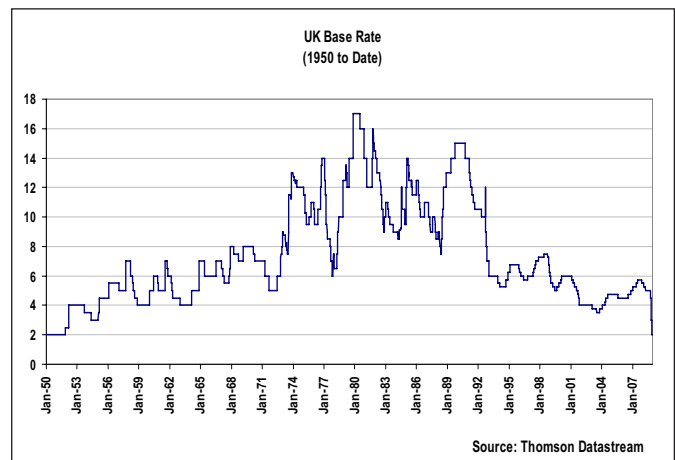


BoE Remains in an Aggressive Mood

The Bank of England cut official interest rates by a further 1.0% at its December policy meeting. That interest rates have been cut by a cumulative 3% in the eight weeks from early October to 4th December highlights the seriousness of the situation facing the UK economy, with further easing anticipated in the coming months.

The minutes of the December meeting confirm that all nine MPC members voted for the cut. They also reveal that, with a significant margin of spare capacity now expected to open up and inflation projected to significantly undershoot its target over the medium term, **the MPC considered voting for an even bigger reduction.**

However, the risk that an unexpectedly large cut could undermine confidence in the economy and cause an "excessive fall" in the exchange rate prevented it from doing more than 1% at this juncture.



The discussions, however, indicate that **another cut of at least 0.50% is on the cards for January, with further easing likely thereafter.** Markets are already speculating about the prospect of a move to a zero interest rate policy, similar to what we have seen in the US. Such a move could also be backed up by other more creative policy measures aimed at improving the functionality of the financial system, which remains under severe pressure.

The December minutes also noted the importance of bank lending to both households and businesses, remarking on the underlying weakness in credit growth as a cause for concern. The actions of banks and other financial institutions, as they look to reduce leverage, are reinforcing the downward pressure on the real economy.

Adjustments to official interest rates, however, would not be enough to tackle credit constraints. According to the MPC "further measures to underpin lending growth would be needed, building on the government's package announced in October to recapitalise and guarantee funding to the banks."

Gloomy Economic Data Support Actions of MPC

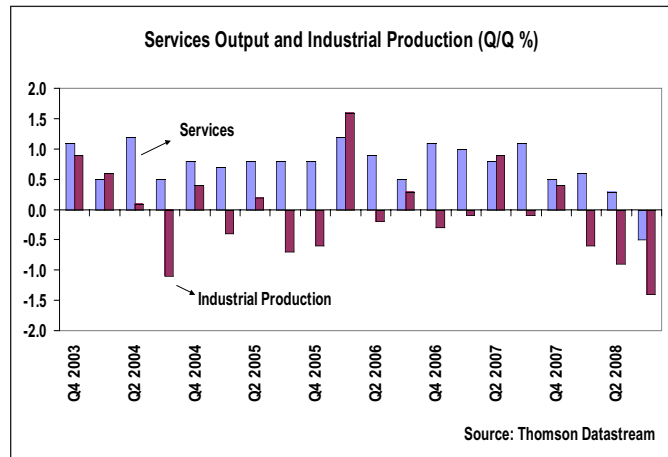
The dramatic actions of the MPC have been backed up by recent data. The economy contracted by 0.6% in Q3, the first fall in activity since Q2-1992. As a result, the year-on-year growth rate decelerated to 0.3%, from 1.5% in Q2. The downturn in the manufacturing sector intensified over the period with output decreasing by 1.6%, compared with a fall of 0.7% in Q2.

Services output, meanwhile, decreased by 0.5%, 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 2.8% (driven by a collapse in residential investment) and net exports knocking 0.2% off GDP, the government was the only sector providing any support to the economy in Q3.

Slowdown Evident Across All Sectors

Leading indicators point to an even greater contraction in activity in Q4. Both the manufacturing and services PMI's collapsed to record lows in November with a weighted average of the two now at levels consistent with a pronounced downturn in activity. Another weak reading for manufacturing has been released for December. We are currently pencilling in a 1.0% drop in GDP for Q4, with downside risks to this forecast.

