

Policy to Remain Accommodative on BoE Caution

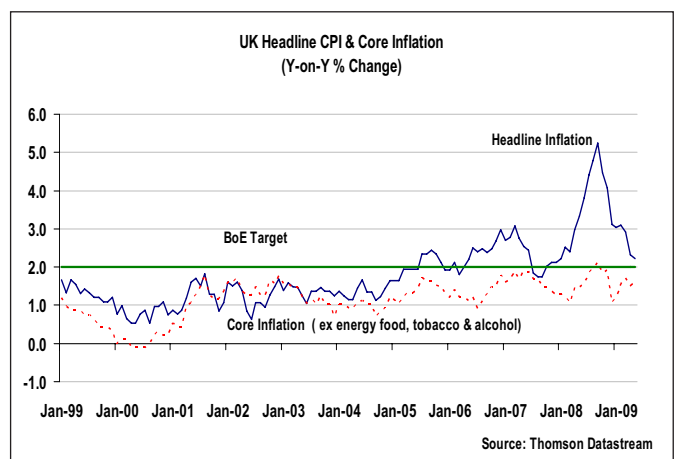
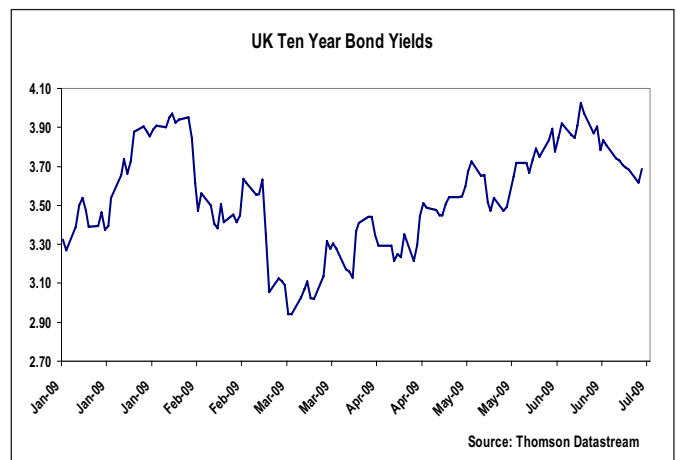
The Bank of England left official interest rates on hold at 0.50% at its June meeting. The Committee also voted to continue with its programme of quantitative easing, as announced following the May policy meeting. It estimates that it will take until the end of August to meet the current £125 billion target for asset purchases, with any decision regarding an extension of the programme likely to be put on hold until then. Thus, we expect no change in policy at this month's meeting.

It is still too early to assess the impact of the asset purchase programme on the rate of economic activity, though the Bank does feel that there are some tentative signs that the increased liquidity is feeding through. Meanwhile, after a spike upwards, UK bond yields have come lower again but this is as much to do with some reassessment of the global economy's recovery prospects as it is down to the activities of the BoE.

With regard to its assessment of the UK economy, both the minutes of the June meeting and subsequent comments from MPC members, show that, while encouraged by the recent indicators, the BoE remains cautious with regard to any signs of a pick up in the rate of economic activity. Any recovery will in the words of Mervyn King be a "long, hard slog".

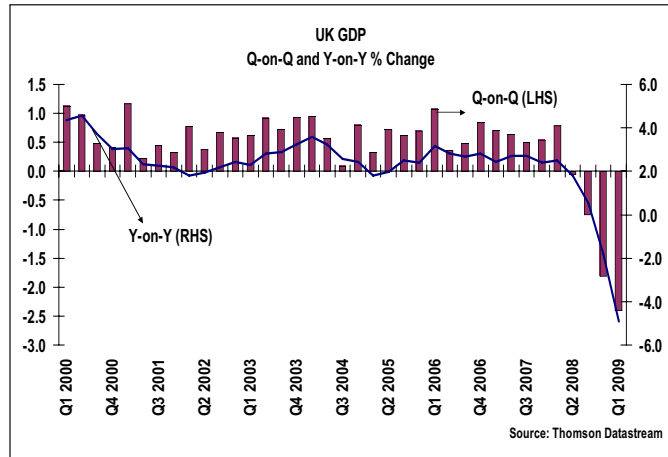
Its central projection for inflation to be well below target in two years time, as outlined in the May Quarterly Inflation, remains unchanged. This is despite the fact that the annual rate of inflation (as measured by the CPI) remains very slow in terms of trending downwards. It eased only marginally to just 2.2% in May from 2.3% in the previous month. The comparable rate of inflation in the US is -1.3% and 0.0% in the eurozone. However, the full effects of the sharp slowdown in the economy and rise in spare capacity have yet to be felt in the UK inflation rate.

Thus, any tightening of monetary policy, either through a rise in official interest rates or the reversal of QE activities, is some way off. Indeed, the central bank may yet raise the scale of its quantitative easing activities to the full £150 billion sanctioned by the Treasury.



