

STEVEN BELL DISCUSSES THE PMI FOR SERVICES AND HOW IT CAN BE USED TO INDICATE ANY POTENTIAL INTEREST RATE MOVES BY THE CENTRAL BANKS IN THE UK, EUROPE AND THE US.

Central bank watch

In the April issue of *The Treasurer*, (*Watching the old lady of Threadneedle Street*, page 6), attention was drawn to the close link between a particular economic statistic and monetary policy in the UK, Europe and the US. It highlighted how the Purchasing Managers' Index for Services (PMI) indicator was pushing into tightening territory for the UK and the US and the only question was 'when would interest rates rise and by how much?' Meanwhile, the European Central Bank (ECB) was locked in the 'no-go' area. Since then, rates have risen in the UK and the US, while the ECB has put any change on hold.

The current outlook, however, is radically different. The PMI indicator has shifted into rate cutting territory for the ECB (see Figure 1) and looks to be heading the same way for the UK. Meanwhile, it suggests that the US Federal Reserve will remain in tightening mode (See Figure 2).

In the UK, base rates have tended to rise only when the PMI indicator has exceeded 56.8 and vice versa (see Figure 3). When the Bank of England's Monetary Policy Committee (MPC) started to increase rates a year ago the index was close to 60, well above the critical value. Over the summer the gap closed, reflecting the impact of the sudden slowdown in the UK housing market. This weakness seems to be intensifying and is likely to push the PMI indicator below 55 over the next few months. Sterling is also tending to weaken.

Provided it does not fall more than 5% or so from current levels we can expect the MPC to cut rates. My own forecast is that the first cut will occur in January and that there could be a decline to 4% in the first half of 2005.

In Europe the ECB has a particularly large 'no-go' area in terms of the PMI Index for the euro zone. This makes the indicator all the more valuable. The ECB has been on hold with unchanged rates throughout this year. In that sense the PMI for Europe did its job and indicated there would be no change in interest rates. In July it briefly entered into rate hike territory but since then has moved steadily to the left of the chart. With the euro strengthening and the world economy getting the jitters, it seems likely that the PMI for Services for the euro zone will edge lower. Therefore, the question is whether, when and by how much the ECB will cut interest rates. The market is discounting an interest rate increase by the ECB and the weakness of the world economy in the last few weeks has merely caused it to push the date of any increase towards late spring 2005; many had predicted a rate rise by the end of this year. Despite the low level of European rates it seems sensible for corporate treasurers to expect euro short-term interest rates to lie below the curve

with a further rally in swap rates. My advice would be to go long but watch this PMI for services figure and if it starts improving significantly, consider turning bearish.

In the US, there is also a 'no-go' area but the indicator has

Executive summary

- The PMI for Services indicator is a useful guide to measuring potential interest rate moves that could be made by a central bank.
- The US Fed would prefer inflation to rise in order to remove risk of deflation in the event of a new recession. There is enough slack in the US economy to indicate growth of 5% without inflation.
- Despite low European rates, corporate treasurers should expect euro short-term interest rates to stay below the curve.
- The slowdown in the UK housing market is likely to push the PMI for Services Index below 55.

Things to consider when using PMI for Services to watch central banks

PMI for Services is a useful guide for central bank watching, although central banks do not react solely to PMI for Services.

The PMI tells you what the direction of monetary policy changes will be, even if it does not tell you the direction of a particular move in any particular month. Neither does it tell you the extent of any change. To predict this, you will need to rely on the full range of influences of various central banks.

The PMI Services Index approach is also useful as a form of risk analysis. Former TUC General Secretary, Len Murray, once wrote to the Chancellor of the Exchequer, Denis Healy, in 1975, asking 'What risk would you rather take? Raise interest rates now and risk recession or keep them on hold and take the modest risk of inflation rising?'

That may well have been disastrous advice during the mid-1970s when inflation was high and volatile, but it would be good advice today.

