

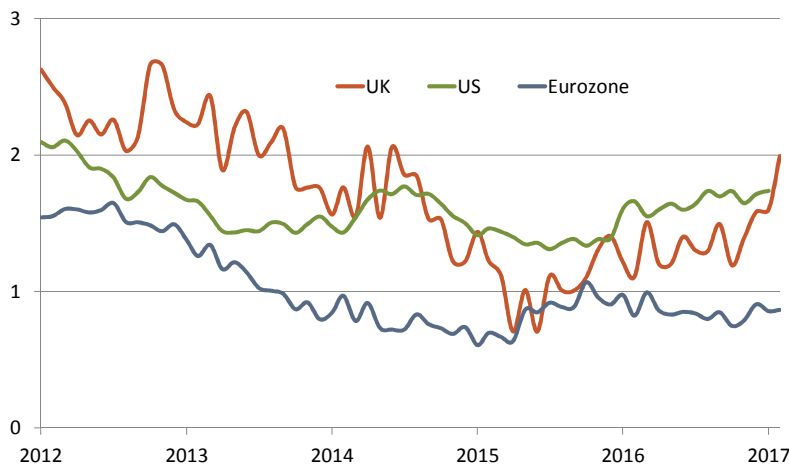


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24 March 2017

Not all inflation is created equal

Core inflation reveals differences in underlying conditions in US, Eurozone and UK



Source: BEA, ECB, ONS. US = PCE ex-food and energy, Eurozone = CPI ex-food and energy, UK = CPI ex-food, energy, alcohol and tobacco. Monthly data

- Rising inflation in the western world:** Last month, headline inflation rose simultaneously to, or above, the Fed's, the ECB's and the BoE's targets for the first time since October 2012. Having narrowly avoided the dreaded deflation in 2015, now we have to worry about inflation. Or do we? Just as deflation risks were grossly exaggerated, increasing inflation now is not a cause for concern as long as central banks do their jobs. Rising inflation in the western world that started in H2 2016 mostly reflects the phasing out of past falls in the price of oil and a temporary jump in food prices due to one-off factors. As our chart shows, measures of underlying inflation point to differences across key regions.
- Can the Fed keep up with Trump?** In January, US core inflation hit 1.7%, just below the Fed's 2% target for headline inflation, which, meanwhile, hit 2.7%. Tight labour market conditions and rising wages point to growing underlying inflationary pressure in the US. The Fed's ongoing gradually policy tightening makes sense. But if Trumponomics and the Paul Ryan fiscal plan raise demand by more than supply, core inflation could overshoot in the medium term. If the Fed responds too late, it may have to play catch-up later on. As US real GDP growth accelerates from here on, we look for two further Fed hikes this year and three hikes in 2018. But the risk that the Fed falls behind the curve is serious.
- The UK is the key place to watch:** The c12% fall in trade-weighted sterling since the Brexit vote will push headline inflation to close to 3% by the middle of the year. Since FX changes only temporarily affect inflation, central banks often look through them. That could be a mistake this time. Of the three regions, the UK has experienced the most pronounced rise in core inflation since 2015. Underlying conditions look well placed for core inflation – 2% in February – to surge.
- The cautious BoE may wait too long:** 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. But monetary policy works with a lag. While the Fed may fall behind the curve, the BoE may turn up after the game is over.
- The Eurozone's inflation risks are exaggerated:** Last in the line for concern is the Eurozone. Its recovery is some two years behind the US and UK. Labour market gains can remain strong well into the medium term before wage inflation spikes. Without the underlying demand and supply conditions in place, headline inflation will be lower than its current 2% rate by the year end. The current core rate of 0.9% is broadly unchanged versus a year ago and well below the ECB's headline target of "close to, but below 2%". The ECB is under no pressure to unwind its policy just yet. It can let its bond purchases run at €60bn until the end of the year before gradually tapering during 2018 and finally hiking in 2019.

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Contacts: Investment Banking

www.berenberg.com

e-mail: firstname.lastname@berenberg.com / e-mail US: firstname.lastname@berenberg-us.com



BERENBERG

PARTNERSHIP SINCE 1590

JOH. BERENBERG, GOSSLER & CO. KG

Internet www.berenberg.com

E-mail: firstname.lastname@berenberg.com

EQUITY RESEARCH

AEROSPACE & DEFENCE

Ryan Booker +44 20 3753 3074
Andrew Gollan +44 20 3207 7891
Charlotte Keyworth +44 20 3753 3013
Ross Law +44 20 3465 2692

AUTOMOTIVES

Alexander Haissl +44 20 3465 2749
Paul Kratz +44 20 3465 2678
Fei Teng +44 20 3753 3049

