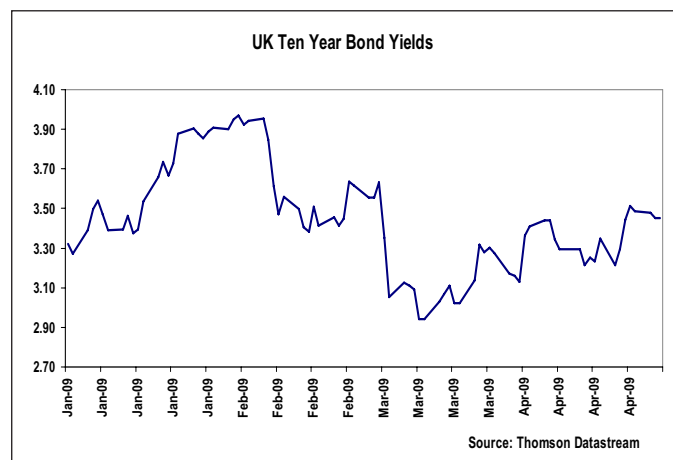


BoE Concentrates on QE Activities

The Bank of England left official interest rates on hold at 0.50% at its April meeting, which was in line with expectations. With official interest rates at such low levels the central bank has effectively exhausted its options in terms of conventional policy action. Thus, its focus has switched to more unconventional activities as a means of easing credit conditions and increasing liquidity flows. In this regard, **the minutes of the meeting outlined the MPCs intention to continue with its planned Stg75 billion of asset purchases under its quantitative easing (QE) policy.**

So far, around Stg26 billion worth of assets have been purchased. As expected, the bulk of the purchases have been of gilts, with smaller volumes of purchases in commercial paper and corporate bonds.

The initial effects of the Committee's purchases have been "encouraging". Yields on gilts fell by a sizeable amount following the announcement of the programme, with the drop concentrated in the range of eligible maturities, which is five to twenty five years. There were also early signs of improved conditions in corporate bond and commercial paper markets, with some spreads narrowing.



However, some of these falls in longer term interest rates have subsequently been reversed (particularly in the 10 year area), with yields coming under upward pressure for a variety of reasons, not least of which were the shocking public finance projections outlined in the recent budget. The continuing rally in stock markets and talk of early indications of a global economic recovery have also impacted.

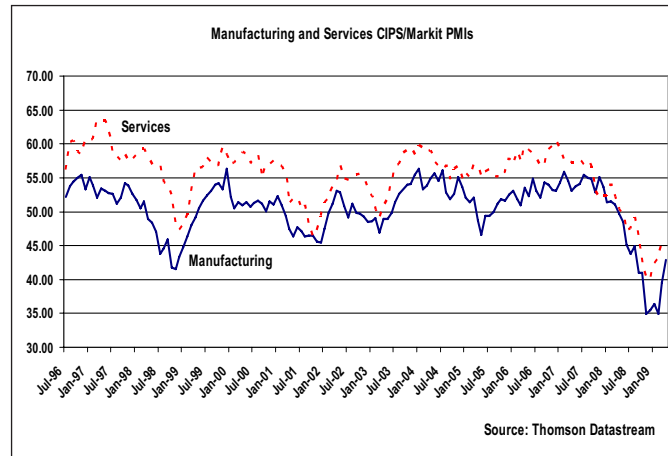
Assuming that the Bank continues to buy assets at its current rate, it will have spent its initial Stg75 billion by June. It then has to decide whether to start another Stg75 billion of purchases, thereby using up the full Stg150 billion authorised by the Treasury. It is likely that the Bank will press ahead with further purchases, with the minutes of the April meeting noting concern that the downward pressure on yields may only last while purchases are being made. However, the MPC's ability to influence the market has been seriously complicated by the news of a huge increase in the level of UK debt that will be issued this year.

In terms of its outlook on the economy, there were some notes of hope from the MPC in terms of its April discussions, with a number of indicators "showing signs of improvement". Meanwhile, credit availability does appear to be improving as reflected in the pick up of the annualised rate of growth in money supply. **However, there are still many uncertainties, and risks remain to the downside. Thus, we remain of the view that official interest rates will remain at ultra low levels for a prolonged period of time, certainly until late 2010.**

Economic Newsflow Turns More Positive

In terms of the economic news flow from the UK over the past month, there has been an increasing number of stories focusing on the prospect of "green shoots of recovery". Both the manufacturing and service CIPS/Markit PMIs improved again in March, indicating that the pace of contraction in economic activity could be slowing. A further rise in the manufacturing index in April puts the leading indicator at its highest level since last August.

There have also been some signs of improvement in other surveys such as the BCC retail and manufacturing reports, as well as the CBI industrial and distributive trades surveys. The latest BoE agents report also indicated that the pace of contraction may be easing.



Meanwhile, conditions in the housing sector remain depressed but signs that the market might be beginning to stabilise continue to build. Recent RICS surveys have shown modest improvements across most indicators, while the Bank's own regional Agents are reporting a growing number of enquiries and viewings, while mortgage approvals picked up again in March.

