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UK Rate Hikes Move Back onto the Horizon

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At the end of 2004, UK fixed-income markets were beginning to price in a rate cut from the Bank of England. At the time, we argued that this was highly unlikely and that, if anything, a modest rate hike was likely in the second half of 2005. Recent comments from the Bank of England have ruled out a rate cut and suggest that a rate hike might happen somewhat earlier than we thought.

Several factors have combined to bring higher rates back onto the near-term agenda. At 0.7%, fourth-quarter GDP growth surprised on the upside and, at 1.6%, inflation has risen faster than the Bank of England expected. Meanwhile, the housing market is showing signs of stabilizing, the labour market is tightening, and factory-gate price pressures continue to build.

In light of these developments, the Bank of England has raised its growth and inflation forecasts. It now expects growth to be at, or slightly above, trend this year and clearly above trend in 2006 **(Display 1)**. With the economy already operating at, or probably above, full capacity, it is not surprising that the Bank expects inflation to move above target at the end of its two-year forecast horizon.

The minutes of the Bank of England's last Monetary Policy Committee (MPC) meeting show that, for one member, these arguments justified an immediate 25-basis-point rate hike. However, the other eight members of the MPC did not find these arguments compelling. This is because the risks to growth and inflation are thought to be mainly on the downside, with the key risk still being the consumer.

Since it started raising interest rates in November 2003, the Bank of England has been conscious that high consumer debt and the possible overvaluation of the housing market could lead to a much bigger negative impact on consumption than traditional models suggest. This is why the Bank raised rates only gradually last year and is one of the main reasons it paused the tightening process in August.

The near-term outlook for consumer spending is still uncertain. On the one hand, recent evidence from the housing market suggests that prices are stabilizing. On the other hand, January's 1.0% gain in retail sales cannot disguise the fact that the recent trend has been weak.

Looking beyond the near term, the fundamentals underpinning consumption remain sound. Average earnings growth continues to rise, reaching 4.5% in December. Meanwhile, employment is growing at 1.0% per annum and non-wage income is buoyant. On our estimates, real household income is likely to grow by 4.0% in 2005 and 3.6% in 2006.

Consumption growth is unlikely to be as strong as this. First, households need to pay their tax bills and mortgages. Although there are no significant tax changes this year, interest payments are likely to rise strongly again. However, even allowing for this and for a modest rise in the savings rate, we still expect consumption to grow by 2.5%. Next year, barring tax hikes or a substantial rise in the savings rate, consumer spending growth is likely to rise as the impact of rising interest rates fades **(Display 2)**.

Conclusions

Interest rates are likely to rise again if the Bank of England's growth and inflation forecasts are correct. What is preventing the Bank from acting is concern about the outlook for consumption, heightened by weak retail sales at the end of 2004.

In our view, the fundamentals underpinning the consumer are sound and will soon be reflected in stronger data. This points to a 25-basis-point rate hike in the second quarter. Although rates could rise again later in the year, the Bank of England is still likely to favor a cautious approach, given the fragile nature of the housing market.

The 10-year spread between gilts and euro-area bond yields currently stands at 105 basis points, the widest for several years. With the UK closer to the top of the interest-rate cycle than the euro area, gilts would seem to offer good value. However, the experience of the last few years is that the short-rate differential tends to be a key driver of the yield gap **(Display 3)**. As the short-rate gap is unlikely to move markedly in the UK's favour in the near future, it is likely that any spread narrowing will be modest at best.

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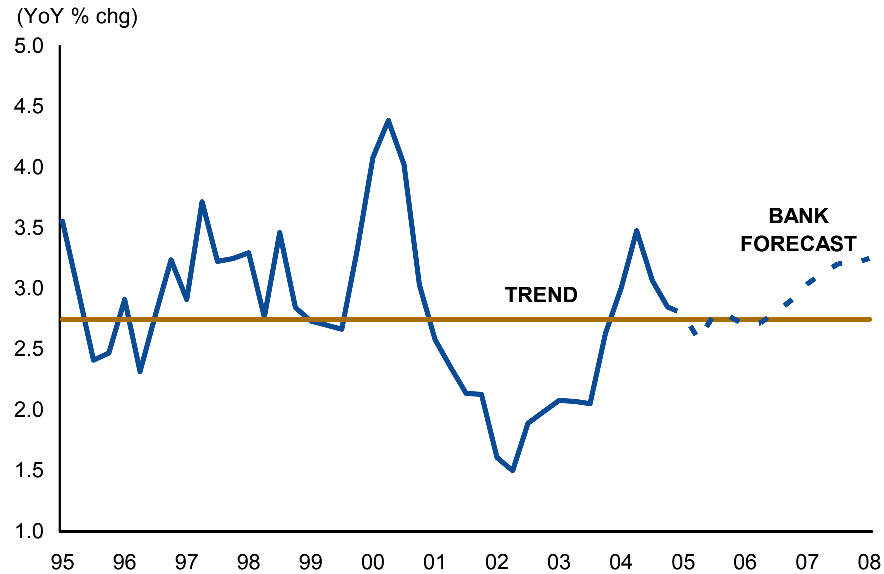
Display 1: The Bank of England Sees Growth Above Trend for Most of Its Forecast Horizon

