

BoE Stands Ready to Act Again if Recovery Falters

At its July policy meeting the Bank of England voted to leave UK interest rates on hold at 0.50%, the historically low level that has prevailed since March 2009. It also voted to leave the stock of asset purchases (or quantitative easing) unchanged at £200 billion. An unchanged outcome is also expected from the August meeting, which takes place next week.

The minutes of the July meeting show, to no great surprise, Andrew Sentance dissenting from the general view and voting for a rate hike for the second month running. He is likely to do so again

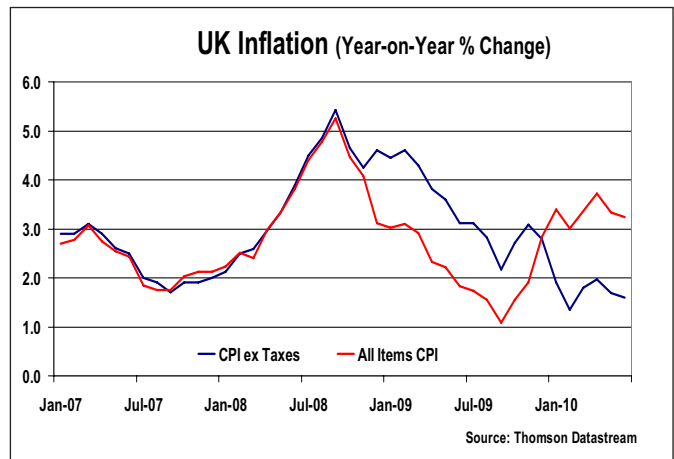
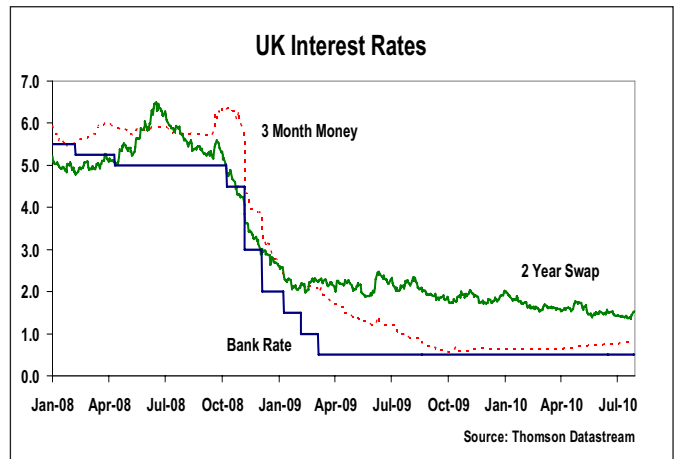
at the August meeting. This reflects his view that the improvement in economic conditions over the past 12 months has shifted the balance of inflation risks to the upside.

However, the record of discussions at the meeting suggests that **Sentance has little support amongst his MPC colleagues**. While pointing to the fact that the CPI rate was likely to remain above target for some months, risking a rise in medium term inflation expectations, the committee actually considered arguments in favour of a modest easing in the stance of monetary policy.

These arguments included a softening in the medium term outlook for GDP growth, with the BoE noting that the recent weaker trend in business surveys indicates a deceleration in the rate of recovery between the second and third quarters. This would exert additional downward pressure on the CPI, once the impact of temporary factors had waned. A **further modest monetary stimulus "would act to offset this softening in demand"**.

