

## Weekly Bulletin – 18<sup>th</sup> August 2008

The rally in the debt markets continued last week as term rates in the USD, EUR and GBP markets all moved lower. The most marked move was in the GBP market where a dovish Bank of England Quarterly Inflation Report encouraged the markets into believing that the prospect of rate cuts might be advanced from the previous consensus of the 2<sup>nd</sup> quarter of next year. EUR and USD rates saw more modest reductions.

The tone of the Inflation Report and some of Mervyn King's subsequent comments have led some to believe that we may now see the MPC reducing its refinancing rate before the year is out. While there were warnings that inflation may hit 5.00% over the course of the next couple of months, and King noted that the risk for the inflation forecast was clearly on the upside, the forecast for future levels in the Report showed the CPI-targeted rate falling to below 2.00% within the next two years and moving decisively lower thereafter.

The market is now moving to a position where it believes that rate cuts will be forthcoming as soon as inflation peaks. Last week's figures showed July CPI at 4.4% which, while slightly higher than the median forecast, is largely irrelevant when the market is already discounting further hikes over the coming months. The big question has become guessing when the peak will be seen and how soon afterwards will the MPC have sufficient confidence that a reversal is sufficiently unlikely in order to begin cutting rates.

We feel that the optimists may be getting a bit ahead of themselves. While Mervyn King may have noted last week that he was not particularly concerned over wage pressures – a major change from his habitual position, but hardly surprising given the fall in average earnings to 3.4% in June from 3.8% the previous month – it has become clear that the MPC has been looking at the core inflation figure, which excludes energy and food costs, for guidance in setting monetary policy.

Last week's figures showed the core inflation figure moving up from 1.6% to 1.9%, making an increase of 0.6% in the last 5 months. Given that this index excludes most of the volatile price movements, this is quite an increase. The clear inference must be

that retailers are passing on an increasing proportion of their additional costs – i.e. the much feared 'second round' effect. It may be the case that consumer reluctance to spend may force the retailers to reverse this policy in order to achieve an acceptable level of sales, we suspect that the MPC may well want to see the core inflation index stabilise as well as the CPI measure starting to fall before loosening their current stance.

It was only just over two months ago that the 2 year swap rate was trading at 6.50%. It has now fallen to below 5.40%, a pretty remarkable rally given that there has been no movement in base rates to support it and that the ongoing dislocation in the money markets has seen the downward movement in 3 months Libor restrained to a miserly 16 bps. While we are very bullish on the prospect for lower rates over the course of the next year, the scope for rates to fall much further in the immediate future is probably limited and a short term reversal should not be discounted.

EUR rates benefited from the revision in June's inflation figure from 4.1% to 4.0%. This is hardly a major move, it has encouraged the market to believe that inflation has now peaked despite the comments from a couple of ECB members that there are still inflationary risks despite rapidly slowing economic growth. 2<sup>nd</sup> quarter GDP was confirmed as a fall of 0.2% last week, causing the year-on-year figure to fall from 1.5% from 2.1% in the first quarter. With growth expected to be weak in the third quarter, it would seem likely that the pressure on the ECB will turn from being the avoidance of any further rate hike to the prospect of rate cuts. However, with 3 month Euribor remaining at only a fraction under 5.00%, there is a limit to how far short and medium term rates might fall.

Economic data being released this week that may prove to be influential include: on Tuesday, the PPI figures in the US and the release of the latest ZEW survey in Germany; on Wednesday, the MPC minutes and M4 figures in the UK; and on Thursday, the PMI services and manufacturing surveys across the eurozone and July's retail sales figures in the UK.

**JCD Rathbone**

## Market Expectations

### Sub Heading Copy

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Date	Location	Title	Forecast	Previous Actual
<b>19/08/08</b>				
	<b>US</b>	July PPI m/m	+0.5%	+1.8%
		July Core PPI m/m	+0.2%	+0.2%
		July Housing Starts	+960,000	+1,066,000
<b>20/08/08</b>				
	<b>UK</b>	<b>Bank of England MPC minutes</b>		
		July M4 Lending	+£14bn	+£46.1bn
		July M4 m/m	+0.5%	+1.8%
		July M4 y/y	+10.7%	+11.4%
		July PSNCR Public Finances	-£9.0bn	+£15.5bn
		July PSNB Public Finances	-£4.3bn	+£9.2bn
<b>21/08/08</b>				
	<b>UK</b>	July Retail Sales m/m	-0.2%	-3.9%
		July Retail Sales y/y	+2.0%	+2.2%
	<b>EUR</b>	August PMI Services	+48.0	+48.3
		August PMI Manufacturing	+47.1	+47.4
		August PMI Composite	+47.7	+47.8
	<b>US</b>	July Leading Indicators	-0.2%	-0.1%
		August Philly Fed Survey	-15.0	-16.3
<b>22/08/08</b>				
	<b>UK</b>	June Index of Services 3m/3m	+0.4%	+0.4%
		Q2 GDP q/q	+0.2%	+0.2%
		Q2 GDP y/y	+1.6%	+1.6%

