

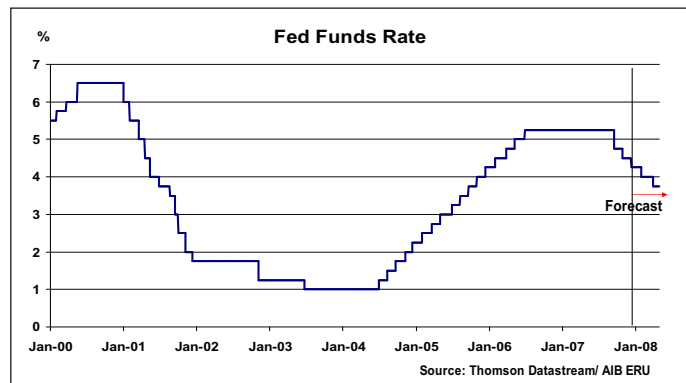


FED CUTS RATES BY A FURTHER 0.25%

The US Federal Reserve cut its key market interest rate, the Fed funds rate, by 0.25% to 4.25% yesterday evening. The cut was in line with the market consensus. Expectations of an even larger rate cut were scaled back in the aftermath of the solid employment report for November, published last Friday. One Fed member, though, did vote for a 0.5% cut. The Fed also reduced the discount rate by 0.25%. This disappointed markets which had hoped for a 0.5% cut in this rate to ease some of the pressures in money and credit markets.

The accompanying FOMC policy statement also disappointed markets. While it noted that economic growth is slowing and strains in financial markets have increased, it also flagged that some inflation risks remain. Furthermore, it refrained from offering the usual assessment of the balance of risks facing the economy. The 0.25% cut in the Fed funds rate follows the 0.25% and 0.5% reductions sanctioned at the previous two FOMC meetings at end October and mid-September. Thus, the Fed funds rate has now been cut by 1% in total.

The general expectation is that rates will be cut further in 2008. The problems in the housing market continue to deepen, with further very poor data on housing starts and home sales in recent months. Consumer confidence has also taken a pounding in recent months which, combined with the surge in oil prices, is likely to restrain consumer spending. Business investment could also be hit by the continuing difficulties in financial markets and uncertainty about the economic outlook. **Overall, the risks to growth are very much on the downside.** We believe that the pick up in GDP growth evident in Q2 and Q3 2007 will not be sustained, with the economy weakening again over the winter.



At the same time, conditions in financial markets remain fraught. The Fed statement last night noted the increased strains in financial markets. Credit spreads remain wide and debt financing is difficult to execute in many markets. Bid-offer spreads are very wide in the interbank market, which continues to trade well above the level of official interest rates. Concerns also persist about large write-downs by financial institutions of investment losses in debt markets.

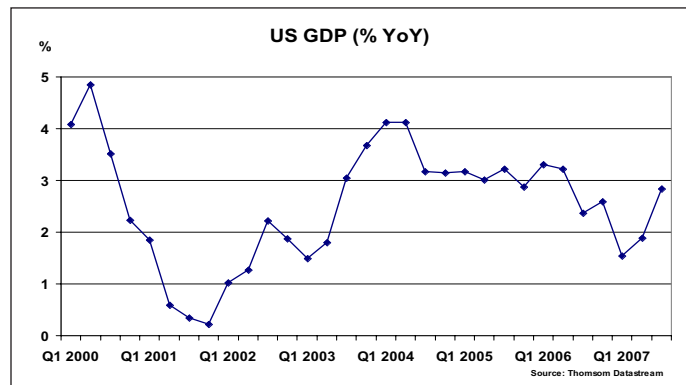
In our view, then, policy will be eased further. **The Fed is likely to cut rates by 0.25% at its upcoming meetings in January and March as it becomes clear that growth has moved well below trend again.** This would take rates down to 3.75%. Policy may then be put on hold in Q2 if signs begin to emerge of a stabilisation in the housing market and a return to more normal trading conditions in financial markets. However, **one cannot rule out a full-blown, prolonged credit crunch next year that would necessitate further rate cuts.** Futures contracts have been very volatile recently and are currently pricing in further rate cuts of close to 0.75% in total during 2008.

WEAK DATA TO PROMPT FURTHER RATE CUTS

The US economy regained momentum in mid 2007, with GDP rising by 4.9% annualised in Q3 after a gain of 3.8% in Q2. Net trade made a significant contribution to growth in the last two quarters, as exports surged by 7.5% and 18.9% annualised in Q2 and Q3, respectively. Meanwhile, business investment and government spending also rose strongly in the last two quarters, while there was a pick up in inventory accumulation too. However, the decline in housebuilding, which has been the principal factor behind the weakness of the economy since Q2 2006, remains very much in place. Housing investment fell at annualised rates of 11.8% and 19.7% in Q2 and Q3 2007, respectively.

GDP growth, though, looks to have weakened again recently.

Leading activity indicators such as the ISM surveys have declined in recent months, while consumer confidence has slumped. The marked rise in oil prices is now weighing on consumer spending. Business investment could be restrained by the difficulties in financial markets and growing uncertainty about the economic outlook. The sharp fall in housing output is set to continue, judging by the recent trend in housing starts and permits. We would not be surprised either to see a renewed rundown of inventories over the winter. Overall, then, growth looks set to move well below trend in Q4 2007 and Q1 2008. The general expectation is that growth will pick up again, thereafter, as the downturn in housing begins to ease and conditions in financial markets improve.

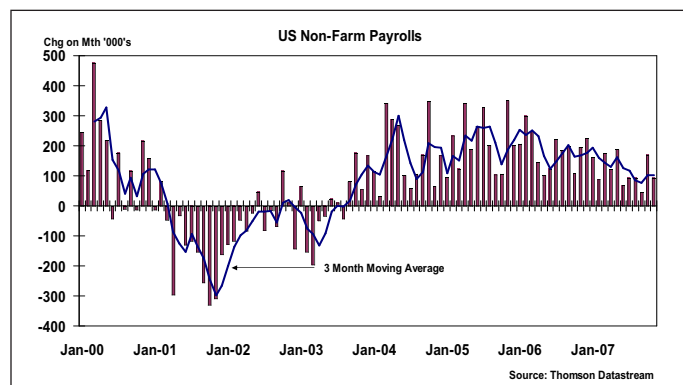


Meantime, despite some strong GDP figures, employment growth has weakened in 2007, especially since mid-year.

Growth in non-farm payrolls has averaged 99,000 per month to date in H2 2007, down from 134,000 in H1. The slowdown in employment growth recorded in the household survey has been even more dramatic, decelerating from 2.2% yoy at end 2006 to 0.7% yoy by November. However, there has also been a very sharp fall-off in labour force growth since end 2006. As a result, the unemployment rate has remained low, standing at 4.7% in the past three months, up from 4.5% in H1 2007.

The weakening labour market trends are likely to continue in the coming months

given the deepening downturn in the housing market, associated problems in financial markets and a renewed weakening in GDP growth. Thus, the unemployment rate could move up to around 5% early next year. Meantime, core inflationary pressures have eased a lot. Hence, despite high oil prices, inflation should not be a barrier to further Fed easing.



Thus, we expect policy to be eased further. **The Fed is likely to cut rates by 0.25% at its upcoming meetings in January and March as it becomes clear that growth has moved well below trend again.**

This would take rates down to 3.75%. Policy may then be put on hold in Q2 if signs begin to emerge of a stabilisation in the housing market and a return to more normal trading conditions in financial markets. However, **one cannot rule out a full-blown, prolonged credit crunch next year that would necessitate rates being cut by even more than our forecast 0.5%.**