BANKS

Adam Barrass +44 20 3207 7923
James Chappell +44 20 3207 7844
Andrew Lowe +44 20 3465 2743
Andreas Markou (EM) +44 20 3753 3022
Alex Medhurst +44 20 3753 3047
Eoin Mullany +44 20 3207 7854
Peter Richardson +44 20 3465 2681
Jonathan Sharpe +44 20 3753 3031

BEVERAGES

Javier Gonzalez Lastra +44 20 3465 2719
Batuhan Karabekir (EM) +44 20 3465 2631
Adam Mizrahi +44 20 3465 2653
Matt Reid +44 20 3753 3075

BUSINESS SERVICES, LEISURE & TRANSPORT

Roberta Giaccia +44 20 3207 7805
Najet El Kassir +44 20 3207 7836
Stuart Gordon +44 20 3207 7858
Josh Puddle +44 20 3207 7881
Katherine Somerville +44 20 3753 3081
Julia Winarso +44 20 3465 2627

CAPITAL GOODS

Sebastian Kuenne +44 20 3207 7856
Philippe Lorrain +44 20 3207 7823
Rizk Madi +44 20 3207 7806
Horace Tam +44 20 3465 2726
Simon Toennessen +44 20 3207 7819

EQUITY SALES

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Calum Marriss +44 20 3753 3040

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Abigail James +44 20 3753 3078

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SALES

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Miel Bakker +44 20 3207 7808
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Alexander Wace +44 20 3465 2670

GERMANY

Michael Brauburger +49 69 91 30 90 741
Nina Buechs +49 69 91 30 90 735
André Grosskurth +49 69 91 30 90 734

CHEMICALS

Sebastian Bray +44 20 3753 3011
Rikin Patel +44 20 3753 3080
Andrew Heap +44 20 3207 7918

CONSTRUCTION

Saravana Bala +44 20 3753 3043
Lush Mahendrarajah +44 20 3207 7896
Robert Muir +44 20 3207 7860
Olivia Peters +44 20 3465 2646

ENERGY

Yuriy Kukhtanych (EM) +44 20 3465 2675

FOOD MANUFACTURING AND H&PC

Rosie Edwards +44 20 3207 7880
Yordana Mavrodieva +44 20 3207 7817
Fintan Ryan +44 20 3465 2748
James Targett +44 20 3207 7873

FOOD RETAIL

Batuhan Karabekir (EM) +44 20 3465 2631

GENERAL MID CAP - EU

Gunnar Cohrs +44 20 3207 7894
Martin Comtesse +44 20 3207 7878
Charlotte Friedrichs +44 20 3753 3077
Flavien Hias +44 20 3465 2693
Aymeric Lang +44 20 3753 3037
Gerhard Orgonas +44 20 3465 2635
Anna Patrice +44 20 3207 7863
Benjamin Pfannes-Varrow +44 20 3465 2620
Simona Sarli +44 20 3207 7834
Julia Scheuffler +44 20 3753 3016

GENERAL MID CAP - UK

Sebastian Chantry +44 20 3207 7861
Sam England +44 20 3465 2687
Ned Hammond +44 20 3753 3017
Edward James +44 20 3207 7811
Benjamin May +44 20 3465 2667

GERMANY (cont'd)

Florian Peter +49 69 91 30 90 740
Joerg Wenzel +49 69 91 30 90 743

UK

Alexandra Clément +44 20 3753 3018
Fabian De Smet +44 20 3207 7810
Karil Hancock +44 20 3207 7803
Sean Heath +44 20 3465 2742
David Hogg +44 20 3465 2628
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Peter Kaineder +44 20 3753 3062
James Matthews +44 20 3207 7807
James McRae +44 20 3753 3036
David Mortlock +44 20 3207 7850
Eleni Papoula +44 20 3465 2741
Bhavin Patel +44 20 3207 7926
Kushal Patel +44 20 3753 3038
Richard Payman +44 20 3207 7825
Clémence Peyraud +44 20 3465 2651
Christopher Pyle +44 20 3753 3076
Joanna Sanders +44 20 3207 7925
Mark Sheridan +44 20 3207 7802
George Smbert +44 20 3207 7911
Anita Surana +44 20 3207 7855
Paul Walker +44 20 3465 2632

FRANCE

Thibault Bourgeat +33 1 5844 9505
Alexandre Chevassus +33 1 5844 9512
Dallia Farigoule +33 1 5844 9510
Benjamin Voisin +33 1 5844 9507

SCANDINAVIA

Frederik Angel +44 20 3753 3055
Marco Weiss +49 40 350 60 719

GENERAL MID CAP - UK (cont'd)

