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UK: RISING INFLATION TAKES A BREATHER - BUT IT WON'T LAST, OR BE THAT BAD

Berenberg Macro Flash

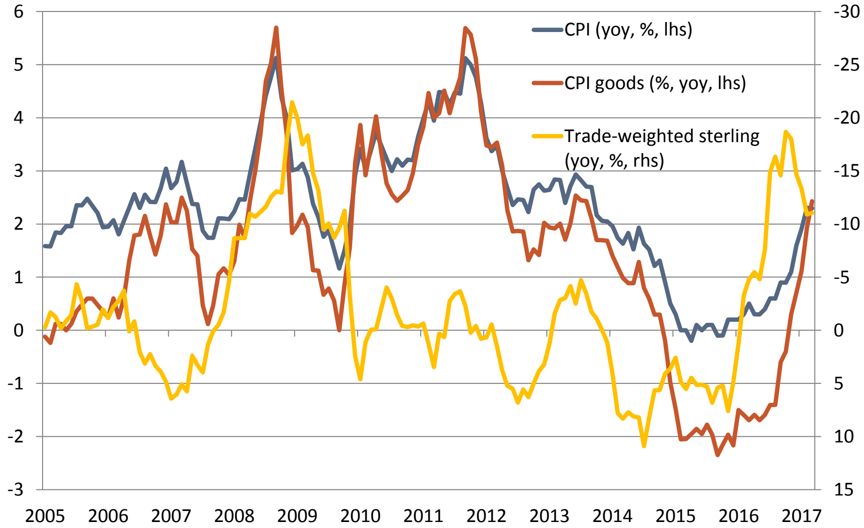
March, yoy	CPI	Core CPI
Actual	2.3%	1.8%
Previous	2.3%	2.0%
Consensus	2.3%	1.9%
Berenberg	2.5%	2.1%

A temporary breather in March: After accelerating by more than expected in February, inflation stabilised in March (2.3%). But it won't last. The headline rate will likely need to rise a little higher into the middle of the year as producers pass on the higher input costs from the drop in sterling after the Brexit vote. All major components of inflation increased on an annual basis. Separate data released by the ONS showed that growth in factory input prices eased to 17.9% yoy from 19.4% in February. Meanwhile factory output prices growth eased a little to 3.6% yoy from 3.7% in February. The slowdown in factory prices growth is mainly due to the stabilisation in sterling in recent months and the fading base effects from past changes in energy prices. CPIH (CPI inc. owner occupiers' housing costs) - the ONS's preferred inflation series - was 2.3% in March, unchanged from February. *Note: The Chancellor could alter the BoE's official target to CPIH later in the year. The BoE currently targets CPI.*

Inflation will peak soon, but it won't be that bad: The major sources of upward pressure to the headline inflation rate, (1) the exchange rate and (2) energy prices, seem to have peaked – Charts 1 and 2. It will take a few months for these higher costs to pass through and fully show up in the headline inflation rate. We therefore 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. Despite the dramatic decline in the exchange rate immediately after the Brexit vote and the rise in the oil price in sterling terms since mid-2016, these inflationary forces are relatively modest compared to recent history. During the financial crisis, sterling declined by almost 30% on a trade-weighted basis, while the oil price peaked at almost £70 a barrel. And in 2012 oil prices peaked at nearly £80 per barrel. During both periods, headline CPI peaked at 5.1%, before dropping sharply thereafter. Sterling is down only c12% on a trade-weighted basis since June 23 and the oil price is a little over £40 per barrel. Today's inflation story is much less severe and thus has much more smaller implications for the economic outlook.

