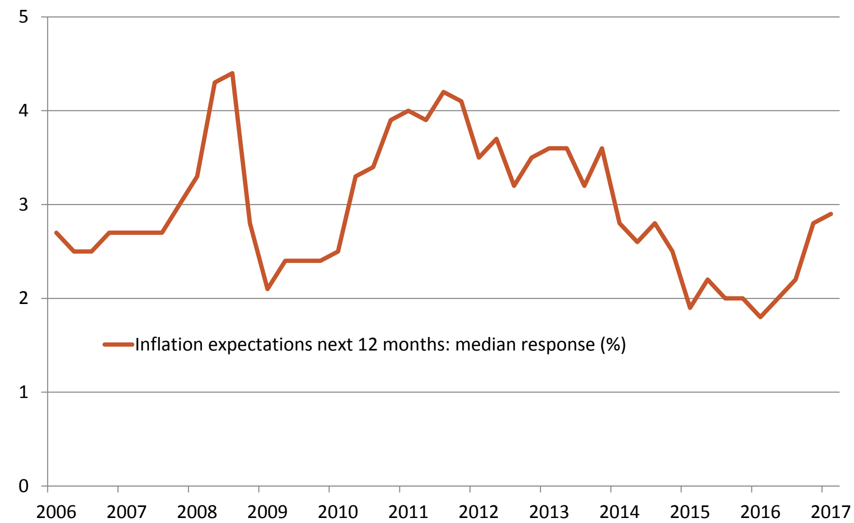
As our base case, we look for a 25bp first rate hike in Q2 2018, with a 30% chance the BoE raises the bank rate earlier. After today's data release, risks to that call are skewed towards the BoE hiking sooner rather than later. After the first hike, the BoE will likely continue to proceed with extra caution, with small and infrequent rate hikes signalled far in advance, and with a strong bias toward remaining in neutral as and when risks to growth surface. For our detailed analysis on UK monetary policy in the last 20 years see 'UK: lessons from two decades of BoE policy'.

Chart 1: Headline inflation versus core inflation



Source: ONS, Berenberg calculations. Monthly data.

Chart 2: Bank of England/TNS inflation survey. Median inflation exp. 12m ahead



Source: Bank of England/TNS. Quarterly data.

yoy %	FEB	JAN	DEC	NOV	OCT	SEP
CPI	2.3	1.8	1.6	1.2	0.9	1.0
Core	2.0	1.6	1.6	1.4	1.2	1.5

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