

# Sticky UK services inflation, but the doves still hold most of the cards

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- A busy period of UK data has seen outturn figures broadly in line with expectations. Today's CPI numbers confirmed that headline inflation fell markedly at the start of the year, and the direction of travel will remain downwards. Underlying price pressures in the services sector remain stubbornly high, however, which will give some BoE officials pause for thought.

- The broader macro backdrop still supports further policy easing. Labour market slack is clearly evident in the UK. The unemployment rate has reached a five-year high, and wage growth is now back to pre-pandemic norms and close to being target-consistent. The UK's growth profile is bumpy but underlying demand also remains relatively soft. With that in mind, we see little reason for policymakers to hold off from cutting rates again, despite sticky services inflation. We still expect the BoE will cut at the next meeting in March and take rates to 3.25% later in the year.

### A mixed inflation print but labour market slack supports further easing

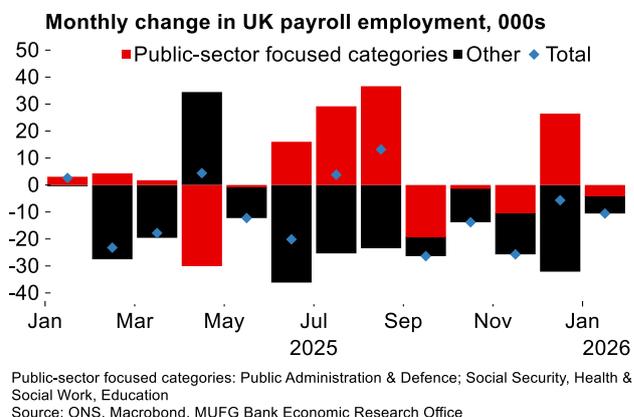
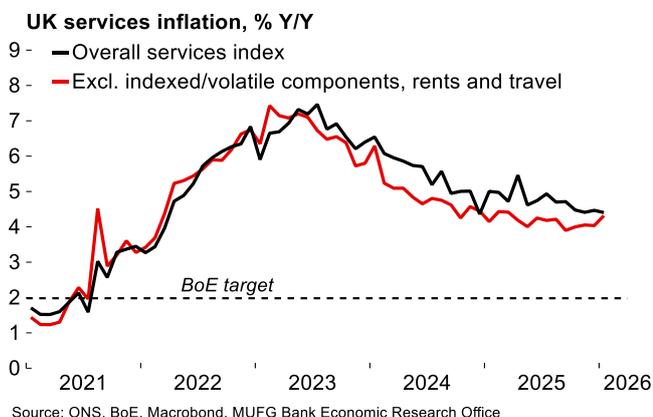
Headline inflation eased to 3.0% in January, down 40bp, in line with market expectations. Base effects and a reversal of previous pressures from volatile components such as air fares drove the decline, as well as progress on food inflation. The direction of travel is likely to remain downwards with inflation set to mechanically fall to around target over coming months due to stronger base effects and government energy support from April.

However, underlying disinflation was less pronounced in this release than expected. The core and services measures only decreased by 10bp each, to 3.1% and 4.4% respectively (both 30bp above the BoE projections). The BoE will certainly be unsettled by signs of sticky underlying services. We calculate that the BoE's gauge of underlying services inflation (which excludes indexed/volatile components, rents and travel) increased from 4.0 to 4.3%, which policymakers will find uncomfortable.

As a result, we see it as a much more mixed CPI release than the fall in the headline number suggests. Crucially, though, it comes on the back of clearer evidence of labour market slack in yesterday's release. The unemployment rate increased to a five-year high of 5.2% in the three months to December. Payroll employment fell yet again in January. While there was a significant upward revision to the December figure (now estimated at -6k, from -43k previously), the private sector continues to shed jobs at a steady clip with weakness broad-based across a range of industries.

On the pay front, private sector regular wage growth eased from 3.6% to 3.4% in the three months to December, in line with market and BoE expectations, helped by a downward revision to the November estimate. The rate now matches the pre-pandemic (2018-19) average rate exactly. We expect the numbers will continue to grind lower over this year and fall below the 3.25% mark [estimated](#) by the BoE as being target-consistent.

