Macro Comment UK

Are second-round effects a risk from the upcoming spike in inflation?

An inflation spike is expected later this year, but the causes are one-off in nature, which means the Bank of England (BoE) is minded to “look through” it when setting interest rates. However, there are additional risks of second-round effects occurring in the post-covid era that will require the BoE to remain vigilant. These risks add to uncertainties around the Bank Rate pathway for 2025 and 2026. Our base case remains that rates are gradually cut to 3.5%, reaching that level in 2027, with rate-setters balancing inflation persistence with weakness in growth and potential disinflationary forces.

Daniel Mahoney, daniel.mahoney@handelsbanken.co.uk

James Richard Sproule, james.sproule@handelsbanken.co.uk

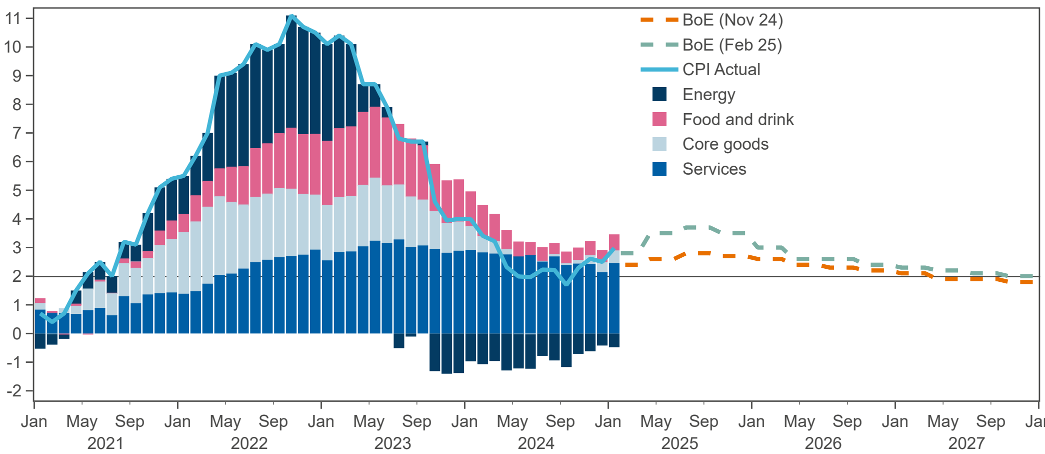
Johan Löf, +44 7483947454, johan.lof@handelsbanken.co.uk

A spike in UK inflation is approaching

BoE set to "look through" the upcoming inflation spike.

The Bank of England's latest report outlined a considerable upward revision of near-term projections for UK inflation. At the time of the November report, y-o-y CPI was expected to peak at 2.8% in Q3 2025[1], but this is now expected to be 3.7%[2]. This upward revision is being driven by higher energy prices, increases in other regulated prices and, to some extent, the fact that many retailers are set to pass on some of the costs associated with higher payroll costs. The impact of changes to household energy prices will be particularly notable, with its contribution to headline y-o-y CPI jumping by over 0.6pp from March to April[3]. Given that these drivers of the upcoming inflation spike should be one-off in nature, MPC members will be minded to “look through” the spike when setting interest rates this year since their current projections are for inflation to return to 2% in the medium term under the assumption of market expectations for interest rates (see below).

UK y-o-y CPI inflation (2021-27)



Sources: Macrobond, Pantheon and Bank of England

The BoE has raised its near-term inflation forecasts significantly

The increase in inflation should be “transitory”

Market pricing suggests the upcoming inflation will be transitory.

There is a strong likelihood that this upcoming inflation spike will indeed be “transitory”. The inflation spike of 2025 projected by the BoE is modest compared to the inflation spike of 2022, when y-o-y CPI peaked at 11.1%, which means that second-round effects are less likely to occur this time around. Market participants certainly seem to be of this view: compared to November 2024 (when the previous BoE inflation report was published), UK 1y1y inflation swaps are now trading roughly flat and 2y1y inflation swaps are trading at lower levels. Moreover, 5y5y forward