### STERLING INTEREST RATES

	31.12.07	11.08.08	18.08.08
1mth LIBOR	5.95	5.39	5.38
2mth LIBOR	6.00	5.59	5.57
3mth LIBOR	6.00	5.80	5.78
6mth LIBOR	5.95	5.98	5.94
12mth LIBOR	5.75	6.13	6.04

### Interest Rates Swaps Quarterly ACT/365

2 years	5.23	5.50	5.35
3 years	5.16	5.46	5.33
5 years	5.12	5.37	5.25
7 years	5.09	5.27	5.16
10 years	5.04	5.15	5.06
15 years	4.97	5.02	4.95
20 years	4.90	4.87	4.82
30 years	4.74	4.60	4.57

### EURO INTEREST RATES

	31.12.07	11.08.08	18.08.08
1mth EURO	4.29	4.49	4.49
2mth EURO	4.55	4.76	4.76
3mth EURO	4.69	4.97	4.96
6mth EURO	4.72	5.16	5.16
12mth EURO	4.77	5.34	5.32

### Interest Rates Swaps Quarterly ACT/360

2 years	4.42	4.66	4.57
3 years	4.41	4.57	4.46
5 years	4.43	4.51	4.41
7 years	4.49	4.53	4.43
10 years	4.59	4.62	4.52
15 years	4.72	4.77	4.65
20 years	4.77	4.80	4.69
30 years	4.75	4.74	4.64

### DOLLAR INTEREST RATES

	31.12.07	11.08.08	18.08.08
1mth	4.75	2.60	2.55
2mth	4.80	2.80	2.80
3mth	4.85	2.90	2.95
6mth	4.80	3.25	3.25
12mth	4.45	3.40	3.40

### Interest Rates Swaps Quarterly ACT/360

2 years	3.78	3.38	3.34
3 years	3.89	3.73	3.67
5 years	4.16	4.11	4.04
7 years	4.39	4.36	4.28
10 years	4.63	4.60	4.51
15 years	4.84	4.79	4.71
20 years	4.93	4.87	4.79
30 years	4.97	4.92	4.84

### PROPERTY DERIVATIVES

INDEX	TERM (years)	BID	OFFER
		FIXED RATES	
TOTAL RETURN	Dec 08	-13.75%	-13.00%
	Dec 09	-8.75%	-8.25%
	Dec 10	-3.75%	-3.25%
	Dec 11	-1.00%	-0.25%
	Dec 12	0.75%	1.75%

### STERLING RPI

	31.12.07	11.08.08	18.08.08
UK ZERO COUPON SWAPS			
5 year	2.86	3.34	3.32
10 years	3.16	3.73	3.70
15 years	3.39	3.82	3.81
20 years	3.46	3.86	3.90
25 years	3.54	3.91	3.94
30 years	3.51	3.90	3.90
Base Index	208.9	216.8	216.80

### EURO HICPXT

	31.12.07	11.08.08	18.08.08
EURO ZERO COUPON SWAPS			
5 year	2.41	2.46	2.49
10 years	2.42	2.59	2.58
15 years	2.45	2.64	2.64
20 years	2.47	2.67	2.67
25 years	2.49	2.69	2.69
30 years	2.51	2.70	2.71
Base Index	104.6	108.1	108.40

### FOREIGN EXCHANGE RATES

	31.12.07	11.08.08	18.08.08
£/US\$	1.9975	1.9234	1.8670
£/€	1.3576	1.2781	1.2659
€/£	0.7364	0.7827	0.7903
€/US\$	1.4711	1.5053	1.4752
US\$/YEN	112.03	109.92	110.26

All rates taken are based on offered side opening levels on the date of this bulletin.



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