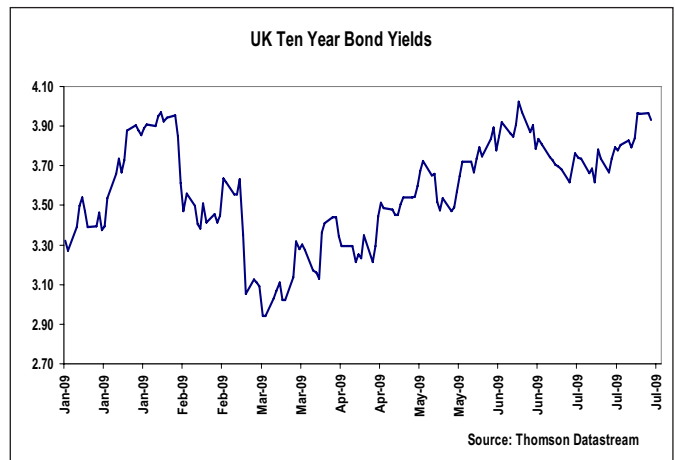


BoE Remains Guarded on UK Economic Outlook

The Bank of England left official interest rates on hold at 0.50% at its July meeting. The Committee also voted to continue with its Stg125bn programme of quantitative easing. However, it would do so at a slower rate than previously, ensuring that the purchases would continue until the August policy meeting, when the situation would be reviewed.

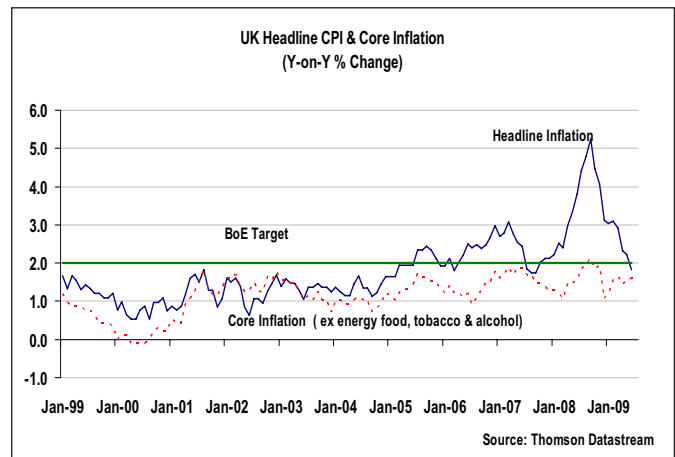
As the Bank continues to monitor the effectiveness of its Asset Purchases Programme, the preparation of the August Quarterly Inflation report (due for release 12th August) offers an ideal opportunity to evaluate the stock of purchases "in light of a fully updated assessment of the outlook for growth and inflation", thus amplifying the importance of next week's policy meeting. **We expect no change in official rates on Thursday next but the BoE could well extent its QE activities to the full Stg150bn sanctioned by the Treasury.**



In terms of the MPC's current view on

the economy, the minutes of the July meeting could be described as slightly less dovish than the previous ones, with the committee noting that, while overall the prospects for the economy in the medium term were unchanged, the downside risks to GDP in the near-term had "probably diminished".

Meanwhile, with regard to inflation, the CPI rate near term could be a little higher than the projected path outlined in May's Inflation Report. The latest monthly data show the annual CPI rate easing to 1.8%, its lowest level since September 2007. It is also the first time since then that the CPI has moved below the BoE's 2.0% target. **However, compared to the eurozone and the US, inflation in the UK remains relatively high.**



Nonetheless, the MPC sees a strong case for focusing on underlying trends rather than monthly data. It is quite possible that the factors expected to push down inflation

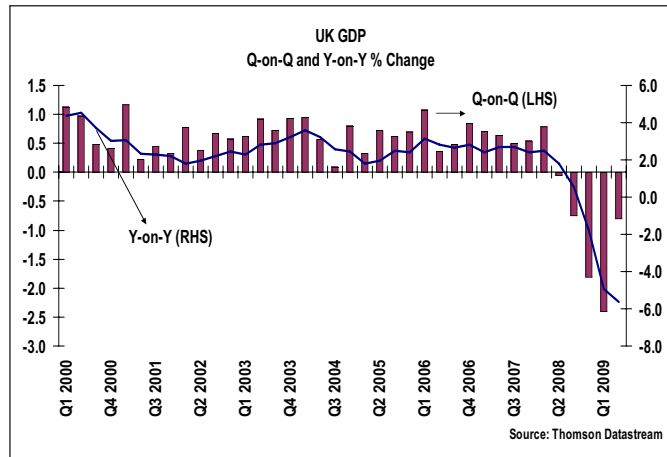
over the medium term are taking longer than anticipated to work through and the CPI is still expected to be well below the 2% target over the medium term. **Thus, any tightening of monetary policy, either through a rise in official interest rates or the reversal of QE activities looks to be some way off.**

Rate of Contraction Eases in Q2

Data released just last week show that the UK economy contracted by a further 0.8% in the second quarter of this year. This marks the fifth consecutive quarter of contraction in GDP, which so far in this recession has fallen by a cumulative 5.9%, making it one of the worst downturns in modern history. Still, while the 0.8% drop in output was below market expectations, it represents a considerable improvement on the 2.4% fall seen in the first three months of the year.

