



## Recession Over but No End in Sight to Low Rates

The Bank of England left UK interest rates on hold at 0.50% at its January meeting, while voting unanimously to continue with its quantitative easing (QE) programme as announced last November. This decision was in line with expectations, with the committee indicating that it would wait until the publication of February's Inflation Report to undertake a full assessment of the monetary policy outlook, making next week's meeting a very important one.

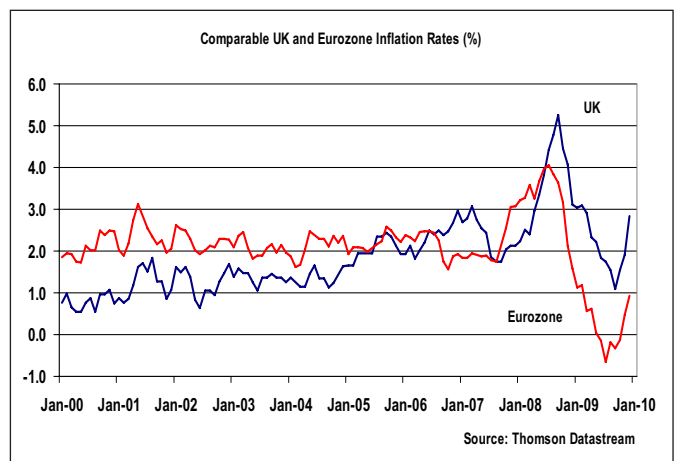
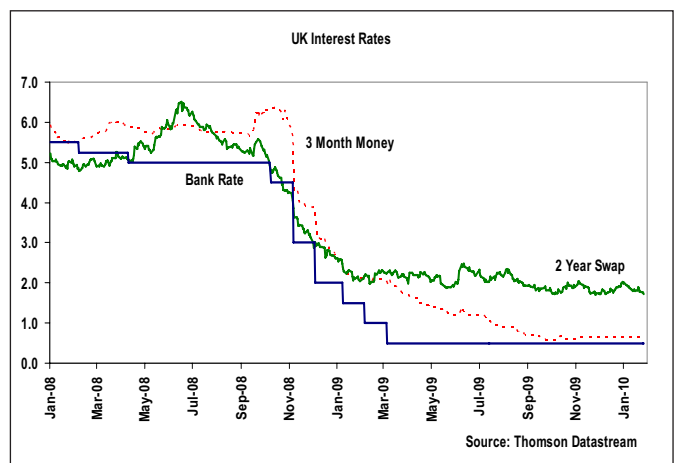
The minutes of the January meeting suggest that the **MPC is unlikely to extend its QE activities next week** as the committee agreed that recent developments do not provide grounds for changing the view about the economy's medium term prospects. Furthermore, the minutes also revealed that the two MPC members, Miles and Dale, who voted in November for a larger amount of asset purchases than the current Stg200bln target, dropped their December's comments that this might still be justified.

**While it is looking unlikely that QE will be extended near term, we do not envisage any policy tightening for some time and expect official rates to remain on hold until well into the second half of 2010. This view was reinforced by the recent release of much weaker than expected Q4 GDP data.**

**The Bank's resolve to maintain a very accommodative policy stance could, however, be tested by inflation trends over the coming months.** December's data showed a sharp spike upwards in the CPI to 2.9% from 1.9% previously as year-on-year base effects and changes in the VAT rate impacted. The core rate jumped from 1.9% to 2.8%, leaving core inflation in the UK well ahead of that in the US and the eurozone.

The rise in the CPI was ahead of MPC's projections, with further increases likely near term. The CPI should fall back over the medium term but the current data could heighten concerns amongst some committee members about second round pricing effects.

