Economic Research Unit

Economics Weekly

UK CPI and Labour Market data point to March rate cut

Together, yesterday's UK labour market data indicating the unemployment rate rose to 5.2% in Q4 2025 and this morning's CPI data showing inflation falling to 3% in January, copperfasten the likelihood of a 25bp rate cut at the Bank of England's March 19th meeting. However, we still believe the market is underpricing the likelihood of rates being cut to 3% by end-2026, such is the deterioration in the UK labour market. Notably, the 'single-month' measure of the unemployment rate rose to 5.4% in December, so the headline 3-month average rate should rise above 5.2% next month. Also, recent PMI and Recruitment Employer Confederation (REC) surveys paint a bleak view, pointing to further job cuts in early 2026.

UK Unemployment rate will almost certainly rise above 5.2% next month: Yesterday's release indicating the unemployment rate rose to 5.2% in Q4 2025 (vs 5.1% consensus) caught markets by surprise, putting sterling on the back foot and leading investors to price-in a March Bank of England rate cut as almost a certainty. However, it often isn't fully appreciated the headline unemployment rate is actually a 3-month average. The '*single-month*' measure of the unemployment rate has increased from 5.0% in October, to 5.3% in November and 5.4% in December. So January's data will almost certainly show headline unemployment rising towards our forecast for 5.3% on average in 2026.

Pay-rolled employees, vacancies and pay growth soften: Other indicators in yesterday's release point to further deterioration at the beginning of 2026. The ONS' measure of pay-rolled employees fell by 10,500 in January, to 30.1 million, down 1.2% year-on-year. Vacancies also fell slightly to 726,000 in the three months to January. The number of unemployed persons per vacancy is now 2.6 - the highest level (ex-Covid) since 2015. Crucially for the Bank of England the labour market data also show looser conditions translating into weaker pay. Regular (excluding bonuses) private sector earnings growth fell to 3.4% in December, now close to levels consistent with the Bank of England's 2% inflation target.

Surveys suggest labour market will continue to loosen in early-2026: January's UK Services PMI indicated employment fell at a faster pace in January, than in December. Firm's cited squeezed profitability, fragile market conditions, efforts to raise productivity via automation and payroll costs all holding back hiring. The PMI surveys also indicated construction sector jobs contracted at a solid pace in January and employment in manufacturing fell for a 15th consecutive month. The latest Recruitment Employers Confederation (REC) survey also paints grim picture, albeit reporting a softer drop in permanent placements and vacancies in January, than in late 2025.

CPI inflation still on track to fall to 2% by April: This morning's news that CPI inflation fell to 3% in January was in line with market expectations, albeit with the core rate a tick higher at 3.1% than anticipated. Services inflation declined to 4.4%, reinforcing the view the deceleration in pay-growth is now translating into consumer prices. That said, services inflation was higher than expectations, pushed up by volatile items, hotel prices, live music prices and insurance prices. Nonetheless, January's out-turn still leaves CPI inflation on track to fall to 2% in April/May as the range of cost-of-living measures announced in November's Budget are implemented; the £150 average reduction in household energy bills, freezing rail fares and prescription charges, and extending the 5p fuel duty cut.

March rate cut now seen as close to a certainty, sterling under pressure: Options prices are now imply an 84% probability of 25bp rate cut to 3.5% from the Bank of England on March 19th, vs 73% at the end of last week. Two rate cuts to 3.25% are now fully priced-in by end-2026. Hence, 2-year UK swap rates fell below 3.4% for the first time yesterday. Sterling was also under pressure, depreciating close to 87.5p against the euro yesterday, before paring back losses. However, we still believe the market is underpricing the likelihood of the Bank of England acting more aggressively, cutting rates to 3% in 2026, given the deterioration in the labour market and as CPI inflation falls back towards 2% in the coming months.

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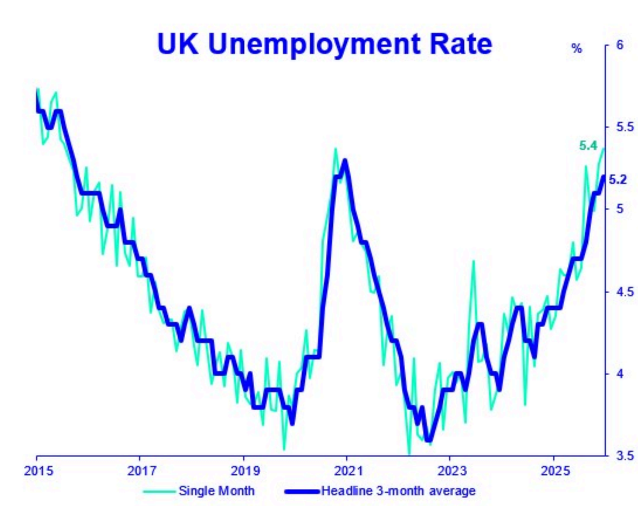

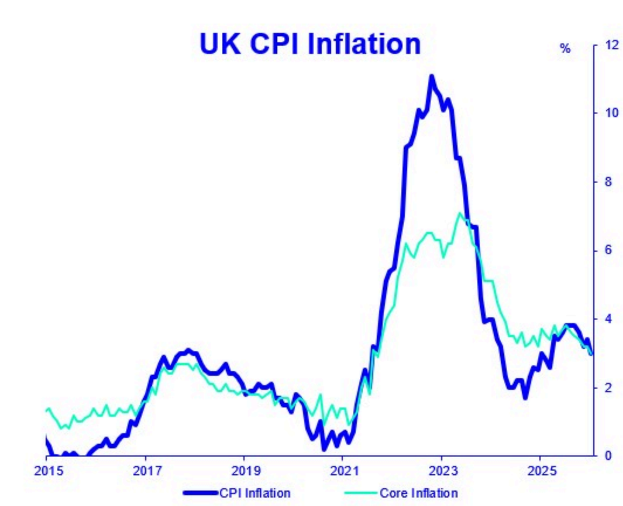

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