



Weekly Bulletin – 25th June 2007

The news last Wednesday, on the release of the minutes of the latest MPC meeting, that the committee had voted to keep rates unchanged at 5.50% by a majority of 5-4, with Governor Mervyn King being outvoted again, was initially greeted by the market as bullish for sterling. The GBP/USD rate rose about a cent to 1.9930 in the immediate aftermath on the basis that, against a market expectation of a 7-2 split for a 'no-change' decision, the 5-4 vote meant that the committee was further down the path to the next rate hike than previously expected and that this would now occur as early as July and, certainly, no later than August.

We have noted previously that, at some point, the foreign exchange market would stop regarding further rate hikes as unequivocally good news for the pound and Tuesday's disappointing news from Tesco may be an indication that consumers are beginning to feel the pinch. If so, sterling's longer term fortunes may still revolve more around foreign, rather than domestic, monetary policy. Attracting capital is a competitive business and it is, therefore, not the absolute level of interest rates but interest rate differentials which drive the markets.

The UK currently enjoys an official interest rate premium of 0.25% with the US, 1% with the eurozone, 3% with Switzerland, 5% with Japan and, interestingly, minus 2.5% with New Zealand, a country which is currently reminding the world what monetary tightening really means. Taking these in turn, the markets have entirely unwound expectations, which persisted until recently, of rate cuts in the US; rhetoric from Jean-Claude Trichet remains hawkish and few now believe eurozone rates have peaked at 4%, despite last week's unexpected fall in the German ZEW index of economic expectations; the Swiss National Bank is fretting about carry trades pushing down the value of the CHF with a potential adverse impact on inflation; in Japan, although the markets have been awaiting rate rises for some time and continue to be disappointed, rates are surely not going down; while New Zealand is clamping down so hard on inflation through monetary policy that the NZD continues to appear significantly overvalued.

For the UK, this means that our sterling-supportive interest rate differential is increasingly likely to be eroded over the following months by the actions of foreign central banks. If higher overseas interest rates began to attract capital out of the UK, and sterling weakened, the MPC's job would become much more difficult since a weaker currency always represents a *de facto* monetary easing. There exists the risk that the MPC might have to raise rates further than currently expected to combat the inflationary effects of a weaker currency which suddenly found itself facing stiffer international competition.

At some unknown point this would in all likelihood, lead the markets to turn against the GBP as it became apparent that higher rates had begun to damage the real, debt-burdened economy.

It is interesting that Mervyn King has, not to date, publicly mentioned such a scenario, though it will doubtless have been discussed at length at MPC meetings. Perhaps his memories of September 1992 remain too vivid. Readers with long memories will recall that, on Black Wednesday, it was only after the Bank had raised rates from 10% to 12% - and the market had judged this to be unsustainable - that the steady stream of sterling selling turned into a swollen, unmanageable river.

Change in the fortunes of high-yielding currencies usually happens suddenly however, and last week, it was for the time being 'business as usual' as investors continued to be attracted to the 8% yield of the NZD, forcing the Reserve Bank of New Zealand to intervene and sell the currency.

There was even excitement in Sweden, as the Riksbank raised interest rates last Wednesday by a fully anticipated 25 bps to 3.5% but accompanied this with hawkish comments which caused the SEK to appreciate on the day by 1.5% against both the EUR and USD.

This week will see the foreign exchange markets looking for more evidence of potentially higher rates anywhere. In the short term, the high-yielders look likely to continue to find support. However, this will not always be the case.

In terms of forthcoming data, this Thursday will see the release of Hometrack and Nationwide's house price data, with the latter expected to show an annualised increase of 10.4% in the year to June. Friday will see the release of final Q1 UK GDP, expected to confirm an annualised rate of 2.9%; final May M4 is expected to come in at annualised rates of 13.8%, while May mortgage approval data from the Bank of England are expected to show a figure of 105,000.

With a relative paucity of market-moving data expected in the UK, the market can be expected to take much of its inspiration from the States, where June consumer confidence on Tuesday and final GDP on Thursday will provide a backdrop on Friday for the core PCE deflator, the Fed's preferred inflation measure. This is expected to show a reduction in the annualised rate from 2.0% in April to 1.9% in May. Recent movements in term rates demonstrate the market is unlikely to suffer disappointment gladly.

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