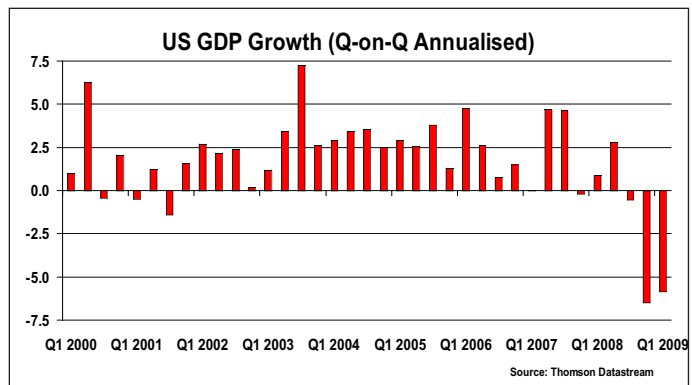


FED RATES VERY MUCH ON HOLD

As expected, the US Federal Reserve kept its key interest rate, the Fed funds rate, in a target range of 0 to 0.25 per cent at the conclusion of its FOMC policy meeting yesterday. The Fed has kept rates at this historically low level since last December. In its post meeting statement, the Fed reiterated that **economic conditions are likely to warrant continuing exceptionally low levels of the Fed funds rate for some time yet.**

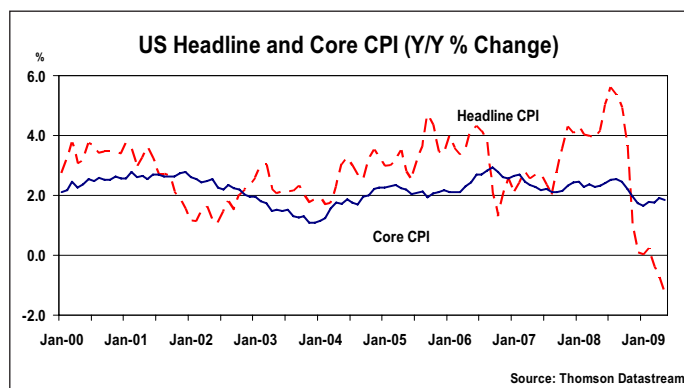
The Fed is employing all available tools to promote the resumption of sustainable economic growth and boost liquidity. **With official interest rates close to zero per cent, the Fed's focus has shifted this year to quantitative easing measures** to stimulate the economy and support the functioning of financial markets. **These involve large scale purchases of agency debt, mortgage backed securities and Treasuries.**

There has been speculation that, given recent signs of some improvement in the US economy, the Fed will begin to hike rates by end year. While this rate hike speculation has eased somewhat in the past few days, the **Fed funds futures contracts are still discounting at least a 50-50 chance of a December rate hike.** There was nothing in the Fed statement last night, though, to indicate that it is considering an exit strategy from its current very accommodative policy stance. In fact, the statement may well further dampen rate hike speculation.



The Fed statement, while somewhat more upbeat in its assessment of the economy, was still cautious about economic prospects. It noted that economic growth is likely to remain weak for some time, though the pace of economic contraction is slowing.

The Fed, meanwhile, expects inflation to remain subdued for some time, given still substantial resource slack. It is, though, less concerned about deflation given recent rises in energy and commodity prices.

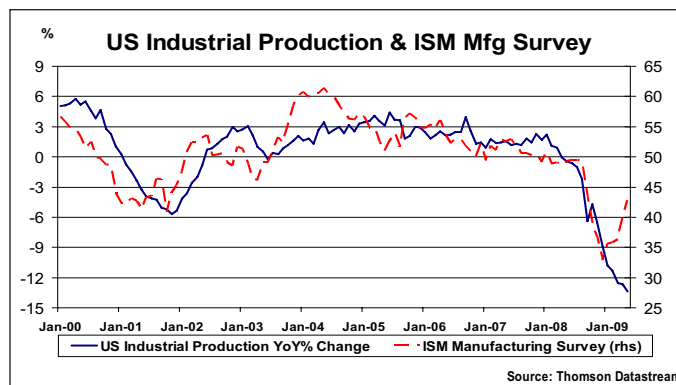


These conditions are likely to warrant a very low Fed funds rate for an extended period and a continuation of its quantitative easing measures. We do not expect the Fed to starting hikes rates until well into 2010 at the earliest.

