

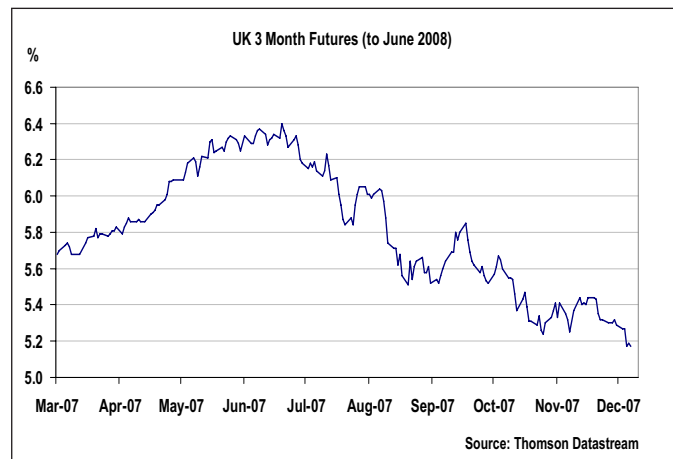


## More Rate Cuts Expected as UK Economy Cools

The Bank of England cut interest rates by 0.25% to 5.50% at its December meeting, the first time UK monetary policy had been eased in over two years. A string of weaker than expected data in the days running up to the policy announcement suggested that a rate cut was on the cards, though the decision was expected to be a close one given the views expressed by some MPC members. However, the minutes of the meeting showed a more one sided outcome than anticipated, with all 9 committee members voting for the reduction.

This was the first time that all committee members voted to ease monetary policy since 2001. In terms of the context of the decision, the MPC continued to sound a note of caution about the upside risks to inflation but these concerns were clearly outweighed by the downside risks posed by the deterioration in financial markets conditions and growth prospects.

Data released since the December meeting indicate that we will see a marked downturn in the pace of economic activity in 2008 and we now anticipate that rates will be reduced by at least another 0.75% over the coming months. The next move could come as soon as this Thursday.



### *Pace of Economic Activity Clearly Decelerating*

The UK economy began 2007 on a strong note. Above trend growth combined with an upward spike in inflation prompted a surprise rate hike of 0.25% at the January 2007 MPC meeting. This was followed by two further increases of 0.25% in May and July, bringing official rates to 5.75%, their highest level since 2001. With data to Q3 indicating that the economy continued to operate above capacity and with inflation risks remaining on the upside, markets speculated that rates could go as high as 6%.

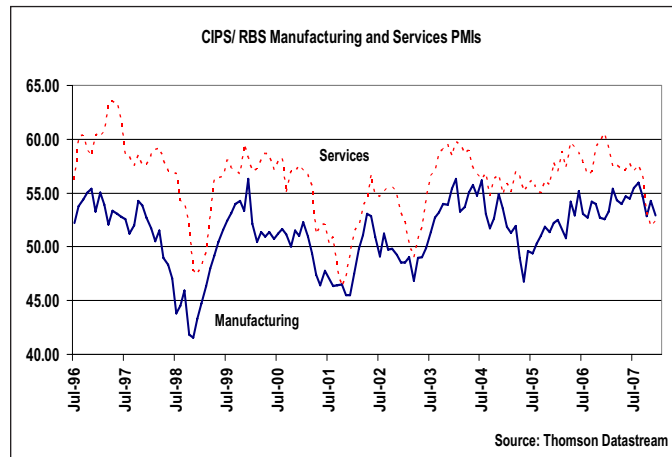
However, by Q4 talk of further rate hikes moved firmly off the agenda on growing concerns about the turmoil on financial markets, which in the case of the UK was compounded by the problems at Northern Rock.

GDP growth (on an annual basis) averaged 3.2% in the first three quarters of last year and is forecast to average 3.1% for the year as a whole. This robust performance has been driven by the services sector, which accounts for some three quarters of total UK output. The latest economic news, however, suggests that the pace of activity weakened sharply towards the end of the year and is likely to continue doing so over the coming months.

Given the five interest rate increases since August 2006 (which saw rates rise from 4.50% to 5.75%) and the strength of sterling, the economy was always expected to loose pace over the latter half of 2007 and into 2008 as tighter financial conditions eventually impacted. **However, the credit crisis has intensified the downward risks to growth prospects and it is estimated that average GDP growth could be as low as 1.8% in 2008.** This would represent the worst growth performance since 2005.

Initial estimates show that output in the services sector increased by 0.7% in the three months to October, down from 0.8% and 0.9% in the two previous three month periods. **Services sector survey data indicate a sharp cooling in the pace of activity going into the year end.**

After a fall to a four year low of 51.9 in November, the services PMI recovered some ground last month, rising to 52.4. However, market conditions were reported as being tough, with business expectations at their lowest level for six years.



