



Weekly Bulletin – 8th January 2007

Looking back to a year ago, we thought that the domestic interest rate market was likely to experience a dull time. This was a pretty widely held view with forecasters predicting that base rates would be anywhere between 4.00% and 5.00% by the end of the year. A 1.00% variance between the most bullish and bearish forecasters represents a fairly narrow spread. As we were at the upper end of these forecasts we could have given ourselves a reasonable pat on the back had it not been for our forecast for medium term rates which put an upper level of 4.85% on the likely trading range. While this forecast held up well for the first half of the year, the major up-tick seen in December, which pushed medium term rates to a high of 5.50%, ensured that not only our forecast, but pretty well everybody else's were left high and dry by the end of the year.

The much greater volatility seen last year, particularly in the final quarter, has ensured that the forecasts for base rates cover a much wider range than a year ago with forecasters predicting a range from 4.00% to 6.00% in 12 months' time. It has to be said that the optimists at the lower end of the range have been sounding a lot less confident of late. The market is starting the year trading at much higher levels than the economists' expectations. Forecasters expecting rates to rise above the current 5.00% level are still in a minority, whereas the market has priced in the almost certainty of a 0.25% increase being seen next month, assuming that the MPC does not jump the gun and announce a hike after their meeting this week. Furthermore, the market is now pricing a 60% chance that rates will then rise further to 5.50%, a view held by only a couple of bearish economists.

Our view is that the MPC will find sufficient justification to raise rates to 5.25% and it matters little whether they move this month or next. If they move this month, it will be seen as a pre-emptive shot across the bows of wage negotiators to ensure that the much-vaunted second round inflation fears are not substantiated through high increases in the forthcoming wage negotiation round. Thereafter, reduced disposable incomes through higher tax, mortgage costs and energy bills should impact on consumer spending. If combined with lower oil prices, the current 2.7% CPI inflation rate should retreat back to the 2% target level during the first half of the year. However, we would not be too excited about this producing a rapid reduction in rates for as long as Mervyn King manages to spot potential inflation risks around every corner. Even if the CPI measure falls to and below the target level, we feel that it will take a downturn in the housing market or a much weaker than expected level of economic growth to get base rates back to below 5.00%.

Medium term rates are more difficult given the rapid increase that has been seen at the end of the year. We would perceive that the recently reached 5.50% level should mark the top of the market and that it should be difficult to go much higher than this level, even if the market's projection of base rates eventually hitting 5.50% proves to be correct. However, there is not much chance of term rates decreasing to any great extent until we reach the point where the market becomes

convinced that the MPC has ceased tightening monetary policy and that the next rate movement will be downwards. This may involve a considerable wait and a number of false dawns. However, we would expect to see term rates at below 5.00% before the year is out.

Our predictions for EUR rates during 2006 were a long way wide of the mark with the ECB going for a consistent programme of removing monetary accommodation throughout the year culminating in a final move to 3.50% in December, some 0.75% higher than our original end of year prediction. While the market is now trading on the basis of another 0.50% rise during the year, with the first move expected in February, term rates are now flat thereafter at just over 4.00%, having traded down to well below this level in November.

The language emerging from the ECB shows no sign of moderating and, having fooled us and most of the market, last year, we feel that if the eurozone economy continues its recovery the tightening process may well not stop at the 4.00% level. Recent economic statistics emerging from Germany, particularly on unemployment, have been remarkably strong and this week's factory orders and industrial production numbers are expected to provide supporting evidence of a buoyant economy. Term rates, again, are unlikely to be able to stage much of a rally until the peak in short term rates has been reached. Equally, we suspect that they will have some trouble in falling much below 4.00% even when the ECB does let up on its tightening policy.

Our record in the US was much better as we correctly forecast that the FOMC would continue to tighten for much longer than the market and the great majority of forecasters predicted. While, following the departure of Alan Greenspan, short term rates ended their upward spiral in June, having reached 5.25%, we felt getting within 0.25% represented a good effort.

The autumn rally in US term rates, based on the expectation that rates would be on the way down again by the middle of this year, has now dissipated and rates, which have an incredibly flat yield curve of less than a 0.10% spread in any period between 2 and 20 years, trade just above 5.00%. It would appear to us that the US economy is much more resilient than many economists believe. With Ben Bernanke consistently warning that inflation remains a danger, we see the FOMC doing little other than a bit of fine tuning over the course of the year which, in turn should see term rates moving in a fairly narrow band around current levels.

This week sees little in the way of influential UK economic news although the BRC retail sales figures, out tomorrow, will be closely followed in order to gauge the strength of the Christmas shopping period. The main interest will be the announcements made after ECB and MPC meetings finish on Thursday. We expect both to set the market up for rate hikes next month, although it would not be a total surprise if the hard men on the MPC pushed for more immediate action.

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