



Upside Surprise on Inflation Cements Case for May Rate Rise

Recent events in the UK have cemented the case for an interest rate increase in May. The annual CPI rate of inflation shot above 3% in March, thus requiring Mervyn King to write a letter of explanation to Gordon Brown as to why inflation was more than 1% above target and, more importantly, outlining what he and his colleagues on the MPC intend to do about it. Meanwhile, the minutes of the April MPC meeting showed the hawks back in the driving seat.

CPI Now More Than 1% Above Target

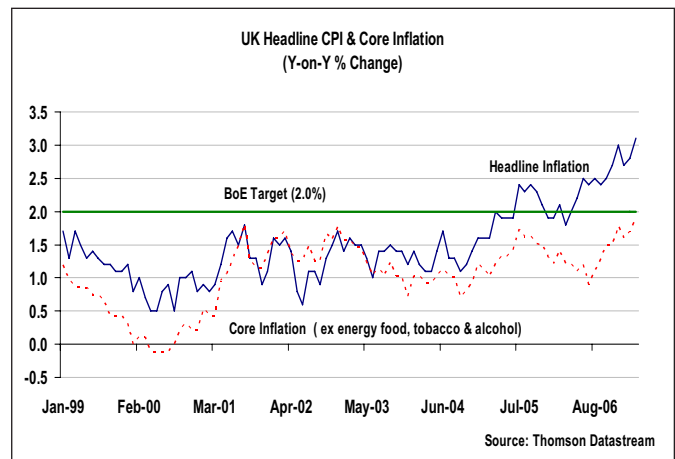
The headline year-on-year CPI rate rose to 3.1% in March, the highest level since comparable records began in 1997 and well above market expectations.

As well as higher petrol prices, rising food prices (a global phenomenon right now) accounted for the larger than expected rise in the CPI rate. However, **there was also evidence of a pick-up in underlying inflationary pressures.**

The annual core rate of inflation, which excludes volatile food and energy, as well as alcohol and tobacco, also rose by much more than expected, climbing to 1.9% from 1.7% previously. One of the main contributing factors here seems to have been the sharp rise in the cost of furniture. Meanwhile, the more traditional RPI rate of inflation climbed to 4.8% year-on-year, the highest rate since July 1991, when it was 5.5%.

Inflation still looks set to fall back over the balance of the year, and in his letter to the Chancellor, Mervyn King stated that at first sight the March data do not appear to alter the broad picture as outlined in the February Quarterly Inflation report. At the same time, however, **he also noted that some of the upside risks to inflation as identified by the MPC had begun to materialise and the Bank will do what is necessary to keep inflation on track.**

Although developments in terms of wage settlements continue to be relatively benign, **the bank appears to be increasingly concerned about the growing evidence of a build up in firms "pricing power".** Over recent months, official data for output prices as well as surveys (including one carried out by the BoE's own Regional Agents) regarding pricing intentions have confirmed that the pricing climate for businesses has become a little easier. Such developments could slow the reduction in the CPI rate.

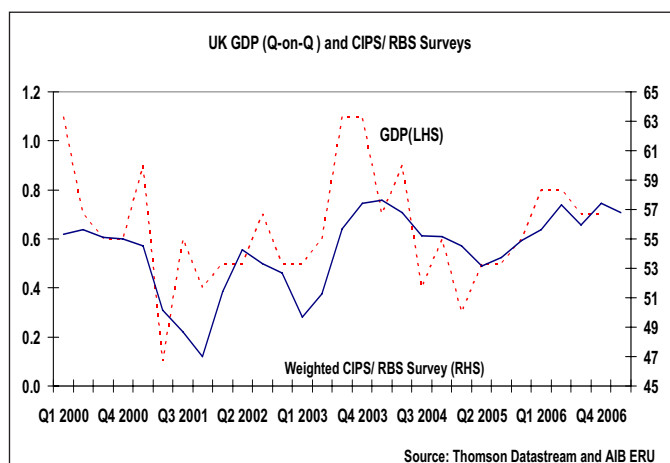


The hawks on the MPC certainly see the balance of risks to inflation remaining on the upside and it seems to be just a timing issue that prevented more than two committee members from voting for a rate hike in April. Some felt that, as markets were not expecting a rate hike in April, a move at that point could lead to an unwarranted upward shift in the yield curve. **It was also felt that any change in policy could be better explained in the context of the release of the May Inflation Report, further confirming the case for a rate hike next month.**

Activity Data Stay Strong

As well as the upside surprise on the inflation front, activity data continue to support the case for higher rates. The manufacturing CIPS index fell modestly to 54.4 in March but remains at levels consistent with continued expansion in activity going forward. New orders in particular remained at elevated levels.

The prices charged component of the manufacturing CIPS survey eased back a little but this only served to reverse some of the previous month's sharp increase. The index is still at levels consistent with output price inflation remaining strong in the coming months. Whether firms can make price increases stick will depend on the level of demand, which for now remains strong.

