



## Weekly Bulletin – 11<sup>th</sup> June 2007

The debt market suffered another grim week with the medium and longer term pushing higher in all major currencies. Indeed, it was the ultra-long rates that suffered the most damage. The GBP and EUR 30 year rate increased by circa 0.13% over the week, while US equivalent boomed out by 0.25%. This ultra-long end of the market has had quite a dramatic month. A month ago the 30 year USD rate, currently 5.92%, was trading 0.50% lower and the EUR rate, currently 4.77%, was trading 0.30% lower. In comparison, the 0.20% increase that has been seen in the GBP 30 year rate to 5.19% looks relatively mild.

Events in the shorter end of the market seemed to get overlooked as a degree of panic took over longer dated maturities but, for the record, the ECB duly raised rates by 0.25% to bring their refinancing rate up to 4.00%. The MPC, in contrast, decided to leave rates on hold which had no effect on the market as it simply regards the failure to act this month as a stay in execution.

President Trichet did not do the market any favours in the post ECB meeting press conference in maintaining a fairly bearish tone. In particular, he noted that the ECB would continue to 'monitor closely all developments', which is normally taken as code to expect a further rate hike within the next quarter. Probably worse, he also noted that monetary policy was 'still on the accommodative side'. This does not bode well for those who had assumed that 4.00% represented the likely level where the ECB might regard monetary policy as being neutral. While some believe that 4.50% will probably mark the end of monetary policy being regarded as accommodative, others believe that it will require rates to rise to 5.00% before a neutral point is reached.

With the ECB still having concerns over the high level of money supply and the potential for inflationary wage settlements, combined with unemployment being at a historic low, short and medium term EUR rates would still appear to have scope for further increase, although one would expect the yield curve to flatten, or even reverse, if rates press on through to the 5.00% level.

UK rates, of course, appear to live almost perpetually in a reverse yield curve and are unlikely to move out of this situation in the foreseeable future. The question for the UK is just how far the MPC will push rates given that there are virtually no signs currently that the consumer shows any sign of higher rates having an impact on confidence. Indeed, the Nationwide confidence survey

released last week showed consumer confidence at its highest level for 18 months.

This week sees the release of a number of important domestic economic data. Today sees the release of the producer input and output price indices. These are likely to show some moderation in the annual figure, but only due to the removal of last year's very high monthly increase. These figures probably provide the MPC with its best guide to future inflationary pressures and, unless there is a fall in the oil price in the near future, these could start to show some unpleasant results. We also expect these figures to become more influential. Tomorrow sees the release of the latest trade figures. No doubt this will show another major deficit and, as usual, will be totally disregarded by the market.

The latest inflation figures are also released on Tuesday. These are expected to see the targeted CPI measure fall back to 2.6%, which would be the lowest level since last October. However, given the energy increases that are dropping out of the index, a 0.2% reduction in the annual rate is hardly much to get excited about. The MPC would have known the inflation figures when they met for their meeting last week and one assumes that they would have raised rates if they had been really poor. There is some hope, therefore, that a better figure might emerge.

The latest labour market figures are released on Wednesday and these should show that the MPC's concerns over inflationary wage settlements were misplaced. However, the impact of wage increases has dropped out of the MPC's rhetoric over the past few months and is likely to become a much less influential statistic over the coming months. This is in comparison with the retail sales figures which will be announced on Thursday. These are expected to show a reasonable month-on-month increase of about 0.3% which would cause the annual rate to fall to 3.8%. However, with consumer confidence running at such a high level, it would probably require another negative month-on-month result in order for the market to rally.

Based on this week's economic data not producing any unpleasant surprises, we would fancy the UK market holding steady this week – or even producing a small, and temporary, rally this week. However, with rates being so volatile in the US, we are more likely to play follow the leader than be influenced by domestic considerations.

**JCD Rathbone**