Welcome to zombie Britain Mr Carney

As Carney takes over from King, expectations are running high on his ability to stimulate the economy

The annual London gathering of the world's top tennis players is underway with Wimbledon in full swing. One regular attendee likely to spend more time there in the future is Sir Mervyn King, who will retire after a decade of service as the Governor of the Bank of England, and Chairman of the Monetary Policy Committee.

His replacement, Mark Carney, departs the Bank of Canada after five years as governor. Carney was handpicked by Chancellor George Osborne to provide more 'monetary activism' to offset the government's efforts in implementing austerity. Expectations are already high about the impact Carney will have on monetary policy and the range of new measures that he will introduce. Can Carney delivery?

What will Carney find?

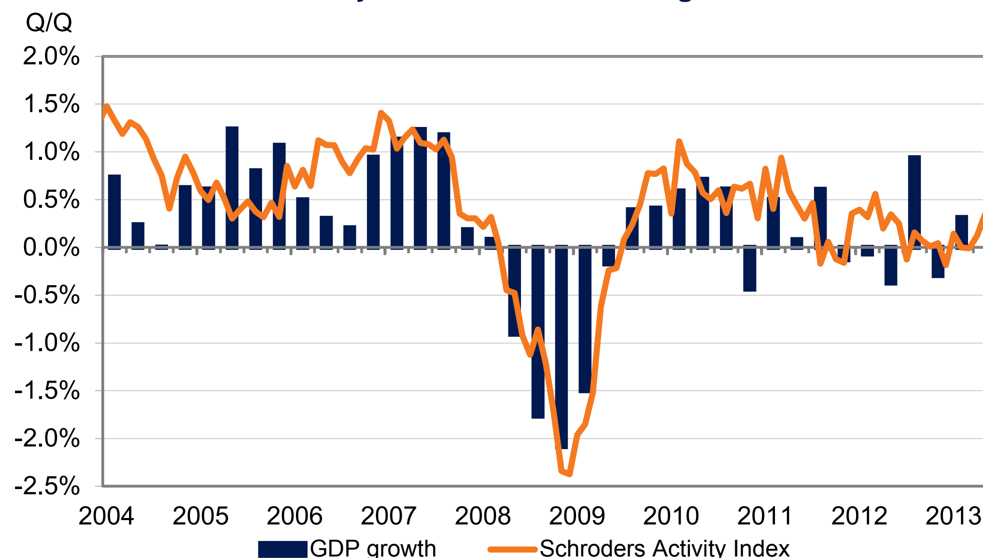
When Carney arrives to take over as governor, he is likely to find a household sector riddled with debt and overly leveraged towards a housing market that appears to be over-valued by traditional measures, a hawkish oddly-formed coalition government struggling to reign in the nation's public deficit, a corporate sector refusing to invest, with some parts surviving only thanks to low interest rates, and a banking system that is partially functioning, under capitalised, and lacks competition. Welcome to zombie Britain Mr Carney.

Carney is likely to find many structural headwinds, but there are some positives that can be found…

The structural headwinds are immense, but there are some encouraging signs appearing on the cyclical front. In his annual Mansion House speech, the Chancellor said that "Britain has left intensive care".

When we upgraded our forecast for UK growth in last month's edition of the Economic and Strategy Viewpoint, we highlighted the recent stronger output data from both the production and service sectors. More recently, the Schroders Activity Index hit a 14-month high, indicating that the pick up in growth should continue into the second, and possibly the third quarter of the year (chart 8).

Chart 8: Schroders Activity Index hits 14-month high



Source: Thomson Datastream, ONS, Markit, CBI, Schroders. 26 June 2013.

In addition to the Schroders Activity Index, the latest data from the Markit manufacturing PMI shows that new orders are outpacing inventories, which suggests that manufacturing output is likely to return to positive growth by the end of the year (chart 9). The new orders to inventories ratio has historically provided a strong leading signal of growth in the manufacturing sector.

