



Weekly Bulletin – 16th July 2007

The debt markets tried to stage a rally in the middle of last week with term rates, at one point, a good 0.10% lower than at the start of the week. However, it did not last very long and by the end of the week all the gains had been lost. The rally had been driven by the US where ongoing horror stories over the potential impact of the collapse in the sub prime mortgage market, combined with little sign of any recovery in the US housing market, have been spooking the markets on a variety of fronts.

The most obvious reaction to the threat, or fear, of a credit crunch in response to the sub prime market has been to push up credit spreads. Many would say not before time. However, the previously narrow level of credit spreads has largely been created by several large hedge funds taking almost exactly the same bet as LTCM, at that time the largest hedge fund in the world, did 10 years ago. The collapse of the sub prime mortgage market has already seen several hedge funds being wound up and it would be surprising if more were not to follow. A further result of the collapse in sub prime mortgages has been that the high yield bond market has departed off on one of its irregular and involuntary holiday periods.

The potential US credit crunch has also been blamed for the latest spell of unease for its currency. The USD hit a series of new lows against the EUR last week as well as a 26 year low against the GBP. There does not seem to be any rationale to ally the performance of the USD with the current problems in the sub prime market, even if it may lead to substantial problems for some large hedge funds. The USD was remarkably steady when LTCM collapsed and through a variety of other economic crises in the late 1990's.

While last week's mini, and short lived, rally in the debt markets might be partly ascribed to the potential for the FOMC to react to the problems of the housing market by relaxing monetary policy, it is certainly not a probability that the US market is willing to adopt currently, having been led astray by this possibility several times in the past year. Indeed, the very flat yield curve would intimate that the FOMC is likely to remain inactive on the monetary policy front for an extended period.

The UK market will continue to be influenced by events on the other side of the Atlantic, but is likely to turn its concentration back on to more domestic matters this week and it will not be short of information to consider.

First up, tomorrow, are the latest inflation figures. The CPI figure is expected to show another fall, but probably only by a notch or two from the current 2.5%. While recent surveys would suggest that core inflation should have fallen and reduced utility bills should still be having

a beneficial impact, the increase in petrol prices is expected to keep this at fairly minimal levels.

The latest labour market figures are released on Wednesday. Unemployment is expected to have fallen again and average earnings are expected to fall from 4.0% to 3.6%. This is a pretty remarkable figure given the MPC raised rates 6 months ago, primarily because they were concerned about inflationary wage awards. In fact, at 3.6% they could be described as being disinflationary. Mervyn King would do his, and the MPC's credibility, no harm if he noted that this is no longer a concern and, if he could bring himself to admit to an error, was misplaced in the first place.

On Thursday the latest retail sales figures, government finance statistics and money supply data are all released. The former are expected to show a small month-on-month increase if the earlier BRC survey figures are to be believed, but the annual increase is expected to drop back some 0.5% to 3.4%. However, the dire weather makes this month's figures difficult to forecast and it would not be surprising if the outcome was rather less bullish. The government borrowing figures are normally ignored by the market, but are expected to be in line with ensuring the previous Chancellor's estimates will be beaten – just. The money supply data, in contrast, has now been given greater prominence by the MPC and will, therefore, become influential for the market. Another 1% increase is expected this month which would bring the year-on-year number down fractionally to 13.5% from 13.9%.

Friday sees the release of the preliminary forecast for GDP growth for the 2nd quarter. This is expected to come out at 0.7% which would maintain annual growth at 2.9%. This would be pretty much in line with the Bank of England forecasts and should not provoke any market reaction were it not for some members of the MPC thinking that a below trend level of economic growth might be helpful in getting inflation back to its target level.

If this is not enough economic information for the market, it can also look forward to the release of this month's MPC minutes. There is considerable interest in the voting pattern for the rate increase. Some commentators are suggesting that if the vote for the rate increase was 7 -2 or greater, then it increases the chances of a back to back rate hike in August.

The domestic debt market could well be in for a very volatile week.

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