Surprise fall in UK services inflation unlikely to unlock September rate cut

Just as the recent upside surprises in UK services inflation looked a lot like noise, it's only fair to conclude that the same is true of the latest downside miss too. The Bank of England, we suspect, won't read too much into them just yet

Volatility in hotel prices has impacted UK services inflation

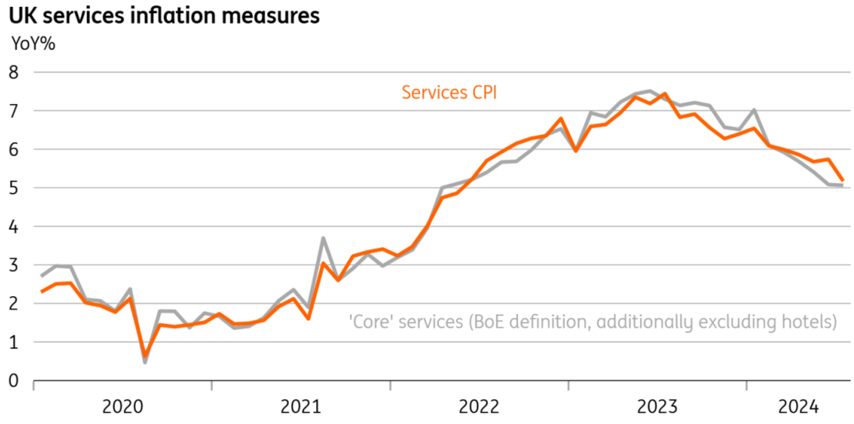
The latest UK CPI figures for July reveal that services inflation fell much more dramatically than just about everyone had expected. Services CPI now stands at 5.2%, down from 5.7% and crucially, well below the BoE's 5.6% forecast.

On the face of it, that looks like very welcome news which in theory, you might expect could speed up the process of lowering rates. Remember that services inflation is the main guiding light for Bank of England policy these days. But dig into the details and we suspect the Bank will be taking these figures with a pinch of salt.

Don't forget that the BoE had been grappling with services inflation which, for the past few months, has been coming in a fair bit above expectations. Much of this surprise could be traced back to chunky rises in regulated prices back in April at the start of the financial year, most of which is inherently backward-looking in nature. Then in June, an unusual surge in hotel prices kept the overall service inflation index elevated.

Much of this looked like noise and the BoE itself concluded that these upside surprises didn't tell it much about the trajectory of inflation over the medium-term. Indeed, we replicated a measure of "core services" inflation, put together by the Bank of England, which excludes various items like rents and airfares, and we additionally took out hotels given the recent volatility. Back in June, this measure showed that services inflation had fallen back more aggressively than the headline metric, once those components were removed.

Alternative 'core services' metric was flat in July



Source: Macrobond, ING calculations

Core services inflation excludes rents, package holidays, air fares and education. We've additionally removed hotels given recent volatility

This time, as the chart above shows, our metric of core services inflation was unchanged at 5.1%. In other words, just as the upside surprises of recent months looked like noise, it's only fair to conclude that the same is true of this latest sharp fall in services inflation as well. We suspect that's the conclusion the Bank is likely to reach too.

That said, we still think the news on services inflation is likely to gradually improve as the year wears on. Surveys show firms are raising prices much less aggressively than they were. And that should help unlock at least one rate cut in November, and we suspect another in December. We suspect the Bank will pause at the next meeting in September.

Finally, just a quick word on headline inflation. That came in at 2.2% in July, and we suspect it will creep higher towards 3% into year-end. That's largely because the impact of lower household energy prices is dropping out of the annual comparison, and the downward trend in food inflation looks like it is more or less complete.

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