

BoE Constrained by Inflation

The Bank of England is expected to leave monetary policy on hold for the fifth month running when it concludes its September meeting next week. The MPC cut interest rates by a cumulative 0.75% between December 2007 and April of this year. Concerns about rising inflation (the annual rate of inflation rose to 4.4% in July, more than double the MPC's target) mean that policy has been on hold since then. We still see the next move in rates as being downward, though this is unlikely to happen until the inflation situation improves. Recent communication from the Bank of England would appear to support this view.

MPC Now Expects Inflation to Hit 5%

According to the latest Quarterly Inflation report (13th August) the central bank's near-term outlook for inflation has deteriorated, with the CPI now expected to peak at 5% or slightly above, revised up from the peak of 3.7% outlined in the May report.

However, based on an unchanged interest rate scenario, the medium term outlook for inflation was revised down, with the CPI forecast to slightly undershoot its 2.0% target over the two year horizon.

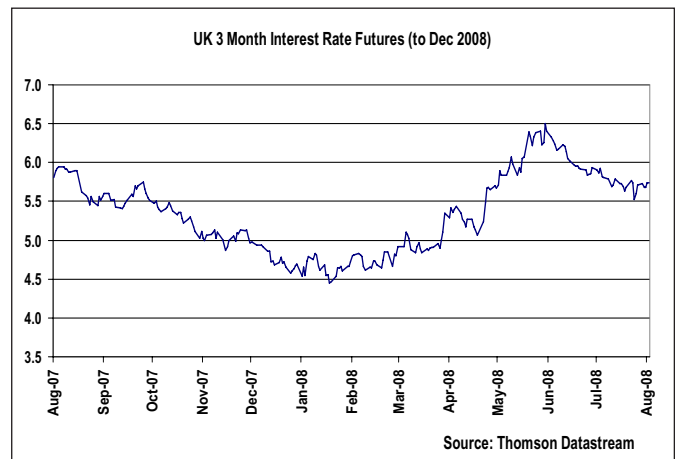
This suggests that the MPC seems some modest scope for policy easing over the forecast period.

The report was more dovish than anticipated, as reflected in the reaction of interest rate expectations and the sharp fall in sterling. Prior to the Inflation Report there was still some speculation in the marketplace that the bank rate could be increased before year end. However, following its release, markets moved to discount up to two rate cuts in the UK by early 2009.

But Increasing Focus on Downside Risks to Growth

The minutes of the August MPC meeting were also on the dovish side. The committee voted 7-2 to keep rates on hold but considered all three policy options, that is cutting, raising and keeping rates on hold. In July there was no central discussion of the merits of a cut in rates. The key issue for the committee was how persistent the high rate of inflation was likely to be and how large a margin of spare capacity would be necessary to help bring the CPI back towards target.

The conclusion seemed to be that flat output over the next year would bring inflation back to slightly below the 2.0% target in the medium term. The risk, however, is that growth will come in even weaker, bringing rate cuts onto the agenda.



Pace of Growth Has Already Stagnated

Activity data released over the past month indicate that by Q2 of this year the UK economy had already stagnated. **GDP growth was flat in the three months to June, compared to 0.3% in the previous period.** This represents the weakest outturn since Q2-1992. As a result, the year-on-year growth rate decelerated to 1.4%, down from 2.3% previously and 3.3% in the same period in 2007.

Output from the services sector slowed to 0.2%, compared to growth of 0.3% in Q1, and 0.9% in the same quarter last year. Activity in the business services sector was notably weak as conditions in financial and related services sectors remained difficult.

