



Making Up for Lost Time

The Bank of England has stepped up its campaign to limit the depth and duration of a UK recession, slashing rates by 1.50% at its November policy meeting. The cut, which leaves the Bank Rate at 3.0% (its lowest level since 1954), was the most aggressive policy move since the committee was established in 1997 and illustrates the extent to which the MPC believes that UK economic conditions have deteriorated.

In the statement accompanying the announcement of the rate cut, the Bank emphasised the marked deterioration in the outlook for economic activity at home and abroad, while also highlighting the substantial downward shift in the prospects for UK inflation.

The minutes of the meeting, which revealed that the committee actually discussed a cut of 2.0% but decided against it given the impact it could have on market sentiment and sterling, reinforced this message and indicated that the Bank has much

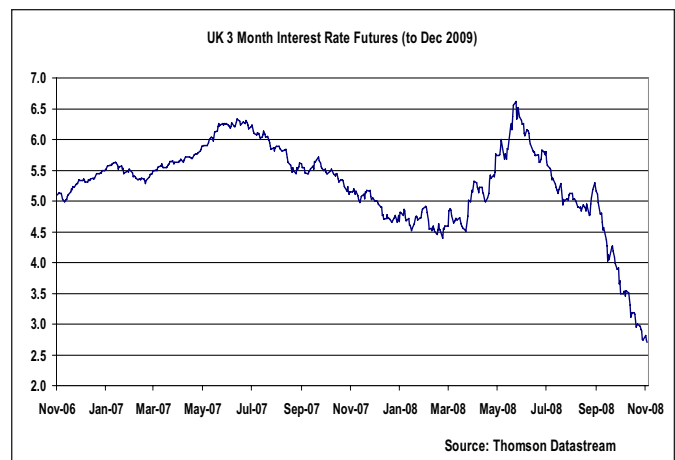
further to go in terms of its downward adjustment to rates. **We anticipate another cut of up to 1% when the MPC meets next week, with further easing thereafter. Rates are predicted to be as low as 1.50% by end Q1-2009.**

The now mega dovish views of the BoE were also reinforced by comments from Mervyn King before the Treasury Select Committee on 25 November, when he said that **the central bank will take whatever steps are necessary to "steer the economy into calmer waters"**. Furthermore, with commercial banks slow to pass on official rate cuts, he believes that the policy response may need to be more aggressive than under normal circumstances.

November Inflation Report Signals Scale of BoE Concern

The November Inflation Report also paved the way for further significant easing, with the projections implying that a much lower level of Bank Rate is likely to be required to ensure that inflation meets its target over the medium term.

CPI inflation peaked at 5.2% in September, before falling to 4.5% in October. It is projected to fall sharply over the medium term as the contribution from higher commodity prices wanes and the margin of spare capacity in the economy increases. **Indeed, the MPC believes that the CPI rate will be well below 2% by end 2009 and has not ruled out a brief decent into deflation.** In terms of second round effects that the BoE was worried about, there is little sign that elevated inflation expectations have fed through to wage claims. Indeed, recent surveys report little evidence of employee resistance to below inflation wage settlements.



Economy Falls into Recession

The marked deterioration in the outlook for the UK that the BoE has referred to has certainly been evident in recent data releases, which show widespread weakness across all sectors of the economy. On a GDP basis, the economy contracted by 0.5% in Q3, the first fall in activity since Q2-1992. As a result, the year-on-year growth rate decelerated to 0.3% from 1.5% in Q2.

The downturn in the manufacturing sector intensified over the period. Hit by not only a contraction in domestic demand but a fall off in export orders, output decreased by 1.3% in Q3, compared with a fall of 0.7% in the previous quarter.

Services output, meanwhile, decreased by 0.4%, compared with growth of 0.2% in the second quarter. A 1.9% drop in the demand for consumer related services, contributed to a 0.2% fall in overall household expenditure.

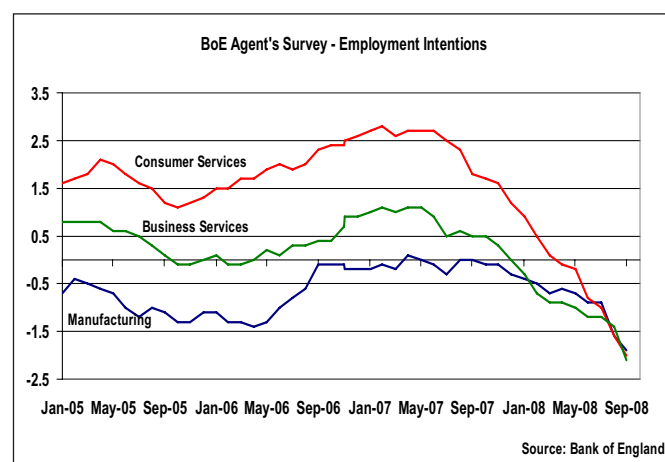
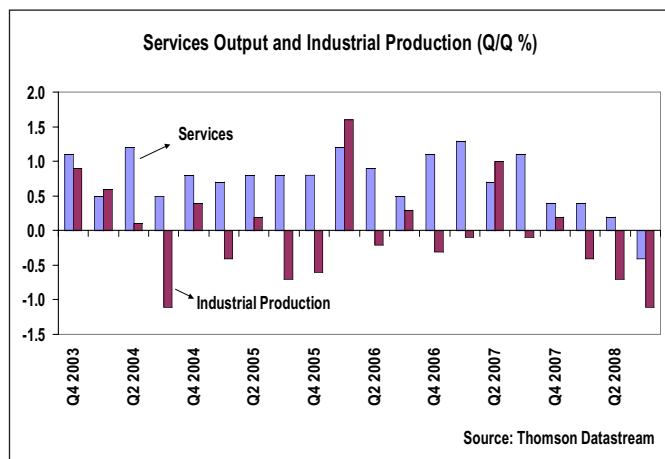
With investment spending contracting by 2.4% (driven by a collapse in residential investment) and the volume of exports falling 0.3%, the government was the only sector providing any support to the economy in Q3.

