



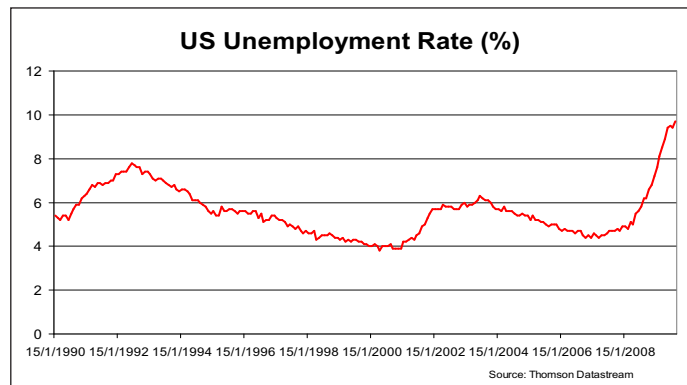
FED RATES TO REMAIN LOW FOR LONG TIME

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 again reiterated that weak economic conditions are likely to warrant continuing exceptionally low levels of the Fed funds rate for an extended period.

With official interest rates close to zero per cent, the Fed's focus shifted earlier this year to quantitative easing measures to stimulate the economy and support the functioning of financial markets. Not surprisingly, given the signs of an improving economy, the Fed did not announce any further expansion of these measures. Instead, it stated that it will gradually slow the pace of mortgage debt purchases to extend the life of the programme to the end of March 2010, interpreted by some in the market as a possible first step towards the removal of its monetary stimulus.

As evidence mounts that the US recession is over, there has been much speculation about when the Fed might begin to hike rates. During the summer, markets were pricing in the possibility of a hike in rates before year end. This talk has now abated and **markets do not see the first rate increase until at least next April.** In this regard, the December 2010 futures contract is trading over 100bps above the December 2009 contract indicating **the market still expects a considerable amount of policy tightening next year.**

We are doubtful about such tightening and indeed the Fed statement struck a nice balance between curbing rate hike expectations and quashing the growing optimism about economic prospects. The Fed statement was somewhat more upbeat than previously in its assessment of the economy, saying that economic activity is improving.



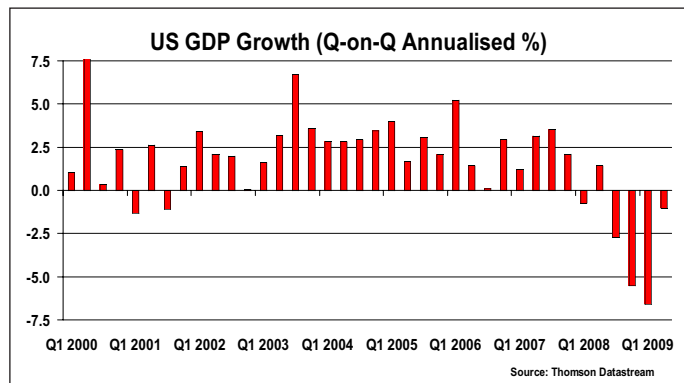
It is still cautions, though, about economic prospects. While showing signs of improvement, economic activity is still likely to remain weak for a time, with continuing high unemployment, sluggish income growth, lower housing wealth and tight credit. The Fed, meanwhile, expects inflation to remain subdued, given the very substantial resource slack, especially in the labour market where wage growth has slowed sharply.

Overall, then, there was nothing in the Fed statement to indicate that it is considering an exit strategy anytime soon from its current very accommodative policy stance. **Although the recession has come to an end, the pace of recovery is expected to prove subdued. Thus, unemployment is likely to rise further and remain high next year.** This is a very important consideration in setting monetary policy in the US. Such economic conditions are likely to result in the Fed funds rate remaining very low for an extended period. **We maintain the view that the Fed will not starting hikes rates until late in 2010 at the earliest.**

Recovery Expected To Be Subdued

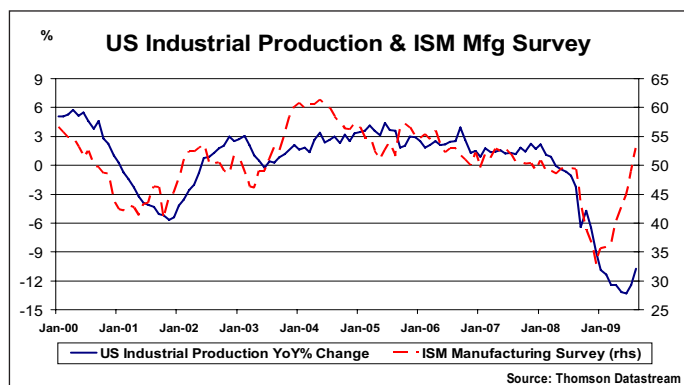
It seems almost certain that the recession which began in the US at the end of 2007 ended in Q2 2009. It proved a long and deep recession, with GDP declining by almost 4% in the year to Q2 2009 alone. Meanwhile, the unemployment rate has soared from under 5% to close on 10%. Normally one would expect a very strong rebound in activity after such a severe recession, especially given the extent of policy easing, both monetary and fiscal. **However, the US economy is facing many headwinds, suggesting that the pace of recovery will be relatively modest so unemployment looks set to rise even further and remain at elevated levels for a prolonged period.**

GDP contracted by just 1.0% annualised in Q2 this year, following the very sharp 6.4% and 5.4% contractions in Q1 2009 and Q4 2008, respectively. **The expectation is that the economy could grow at a 2.5-3.0% rate over H2 2009** lead by inventory rebuilding, a pick up in exports, revival in house building and as the fiscal stimulus package impacts more fully on activity.



Both the manufacturing and services ISMs have been on a rising trend for a number of months now, with the manufacturing index hitting 52.9 in August and the services business activity index rising to 51.3. This is translating into stronger real data. Industrial production rose by 0.8% in August after a 1% rise in July. Retail sales excluding autos rose by 1.1% in August, while auto sales surged in the month, boosted the government's 'cash for clunkers' scheme. Housing starts are now firmly trending upwards from their trough in the spring, with sales of both new and existing houses picking up sharply. Meanwhile, exports rose for a third consecutive month in July. Thus, a return to growth seems assured in the US for H2 2009.

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, so the improving data are not unexpected. **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. Credit availability is still constrained. There are large overhangs of unused industrial capacity and vacant homes. Meantime, the scale of job losses is still high and unemployment is expected to continue moving upwards into 2010. The fiscal stimulus is temporary and will abate over the course of 2010. Inventory rebuilding will also wane next year unless final demand strengthens considerably. Given all these headwinds, the recovery in activity is likely to prove subdued enough in 2010. GDP is expected to rise by 2% or less next year.

This suggests that inflationary pressures will remain well contained. Indeed, the core CPI rate and core PCE price deflator, which both currently stand at 1.4%, are likely to fall further. The Fed, then, is facing an environment of a relatively weak upturn in economic activity, high and rising unemployment and very weak inflationary pressures. It suggests that a hike in US rates is unlikely before the end of 2010.