



Weekly Bulletin – 14th May 2007

The meetings of the major central banks last week produced the expected results. The FOMC left rates unchanged and did little to suggest that they will do anything else until there is a clearer picture in the USA. The ECB also left rates unchanged, but President Trichet repeated the mantra of the requirement for 'strong vigilance', reinforcing the market's belief that a rate hike to 4.00% next month is a certainty. The MPC did raise rates, but only by the standard 0.25% to 5.50%, thus relieving fears that they might opt for a more strident message to be given to the free-spending consumer.

Despite the fears that the MPC would raise rates by more than 0.25%, there continues to be a divergence of opinion between the majority of economists and the market on where UK rates will peak. A series of polls continues to find that the majority of economists believe that the latest hike will prove to have taken rates to the highest level that will be reached in the current interest rate cycle. In contrast, the market is trading on the basis that a further rise in base rates is almost a foregone conclusion. Indeed, some commentators are expecting the increase to emerge in the next two months, thus breaking away from normality where rate changes are promptly justified by the release of the quarterly inflation report.

The MPC's key fear is that the consumer is not being sufficiently vigilant in ensuring that manufacturers and retailers do not pass on price increases that will threaten the inflation range target once the immediate anticipated reduction in inflation, caused by last year's energy price rises dropping out of the index, has passed through the system. Mervyn King will not fancy the prospect of inflation falling back over the course of this year, only to find himself writing to the new Chancellor in 2008 as the CPI measure hits 3% again.

The series of increases seen since the end of last year has clearly had virtually no impact on the consumer to date. Furthermore, there is also evidence that the strength of the housing market has encouraged some to remortgage their houses to remove equity in order to indulge in domestic spending. We would have thought that one has to be a fairly optimistic economist if one thinks that the latest rate hike will prove to have done the business. Furthermore, we will be snowed with economic information that may well determine whether we are likely to suffer a further rate hike and whether that is

likely to occur before the standard three month interval between changes to the base rate has elapsed.

The producer input and output indices are released today. While the market does not, in our opinion, give these figures sufficient regard, they are still likely to project a level of price increases in the pipeline with which the MPC will feel uncomfortable. While the input prices will be affected by the considerable rise in the oil price last month, both the input and output annual rates are expected to rise by about 0.2% on the month.

The headline figure will emerge on Tuesday with the release of the latest inflation figures. The median forecast is for the CPI measure to fall from 3.1% to 2.8%. This reduction can be justified by the reduction in energy costs alone and we would be hopeful that a reversal in some of the more major increases last month, particularly furniture, may reduce the number to a lower level than that expected by the market. The latest labour market data are released on Wednesday and are not expected to have much influence. Perhaps they should, as having been held up as a potential influence for higher inflation it would now appear that average earnings growth, excluding bonuses, is actually falling. Finally, on Friday, the latest retail sales figures are released. The BRC and CBI surveys provided mixed messages and the median expectation is for a monthly rise of 0.5% which would leave the year-on-year increase at a very healthy 4.7%.

However, the major event of the week for the market will be the release of the Bank of England's quarterly inflation report. The market is expecting this document to emphasise quite clearly that at current rates (which include the expectation that base rates will rise again to 5.75%) the mid inflation forecast comes out at 2% or a fraction higher. If this proves to be the case, not only will it take a fairly major, and unexpected, event for the market to stage much of a rally from its current short term trading levels, but there would also start to open up the prospect of not just another one base rate hike, but the potential for a couple more before the current interest rate cycle ends

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