UK inflation dips, but Brexit still the sole focus for the Bank of England

UK inflation edged lower in January, but what matters more for the central bank is the recent strength in wage growth. That said, the outlook for interest rates is still solely dependent on Brexit and that means policymakers will remain on the sidelines for the time being

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For the first time in two years, UK inflation is back below the Bank of England's 2% target. That said, the fall from 2.1% to 1.8% in January largely reflects the dip in global oil prices towards the end of last year. Our commodities team expects prices to stabilise more-or-less this quarter, which should mean a more benign year for UK inflation. Depending on what happens to petrol prices, we expect headline CPI to remain fairly sticky in the 1.5-2% region for much of this year.

1.8% Headline CPI (YoY%)

Lower than expected

For the Bank of England though, what matters is where inflation goes beyond 2019. Wage growth has stayed strong, and amongst the short-term Brexit warnings, the Bank of England still hinted last week that mounting domestic inflationary pressures could require a faster pace of tightening than currently anticipated by markets. This is one reason why we don't think a rate hike should be ruled out just yet this year.

Whether core inflation does respond to higher wage pressures relies partly on corporates having sufficient pricing power to pass the costs on. In the current consumer environment, this may not be the case.

As ever though, the outlook for interest rates really depends on Brexit, and with a growing likelihood that the saga could stretch to the eleventh hour, the economy is in for a bumpy ride over the next few weeks. Reports indicate it might not be until the 21 March EU Council meeting before talks reach a crunch. For businesses, this would mean not knowing what trading terms they'll face as soon as the following week.

At the very least, this uncertainty will keep hiring and investment on hold, keeping a lid on growth. In the meantime, the Bank of England will remain firmly on the sidelines.

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