

Weekly Bulletin – 2nd April 2007

UK and EUR rates continued to drift upwards last week on a mixture of encouraging economic news and, in the UK's case, increased nervousness that the MPC will raise rates at its meeting later this week.

The main item for the UK this week will be the MPC meeting as there is little economic data being released that is likely to have much influence on the market. Most polls of forecasters would indicate that the MPC is likely to leave rates unchanged. A Reuters poll of 60 economists showed only 11 believing that rates will rise this week, while a similar poll by Bloomberg showed only 8 out of 54 thinking that a rate hike was likely. A shadow MPC committee run by the Sunday Times showed a majority voting in favour of a rate increase, but this poll normally seems to reflect what the members think should happen, rather than what actually will happen.

Considering that last month's vote was 8 – 1 in favour of leaving rates on hold with the sole dissenter, David Blanchflower, actually voting for a rate cut, it may seem odd that there is so much discussion of a rate change in a month that does not even coincide with the release of the Quarterly Inflation Report. However, the 'surprise' rate hike in January has put the market and all economists on notice that the MPC may act at any meeting. Furthermore, while 8 members of the MPC voted for no change last month, it was on the basis that there was a tacit agreement that a further rate hike was almost a certainty to occur before the current rising rate cycle comes to an end.

Since the last meeting, pretty well all the economic news emanating from the UK would support a rate increase. Inflation came out at a higher level than expected, thus offsetting the much improved performance of the previous month; retail sales figures were much stronger than expected; house prices continue to rise; and there is growing evidence that manufacturers and retailers are being able to increase prices without suffering a buyers' strike. It would be surprising if this evidence, which would support the concerns previously aired by the hawks, Messrs Besley and Sentance, were not enough for them to go back to their previous voting stance for a rate hike. Whether it is sufficient for Mervyn King and some of the more hawkish Bank of England members to join them is more questionable. We would assume that at least one of the hawks, Paul Tucker, would vote against a rate hike this month on the same basis that he opposed an increase in January in that it could not be supported by the Inflation Report.

We think the decision will be much closer than the Reuters and Bloomberg forecasts would suggest.

Irrespective of the eventual voting pattern, we would expect the MPC seriously to debate the merits of waiting for another month or to decide that they have quite enough evidence not to wait any longer. However, the decision is not likely to have any immediate effect on market levels outside the short term. Even if the MPC decides to hold off this month, dealers will just take this as being a delay in the inevitable which is already completely discounted in current rate levels.

For those borrowers concerned about rising interest rate costs, a glance across the Atlantic last week would not have been encouraging. This does not relate to interest rate costs, but the ongoing impact that the hiatus arising from the sub-prime lending market is having on margins. Not surprisingly, the fallout in this sector had an immediate effect on the dealing levels of non-investment grade paper emanating from CMBS issues. Last week saw its influence creeping into higher grade paper. Even AAA-rated issues saw their margins widening to 29bps over swaps. This represents an increase of about 4 bps over the week and 7 bps from the lows reached earlier in the year. BBB-rated paper, not surprisingly, fared even worse, rising by 10 bps over the week. If maintained, this widening in spreads in investment grade paper is likely to cross the Atlantic as there is no fundamental reason why it should vary to any great degree within the major markets.

A widening in spreads is also likely to impact on the ability to issue into the market. Any investor in this type of paper dislikes volatility and is likely to hold off being an aggressive purchaser until he feels that the market has ceased to weaken. There was evidence in the US last week that some planned issues were being held back until better conditions return.

Apart from the MPC meeting, this will be a dull, if short, week for UK debt dealers. The PMI surveys for the manufacturing and service industries are released today and Wednesday respectively. Both are expected to show continued buoyancy in orders, although there is some concern that the service sector may not be able to hold its current high level. Thursday sees the release of the latest industrial and manufacturing data which, again, are expected to be in positive territory. However, the major economic statistics that are likely to prove influential are being released in the US where the factory orders figures, announced on Wednesday, and the latest non-farm payrolls numbers, released on Friday, are likely to have a greater impact than any UK economic release.

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