

Weekly Bulletin – 26th March 2007

UK rates have moved up by about 0.10% over the past week as considerably worse than expected inflation figures and a higher than forecast bounce in retail sales caused the market to revise its growing optimism that a further rate hike might not be required, despite a surprising voting pattern at the MPC's meeting.

The rise in inflation saw the targeted CPI measure increase from 2.7% back up to 2.8% while the headline figure moved up to 4.6%, the highest level seen since August, 1991. One might question whether this increase in the CPI measure has very much relevance. Two months ago CPI inflation was running at 3.0% and if anybody had suggested that it would fall to 2.8% within two months, this would have been regarded as being reassuring. It is, therefore, only a poor result in that it reversed a proportion of last month's unexpectedly large 0.3% reduction. In any event, it is already established that the CPI measure will fall very rapidly over the coming months as last year's energy cost increases fall out of the index.

One interesting item to emerge at the end of last week was the latest Bank of England survey on attitudes to inflation. This has been held up as being an important survey by the MPC in demonstrating the expectation of inflation in terms of consumer spending and wage increases. This month's report showed that as many as 30% of those interviewed thought that interest rates were either unchanged or lower than a year ago. It has been suggested that this increases the chances of rates rising again. It would seem to us to demonstrate that the survey is fundamentally worthless.

With the market having been upset by the inflation figures, the release of the latest set of retail sales figures did nothing to calm the nerves. While February's sales showed a strong 1.4% increase, this was compounded by an adjustment to January's from a 1.8% fall to a revised 1.5% reduction. This has made a major impact on the year-on-year number which has now leapt to a very impressive 4.9% – another result that is unlikely to discourage the MPC from raising rates again.

One factor that did emerge to placate the market was the release of the minutes of this month's MPC meeting. This showed an 8 -1 split, with David Blanchflower voting for a rate cut. This split came as a major surprise as, quite apart from Blanchflower's resuming his role as an arch dove, Messrs Besley and Sentance had been expected to maintain their stance in voting for a rate hike.

The market has not taken the minutes to show a major relaxation in attitude by the MPC, especially as Mervyn King constantly warns against taking any particular month in isolation. Also, this month's meeting came

immediately after the unease in the equity markets which may well have had a mollifying influence on the more strident members. One more permanent, encouraging factor that did emerge was that the MPC have become much more relaxed over a large pick-up in wage increases, the second round inflation concept so constantly raised by the Governor as a major reason for increasing rates.

Almost forgot - last week also saw what will be Gordon Brown's last Budget. Despite considerable excitement over cutting income and corporation tax bands, the net result of the budget was almost exactly neutral with one hand taking back what the other had given out. About the only factor in its favour was that it simplified some aspects of tax policy, something one hopes his successor will continue.

EUR rates also tightened last week, although not to the same extent as UK rates. This was on a continuation of strong economic figures and we expect this trend to continue this week as the latest German IFO index is released (expected to be slightly lower, but still very strong) as well as German and French unemployment figures (both of which are expected to show a reduction). Despite money supply remaining at high levels and inflation expected to inch higher towards its 2.0% target, the market assumes that the ECB will only raise rates once more before an extended period of leaving rates unchanged. This, in our opinion, continues to be a pretty optimistic outlook.

This week sees little of great interest in terms of influential economic information being released in the UK. The balance of payments figures for the fourth quarter are released on Wednesday and are expected to show an improvement over the previous quarter. Quite apart from probably being temporary, it is a long time since the risk of not being able to finance the deficit was a worry to the market. Thursday sees the release of the latest consumer credit and mortgage approval figures. Consumer credit growth has been moderating for a long time and this trend is expected to have continued in February. The latest mortgage application figures are likely to be more influential. They showed a jump to 120,000 in January which came as a surprise to the market, but may be explained by a rush to secure 'cheap' fixed-rate offers before they ran out after the rate hike. This month's figures are expected to see this figure falling back, but not to a level that is likely to have much influence on the market.

With a relatively light set of economic statistics being released in the US, the markets may well spend this week settling down at around current levels.

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