



Monthly Market Outlook

November 2007

Overview

- Fed cuts rates as expected, but signals neutral stance on future rate cuts
- UK housing market slowing
- Eurozone inflation above the ECB's target

US

With the US Federal Reserve (Fed) cutting rates by 25 basis points (bps) to 4.5%, as widely expected on the last day of October, the tone of the accompanying statement gave a few clues to Fed policy in the coming months.

The second cut in successive months came following continued despair in the US housing sector and further subprime-related losses, as witnessed by the US\$8bn mortgage-related write down at Merrill Lynch. However, with growing anxiety over inflationary pressures from the soaring cost of crude oil and a plunging dollar, which drove the euro to a record US\$1.45 and the pound to a 26-year high of US\$2.08, the Fed sounded a warning to investors that "after this action, the upside risks to inflation roughly balance the downside risks to growth", suggesting it was shifting to a neutral stance on future rate cuts.

In the accompanying statement the Fed said that the cut, on top of the 50bps cut in September, should "help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruption in financial markets, and promote moderate growth over time". The committee left little doubt, however, about its quandary over conflicting pressures from the prospect of slowing growth coupled with rising inflationary pressures. Underlining these concerns, one Fed governor voted to leave rates unchanged, signalling that the Fed may be more hawkish than markets had hoped.

UK

The interest-rate increase signalled in August's Inflation Report seems increasingly unlikely. CPI inflation remains below the 2% target at 1.8% and RPI, which excludes mortgage interest payments, fell from 4.1% to 3.9% in September.

According to the Nationwide, the price of the average house rose by a seasonally adjusted 1.1% in October. However, the surprisingly strong rise in the Nationwide house price index is at odds with the growing evidence of weaker buyer confidence, slowing mortgage demand and easing house-price pressures shown by most other housing-market indicators.

September mortgage approvals have started to reflect tighter credit conditions in the market. The number of new mortgage approvals has fallen by 20% in September from a year earlier, according to Bank of England. In September, 102,000 new mortgages were approved for house buyers, 25,000 fewer than in September 2006, and 6,000 fewer than in August.

The Land Registry for England and Wales reported that annual property-price inflation had dropped from 9.4% year-on-year (y-o-y) in August, to 8.7% y-o-y in September. Publishing its annual housing-market forecasts, the Council of Mortgage Lenders (CML) said that house-price growth would slow down to just 1% for 2008, from an estimated 7% this year. It predicted that there would be a 15% decline in property sales during 2008, down to 1.01 million from an expected 1.17 million this year. The CML also forecast a 50% rise in the number of home repossessions in 2008.

The perception that there will be no change in UK interest rates has been strengthened by comments from Monetary Policy Committee (MPC) member Kate Barker, who recently stated that "we are asking ourselves if things are so different from August and do we actually have to cut rates?". In a separate speech,

Barker, seen as a swing voter on a divided MPC, said that she did not expect the turmoil in the financial markets to trigger weakness in the housing sector or business confidence, although she would be monitoring both measures closely in the months ahead. Her comments suggest that she is not ready to vote for a cut in interest rates, adding to the chances that rates will stay on hold.

Europe

The European Central Bank (ECB) also finds itself in the position of having previously signalled a further rate hike. Although at the last policy meeting ECB President Jean-Claude Trichet pointed out that the ECB retains a tightening bias, he also stated that "it remains necessary to gather additional information and examine new data before drawing further conclusions for monetary policy".

Some of the more hawkish ECB members have continued to warn that risks to eurozone inflation are still on the upside. Axel Weber went one step further and hinted that interest rates may yet need to increase, stating "medium-term risks to price stability define our need to act, and they have increased in the recent past".

Eurozone inflation, at 2.1%, has now moved above target for the first time in over a year. Most of the increase from the August rate of 1.7% was a result of a jump in energy contribution, and this was before the oil price hit a new record high. Food-price inflation is also likely to remain elevated. However, some of the increase will be offset by the unwinding of the German VAT increase that took effect in January 2007. Furthermore, the strength of the euro should help dampen goods-price inflation. The slight reduction in M3 money growth, from 11.6% to 11.0% y-o-y, is unlikely to ease the ECB's concerns about the inflationary impact of rapid growth in the money supply.

Although the recent fall in Germany's Ifo index, from 104.2 to 103.9, the lowest level since February 2006, was the fourth consecutive fall, the fall was not as sharp as was feared. While German business sentiment has now clearly passed its peak, the current level remains high on a historical basis.

Although a further hike remains a possibility, it is still too soon to judge the wider economic fallout of the subprime-related turmoil; as such the ECB is likely to hold rates for now.

Key Data & Events in the Month Ahead

| Date | Indicator/Event |
|--------|------------------------------------|
| 8-Nov | ECB Interest-Rate Announcement |
| 8-Nov | BoE Interest-Rate Announcement |
| 8-Nov | US Employment Report |
| 13-Nov | UK Consumer Prices |
| 14-Nov | BoE Quarterly Inflation Report |
| 15-Nov | Eurozone Consumer Prices |
| 19-Nov | NAHB US Housing Market Index |
| 21-Nov | UK MPC Minutes |
| 23-Nov | UK GDP (3rd quarter) |
| 28-Nov | German Ifo Business Climate Survey |

Source: Bloomberg

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