

Weekly Bulletin – 26th February 2007

Rates struggled to hold their improved levels over the course of last week, but a rally at the very end of the week which has been continued today sees rates back to, and even below, the levels prevailing seven days ago.

The major event for the UK debt market last week was the release of the minutes of the MPC meeting which showed a 7 -2 vote in favour of leaving rates on hold. As expected, the two hawks pushing for a rate hike were the latest recruits to the committee, Tim Besley and Andrew Sentance. There has been a suggestion that new independent recruits to the MPC should have a 'running-in' period where they attend meetings, but are not allowed to vote. Anybody reading Dr. Sentance's comments in the Times last week, which appeared to be singularly one-eyed in terms of future inflationary pressures, might be inclined to combine this suggestion with also having to pass a test at the end of the probationary period.

However, if one excludes the concerns of the two hawks, the remainder of the committee appeared to believe that a further rate rise might be regarded as excessive tightening, particularly as high pay settlements – one of the MPC's major concerns – show little sign of coming to fruition. Furthermore, some members of the committee also noted the point this bulletin has been making, that there are 'considerable downside risks to inflation in the near term' due to the reversal of rises in energy costs.

The main conclusion to the minutes has been that it is now unlikely that, barring some very unwelcome and unexpected economic statistics emerging, the MPC will raise rates at its meeting next month. The minutes noted that the majority of the members would prefer to wait and see what the impact of the latest rise will be before taking further action. A further rate hike in May to coincide with the publication of the next Inflation Report would appear to be the popular outcome amongst the forecasters, although the range of forecasts is very wide, with some of the more bullish forecasters now reverting to their predictions of a 5.25% peak.

Whatever, the forecasters say, the market is still trading on the basis that a further 0.25% rise is a certainty and another hike after that is still likely. There is still, therefore, considerable scope for the market to rally further if doubts over whether another rate increase will be needed start to become more credible.

One central bank that did take action last week was the Bank of Japan which doubled the underlying cost of funding by raising rates from 0.25% to 0.50%, the highest level seen in 10 years. The increase had hardly been unexpected given that GDP is, at last, growing strongly, although some believe this to be a fairly temporary respite. Furthermore, inflation remains at very low levels and may well go negative over the course of the next few months. The immediate result was for the JPY to depreciate again, hitting a record low against the EUR. This is hardly a message to those indulging themselves in long-established carry trades to close them out in the near future.

Another central bank that is strongly expected to take action when its members meet again on 8th March is the ECB. Last week saw stronger than expected confidence figures in both France and Germany and, in the former, a much larger increase than had been expected in consumer spending. This week sees a range of further economic information from the major eurozone countries, virtually all of which is expected to back up the prediction of increased economic growth. Combined with President Trichet's comments on the need for vigilance after the ECB's last meeting, the case for a rate hike to 3.75% appears overwhelming. The market is trading on the basis that this rate hike is a certainty and that probably there will be another at some stage during the course of this year but that, thereafter, the ECB will hold off further increases. It would seem to us that the eurozone economy has taken the rate hikes seen so far in its stride and there is no reason why a further couple will cause too much concern. While that may remove the ECB's premise that it is still running a monetary policy that is accommodative, the market is giving no credence to its moving to a policy where it feels that a degree of tightening is required. We still feel that a cautious attitude should be taken to EUR interest rate exposure.

While the eurozone and the USA will have plenty of new economic data on which to focus, the UK market will be restricted to the latest Nationwide house price index, the latest mortgage lending figures and the PMI index (both of the latter out on Thursday) for interest. A bit of consolidation at these lower levels would be a welcome outcome to the week.

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