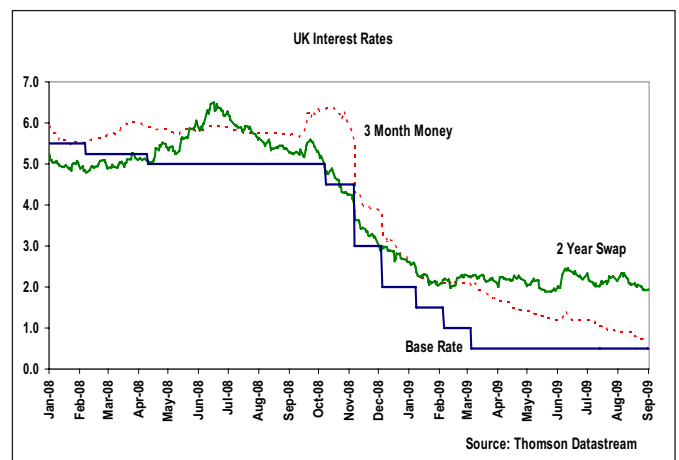


UK Rates to Stay Low for Prolonged Period

The Bank of England left official interest rates on hold at 0.50% at its August meeting. At the same time it voted to extend its programme of asset purchases by another £50bn to a total of £175bn, with the purchase of the additional assets to take place over the course of the next three months. We expect no policy changes at this month's meeting. However, with the July minutes showing three MPC members, including Mervyn King, voting to increase the size of the asset purchase programme by as much as £75bn, we could yet see further quantitative easing.

Even if £175bn proves to be the final sum, the minutes of the meeting as well as the **Bank's latest Inflation Report (published on 12th August)** gave a clear signal that monetary policy is unlikely to be tightened anytime soon.

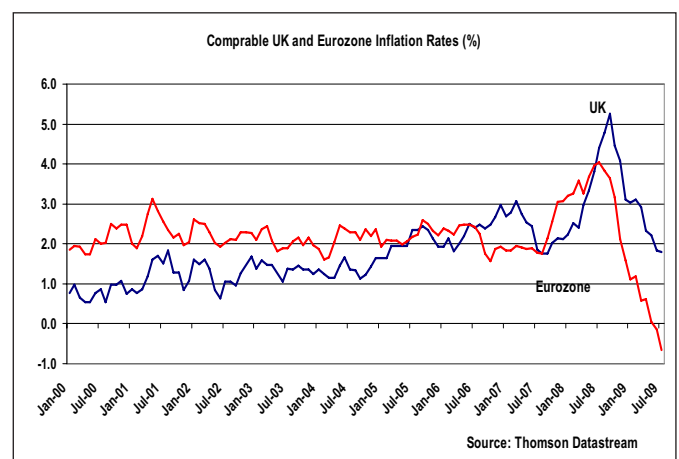
While Q2 GDP data were weaker than anticipated, more timely indicators of activity, including key business surveys, indicate that output probably stabilised in the middle of the year. **However, while the MPC believes that the worst of the near term downside risks to economic activity have lessened, there is still much uncertainty about how durable any recovery will prove to be in the medium term** and the large amount of spare capacity in the economy will only be gradually eroded.



Downside Risks to Growth Outweigh Sticky Inflation

As regards the balance of risk to the outlook for inflation, recent CPI data have surprised on the upside. The annual CPI rate was unchanged in July at 1.8%, while the core rate actually rose from 1.6% to 1.8%. However, despite the "stickiness" of the UK CPI, the MPC is still projecting a below target inflation rate over its two year policy horizon.

Thus, with downside risks remaining on the growth front and inflation projected to be below target over the next two years, 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.

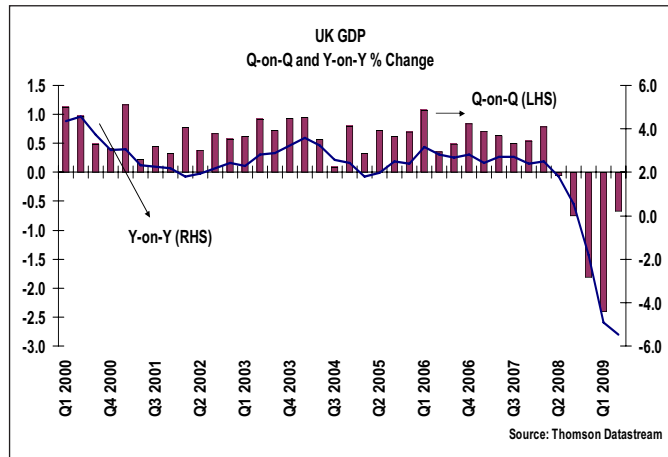


Worst of Recession Over for UK Economy

The UK economy has been in recession since early 2008, contracting by a cumulative 5.8% over the fifteen month period to end Q2-2009. The recession has been characterised by a sharp downturn in terms of industrial and construction output, as well as a fall off in household consumption and general business investment. Indeed, net trade (due to a fall off in imports as opposed to a pick up in exports) and government spending are the only sectors of the economy lending any support.

