

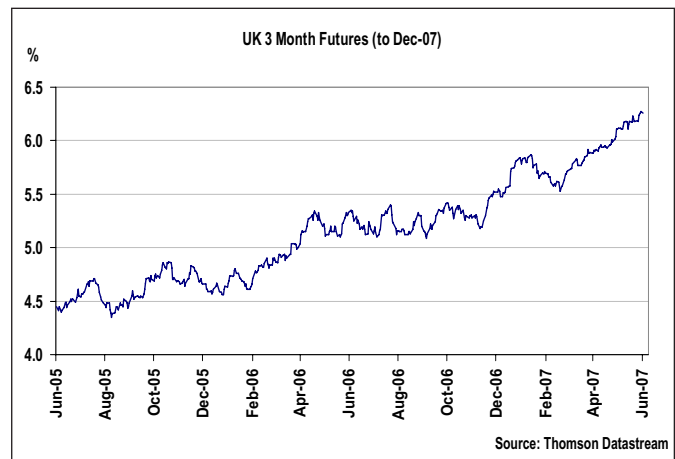
Hawkish June Minutes Point to July Rate Hike

The Bank of England meets next week amid intense speculation that UK rates will be raised by a further 0.25% to 5.75%. The hawkish tone to the minutes of the June policy meeting also means that the market has now fully priced in a Bank Rate of 6.00% by year end. Indeed, there is increasing speculation that rates could even move beyond this level.

Majority Take Wait and See Approach

UK monetary policy was left on hold in June but only by the slimmest of majorities, with the MPC voting 5-4 in favour of steady rates. For those voting against a rate hike, the main debate seemed to over the timing of a move rather than over the need for one.

The majority felt that the rise in market rates over the past month had already provided a degree of tightening and there were some concerns that an unexpected rate move would lead to an unwarranted rise in yield curve.



But Hawks Saw No Reason to Wait

In the case of the hawks (including Mervyn King) though, there was no compelling reason to wait. In their view, growth needed to slow for inflation to hit its target in the medium term and it was not clear how this was going to happen without a further rise in official rates. Moreover, by raising rates now, the peak in rates could eventually be lower.

At the time of the June meeting, the economy was expanding at a robust pace, growth in monetary aggregates remained strong, inflation expectations were high and there was continued evidence of increased pricing power. **Not much seems to have changed since then. GDP data released later this week are expected to confirm that the economy grew by 0.7% in Q1 with leading indicators suggesting a similar growth rate for Q2.**

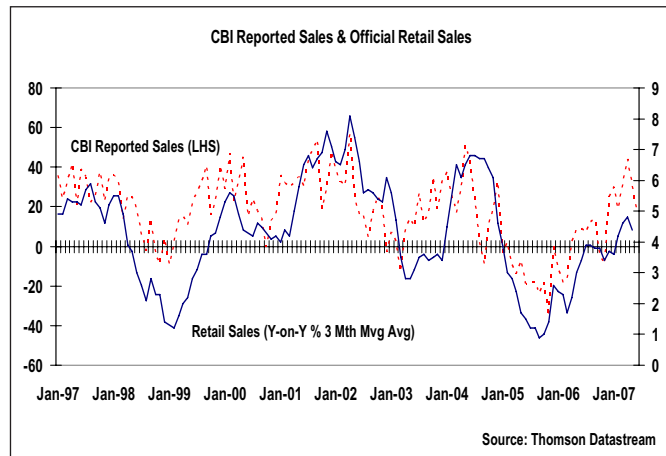
The CIPS/RBS manufacturing survey rose to 54.9 in May, its highest level since February. A rise in the stock of finished goods helped to offset a modest fall in new and export orders but the employment and input prices components were also strong.

May's report on the services sector showed business activity at high levels, with the headline index at 57.2, consistent with growth of 0.8%. Meanwhile, as reported by the latest BoE Agents survey, capacity constraints in both sectors remain high.

Pace of Consumer Spending Still Strong

Anecdotal evidence suggests that the pace of consumer spending could be slowing. Tesco recently warned of a slowdown in non-food sales as the consumer environment becomes more cautious, while the BoE's Agents are reporting early signs of an easing in discretionary spending. A report by Ernst & Young also talked about monthly discretionary income in the UK being at its lowest level for 5 years. The CBI distributive trades survey for June also disappointed.

In terms of official data though, higher interest rates appear to be having little impact, with retail sales up a solid 0.4% in May. The year-on-year growth in sales did decelerate to 3.9% from 4.2% but with consumer confidence hitting a two year high in the same month, it may be some time yet before we get a clear downturn in spending.