UK Real GDP Growth and Bank of England Central Projection



Source: Haver Analytics, Bank of England and Alliance Capital Fixed Income, February 25, 2005

The Bank of England raised its economic growth forecast in its February Inflation Report. It now sees growth above trend, and rising, for most of the next two years. Although the Bank sees the risks to this forecast as being to the downside, it is clear that if its forecasts are correct, rates will have to move higher.

Display 2: Buoyant Income Growth Supports Consumption

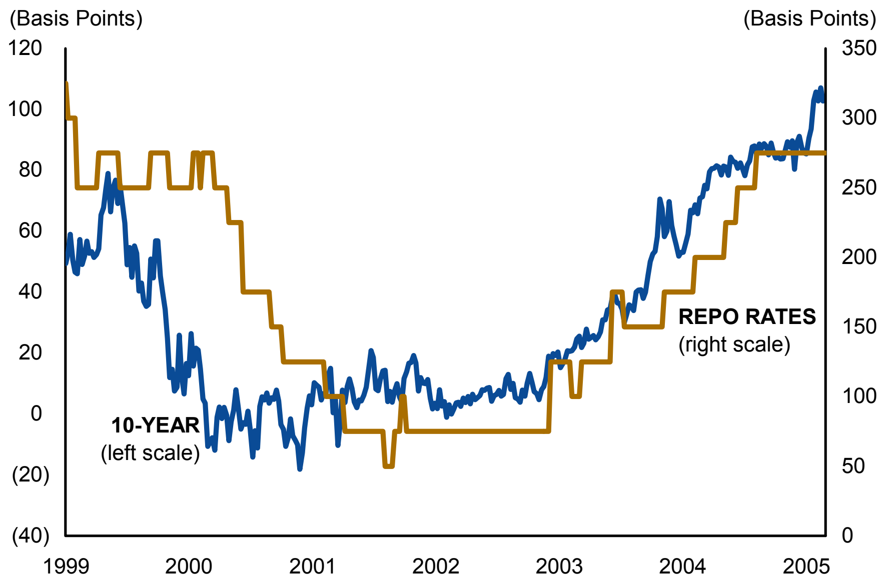
Year-over-Year Percent Change in UK Household Appropriation Account

	2003	2004	2005E	2006E
Wages and salaries	3.5	5.1	5.5	5.5
Other income	6.0	6.8	6.2	5.6
Primary income	**4.5**	**5.8**	**5.8**	**5.6**
Interest payments	4.1	17.0	15.0	5.0
Taxes	3.8	7.6	7.0	7.0
Disposable income	**4.1**	**4.4**	**4.6**	**5.1**
Real disposable income	2.2	3.5	2.7	3.1
Savings rate	5.5	5.7	5.9	6.0
Real private consumption	**2.3**	**3.3**	**2.5**	**3.0**

Note: Other income is profits, property income and employers social contributions.
Source: Haver Analytics and Alliance Capital Fixed Income, February 25, 2005

Rising interest payments are likely to depress disposable income growth this year. Nonetheless, both wage and non-wage income growth remain strong and should continue to provide solid support for consumption. As the impact of higher interest rates fades in 2006, consumption growth could accelerate again.

Display 3: Limited Scope for Gilts to Outperform in the Near Term
Interest-Rate Differentials, UK minus Euro Area



Source: Bloomberg L. P. and Alliance Capital Fixed Income, February 25, 2005

The 10-year yield spread between gilts and euro-area government bonds is at its highest for several years. However, with the short-term interest-rate gap unlikely to narrow in the near term, and possibly even set to widen, it will be difficult for gilts to outperform.