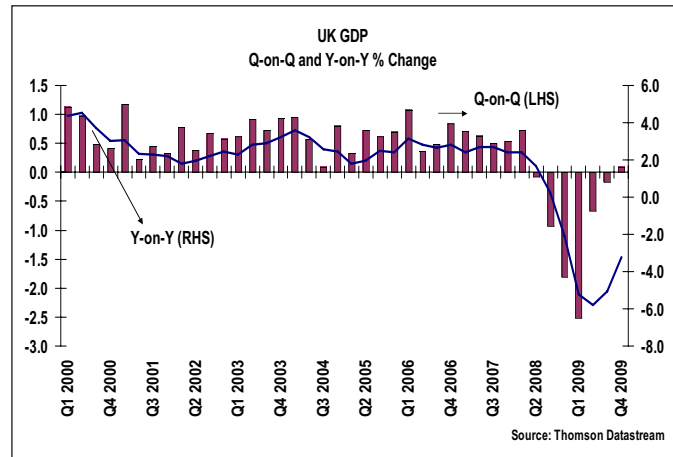
**However, with the MPC indicating that it is prepared to look through a near-term rise in inflation as long as excess capacity bears down on the CPI over the medium term, this is unlikely to result in any policy changes.**



## Q4 Data Signal End to Recession but Only Just

Provisional Q4 GDP data signaled an end to UK recessionary conditions, with the economy growing by 0.1% over the three month period, the first expansion in activity since Q1-2008. However, the pick up in output was well below expectations and provides little evidence of a move towards a robust recovery.

The increase in output was due mainly to increased activity in distribution, hotels and restaurants, as well as a pick up in government and other services and manufacturing. Overall, however, the services sector expanded by just 0.1%, which was very disappointing. Industrial production, meanwhile, was also up 0.1%. Construction output was flat as compared with the previous quarter.

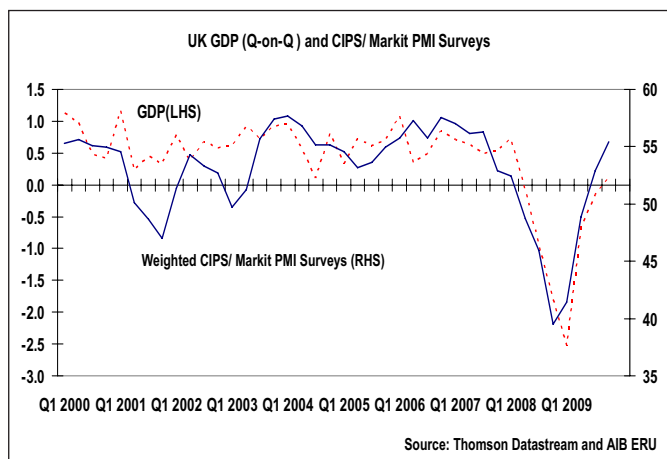


Thus, while the UK may be officially out of recession and Q4's numbers could yet be revised upwards, all sectors of the economy continue to operate below trend, with GDP in the closing three months of last year some 3.2% below where it was in Q4-2008. Cumulatively the economy has contracted by 6.0% since the recession began, much greater than the downturns seen in previous recessions of the early 1980s and 1990s. The UK is clearly lagging other majors in terms of the economic cycle. The road to recovery looks set to be a bumpy and slow paced one, with GDP growth expected to be sub 1% in 2010.

## Data Point to Sluggish Recovery

Recent survey data support the case for a recovery in activity over 2010. Both the CIPS/Markit PMI manufacturing and services surveys have been back above the key 50 level for some months now and, at a respective 54.1 and 56.8 in December, are currently at their best levels since late 2007. Other leading surveys for December, including those from the BCC and CBI, are also generally supportive of stronger activity. Meanwhile, the latest BoE agent's survey points to an easing in the downturn in demand.