Weak Q1 to Represent Bottom of Cycle

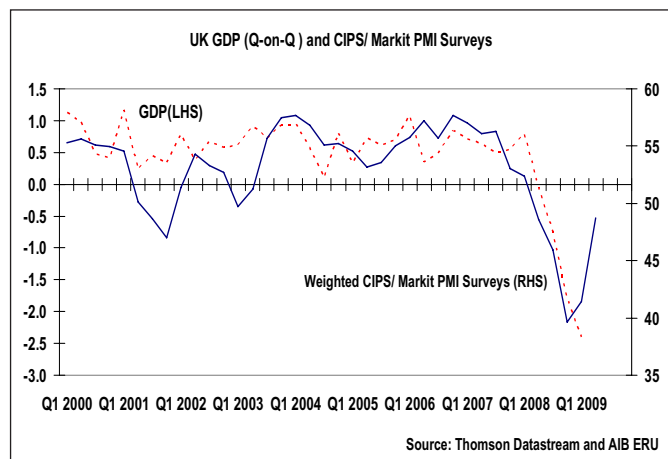
The UK economy contracted by 2.4% in the first three months of this year, a sharp downward revision from the original estimate of 1.9% and the biggest quarterly fall in output since Q2 1958. In year-on-year terms the economy contracted by 4.5%. Allowing for the 1.8% and 0.7% fall in GDP seen in the two previous quarters, the UK economy has contracted by a cumulative 5.0% so far in this recession, one of the worst performances on record. Output from the industrial sector contracted by 5.1% in Q1 as destocking acted as a major drag on the economy. Output from the services sector contracted by 1.6%, while construction output fell by 6.9%.



As Rate of Contraction Set to Ease

While the sharp downward revision to the Q1 numbers leaves an even weaker than anticipated platform for any recovery in activity over the remainder of the year, the rate of contraction looks set to ease considerably over Q2. Indeed, on the basis of the recent trend in leading indicators, markets are speculating about a return to growth in Q3.

There has been a steady rebound in the manufacturing and services CIPS/Markit PMIs since February, though the rate of recovery in the services sector appears to have stalled somewhat in June. At the same time, however, currently at a respective 47.0 and 51.6, both indices are now well up on the cyclical lows of 35 and 40 recorded last November. Real activity data are also starting to improve. After a disastrous start to the year, manufacturing output rose 0.2% in March and April, suggesting that the drag from the industrial sector should ease in Q2 and beyond.



Although results have been less consistent than the trend in the PMI's, there are signs of a bottoming out 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 should ease over the coming quarters.

High Street Spending Holding Up and Housing Sector Stabilising

Meanwhile, despite a weaker than expected retail sales report for May, high street spending seems to be holding up reasonably well, consumer confidence is picking up and the monthly rate of increase in the claimant count has slowed to less than half of what it was at the beginning of the year.

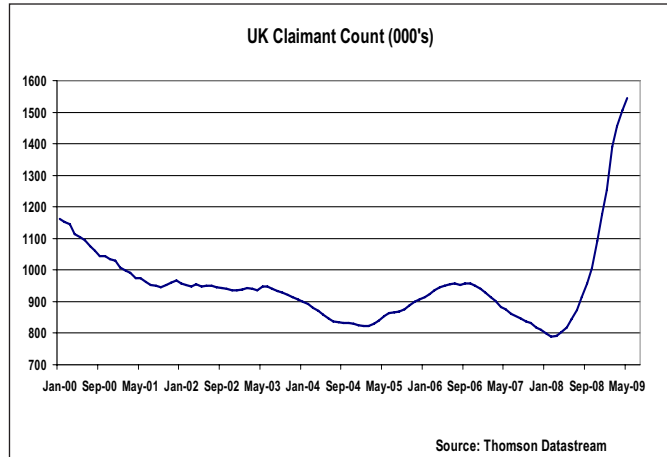
We continue to see evidence of a stabilisation in housing market activity, with the RICS survey showing improvement across most categories, while the Bank's own regional agents continue to report a growing number of enquiries and viewings. The rate of decline in house price inflation also continues to cool, with the Nationwide index showing prices rising 1.3% in May and 0.9% in June.



But Any Recovery Will be Restrained

While there is certainly growing evidence to suggest that the economic outlook for the UK is brightening, we are not forecasting a sharp rebound in activity as all sectors of the economy look set to remain impaired. Despite a better than anticipated performance from the high street, total household consumption contracted by 1.3% in Q1, with the volume of spending 3.1% lower than where it was in the same period last year. **We remain of the view that household expenditure will be subdued over the coming quarters**, undermined by still relatively low consumer confidence, as well as ongoing weakness in the housing market, a rising savings rate as household balance sheets are rebuilt and weak labour market conditions.

Although the rise in the claimant count has eased the unemployment rate (ILO basis) has already risen to 7.2%, its highest level since November 1996. The annual rate of growth in average wages, excluding bonuses, fell to 2.7% in the three months to April, the lowest rate of growth since records began in 2001. Furthermore, the need for fiscal restraint over the medium term is also likely to impact negatively on household finances.



Housing Activity Still Subdued

There are also concerns about how far any recovery in the housing sector will extend. The conversion from enquiry to sale remains below historical norms and while there is some evidence that the availability of mortgage finance is starting to improve, credit conditions remain difficult. 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.

This general level of weakness in the economy does not suggest a healthy outlook for investment activity which contracted by 7.5% in Q1, while the sharp deterioration in the government fiscal position leaves little scope for any further stimulus from this sector. **Thus, notwithstanding the prospect of a return to growth in H2, GDP is still expected to fall by well over 4% this year, with average growth of 0.9% pencilled in for next year.**

UK Interest Rate Forecasts (to end quarter)					
	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.50	1.16	1.68	2.18	3.59
Sept '09	0.50	1.20	1.75	2.30	3.60
Dec '09	0.50	1.20	1.75	2.30	3.60
Mar'10	0.50	1.30	1.85	2.40	3.70

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

This subdued outlook is one shared by the MPC, which in terms of comments over recent weeks has been at pains to emphasize the continued downside risks to the economy, including the impact of a newly resurgent sterling on any recovery in the traded sector. **This supports our view that official rates are set to remain very low for a prolonged period of time.**

03 July 2009