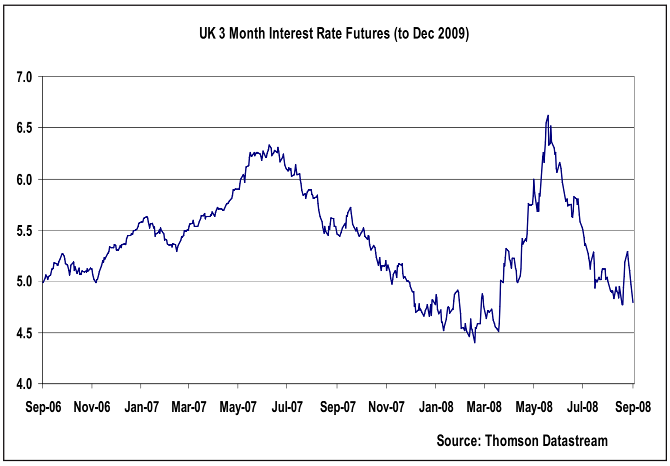
BoE Edging Towards Rate Cut

At its September policy meeting the Bank of England's policy committee elected to leave the Bank Rate on hold for the fifth consecutive month. We expect another unchanged result when the committee meets next week. However, the minutes of the September meeting indicate that the Bank is edging closer to a rate cut. Not only did David Blanchflower change his vote to a 0.50% cut (as opposed to the 0.25% cut he has being voting for since last May) but well known hawk Tim Besley, who had opted for a rate hike in July and August, voted to hold rates steady.

Lingering inflation concerns, particularly in light of the recent sharp depreciation of sterling, saw the committee discuss the merits of a rate hike again this month.



However, it concluded that there was little evidence that medium term inflation expectations had become dislodged or that wage settlements were being driven upwards. Furthermore, the impact of an unexpected increase in the Bank Rate on sterling was uncertain and it could encourage a "broader reassessment" of UK economic prospects.

At the same time, a rate cut was argued against on the grounds that it would suggest that the committee was putting "undue weight" on activity indicators. Nonetheless, **the case for policy easing does appear to be building. Indeed, given the tone of recent data and the rapid deterioration of conditions in financial markets, there is now a real prospect of a rate cut before year end.**

Inflation Hits 16 Year High in August

UK inflation hit a 16 year high of 4.7% in August, up from 4.4% in July and the 4th straight month that the CPI has been above the BoE's 2.0% target. Prices were up 0.6% on the month with strong upward pressure coming from higher food and energy bills.

Perhaps more worrying was the news that core inflation (which excludes food, energy, alcohol and tobacco) rose to 2.0%, its highest level since January 1997. This compares with a rate of just 1.3% at the beginning of the year.

As a result of the August numbers, BoE Governor King was required to write another letter of explanation to Chancellor Darling. Mr. King expects inflation to peak at around 5% over the next month or so as previous increases in food and utility prices work their way through.

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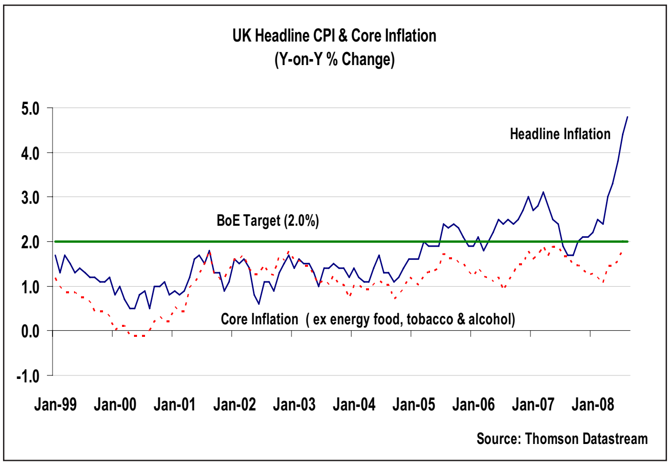
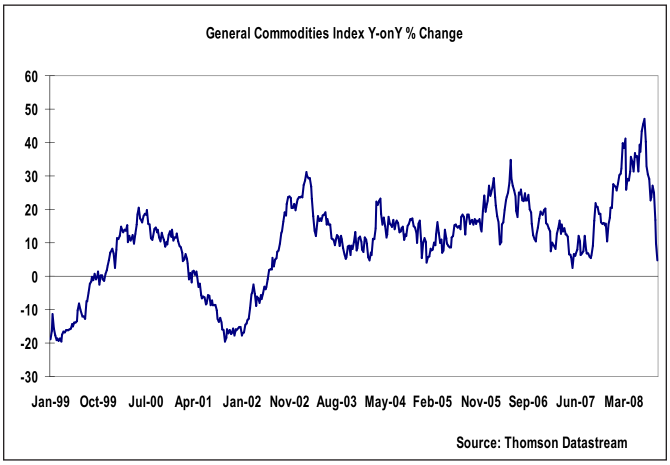
The CPI is then forecast to remain well above target going into 2009 but should undershoot its target over the two year forecast horizon. While the Bank believes that the inflation rate will fall below target over time, the risk continues to be that an extended period of elevated prices will become embedded in medium terms Inflation expectations. **Thus, a period of below trend growth is still seen as necessary to keep inflation expectations in check.**



MPC Now Expects Inflation to Hit 5%

Nonetheless, while the CPI may not peak for a month or two, recent developments in global energy and food prices should dampen upside inflation risks going forward. Oil is currently down over 50% from its July peak, with other commodities also significantly lower.

