

Weekly Bulletin – 23rd April 2007

The UK debt market had another rocky old time last week as it had to take on board a variety of economic statistics that confirmed that a rate hike next month is a virtual certainty, and that a further rise hereafter is looking increasingly likely. It hardly needed a set of unhelpful economic numbers to confirm that a rate hike would be forthcoming next month. One look at the minutes of the MPC's meeting would show that an increase would probably have been forthcoming this month if the Bank of England cabal had not decided that they preferred to go back to rate changes coinciding with the Quarterly Inflation Report months. Even so, the two independent hawks, Messrs Besley and Sentance, still voted for a rate hike and even the arch dove, David Blanchflower, gave up his call for a rate cut.

The figures that really hit the headlines were the inflation numbers where the CPI measure rose to 3.1% thus requiring Mervyn King to write to Gordon Brown explaining this turn of events. The letter, and the response, were careful to note that inflation had reached this level largely due to circumstances beyond the MPC's control and which were almost certain to be reversed over the coming few months.

Furthermore, there seemed to be a number of features within March's figures which would seem to be one – offs. The rise in furniture inflation was, at first sight, extraordinary. It managed to leap from 1.5% to 5.00% month on month. This, by itself, managed to increase the inflation number by 0.7%. However, it would appear that March is the favourite month for furniture, and other, retailers to increase prices as it precedes the Easter 'special offer' season when, on the back of March's price rises, they can then make even greater price cuts the following month. We would be pretty confident that much of this sector shows a substantial reduction in inflation in the coming months. We are still fairly confident that the CPI measure will fall by 1.00% or more over the next three months.

However, the market is looking through the immediate fall in inflation and is concentrating on longer term trends. Quite apart from the immediate inflation level, the producer price indices last week came out at considerably higher levels than had been expected. This is hardly a helpful portent to future inflation trends once the increase in energy prices last year falls out of the index and, therefore, brings CPI inflation down to its target level or lower. If at that point it is simply replaced by the prospect of more core inflationary pressures, not only will interest rates fail to decline, they may well continue to increase.

The main problem for the MPC is that despite higher tax and interest costs, the consumer does not appear to have a reduced appetite towards spending and, worse,

may be prepared to accept price increases greater than inflation. Recent evidence would show that the practice of remortgaging to produce equity release to fuel these habits is on the rise. Until there is evidence that higher interest rates are actually having an effect, the MPC is likely to just continue the current tightening process until it actually has some effect.

Most forecasters, including ourselves, had felt that it would only need a couple of rises, combined with higher taxes, to force consumers to contain their spending habits. This has proved incorrect and it is difficult to see how or what is going to halt the quarterly rate increases until there is some sign that they are starting to have an effect. Current survey evidence would show that the public's general knowledge on interest rate movements is fundamentally lacking with a remarkably high percentage appearing not to even recognise that rates have been rising. If next month's rate increase does not start to moderate spending patterns, the MPC may decide that the best way to resolve this might be the short sharp shock as used by the Bank of England in the past. It would be difficult to argue against this policy currently. With headline inflation currently at 4.8%, the highest level since 1991, a quick 1% rate hike would be very easy to justify and would still be a low rate in comparison with some of the levels that have been seen in the intervening period. Indeed, we would not be surprised if the MPC went to a halfway position by raising rates by 0.5% at their May meeting.

This week sees a number of economic statistics that may have more attention paid to them than is standard. Today's money supply figures, while remaining high, should show a small reduction. The public finances do not normally rank high in the market's order of influential data, but the figures to be released on Tuesday will be the final set of the year. The Chancellor has already moved his forecast down to £35 bill. and the chances are that this will be achieved with some ease. Given that most economists doubted his ability even to meet his initial £36.8 bill forecast, Gordon will no doubt use this as a demonstration of his return to prudence. Probably the most influential statistic of the week will be the CBI industrial trends survey which will be analysed closely to see if it reflects the growing concerns over the ability of manufacturers to make higher prices stick. This survey is released on Wednesday, as will be the preliminary estimate of the 1st quarter's GDP. Most forecasters are going for a rise of 0.6% or a notch higher. While this would bring the annual rate down to 2.8%, somewhat below the MPC forecast of 3.1%, we doubt this will merit much attention in their monetary policy deliberations.

We suspect another nervous week is in prospect.

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