



SERVICES SPENDING PUSHES UK INFLATION HIGHER AS US TALKS WITH RUSSIA SPUR EU DEFENCE STOCKS

This week UK inflation accelerated unexpectedly. The basket of goods used to make up the prices index is a best attempt at replicating average spending and sometimes this is more representative than others. The recent pick up in services inflation is partly due to the introduction of VAT to private school fees and, while this will be felt keenly by those affected, it is far enough from the average experience to be put down as a bump in the figure. However, services inflation overall remains a significant driver of price rises and, combined with increasing wages, will give the Bank of England more reason to remain cautious when it comes to interest rates.

Meanwhile, a month after assuming office the Trump effect is still being felt. It is most evident in defence stocks this week, as the 180° turn in US policy towards Ukraine is forcing the UK, the Eurozone and the Baltic states to rapidly review their approach to security. European defence stocks have been rising since last Autumn as Trump's lead in the presidential election became apparent, but the urgency has spiked in the last two weeks.

THE MARKETS THIS WEEK

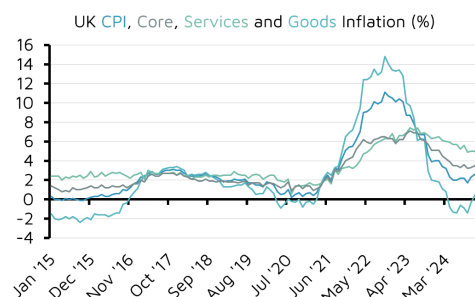
FTSE 100	S&P 500	Nikkei 225	STOXX 600	Hang Seng	US 10 Yr	UK 10 Yr	Brent Crude	Gold	Copper	GBP USD
-0.97%	+0.15%	-0.95%	-0.30%	+3.79%	-0.04%	+0.11%	+0.77%	-0.73%	-4.77%	+0.52%



UK: HIGHER INFLATION AND RISING WAGES REDUCE RATE CUT HOPES

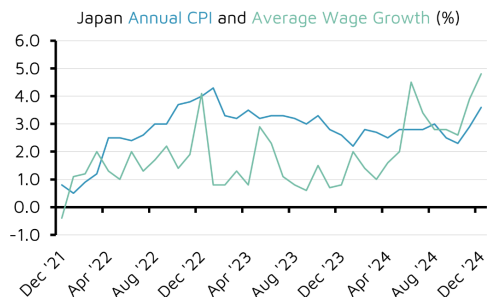
UK inflation accelerated in January as the annual rate for the Consumer Prices Index rose to 3%. This is a big rise from 2.5% a month earlier as services prices continue to climb. The core measure of price inflation (excluding food and fuel) also rose faster than expected as it accelerated from 3.2% to 3.7%. Although the UK unemployment rate has remained static, average wages are also increasing faster than predicted. Average annual wages excluding bonuses increased 5.9% in the three months to December. The Bank of England has forecast CPI inflation rising to 3.7% this year but the rate of acceleration and hot wage growth makes interest rate cuts less likely.

UK gilt yields rose this week, as the potential for fewer rate cuts weighed on prices, and sterling extended recent gains against the dollar and euro. Meanwhile, the minutes from the Federal Reserve's last rate setting meeting shows concern about accelerating inflation as members want to see more evidence that it is cooling before considering another rate cut.



JAPAN: ECONOMIC GROWTH AND INFLATION POINT TO RISING RATES

Japanese economic growth in the final quarter of 2024 rose to 0.7% to turn GDP growth positive for the year. Although some domestic consumption remains fragile, strong exports and rising business investment have boosted the economy. Underpinning some of this growth is a sustained shift to above inflation wage gains. Last year average wages rose 5.3% following the annual Shunto – or collective wage bargaining which takes place each spring. Economists predict this year's settlement will average 4.9% as labour shortages persist. Around 60% of employers are expected to raise pay this year.



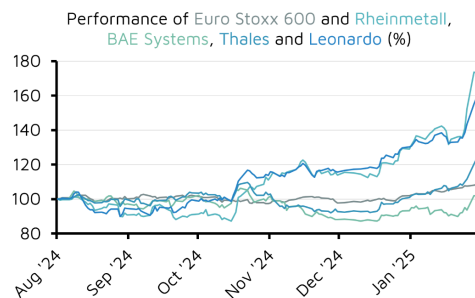
After years of low or negative inflation, price rises appear to be becoming ingrained, with CPI inflation rising 3.6% in December. Last month, the Bank of Japan hiked interest rates to 0.5% as rising wages and prices allow it to continue to normalise its monetary policy. Markets expect rates to be hiked further in 2025 and this has helped the yen reverse some of its recent weakness, thus boosting returns for UK-based investors in Japanese stocks.



EUROPE: WEAPONS MAKERS SURGE ON PROSPECT OF A MUSCULAR EUROPE

European defence stocks rallied this week as investors bet on higher military spending as the region considers how to fill the gap left by the US reducing its commitment to European security. Germany's Rheinmetall soared 14.1%, Italy's Leonardo surged 13.1%, French weapons maker Thales jumped 11.7.8% and Britain's BAE Systems climbed 9.8%. The rally was broad as the Stoxx Europe Aerospace and Defense and FTSE 350 Aerospace & Defense indices rose 3.9% and 3.2% respectively.

The US government is pushing for a quick end to the war in Ukraine and has said that US troops would not be deployed there to keep the peace after fighting ends. European countries are wrestling with how to guarantee Ukraine's security and develop a security architecture that is less reliant on America. The UK has suggested raising defence spending to 2.5% of GDP and there are suggestions that the European Commission borrows from financial markets to fund the €500bn in additional spending the EC forecasts is needed.



Data sourced from Office for National Statistics, Statistics Bureau of Japan, Trading Economics and Investing.com.

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