Financial markets are too pessimistic

The financial markets are now expecting base rates to rise 0.5% by the end of the year. This is wrong. Official rates will continue to fall. Pessimism in the financial markets is not new, but the current deterioration in sentiment is remarkable. Only two weeks ago the Chancellor shaved another quarter point off base rates in a move that was widely welcomed.

This latest deterioration in interest rate expectations highlights two things. First, it illustrates the extent to which global economies have become integrated. Misplaced fears that US interest rates will rise is the main reason for the latest deterioration in UK interest rate expectations.

Second, it reflects deep scepticism among many in the financial markets that inflation will remain low. The belief is that inflation is around the corner and thus interest rates will rise.

Both factors are related. The UK has enjoyed a similar economic cycle to the US. These economies have experienced modest recoveries, with low inflation. Firms have continued to downsize, cut costs and become more efficient. One consequence of this has been that most people have remained concerned about sluggish wage growth and increased job insecurity. Just as the UK authorities have cut interest rates gradually, and often against the wishes of the markets, so too has the US Federal Reserve.

Interest rates in both the US and UK are lower than in recent economic cycles. This has made many people nervous. And inflation looks to remain low.

However, news that US non-farm payrolls rose by 705,000 in February was sufficient to trigger fears that the US economy was growing so strongly inflation would follow. The US bond market has weakened and the US stock market looks vulnerable. These jitters have spread to the UK.

Yet the US jobs data is not as strong as many suggest. The rebound follows a big fall in January when bad weather affected the economy. In the first two months of this year, the payrolls rose by exactly the same amount as at a similar stage of last year, which was hardly a time of buoyant US growth. Moreover, the household survey in the US, which provides another snapshot of the US labour market, shows that in February 706,000 part-time jobs were created but 521,000 full-time jobs were lost. This is hardly indicative of the booming growth people have been fearing for the last week. Rather it suggests more of the same in terms of a modest recovery, with firms still downsizing and cost-cutting, and a shift in the labour market towards more service sector and part-time jobs. This is consistent with steady but not unsustainable growth.

But the uncertainty generated by the latest data and the subsequent volatility of the markets suggest that the Federal Reserve Board will not be able to cut US rates at its next policy meeting on 26 March. However, a rate cut by the summer remains a strong possibility, particularly as inflation will remain low.

But this pause in the US could delay rate cuts in Europe. During the last week two Bundesbank Council members have hinted that lower German interest rates could be delayed by the rise in German bond yields triggered by the US data. It is in this environment that the UK markets are now expecting a 0.5% base rate rise by Christmas.

Two factors suggest these fears will not materialise. First, interest rates on the continent are still likely to fall. Weak growth, low inflation and tight fiscal stances mean that interest rates will have to act as the shock absorber for the European economy. This is particularly the case in Germany, the locomotive of European growth, and as German interest rates fall so, too, will interest rates elsewhere in Europe. This will be particularly necessary among countries seeking to achieve the Maastricht convergence criteria.

Second, despite its improved performance, the UK economy still faces downside risks in coming months, as companies at home reduce their excess inventories of unsold goods and exporters face a slowdown in European markets. February's rise in unemployment is indicative of this slowdown. This will restrain growth. With low inflation persisting, the Chancellor will have both the room and the need to cut official rates.

Although the Bank of England and the Chancellor cannot ignore what the markets are saying, I think they can afford to turn a blind eye. For much of the last year, financial markets around the globe have been too pessimistic about inflation and other interest rates. They are, once again, too pessimistic now. Inflation will remain low and official rates should fall. Expect base rates to fall to 5.5% by the summer. And don't rule out a cut to 5% before Christmas.

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Despite the pessimism of the financial markets, low inflation will allow interest rates to fall, says Gerard Lyons.