

Weekly Bulletin – 9th July 2007

As had been fully expected by almost everybody, the MPC duly decided to raise interest rates by a further 0.25% to 5.75% at their meeting last Thursday and this had no impact on the market. The fact that period rates subsequently rose to end the week at new highs was more down to a resurrection of concern over inflationary pressures in the US rather than any domestic consideration.

While UK rates were more driven by global considerations than domestic news, there was little doubting that the information that the MPC saw being released prior to making their decision would have done little to deter their conclusion. The CIPS surveys, in particular, both showed considerable strength. The aspect which would have concerned the MPC most was the prices balance contained within the surveys which would have done nothing to calm their fears over future price inflation.

As this bulletin has noted previously, the MPC is behind the curve on the interest rate front having spent its time talking about inflationary pressures rather than taking any decisive action. The result of last week's 0.25% hike is that economists and commentators have moved straight on to discussing when the next rise will take place. Forecasts range from next month, for the ultra bearish, to November, when the next Inflation Report is released. October is probably at the shortest odds. There are still a few brave souls who are forecasting that the current 5.75% level will prove to be the peak for this particular interest rate cycle.

However, the market is now not only completely discounting a rise to 6.00%, but also the strong likelihood of another 0.25% increase after that. A further increase, therefore, is most unlikely to have any impact on anything other than very short term rates. In our view, the MPC would be better off getting on with it and reaching the 6.00% mark next month to show that they really are serious about tackling inflationary pressures. This would likely bring howls of pain from retailers and highly leveraged (unhedged) borrowers, but that would be what it was supposed to do. The advantage of moving early to the 6.00% level is that by moving much more quickly up to market levels, the MPC really will have a chance to review what effect its tightening policy is having. The alternative, inching along by moving up by 0.25% a quarter, a sort of death by slow cuts, means that the MPC never catch up to a level where they can have

time to pause and reflect without being pressured by the market.

The ECB operates differently by having developed a well defined set of traffic lights which ensures that everybody knows what it is going to do. Dealers now know that the statement 'monitor very closely' is a pseudonym for a warning that a change is likely within a couple of months and the need for 'strong vigilance' is a sign that rates will be increased the following months. This is, of course, simple stuff when you are pretty certain well in advance what you are going to do with interest rates. This has hardly been difficult for the ECB as it has been reversing a policy that looked to kick start the German and French economies through very low interest rates. The fact that we have been going through a reversal of this process has made rate prediction a pretty easy science even if most forecasters expected the removal of monetary accommodation to have been completed at a lower rate level.

However, it is likely that the ECB is either at or rapidly approaching the point where it feels that monetary accommodation is no longer required. The last two ECB meetings have noted the need for close monitoring, without the 'very', which has caused some to believe that the ECB may be installing the rather odd system that is in place in some eurozone countries of having a preliminary set of lights that flashes at amber constantly as a warning that the main set of lights lie just ahead. Unfortunately, they do not tell you what colour they will be at in advance. It may be that the ECB has got to, or is rapidly approaching, the point at which it does not know how it is likely to manage interest rate policy in advance. At this point the traffic light system will become a lot less reliable.

This week sees little in the way of influential economic releases in the UK although the producer price indices, to be released today, should be significant. Tomorrow sees the announcement of the latest set of trade figures as well as the release of the BRC retail monitor. The latter is likely to give the first indication of the damage that the ghastly weather that the UK has suffered over the past month has wreaked on the industry. Influential news is also in short supply in other major economies, so the UK debt market will probably be left to wallow in line with the US market.

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