UK inflation unexpectedly picks up amid stubborn services price rises

After an unexpected pick-up in UK inflation, the market may be getting ahead of itself by pricing a May rate cut. Services inflation is likely to remain stubborn in the near term, while much depends on the size of any fiscal stimulus at the March budget

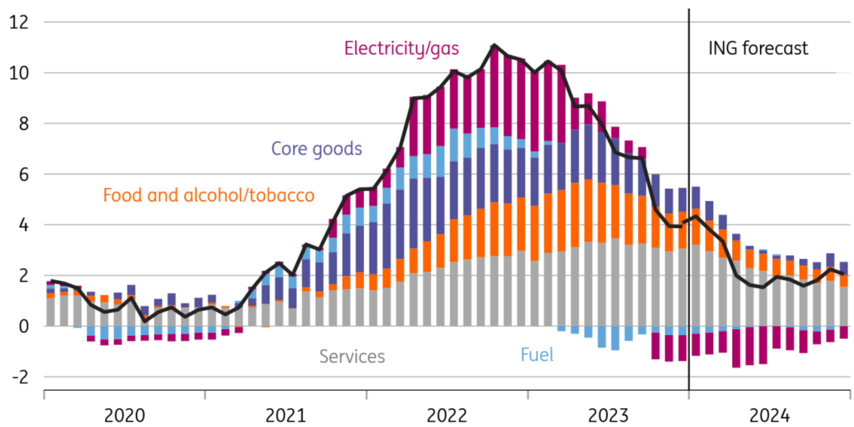
UK inflation came in higher than expected in December, and this seems to be largely down to unexpected stubbornness in services inflation. Headline CPI unexpectedly rose to 4% (expected at 3.8%) while services inflation nudged up to 6.4% from 6.3% a month earlier, defying expectations for a further fall.

It is worth putting this in context by saying that even with this latest surprise, services inflation is still some 0.5 percentage points below the Bank of England's most recent projections. Some of this latest boost can also be chalked down to some stickiness in things like airfares and accommodation/package holidays, which the Bank itself said in the December meeting minutes were "not reliable" indicators of inflation persistence. And there were some pockets of good news.

Rent inflation, on a month-on-month basis (admittedly not seasonally-adjusted) was a little softer than we'd expected, while restaurants/bars continued to experience less aggressive month-on-month price rises than a year earlier. This latter category, we think, is one of the better gauges of underlying inflationary pressure in the service sector.

The lesson here is not to react to one month's worth of data on services inflation, which has bounced around a bit over recent months. But it is a reminder that the decline in services CPI will be gradual in the near term, and we don't expect this to dip below 6% until at least March.

Contributions to UK inflation and ING forecasts (YoY%)



Source: Macrobond, ING calculations

Still, the wider inflation story is looking brighter. Despite this latest setback, we continue to expect headline CPI to dip slightly below 2% in April and down to the 1.5% area in May/June. We expect this downtrend to be relatively broad-based, with further improvements highly likely in food and energy. On a seasonally-adjusted and three-month annualised basis, food inflation is running at roughly 2%. Meanwhile, natural gas prices point to, at the very least, a 15% fall in household energy bills in April.

What does this all mean for the Bank of England? Financial markets are pricing a rate cut in May, which we're still concerned might be a little premature. We don't rule it out, but we think it requires a) more tangible progress on both services inflation and wage growth in 1Q than we currently expect, and b) a relatively muted fiscal package from the Chancellor at the March budget. For now, we're pencilling in an August cut with 100bp of easing to follow this year, though we'll keep that under review as the data and fiscal news comes in over the next couple of months.

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