The downturn was at its most intense in late 2008/early 2009, with the economy contracting by a respective 1.8% and 2.4% in Q4-2008 and Q1-2009. More recent data

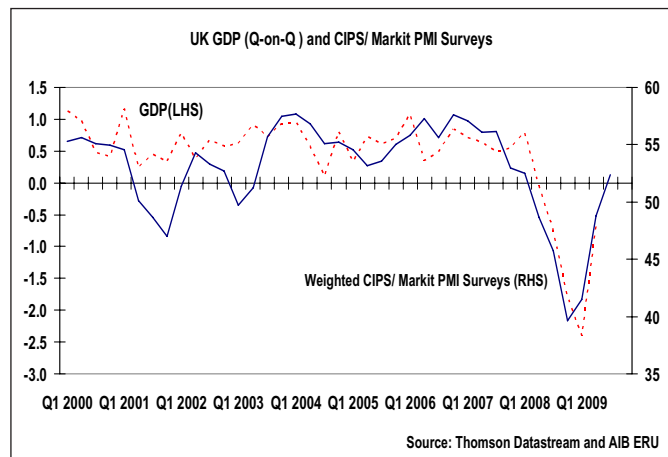
show that the worst of the recession has passed, with GDP declining by a much more modest 0.7% in the second quarter of this year. About half of the improvement compared to the previous period was due to an easing in the pace of destocking. Nonetheless, inventories still continued to fall at a fairly aggressive pace, which points to a boost to growth from restocking in the second half of the year.



Survey Evidence Points to Return to Growth in H2

There is further evidence of an easing in recessionary conditions in leading indicators like the CIPS manufacturing and services PMIs. At a respective 49.7 and 54.1, the indices are now well up on last November's cyclical lows of 35.1 and 40.1. Thus, despite the disappointing dip in the manufacturing index back below the key 50 level in August, a weighted average of both points to a return to growth over the course of H2.

Although results have not been universally positive, we also continue to see signs of stabilisation and indeed 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 agent's survey also indicated that the pace of contraction should ease over the coming quarters, with widespread reports last month that the pace of destocking has slowed.



High Street Spending Resilient, Housing Market Recovers

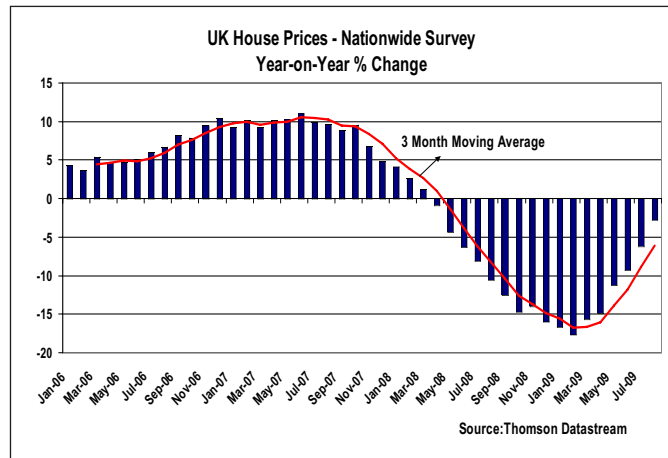
High street spending has proved to be reasonably resilient over the downturn. Following impressive growth of 1.3% in June, retail sales rose another 0.4% in July. Furthermore, the data show evidence of a pick up in more discretionary areas of spending, though the increased activity has come at the expense of falling margins, with the retail sales deflator at -0.7% in July, its lowest level since the end of last year. There are also signs of a pick up in spending off the high street, even in the number of new car registrations, which have improved as a result of the introduction of the scrappage scheme in May.

A stabilisation in housing market activity also appears to be gathering momentum, with all the main surveys now showing prices up on a monthly basis. Most notable is the closely watched Nationwide index, which shows prices rising in each of the past four months. As a result, the year-on-year rate of decline in house



price inflation has moderated to 2.7%, compared to 16/17% at the beginning of the year. Mortgage approval numbers also continue to trend upwards, with the latest data for July showing the best numbers since April 2008.

Like in the US and eurozone, the weakness in the economy has been acutely evident in a rapidly rising unemployment rate. Here too, though, there are signs that the rate of deterioration is easing. The monthly rise in the claimant count had moderated to 25,000 by July, well down on an average increase of 94,000 in the first three months of the year. Surveys of employment intentions are also less weak than they were earlier in the year.



Any Recovery Will be Restrained

Thus, there is growing evidence that the UK economy is responding to the massive fiscal and monetary stimulus that it has received. Nonetheless, like other major economies, the UK still faces significant headwinds. Any recovery in activity is likely to be subdued and the path to recovery likely a bumpy one.

Despite relatively robust high street activity, total personal consumption (goods and services) is expected to remain weak, weighed down by strained household balance sheets, given a projected rising savings ratio and weak earnings growth, as well as a 13 year high unemployment rate of 7.8%. There are also concerns about how sustainable any recovery in the housing market will prove to be, given that the increase in prices over recent months is reported to be more a reflection of a shortage of properties for sale rather than a fundamental pick up in demand or increased lending activity. **Thus, with credit conditions still constrained, construction sector activity remains "severely depressed", as does business investment generally.**

There is also little evidence to suggest that the fall in the value of sterling will provide any major boost to growth anytime soon, with the July CBI industrial trends report actually showing a drop in export orders. **Furthermore, the dire state of the public finances points to the likelihood of severe fiscal consolidation in the years ahead,** including the inevitable prospect of higher taxes and spending cuts.

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.

UK Interest Rate Forecasts (to end quarter)					
	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.50	0.67	1.21	1.95	3.33
Sept '09	0.50	0.70	1.25	2.00	3.40
Dec '09	0.50	0.80	1.40	2.10	3.50
Mar '10	0.50	1.00	1.50	2.20	3.60

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

4th September 2009