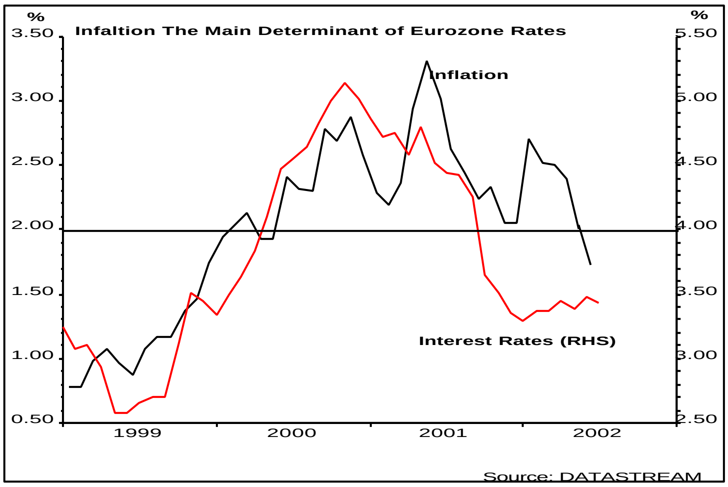
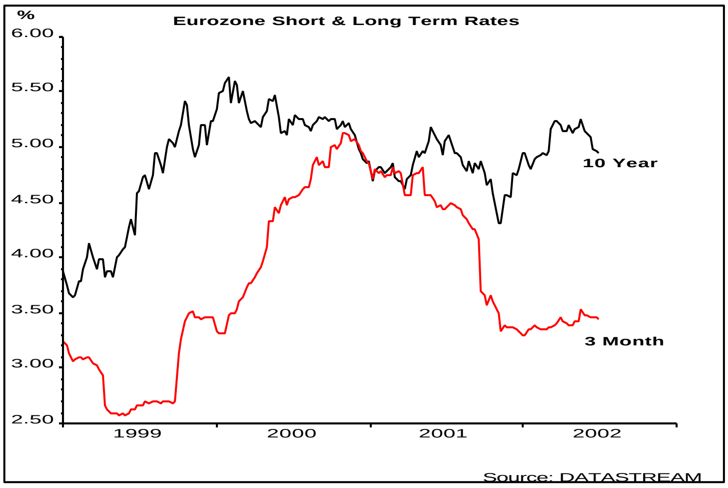
Its All a Matter of Timing

The governing councils of the ECB and the Bank of England both elected to leave interest rates unchanged at their respective policy meetings this week. Rates in the eurozone have been on hold at 3.25% since November of last year, while rates in the UK have been kept at 4.00%.





Recovery in Euro Buys ECB Some Time

Growth in the eurozone is still sluggish, particularly in Germany, and the pace of economic growth remains well below trend.

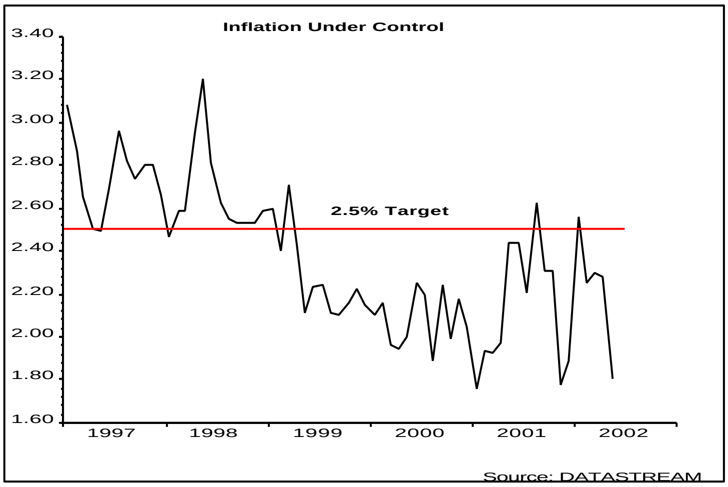
But inflation is the primary determinant of eurozone interest rates. Of late the ECB has become increasingly concerned about the inflation outlook. Inflation fell to 1.7% (provisional) in June but is expected to move back above the ECB's 2.0% ceiling in coming months.

