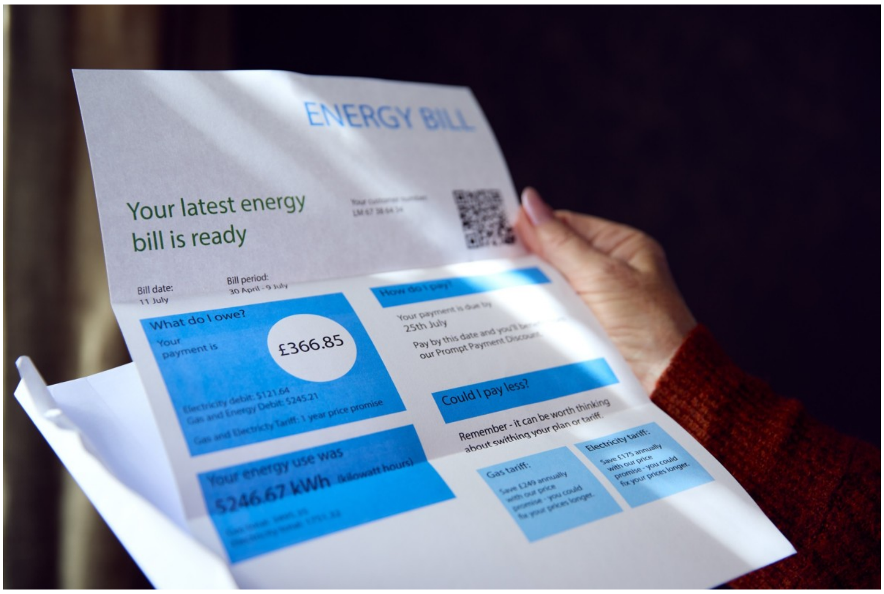
Tumbling UK energy bills to help take headline inflation below 1.5% in June

UK energy prices will fall by 12% in April and it's likely the regulator will lower the price cap again in July. That's set to take headline inflation below 2% in April and we think it will stay below the Bank of England's target for much - if not all - of 2024. That should help unlock a summer rate cut, if coupled with progress on services inflation and wage growth

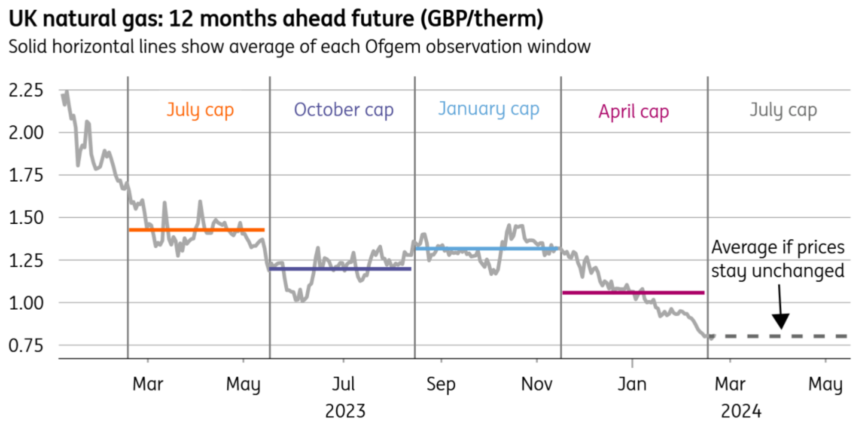


Gas prices have fallen sharply and that means lower consumer bills

The UK energy regulator has announced that household electricity and gas bills will fall by 12% at the start of April, on the back of a decent fall in wholesale natural gas prices. That more than offsets the 5% rise we saw at the start of January, and as the chart below shows, we should expect another reasonable leg lower when the cap is next updated for the start of July if wholesale prices stay as low as they are today.

Ofgem, through a fairly complicated methodology, takes an average of gas/electricity futures prices across an observation window, in a way that’s meant to fairly reflect the costs energy providers are incurring to hedge/secure their supplies for the coming months.

Lower UK natural gas prices point to another fall in consumer bills in July



Source: Macrobond, ING calculations

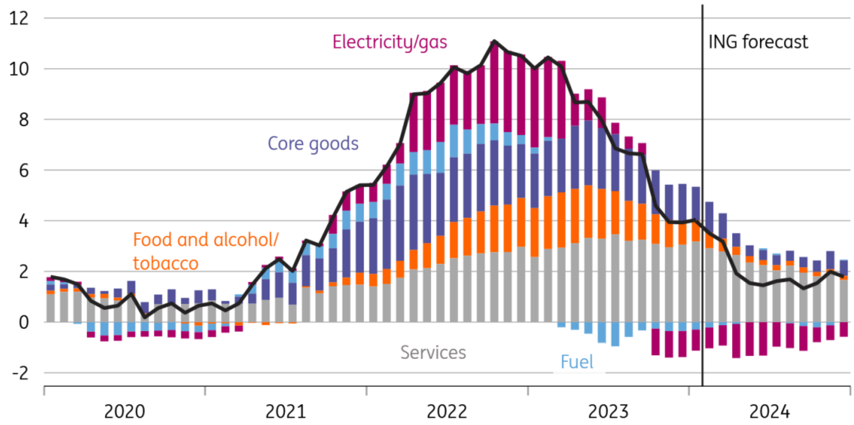
Wholesale natural gas prices feed into the quarterly review of the Ofgem energy price cap. The regulator takes futures prices at various time intervals and across an observation window. Using a complex methodology, it tries to predict the wholesale cost of energy prices during the three months of the next price cap window.

