

UK Rates Set to Remain on Hold

Events over the past month leave us more convinced that UK rates remain on hold for now, with a no change announcement anticipated next week. We still see the next move in rates as being downward, though this is unlikely to happen until the inflation situation improves. The recent fall in oil prices suggests some light at the end of the tunnel on the consumer prices front but this will not prevent a rise in the CPI to 4% and possibly above in the near term.

3-Way Split on MPC in July

The minutes of the July MPC meeting showed a three way split. David Blanchflower voted for a rate cut, as he has done on the previous three occasions. Meanwhile, Tim Besley voted for a hike, with the majority going for no change.

A rate hike was discussed and the final decision was described as a difficult one, with the majority believing that the upside risks to inflation had intensified.

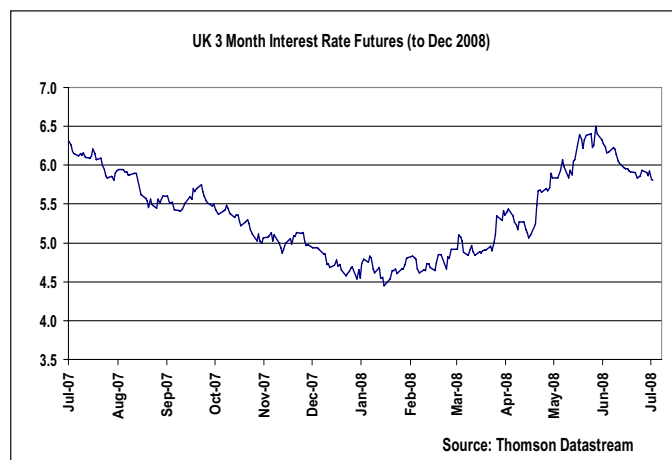
The minutes could be described as relatively hawkish and there was no discussion regarding the merits or otherwise of an easing in policy. At the same time, however, there was no indication that a rate increase was imminent.

According to the minutes, the upside news on inflation had "made it necessary to have more spare capacity" in the economy but the downside news on activity indicates "that a higher level of Bank Rate would not be needed in order to generate this". An increase in rates at this point risked "a significant undershoot of the inflation target in the medium term". Comments from MPC members since the July meeting also show little inclination of a move towards a rate hike and indeed if anything, in reference to continued gloomy news on the economy, show a softening in tone

Mix of Data Continue to Highlight BoE Dilemma

UK data continue to highlight the dilemma that the BoE faces as it looks to reconcile the conflict between the outlook for the real economy versus rising inflation. The CPI rose to 3.8% in June, with additional upside pressure (and further letters to the Chancellor) expected over the coming months. Meanwhile, producer output price inflation is running at record high levels, while survey based measures of inflation expectations have picked up.

The May Quarterly Inflation Report forecast that the CPI rate would peak at around 3.7% in Q4. More recently Mervyn King has said that he now expects the peak to be above 4%. The next inflation report, due for release on 13th August, should give us the latest in terms of the Bank's thinking on the medium term outlook and the implications that this will have for monetary policy.



Activity data released over recent weeks indicate that the downside risks for the economy have also intensified. **The first estimate of Q2 GDP shows that the economy grew by 0.2% in the three months to June, compared to 0.3% in the previous period.** This represents the weakest outturn since Q1-2005. As a result, the year-on-year growth rate decelerated to 1.6%, down from 2.3% previously and 3.3% in the same period in 2007.

Output from the services sector picked up to 0.4%, compared to growth of 0.3% in Q1, though it should be noted that in Q2 2007 the services sector was growing at a rate of 0.9%.

The pick-up in services output, however, was offset by weaker construction and industrial production activity. Output from these sectors fell by a respective 0.7% and 0.5% in the quarter, compared to +0.4% and -0.2% in the previous period. Weaker manufacturing activity made the biggest negative contribution, with output down 0.4%, compared to a rise of 0.4% in the previous period.

Leading Indicators Suggest Further Weakness Ahead

Leading indicators suggest further weakness going forward. **The manufacturing PMI fell to 45.8 in June (from 49.5), its lowest level since December 2001,** when activity was hit by the fall out from the 9/11 terrorist attacks. **At the same time the survey revealed that manufacturers continue to look to pass higher input costs,** with the prices charged component of the index at its highest level since the series began.