On balance though, the committee felt that the most appropriate action for now was to leave policy unchanged, with the

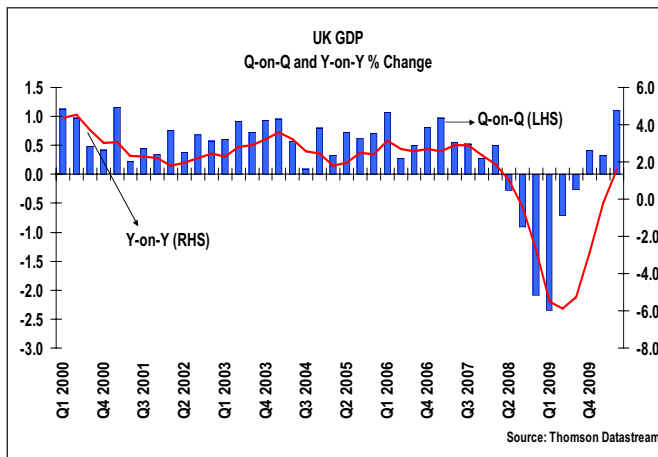
publication of the next Quarterly Inflation Report (11th August) providing the opportunity to carry out a full re-evaluation of the medium term outlook in light of recent economic news, including the impact of the Budget. With regard to this review, **Q2's better than expected GDP report should be a pleasant surprise for the BoE. Nonetheless, judging by the tone of the July minutes, the bank stands ready to act again if the pace of recovery falters. At the very least, we expect that rates will remain at ultra low levels for a prolonged period.**



UK Economy Shows Sharp Upturn in Q2

The latest GDP data show that the UK economy expanded for the third consecutive quarter in the three months to June 2010. Indeed, the pace of expansion was nearly double what was anticipated, with GDP rising by 1.1%. This marks the strongest quarterly growth rate since Q1-2006, lifting the year-on-year growth rate to 1.6%.

The 1.0% rise in manufacturing (the same rate of expansion as in Q1) was pretty much as expected. The surprise was the 0.9% rise in service industries, well up on Q1's meagre 0.3% growth rate, with distribution, as well as business and financial services, doing well. Construction also outperformed expectations, with output up 6.6% compared to a fall of 1.6% in the previous quarter.



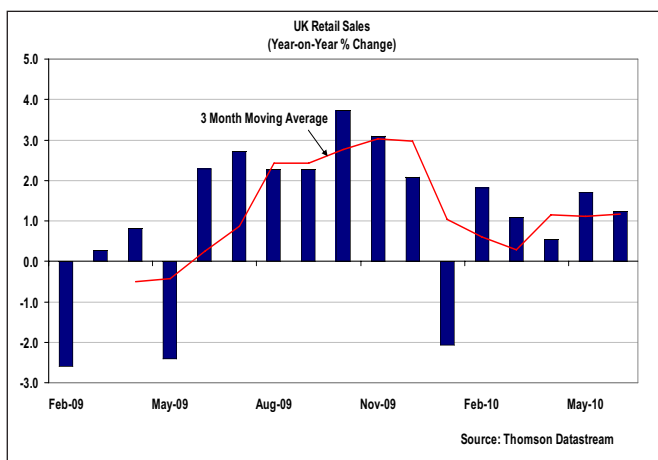
But This Could Prove to Be The Peak of The Recovery Cycle

While the strong Q2 GDP data were welcomed and suggest that growth for the year as a whole could be above 1.5%, the 1.1% increase in output could well prove to be the peak of the recovery cycle. Indeed, recent business activity and sentiment surveys suggest that the rate of growth will ease back in Q3. The manufacturing PMI eased back from 15 year highs in June, though a reading of 57.5 leaves it well up on its cyclical low of 35.1. The services PMI meanwhile, has been easing back steadily over recent months. It is currently at 54.4, down from highs of 58.4 seen in February. Other surveys, including those from the CBI and BCC, as well as the Bank of England's own Agents report show that, while conditions are improving, the economy continues to operate with a significant degree of space capacity.

Consumer Spending to Come Under Pressure

Retail sales rose 1.6% in the three months to June, a stellar improvement on Q1's drop of 2.5%, when activity was hit by January's VAT rise. However, Q2 spending was likely boosted by events such as the World Cup, pre-Budget purchases and good weather.

It is hard to see this level of spending continuing in light of the fact that consumers face a combination of high debts and weak wage growth, as well as severe fiscal tightening. Indeed, consumer confidence fell for the fourth consecutive month in June, and is now back at seven month lows.



