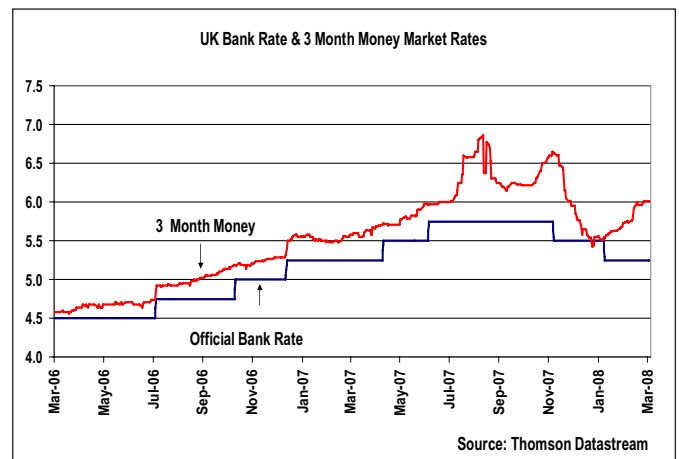


## Growing Risk of an April Rate Cut

The Bank of England left interest rates on hold at 5.25% in March. Two committee members voted for a rate cut but the rest of the MPC appeared to be in no rush to push rates significantly lower. They argued that recent data pointed to a "less of a slowdown" in Q1 than had been expected and that cutting rates at that point could signal less of a focus on inflation than was desired. However, the deterioration in credit and inter bank markets since then suggests a significant possibility of a rate cut at next week's gathering.

### Credit Conditions Still Difficult

There has been a marked rise in money market rates since the March MPC, leaving firms and households facing more difficult credit conditions. 3-month rates are currently 0.75% above the Bank rate, up from 0.50% a month ago. Responding to higher wholesale rates, some mortgage providers have increased their lending rates. Others have pulled out of the market altogether. Lenders indicated in the BoE's Q1 Credit Conditions Survey released just this morning that they expect to further reduce the availability of credit over the next three months.



Comments from MPC members, including Governor King, to the Treasury Select Committee on 26 March suggested that, given the renewed difficulties in credit markets, the risks have tilted sufficiently to the downside to justify a rate cut next week. When asked if the recent increase in the margin above the Bank rate that mortgage lenders are charging on loans made the MPC more predisposed to cutting rates, King simply replied "yes".

### Economic Slowdown Modest...So Far

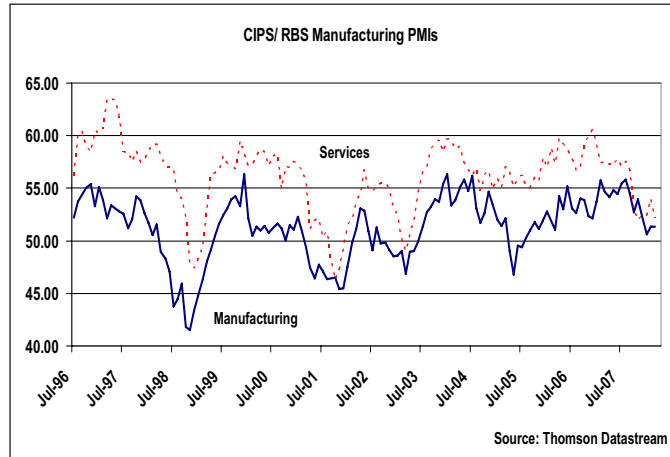
Economic news over the past month has been mixed. Q4 GDP growth was confirmed at 0.6%, the same rate as Q3. The year-on-year growth rate, however, fell from 3.1% to 2.8%. Leading indicators around the turn of the year had suggested a marked deceleration could be in prospect in Q1. However, activity and survey data available so far for the period have not been as bad as feared. Indeed, some releases, particularly on the retail and manufacturing sectors, could be described as relatively upbeat. Indications now are that the economy expanded by another 0.6% in the first three months of the year, implying a year-on-year growth rate of 2.7%.

Official manufacturing output data for January were better than expected and the manufacturing PMI has surprised on the upside for the last two months. The index is well off the highs seen last year but expansion continues nonetheless. While there has been a

noticeable decline in production for domestic markets, the depreciation in sterling has helped offset this. A number of surveys are showing solid growth in export orders, with weakness in US demand offset by strength in sales to other markets. Overseas orders are expected to remain buoyant in the near term but **we fear that demand will fall off over the course of the year as the full global impact of the financial crisis takes hold.**

**Data on the services side have been less positive. The services PMI held up well in the first two months of the year. However, it fell sharply in March** and output from this sector has clearly declined from its previous rapid pace. **With tighter credit conditions and faltering business and consumer confidence expected to impact further going forward, service providers are increasingly pessimistic about the outlook for Q2.**

The slowdown is still most evident in the demand for professional and financial services, though there are increasing reports of a reduction in the demand for other services.