Owen Shirley +44 20 3465 2731

GENERAL RETAIL

Conrad Bartos +44 20 3753 3053
Michelle Wilson +44 20 3465 2663

HEALTHCARE

Scott Bardo +44 20 3207 7869
Jakob Berry +44 20 3465 2724
Alistair Campbell +44 20 3207 7876
Klara Fernandes +44 20 3465 2718
Tom Jones +44 20 3207 7877
Joseph Lockey +44 20 3465 2730
Louise Pearson +44 20 3465 2747
Laura Sutcliffe +44 20 3465 2669

INSURANCE

Trevor Moss +44 20 3207 7893
Emanuele Musio +44 20 3207 7916
Iain Pearce +44 20 3465 2665
Sami Taipalus +44 20 3207 7866

LUXURY GOODS

Mariana Horn +44 20 3753 3044
Zuzanna Pusz +44 20 3207 7812

MEDIA

Robert Berg +44 20 3465 2680
Laura Janssens +44 20 3465 2639
Alistair Reid +44 20 3207 7841
Sarah Simon +44 20 3207 7830

METALS & MINING

Alessandro Abate +44 20 3753 3029
Fawzi Hanano +44 20 3207 7910
Yury Vlasov +44 20 3465 2674

REAL ESTATE

Kai Klöse +44 20 3207 7888
Tina Munda +44 20 3465 2716

SWITZERLAND, AUSTRIA & ITALY

Andrea Ferrari +41 44 283 2020
Carsten Kinder +41 44 283 2024
Gianni Vignina +41 44 283 2038
Jamie Nettleton +41 44 283 2026
Benjamin Stillfried +41 44 283 2033

CRM

Laura Cooper +44 20 3753 3065
Louise Hughes +44 20 3753 3066
Jessica Jarmyn +44 20 3465 2696
Edwina Lucas +44 20 3207 7908
Greg Swallow +44 20 3207 7833

CORPORATE ACCESS

Lindsay Arnold +44 20 3207 7821
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Vincent Klein +33 1 58 44 95 09
Antonio Scuoitto +33 1 58 44 95 03

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Georgios Kertsos +44 20 3465 2715
Gal Munda +44 20 3465 2746
Richard Odumusu +44 20 3207 7851
Tammy Oiu +44 20 3465 2673

TELECOMMUNICATIONS

Josep Bori +44 20 3753 3058
Ondrej Cabejssek (EM) +44 20 3753 3071
Nicolas Didio +44 20 3753 3091
Usman Ghazi +44 20 3207 7824
Siyi He +44 20 3465 2697
Laura Janssens +44 20 3465 2639
Paul Marsch +44 20 3207 7857
Michael Summerville +44 20 3207 7914

THEMATIC RESEARCH

Nick Anderson +44 20 3207 7838
Asad Farid +44 20 3207 7932
Robert Lamb +44 20 3465 2623
James Sherborne +44 20 3753 3073

TOBACCO

Jonathan Leinster +44 20 3465 2645

UTILITIES

Andrew Fisher +44 20 3207 7937
Neha Saxena +44 20 3753 3048
Lawson Steele +44 20 3207 7887

ECONOMICS

Florian Hense +44 20 3207 7859
Carsten Hesse (EM) +44 20 3753 3061
Kallum Pickering +44 20 3465 2672
Holger Schmieding +44 20 3207 7889

LONDON

Mike Berry +44 20 3465 2755
Stewart Cook +44 20 3465 2752
Mark Edwards +44 20 3753 3004
Tristan Hedley +44 20 3753 3006
Peter King +44 20 3753 3139
Christoph Kleinsasser +44 20 3753 3063
Chris McKeand +44 20 3207 7938
Simon Messman +44 20 3465 2754
A.J. Pulleyn +44 20 3465 2756
Matthew Regan +44 20 3465 2750
Asbjorn Rogge +44 20 3753 3051
Michael Schumacher +44 20 3753 3006
Paul Somers +44 20 3465 2753

EQUITY TRADING

HAMBURG

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Linus Weidner +49 40 350 60 798
Philipp Wiedmann +49 40 350 60 346
Christoffer Winter +49 40 350 60 559

LONDON

Edward Burillon-Rush +44 20 3753 3055
Richard Kenny +44 20 3753 3083

ELECTRONIC TRADING

Daniel Eichhorn +49 40 350 60 391
Matthias Führer +49 40 350 60 597

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SALES (cont'd)

Emily Mouret +1 415 802 2525
Peter Nichols +1 646 445 7204
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CORPORATE ACCESS

Olivia Lee +1 646 445 7212
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SALES TRADING

Christopher Kanian +1 646 445 5576
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ECONOMICS

Mickey Levy +1 646 445 4842
Roiana Reid +1 646 445 4865