

UK Rate Outlook

Cuts more likely and more of them than market pricing suggests

Introduction

Although pricing has shifted in the right direction since Friday, current market pricing for the UK still looks unduly pessimistic to us. We would argue that the market is not pricing in enough by way of rate cuts either in the short-term, i.e. the next 3 months – or the longer term, over the next 12-24 months.

The distinction between the short and medium term arguments, echos the point made by Mervyn King in his recent testimony to the Treasury Committee between the real economy and the financial markets. The short-term argument for lower interest rates is about market conditions, and LIBOR specifically, as opposed to the macroeconomic outlook per se. The longer term argument reflects our own more relatively pessimistic view of the outlook for the UK housing market and the economy. But where we would differ slightly in tone from King's comments is that we would argue that there is a clear overlap between these two worlds. Hence, while we acknowledge that the current macro dataflow does not unambiguously argue for lower rates – inflation and more importantly inflation expectations are too high and employment and retail sales data have been surprisingly strong - if rate cuts are as limited as current pricing suggests then the medium-term macro outlook will be far worse than current market pricing implies.

The attached article published by Dow Jones last Friday runs through these arguments in more detail. In the sections below we provide a graphical illustration of how tight credit conditions remain in the UK.

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Still too little..

Although it has moved somewhat since Friday, current market pricing implies around a 75% chance of a rate cut this week. A full cut is priced in by May - the next *Inflation Report* month - and beyond then there is just about one more cut priced in by the end of the year with little thereafter.

This is puzzling on two fronts. First, in his testimony to Parliament, Mervyn King was about as explicit as we can recall him ever being about the prospect of further rate cuts and about additional help to ease the interbank problem. When a select committee member asked whether the market conditions would make the MPC more predisposed to cutting borrowing costs from their current level of 5.25pc, King replied: "Yes." The text below is from his opening statement:

"The financial crisis has moved into a new and different phase. Across the world ,confidence in financial markets is fragile. It is not that banks, at least in the United Kingdom, have made loans that are likely to result in unsustainable losses. The heart of the problem is not in the real economy; it is in the financial sector itself. It stems from an 'overhang' on banks' balance sheets of assets in which markets have closed. These assets cannot now be sold or used to secure funding in the market – they are difficult to finance. That has created uncertainty about the strength of banks' financial positions.

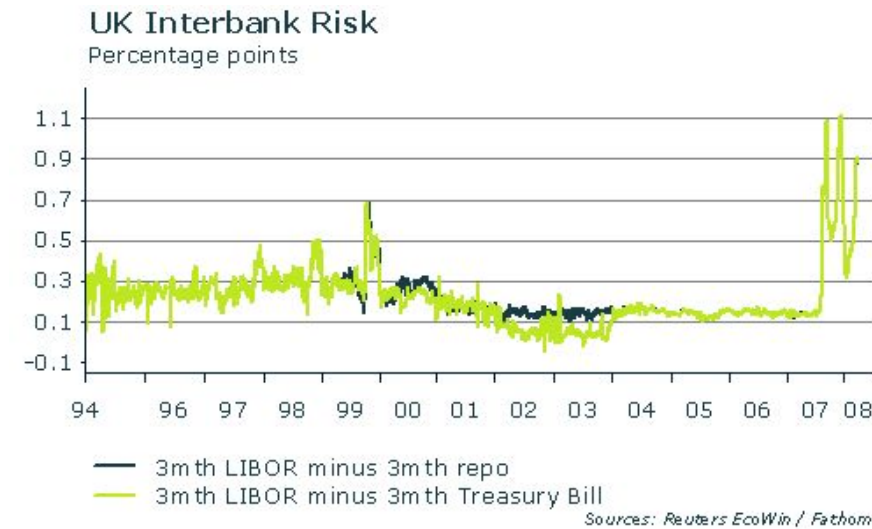
These are the sort of circumstances I described in my statement to you in September as those in which central bank action is necessary to prevent a major shock to the system as a whole. I want to assure you that the Bank will provide the liquidity

assistance that the system needs in order to restore confidence.”

Note, the argument here is about market conditions explicitly, rather than the wider macro economy. The Bank of England's apparent willingness to engage more directly with the interbank problem is of course welcome. But equally welcome is the more subtle shift towards the recognition that the level of LIBOR matters as well as the spread over the base rate or overnight rate. past comments had tended to focus on the fact that LIBOR spreads had also failed to narrow in other countries like the US which have cut far more deeply.