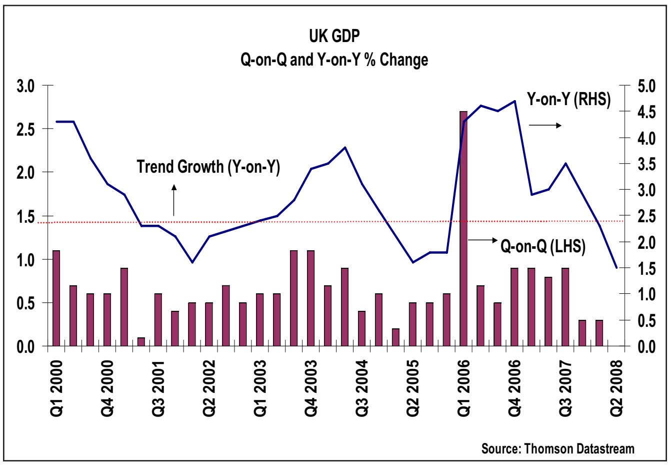
Indeed, there are already some early signs that pipeline costs pressures in the UK are starting to ease. The August producer prices report showed manufacturers output prices falling 0.6% over the month, the sharpest deprecation in 22 years, reflecting the recent fall in energy prices. **Core output prices were down 0.1%, the first monthly drop since October 2005, suggesting that the sharp downturn in economic activity is starting to have an impact.**



September's 8 point fall in the CBI's balance of manufacturers expecting prices to rise indicates something similar. Meanwhile, sterling' sharp fall on forex markets seems to have been arrested, for now at least, as concerns about the fallout from the burgeoning financial crisis leaves currencies in a stalemate position.

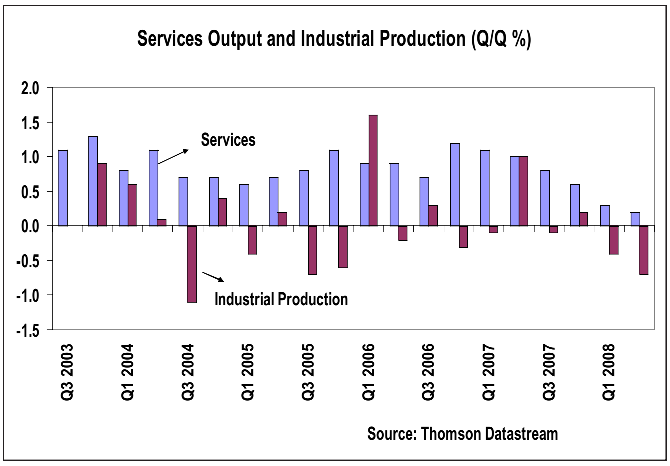
Economic Slowdown Well Underway

Furthermore, the move to a period of below trend growth deemed necessary by the BoE to dampen inflationary pressures appears to be well underway. **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 1.5%, 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. **There was also a sharp contraction in construction and manufacturing activity, where**

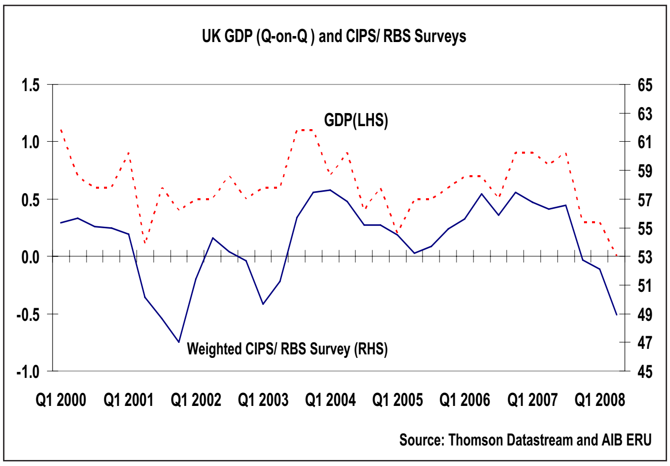
output fell by a respective 1.1% and 0.8% in the quarter, compared to a rise of 0.4% in both sectors in the previous period. The downturn in construction was mainly driven by a fall off in private housing activity but there was also evidence of a deceleration in private commercial activity.