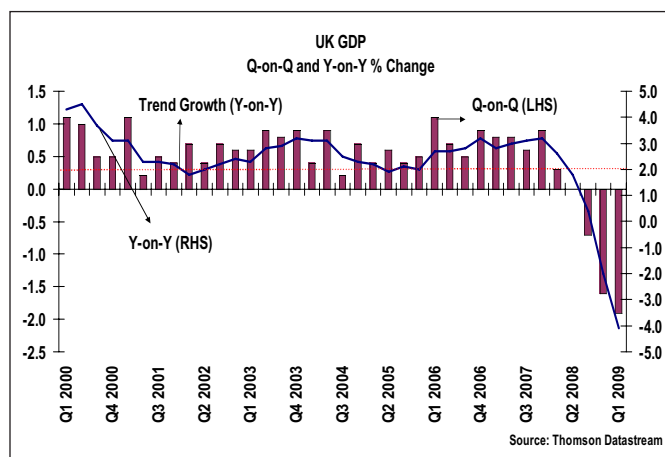
The rate of decline in house price inflation also appears to be cooling. Nonetheless, prices are still around 18% off their peaks and widespread expectations of further price falls, tight credit conditions and falling consumer confidence are all expected to continue curtailing transaction activity in the housing market.

Official retail sales data for April were also better than expected, with the volume of sales rising 0.3% over the month. The annual growth rate, meanwhile, picked up from 0.4% to 1.5%. However, the rebound in activity was very modest when seen in the context of the 2% drop in volumes the previous month. Furthermore, spending on consumer services remains depressed.

We remain of the view that household expenditure will be further undermined by ultra low consumer confidence (despite another improvement in the Gfk index in April, it remains well below its long term average), as well as ongoing weakness in the housing market and continued deterioration in labour market conditions. Rebuilding of household balance sheets should also have a negative impact. The Q4 GDP data showed the savings rate spiking up to 4.7% in Q4, the highest since Q1-2006, and up from 1.7% in the previous period. This uptrend is expected to continue over the coming quarters.

But Real Activity Data Remain Distinctly Soft

Thus, any indications of a bottoming out in the downturn in the UK are only very tentative at best and should be treated with caution. For the most part, they have come in the form of survey and anecdotal evidence rather than real activity data, which remain distinctly soft. Furthermore, while leading indicators may be off their lows they remain at levels consistent with a significant contraction in the pace of activity.





Provisional GDP estimates for Q1 show that the economy contracted by a larger than anticipated 1.9% in the first three months of the year. Allowing for the 1.6% and 0.7% fall in GDP seen in the two previous quarters, this means that the UK economy has contracted by a cumulative 4.3% so far in this recession, the worst performance for over three decades. Output from the industrial sector contracted by 5.5% in Q1, the largest quarterly fall in production since Q1-1974. This came as no great surprise given the trend of recent monthly manufacturing production data. However, output from the services sector fell back by 1.2%, the biggest quarterly fall since Q3-1979.

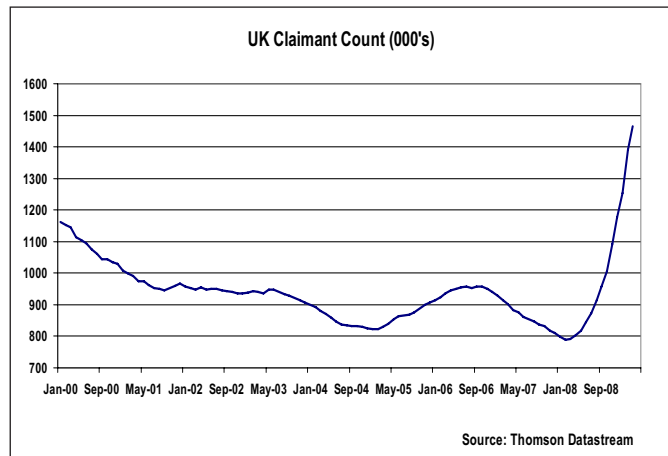
The news of a weaker than forecast performance in Q1 suggests that the recession will be even deeper than previously envisaged, meaning that the recovery will take longer. On the basis of the provisional data we now anticipate that the UK economy could contract by up to 4.5% this year and a further 0.6% next year, a considerably weaker outlook than the one outlined by the Chancellor in his recent budget statement.

Labour Market Indicators Continue to Show Pronounced Weakness

There has been no let up in terms of the rate of deterioration in labour market conditions.

The claimant count rose by a further 73,700 to 1.46 million in March, its highest level since October 1997. The unemployment rate, meanwhile, (ILO measure in the three months to February) has risen to 6.7% from 5.5% at mid 2008 and 5.2% at end 2007.

This is the highest jobless rate since October 1997. Meanwhile, the annual rate of growth in average wages, excluding bonuses, fell to 3.2% in the three months to February, the lowest rate of growth since records began in 2001. **This continued deterioration in labour market conditions, as well as the downward adjustment in terms of wage inflation, will weigh on consumption activity going forward.**



Inflation Surprises on the Upside

The annual CPI rate rose unexpectedly to 3.2% in February but resumed its downward trajectory in March, falling back to 2.9% its lowest level since March of last year. However, this still leaves the CPI almost a full per cent above the BoE's 2.0% target and well above the corresponding rate of inflation in the eurozone.

Nonetheless, falls in the cost of utilities, as well as the substantial contraction in the rate of economic growth, should see the CPI rate come down much more sharply over the coming months. Thus, inflation is still expected to fall well below its 2% target before year end and **the current rather sticky nature of the UK CPI does not change our view that rates are set to remain very low for a prolonged period of time.**

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.50	1.45	1.92	2.07	3.05
June '09	0.50	1.40	1.85	2.00	3.00
Sept '09	0.50	1.30	1.80	2.00	2.90
Dec '09	0.50	1.20	1.70	2.00	2.80

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