



Weekly Bulletin – 29th May 2007

The UK debt market suffered another shift to higher yields last week with the minutes of May's MPC meeting leaving little doubt that further rate hikes are in the pipeline. The market's reaction was to shift rates so that a 6.00% base rate is now factored into the yield curve.

The minutes showed a unanimous vote for this month's 0.25% increase with even the arch dove David Blanchflower voting for the rate rise. While fears that Messrs Besley and Sentance would vote for a 0.50% hike proved unfounded, the fact that the Committee talked in some detail on whether an increase of this amount was necessary was enough to persuade many economists that there was little chance that the current trend would end without base rates hitting the 6.00% mark.

The major debate was on when the MPC would authorise the next increase. August, to coincide with the next Inflation Report, remains favourite, but there is a growing number of forecasters who expect the MPC to act again next month with a further rise being made in August. This would be a repeat of the pattern of rate hikes that was seen in 2004. While the MPC has attracted criticism for 'surprising' the market following the January rate increase, it could hardly be open to this accusation again after making it so clear that another rise is almost certainly necessary.

The sight of rates for two, three and four years moving up above 6.00% for the first time since the autumn of 2000 is likely to cause increasing pain for those who have remained determined to be underhedged. Fortunately for most borrowers, hedging has become an accepted practice when borrowings rise and the latest rise in rates will have relatively little impact. However, there was evidence last week that some banks were busy chasing up companies who have failed to meet the minimum hedging requirements in their loan facilities. Not a happy telephone call to have at current levels.

Unfortunately, some of the solutions being offered are hardly appropriate. Inevitably the bank cancellable swap is alluring in the current circumstances given the immediate cost saving to prevailing market levels. It should, however, be avoided at all costs. Anybody tempted to enter into this arrangement should speak to the borrowers over the past couple of years who are now seeing their banks busy exercising their option to cancel, thus leaving them unhedged just when it is most needed. The small saving made over the past year or two in comparison with a vanilla swap now pales into insignificance in comparison to the 1% to 2% increased costs they are now having endure over the next few years. It needs to be remembered that at the current high levels of interest it is the borrower that needs

flexibility, not the bank. Occasionally, this structure masquerades as a bank extendable swap. The effect is exactly the same as a bank cancellable swap.

The UK is not the only market that is suffering from concerns over future rate levels. The EUR market has now all but given up hope that rates will peak at 4.00%, a level that they are almost certain to achieve following the ECB meeting on 6th June. The surprisingly large fall in consumer spending announced last week in a number of countries, but particularly Germany (-1.4% quarter on quarter) following the VAT increase in January, was largely discounted as being historic on the basis of very strong consumer confidence.

The result of generally strong survey evidence, like last week's Ifo survey, is that most forecasters are pencilling another rate hike to 4.25%, probably in September, and a strong chance of yet another increase in the last quarter of the year.

This week sees little in the way of domestic economic information. On Thursday the latest consumer credit and mortgage application figures will be released. Evidence from various surveys has shown a weakening in mortgage applications and this is expected to be reflected in the official statistics with a small drop. This would compound evidence that house prices are levelling out, but is not likely to have any impact on the MPC's concerns which have long since moved to other aspects of the economy. Thursday will also see the release of the CBI distributive trades survey. Last month's survey was very strong, but proved a poor indicator of the official sales figures that showed a fall. The CBI index is expected to show a sharp fall from its bloated +44 level down to about +15. Friday sees the CIPS survey on manufacturing which is expected to show an increase from its current 53.9 level. However, with the MPC concentrating on future price pressures, it will be survey's findings on the prices paid balance that will be the key focus.

The eurozone sees a number of key economic indicators being released this week including the latest money supply figures on Wednesday (expected to fall slightly from the current very high levels), inflation figures on Thursday (expected to be static at 1.9%) and unemployment on Friday (Germany on Thursday) which expected to show another decline.

We find it difficult to see how UK rates can push much higher from current levels in the short term, but the market is hardly in a mood where any sort of worthwhile rally can be contemplated.

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