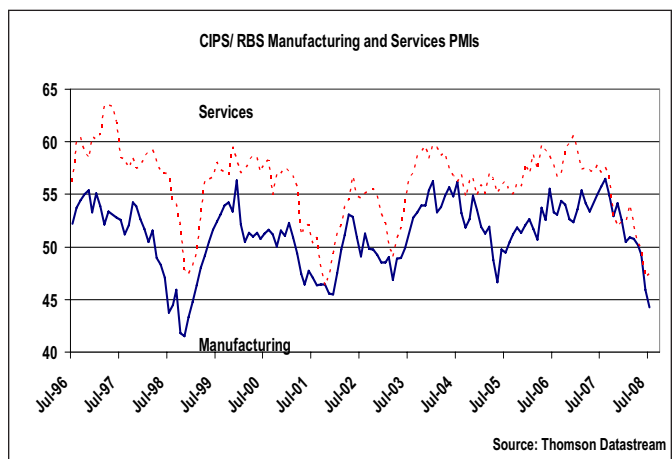
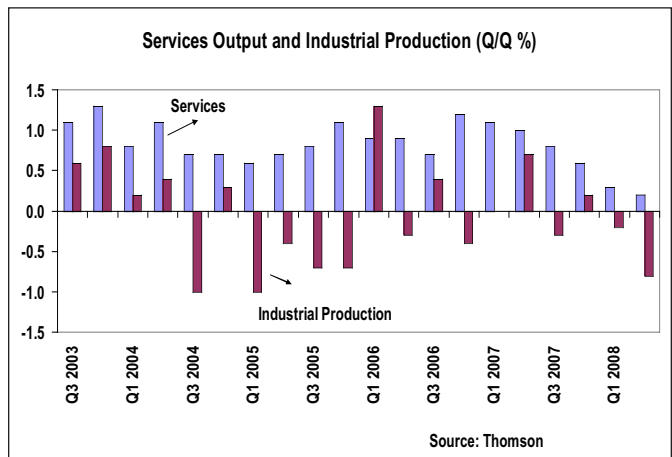
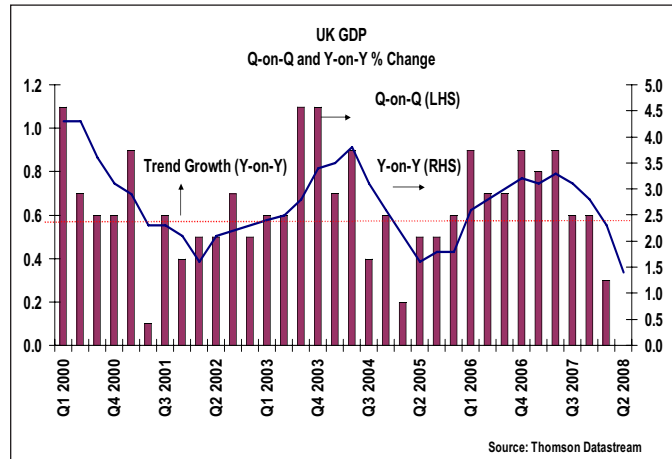
There was a sharp contraction in construction and manufacturing activity. Output fell by a respective 1.1% and 0.8% in the quarter, compared to a rise of 0.4% in both sectors in the previous period.

The downturn in construction was mainly driven by a fall off in private housing activity but there was also evidence of a deceleration in private commercial activity. In expenditure terms, spending on fixed investment fell 5.3% over the quarter, compared to a fall of 1.5% in the previous period.

Leading Indicators Suggest Further Weakness Ahead

Leading indicators suggest that growth could weaken further over the course of 2008. **The manufacturing PMI fell to 44.3 in July (from 45.8), its lowest level since the end of 1998.** Falls in the new orders and export balances suggest that the output index will fall even further in the months ahead. **At the same time, the survey revealed that, despite the cooling in activity, manufacturers continue to look to pass on higher input costs,** with the prices charged component of the index still at its highest level since the series began.

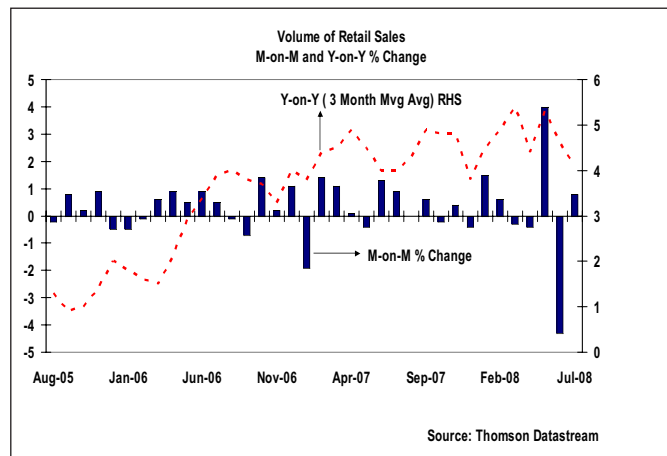
There was a slight pick up in the services PMI in July from 47.1 to 47.4. However, this does little to reverse the sharp drop seen in previous months and **the index remains well below the key 50 level.** Furthermore, both the new business and future expectations sub indices continued to fall in July.



Retail Sales Surprise Once Again in July

The surveys do not reflect retailing activity but the recent news from this sector has been mixed. **According to official data, sales volumes slumped in June, falling 4.3% on the month, pulling the year-on-year growth rate down to 2.2% from 7.9% in May.**