RECESSIONARY PRESSURES BEGIN TO EASE

The official view is that the US recession started in December 2007 but it is only since last autumn, following the collapse of Lehmans, that it has morphed into a very deep downturn in activity. GDP contracted by 5.7% annualised in Q1 2009 and 6.3% in Q4 2008, led by very sharp falls in business investment and exports and the continuing marked decline in housing - housing investment contracted by 38.7% annualised in Q1 after a 22.8% fall in Q4 2008, the twelfth consecutive quarter that it declined at a double-digit rate. Inventories have also fallen.

Recent indicators suggest that the pace of economic contraction eased in Q2. Both the manufacturing and services ISMs have been rising for a number of months now, although they are still at levels consistent with contracting activity. The leading indicators index rose strongly in April and May. There was a good pick up in retail spending in May, while construction spending rose in March and April. Consumer confidence has also picked up.

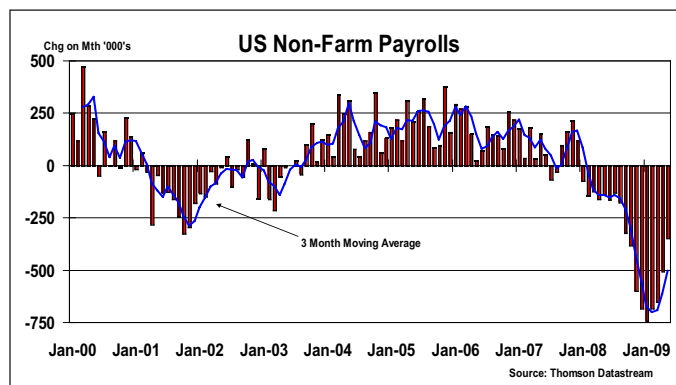


The latest Fed Beige Book survey, though, shows that the economy remains weak, and even deteriorated further in some parts of the country in April/May. The industrial sector continues to suffer, with manufacturing output falling by 1.0% in April and 0.6% in May. Housing permits and starts declined further in April/May from their levels in Q1. Thus, the economy is still in the grip of recession, although the pace of contraction is slowing.

Nowhere is the weakness of the economy more evident than in the labour market. While the rate of decline in non-farm payrolls has slowed, May still saw employment fall by 345,000, bringing to almost 3 million the number of jobs lost year to date in the US. The unemployment rate continues to soar, climbing to 9.4% in May from 8.9% in April and 7.2% at end 2008.

There is no doubt that US policy is very expansionary, with a massive fiscal stimulus, zero official interest rates, significant quantitative easing and a weak currency. However, **the economy is still facing very significant headwinds.**

Household balance sheets are weighed down by heavy debts and pressures on disposable income, with the focus very much on rebuilding savings. The renewed rise in oil prices crimps spending power even further. Despite the more stable banking system, the Beige Book reports that credit conditions remain stringent or have tightened even further. There has also been a marked rise in long-term interest rates recently. The scale of job losses is still very high. Global demand remains very weak. Overall, the economic environment remains very challenging.



The pick up in leading indicators and expansionary policy stance does suggest that there should be a return to growth in the US economy later this year. However, given the factors set out above, **the pace of recovery is likely to prove very subdued.** Combined with the large amount of spare capacity in the economy, particularly very high unemployment, **it suggests that rates are going to remain very low for a prolonged period. Pricing in policy tightening by end year is way off the mark in our view.**