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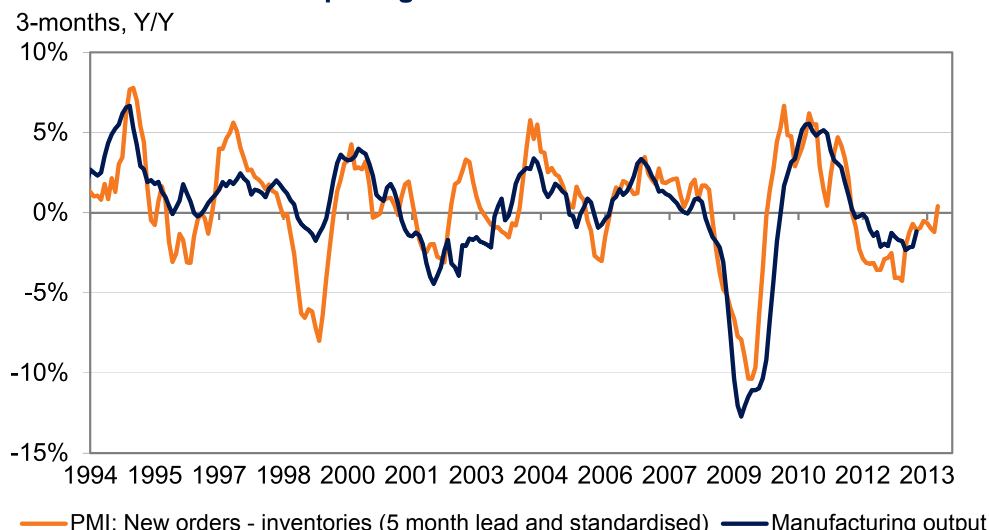
…for example, new orders are outstripping inventories, suggesting factory output should rise…

Chart 9: New orders outpacing inventories



Source: Thomson Datastream, ONS, Markit, Schroders. 26 June 2013.

Elsewhere in the economy, the performance of the labour market continues to hold up, despite the weak productivity gains. The economy added 92,000 jobs in the three months to April, while the unemployment rate remains steady at 7.8% - down from 8.1% a year earlier.

Green shoots in the housing market?

One part of the economy which is showing promise is the housing market. The government has decided to focus its efforts on restarting activity in the housing market in the hope that it will boost the wider economy. The Funding for Lending scheme has been successful in helping to reduce mortgage rates, while the forthcoming 'Help to Buy' schemes aimed at bridging the capital shortfall for potential home buyers, should come online over the next year.

…meanwhile, the housing market appears to be turning up thanks to government measures and lower rates.

The falls in mortgage rates and emphasis on boosting housing activity appears to be working. The Council for Mortgage Lenders reports that gross lending increased to £14.7bn in May – its highest level since October 2008, and represents a 16.8% rise compared to May 2012.

The Royal Institute of Chartered Surveyers (RICS) also reports increased activity. New buyer enquiries are at their highest level since October 2009, while the RICS survey of pricing (change rather than level) is at its highest point since June 2010.

In analysing the progress made in the recovery in national house prices since the 2008/09 financial crisis, we find varying results depending on which survey we use, and whether it is a survey of transaction prices or asking prices. However, the trend in growth is more evident. Chart 10 shows the range of results from survey evidence available including the official ONS data. There is little doubt that prices nationally are rising at a robust pace, and rising at an even faster pace in the Southeast of England.

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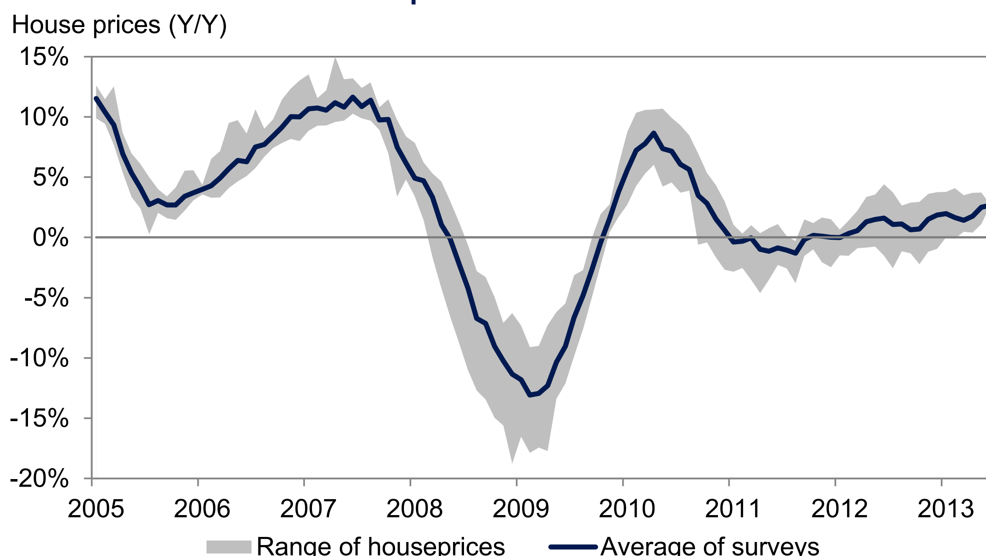
Chart 10: Growth in UK house prices returns



