Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 203 465 2672

UK: INFLATION JUMPS ON OIL PRICE EFFECT AND BUILDING RECOVERY

Berenberg Macro View

Inflation normalising

After the COVID-19 shock, a VAT cut in the hospitality sector and an ultra-low oil price temporarily pushed inflation towards zero last year, the latest data show a fading of one-off factors and a broadening recovery in inflation commensurate with the emerging economic upswing.

- The yoy rate of headline inflation (CPI) rose to 0.7% in March from 0.4% in February – slightly below our and the consensus projection of 0.8%. Core inflation increased to 1.1% from 0.9% - Chart 1.
- After several months of declines, goods prices moved sideways in March (up from a 0.5% yoy fall in February) while services inflation remained stable at 1.5%.
- Across the major components of CPI, transport (0.5ppt) and recreation (0.3ppt) contributed the most to the gain in annual CPI while clothing and footwear, utilities and food subtracted from the headline rate – Charts 2 and 3.
- Despite the higher yoy oil price in March (+82.8% in sterling terms for a barrel of Brent crude) and the positive contribution of transport costs to CPI, the broader energy component declined 2.5% yoy - subtracting 0.15ppt from the annual rate of CPI. However, the drag was less than in February (-0.35ppt) and much less than the May 2020 low (-0.74ppts). This trend will reverse sharply in coming months as the base effects of higher oil prices during 2021 versus 2020 pass through to general prices more forcefully.

How much will the oil price effect add to inflation?

In April, a barrel of Brent crude oil in sterling terms rose 223.5% yoy - nearly three times faster than in March. April 2020 was the height of the Covid-19 market panic, which tipped oil futures prices briefly negative as global production ground to a halt under the harsh pandemic restrictions. If the oil price hovers around $65 per barrel of Brent crude in coming months and GBPUSD edges towards 1.42 (our base case for mid-2021), then the yoy change in sterling oil prices would fall to 94.4% in May, 43.4% in June and 33.4% in July. This would be consistent with the oil price effect contributing around 0.5-0.8ppt to yoy headline inflation in the coming months via the energy component of CPI – Chart 4.

The level of the oil prices matters as much as the annual change. When prices rise a lot from a low base, the impact on headline inflation is often lower than more modest rises from a higher initial oil price.

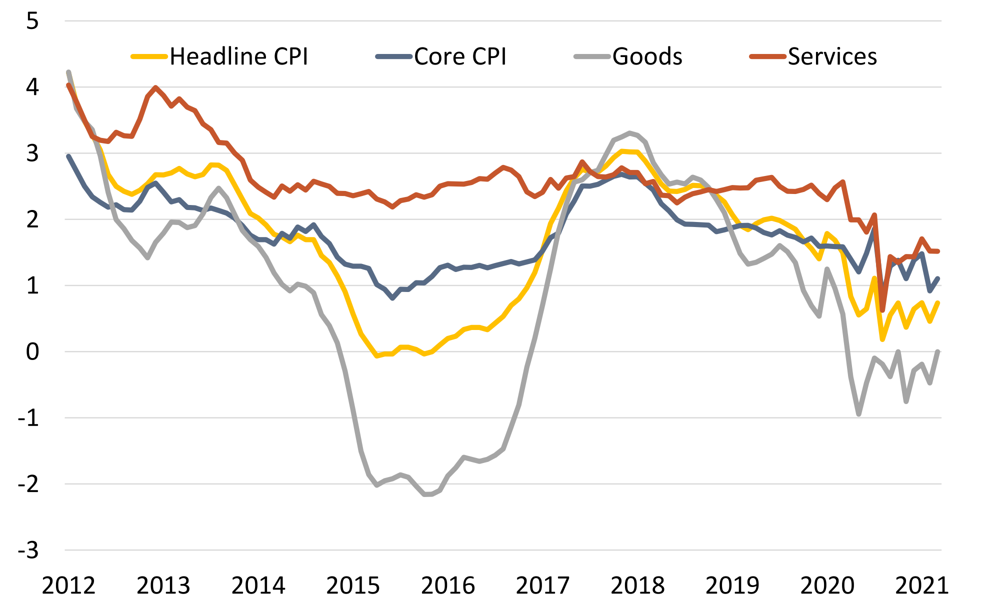
As our base case, we expect headline inflation to rise to close to 2% in coming months as the effect of higher oil prices versus a year ago continues to passes through, the VAT cut on hospitality begins to unwind from September and the cyclical upswing adds to underlying inflation. But there remains a high degree of uncertainty over our projection for the upcoming contribution from the oil price effect. Because of the very reduced level of global production in 2020 when the oil price briefly tanked, the effect of low energy prices did not fully transmit into goods prices or consumer prices more broadly. This may dampen the impact of the wild swing in oil prices – unlike the 2015-2017 episode of sustained low oil prices on inflation followed by the surge thereafter.

As chart 4 shows, the most recent comparable one-off spike yoy rate in oil prices in 2017 did not fully pass through to energy prices – in January 2017 the yoy % change in sterling oil prices jumped 107%. The downside surprise in headline CPI in March may signal the trend to come.