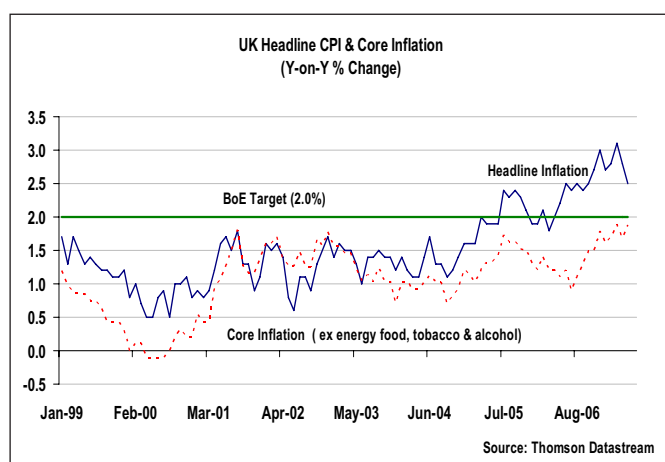
There are tentative signs of a slowing in housing activity, with the number of mortgage approvals falling for the third month in a row in April and further reports of a fall off in buyer interest. However, house price inflation still remains high, with the year-on-year pace in prices in all surveys still well above where it was this time last year.

CPI Continues to Trend Lower

Turning to the inflation picture, the headline CPI rate has been on a downward trend since March's reading of 3.1%, falling back to 2.8% in April and 2.5% in May.

The CPI rate is expected to continue trending lower over the coming months as positive base effects impact, though the near term outlook has deteriorated a bit due to the recent trend in energy prices.

The news on wage settlements also continues to be positive, with annual growth in average earnings at 3.5% (ex bonuses) in April, well below the MPC's comfort level of 4.5%.



However, with the RPI (the reference point for wage negotiations) currently at 4.3%, the BoE cannot afford to relax, particularly as its own survey of inflation expectations remained at elevated levels in May.

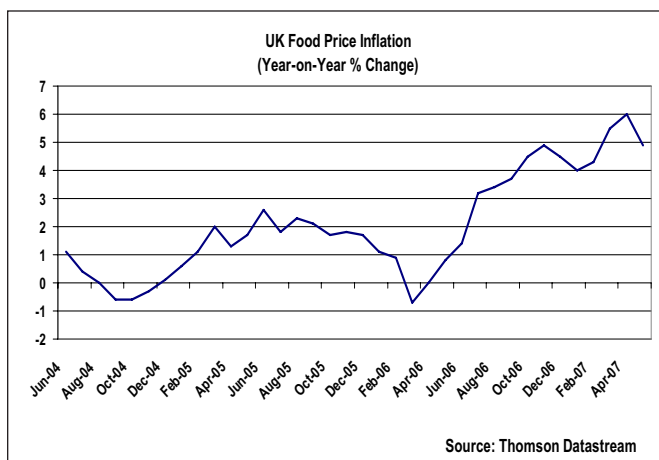
Furthermore, underlying inflationary pressures appear to remain strong. Core inflation (CPI measure) picked up a little again in May, rising to 1.9% from 1.7% previously, largely due to a sharp rise in airfares. Furthermore, the cost of household goods/furniture rose again.



While the rate of food price inflation eased back a little in May it remains high at 5.0% year-on-year. Given global supply developments, relatively high food prices could continue to exert upward pressure on inflation over the coming months.

This could offset to some extent the positive impact of year-on-year energy price developments and thus slow the rate of deceleration in the headline CPI.

Goods inflation on the high street has also risen sharply, as evidenced by the retail sales deflator.



Surveys Continue to Suggest Pick Up In Pricing Power

However, top of the list in terms of worries for the MPC right now is the evidence of a build up in “pricing power”. Over recent months, official data and surveys have confirmed that the pricing climate for businesses is more favourable, with companies looking to rebuild margins on the back of strong demand conditions. Some of these surveys turned a little more positive over the past month (notably those from the services sector) but the majority remain at elevated levels.

In its recent Quarterly Inflation Report the MPC commented that surveys were providing “corroborative evidence of continued pressures of demand on supply” and overall they “point to a possible upside risk to inflation”. Thus, if these adverse pricing developments are maintained, they could well slow the reduction in the headline CPI rate.

Move to 5.75% Seen in July

Thus, with overall economic activity remaining at robust levels, and the risks to inflation continuing to be skewed to the upside, a rate hike in July looks pretty certain and, indeed, has been fully priced in by the market.

The market then expects another 0.25% increase to 6.0% before year end. However, policy could well be put on hold at 5.75%, as the BoE takes time out to assess the impact of its monetary tightening.

	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.50	5.95	6.30	6.23	6.14
Sept '07	5.75	5.90	6.25	6.25	6.20
Dec '07	5.75	5.85	6.20	6.10	6.10
Mar '08	5.75	5.85	6.10	6.00	6.00

* Swap Forecasts Beyond 1 Year.
Current Rates Sourced From Reuters, Forecasts AIB ERU

27th June 2007