Slowdown Evident Across All Sectors

Leading indicators point to a continued contraction in activity in Q4. After a sharp fall in September, the manufacturing PMI recovered a little in October but the services PMI survey plummeted last month, falling to 42.4 from 46.0 previously. A weighted average of the two indices is currently at levels consistent with an economy that is in the midst of a sharp downturn in activity.

Marked falls continue to be evident in the CBI industrial and distributive trades survey, with export orders falling despite the depreciation in sterling. The latest BoE agents report provided yet more evidence that the downturn in activity is becoming more pronounced and widespread.

There was increasing evidence of a slowing in capital spending, with business confidence badly hit by the rapid pace of weakening in economic activity as well as tighter credit conditions.



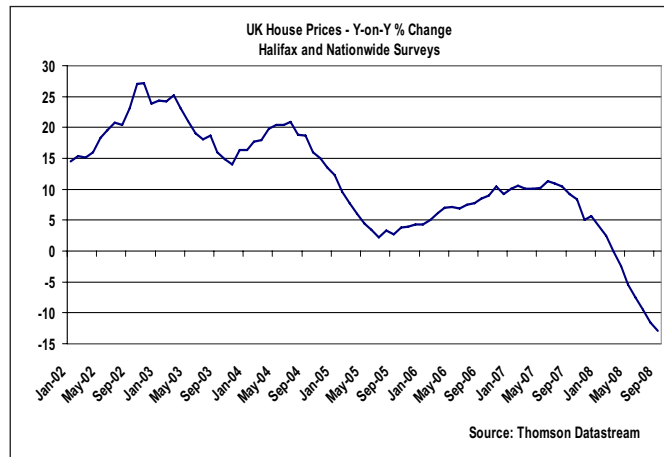
Meanwhile, employment intentions have fallen sharply and household consumption was reported to still be at its weakest level since the survey began in 1997. Retail spending on a wide range of items fell sharply over the month, with households also switching to unbranded products and discount outlets as they search for value for money. In terms of official data, October's retail sales report came in better than expected. However, the year-on-year growth rate in the volume of retail sales stood at 1.9%, compared to a growth rate of 4.2% in the same month last year.



The recent fall in inflation, coupled with a wave of heavy discounting by major retailers and the temporary VAT reduction, may provide some boost to High Street activity before year end. Nonetheless consumers look set to continue cutting back on discretionary spending as households react to mounting budgetary pressures. Real income growth is weak, personal savings are low and household asset wealth is falling. On top of this, unemployment is now soaring, with the claimant count hitting 980,900 in October, a cumulative rise of 185,000 since the beginning of the year.

Housing Sector Remains Under Pressure

Conditions in the residential construction sector also remain difficult, with average house prices reported to be 14% off their peaks. Widespread expectations of further price falls, tighter credit conditions and falling consumer confidence are all reported to be curtailing transaction activity in the housing market.



Banking data indicate further weakness ahead, with total mortgage approvals down 67% in year-on-year terms in September. Approvals for house purchase by Banks and Building Societies were down a respective 58% and 65%, with approvals by other specialised lenders down over 95%. **Access to credit facilities from all mortgage providers looks set to remain difficult going forward.** This is despite the aggressive policy moves from the BoE, with financial institutions continuing to adjust their balance sheets, thus reining in growth in lending.

Interest Rates Set to Fall to Very Low Levels

In his recent Pre-Budget report Chancellor Darling announced the details of a £20bn stimulus package, which is a positive development in terms of providing support to the economy and was applauded by the BoE.

However, it is not of sufficient scope to prevent a deep contraction in the overall pace of economic activity, nor does it preclude the need for further aggressive action from the BoE. Thus, we would not be at all surprised if the MPC cut rates by 1% next week, before reducing rates to 1.5% or below in early 2009.

	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	3.00	3.93	4.13	3.18	3.67
Dec '08	2.00	3.00	3.60	3.10	3.50
Mar'09	1.50	2.30	2.80	3.00	3.40
Jun '09	1.50	2.30	2.40	3.00	3.20

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

28th November 2008