'THERE IS STILL SOME SLACK IN THE ECONOMY AND A REASONABLE GUESS IS THAT THE US COULD GROW BY 5% OVER THE NEXT FOUR QUARTERS WITHOUT MOVING INTO INFLATION TERRITORY'

been well above the critical value, despite weaker than expected growth and employment data. High oil prices seem to be weakening growth rather than raising inflation. With the latter so low, one might question whether the Federal Open Market Committee (FOMC) should be raising rates at all. But the level of the PMI suggests that they will continue with their policy of tightening at a moderate pace.

In the UK, inflation has been below the new Consumer Prices Index (CPI) target ever since it was introduced. Were it not for rising oil prices, Governor of the Bank of England, Mervin King, would have had to write the first Governor's letter to the Chancellor of the Exchequer explaining why inflation had fallen more than 1% below the target. Having achieved his goal of slowing the UK housing market, he must be afraid that the dream will turn into a nightmare if the market keeps on declining. There is always the question of sterling weakness, something that so often wrecked monetary policy before the Bank became independent. A 5% or 10% decline in sterling from here would cause the Bank of England to keep on hold at least for a while. But I still think base rates will head lower.

We can apply a similar analysis to the US, where there is no explicit inflation target but the Federal Reserve has made it clear that it would prefer inflation to rise a little from current levels in order to remove completely the risk of deflation when the economy suffers its next recession.

Economic models tend to work better stateside than they do in many other countries and the evidence clearly suggests that there is still some slack in the economy and a reasonable guess is that the US could grow by 5% over the next four quarters without moving into inflation territory. This seems highly unlikely in the current economic environment and therefore an aggressive tightening from the Fed does not seem to be plausible. Indeed it could pass at the next two meetings – a more dovish outlook than the current market consensus.

Finally, the ECB faces more difficulties. Despite disappointing growth this year, inflation has failed to decline and the strength of the euro already threatens to further weaken the manufacturing sector. The ECB is the least active of the major central banks (though it makes up for this by being more likely to move in steps of 50bps points). It is also the youngest and least transparent of the central banks considered here. I would simply focus on the PMI index and bet on a 25bps cut at some stage.

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Figure 1. Euro zone PMI Services and the ECB Refi rate

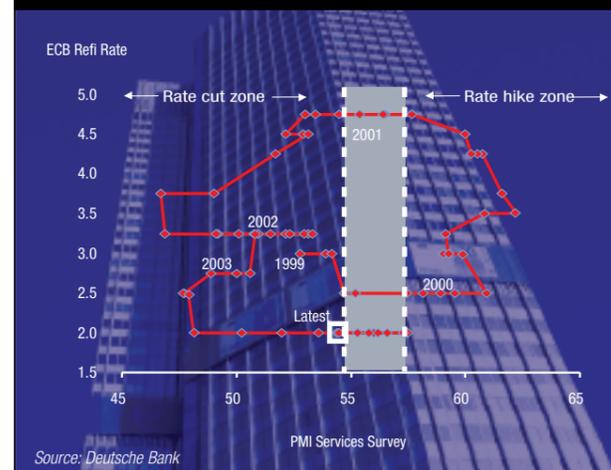


Figure 2. US PMI Services and Fed Funds' rate

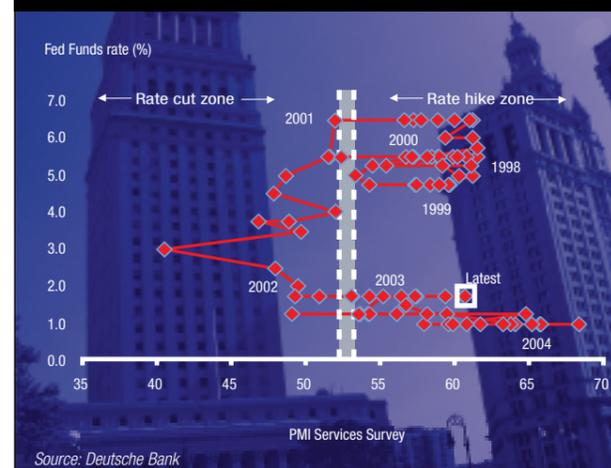


Figure 3. UK PMI Services and base rates

