

Market Overview – October 2010 to March 2011
(courtesy of Sector)

Quarter – October to December 2010

The quarter provided a marked change in sentiment as a more robust economic backdrop in the UK and overseas led market participants to reassess their views on interest rate prospects in the UK.

The lead up to the quarter had been dominated by signs of a slowdown in international growth and renewed Eurozone sovereign concerns, this time centred on Ireland. The economic background suggested that the surprising strength seen earlier in 2010 would not be sustained. Investors were of the view that there would be little pressure on the Bank of England to raise rates, despite inflation levels remaining above 3%.

The Bank of England continued to argue that the higher than expected rate of inflation was generated by temporary factors which would ebb away over their two-year time horizon forecast period. In addition, the Bank believed that there was sufficient spare capacity in the economy to absorb these pressures without having a material longer-term impact.

The Government held to its fiscal commitment in the October Comprehensive Spending Review. This outlined an austerity package totalling £81bn over the coming years.

However, from this point on, much of the domestic data suggested that the economy was faring better than expected. This included activity indicators that suggested the recovery still had reasonable momentum and spending data showing a continued recovery in tandem with better than expected consumer confidence figures. The data came on the back of third quarter growth figures which came in at twice the expected rate. Despite conditions in the labour market showing further deterioration and fresh house price falls, the domestic economic position seemed markedly improved as the quarter progressed. This also manifested itself in a series of surveys released in the latter stages of the period which showed consumer's inflation expectations had risen appreciably over the quarter as a whole. This has been highlighted as a key factor for some members of the Bank of England's Monetary Policy Committee (MPC) in their rate deliberations.

The encouraging economic background and rising inflation rates through the quarter dispelled almost all expectations that the Bank of England would embark on another round of Quantitative Easing, with the result that gilt prices (i.e. Government stock) fell during the quarter.

In money markets, the economic environment and especially growing inflation concerns were feeding through to the longer end of the curve. While short-dated yields showed little movement, further out, levels were being offered which had not been seen since late-Summer 2009 as forecasters reined in their expectations of when the MPC would act on rates

Quarter – January to March 2011

Financial markets produced a more mixed performance in the first quarter of 2011 following the rise in bond and money market yields in the previous quarter. On the domestic front the key deliberation for investors was the timing of the first interest rate rise from the Bank of England. However, international event also played a major role in market sentiment in this quarter.

The severe winter weather conditions through December were expected to have had a dampening effect on activity and this was confirmed when official figures were announced. The result was a short term spike in gilt prices during the latter stages of January and also a dip in longer dated money market yields as investors reassessed their profile for interest rate changes through 2011.

Although the growth data did see some reassessment of interest rate projections, markets soon reverted to the view that the drop was a blip rather than the start of a trend lower. The view was based on continued rising cost pressures, at both the consumer and wholesale level. This view was reinforced by MPC minutes which showed two members voting for a rate increase in January, rising to three members in February. Alongside these changes, the tone of the minutes implied that other members would change their view if subsequent data releases indicated that the economy bounced back from the winter.

However UK data for the remainder of the quarter suggested that the bounce back would not necessitate the MPC to begin raising rates. The view came despite a continuation of rising inflationary pressures on all fronts.

Adding to the government bond gains was the earthquake, tsunami and nuclear disaster which hit Japan in early March. The impact of the events saw a further shift in sentiment away from more “risky” assets to the benefit of government debt. Closer to home, Eurozone periphery concerns added to bond gains in February and March as Portugal joined Greece and Ireland in going to the EU/IMF for external financial assistance.

As the quarter drew to a close, gilts struggled to find any further gains and prices eased back from their overseas-related highs. Agreement in the Eurozone to expand the size of its Financial Stability Facility (EFSF) helped to soothe some investor concerns. In addition, after the initial switch to “safe havens”, investors gradually reversed their positions towards quarter-end. On the domestic front, the UK Budget proved of little interest by essentially reinforcing the Government’s position on tackling the debt burden. Of more interest was evidence from the Bank of England showing a rise in inflation expectations in the UK which left many investors believing that, despite the weak state of the economy, the MPC would still potentially look to raise rates in the near term. This view was also enhanced following the signal from the European Central Bank that it was to begin raising rates imminently in reaction to rising inflation in the Eurozone.