



## Weekly Bulletin – 5<sup>th</sup> March 2007

Interest rates in the UK, US and eurozone start this week at substantially lower levels than seven days ago as the rally is extended into its third week. The stimulus for the rally last week was the sudden and unexpected fallout in the equity markets. While Tuesday's fall in the equity markets did not seem to be generated by any one fundamental event, it quite clearly shows that the level of confidence in the value of financial assets may well have been over cooked.

The initial move in China appeared to be generated by, probably misplaced, domestic concerns. The 8% fall in the index simply being a reversal of the increase that had been seen to date. While it may have been a purely domestic move, it was soon replicated in the US where a warning from Alan Greenspan that the US economy might fall back into recession by the end of the year was hardly a welcome accompanying factor. However, Greenspan has been warning about financial assets being over valued on and off ever since leaving the Fed and there would not appear to be any reason for the markets to react more violently on this occasion, especially so soon after his successor had given such a relaxed testimony to Congress on the state of the economy.

Irrespective of the validity of the movements in the equity markets which saw the Dow Jones fall 4.2% and the FTSE 100 completing a copycat 5% loss, there is little doubt that the market has suffered a blow to its confidence. Most commentators are expecting Tuesday's fall to prove little more than a temporary setback, but it would be surprising if there were not further alarms before, and if, the market regains its equilibrium.

The impact on UK rates has been considerable and has brought the market's trading levels back to reflecting the majority view of most economists. While it is still trading on the basis that base rates will rise once more, the prospect of the peak not being reached until 5.75% or even 6.00% has now disappeared.

Last week's events provide an interesting backdrop to the meetings of the MPC and ECB on Thursday this week. The result of the ECB meeting appears to be a foregone conclusion with virtually every forecaster expecting it to raise the refinancing rate to 3.75%. Almost all of the economic data that has emerged over the past month would support and validate another upward hike. Furthermore, the services PMI index across the eurozone and German factory orders, both of which are released before the ECB meets, are expected

to provide ongoing evidence of a strengthening economy.

Not only do we expect the ECB to raise rates this week, we also expect the accompanying statement from Trichet to leave little room for doubt that this will not prove to be the last upward move in this cycle. President Trichet has referred to all the moves to date as the removal of monetary accommodation which implies that the ECB has yet to reach a level where monetary policy might be regarded as neutral. Quite apart from the market scarcely reflecting the impact of the ECB raising rates to 4.00%, which might prove to be the neutral point, any thoughts that the state of the eurozone economy could require a restrictive or tightening policy to be enacted is completely absent from prevailing market rates. Not surprisingly, the downward move in EUR rates was much more subdued than that in the US and UK.

Unlike the eurozone, the UK economy has been throwing out mixed messages over the past month with the reduction in inflation combined with some awful retail sales figures supporting the argument that the MPC should keep further rate hikes on hold. The bears would argue that there are latent inflationary pressures building up, as evidenced by the manufacturing PMI figures and continuing evidence that both retailers and manufacturers are confident of increasing their prices without meeting resistance.

We suspect that the MPC, if it had any doubts, will find last week's hiatus a good enough reason not to supply the market with a further shock. Furthermore, their neurosis over the potential for wage increases to spark inflationary pressures should have been relieved by the announcement of the 1.9% increase in the public sector. Unless there is a nasty shock arriving in the inflation figures next week, we would expect all those members of the MPC who voted to leave rates on hold last month will do so again, leaving Messrs Besley and Sentance continuing to vote for a rate hike.

New domestic economic data are thin on the ground this week with just the CIPS index for the service sector (today), the BRC retail sales monitor (tomorrow) and industrial production figures (Friday) being announced. None is likely to have much impact on the market. In any event, the market is likely to take its lead from a potentially very volatile US market where factory orders (Tuesday) and, particularly, the latest non-farm payroll figures (Friday) are major potential influences.

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