



FED CUTS RATES BY 0.5%

The US Federal Reserve cut its main interest rate, the Fed funds rate, by 0.5% to 4.75% yesterday. The cut was larger than the 0.25% expected and sparked strong gains on Wall St and a further slide in the dollar. The Fed also cut the discount rate by 0.5%. In the accompanying policy statement, the Fed hinted that further policy easing could be on the cards to counteract the growing downside risks to economic growth, stating that it will continue to assess the effects of recent developments on economic prospects and act as needed.

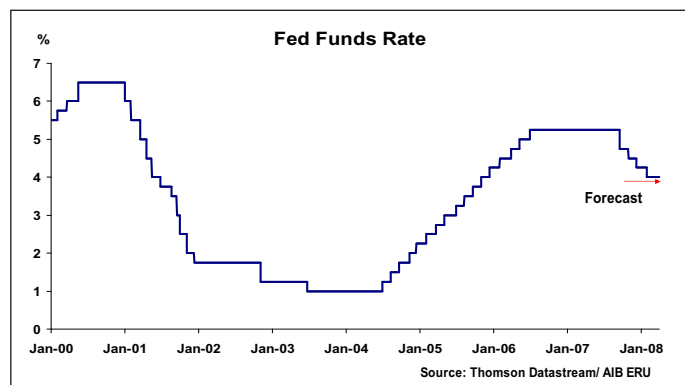
We have long held the view that interest rates would be cut this year, given that the US economy has been growing below trend since mid-2006. The focus of the Fed over the past year, though, has been on counteracting inflationary pressures. In recent months, however, the core personal consumption deflator has dipped below 2% year-on-year. Furthermore, there was an appreciable weakening of employment growth over the summer months. The unemployment rate has also started to edge up slightly.

Meanwhile, **the problems in the housing market continue to deepen and have spilled over into financial markets.** Difficulties in the subprime market have given rise to broader concerns about credit quality. Interbank rates have risen and credit spreads have widened, with both markets also suffering from illiquidity, while stock market volatility has also increased. As a result, the downside risks to economic growth have increased. Taking all these factors into consideration, **it was quite clear that the mildly restrictive stance of monetary policy had become inappropriate,** with rates pitched at 5.25% since mid-2006.

In our view, policy needs to shift to a neutral to slightly accommodative stance. Thus, **we think yesterday's rate cut will be followed by further**

reductions in the Fed funds rate over the coming months. We expect to see 0.25% rate cuts at the two remaining FOMC meetings this year and a further 0.25% rate cut in the first quarter of 2008. **This would take rates down to 4%.** Policy may then be put on hold if signs begin to emerge of a stabilisation of the housing market and a pick up in the pace of economic activity.

We believe that the risks to this forecast are on the downside. The Fed may yet be forced to make further rate cuts of 0.5% in the months ahead if it appears that the economy is headed for a recession. Alternatively, it may have to continue cutting rates well into next year if there is little sign of a bottom to the downturn in the housing market and a pick up in overall economic growth. **It is worth noting, though, that the consensus forecast on rates from the main US investment houses is much more cautious.** A Reuters poll last night shows the median forecast is for just one further cut of 0.25% in the Fed funds rate to 4.5%. In our view, weak economic data over the coming months will warrant deeper rate cuts than this.



WEAK GROWTH WARRANTS FURTHER POLICY EASING

The US economy has been losing momentum for more than a year now. GDP growth slowed to an average 1.7% yoy in the first half of 2007, well below the trend rate and also the growth rate of over 3% yoy recorded between mid-2003 and mid-2006. The decline in housebuilding has been the primary factor behind this deceleration in GDP growth. Housing output fell by 16.5% yoy in the first half of 2007. Growth in business investment has also slowed, while consumer spending has lost momentum since the spring. There has also been a marked fall-off in the pace of inventory accumulation in recent quarters.

Export growth, though, has held up, boosted by strong global activity and a weakening dollar. However, there has been a marked fall-off in import growth in response to weaker domestic demand, so improving net trade is now making a significant contribution to GDP growth. Indeed, excluding external trade, growth in the US economy averaged a very sluggish 1.3% yoy in the opening half of 2007.

The deceleration in growth is impacting on the labour market. Growth in non-farm payrolls slowed from 1.7% yoy at end 2006 to 1.2% by August.

The slowdown in employment growth recorded in the household survey is even more dramatic, decelerating from 2.2% at end 2006 to 0.8% yoy by August. However, there has also been a very sharp fall-off in labour force growth, which has declined from 1.8% to 0.8% yoy since end 2006, reflecting in particular a marked drop in the labour force participation rate. As a result, the unemployment rate has remained low, edging up slightly to 4.6% in the past two months, having been stable at 4.5% in the opening half of 2007.

There was an appreciable weakening in the pace of job growth over the summer months in particular. Non-farm payrolls rose by a paltry 44,000 on average in the three months to August. This trend is likely to be sustained over the balance of the year given the deepening downturn in the housing market and associated problems in financial markets. Thus, the unemployment rate can be expected to edge higher towards the 5% level, a clear harbinger for further Fed rate cuts.

Inflationary pressures are easing and should not be a barrier to further Fed rate cuts. The core CPI rate has eased from 2.7% to 2.2% yoy since the start of the year, while the important core PCE deflator has fallen from 2.5% to 1.9% yoy, below the all important 2% threshold. A rise in the unemployment rate would ease Fed concerns about capacity constraints in the economy and upward pressure on wage costs.

Looking ahead then, over the next couple of quarters, **we see growth continuing well below trend given the deepening problems in the housing sector, with unemployment likely to edge higher and core inflation rates remaining contained. Thus, there is little in our view to prevent the Fed delivering further rate cuts that would take the funds rate down to 4% by early next year.**

