

BoE Remains In Cautious Mood

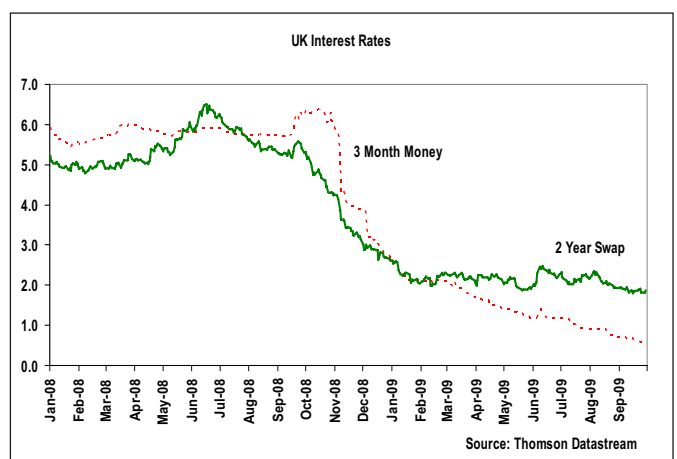
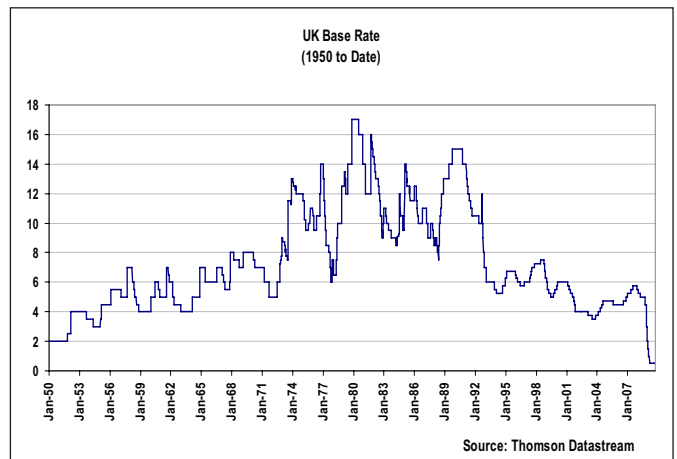
The Bank of England left official interest rates on hold at 0.50% at its September meeting. It also voted to continue with its quantitative easing programme of asset purchases totalling £175 billion. We expect no policy changes following next week's meeting. Additional QE remains a possibility as the September minutes show that those MPC members (including Mervyn King) who had preferred a larger stimulus at the August meeting still felt that further asset purchases could be justified. However, the MPC has set out a time frame of waiting until the November Inflation Report before deciding whether to extend its QE activities again.

On the economy front, the minutes acknowledged recent positive developments. The global economy continues to improve, while UK leading indicators were consistent with a return to growth in H2-09. There was further evidence of a recovery in the UK housing market, household spending was holding up better than expected and there were suggestions of a pick up in money supply growth. There were also positive signals from asset markets associated with higher earnings forecasts and the more positive macroeconomic outturns.

At the same time, however, the MPC pointed out that the data must be seen in context. While recent developments are positive they are unlikely to have major implications for the medium term inflation outlook.

Over the past year the UK economy has contracted by over 5% and a large degree of slack had now built up. Unemployment is likely to continue increasing for some time, the banking industry still has to complete its process of balance sheet adjustment and growth in final domestic demand (essential for a sustainable recovery) remains weak.

Even if GDP turned positive in Q3, it is unlikely to have reached the point where the level of spare capacity is shrinking. Thus, the MPC continues to project a below target inflation rate over its two year policy horizon and we remain of the view that 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.

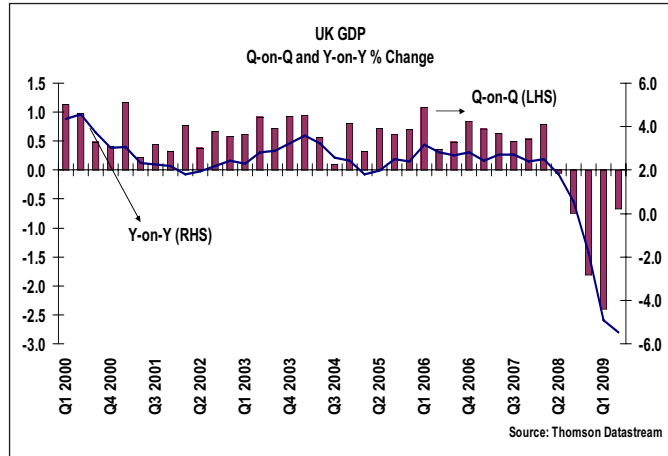


Worst of Recession Over for UK Economy

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 2.5% 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 0.6% 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.



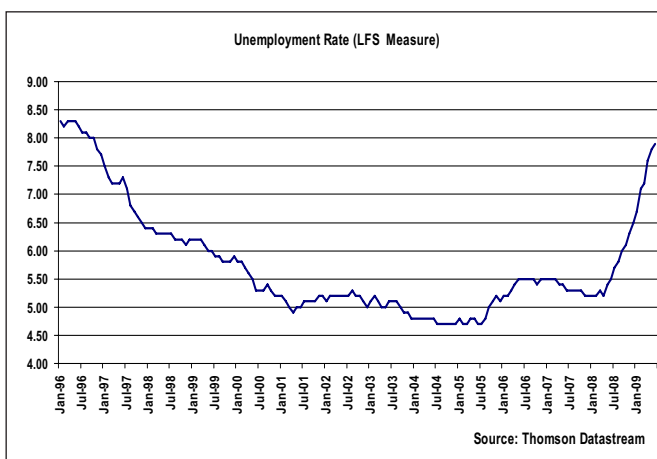


Like in the US and eurozone, the weakness in the economy has been acutely evident in a rapidly rising unemployment rate. Here too, though, there are signs that the rate of deterioration is easing. The monthly rise in the claimant count had moderated to 24,400 by August, well down on an average increase 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 Economic Recovery Will be Subdued

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 is likely to be 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 7.9%.



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, the picture from the construction sector remains one of "depressed and shrinking activity"**. Indeed, business investment generally remains weak. Overall investment fell 10.2% in the second quarter of the year and was down 21.8% in year-on-year terms, an historically weak rate.

There is also little evidence to suggest that the fall in the value of sterling will provide any major boost to growth anytime soon, though the CBI industrial trends survey did at least see a renewed improvement in the export orders book after the previous month's disappointing dip. The latest manufacturing PMI survey also showed an improving trend in export orders. **Meanwhile, 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	0.57	1.23	1.73	3.11
Dec '09	0.50	0.60	1.25	1.75	3.15
Mar '10	0.50	0.75	1.35	1.90	3.30
Jun '10	0.50	0.90	1.50	2.10	3.50

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