Headline inflation could go as low as 1.4% in June

All of this should be sufficient to take headline inflation below target in April to 1.9%, and we think it could go as low as 1.4% in June. Household energy alone will be shaving 1.3 percentage points off headline CPI during the second quarter, but by the end of the second quarter, much lower food and core goods inflation will make a material difference, too.

Of course, much of this energy effect has been anticipated for some time now, and a sub-target inflation figure in the second quarter was a feature of the Bank of England's most recent forecasts at the start of February. But our forecasts for the rest of this year are below that of the Bank, and in particular, we think the official 2.7% forecast for the fourth quarter seems too high. We think CPI is more likely to stay below target for the vast majority, if not all of this year, especially if we get another drop in energy bills during July.

UK inflation set to dip below 2% in April



Source: Macrobond, ING

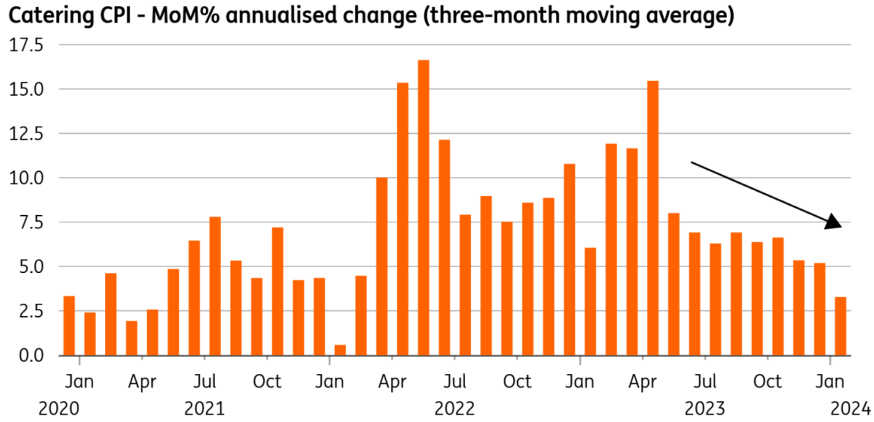
Services inflation and wage growth are key for the BoE

So what does this all mean for the prospect of rate cuts? Bank of England Governor Andrew Bailey caught the headlines this week by emphasising that inflation doesn't need to be back to target for the Bank to cut rates. That obviously shouldn't be taken literally given what headline CPI is likely to do in the second quarter, and what the Bank is really wanting to see is greater progress on services inflation and private-sector wage growth over the next few months.

The Bank is forecasting services CPI to fall from 6.5% to 4.9% in June, something we broadly agree with, and we expect to see further gradual downward pressure through the summer. A lot of this near-term stickiness is down to rental inflation, which still appears to be intensifying, as well as the impact of annual "CPI plus" index-linked price rises for things like phone contracts and the internet.

But dig a little deeper, and the news does seem to be slowly improving. If we look at catering for instance, which we think is a decent gauge of genuine domestically-generated, persistent inflation in the services basket, momentum has been slowing for several months. We think this is in part down to the lagged effects of the fall in natural gas prices, which when they rose originally, had put huge upward pressure on costs in an area of the economy with a high concentration of smaller businesses.

Catering inflation has been cooling over recent months



Source: Macrobond, ING calculations

Seasonally-adjusted by ING

We expect an August rate cut

The other important metric for the BoE - private-sector wage growth, currently 6.2% - is proving sticky too. On paper, the news here should start to get better from the BoE's perspective, in that the data clearly shows the jobs market is cooling. Vacancy numbers are well down and should close in on pre-Covid levels over the summer. The issue for the BoE is that according to its own surveys, wage growth expectations among Chief Financial Officers (CFOs) have been consistently stuck around 5% for quite some time. Despite the reduction in hiring demand, we suspect the slowdown in pay growth will continue to be pretty gradual for the time being.

The bottom line is that even with headline inflation set to fall below target in April, the Bank of England will continue to tread carefully as we go into the second quarter. Slow progress on services inflation and wage growth in the near term, coupled with the prospect of tax cuts in March, means we suspect that the second quarter will be too early to see a UK rate cut.

But assuming the Federal Reserve and European Central Bank have cut by June, and that the underlying inflation data does slowly head in the right direction as we approach the summer, we think the Bank will be satisfied enough to begin rate cuts in August.

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