The above range and average are taken from the following house price surveys and are based on transactions and asking prices with final data taken in brackets, and e xtrapolated forward to June: DCLG/ONS (Feb), Halifax (May), Nationwide (May), Rightmove, Hometrack, Acadametrics.
Source: Thomson Datastream, Schroders, and the above mentioned sources. 25 June 2013.

There is clearly a relationship between house prices and overall household consumption, although it is impossible to prove the causality of the relationship. Do higher house prices reflect strong economic growth, or do higher house prices have a wealth effect that enables households to leverage up through equity withdrawals. Before the financial crisis, there was a little truth to both of those explanations. The government certainly hopes that in boosting activity and possibly prices (although not an explicit target), household consumption could rise.

Rising housing market activity could help boost the economy more likely, although not to the same degree as pre 2008

The rise in housing market activity should boost consumption-related to housing. Chart 11 shows the strong historical relationship between growth in the volume of mortgage approvals, and the volume of retail sales in housing goods stores.

Chart 11: Increasing housing transactions should support retail sales

Source: Thomson Datastream, British Bankers Association, ONS, Schroders. 26 June 2013.

Rising government bond yields across the world are likely to feed through to higher mortgage interest rates in the coming months…

While household goods stores should see a boost to their takings in the near future, we are unlikely to see a dramatic bounce in overall consumption. Changes to lending practices following the financial crisis mean that mortgage equity withdrawals are less likely to be used in the way that they were pre-2008 to fund the credit binge consumption booms that led up to the financial crisis.

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Given the changes in lending practices following the financial crisis, we are unlikely to see much in the way of mortgage equity withdrawals funding credit binge spending.

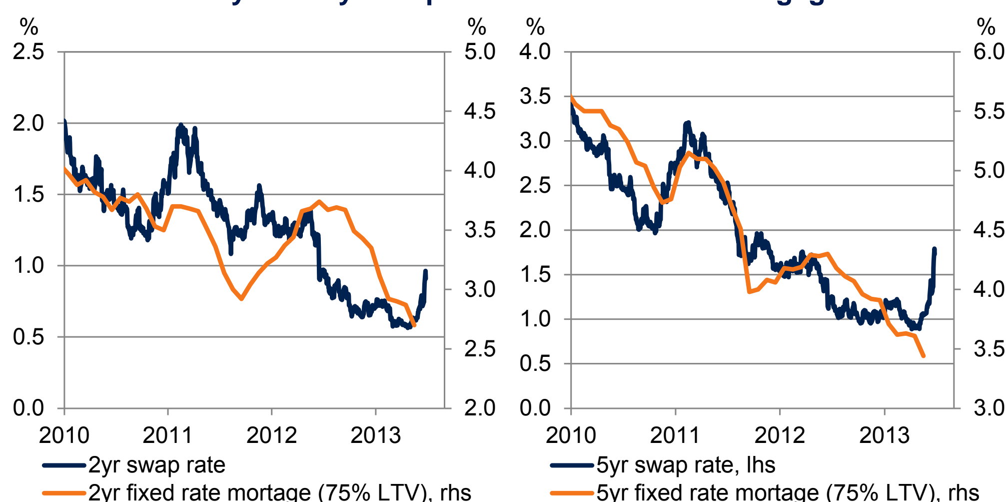
Impact of rising yields

Before getting too excited about the prospects of house prices recovering, the recent rise in global government funding rates is very likely to cause interest rates in the UK mortgage market to rise significantly over the coming months.

The market for fixed term mortgages relies on the swap market, as it allows banks to secure an amount of funding at a fixed rate, which is then passed on with a margin to borrowers. Banks have been able to lower interest rates in recent months, largely thanks to falling gilt yields and swap rates, but also thanks to the Funding for Lending Scheme, which the government introduced to encourage greater lending.

