Clothing prices rise, MPC patience not wearing thin

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CPI inflation remained steady at 3.1% for the third month in a row in September, in line with market expectations, although we had expected a modest fall. If inflation would remain over 3% in October, Mervyn King will be forced to write his ninth letter to the Chancellor in under four years, explaining why inflation has exceeded the target by over 1%. The headline RPI measure also remained relatively stubborn, edging down only marginally to 4.6% from 4.7%.

There were a number of interesting features in the inflation report. For example, food price inflation rose to 4.9% from 3.9%, but this was exclusively due to a decline a year ago. On the other side, services inflation moderated to 3.7% from 4.0% the month before. However the huge standout in September was the behaviour of clothing and footwear prices, which surged by 6.4% on the month, taking the year-on-year change to +0.9%, the first annual increase since March 1992 when the CPI figures are classed as experimental. After a long period of clothing price deflation, it is not clear why the figures are now rising - the upturn in prices seems rather counterintuitive given the uncertain consumer climate. It is too early for the rise in cotton prices to be affecting the numbers, while sterling's relative stability over the past 18 months suggests that it is difficult to blame the pound's post-2007 weakness.

Interestingly the RPI clothing and footwear series has been in positive annual territory since February and is now running at a rate of 9.4% There is an issue here in terms of the way that the ONS changed its price collection methodology earlier this year, enabling it to gain a larger sample of price quotes, which in turn has increased the variation in price changes. The CPI and RPI series are averaged differently. The 'geometric' method used for the CPI dampens down larger increases than the 'arithmetic' way in which the RPI is compiled, hence the bigger difference between the two series. Of course this does not necessarily explain why clothing costs are now rising per se, although we suspect the change in methodology might be an underlying cause. It certainly accounts for why the wedge between RPIX inflation (4.6%) and CPI inflation is extremely high at present at 1.5%, given a long term difference of 0.7%.

Away from the technicalities of index construction, what does this mean for monetary policy? Our own view is that it is difficult to characterise above target inflation as 'temporary' given that the targeted measure has been running above 2% for four out of the past five years. However the MPC still seems willing to attribute the current level of inflation to special factors and to conclude that the CPI will return to target in the medium term.

Higher rates are a long way off - In a speech in Dublin on the 12th of October, committee member David Miles pointed out that the current upswing is not 'normal' and that there is a risk of attempting to tighten policy too quickly, in which case the MPC would stand accused of not learning from the events of 2008. Against that, he also drew attention to upside risks to inflation. In Q&A he also spoke about the possibility of restarting the QE programme. There is certainly a significant chance that the committee will choose to launch a fresh round of QE, but for now we stand by our central view that the high prevailing rate of inflation will be a deciding factor in dissuading the committee from sanctioning more easing. However higher rates remain a long way off.

Trade figures presented in October disappointed (again), with a deficit of £8.2bn in August compared with a consensus number of £8.1bn and our own forecast of £7.7bn. Volume figures for Q3 so far suggest that net exports will be a drag on GDP for the fifth quarter in succession.