



INFLATION FORECAST

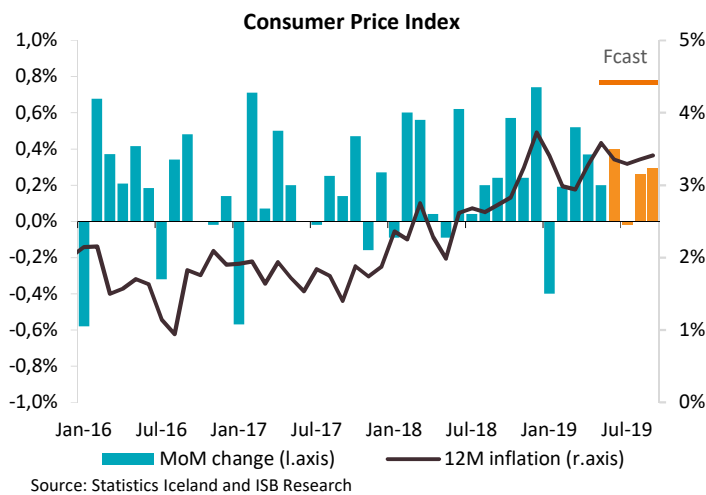
12.6. 2019 | Íslandsbanki Research

Summary

- We forecast a 0.4% rise in the CPI in June
- Lowering headline inflation to 3,4%
- Airfares the main upward-pushing item
- Inflation subside somewhat in coming quarters
- Inflation 2.9% at the end of 2019 and 2.8% at the end of 2020

	1m	3m	6m	12m	24m
Change in the CPI	0.2%	0.6%	1.5%	2.8%	5.9%
Annualised	2.4%	2.4%	2.9%	2.8%	2.9%
	2018	2019	2020		
Inflation at yr-end (Dec-Dec)		3.7%	2.8%	2.7%	
Average YoY inflation		2.7%	3.2%	2.9%	
Average YoY wage rise		6.0%	5.2%	5.4%	
Imputed rent (owner-occupied housing costs), YoY rise		6.5%	2.6%	3.0%	
Trade-weighted ISK index (TWI) (yearly average)		166.7	179.8	180.0	

Inflation set to taper off



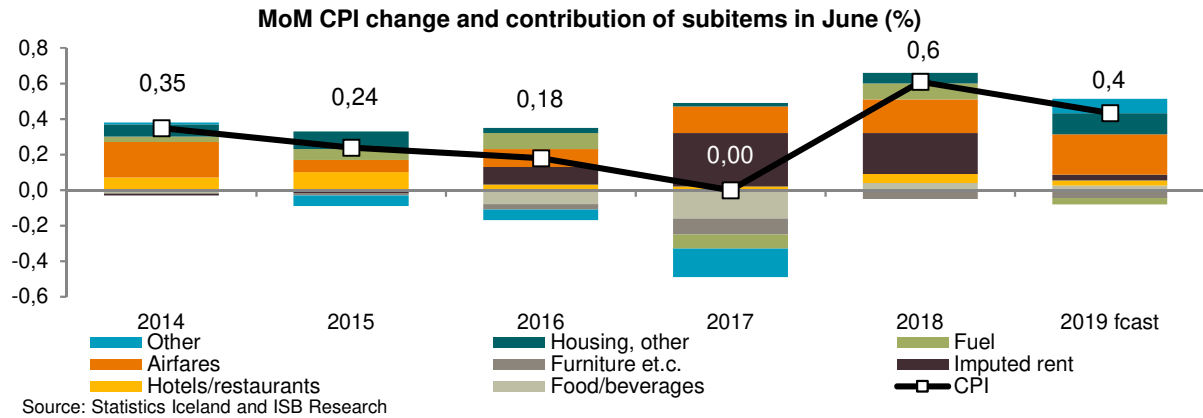
We expect the consumer price index (CPI) to rise by 0.4% month-on-month in June, lowering headline inflation to 3.4%, from 3.6% in May. The outlook is for inflation to subside somewhat in coming quarters, owing to a more favourable outlook for 2019 wage developments coupled with a slowdown in house price inflation. We forecast that inflation will measure 2.9% at the year-end, putting the Central Bank's (CBI) inflation target well within range, and then taper off to 2.8% at the end of

2020 and 2021. Statistics Iceland (SI) will publish the June CPI at 9:00 hrs. on 26 June.

Airfares the main upward-pushing item in June

According to our measurements, higher airfares will be the main driver of the rise in the CPI in June. This spike in airfares follows the usual seasonal patterns, as ticket prices generally jump over the summer months. We expect the travel and transport component as a whole to push the CPI upwards by 0.20%. The main inflationary factor in the travel and transport component is air transport, which we expect to rise by 13% (0.25% CPI effect). On the other hand, we expect a 1.0% decline in fuel prices (-0.03%). It is difficult, however, to measure the subcomponent for airfares following the collapse of WOW Air, which prompted SI to change its methodology at very short notice.

We also project that the housing component will rise by 0.50% month-on-month (0.15% CPI effect). The main upward pushing items here are home maintenance and repair, particularly to include the labour component. After wage agreements for tradesmen and labourers in the construction industry were revised, the labour component of the building cost index rose by 5.4%, which we expect to push the CPI upwards by 0.10%.