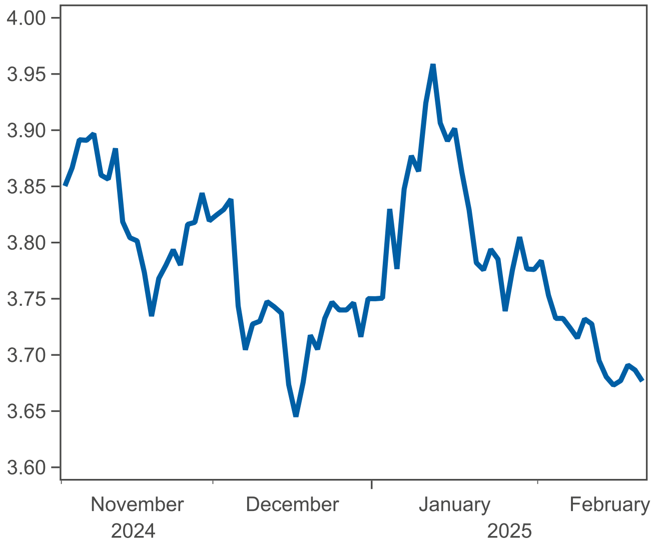
Handelsbanken

inflation swaps – effectively what is being priced for average inflation in five to ten years' time – currently stand at roughly 3.2%[4]. Note, of course, that these inflation swaps are priced in terms of RPI (typically higher than CPI) and that this figure is below the level seen throughout 2018 and 2019. This indicates that markets remain confident in the BoE's long-term ability to achieve price stability.

UK Inflation Swap 5y5y (2010 - Present)

Source: Bloomberg

2y1y UK inflation swap (01.11.24 - 21.02.25)



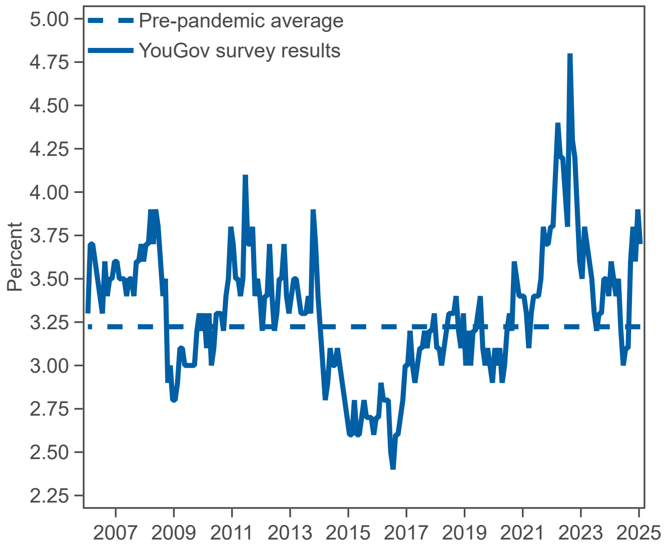
Source: Bloomberg

New context may suggest increased likelihood of second-round effects

Despite this, there are both domestic and international reasons why the BoE will need to remain vigilant with respect to second-round effects[5]. First, current indicators of domestically generated inflation (services inflation and nominal wage growth) remain elevated, and market pricing for interest rates has become more hawkish than assumed in the November 2024 MPC inflation report. Second, there is evidence that inflation expectations in the UK are no longer as firmly anchored around the 2% inflation target as they were prior to the pandemic. While the BoE's Decision Maker Panel survey has seen no recent jump in medium-term inflation expectations, longer-term inflation expectations, according to the YouGov metric, have recently spiked and are notably above the 2010s average. Furthermore, households are more attentive to inflation data in the post-covid era. This domestic backdrop is developing in a global environment in which supply shocks are likely to be both more frequent and volatile due to geopolitical disruption, which leads the Bank of International Settlements (BIS) to conclude that central banks may not be able to look through increases in commodity prices in the way they used to be able to[6]. These factors would suggest that, while it is likely that no second-round effects will emerge from the upcoming spike in inflation, it may not be as certain as it would have been had we been operating in an environment that existed at some point during the two decades prior to the pandemic.

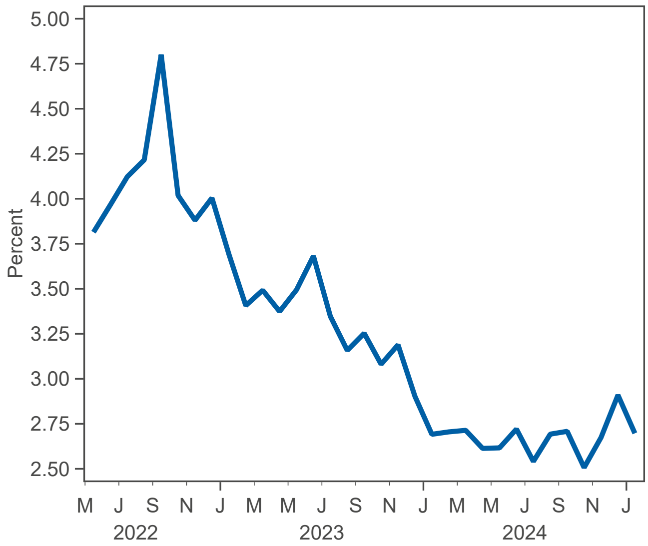
Some evidence that inflation expectations in the UK are no longer as anchored around the 2% inflation target. Moreover, global supply shocks may be more frequent and volatile in the post-covid era.