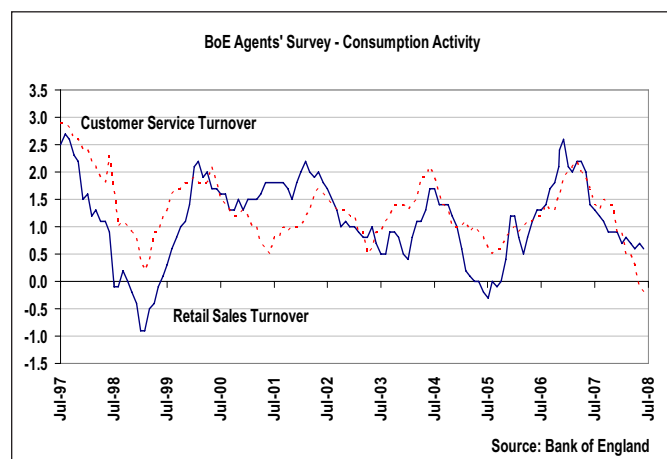
The July retail report went on to show sales up a surprising 0.8% on the month, confounding expectations for another weak number. The monthly sales data, however, should be interpreted with some caution as they are very volatile. **Year to date sales are up just 1.7% and we see the sector as being increasingly vulnerable going forward.**



Furthermore, the strength of retail sales is not reflected in the pace of growth in total household expenditure, which fell by 0.1% in Q2, down from growth of 1.1% in Q1, as spending on consumer services was weak.

The official data are also at odds with retail surveys, which have been indicating a fall off in consumer spending 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 August, meanwhile, reported further evidence of households reining in discretionary spending.** Car sales are also relatively weak, with cumulative registrations down 3.0% year-on-year in the first seven months of the year.

Meanwhile, consumer confidence remains in a free fall and is currently at a 34 year low. **Real income growth is weak, personal savings are low and household asset wealth is falling.** 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.**

The employment indices of both the manufacturing and services PMI's fell again in July and are now well below 50. Meanwhile, 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 latest data on the construction/housing sector makes for gloomy reading. The construction PMI fell to 36.7 in July, the lowest reading since the series began in 1997. Furthermore, while activity in the commercial property market has been underpinned by work in progress, output is now starting to weaken.

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.

Given the correlation between housing activity and household spending, the likelihood is that the downturn in this sector will impact negatively on consumption activity (see chart opposite). Indeed, evidence of this is already beginning to emerge. Following a drop of 0.7% in June, sales of household goods fell 3.2% in year-on-year terms in July, down from an average growth rate of 6% in the previous 5 months and 7.8% in 2007.

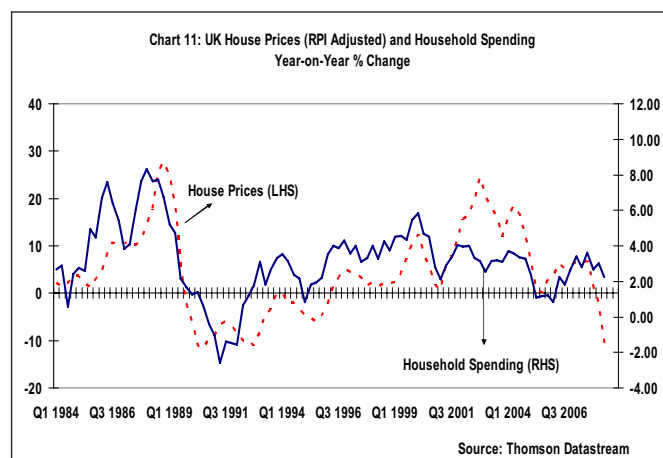
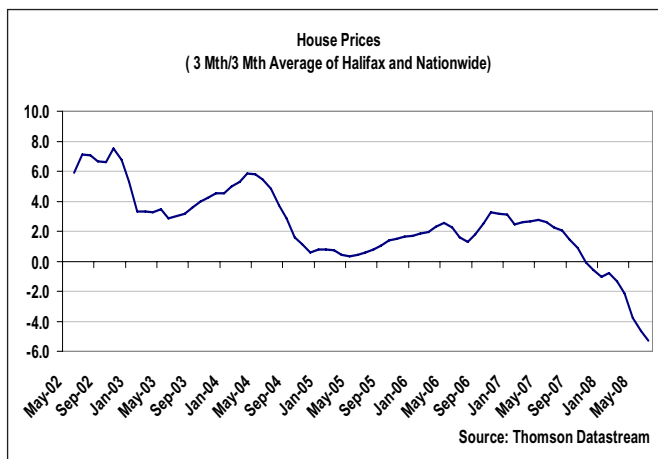
Downturn in Growth to Facilitate Eventual Easing in Rates

On the basis of the recent GDP data we have revised down our forecast for UK GDP growth in 2008 to 1.2%, compared to 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 5% 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.

26th August 2008



| UK Interest Rate Forecasts | | | | | |
|----------------------------|-----------|-------|--------|---------|---------|
| | Repo Rate | 3 Mth | 1 Year | 2 Year* | 5 Year* |
| Current | 5.00 | 5.76 | 6.04 | 5.44 | 5.35 |
| Sept '08 | 5.00 | 5.75 | 6.00 | 5.40 | 5.30 |
| Dec '08 | 5.00 | 5.70 | 5.90 | 5.35 | 5.25 |
| Mar'09 | 4.75 | 5.40 | 5.50 | 5.10 | 5.00 |

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