



## Weekly Bulletin – 29<sup>th</sup> January 2007

Interest rates in the UK continued their upwards drift throughout last week, although the rise in UK rates was concentrated in the longer maturities. However, this was not just a domestically-generated bout of further pessimism but, as before, followed the trend being set in the US where the rate increases were rather more marked. This transatlantic influence also had its effect on EUR rates.

The major event in the UK last week was the release of the minutes of the MPC meeting which showed that this month's rate hike had been a close-run thing with the 5 -4 vote in favour being very different from expectations. Furthermore, there were some notable surprises on individual votes. Given the close vote, it might have been expected that Kate Barker, who is normally regarded as being dovish, would have voted for a 'no-change' decision. On this occasion, however, she lined up with the hawks. The biggest surprise was Paul Tucker, who holds the voting record as being the most hawkish of the MPC members, voting for a 'no-change' decision.

At first sight, it might appear that there are a number of divergent opinions starting to emerge within the MPC. This assumption is likely to be proved incorrect. While one might regard David Blanchflower and, possibly, Rachel Lomax as being likely to rank in the dovish camp, the reason for Charles Bean and Paul Tucker voting against a rate hike was more one of timing rather than opposing the continuing trend to tighten monetary policy. Paul Tucker, in particular, was concerned that a move away from coinciding rate movements with months that contain the publication of the Inflation Report would produce an overreaction in market rates.

If one looks at the levels to which the market has now moved, Paul Tucker may well be feeling that his fears have already come to fruition. The futures market is now trading on the basis that 3 months Libor will be 5.85% by the middle of this year and will show very little sign of a downward movement over the course of the following year. While most economists are now coming around to the conclusion that the MPC will enforce another rate hike, few are yet on the market's wavelength that a further two hikes are almost a certainty and that base rates hitting 6.00% is a reasonable possibility.

The economists will claim that the effect of the rate hikes to date, especially those in November and January, have hardly had a chance to take effect and that, combined with increased taxation, the squeeze they will apply on the consumer should be sufficient to pull back inflationary pressures. Furthermore, the reduction in energy costs should eventually feed through to the CPI inflation measure producing a sharp fall in the second half of the year, a move recognised by Mervyn King in a speech last week.

While the market's current view on rates is likely to be maintained by some strong economic data, last week's projected rise of 0.8% in quarter 4 GDP being a good example, it is difficult to believe that a further 0.5% increase in base rates would not be overkill. Already the first wobbles are being seen in the housing market with repossessions growing strongly and this week's mortgage applications statistics are likely to show a fall. We suspect, left to its own devices, the UK debt market should be able to stage quite a reasonable rally eventually.

However, the question is whether the UK can be immune from less favourable influences elsewhere. As this bulletin pointed out two weeks ago, while the upward shift in term rates was ascribed to the influence of the 'shock' rate hike, US rates moved upwards by an even greater amount during that week. They have hardly shown any signs of reversing the major upward trend that has taken place since the beginning of December and all the talk of potential rate cuts at some stage this year has completely disappeared. There is a considerable danger that, as inflationary pressures start to subside in the UK, the ability of the market to rally may be constrained by external influences.

This week sees little in the way of influential statistics being released in the UK. Apart from the mortgage application and unsecured lending figures (on Tuesday), the CIPS survey on manufacturing is released on Thursday amongst mixed opinions on whether it will show a further decline and both the Nationwide and the Halifax will announce their latest house price surveys. All the major action will be in the US where the FOMC meets on Thursday to determine any change in monetary policy. It would be a major surprise if any rate change were announced, but the markets will be analysing the accompanying announcement to see whether the growing fears that rate increases may be on the cards are justified. The US also sees a range of influential economic statistics being released this week including the personal core expenditure deflator (the FOMC's favoured guide to inflation levels) on Thursday followed by the labour market data the following day. While the non-farm payroll figures are normally the most important part of these figures, the market will also be closely watching the hourly earnings increase which is running at historically high levels.

One would hope that the market would manage some respite from the continual upward pressure on rates that has been seen over the past six weeks, but it is likely to remain very nervous with the majority of the economic data likely to support the potential for continued strong economic growth.

**JCD Rathbone**