Weekly Bulletin – 21st May 2007

The debt markets suffered another difficult time last week with rates increasing almost across the board. The US had the worst time with 5 year rates increasing by about 0.15%. In comparison, the rise in the 5 year rate of 0.07% in EUR and of 0.04% in the UK were quite subdued. Given that the Bank of England Inflation Report, released last Wednesday, was pretty overt about the need for further rate hikes, the rise in UK rates might be regarded as unexpectedly minor, but probably reflects the market having already determined that it was almost inevitable that rates would have to rise again before the current upward trend has run its course.

The UK market was inundated with new information last week, most of which would support another rate increase. The producer price indices showed that there is little let-up in the inflationary pressures in the pipeline while we thought the actual inflation figures, showing a reduction to 2.8% in the targeted CPI measure, were hardly encouraging, even if they were in line with the market's expectations. About the only measure of good news were the latest retail sales figures which showed a month-on-month decline. This was unexpected and may just herald the start in a let-up in consumer demand. However, the market was hardly likely to get too excited about one month's figures especially when it was combined with an upward revision of the previous month's figures.

While the economic information might have been inconclusive, the Inflation Report was not. While the forecast showed the CPI measure hitting its 2% target in two years' time, it needs to be remembered that this is based on current trading levels that already have a further rate rise built in. This has led many to question whether a rate increase may be expected before the next inflation report month which is August. Given that the MPC is anxious not to repeat last January's performance by producing a 'surprise', the release of the minutes of this month's MPC meeting, on Wednesday, and the reaction to it is likely to be key in managing expectations for an early increase. If the MPC does decide not to wait around, we think that the increase will almost certainly come next month as there is no obvious point in waiting around until July when the inflation report is produced the following month.

The key point to examine when the minutes are published is to see whether the potential for a larger increase was considered to any great degree. This is likely to be more important than the voting pattern where the market is expecting David Blanchflower and, possibly, Rachel Lomax to have voted in favour of leaving rates unchanged. In contrast, the market feels that Messrs Besley and Sentance may have argued for the requirement of a 0.50% increase, even if they did not eventually vote in favour of this outcome. However, if it becomes clear that the potential for a 0.50% increase was quite seriously considered and there was some support for the concept from the Bank of England cabal, this could easily be interpreted by the market as meaning that it was being prepared for another rate increase as soon as next month, thus ensuring that Mervyn King did not then come under criticism for any rate movement being a surprise. In any event, with the market starting the week trading on the assumption that rates are more likely to peak at 6.00% rather than 5.75%, Mervyn King could claim, with some justification, that a rate hike outside the 'normal' inflation report months could hardly be taken as a surprise.

The EUR market also showed some signs that it was moving away from its previous assumption that rates would go on hold once the ECB had implemented a further 0.25% rise in the refinancing rate to 4.00%. Not only has it become exceedingly clear that this move will be achieved next month, the complete lack of any indication from the ECB or any of its leading figures that it will then cease the policy of removing monetary accommodation, has startled the market into moving rates to well outside its previous trading range. The reticence of the ECB to placate the market is not difficult to understand. Economic growth for the 1st quarter has come in at a higher level than expected and, like the UK, there is no sign that the rate hikes seen to date have had much impact. Indeed, it would appear that, in Germany, the long awaited revival in consumer spending may actually be on the march despite not only rate hikes but also the rise in VAT.

This week sees little in the way of influential domestic economic statistics other than the latest money supply figures (out today) before the release of the MPC minutes on Wednesday. The second estimate of the 1st quarter's GDP is released on Friday, but is expected to confirm the initial 0.7% growth figure. There are rather more interesting releases overseas. In the US, the latest durable goods orders and new house sale figures are both announced on Thursday. The eurozone will be anticipating another strong showing from the influential German ZEW and IFO surveys that will be released on Tuesday and Thursday respectively.

Another nervous week is in prospect.

JCD Rathbone