YouGov/Citi Survey of Inflation Expectations 5y5y (2006 - Present)



Sources: YouGov and Citi

3-year ahead BoE Survey Inflation Expectations (2022 - Present)



Source: Bank of England

Uncertainties associated with interest rate pathway

This adds to uncertainties regarding the future interest rate pathway in the UK, especially if further supply shocks hit the UK from, say, escalatory tariffs[7]. After all, evidence from the BIS suggests that larger supply shocks that occur at times of already-high inflation are more likely to induce second-round effects. This is a scenario that was observed when energy prices jumped after Russia's invasion of Ukraine.

Uncertainty about future interest rates is certainly material, but our base case scenario remains for gradual reductions in base rate.

There is also, of course, a key question to be answered with respect to what exactly is driving current weak growth in the UK. If it is being driven by suppressed demand then there is scope for a reasonable loosening of monetary policy. However, if it is prompted by constrained supply, this may require monetary policy to remain in more restrictive territory for longer. Minutes of the MPC meeting suggest that the seven members backing a 0.25pp cut to rates in February are split on this question[8].

This highlights a significant degree of uncertainty surrounding the interest rate trajectory, both on the upside and downside. However, while uncertainty about future interest rates is certainly material, our base-case scenario remains for gradual reductions in Bank Rate, reaching 3.5% in 2027. Such a path is underpinned by the BoE balancing inflation persistence with weakness in growth and disinflationary forces.

Footnotes

1 Bank of England, Inflation Report, November 2024 ↩

2 Bank of England, Inflation Report, February 2025 ↩

3 Calculations based on Pantheon data ↩

4 Figures from Bloomberg as of 20.02.2025 ↩

5 Background reading: Our previous analysis on second-round effects, inflation expectations and changed price- and wage-setting behaviour in the economy include "Brave new nominal world"; p. 9-12 in Global Macro Forecast September 2023, , and "What stops a new high-inflation regime"; p. 15-17 in Global Macro Forecast September 2022, ↩

6 Bank of International Settlements Bulletin, Commodity prices and monetary policy: old and new challenges, January 2025 ↩

7 Our overall global inflation analysis warns that central banks may not have the normal playbook option to look through an inflation impulse from potential tariff escalations. See: "The trade tariff threat – hurting growth, stoking inflation, and creating risks"; p. 9–14 in Global Macro Forecast January 2025, ↩

8 See paragraphs 19 and 20 of the February 2025's Monetary Policy Committee's minutes ↩

Research disclaimers

Svenska Handelsbanken AB (publ) (collectively referred to herein as 'SHB'), is responsible for the preparation of research reports. SHB is regulated in Sweden by the Swedish Financial Supervisory Authority, in Norway by the Financial Supervisory Authority of Norway and in Finland by the Financial Supervisory Authority of Finland. All research reports are prepared from trade and statistical services and other information that SHB considers to be reliable. SHB has not independently verified such information.

In no event will SHB or any of its affiliates, their officers, directors or employees be liable to any person for any direct, indirect, special or consequential damages arising out of any use of the information contained in the research reports, including without limitation any lost profits even if SHB is expressly advised of the possibility or likelihood of such damages.

The views contained in SHB research reports are the opinions of employees of SHB and its affiliates and accurately reflect the personal views of the respective analysts at this date and are subject to change. There can be no assurance that future events will be consistent with any such opinions. Each analyst identified in this research report also certifies that the opinions expressed herein and attributed to such analyst accurately reflect his or her individual views about the companies or securities discussed in the research report. This research report does not, and does not attempt to, contain everything material that there is to be said about the company or companies described herein. For additional information about our research methodology please visit, https://www.researchonline.se/desc/disclaimers

Research reports are prepared by SHB for information purposes only. The information in the research reports does not constitute a personal recommendation or personalised investment advice and such reports or opinions should not be the basis for making investment or strategic decisions. This document does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any securities nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever. Past performance may not be repeated and should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and investors may forfeit all principal originally invested. Investors are not guaranteed to make profits on investments and may lose money. Exchange rates may cause the value of overseas investments and the income arising from them to rise or fall. This research product will be updated on a regular basis.

No part of SHB research reports may be reproduced or distributed to any other person without the prior written consent of SHB. The distribution of this document in certain jurisdictions may be restricted by law and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions.

The report does not cover any legal or tax-related aspects pertaining to any of the issuer's planned or existing debt issuances.