The continued decline in output was due to decreases in all components of the economy. Manufacturing output fell 0.3%, compared to a drop of 5.5% in Q1, while the construction and services sectors contracted by a respective 2.2% and 0.6%.

In Q1 output from these sectors fell back by a respective 6.9% and 1.6%. The extent of the contraction in the services sector was disappointing and the 0.8% overall drop in activity has undermined the outlook for the second half of the year. It should be noted, however, that the data are just provisional and may yet be revised.

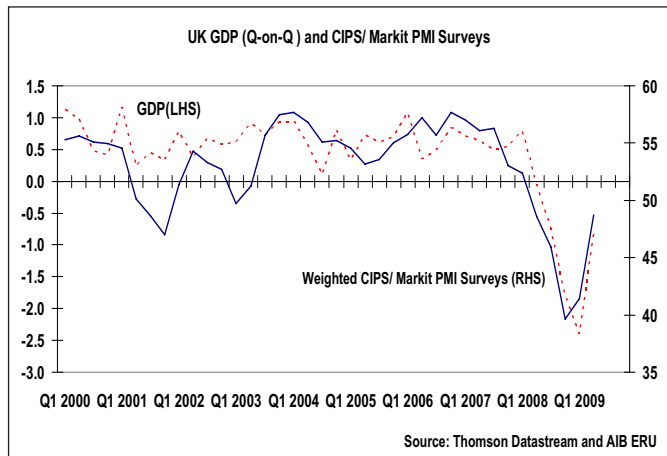


Indicators Suggest Return to Growth in Q3

Furthermore, leading indicators continue to suggest a return to positive 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 did stall 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.

Although results have not been universally positive, we also continue to see 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 should ease over the coming quarters.



High Street Spending Holding Up and Housing Sector Stabilising

Meanwhile, on the basis of the latest official retail sales report, which is for June, high street spending seems to be holding up reasonably well, consumer confidence continues to recover from its lows and the monthly rate of increase in the claimant count has slowed considerable from what it was at the beginning of the year.

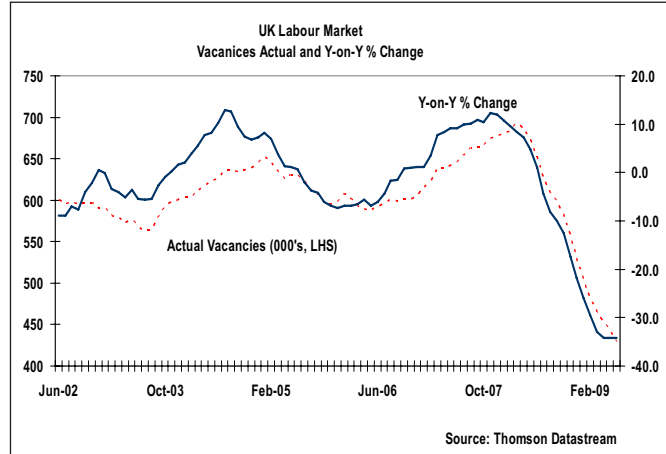
The past month has also brought further evidence of a stabilisation in housing market activity, with surveys showing increased viewings and transaction activity as well as a rising percentage of asking prices being achieved. The rate of decline in house price inflation continues to cool, with the Nationwide index showing prices rising for each of the past three months. Meanwhile, mortgage approvals, although still historically low, hit almost 48,800 in June. This represents the highest absolute level since April 2008 and a year-on-year increase of 35%.



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 the resilience of the high street, we remain of the view that total household expenditure (goods and services) will be subdued over the coming quarters, undermined by still relatively low consumer confidence, a rising savings rate and weak labour market conditions. Although the rise in the claimant count has eased the unemployment rate (ILO basis) has already risen to 7.6%, its highest level since late 1996. The annual rate of growth in average wages, excluding bonuses, meanwhile, fell to 2.6% in the three months to May, 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, Fiscal Restraint to Act as a Drag

There are also concerns about how far any potential recovery in the housing sector will extend. The conversion from enquiry to sale remains below historical norms and credit conditions continue to be reported as difficult. Prices are still around 14-20% off their peaks (depending on which survey you look at) and the possibility of further price falls, tight credit conditions and a weak labour market could all continue to curtail housing activity over the coming months. Indeed, after showing signs of stabilising/improving in May, both the BoE's Agents construction sector activity index and the construction PMI fell back in June.

This underlying level of weakness in the economy does not suggest a healthy outlook for investment activity, while the sharp deterioration in the government fiscal position leaves little scope for any further stimulus from this sector.

Furthermore, much of the softening in the rate of contraction in the economy in Q2 is likely to have been due to a turn in the inventory cycle. Also there is little evidence to suggest that the fall in the value of sterling will provide any major boost to growth anytime soon, despite the improvement in the CBI's survey of export orders in June.

UK Interest Rate Forecasts (to end quarter)					
	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.50	0.90	1.44	2.21	3.71
Sept '09	0.50	1.00	1.60	2.30	3.70
Dec '09	0.50	1.10	1.70	2.35	3.75
Mar '10	0.50	1.20	1.80	2.40	3.80

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

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 1.0% pencilled in for next year. This cautious outlook is one shared by the MPC, supporting our view that official rates are set to remain very low for a prolonged period of time.