Marked falls also continue to be evident in the CBI industrial and distributive trades surveys, with export orders falling sharply despite the weakness of sterling. **The latest BoE agents report provides yet more evidence that the downturn in activity is becoming more pronounced and widespread.**

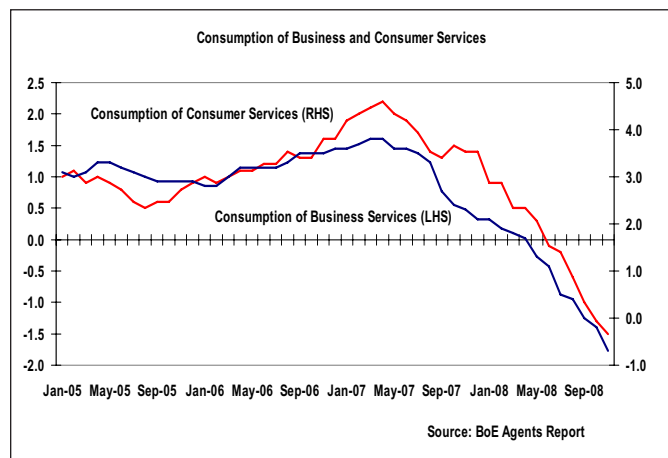


There was **increasing evidence of a slowing in capital spending,** with investment intentions cut back sharply in line with the weakening outlook for demand and concerns over financing. Meanwhile, employment intentions have been reduced further across all sectors, with the majority of contacts reporting that they would be looking to reduce head count over the next few months. For a growing proportion this would mean redundancies.

Household Finances Under Increasing Pressure

The Agents report also shows retail spending falling sharply, with households continuing to switch to unbranded products and discount outlets as household finances came under increasing pressure. In terms of large tickets items, new and used car sales were reported to be particularly weak, despite sharp discounting.

However, official retail sales for November were once again stronger than expected, remaining out of line with depressed survey findings. The volume of sales was up 0.3% on the month, compared to a forecast fall of 0.6%. **However, the year-on-year growth rate stood at 1.5%,** compared to a growth rate of 4.5% in the same month last year.



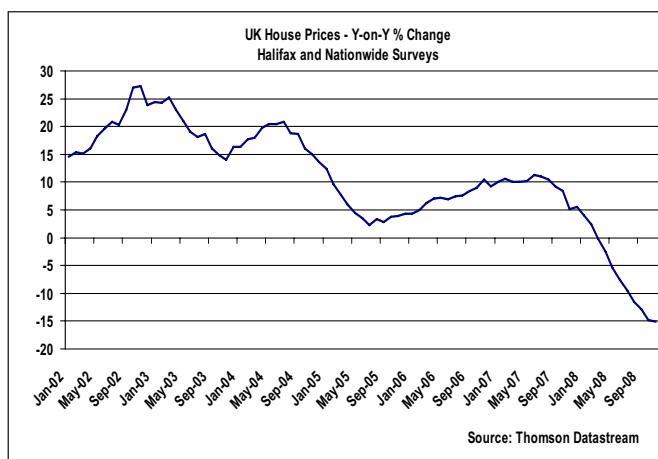
The recent fall in inflation, coupled with a wave of heavy discounting by major retailers and the temporary VAT reduction, could provide some boost to High Street activity. Nonetheless, **consumers look set to continue cutting back on discretionary spending as households react to mounting budgetary pressures.**



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 1,071,900 in November, after a cumulative rise of 164,000 in the latest three month period. The unemployment rate, meanwhile, (ILO measure) has risen to 6.0% from 5.5% at mid year and 5.2% at end 2007.

Housing Sector Remains Under Pressure

Conditions in the residential construction sector also remain difficult, with the construction PMI shrinking at its fastest pace ever in December. Meanwhile, average house prices are reported to be 15-20% off their peaks. Widespread expectations of further price falls, tightened credit conditions and falling consumer confidence are all reported to be curtailing transaction activity in the housing market. Credit conditions will remain tight with the gap between official and wholesale rates still elevated, though there has been some narrowing of this margin recently as year end liquidity demands ease.



Interest Rates Set to Fall to Very Low Levels

The scale of monetary adjustment introduced to date by the Bank, as well as fiscal stimulus measures announced in the Pre Budget Report, should be positive in terms of providing support to the economy over the medium term.

However, given the severity of the situation, this does not preclude the need for further aggressive action from the BoE. Thus, we would not be at all surprised if the MPC cut rates to 1% or below in early 2009.

Rate Outlook to Weigh on Sterling

Against a background of deep concerns about the outlook for the UK economy and expectations for further aggressive easing from the Bank of England, **sterling has fallen sharply versus the dollar and euro over recent times, amid increasing speculation of a move to parity for sterling/euro.** The UK currency looks set to remain under pressure in the opening months of 2009 as its role as a high yielding, safe haven alternative continues to be eroded.

At this stage we see scope for another move beyond Stg0.95p for sterling/euro in early 2009. Over a 12 month horizon, however, we see a return toward more "fair value" levels as the impact of comprehensive UK policy action starts to feed through into the economy, with sterling moving back to around 85p against the euro.

5 January 2009

	UK Interest Rate Forecasts				
	Repo Rate	3 Mth	1 Year	2 Year*	5 Year*
Current	2.00	2.64	2.96	2.60	3.18
Mar'09	1.00	2.00	2.60	2.50	3.10
Jun '09	1.00	1.90	2.50	2.40	3.00
Sep '09	1.00	1.90	2.50	2.40	3.00

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