Another leg up for bond yields soon - rising inflation may push benchmark rates higher
The building cyclical upswing will contribute to gains in headline and core inflation over the medium-term. After real GDP reaches its pre-pandemic level in Q1 2022, tight labour markets and a strong policy tailwind can lift headline inflation to 2.3% by late 2022. A sustained recovery combined with structural factors such as labour shortages due to ageing populations across major parts of the global economy and deglobalisation in goods trade can support inflation at a rates around 2.5% through the middle of the decade.

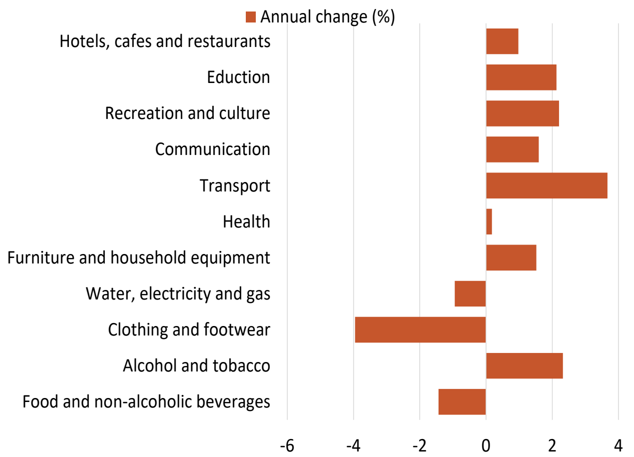
Recent downside surprises in UK inflation data as well as a calmer situation in global bond markets seem to have put the uptrend in gilt yields on hold for now. This is likely to be temporary. Further near-term gains in inflation, faster economic growth as the economy re-opens and the effect of BoE asset purchase tapering in H2 2021 should lift 10 year gilt yields towards 1.5% by end-2021 from their current level of 0.72%.

Chart 1: Annual inflation rates (%)



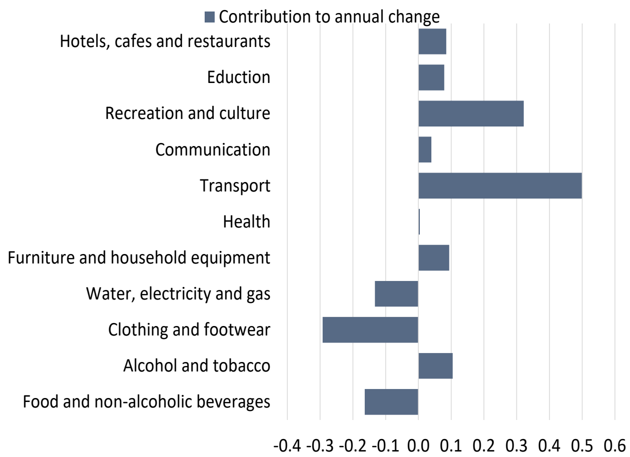
Three month moving average up to 2020. Monthly data. Source: ONS

Chart 2: Annual change in key CPI components



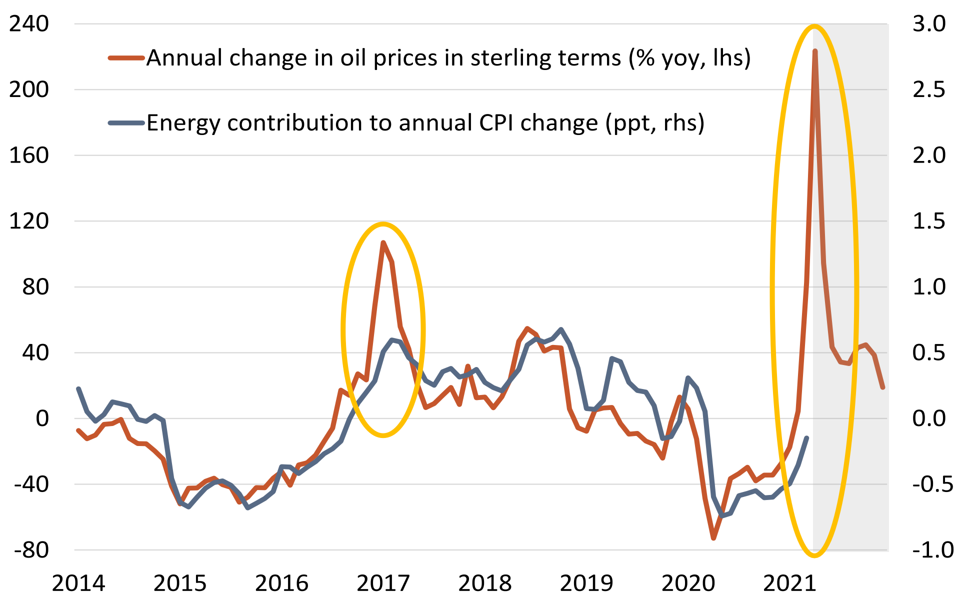
Monthly data. Source: ONS

Chart 3: Contribution to annual CPI rate



Monthly data. Source: ONS

Chart 4: Contribution of oil prices to annual CPI



Shaded area shows scenario based on a $65 dollar per barrel of Brent crude and a rise in GBPUSD to 1.47 by December 2021. Monthly data. Source: BoE, ONS

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