



Market Turmoil Clouds Outlook for Rates

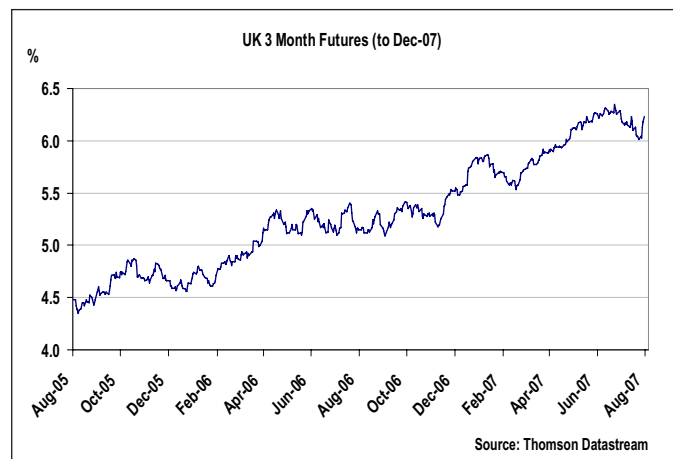
The Bank of England's Quarterly Inflation report, released on 8 August, sent a strong signal to financial markets that the repo rate would be raised by another 0.25%. Events since then have left the outlook for monetary policy a lot more uncertain but we still see expect a move to 6.00% by year end.

Inflation Report Pointed to Higher Rates

On the face of it, the August Quarterly Inflation Report appeared quite dovish, suggesting that rates were close to their peak. The MPC acknowledged that the economy would slow over time, citing evidence that consumer spending and the housing market were already starting to cool. Meanwhile, its central projection for inflation envisaged a move to below the 2% target over the medium term.

However, this forecast for inflation to hit its target over the medium term was based on market expectations for higher interest rates. Furthermore, the CPI projection, based on unchanged interest rates, showed inflation remaining above target over the forecast period.

So, at least one more rate hike before year end seemed like a done deal. However, as the month progressed, the interest rate outlook became increasingly uncertain.



Sharp Fall in Inflation in July

The sharp fall in the (CPI) inflation rate in July suggested that another rate hike may not be required after all. The headline CPI rate fell from 2.4% to 1.9%, the first time since March 2006 that it has been below the MPC's target of 2%. Lower food and energy prices helped pull the headline rate lower.

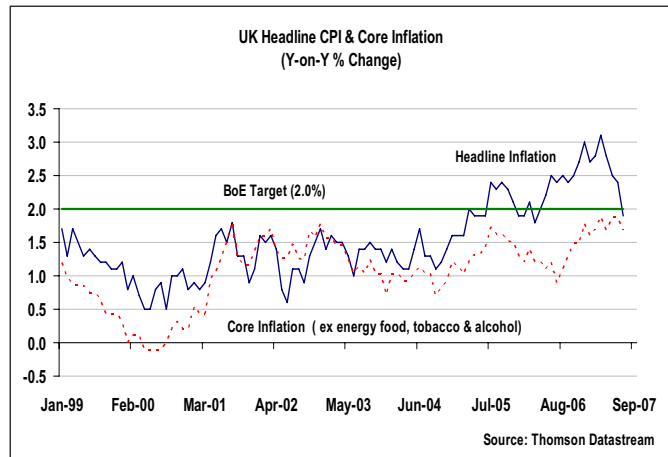
There was also an impressive drop in core inflation (excludes food, energy, alcohol and tobacco) from 2.0% to 1.7%, its lowest level since February. The drop was mainly due to a 10% monthly fall in furniture prices, reversing the upward trend of recent months.

Inflation could go back above target again over the coming months as energy base effects become less favourable and flood plus foot and mouth effects push food prices back up. Still, the positive July inflation report could go some way towards easing the MPC's concerns about households' inflation expectations.

Minutes of August Meeting Also More Dovish Than Anticipated

The release of the minutes of the August policy meeting also raised questions about the need for further policy tightening. All nine MPC members voted to leave rates on hold, with the tone of discussions appearing on the dovish side.

There was a range of views about the risks to growth and inflation, leaving the future path of rates dependent on the evidence as to whether and how these risks were crystallising. However, "most members emphasised that they had no firm view on whether rates would need to rise further".



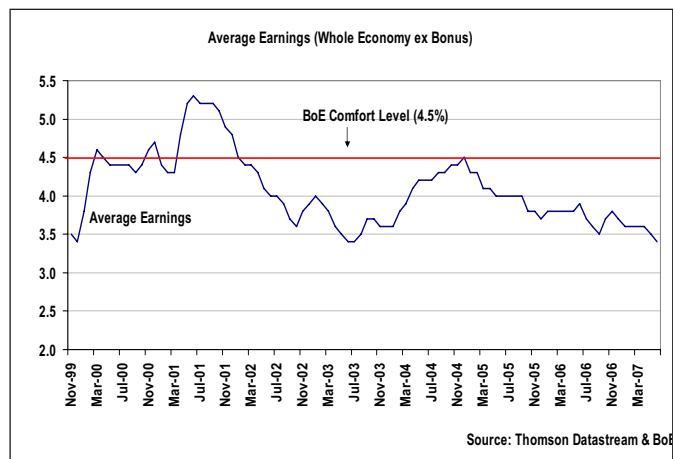
This more relaxed outlook seemed to be backed up by the BoE's Agents Report for August. While capacity constraints were once again reported as high, there was a softer tone to the report than seen for some months, particularly in relation to consumer spending. Housing market conditions were also reported as weaker.

