Weekly Bulletin – 23rd July 2007

The worsening of the sub prime lending market and various projections that it will become worse was sufficient for the US market to set off on a reasonable rally last week. This, in turn, exported itself to other major currencies with the result that UK rates fell by up to 0.10% despite having to absorb a range of economic data that was hardly likely to deter the MPC from continuing to tighten monetary policy. The only note of optimism for the doves was that Charlie Bean, the Bank of England's Chief Economist, voted against this month's rate hike.

Setting monetary policy would appear to have much in common with trading: both are at all times extremely difficult but both can also appear very easy when one gets it right. Last week, strong UK GDP growth (up 0.8% in the second quarter, compared to up 0.7% in the first), combined with a worrying rise in core inflation to a 10 year high of 2%, caused the foreign exchange market to become more convinced than ever that the MPC has not got it right, is running 'behind the curve' and will need to raise rates more forcefully.

This caused a rise in the GBP/USD exchange rate to a fresh 26 year high of 2.0587. The last time we were here, in 1981, the pound was a petro-currency on the back of North Sea oil, the tax revenues from which represented 9% of total government receipts, and Margaret Thatcher and the late Sir Keith Joseph were on a mission to squeeze inflation out of the system at all costs. The year ended with base rates at 14.5%.

Much of the recent powerful rise in the GBP/USD rate over the past few weeks has, of course been due to USD weakness, rather than GBP strength, with the EUR also making all-time highs against the USD. Thus the EUR/GBP exchange rate has been relatively stable. Last week, however, was different, in that the GDP and core inflation data increased the demand for sterling across the board, with the pound strengthening 0.7% on the week against the EUR to close at 0.6724.

The difficulty for the MPC is in the time-lags between a rise in base rates and their impact on the real economy. Much has been made of the potential 'time-bomb' effect as short term fixed rate mortgages taken out two to five years ago run off over the coming months. This will, doubtless, have been one of the considerations that influenced three of the six MPC members who voted for the hike to 5.75% to declare themselves inclined now to wait and observe the effect of previous tightening before raising rates further.

A closer look at last week's GDP figures, however, shows that the UK manufacturing sector continues to shrug off both the extremely strong GBP/USD exchange rate and the effects of the five recent, consecutive 25 bps rate rises. Additionally, the world economy, Japan excepted, is booming and the open UK economy tends to benefit from an increase in international trade. Perhaps it is these factors, along with the continued strength of the UK service sector (which grew at the same 0.8% rate as overall GDP in Q2 2007) which have combined to tighten the (skilled) labour market and convince the UK consumer that there is, as yet, no real need to rein in spending to any meaningful extent.

All this would suggest that the doves may have to wait some time for a slowdown and that Mervyn King will become increasingly impatient. Of course, any extent to which monetary policy is left too loose now will lead ultimately to a higher peak in rates than would otherwise have been the case in this cycle, potentially with very serious consequences for the real economy and the value of the pound. For the time being, however, the market views that risk as one for another day.

With the USD under continued pressure over the sub-prime mortgage lending fallout and sterling trading strongly per se, our 1.8000 forecast for the year end GBP/USD rate looks somewhat off the mark. Indeed, with the exchange rate at 26 year highs, we cannot rule out the possibility that, having formed what appears to be a secure base above 2.000, the rate is in a new trading range, the top of which may be considerably above current levels. In order for the GBP/USD exchange rate to trade much higher, however, we feel that the market's perception of sub-prime lending and its associated derivatives in the States would have to worsen from an already fairly dire assessment (Ben Bernanke warned the markets last week to expect losses of between USD 50bn and USD 100bn from sub-prime fallout). Additionally, the UK consumer would have to demonstrate a continued imperviousness to tightening monetary policy – something which becomes less likely with each rise in base rates.

There are no influential economic data being released in the UK this week, so the market is likely to continue to play follow my leader after the US market.

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