Swap rates have already risen sharply on the back of the more hawkish tone from the US Federal Reserve, but the rises so far suggest that fixed rate mortgages of between two to five years, and using a 75% loan-to-value ratio, should see a rise of between 75 and 100 basis points in the coming months (charts 12 & 13).

Charts 12 & 13: 2yr and 5yr swap rates vs. fixed term mortgage rates



Source: Thomson Datastream, ONS, Schroders. 26 June 2013.

…which could choke off the recovery, or even cause a triple-dip recession

The rise in market interest rates will not only feed through to new fixed interest rate mortgages, but also all borrowers on floating standard variable rates. Rising mortgage rates could easily choke off the recovery in the housing market before it gathers momentum. Worst still, it could have a more negative impact on the wider economy towards the end of the year. The UK may have avoided a triple-dip recession at the start of the year, but it could find itself flirting with the triple-dip again early next year.

What can Carney do?

Even before his arrival, Carney had already triggered a major debate over the appropriate target for the Bank of England. Carney had suggested that nominal GDP targeting may be a more appropriate target, especially during the current period where short term inflationary pressures mask longer-term deflationary pressures caused by an excess of spare capacity in the economy. The debate over nominal GDP targeting versus inflation targeting was put to rest by the Chancellor in his last Budget speech. While the current 2% inflation target remains in place, the Chancellor was clear that he expects a greater use of the tools available to the Monetary Policy Committee (MPC) in order to support his efforts to cut the nation's budget deficit – a task that he has struggled to make much progress on due to the weakness of the economy, highlighted by the big cuts to departmental budgets outlined in his speech accompanying the Comprehensive Spending Review.

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Carney's first policy change could be to introduce forward guidance on interest rates

The first change Carney is likely to make is the introduction of forward guidance on interest rates. The Bank of England has always been reluctant to give explicit signals on the path of monetary policy as it felt it could reduce the flexibility it has in changing policy on a monthly basis. The Chancellor specifically mentioned the use of forward guidance as a tool at the Bank's disposal, and so we expect that tool to be utilised either after the next MPC meeting on 4th of July, or following the August Inflation Report.

As we have discussed in the past, the use of forward guidance will only have an impact if the time horizon is long enough to change market expectations. Based on Euro-Sterling strip futures, the market expects the Bank of England base rate to rise between June and September 2014. On this basis, forward guidance would need to encompass at least a y ear to have any impact. We see a good probability that Carney chooses to do this in the near future. This could lower gilt yields and possibly GBP. Note that our forecast sees interest rates on hold until 2015.

Whether forward guidance moves financial markets or not, there will still be an impact on the decision making process of the average consumer – who is unlikely to be as well informed as markets. Greater re-assurance that interest rates will remain on hold, or even lower for longer, could encourage greater risk taking in consumption and investment decisions.

Carney is also due to give an as sessment of all tools available to the Bank alongside the August Inflation Report. The effectiveness, scope and side effects of each tool will be scrutinised, and the Bank's report should give us a clearer steer on the tools likely to be utilised.

In addition to forward guidance, below is a list of options open to the Governor:

1. Increasing QE;
2. Restarting corporate debt purchases;
3. Buying assets backed by residential mortgages, either from the secondary market, or from the government in the future;
4. Cut the main policy interest rate further from 0.5%;
5. Cut the deposit rate for banks, taking it into negative territory;
6. Introduce supplementary targets (e.g., the unemployment rate like the Fed);
7. Cancel current holdings of government bonds, effectively making QE purchases a permanent give away;
8. Through the Financial Policy Committee, lower capital requirements for banks, and therefore encourage more lending.

Other more meaningful measures would require the support of the rest of the MPC

What Carney cannot do is force through stimulus without the majority support of the relevant committee. Unlike the Fed, members of the MPC are personally, not jointly, responsible for delivering the MPC's mandate on price stability. For example, Mervyn King has been outvoted in the last five meetings in calling for more QE. The new governor will undoubtedly bring a fresh perspective to the debate, but may struggle to gain much traction in introducing some of the more radical ideas listed above, at least, not without a substantial downturn in the economic activity.

Of the options above, we see an expansion of QE as the most likely course of action. We continue to forecast a £75 billion expansion in the BoE's asset purchase programme by the end of the year, but likely to start in August. This would be dependent on macro data beginning to soften, as mortgage rates start to climb. In any case, Carney will be under pressure not only from the Chancellor, but also markets, to deliver further stimulus in some form.

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