King holds court in Newcastle, but there's better news in Davos

THE MACRO VIEW

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Put shock 0.5% drop in GDP figures behind us

It's the PMI numbers that matter to the market now

The UK market had one eye on domestic affairs last week and the other on whether anything of importance would emerge from the great and the good, and the bankers, attending the World Economic Forum in Davos.

On the domestic front, the main influences on the market were the initial estimate of GDP for the fourth quarter and the release of the latest Monetary Policy Committee minutes.

The main shock to the market was the news that GDP fell by 0.5% in the final quarter of last year.

This compared with a median expectation of a rise of a similar amount.

It would appear that the economists had forgotten about the appalling weather we suffered in December and the impact it would have on GDP.

Their excuse is that it had not shown up on business surveys they use to produce their forecasts, although one would have thought that the huge reduction in retail sales figures immediately before Christmas might have given them a clue.

It would appear that if one dropped a whole day's economic activity it would have a 1% impact on the index.

Hence, the variation from the expected outcome only reflects a day lost to the weather – given that Scotland was largely closed down for a week and Heathrow for four days, this would not seem an unrealistic result.

Whether the result is just weather-related should be evident in the next set of quarterly figures, which should benefit from a catch-up rebound.

In any event, the debt market, having initially seen a sharp rally, soon gave up its gains and reverted to previous levels.

The mood of the market was not helped by the release of the minutes of the last MPC meeting, which showed that Martin Weale had voted for a 0.25% rise in base rates, thus ending Andrew Sentance's long period of isolation in voting for a rate hike.

Furthermore, a couple of other members showed clear concern over rising inflation. Adam Posen continued to favour going in the other direction by initiating a further bout of quantitative easing.

What was more interesting was that Mervyn King seemed to imply that the reduction in GDP justified the MPC's stance in holding base rates at 0.50%.

King was not at Davos, but in a speech in Newcastle he predicted that inflation would soon rise to between 4% and 5%. The result was to further concern the markets about the MPC's laissez-faire attitude towards controlling inflation, with the inevitable consequence for the pound.

While the governor of the Bank of England may have decided to avoid the Davos gathering, the chancellor and the prime minister did attend.

The noises coming back from the chancellor, particularly after the announcement of the GDP figures, were pretty defensive. This was in stark contrast with the overall tone of the conference, which was wallowing in the prospect of a strong economic recovery and, for the most part, a growing conviction that the eurozone was starting to get the problems of the periphery countries under control.

It may have come as a surprise to him, but the chancellor's boasts over curbing the deficit did not meet with any great applause.

Indeed, George Osborne spent some time exhorting UK corporates to stop hoarding cash and start investing.

However, with the International Monetary Fund publishing a bullish forecast for global economic growth, UK corporates are more likely to be placing their investments outside the UK, and a vague promise to improve the tax structure to promote business in the UK is hardly likely to be taken as much encouragement to do otherwise.

One other prediction of the IMF report is that non-oil commodity prices are likely to rise by 11% this year – not a prediction that will comfort the MPC.

Another encouraging message, other than to the UK, was the first bond issuance by the European financial stability facility. Admittedly it was for only €5bn, but it was oversubscribed by nearly 10 times.

The issue level was only 6 bps above the mid swap rate and 56 bps above the German bund yield. This was regarded as a strong result, although it would not be difficult to see the spread against bunds decreasing further if, and it is a big if, the sentiment of support for the periphery countries continues to improve.

Most of the economic news this coming week will revolve around the PMI surveys, with the manufacturing index due on Tuesday and the service sector index on Thursday.

In the UK, the latest lending and mortgage approval data will be released on Tuesday, as will the latest Nationwide house price survey.

Domestically, the PMI surveys will be analysed closely following last week's shock GDP result, but the really influential statistics will come from the USA, with the latest non-farm payroll figures bringing the week to a close.

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↑Bank of England governor Mervyn King says inflation will soon be between 4% and 5%