The charts below summarise current conditions in the UK interbank and wider credit market. They show that the interbank spread remains in crisis territory – just 20bps lower than it peaked last year. Using swaps, both the 2yr and 5yr spread over the zero coupon yield are way above where they peaked last summer. And that, in a nutshell, is the strongest argument for a cut in April and for as much as -50bps by May.

Further out, as we argued in our latest G4 Outlook: Great Expectations, we see the risk to the UK of an outright recession (negative annual growth) over the next 4 quarters at a historically high 33%. Our final chart illustrates the link between the financial and real economy. It plots the business outlook from the CBI financial services survey against the headline services PMI. With expectations plunging to levels last seen in 1989, the outlook for the rest of the service sector and hence the wider UK economy looks bleak. We expect to see a much more growth-oriented *Inflation Report* in May which should open the door to more aggressive easing in the second half of 2008 than is currently priced in.



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UK Interbank Risk

The news from the swaps market is no better. Shorter term swap spreads are at their highest levels since Bank of England independence and beyond in the case of two-year spreads. This is a very clear illustration of how dysfunctional wholesale markets remain, and how little if any good news is trickling down to the beleaguered mortgage market. As noted above the Bank of England can next to nothing to affect either spread or the spread between swap rates and mortgage rates directly; but it can pull the whole equation down by reducing the base rate.

UK Interbank Risk

Percentage points



Sources: Reuters EcoWin / Fathom

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UK Investment Grade Spreads

Hopes for a business investment-led rebalancing of the economy have to overcome a number of hurdles. Not least of these is the sharp rise in the real cost of capital in recent months. Moreover, a depressed consumer outlook against the background of a slowing global economy does not bode well for those volatile 'animal spirits'.

UK Investment Grade Spreads

Percentage points



Sources: Reuters EcoWin / Fathom

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Mervyn King a dove?

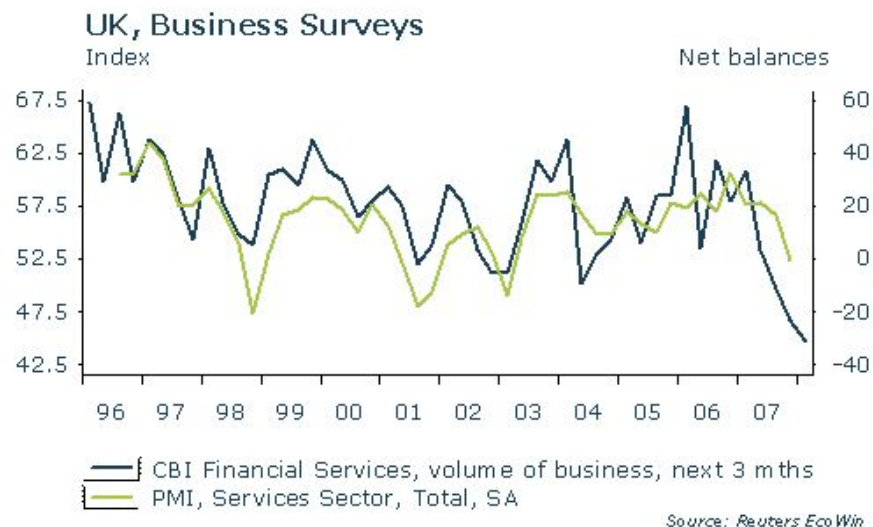
Mervyn King's speech today has been interpreted as being dovish, largely because the headline writers picked up on one phrase, namely, 'we cannot allow the economy to slow too sharply'. But when read in the context in which King delivered the speech, it was as ever a fairly balanced and nuanced point.

"Our inflation target is symmetric. We are not aiming for inflation below 2%, but at 2%. So even though some slowdown in the growth rate of economic activity is likely to be necessary to ensure that inflation returns to the target, we cannot allow the economy to slow too sharply, lest a margin of spare capacity is produced that pulls inflation down below the target next year. We face a difficult balancing act.

Why should we not focus on growth for a while and forget about inflation? The answer is that once higher inflation becomes entrenched, it may be costly to dislodge. Past UK recessions were associated not with slowdowns in the world economy, but with

attempts to squeeze inflation out of the UK economy. The best thing that we can do to promote economic stability is to avoid inflation, and inflation expectations, from becoming dislodged from the target in the first place."

In fact, we would argue that when read in its entirety, the passage above is not particularly dovish at all. Now, if we were to swap the ordering of these two paragraphs around, that would be a different story. Textual analysis aside, the macroeconomic case for monetary easing continues to rely more on forecasts than hard data. But the lessons from the US are that stress in the housing market will eventually spread to the real economy via the financial sector. The chart below also makes this point. So to reiterate, we would argue that despite recent price action, too little, too late, is priced in by way of UK rate cuts.



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