Leading Indicators Suggest Activity to Remain Subdued

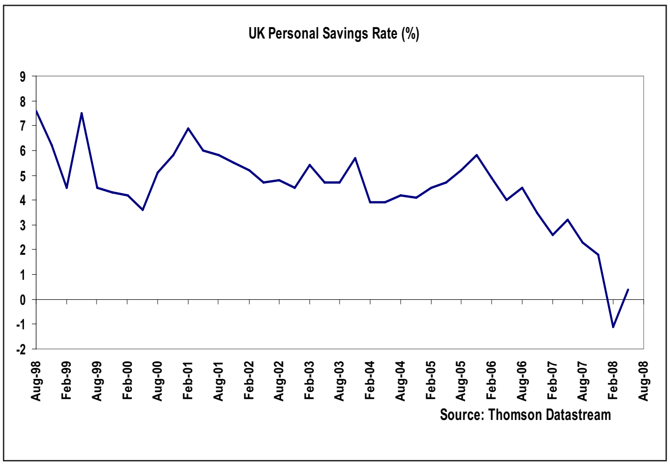
Leading indicators suggest that growth will remain stagnant over the remainder of 2008 and into 2009. Indeed, there is a very real chance of an outright fall in GDP in Q3. Both the manufacturing and services PMI's picked up a little in August but remain at levels consistent with an economy that is close to recession.

After a poor outturn in Q2, manufacturing production got of to a bad start in Q3, with output contracting by 0.2% in July. The news of an imminent recession in the eurozone does not bode well, suggesting that weaker external demand will offset the positive impact to the traded sector of a weaker pound. Meanwhile, the demand for business and consumer services is reported to be at its lowest levels for some time.



In terms of high street spending, signals remain mixed. Retail activity surprised on the upside again in August, with the volume of sales up 1.2% following a rise of 0.9% in the previous month. However, the official data are 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.

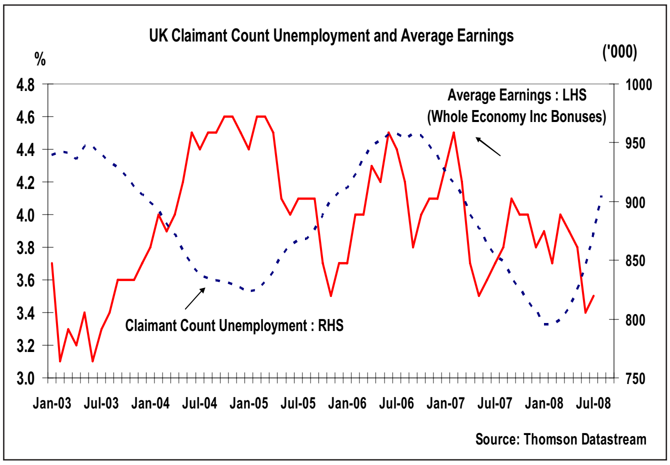
The BoE's Agents survey for September, meanwhile, reported further evidence of households reining in discretionary spending. Car sales are also relatively weak, with cumulative registrations down 4.0% year-on-year in the first seven months of the year.



Household Finances Are Stretched

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.** Q2's national accounts data showed that the household savings ratio at 0.3%, the second lowest reading on record after -1.1% in Q1.

With finances already stretched, this suggests that consumers have little to fall back on as household income comes under pressure from the general slowing in activity and in particular the slowing in the labour market.



Labour Market Conditions Weaken

Although the labour market remains in a relatively healthy state, employment conditions are clearly softening. The claimant count has risen by 110,000 since the start of the year, while the Q2 labour force survey showed a decrease of 16,000 in employment levels in the three months to July. **The employment indices of both the manufacturing and services PMI's remained well below the key 50 level in August, indicating further job losses in the months ahead.** 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

Despite a recovery in the construction PMI from a series low of 36.7 in July to 40.5 in August, data on the housing sector continue to make for gloomy reading. All key house price surveys are now showing prices falling sharply on a year-on-year basis, with average house prices reported to be 10-12% off their peaks. Banking data suggest further weakness ahead as households face tighter credit conditions, with mortgage approvals now down over 70% in year-on-year terms. **There are also growing concerns about the public sector, with recent data raising fears about the impact of the general economic slowdown and the financial crisis on the fiscal balances.**

But When Are Rates Likely to Fall ?

On the basis of the recent GDP data, we estimate that the UK economy will grow by 1.1% in GDP growth in 2008 and just 0.3% next year, compared to 3.1% in 2007. Below trend growth should help drive UK inflation lower over the medium term, thus facilitating an easing in monetary conditions.

UK Interest Rate Forecasts

	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	5.00	6.26	6.48	5.30	5.16
Dec '08	4.75	5.75	5.95	4.95	5.10
Mar'09	4.50	5.25	5.45	4.60	4.70
Jun '09	4.25	4.90	5.10	4.50	4.60

* Sw ap Forecasts Beyond 1 Year.
Current Rates Sourced From Reuters, Forecasts AIB ERU

Currently, the MPC does not appear to be ready to cut rates as it continues to emphasise the upside risks to inflation and the possibility of second round effects. However, the peak in inflation may only be a month away which could open the door to a rate cut before year end, with further policy easing anticipated in early 2009. The November Inflation Report may may pave the way for such policy easing.

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