Weak labour market conditions also pose a threat. The rise in UK unemployment has been less severe than anticipated. Over 150,000 people have

left the claimant count since the beginning of the year, bringing it down to 1.46 mln from a cyclical high of 1.63mln. However, the employment rate remains at its lowest levels since the mid 1990s. The unemployment rate, meanwhile, is at 7.8%, compared to 6.6% at end 2008 and 5.2% at end 2007. Weak labour market conditions are clearly impacting on wages, with the underlying rate of growth in average earnings (ex bonuses) at a subdued 1.8% year-on-year in the three months to May.



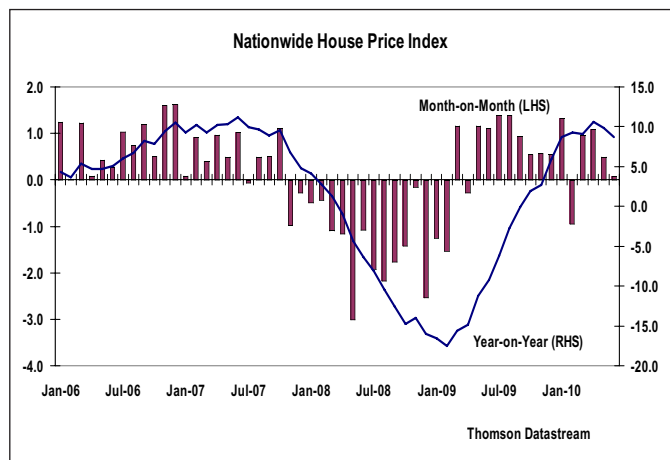
Government Spending to Drag Growth Lower

Government spending supported the economy over the course of 2009 and early 2010 but is set to be a drag on activity from here onwards with a fiscal tightening package that amounts to £128 billion or 8% of GDP scheduled to 2016. **Meanwhile, despite a weaker sterling** (even after recent gains sterling on a trade weighted basis is still 22% below where it was prior to the start of the financial crisis), **there is as yet little sign of any rebalancing in the economy towards the external sector.** Indeed, some recent surveys, including the manufacturing PMI, have shown some evidence of a slowing in export orders.

Pace of House Price Recovery Eases

The pick up in UK house prices has also cooled. The widely reported Nationwide index shows prices rising in 13 of the past 14 months. However, **the rate of price increases is showing clear signs of moderation, with the year-on-year growth rate cooling to 8.7% in June from highs of close to 11% earlier in the year.** The supply/ demand balance that has been driving much of the pick up in the market is being addressed.

Credit conditions continue to be described as tight with lending to individuals and non-financial firms weak again in May and June. Mortgage approvals stood at 49,815 in May, leaving the demand for new loans for house purchase about 16% below its recent November 2009 peak, which in itself was over 50% below the average monthly level of approvals seen before the downturn. The latest RICS survey, meanwhile, showed a sharp fall in new buyer enquiries in June.



Anaemic Growth to Keep Rates Low

Thus, notwithstanding the return to growth, the UK still faces significant headwinds, including high unemployment and marked fiscal tightening, as well as the likelihood of a muted upturn in some of the UK's main export markets.

Furthermore, renewed volatility in financial markets as a result of sovereign associated risk continues to impact on credit markets, with the availability of funding to both firms and households remaining tight.

This anaemic pace of recovery should leave the economy with a considerable degree of spare capacity, supporting the view that official rates are set to remain at their historically low level of 0.50% for a prolonged period of time, certainly well into 2011.

UK Interest Rate Forecasts (to end quarter)					
	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.50	0.74	1.48	1.49	2.55
Sept '10	0.50	0.85	1.50	1.55	2.60
Dec '10	0.50	0.95	1.70	1.80	2.95
Mar '11	0.50	1.10	1.90	2.10	3.30

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