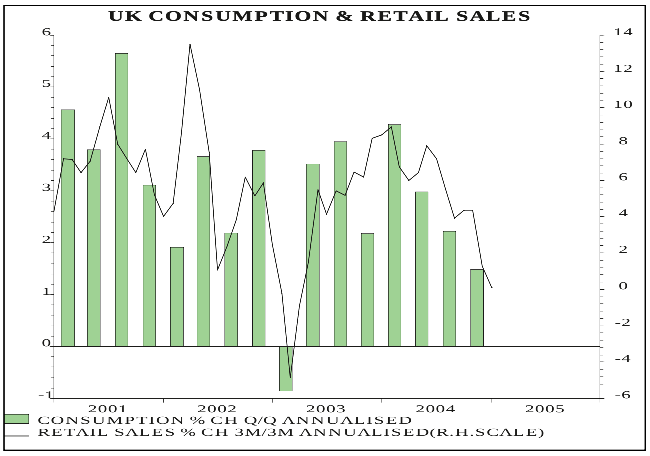
GFC ECONOMICS

DAILY COMMENTARY

THE UK CONSUMER AND THE MPC

Gilt yields have risen some 30-40bps across the curve from their lows touched earlier in the year. While the sell-off in US Treasuries has undoubtedly had much to do with this rise, particularly at the long end, the Bank of England has also done its best to drive UK yields higher. The upward revision to the Bank's growth and inflation forecasts has been followed by hawkish comments from various members of the MPC and the revelation that Paul Tucker actually voted for a rate rise at the MPC's last meeting. Short rate expectations have risen as much as 50bps from their mid-January low, and are now pricing in rates being at least 25bps higher in a year's time. While one more rate rise is quite possible, it is far from certain. More importantly, the recent slowdown in consumption should prove rather more enduring than the Bank is assuming. Any rate hike is, as a result, unlikely to be sustained into next year. Near term, gilt yields are likely to remain under upward pressure from US Treasuries, but further out they should benefit from a weaker economy.



Hawkish Noises From The MPC

The latest minutes from the MPC suggested that one of the arguments for not raising rates at their February meeting may have been that "market participants might be surprised by such a move". If that was the case, it is certainly no longer a barrier, now that the Bank has successfully dispelled the growing consensus that interest rates had peaked. While far from implying that rates are definitely headed higher, recent comments from various MPC members have highlighted the potential need for a further tightening of policy. Kate Barker, for one, stated that "if you look at the inflation forecast at face value, you'd wonder why we hadn't thought about putting rates up, because inflation is clearly above target at the horizon". Meanwhile, Rachel Lomax has emphasised the dilemma the MPC faces between waiting for more data to clarify the outlook, and the need to act pre-emptively since interest rates take a year or more to affect the economy. As for Paul Tucker, his vote for a rise in rates was based on the view that the downside risks to inflation had diminished and growth, equity, credit and housing markets had all been stronger than expected. The majority view, by contrast, was that the risks of an undershoot in inflation were sufficient to justify keeping rates unchanged, though some believed that an increase might be warranted in due course, if the economy evolved in line with the central projection. All this leaves the near-term outlook for interest rates even more dependent than normal on the forthcoming economic data. Indeed, Ms Barker has actually stated that "the main reason we didn't put up rates last time is uncertainty about short-term trends in the economy".

There are significant risks to both the Bank’s growth and inflation forecasts. On the activity front, the prime area of uncertainty is the consumer. The MPC is assuming the unexpected weakness of retail sales in the last couple of months will prove short-lived, and that consumption picks up again to its average real growth rate over the last three years of 2.8%. This assumption, however, continues to look optimistic. The Bank's first line of defence, that it is still far too early to be sure that spending growth has slowed significantly, is looking increasingly threadbare. Even with the bounce in January, the smoothed 3 month annualised growth rate of retail sales has fallen to zero from above 7% last summer. And yesterday's CBI distributive trades survey reported sales remained relatively depressed in February. While this survey has been volatile of late, the trend has weakened substantially since the middle of last

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year. The Bank has also been at pains to point out that retail sales are less than 40% of consumer spending. But the fact is that consumption overall has also slowed significantly, with annualised gains in Q3 and Q4 last year of only 2.2% and 1.5% respectively, well short of the Bank's assumed 2.8% growth rate.

All the same, it has to be admitted that not all the consumer-related data is pointing downwards. Consumer confidence has picked up significantly over the last few months, notwithstanding a slight decline in February. Yesterday's household lending data also showed consumer credit rising £2.3bn in January. This was the largest gain since last June and up around 50% on the increases seen in each of the previous three months. This could be a sign that the consumer is returning to his spendthrift ways, now that fears of a further substantial rise in rates and collapse in house prices have diminished. More likely, it is a statistical vagary or an indication that consumers have unintentionally overstretched themselves, pointing to cutbacks further out. Signs of consumer distress have been mounting, albeit from low levels. Partly on the back of last year's change in bankruptcy legislation, personal insolvencies rose to record levels in Q4. Furthermore, while the number of actual mortgage repossessions was very low last year, repossession actions going through the courts hit a five-year high in the fourth quarter.

The housing market remains key to the consumption outlook, and the most likely prospect continues to be for small m/m price declines. The Nationwide showed house prices up 0.5% m/m in February, their second consecutive rise. However, these gains look unsustainable in light of the continuing dearth of first time buyers and reduced demand from buy-to-let investors who had been plugging this hole. A substantial demand-supply imbalance remains. Indeed, the National Association of Estate Agents reported that the number of homes on sale at the average estate agency was up 100% on a year earlier in January, while the number of buyers on their books was down 36% y/y. This imbalance has so far shown up in reduced transactions rather than lower prices, and the latter should continue to be very sticky. The risk was that the buy-to-let investor would bail out, but all the signs are that this is not happening. Echoing the reassuring findings of the CML survey in October/November, the latest RICS survey found the proportion of landlords wishing to sell their properties after a tenancy expired little changed at around 7%. Even so, with demand set to remain depressed, property prices should grind slowly lower. For one, mortgage approvals for house purchase continue to run at around five year lows. They fell back 3.7% m/m in January and were down 37.8% y/y. It is becoming increasingly clear that the recent weakness has not been exaggerated by the regulatory changes of last October.

Rather than housing becoming a major drag on consumption, it is just not providing the boost it once was. Even by Q3 last year, mortgage equity withdrawal had fallen back to 6.2% of post-tax income, its lowest level since Q3 2002 and down from a high of 8.4% in Q4 2003. All of this points to a significant slowdown in spending growth from the levels averaged over the last three years. This in turn should ensure that both GDP and the CPI undershoot the Bank's forecasts over the coming year. However, it is much less clear whether a sustained slowdown in consumption becomes apparent quickly enough to stay the hand of the MPC over the next few months. In this respect, labour market developments will also be critical, as the upward pressure on earnings is another area of concern for the Bank. Recent comments on this front from MPC member Stephen Nickell were relatively sanguine. January is an important month for wage settlements and Mr Nickell has stated that "despite recent reports, the information we have for January settlements is not particularly startling". On balance, we believe the odds still slightly favour no further rise in rates. More importantly, the assumption of the short sterling contract that 3-month rates will be 5.16% in a year's time looks considerably too pessimistic.