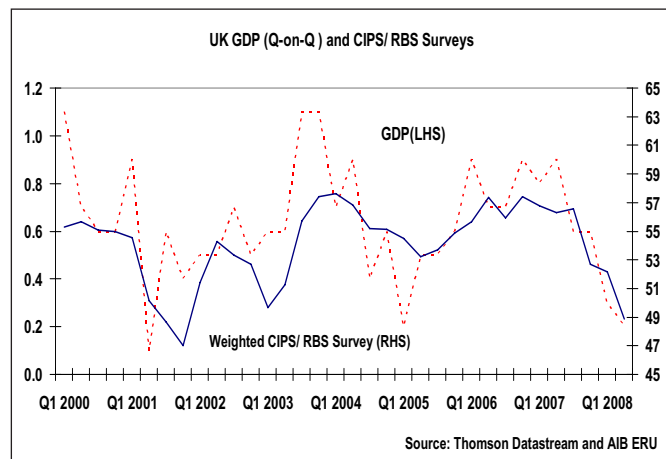
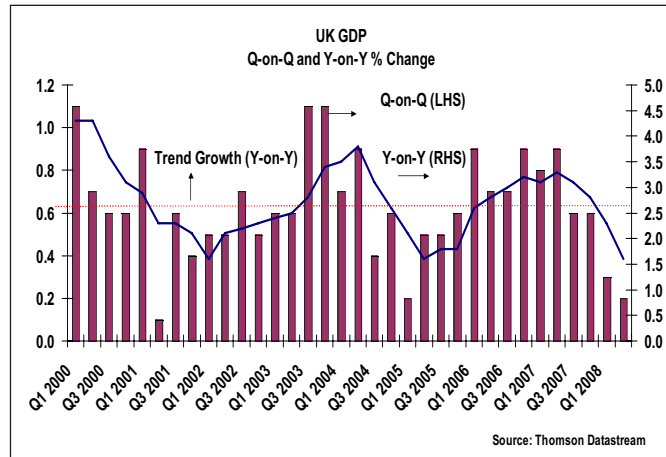
The services PMI, meanwhile, fell to 47.1 in June from 49.8 in May, leaving it also at its weakest level since late 2001.

Activity levels declined further on the back of a record fall in business expectations, with survey participants reporting that rising cost pressures and tighter credit availability were having an increasingly adverse impact on confidence and demand.

Retail Sales Fall Sharply in June

After a surprisingly strong performance in May, retail activity slumped in June. The volume of sales fell 3.9%, pulling the year-on-year growth rate down to 2.2% from 7.9% in May. Although this still leaves sales up 4.8% year-on-year in the first six months of the year, **the June data could indicate that high street spending is at last faltering.**

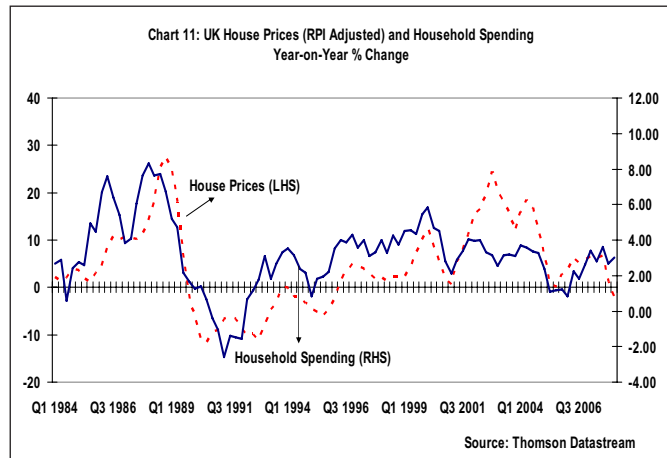
Surveys have been indicating this for some time. Low sales balances have been evident in the CBI and BRC surveys for a number of months, while trading statements from large retailers have been noticeably downbeat in tone. The BoE's Agents survey for July, meanwhile, reported further evidence of households reining in discretionary spending. Car sales are also relatively weak, with registrations down 1.6% year-on-year in the first six months of the year.





Meanwhile, consumer confidence appears to have gone into free fall and is currently at an 18 year low. Real income growth is weak, personal savings are low and household asset wealth is falling. The latest national accounts data show that the household savings ratio has fallen to just 1.1%, the lowest level since 1959.

This suggests that consumers have little to fall back on if household income eventually comes under pressure from the general slowing in activity and in particular any slowing in the labour market. Although the labour market remains in a relatively healthy state, the claimant count is rising and surveys indicate that employment intentions are softening.



Furthermore, there is little evidence of wage rounds coming under upward pressure, despite the sharp rise in inflation expectations.

News from the Housing Sector Remains Gloomy

The news from the housing sector remains gloomy and history would suggest that this will impact negatively on consumption activity (see chart above). Evidence of this correlation is already beginning to emerge. Sales of household goods fell 5.0% in June, with the annual growth rate decelerating to 0.8% from 8.7% in May. All key house price surveys are now showing prices falling on a year-on-year basis. Banking data suggest further weakness ahead as households face tighter credit conditions, with mortgage approvals now down over 68% in year-on-year terms.

The July BoE Agents survey saw survey participants reporting the speed of the downturn in private house building as unprecedented. Also while, activity in the commercial property market was currently being underpinned by work in progress, weakening demand was anticipated going forward.

Downturn in Growth to Facilitate Eventual Easing in Rates

We estimate that the UK economy will grow by just 1.6% this year, down from 3.1% in 2007. Below trend growth should help drive UK inflation lower over the medium term, facilitating an easing in monetary conditions. However, with inflation set to rise towards 4% in the months ahead and remain above target over the balance of the year, this will constrain the ability of the MPC to act in the near term.

Thus, we envisage a period of steady rates over the remainder of 2008 but see scope for rate cuts coming back onto the agenda in H1 2009 as the CPI rate falls back.

UK Interest Rate Forecasts (to end quarter)					
	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	5.00	5.79	6.19	5.74	5.67
Sept '08	5.00	5.75	6.00	5.65	5.50
Dec '08	5.00	5.70	5.90	5.60	5.40
Mar '09	4.75	5.40	5.60	5.40	5.20

* Swap Forecasts Beyond 1 Year
Current Rates Source from Reuters, Forecasts AIB ERU

29th July 2008