



## Weekly Bulletin – 18<sup>th</sup> June 2007

The debt markets just about held their nerve last week as rates continued to rise, but by a much smaller amount than the previous couple of weeks. Again, the biggest increase was seen at the ultra-long end of the market with the EUR and GBP 30 year rates moving up by circa 0.13%. Interestingly, the USD equivalent remained unchanged.

Mervyn King makes his annual Mansion House speech this week, but it would be a surprise if it varied very much from the one he delivered in Cardiff last week. This was the normal warning on inflationary pressures and the requirement for base rates to rise if the consumer continued to show a willingness to accept inflationary price increases. However, it is the Governor who appears to be well behind the curve, rather than the consumer. At the beginning of the year the MPC's concern was based around the annual wage round bringing about higher inflation. Many people, including ourselves, had grave doubts whether high wage settlements were likely and have subsequently been proved correct as last week's benign figures showed. Since then the Governor has changed to worrying about the ability of retailers to pass on inflation on goods and services as the deflationary effect of Chinese imports on the former starts to wane.

This seems to be much closer to the mark and is a prospect that the market has reacted to with some intent. Since the beginning of the year the 2 year rate has increased by about 1.25% thus placing it well ahead of the MPC who have managed to ordain just two 0.25% rate hikes over this period. If Mervyn King wants to put a lid on inflation not rising once the lower energy costs have worked their way through the system over the next couple of months, he should do something about it rather than indulging in an increasingly boring rate rise threatening whine.

In the current rather panicky environment it becomes quite difficult to see the wood from the trees. Quite a lot of our clients are sitting on hedged positions where the current market provides some interesting possibilities. What would you prefer to have at the moment, a 5.50% swap or a 5.75% cap for the next 5 years? The monetary value of the two is about the same and last week we saw the first signs of some borrowers, for whom an increase of 0.25% in their maximum cost has relatively little impact, starting to switch out of swaps into more flexible hedging structures. If one assumes that the MPC regards 5.00% as an appropriate interest rate level given that inflation is under control and it is following a neutral monetary policy, the savings to be derived from the cap alternative may be more than useful in a couple of years' time.

Last week saw the first signs that the economic recovery in the eurozone may be starting to fade. Industrial production fell by 0.8% in April, bringing the annual rate down sharply to 2.9%. The market is not in a mood to pay much attention to economic statistics that might spark a rally in the debt markets and decided that this was a monthly aberration caused by the timing of the Easter holidays. It may also be a reaction to the high level of stock-building that has been growing over the past 18 months. However, a confirmation of a slowing of economic activity may start to provide some ammunition for those suggesting that the ECB may be near the end of its removal of monetary accommodation.

This week sees the release of some quite key information in the UK. Wednesday is likely to be quite active as it will see the release of May's latest money supply figures, the latest government finance figures and the minutes of this month's MPC meeting. These are then followed by the latest CBI monthly trends survey on Thursday. The money supply figures are not expected to provide good news with most forecasters predicting a small increase in the annual rate from the current 13.2% level. The money supply data seems to be regarded as important by some MPC members, but not by others. It is difficult to forecast, therefore, what a major variant to the consensus forecast might portend for the market. The government finance figures are likely to maintain their improving trend, but are unlikely to have much influence on trading levels.

The minutes will be closely analysed to see to what extent a rate hike had been discussed at this month's meeting and whether any of the members voted for one. It would come as no surprise to find that Messrs Besley and Sentance voted for an increase, but it will probably require some skilled teacup-reading to decide whether there is likely to be sufficient support to make a rate increase next month likely. We think that the jaw-jawing will continue to August.

Thursday sees the release of the latest CBI monthly trends survey. This survey now receives enhanced attention as it is the prime source of pricing intentions and May's survey showing projected increases at a 12 year high has been partly responsible for the increase in rates that has been seen over the past month. It is almost certain that we will see a fall back from the +25 level seen last month with a range between +18 and +13 covering most forecasts. However, for core inflation to show no increase it would have to drop back to +10.

With most of the releases out this week expected to show the requirement for further rate rises, an interesting week is in prospect.

**JCD Rathbone**