



Weekly Bulletin – 15th January 2007

It had been the intention for this, second, bulletin of the year to contain our annual forecasts for movements in the major foreign exchange markets this year, but we are deferring James Stretton's words of wisdom for a week in order to consider the implications of the MPC's 'shock' decision to increase rates at their meeting last week.

Firstly, we would question how great a shock it actually was. While it certainly will have been to the unfortunate RBS economist who last Thursday sent an email to the bank's customers assuring them that the MPC would leave rates unchanged and that they believed that 5.00% would prove to be the peak of the monetary tightening cycle, it was much less of a shock to bank dealers. As was noted in last week's bulletin, there was a major divergence between the trading levels in the interbank market and the forecasts of most economists, with the former being much more bearish.

This situation has not changed substantially. Those economists previously predicting that base rates would peak at either 5.00% or 5.25% have, in the main, just increased their forecast level by 0.25%. This is still somewhat lower than market levels that now take an increase in base rates to 5.50% as a certainty (and with the next move likely to be in March) and with the strong likelihood that short term rates will peak at 5.75%. Hence, to borrow money for a year will now cost over 5.75% (interest paid quarterly) and two year money is only some 0.10% cheaper. However, economists are of the almost unanimous view that rates will be declining before the end of the year and most are expecting short term rates to have declined to 5.00% or lower by the end of 2008. The teenage scribblers are, therefore, predicting levels that are a long way removed from the market's expectations.

While the increase in base rates clearly had an impact on the shorter end of the market, the change in medium and longer term rates was not very marked, particularly when taken in context of other markets. While the 5 year rate starts this week some 0.10% higher than a week ago, it needs to be noted that 5 year US rates have moved 0.15% higher over the same period. This sort of move in the US market could easily account for the move in the UK market without any adverse, or shock, announcements. Even the EUR 5 year rate rose 0.05% and that was on the back of a fairly benign press release after the ECB's meeting.

One reason that the move came as a 'shock' was that both the market and economists have become used to rate moves coinciding with the months containing the release of the Quarterly Inflation Report. This is the first occasion since June, 2004, that a rate change has occurred outside an inflation report month and that move was as part of a staggered 0.50% increase that had commenced the previous month and had clearly been signalled as such. However, we suspect that the reason for the MPC's increasing rates this month will become very obvious over the course of this week, notably tomorrow when the latest inflation figures are released.

The MPC will have had sight of the inflation figures when they met last Thursday. These were known to be poor with a further increase from the current 2.7% a certainty, but most forecasters had been expecting it still to remain below 3.00%. However, it would appear likely that the impact of higher petrol, gas and electricity and food prices may have pushed it as high as 3.1%. If this proves correct, Mervyn King will have to write to the Chancellor explaining why the MPC's monetary policy has not kept inflation within 1% of its target level. This would be the first time since the MPC's formation that the Governor of the Bank of England will have to write such a letter. While it will hardly be a difficult letter to write given the impact of petrol and energy prices to say nothing of university tuition fees, which the Chancellor imposed, it will hardly be a letter that Mervyn will enjoy writing and the 'shock' increase will clearly show that the MPC are on the case.

There are a number of other reasons why the move may have been made this month including a pre-emptive strike against overly high wage settlements (in an environment where the headline inflation figure for December is likely to be not far short of 4.5%), the buoyancy of a housing market and strong retail sales figures (the latest to be released on Friday). These are all valid concerns, but would not be expected to trigger a move outside an inflation report month. We suspect that the inflation number will be the key influence on the MPC's thinking.

In contrast, the ECB clearly had a much more restful meeting than the MPC. The expectation that President Trichet would use the 'strong vigilance' phrase over inflation proved unfounded and the market has now decided that the expected upward move in February will be deferred to March or April. There was, however, a restating that the ECB's monetary stance remained accommodative and the clear suggestion that this would be removed in the fullness of time.

Apart from the inflation and retail sales figures being announced in the UK this week, we will also see the latest producer price indices (today), labour market data (unemployment and average earnings) on Wednesday and government finances (on Friday). Inflation figures are also released for the US and the Eurozone during the course of this week.

We suspect the movements seen in the UK market will prove to be an overreaction in the fullness of time. However, we are just as likely to need more helpful data in the US to start any reasonable rally as improved UK data. At least we know that the petrol price impact will be reversed out in January's inflation data and, hopefully, Tuesday's inflation figures will prove to be the high water mark before a gradual decline sets in.

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