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Market Strategy

INVESTMENT RESEARCH

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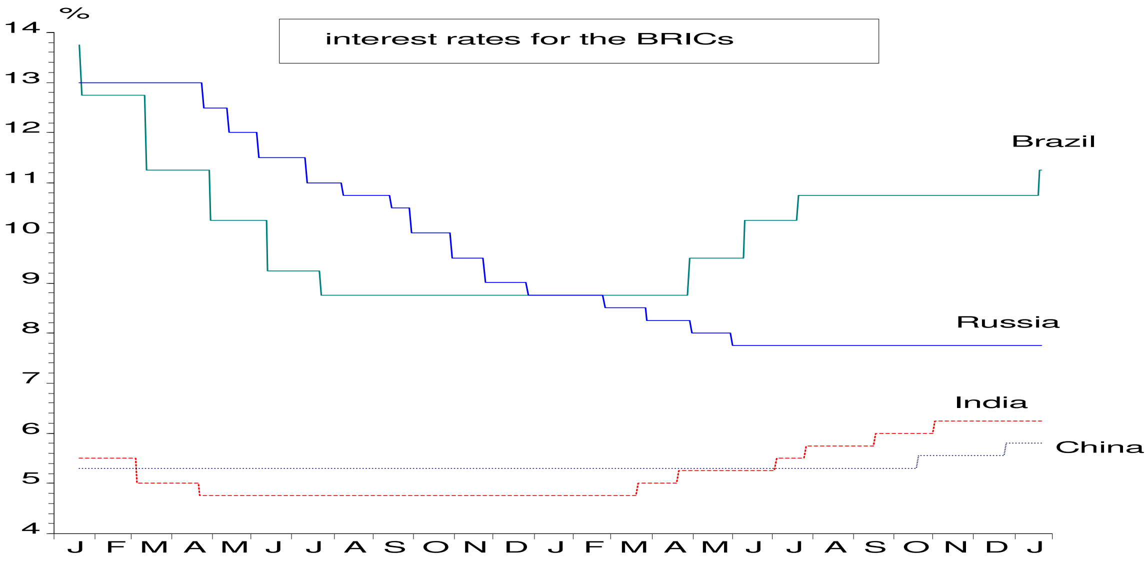
Interest rates are under upward pressure.



Source: DATASTREAM

Last week it was Brazil, this week India and next week, or the week after, China. Interest rates are continuing to rise in the developing world. The Reserve Bank of India meets tomorrow and a quarter point increase is expected.

Equity markets start the week with the US earnings season moving into full swing. Results are due for some 127 companies. By the end of the week over 40 percent of the S&P 500 will have reported. As always, the tide of market sentiment will ebb and flow with the profile attached to the companies reporting on the day but thus far the results have been good. Some 70 per cent have been better than expected.

Also, there is already a discernable pattern in the 'beat-to-misses' ratios with the cyclicals and techs doing better than the defensives and financials. For the banks, the disappointments have had more to do with their position taking (e.g., bond trading in the case of Goldman Sachs, mortgage business in the case of BofA) than anything else.

Better corporate news flow is something the FOMC will take heart from when it meets on Wednesday to review policy. While the pick up in the economy's underlying momentum should be reflected in a modest acceleration of fourth GDP growth to be reported on Friday, the better news flow for the cyclicals, which reflects that momentum too, is encouraging for employment. This won't alter the FOMC's message but the feature will probably be one among several influences on its thinking about whether to extend its QE programme. We think the Fed will see QE through to June and then call it quits.

Bond markets look vulnerable to more selling and the gilt market especially so where rising yields suggest that Andrew Sentence, the lone hawk on the MPC, will gain allies in the coming months.

January's MPC Minutes, released this week, might reveal a little more on this but if these do not, the next set probably will.

UK inflation is not only heading up but rising faster than expected. In addition, the US economy is looking stronger. In leading the developing world, China is still growing faster than expected. This sturdier international backdrop is welcome news for the UK in view of sterling's 'depreciation-enhanced' competitive position.

However, the UK economy is already growing at or slight above it long term average of 2.4 percent. GDP data for the final quarter of last year are released tomorrow. Growth of some 0.5 percent is expected. While this is not quite up to recent quarters it is still in keeping with the economy's long run growth rate if realized.

Combined with weather related supply shocks to commodity prices it all suggests that the UK's bout of inflationary pressure will persist and this sounds like a weaker gilt market to us.

Yields on bunds have risen sharply too, both at the short and long end of the market. Discussion underway to let the EFSF purchase of sovereign debt will not just relieve the ECB of having to do so but return to it the flexibility it wants in exercising judgment over policy.

Inflation is above target and rising. Core inflation remains tame, which is the way the ECB wishes it to stay, but if higher interest rates are required to ensure that higher commodity prices do not feed inflation expectations and core inflation itself, the ECB wants the latitude to respond accordingly.

Like we said at the outset, last week it was Brazil, this week India and next week, or the week after, China. In the developing world the UK and the eurozone are probably next. Certainly the case for emergency levels for interest rates no longer seems relevant.