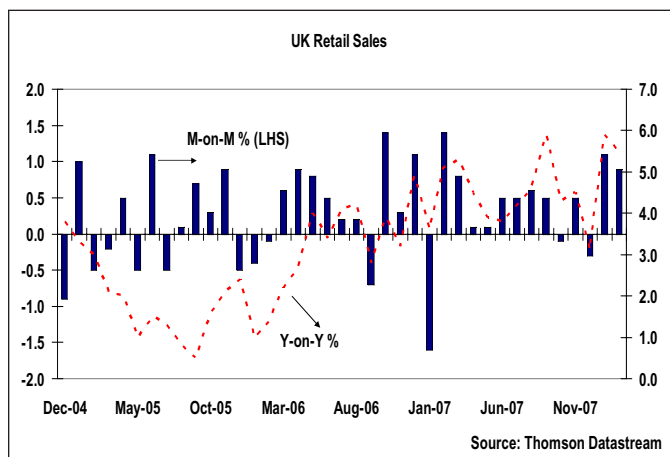
### **Retail Sales Strong but Confidence Has Plummeted**

**The volume of retail sales surprised on the upside again in February**, rising by 1.0%, compared to a forecasted decline of 0.2%. Annually, sales were up 5.5%, suggesting that there is still plenty of life on the High Street. There also appeared to be less evidence of discounting. **However, sales of household goods were weak, indicating that this sector is being hit by the downturn in the housing market. We remain of the view that consumer spending in general will slow over the coming months.**

Despite the tone of official data, **anecdotal evidence from some large retailers has been less than positive.** The latest BoE Agents survey also reported continued evidence of households reining in discretionary spending. The CBI distributive trades survey for March showed that **retailers are still expecting sales to fall going forward and are reporting increased reluctance to buy large ticket items.** Meanwhile, consumer confidence is at a 15 year low, real income growth is weak, personal savings are low and asset wealth is falling.

### **Housing Market Weakens Further**

**Pricing data from the housing sector has been particularly weak over the past month**, with some surveys reporting that sentiment is at its worst since 1990 as the credit crunch bites. After a sharp fall in late 2007, approvals have been broadly steady since December. However, they remain below the 2005 trough and approvals could come under renewed pressure, given that lenders are continuing to restrict the supply of credit.



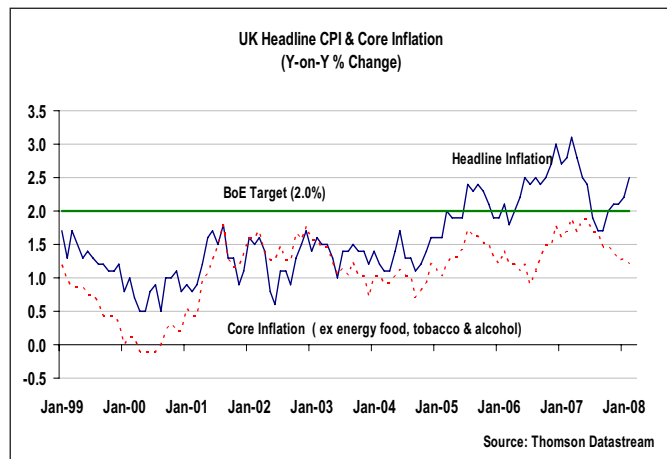
The projected downturn in the pace of general economic expansion and UK likely weakness in the labour market also suggest further weakness ahead in household spending and the property market. **Although official data show that the labour market remains in a healthy state, surveys show that the employment intentions are already softening.**



### ***Inflation Remains A Concern***

**News on the inflation side has not been good, leaving the BoE with a dilemma and constraining its ability to respond to the weaker growth outlook.** The headline rate of inflation hit 2.5% in February, up from 2.2% previously. This represents the highest rate of inflation since May 2007 and the CPI is now well above the BoE's 2.0% target level. **The CPI is expected to climb towards the 3.0% level over the coming months as high food and energy prices impact.**

The annual rate of core inflation (ex volatile items like seasonal food and energy) fell from 1.3% to 1.2%, the lowest level since August 2006, suggesting that there is little evidence of a pass through from higher input prices. Meanwhile, average earnings grew by less than expected in the three months to January, indicating that building price pressures have yet to feed through to the labour market.



**However, other price data/survey evidence released over the month suggest upside risks to prices, a worry for the BoE who sees it as crucial that the rise in the CPI proves temporary.** The annual rate of growth in producer output prices remained at a

16 year high of 5.7% in February. Growth in input prices, meanwhile, is running at its fastest pace for 22 years. The potential impact of the weakness in the pound on import prices is also adding to concerns.

The latest BoE Agents' report stated that as margins are hit, manufacturers are looking to become more active in passing on cost increases, while the prices charged balance of the manufacturing PMI hit a record high in March. **Inflation expectations, or the rate at which prices are expected to rise over the coming year, are at record highs, heightening fears that higher inflation will become entrenched.**

### ***But Weaker Growth Should Provide Some Scope on Policy Front***

However, as developments in financial markets and the banking system begin to take greater affect, **UK growth faces considerable downside risks for 2008.** The external environment is also becoming less supportive.

We predict below trend growth for the UK this year, which should help drive inflation lower over the medium term, facilitating an easing in monetary conditions.

While the case for aggressive action is not seen as compelling, **rates are likely to continue to come down in modest 0.25% stages over the coming months, reaching 4.5% by the end of the summer. As MPC members Lomax and Sentence remarked recently, the BoE has "quite a lot of scope to respond to the current situation".**

	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.25	6.00	5.84	5.09	5.00
June '08	5.00	5.40	5.30	5.00	5.00
Sept '08	4.50	4.80	4.80	4.90	4.90
Dec '08	4.25	4.50	4.60	4.70	4.70

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

***03rd April 2008***