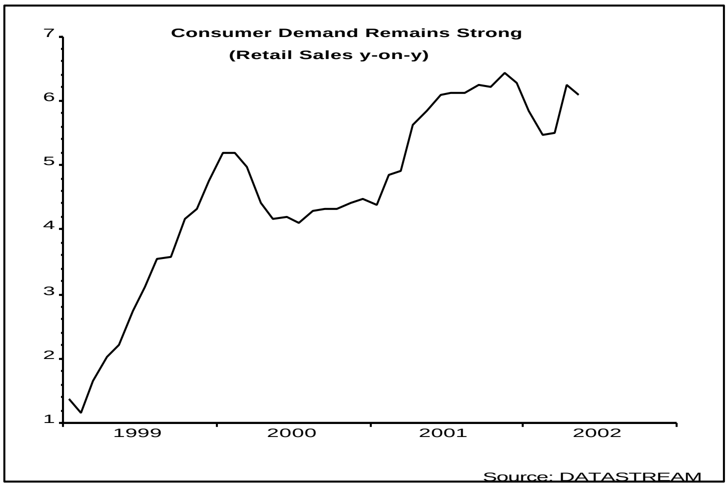
At yesterday's post policy meeting press conference, the ECB confirmed that its policy bias remains towards tightening. The current uncertainty in the global economy mitigates against an immediate rate rise. The recent improvement in the value of the euro is also providing some breathing space. However, the ECB still believes that the outlook for price stability in the medium term remains less satisfactory than it was a few months ago

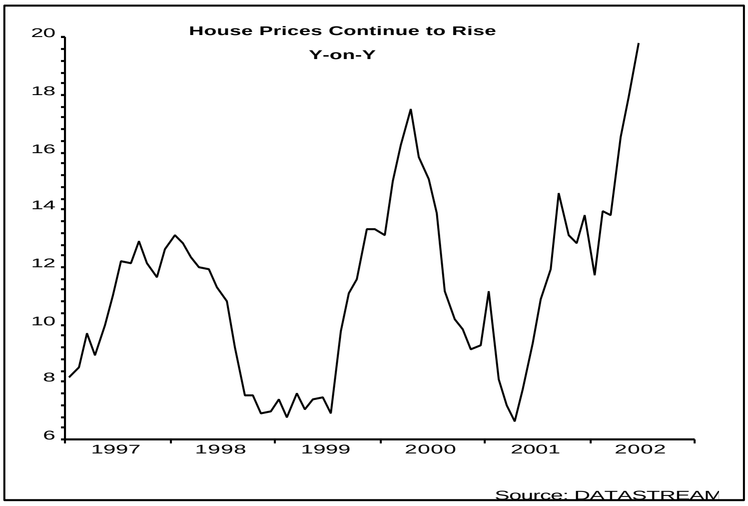
Our View....

A 0.25% rate hike seems likely by end Q3. A further 0.25% increase is possible by end 2002, taking the refi rate up to 3.75%. The market is also pricing in an end year refi rate of 3.75%. We expect the refi rate to be increased by a further 0.25% to 4% in H1 2003.

With the ECB expected to tighten rates in Q3 and US long-term rates likely to rise over the balance of the year, eurozone long-term rates should also trend upwards. Some 0.50% of tightening is already priced in but 10 year rates are still expected to trend back towards 5.50% by year end.







BoE Coming Under Pressure to Hike

A benign inflation environment is affording the Bank of England the opportunity to sit tight on rates at a time of huge uncertainty in global financial markets.

But monetary policy needs to tighten as domestic demand remains strong. Continuing strong growth in consumer spending, services and housing, as well as rapid growth in government spending do not point to an easing in domestic demand.

Recent data from the housing market argues strongly for an immediate hike in interest rates, with even mortgage lenders calling for a tightening. Both the Halifax and Nationwide reported another strong month of house price growth in June. The Halifax house price index rose 2.3% on the month to stand 19.3% above levels a year earlier, while the Nationwide saw a 3.3% monthly gain and 19.8% on the year. The house price earnings ratio is now comparable to the level seen in the late 1980s.

Our View....

We expected official interest rates in the UK to rise by 0.75% by year end, bringing the base rate to 4.75%, with the first rate hike expected in the next month or so. The minutes of the July meeting will offer a clearer insight with regard to the timing. The once highly inverted UK interest rate curve is now quite flat. With the central bank expected to start tightening interest rates in H2 2002 and into 2003 we would expect the 10 year rate to rise to 5.50/60%