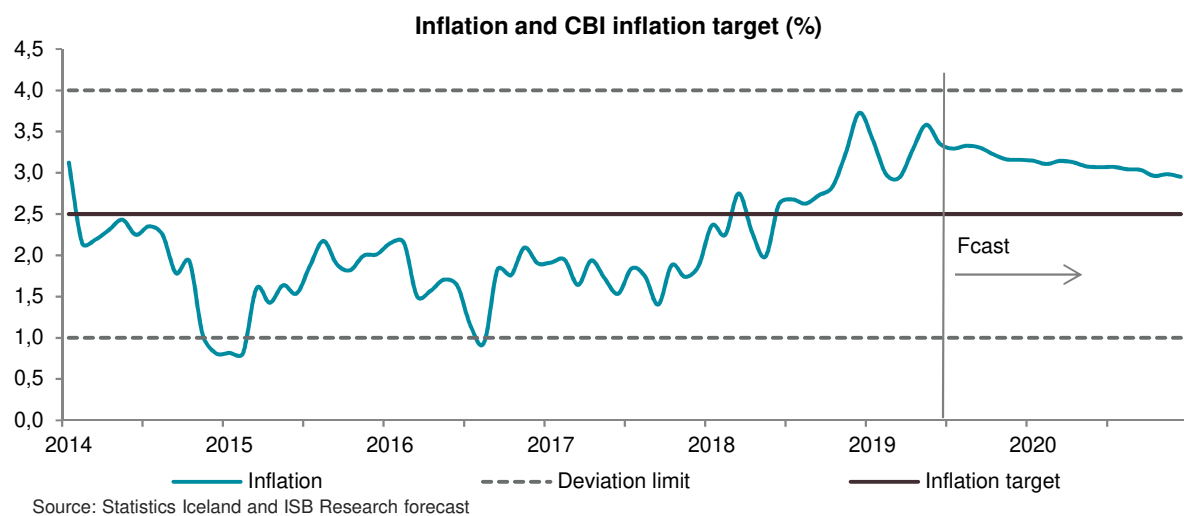


Other housing-related subcomponents are relatively calm these days. We expect imputed rent (mainly a reflection of house prices) to rise 0.20% (0.03% CPI effect) and paid rent to rise 0.40% (0.02%). House price inflation has been much more modest in 2019 to date than it was beforehand. The supply of residential housing has been increasing steadily, and demand has eased as well. The housing market appears to be achieving some sort of balance, and we expect this equilibrium to continue in the months to come.

Excluding airfares and the labour component of home maintenance, the rise in the general price level seems relatively modest these days.

CBI inflation target in sight soon?

The outlook is for inflation to hold the current pace in coming months. We forecast an unchanged CPI in July, a 0.3% increase in August, and a 0.3% rise in September, leaving headline inflation at 3.4% in September. We expect airfares to keep rising in the next few months, fuelled by peak season demand and reduced competition after WOW Air's exit from the stage. Over the forecast horizon, we expect wage hikes to be moderate and house price inflation to hold broadly steady at the pace of the past few months. We also expect imported inflation stemming from goods prices to taper off, provided that the ISK does not weaken any more than it has in the recent term.



Thereafter, we expect inflation to ease in Q4/2019, measuring 2.9% – within striking distance of the CBI inflation target – at the year-end. We then expect it to measure 2.8% at the end of 2020 and 2021. The ISK and wage demands in still-outstanding labour market contracts are



two major upside uncertainties in our forecast, while house prices could result in lower inflation than we have projected here.

Authors

Jon Bentsson, chief economist +354 440 4634
Bergþóra Baldursdóttir +354 440 4637
research@islandsbanki.is
<http://www.islandsbanki.is/English/>

LEGAL DISCLAIMER

This report is compiled by Islandsbanki Research of Islandsbanki hf.

The information in this report originates in domestic and international information and news networks that are deemed reliable, along with public information, and Islandsbanki Research's own processing and estimates at each time. The information has not been independently verified by Islandsbanki which therefore does not guarantee that the information is comprehensive and accurate. The views of the authors can change without notice and Islandsbanki holds no obligation to update, modify or amend this publication if assumptions change.

This publication is only published for informational purposes and shall therefore not be viewed as recommendation/advice to make or not make a particular investment or an offer to buy, sell or subscribe to specific financial instruments. Islandsbanki and its employees are not responsible for transactions that may be carried out based on information put forth in the report. Before making an investment decision, recipients are urged to seek expert advice and get well acquainted with the investments market and different investment alternatives. There are always financial risks related to investment activities, including risk due to international investments and fluctuations in the exchange rate of currencies. Investors' investment objectives and financial position vary. Past performance does not indicate nor guarantee future performance of an investment.

The research report and other information received from Islandsbanki are meant for private use only. The materials may not be copied, quote or distributed, in part or in whole, without written permission from Islandsbanki.

This report is a short compilation and should not be considered to contain all available information on the subject it discusses. Supervisory body: The Financial Supervisory Authority of Iceland (www.fme.is).

UNITED STATES

This report or copies of it must not be distributed in the United States or to recipients who are citizens of the United States against restrictions stated in the United States legislation. Distributing the report in the United States might be seen as a breach of these laws.

CANADA

The information provided in this publication is not intended to be distributed or circulated in any manner in Canada and therefore should not be construed as any kind of financial recommendation or advice provided within the meaning of Canadian securities laws.

OTHER COUNTRIES

Laws and regulations of other countries may also restrict the distribution of this report.

Further information regarding material from Islandsbanki Research can be accessed on the following website: <http://www.islandsbanki.is>.