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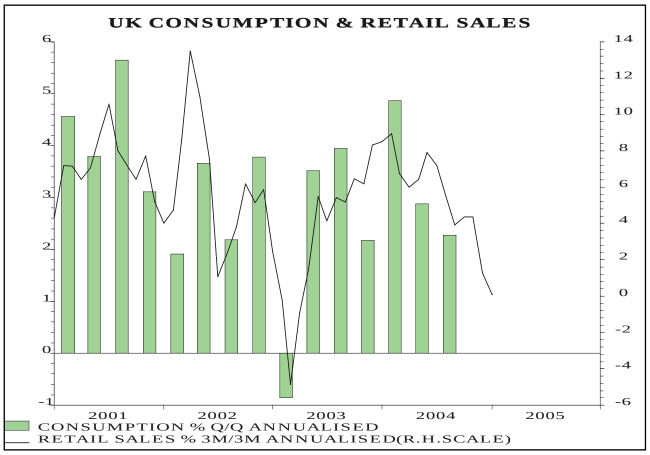
GFC ECONOMICS

DAILY COMMENTARY

CONSUMPTION IS MAIN RISK FACING UK

The Bank of England's inflation report was not as bearish as many had expected. The Bank did raise its growth and inflation forecasts - and is now projecting inflation to be slightly above target in two years time. But it continued to state that the risks to its central projection are on the downside, with consumer spending the main threat. Indeed, the MPC's forecast that consumption continues to grow at around 2.8% p.a., as it has done in the last three years, looks implausible. Retail sales have slowed substantially - notwithstanding the bounce in sales in January. While the risk of a sharp correction in the housing market may have diminished, housing and fiscal policy still look set to turn from a major support to a small drag. Rates look firmly on hold for the time being, but weakness in consumption is likely to push the Bank into cutting rates later this year.



Growth & Inflation Forecast Raised

The MPC is now projecting GDP growth to run at, or slightly above, trend of 2.5% this year and next, before picking up to around 3% in 2007. Inflation, meanwhile, is forecast to edge up steadily to just above 2% in two years time. These upward revisions were not unexpected, as both growth and inflation have exceeded expectations recently. A 1.0% q/q rise in services output fuelled a 0.7% gain in GDP in Q4, and recent upward revisions to manufacturing production suggest the latter is likely to be revised up. As for inflation, the CPI rose 1.6% y/y in January, whereas the Bank had been pencilling in a gain of only 1.2% y/y for Q1.

The overall tone of the Inflation report, however, was not that hawkish. The MPC maintained - as it did in its previous report - that the risks to both its growth and inflation forecasts remained on the downside, with consumer spending posing the main threat. The Bank is assuming that consumption continues to grow at around its average rate of 2.5-3% of the last three years. The likelihood, however, is that this proves significantly too optimistic. Retail sales did increase 0.9% m/m in January, following a 1.1% m/m fall in December. But this gain still implies a sharp slowdown in spending. Retail sales in the last three months were unchanged on three months earlier. This is the weakest performance since early 2003, and is a marked contrast to last summer, when the smoothed 3-month annualised growth rate was running above 7%.

Of course, retail sales are less than 40% of total consumer spending and are more volatile than consumption overall. All the same, the recent slowdown in sales is pronounced and does suggest spending has weakened significantly. Indeed, such a slowdown would appear to be much more in keeping with the deterioration in the fundamentals - most importantly, the rise in interest rates and the end to the house price boom - than the Bank's assumption that consumption growth does not slow at all. While some slowdown continues to look very likely, it has to be said the risks of a sharp downturn in spending have lessened in the last couple of months. For one, consumer confidence has recovered. The GFK measure shows confidence picking up in January, from its September low, to its highest level since late 2002. The growing belief that interest rates are close to their peak, along with reduced fears of a collapse in house prices, are both probably behind this increased optimism.

Certainly, the threat of a sharp fall in property prices has receded. While the various housing

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surveys are currently giving different signals, the broad picture appears to be that house prices have been stable in recent months. The Halifax and Nationwide price indices both rose in January and are higher than three months ago. Rightmove, by contrast, has been reporting m/m price declines, as has the RICS survey. The latter earlier this week reported a further fall in house prices in January, albeit at a slower pace. The recent stabilisation of the market will undoubtedly have reduced the fear of a collapse in prices. And fear itself was one of the obvious potential triggers for a sharp decline in prices.

The buy-to-let investor was another major source of concern for the housing market, and this week's report from the Council of Mortgage Lenders was relatively comforting on this front. New mortgage lending for the buy-to-let market in the second half of 2004 was down 18% on the first half of the year and 16% on a year earlier. However, this decline is no big surprise. The threat was not so much that new lending would fall back but that existing buy-to-let investors would cut and run. And on this point, the CML survey, which was conducted in October and November, was reassuring. Over the next year, only 6% of landlords said they planned to cut their holdings, while 38% actually said they planned to increase them. As to what would prompt landlords to decrease their holdings, rents being insufficient to cover the mortgage and rising interest rates were cited as the most important factor by the vast majority. Only 6% and 14% respectively mentioned stagnating or falling prices.

Even though these comforting words do need to be viewed with some scepticism, they do suggest that, without a further significant rise in rates, there is unlikely to be a mass rush for the exit by buy-to-let investors. If the latter do hold their nerve, this leaves forced selling as the other main possible cause for a short/sharp fall in prices, rather than a more drawn out adjustment. However, with debt service burdens still generally manageable and unemployment at very low levels, forced sales look set to remain relatively few and far between. If this is the case, prices are likely to prove 'sticky downwards', as property owners prove reluctant to cut their asking prices significantly.

While the risk of a crash in the property market has fallen, small m/m declines in prices continue to look very likely. Buy-to-let investors may not become big net sellers as some had feared, but the decline in mortgage lending certainly suggests they are no longer plugging the hole left by first-time buyers, who have been priced out of the market. A demand-supply imbalance remains and the stock of property on estate agents books is relatively high - even if the RICS survey did show the sale to stocks ratio unchanged in January after falling for most of last year. This imbalance, along with the stickiness of prices, points to transaction levels remaining low and prices slowly adjusting downwards.

If house prices do continue to edge down, this is likely to have a material effect on consumption growth - not so much because housing will now be a big negative, but because it will no longer be providing a significant boost. The weaker outlook for the consumer should be reinforced by fiscal policy, which is also slowly turning from a major stimulus to a small drag. The fear, and next year the reality, of tax increases may depress consumption. So should lower employment growth - almost all of the gains in jobs currently appear to be in the public sector. Finally, there is the rise in interest rates, which at the margin is causing problems to the consumer. Personal insolvencies rose 34.6% y/y in Q4 to record levels. Part of the increase is no doubt down to the change in the bankruptcy legislation seen last April. But this probably only explains a portion of it. Insolvencies have been rising since the end of 2002. Much of the recent deterioration almost certainly reflects the surge in consumer debt and rise in interest rates. All this suggests consumption growth will slow, rather than continue to grow at the pace of the last three years as the Bank is assuming. The MPC's admission that consumption constitutes the main downside risk to its growth and inflation forecasts may prove all too prescient.