UK inflation dip represents the calm before the storm

Despite a temporary setback in July, UK inflation is unlikely to be far off 3% in August and will probably be fairly close to the Bank of England's 4% forecast by November. But things are likely to calm down into 2022, and we don't think inflation will be enough of a concern for policymakers to hike interest rates before late next year

Declining clothing prices are partly responsible for the surprise drop in UK inflation

2%

UK inflation rate

July

Lower than expected

The dip in UK inflation is unlikely to last

UK inflation took a bit more of a tumble than expected in July – but this feels remarkably like the calm before the storm. Indeed much of the surprisingly sharp deceleration from 2.5% to 2% can be put down to things like clothing prices, and to a lesser extent, household goods. The former had been seeing a sharp recovery in prices after recent lockdowns, while the latter had been pushed higher by global supply chain constraints.

These are temporary setbacks, and there's little doubt that headline CPI will go well above 3% later this year – and in fact, the next set of data may confirm we got close in August. It's not difficult to see inflation coming fairly near to the Bank of England's forecast of 4% in around November.

When it comes to predicting the date of the first rate rise, however, the size of the peak in inflation feels fairly irrelevant. How quickly it falls back into 2022 is a better question, and we suspect headline CPI could revert close to target by around the middle of that year, a fair bit sooner than the Bank of England most recently forecast.

Part of that unsurprisingly is down to energy, which by late this year will probably account for over a quarter of that 4% headline CPI spike. A huge 12% increase in the cap on household energy bills due for October is a major factor. But that follows a similarly large 9% rise in April, which correspondingly means a little bit of the heat should come out of the inflation numbers from the second quarter next year.

Inflation to calm down into 2022

The bigger uncertainty is what happens to goods prices, in light of the fact that many of the strains in global supply chains are likely to persist for some time to come. Shipping prices have continued to rise, while the latest Covid-19 news in China risks amplifying some existing shortages as we head into the important Christmas/Black Friday trading season.

Still, like energy prices, we think goods inflation will have begun to ease in the spring of next year. And the combination of these factors potentially means that headline CPI will be much closer to target by the middle of 2022.

Any tightening is unlikely to come before late 2022 or early 2023

Ultimately, whether or not inflation stays higher for longer probably relies on wage growth accelerating. There's some evidence (though mainly anecdotal) that some firms have been forced to lift pay in light of recent staff shortages, though we think many of the factors driving this problem will subside over coming months. Indeed one ingredient has been the so-called 'pingdemic', which should be becoming less of an issue now self-isolation rules have changed.

Barring a surprise surge in underlying wage growth over the winter, we don't think inflation will be a huge concern for the Bank of England. Any tightening is, therefore, unlikely to come before late 2022 or early 2023.

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