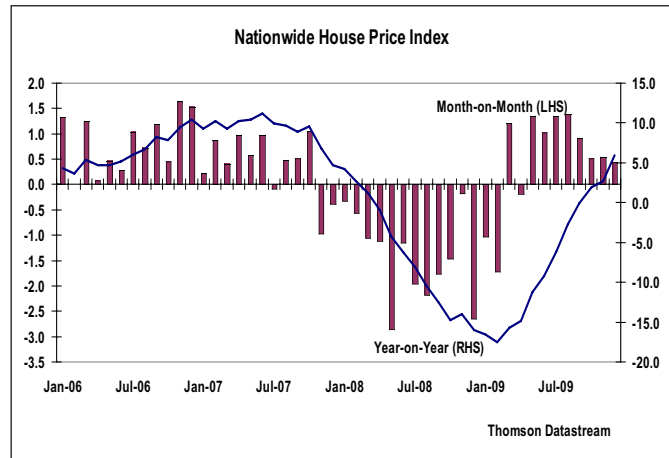
To date, however, this positive trend in leading indicators has not really been borne out in real economic data. It could be argued that high street spending has held up reasonably well but official retail sales data have certainly lagged survey evidence, with demand tailing off ahead of year end. Sales were up 0.7% in Q4, compared to growth of 1.0% in the previous period. This was disappointing given predictions for a surge in spending ahead of the VAT change. Other areas of consumer spending have been boosted by "transient factors" such as the car scrappage scheme, while the demand for services is reported as remaining weak.



As indicated by the January CBI distributive trades report, household spending could remain subdued in 2010, given high unemployment and the sharp rise in the savings ratio. The December labour market report showed the claimant count down by 15,200 and a fall in the ILO unemployment measure for the first time in 18 months. However, the unemployment rate is still at 7.8%, compared to 6.6% at end 2008 and 5.2% at end 2007. Furthermore, after rising in the previous two months, employment started to fall again in November.



**Activity in the manufacturing sector has also failed to match the trend seen in the manufacturing PMI.** After a 1.6% rise in September, manufacturing output was flat in October and November and is still down 7.7% in year-on-year terms. According to the latest BoE Agents survey there is still no sense that growth had picked up strongly or consistently. Many of the companies surveyed continue to experience short order books and volatility in demand. Sterling's depreciation is leading to some growth in export orders, but any growth in terms of external demand is coming from a very weak base.



**The gradual pick up in housing market activity continues.**

In terms of house price inflation, the closely watched Nationwide index shows prices rising in each of the past eight months. This has left prices up 5.9% in year-on-year terms, compared to an annual rate of decline of 16/17% at the beginning of 2009. Meanwhile, the rate of mortgage approvals stood at 60,518 in November, their best level since March 2008. **However, concerns remain about how sustainable any recovery in the market will prove to be.** The increase in prices over recent months is reported to be more a reflection of a shortage of properties for sale in certain areas rather than a fundamental pick up in demand and while they are picking up, mortgage approvals are still more than 50% off their peak.

**UK credit conditions remain generally tight.**

The most recent banking data show consumer credit fell falling again in November. Tight credit conditions should also limit the scope for any pick up in business investment, which fell 0.6% in Q3 from the previous quarter and is down 19.9% in year-on-year terms.

Thus, notwithstanding the modest return to growth in Q4, the UK faces significant headwinds in 2010, including high unemployment and the prospect of fiscal tightening once the election is out of the way. The anaemic pace of recovery should leave the economy with a considerable degree of spare capacity for a prolonged period.

UK Interest Rate Forecasts (to end quarter)					
	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
<b>Current</b>	0.50	0.62	1.26	1.76	3.14
<b>Mar '10</b>	0.50	0.75	1.35	2.00	3.35
<b>Jun '10</b>	0.50	0.90	1.50	2.10	3.50
<b>Sep '10</b>	0.50	1.00	1.55	2.15	3.55

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

**This supports our view that official rates are set to remain very low for a prolonged period of time. Indeed, although the MPC is not expected to extend its QE activities next week, it is likely to leave open the option of doing so further down the line if the economy continues to disappoint.**

**28th January 2010**