The news on the prices side was mixed. The Agents reported that manufacturers continued to rebuild margins, as reflected in the July index for pre-tax profitability. However, those businesses surveyed didn't seem overly concerned about the possibility of sharp increase in the price of some food products as it was felt that the "fierce competition" between major supermarkets would help keep prices under control. Also non-food price inflation was expected to fall as retailers looked to avoid holding excess stock, given the recent slowdown in retail sales growth.

Labour Data and Market Turmoil Also Dampened Rate Expectations

The latest labour market data also argued for no rate change. The pace of annual growth in average earnings currently stands at a very subdued 3.3%, despite the fall in the unemployment rate. Thus, while the MPC may still have concerns about underlying inflation, there seems to be little evidence of any build up in wage pressures.

Finally, the recent turmoil on global credit, money and equity markets resulted in growing expectations that a number of central banks, including the BoE, would either loosen policy or no longer hike rates, in an attempt to support financial markets.



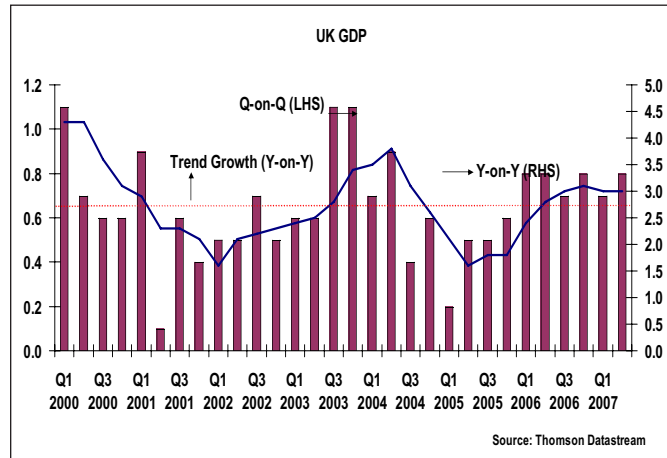
Fundamentals Back in Vogue as Markets Settle

It now seems, however, that financial markets could be over the worst, following the positive response to the Federal Reserve's decision to cut the discount rate. From a low of 6.01% on 17th August, 3 month UK interest rate futures to Dec-2007 have bounced all the way back to 6.24%, pretty much in line with where they closed on the 8th August, after the Quarterly Inflation Report was released, indicating that markets have priced a rate hike back in again.



If market conditions are indeed settling then central banks can turn their attention back to fundamentals. In this regard, last week's revised Q2 GDP data showed that there is still plenty of momentum in the economy, suggesting that the case for a further interest rate increase probably still stands.

Underpinned by strong growth in personal consumption, the economy grew by 0.8% in Q2 or 3.0% in year-on-year terms. This marks the fifth consecutive quarter of above trend growth. **Growth in nominal GDP was 6.9%, the strongest pace of growth since Q3 1990. Moreover, the GDP deflator was 3.8%, the biggest year-on-year rise since Q3 1996.**



Economy Still Has Plenty of Momentum

The dependency on the consumer sector does leave the economy vulnerable over the medium terms, particularly against a background of tighter credit conditions. However, it still entered Q3 with plenty of momentum.

The manufacturing PMI hit a three year high in July, with the price balance at record levels. The CBI industrial trends survey for August also revealed a strengthening in both activity and price pressures.

The services PMI did dip in July, indicating that activity in this sector is cooling. However, the slowdown may not be quick enough or sharp enough to prevent another rate rise.

Meanwhile, despite growing anecdotal evidence of a slowdown in activity, official data indicate that the housing market is holding up reasonably well, as too is the labour market.

This suggests that consumer spending could remain strong for the foreseeable future.

UK Interest Rate Forecasts					
	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.75	6.50	6.61	6.19	5.95
Sept '07	5.75	6.00	6.20	6.20	6.10
Dec '07	6.00	6.25	6.30	6.30	6.00
Mar '08	6.00	6.25	6.30	6.30	5.90

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

So, despite a cumulative official rate rise of 1.25% since August of last year, growth is still above trend. Indeed, the MPC believes that official data are understating the pace of GDP growth and estimates that it could be as high as 3.5%. The MPC also believes that inflation expectations remain high. Furthermore, strong growth in monetary aggregates suggests additional upside medium-term risks to inflation. Thus, the risks are biased towards the MPC tightening again.

28th August 2007