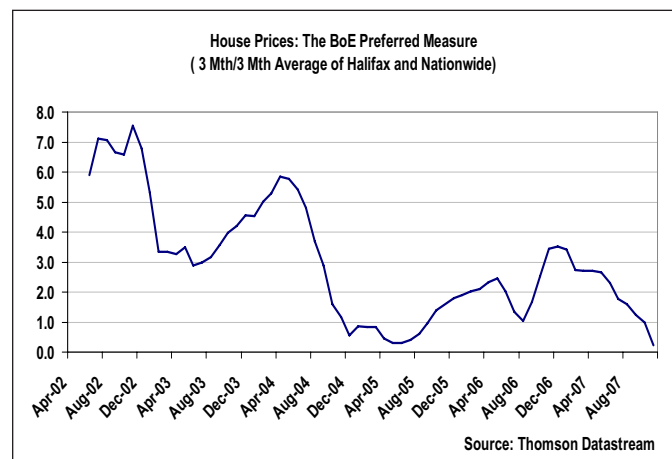
**A similar trend is evident in the Bank of England's Agents report, which is closely watched by the MPC given that it covers a wide range of business contacts right across the economy.** The scores for the services sector have eased markedly in recent months. In particular, capacity utilisation, which was at record levels, has fallen back in the past three months.

Official data from the manufacturing sector show that growth in this area has stagnated and survey evidence does not bode well for the future. **The manufacturing PMI fell to 52.9 in December, with survey participants reporting that they were beginning to feel the squeeze from the turmoil on financial markets and were having to rein in spending as a result.** This helped push the new orders component of the index down to 51.7, its lowest level since March 2006. Exports orders also fell sharply. Our weighted average of the services and manufacturing PMI indicate that GDP growth could be as low as 0.5% in Q4, down from 0.7% in Q3.

### **Housing Sector Slowdown Gathers Momentum**

**The latest data on the housing sector suggest that the slowdown here is also gathering momentum. All of the major surveys are now showing a deceleration in the pace of house price inflation.** Indeed, both the Halifax and Nationwide indices registered a fall in house prices in November.

Mortgage approvals fell to a 5 year low in November, while surveys like the RICS also suggest that there is further weakness ahead, though supply side issues should help prevent a sharp correction in the market.



**A weaker housing market is likely to contribute to a fall off in consumer spending.**

Retail sales volumes were up 0.4% in November and the labour market remains strong. However, the December CBI survey was weaker than expected and consumer confidence has plummeted.



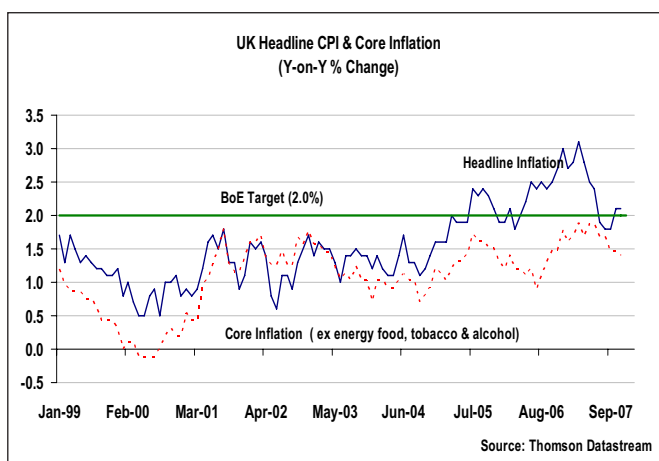
According to the December Gfk survey, sentiment is at a 12 year low, with consumers less inclined to buy large ticket items since the recession of 1991. We have long been concerned that the strong pace of consumer spending was been in part fuelled by the buoyancy in the housing market and a rundown of household savings. With the BoE reporting that lending conditions are becoming more difficult, this correction in the market is likely to impact on consumer spending.

**External Position Also Deteriorates**

Meanwhile, the UK's external position has also weakened dramatically with the current account deficit rising to a record 5.7% of GDP in Q3, compared to 4.0% in the previous quarter. The higher deficit was due to an increase in the deficits on trade in goods and on investment income. Trends here are also negative for future growth prospects.

**Growth Concerns to Outweigh Inflation Risks**

The one factor mitigating against aggressive easing action from the MPC is inflation. The BoE's inflation expectations survey rose from 2.7% to 3.0% in Q4, which marks a series high. Pay growth remains subdued despite the strength of labour market indicators but the rise in inflation expectations could leave some on the committee more cautious with regard to cutting rates too aggressively. However, recent good CPI data offer some room for comfort.



The headline CPI remained steady at 2.1% in November. This is only just above the BoE's 2.0% target and well below the March peak of 3.1%. However, the outturn was better than expected given the recent increases in global energy and food prices and was in contrast with the trend of higher inflation in the US and the eurozone. Meanwhile, the annual rate of core inflation (ex volatile food and energy) fell from 1.5% to 1.4%.

On balance then, concerns about the growth outlook should dominate and the risk of a potential build up of inflation pressures is unlikely to prevent the majority of the MPC for voting for further interest rate cuts over the coming months.

We expect rates to be at 5.00 by end Q1, with further easing possible in Q2 if conditions remain difficult. At 5.50%, official rates in the UK are relatively high which possibly gives the BoE more scope to act than other central banks as they struggle with the inflation versus growth debate.

	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.50	5.78	5.56	5.02	4.93
Mar '08	5.00	5.20	5.20	5.00	4.95
June '08	4.50	4.70	4.90	4.90	4.90
Sept '08	4.50	4.70	4.90	4.90	4.90

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

**7th January 2008**