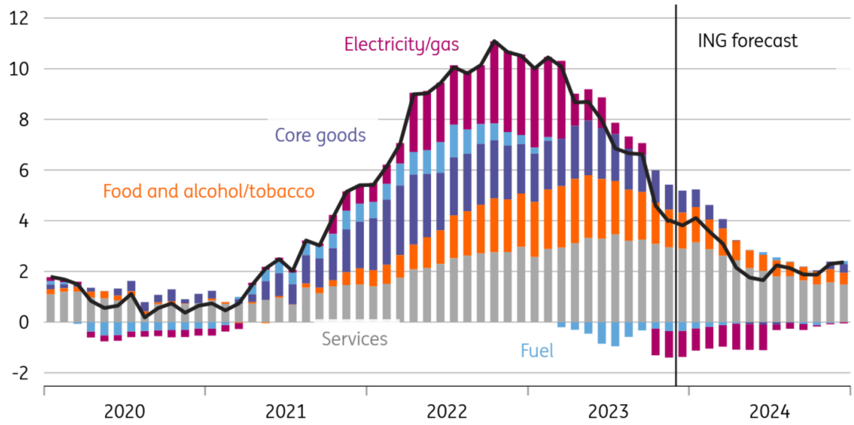
Surprise UK inflation slide bolsters chances of summer rate cut

UK inflation has come in much lower than expected for November and markets are now pricing a whopping 140bp of cuts next year. That's maybe pushing it, but investors are right to be thinking about several cuts next year, despite the Bank of England's recent pushback

UK inflation has dipped below 4%, and that's a huge surprise compared to what had been expected. What's more, the fall in headline CPI to 3.9% (from 4.6%) seems to be fairly broad-based at first glance. We're seeing discounting across the board on consumer goods, from clothing to household goods, and cars. Lower fuel and food contributions helped too.

But the Bank of England will be particularly comforted by the further surprise fall in services inflation, which came down to 6.3%, having peaked at 7.4% over the summer. Admittedly the Bank had argued, as recently as last week, that this downtrend isn't entirely linked to economic factors – the implication being that some of the move is just statistical noise. The Bank could still level that argument at this latest data, with some of the downside surprise linked to a fall in communications prices (ie internet/phone contracts etc) as well as volatile airfares. But we are also seeing more muted price pressures across areas like hospitality and holidays, which are what we'd more traditionally think of as services.

How UK inflation breaks down



Source: Macrobond, ING

So what next? Despite today's positive surprise, we think services inflation could stay sticky in the 6% region into early next year. At face value, that would justify the Bank of England's more cautious approach at last week's meeting. The BoE took a decidedly different line to the Federal Reserve, offering implicit pushback against the quantity of rate cuts priced into financial markets in 2024. Expect officials to keep up that cautious narrative as we enter the new year.

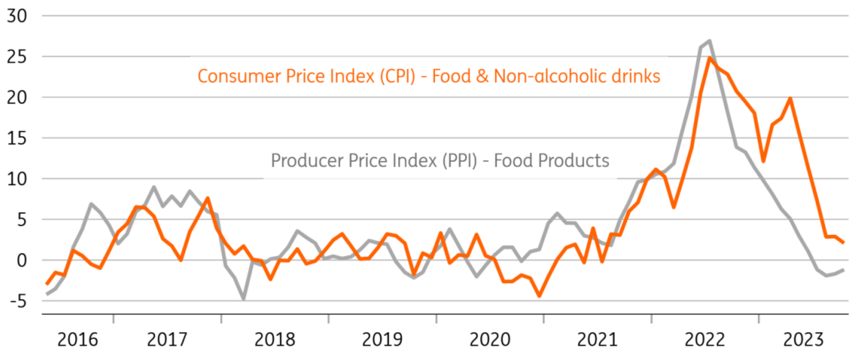
But by the spring, we think the story is likely to begin to change. Areas like hospitality services should continue to experience disinflation. A combination of a further (gradual) slowdown in wage growth and the lagged impact of lower gas prices should help. Services inflation at 4% next summer seems feasible.

If the recent trends in consumer goods categories continue too, then there's a decent chance that headline inflation gets back to the 2% target as soon as May and potentially even dips below, particularly if petrol prices continue to fall (not our base case).

Further downward pressure on food inflation will also be a key driver here. The month-on-month increases in food prices have already slowed considerably since late 2022/early 2023, and there's a reasonable chance we start to see consistent price falls on the back of steadily decreasing producer prices.

Consumer food prices could start falling fairly soon

UK food inflation: CPI vs producer prices
Three month annualised change, seasonally-adjusted by ING



Source: Macrobond, ING

Put that all together, and we think markets are right to be pricing a number of rate cuts for 2024. Investors now expect 140bp of cuts in 2024 after this latest downside surprise on inflation, starting in May. That's maybe pushing it, and we still think the Bank will prefer to tread a little more cautiously with 100bp of cuts starting in August.

But interestingly, this data has also seen investors reassess where the BoE stands relative to the Fed and European Central Bank. Up until now, markets had been expecting both of the latter to be much more aggressive than the BoE, but that narrative seems to be fading.

One thing we've often heard recently is that UK inflation (specifically services) is stickier and therefore that implies slower/later rate cuts relative to the eurozone. We wrote in more detail recently why a lot of the divergence in UK services inflation relative to the continent can be explained by factors not intrinsically linked to economic conditions. In the areas that really count for monetary policy – things like hospitality – the differences are much less dramatic. So while the BoE might be a little later to the cutting game than other European economies, we don't expect the UK to be an outlier when it comes to the extent of policy easing.

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