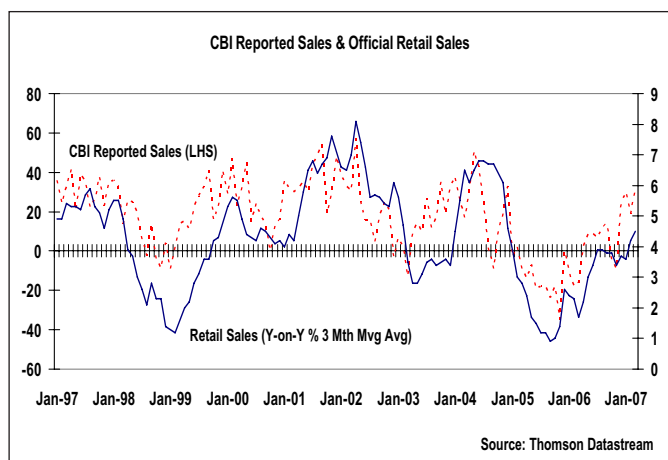


Meanwhile, the latest services CIPS survey confirmed that growth in this sector has slowed somewhat from Q4's robust rate but remains strong nonetheless. **Here too, there was evidence of a rise in pricing power, with the prices charged component of the index rising again. This index is now not far off historical highs.**

Consumers Still Willing to Spend

The latest retail sales data show that the underlying trend in terms of high street spending remains pretty solid. Retail sales were up 0.3% in March (which means that sales were up just 0.4% in Q1 compared to 1.4% in Q4 2006) but in year-on-year terms, volumes were up 4.8%.

Given its current focus, of particular interest to the Bank of England will be the news that the retail sales deflator rose from -0.3% year-on-year to +0.4% in March, its highest rate since last September. Meanwhile, the demand for consumer credit remains at elevated levels.



Leading indicators continue to suggest that higher interest rates are having only a limited dampening effect on housing market activity. According to most surveys, growth in house prices remains at double digit levels. Activity in the construction sector has been generally described as strong, with mild weather facilitating a pick up in output in March.



5.50% Should Represent the Peak in Rates

The release of the March CPI data not only affirmed the case for a rate hike in May but also caused markets to start pricing in a move in rates beyond the 5.50% level. Three month futures to December 2007 are currently at 5.87% and could rise even higher if data released over the coming weeks and months are on the strong side.

While we agree that the risks have moved in favour of additional policy tightening in the second half of the year, on balance we still feel that 5.50% should represent the peak of rates in this cycle.

	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.25	5.62	5.90	5.83	5.69
Jun '07	5.50	5.60	5.85	5.80	5.70
Sept '07	5.50	5.55	5.70	5.65	5.55
Dec '07	5.50	5.55	5.60	5.55	5.45

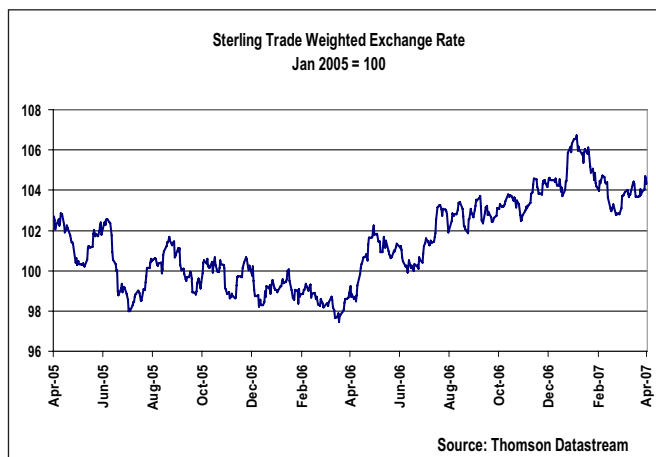
* Swap Forecasts Beyond 1 Year.
Current Rates Sourced From Reuters, Forecats AIB ERU

There should be a marked improvement in the inflation profile over the course of H2, with consensus forecasts showing a Q4 inflation rate of 1.9%. Meanwhile, activity levels are also forecast to cool over the balance of the year as higher interest rates and some deceleration in the global economy impact. **Much, however, will depend on the tone of forthcoming data.**

Sterling Rallies on Rise in Rate Expectations

Expectations that UK rates are to rise have certainly put sterling in the headlines, pushing it through the \$2 level versus the US dollar. Benefiting from the positive risk appetite environment and demand for higher yields, cable is trading at its highest level for 26 years. Concerns about the outlook for the US economy have also helped propel it higher.

The rise in the UK's expected interest rate advantage could keep sterling close to the \$2 level in the near term but we still expect it to weaken in the medium term.



Meanwhile, activity against the euro has been confined to a very tight range around the Stg0.677p level. Stg0.675 should offer support for the euro even if sterling rallies further versus the dollar. For full details of our exchange rate forecasts see our latest **Exchange Rate Monthly** on www.aibeconomicresearch.com.

23th April 2007