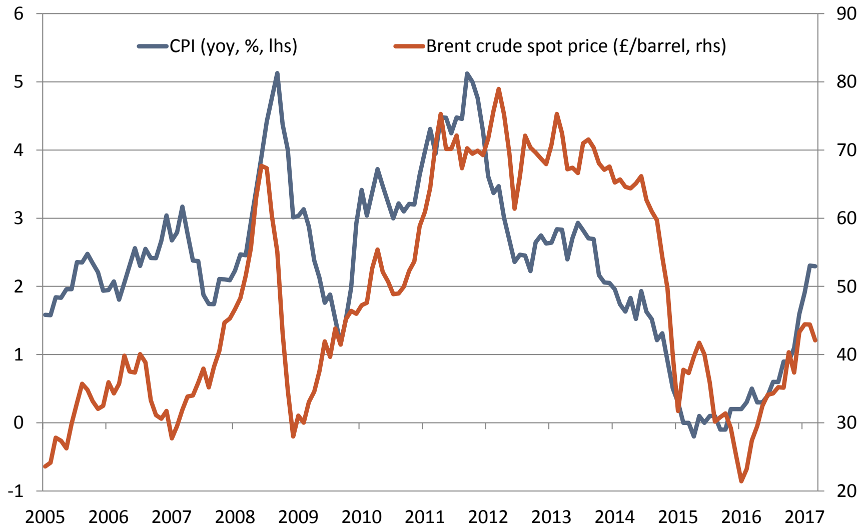
The cautious BoE may wait too long: Core inflation, which excludes the volatile food and energy components, dropped to 1.8% in March, from 2.0% in February. Monthly data are volatile and the one-month dip doesn't change the underlying trend of steadily rising underlying prices – Chart 3.The UK labour market is at full employment and capacity utilisation is high. Meanwhile, households are gearing up to spend more at home and the fall in the trade-weighted sterling is adding to the already rising foreign demand. The BoE, however, amid Brexit uncertainty, is nervous to act in a hurry. While the bank's rate-setting committee was already notably more hawkish in its March meeting than before, it remains concerned about downside risks to consumer spending growth coming from the forthcoming modest real wage squeeze. The BoE will proceed cautiously. We forecast a first rate hike of 25bp in Q1 2018, with a 40% chance of it being in 2017.

Chart 1: Headline inflation, goods inflation and trade-weighted sterling (annual change %)



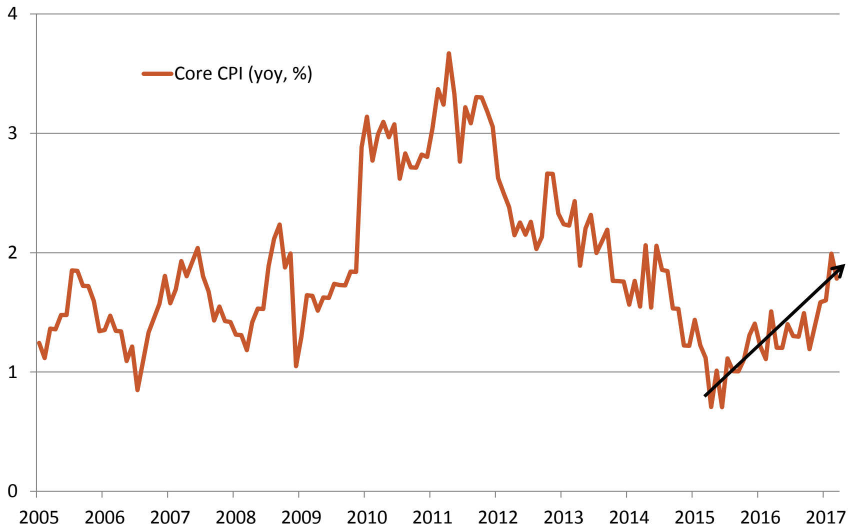
Source: ONS, Bank of England, Berenberg calculations

Chart 2: Headline inflation (annual change %) versus oil price (£/barrel)



Source: ONS, Bank of England, World Bank, Berenberg calculations

Chart 3: Underlying inflation – core CPI and services inflation (annual change %)



Source: ONS, Bank of England, World Bank, Berenberg calculations

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

Source: ONS

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