## Underlying services inflation edged higher in January... ...but the private sector is still shedding jobs



The wider demand backdrop also remains subdued with data last week confirming that the UK economy was limping along at the end of last year. Q4 GDP growth of 0.1% Q/Q fell short of the consensus and our expectation (both 0.2%) after downward revisions to previous data. Steady services growth, which we had previously [held up](#) as a sign of resilience, was revised away and is now estimated to have been flat on a 3m/3m basis.

The caveat here is that the cycle of Budget speculation and subsequent relief (and possibly some residual seasonality) has resulted in a bumpy UK growth profile. While we think that the strong January PMI was flattered by Budget relief and will moderate lower in February (the flash figures will be released on Friday), we still expect GDP growth will improve to 0.4% Q/Q in Q1. Looking ahead, disinflation and further BoE easing are likely to provide some support to activity in 2026, but growth is likely to remain relatively subdued, as we set out [here](#). On an annual average basis we now see GDP growth falling to 1.0%.

### A March cut remains our base case, with more easing to come later in the year

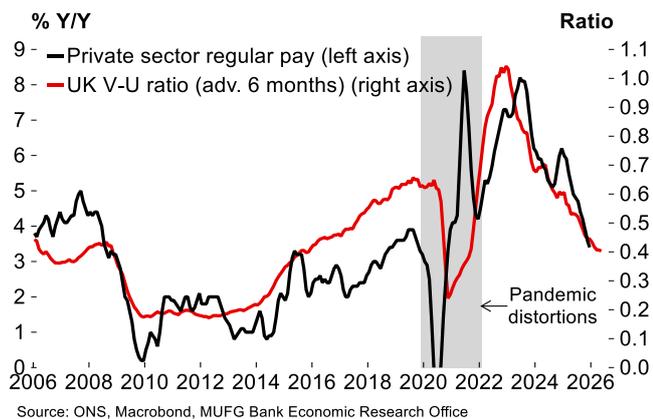
Putting it all together: demand is soft, the unemployment rate is rising, wage growth is cooling and inflation is set to mechanically fall back to target over coming months. The BoE has signalled that at least one more cut is coming. Why wait? The wider picture means that a majority of officials will be more willing to look past today's upside surprise on services inflation, we think, after the dovish turn at the last policy meeting (see [here](#)).

So we continue to expect the next cut will be in March. It's not a slam dunk and will likely be another tight vote, especially if the next labour market numbers are more nuanced (it's worth noting that there will be no more CPI prints between now and the next meeting). Governor Bailey remains the key swing voter but Mann, a self-styled "activist" external member, has emerged as a wildcard that could also tilt the balance in favour of a cut to 3.50%.

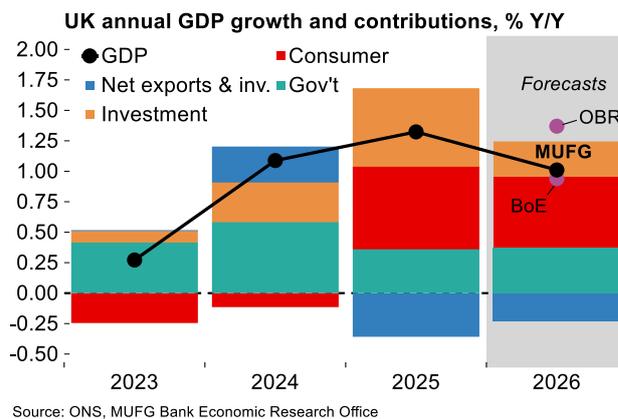
Further ahead we continue to see the terminal rate at 3.25%, but there is still likely to be caution around cutting to that mark as rates approach neutral, despite the generally soft data seen of late. That could promote a slowdown in the 'cadence' of easing. We still see June as a possible juncture for another cut – after the April inflation normalisation is laid bare in the data. But today's numbers mean that this pace of cuts

would likely require good progress on services inflation in the next three CPI prints, as well as further signs of labour market slack.

### Labour market slack, cooling pay growth



### We expect lower annual GDP growth in 2026



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